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Draft text on a simplified insolvency regime

Note by the Secretariat

Contents

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I. Introduction

1. The background to the project of the Working Group on insolvency of micro, small and medium-sized enterprises (MSMEs) may be found in the provisional agenda of the fifty-sixth session of the Working Group (A/CN.9/WG.V/WP.167). This note sets out in chapter II a draft commentary and recommendations focusing on features of a simplified insolvency regime that aim to address needs of individual entrepreneurs and micro and small-sized enterprises in financial distress.

2. The draft commentary and recommendations draw on notes by the Secretariat A/CN.9/WG.V/WP.159, A/CN.9/WG.V/WP.163 and A/CN.9/WG.V/WP.166 considered by the Working Group at its fifty-third to fifty-fifth sessions (New York, 7–11 May 2018, Vienna, 10–14 December 2018, and New York, 28-31 May 2019, respectively), and on the comments made in the Working Group at those sessions with respect to those documents (A/CN.9/937, paras. 105–120; A/CN.9/966, paras. 114–143; and A/CN.9/972, paras. 24–66).

3. The draft commentary and recommendations were prepared in close consultation with experts and build in particular on the results of coordination and cooperation with the World Bank Group's ongoing work on principles for an effective MSMEs insolvency regime, the informal consultations held in preparation for the fifty-sixth session of the Working Group on 14 July 2019 and 2–3 September 2019 and the written comments received from experts on document A/CN.9/WG.V/WP.166. The draft commentary and recommendations also take into account reports of the World Bank Group addressing the insolvency of MSMEs and natural persons and publications of other international organizations and academic writers on those subjects.

II. Draft commentary and recommendations on a simplified insolvency regime

"Background

A. Purpose of this [text]

1. Micro, small and medium-sized enterprises (MSMEs) constitute the majority of businesses in economies around the world. Those in the micro and small-sized part of the spectrum (MSEs), in most economies, take the form of sole proprietorships or small partnerships whose founders, owners or members do not enjoy limited liability protection and thus are exposed to unlimited liability for business debts of MSEs. MSEs tend to be relatively undiversified as regards creditor, supply and client base. As a result, they often face cash flow problems and higher default risks that follow from the loss of a significant business partner or from late payments by their clients. MSEs also face scarcity of working capital, higher interest rates and larger collateral requirements, which make raising finance, especially in situations of financial distress, difficult, if not impossible. As a consequence, they may be prone to business failure more often than larger enterprises. MSEs in financial distress may themselves be the clients of other MSEs that would share the same characteristics and may heavily depend on payments from their clients, with the consequence that business failure of one MSE may cause business failures in the MSE supply chain.

2. Standard business insolvency processes, because of their cost, length and procedural inflexibility and complexity, may be unavailable or prohibitive for MSEs. Burdened by unresolved financial difficulties and old debt, MSEs may be discouraged from taking new risks, may become trapped in a cycle of debt, or may be driven to the informal sector of the economy.

3. Efforts are being made at the international, regional and national levels to find solutions tailored to the specific needs of MSEs in financial distress in the light of the

broad impact of MSEs insolvency on job preservation, the supply chain, entrepreneurship and the economic and social welfare of society. Solutions sought aim at allowing deserving MSEs to remain in the labour market by preserving their know-how and skills and restarting entrepreneurial activities, drawing on lessons from the past.

4. This [text] was prepared to assist policymakers with those efforts. It discusses features of a simplified insolvency regime that could encourage MSEs to address financial distress at an early stage. The focus is on faster, simpler, accessible and affordable insolvency proceedings, with appropriate safeguards. This [text] also addresses aspects of informal debt restructuring negotiations and discusses measures that may be put in place to support MSEs with holding such negotiations and implementing their outcomes.

5. This [text] recognizes that the position of States with respect to both the desirability of putting in place a simplified insolvency regime and the conditions for access to that regime and its features may vary greatly. Some States may encourage addressing financial difficulties of MSEs through preventive informal debt restructuring negotiations outside the formal insolvency proceedings. Other States may prefer designing formal insolvency proceedings specifically for the needs of MSEs. In some jurisdictions, while there may be a single insolvency framework applicable to all business enterprises, certain requirements of such a framework may not be made applicable to insolvency of MSEs. In other jurisdictions, two separate insolvency regimes may exist: one for MSEs and the other for larger enterprises. Finally, some States have enacted laws to deal with the insolvency of MSEs that include both consumers and MSEs.

6. It is left for policymakers in each jurisdiction to determine whether its insolvency regime serves the needs of MSEs. If it does not, policymakers may consider including a simplified insolvency regime in their legal framework, either by adjusting some features of the standard business insolvency law or establishing a separate simplified insolvency regime. It would be for policymakers to identify persons (natural and legal) that may benefit from access to such regime.

7. Specific features of a simplified insolvency regime will inevitably vary from jurisdiction to jurisdiction. In some jurisdictions, formal insolvency proceedings for MSEs may focus on reorganization, while in others it may focus on liquidation. Some jurisdictions may favour a liberal approach to discharge while others may be more concerned about the effect of such an approach on their economies. Constitutional, cultural, social and economic norms of the State as well as regional integration dynamics and concerns over “forum shopping”, i.e., situations when MSEs would consider relocating their business to other jurisdictions to access more friendly regimes, will dictate policy choices on these matters.

B. Issues taken into account in preparing this [text]

1. Specific characteristics of MSEs and issues they face in financial distress

8. While some MSEs will be incorporated, in many States MSEs operate without an incorporated legal personality and without clear separation of business liabilities from the personal liabilities of MSE owners and managers. Regardless of their legal form, MSEs usually have closely intermingled business and personal debts and a centralized governance model in which ownership, control and management overlap (often within a family). Few or no records of transactions between owners, family members, friends and other individuals involved in the operation and financing of the business may exist. It is not unusual for owners to use personal assets for business purposes and to use business assets for personal or family needs. There may be no clearly established ownership of key commercial assets (such as tools or other essential equipment). Works and services performed for MSEs may not be documented or remunerated in accordance with typical commercial practices and the

owner may use its own finances to fund or support the business without having documented those expenditures.

9. Access to credit by MSEs is often made subject to the granting of personal guarantees by the owners or their relatives and friends whose personal assets could be equal to or of greater value than that of MSE. A personal guarantee will typically extend liability for the debts of MSE to those individuals, affecting both personal effects (such as the family home) and business assets.

10. When facing financial problems, the management may be unwilling to request the commencement of insolvency proceedings at the risk of losing control over the business. An owner may hide a financial crisis out of fear of damaging a good commercial name, relationships with employees, suppliers and the market and disrupting existing lines of credit. MSEs may also be prone to adopt more high-risk strategies, attempting to save their business, which may be their only source of income, at all costs. These factors may contribute to the financial crisis and lead MSEs to address financial difficulties at a time when liquidation of the business might be the only solution left.

11. MSEs are likely to have all-encompassing, "blanket" liens covering substantially all assets. As a result, any physical assets of MSEs, which may be the main or the only assets of value to creditors, may already be encumbered to one or a very limited number of secured creditors who are usually able and willing to use enforcement methods available to them under law. Unencumbered assets of MSEs are usually of little or no value for distribution to unsecured creditors who, as a result, will not be willing to invest the time and resources on MSE insolvency proceedings or informal debt restructuring negotiations because the costs of their participation in those proceedings or negotiations may outweigh the return.

12. Because of those characteristics, MSEs encounter specific difficulties in financial distress, which larger enterprises would not usually face. In particular, the hold-outs by secured creditors and disengagement of unsecured creditors jeopardise chances of successful debt restructuring negotiations and reorganization of viable MSEs, leaving liquidation as the only option. MSEs may be ineligible to apply for insolvency in some jurisdictions, or insolvency proceedings may be terminated after their commencement in other jurisdictions, because of the lack of (sufficient) funds in the insolvency estate of an MSE to cover the costs of the proceedings.[1] Because MSEs lack the financial sophistication of larger enterprises, they may not have the financial information required for an application to commence insolvency proceedings as readily available as larger enterprises and they may not understand their rights and obligations in insolvency proceedings and in the period approaching it. The mandatory involvement of insolvency professionals who separate owners and managers of an insolvent entity from the administration of the business, and the social stigma of insolvency may operate as additional disincentives to apply for insolvency.

2. Situation under existing insolvency regimes with respect to MSEs

13. Existing standard business insolvency regimes may be designed with complexities and sophistication of larger enterprises in mind. They usually presuppose the presence of an extensive insolvency estate of significant value and the active engagement of creditors and an insolvency representative. They also usually envisage rigid procedural steps for liquidation or reorganization, such as the establishment of a creditor committee, voting by classes of creditors and complex rules for verification of claims and distribution of proceeds.

14. In addition, existing standard business insolvency regimes usually restrict insolvency proceedings to the business debts of a distinct business entity, which

[1] Some jurisdictions may allow the proceedings to progress only if debtors can cover administrative costs as well as a minimum percentage of proceeds to creditors. Other laws may allow the proceedings to progress for only debtors stricken by specific, compelling, exceptional circumstances (hardship relief).

would not comprehensively address intermingled business and personal debts usually involved in MSE insolvency. Individual entrepreneurs may be treated as individual defaulters and be subject to personal insolvency frameworks, where such frameworks exist. The latter may not provide temporary protection from creditors, nor allow for debt restructuring procedures and discharge. Where discharge is available for individual entrepreneurs, a long waiting period before discharge may apply, leaving full personal liability for many years after liquidation of the business. Heavy penalties, including limitations on freedom of movement and other personal restrictions, may also apply.

15. In some jurisdictions, consumer insolvency laws may apply to MSEs without employees, including individual entrepreneurs whose business debts comprise 50 per cent or more of their total debts. They ordinarily apply to MSEs with relatively low liabilities and may not be available to MSEs who own real estate or who are at the early stages of financial distress. In other jurisdictions, a simplified insolvency regime may only be available to individual entrepreneurs, while in still other jurisdictions, such a regime may be available only to proprietorships, partnerships and other similar unincorporated entities.

3. Adjustments required to address the needs of MSEs in financial distress

16. Specific issues faced by MSEs in financial distress suggest a need for measures that would incentivize MSEs to be as forthcoming as possible with identifying and addressing financial distress at an early stage. It may be especially helpful to consider making available and accessible assistance to MSEs in identifying early signals of financial distress, holding negotiations with creditors, assessing the viability of business and complying with obligations in the vicinity and during insolvency.

17. The law should envisage mechanisms for covering costs of proceedings where an MSE is unable and the creditors are unwilling to finance the insolvency proceedings. It should also be equipped to effectively deal with “zero-asset” cases, ensuring in those cases a cost-efficient oversight and expedient liquidation.

18. MSEs’ characteristics dictate a need also for some adjustments in standard business insolvency proceedings, recognizing that most provisions of insolvency law devised to ensure protection of different categories of creditors and different classes of claims would be inapplicable for businesses with very few creditors and no or very few assets left for distribution to creditors. Proceedings should be made faster, simpler, affordable and accessible to MSEs. In simplified reorganization proceedings, the law should, whenever possible, permit owner(s) and manager(s) of MSEs to continue the operation and management of the business with the assistance of a professional and supervision by a competent State authority.

19. Simplified insolvency proceedings may be prone to abuse. Oversight of simplified insolvency proceedings by a competent State authority and review of decisions taken by that authority, as and when necessary and applicable, should be considered important safeguards. The simplified insolvency regime should also envisage appropriate sanctions for abuse of the system.

C. Glossary

20. The following paragraphs explain the meaning and use of certain expressions that appear frequently in this [text]:

(a) “Competent authority”: a standing body that performs functions related to simplified insolvency proceedings [(other than review of decisions taken by that authority)];[2]

[2] This [text] does not suggest that a specific State authority should perform those functions, recognizing the widely differing conceptual and structural frameworks of legal systems and systems of State administration throughout the world. The focus of this [text] is instead on

(b) “Individual entrepreneurs”: natural persons exercising a trade, business, craft or profession in the form of a sole proprietorship or self-employed activity or as a founder, owner or member of unlimited liability MSEs. For avoidance of doubt, the term intends to encompass business income earners as opposed to wage earners (i.e., employees);

(c) “Unlimited liability MSEs”: micro and small-sized enterprises with or without separate legal personality and without limited liability protection of their founders, owners or members (e.g., proprietorships, partnerships and other unlimited liability entities);

(d) “Limited liability MSEs”: micro and small-sized enterprises with or without separate legal personality and with limited liability of their founders, owners or members;

(e) “MSEs”: individual entrepreneurs, unlimited liability MSEs and limited liability MSEs referred to collectively in this [text]; and

(f) “MSE debtor”: an MSE with respect to which simplified insolvency proceedings have been commenced or initiated. The term “debtor” used in this [text] intends to convey the same meaning unless the specific context suggests otherwise.

features of the simplified insolvency regime, which the competent authority entrusted by the State with those functions should be able to accommodate.

Part one

Annotated recommendations on a simplified insolvency regime

I. Scope

21. A simplified insolvency regime should focus on an early resolution of financial difficulties of MSEs, irrespective of the legal structure through which their economic activities are conducted (a limited liability company, partnership, a sole trader, etc.) and whether or not they are conducted for profit. The term "economic activities" should be given a broad interpretation so as to cover matters arising from all relationships involving economic activity, whether contractual or not. These relationships would include, but are not limited to: any trade transaction for the supply or exchange of goods or services; distribution agreement; commercial representation or agency; consulting; and joint venture and other forms of business cooperation.

22. To the extent that any MSE is excluded from the insolvency law, it will neither enjoy the protections, nor be subject to the discipline, of the insolvency law. An all-inclusive approach to the design of a simplified insolvency regime, encompassing individual entrepreneurs, unlimited liability MSEs and limited liability MSEs, is therefore justified, recognizing however that insolvency of individual entrepreneurs and unlimited liability MSEs may raise policy considerations different from insolvency of limited liability MSEs.

23. In addition, a number of States have insolvency laws that apply different rules to business debts as opposed to personal or consumer debts. In the context of MSEs, it may not always be possible to separate the debts into clear categories. Individual entrepreneurs, owners of limited liability MSEs and their family members may all be involved in business and use consumer credit to finance business either as start-up capital or for operations. Business insolvency may lead to personal or consumer insolvency once a business fails even if the business is a separate legal entity. For that reason, separate procedures with different access conditions and procedural steps applicable to various debts involved in MSEs may not be an optimal solution. It is advisable to cover all debts of MSEs in a single simplified insolvency proceeding; where that is not possible, at least close coordination of related proceedings should be ensured.

24. Finally, a simplified insolvency regime should recognize that the rational economic solution for the vast majority of MSE insolvency cases will result in liquidation. Legislative reform should thus provide for a simple mechanism to sell the MSE debtor's assets, if any, and distribute the proceeds to creditors and liquidate the business. At the same time, caution should be exercised against prematurely liquidating viable MSEs. Simplified reorganization proceedings and other options for timely rescue of viable MSEs should also thus be made available.

Recommendations

1. A simplified insolvency regime should apply to all MSEs, but may provide for different treatment of individual entrepreneurs, unlimited liability MSEs and limited liability MSEs.

2. A simplified insolvency regime should address all debts of individual entrepreneurs in one proceeding unless the State decides to subject some debts of those entrepreneurs to other insolvency regimes; in which case, coordination of related insolvency proceedings should be ensured.

3. A simplified insolvency regime should provide for both simplified liquidation and simplified reorganization [and within simplified liquidation, an option for a debt repayment plan as a condition for discharge of individual entrepreneurs who are ascertained to be able to fulfill such condition].

II. Key objectives of a simplified insolvency regime

25. The UNCITRAL Legislative Guide on Insolvency Law (the "Guide") addresses the key objectives of an effective insolvency law, including the need to provide for timely, efficient and impartial resolution of insolvency, in recommendations 1 to 7. Those recommendations seek to provide certainty in the market by introducing a transparent and predictable legal framework, providing for the preservation and maximization of the insolvency estate to allow equitable distribution to creditors in the case of a failed business, and promoting efficient restructuring of a viable business. At the same time, the recommendations recognize existing creditor rights, establish a clear rule for ranking of priority claims and ensure the equitable treatment of similarly situated creditors.

26. States may consider that the objective of an effective and efficient insolvency law should also be to establish and develop an effective simplified insolvency regime, including simplified liquidation and simplified reorganization. While the key objectives of an effective insolvency law listed in the Guide will remain applicable in the simplified insolvency regime, such regime should focus on the needs of MSEs and minimize the complexity of standard insolvency procedures and their associated costs for MSEs. It should therefore aim to put in place expeditious, simple, flexible and low-cost insolvency proceedings, encourage, facilitate and incentivize early access of MSEs to them and provide for expedient liquidation of non-viable MSEs and conditions for an early rescue and continuation of viable businesses.

27. Eligibility and commencement standards and criteria for release of MSEs from debts should be formulated for simplified insolvency proceedings with those objectives in mind. In addition, the simplified insolvency regime must provide measures to overcome bottlenecks that may arise because of creditor disengagement or unsophistication of MSEs. Those measures should not jeopardise the rights of the MSE debtor and creditors to object to the course of the proceedings and to seek review. The protection of the rights of the MSE debtor and creditors will need to be maintained as a key objective in the simplified insolvency regime. The system of safeguards and sanctions should also be in place, which should aim at effectively preventing abuse, fraud and irresponsible behaviour and provide appropriate penalties for misconduct.

Recommendation

4. One objective of an effective insolvency law is to establish a simplified insolvency regime that should aim to:

(a) Provide for expeditious, simple, flexible and low-cost insolvency proceedings;

(b) Make such proceedings easily available and accessible;

(c) Enable expedient liquidation of non-viable MSEs and continuation of business of viable MSEs through such proceedings;

(d) Ensure protection of the MSE debtor, creditors and other persons affected by insolvency proceedings;

(e) Put in place effective measures to [address creditor disengagement] [facilitate creditor participation] and address concerns over the social stigma of insolvency; and

(f) Implement an effective sanctions regime to prevent abuse of the simplified insolvency regime and provide appropriate penalties for misconduct.

This objective is in addition to other objectives of an effective insolvency regime, such as the provision of certainty in the market to promote economic stability and growth, maximization of value of assets, preservation of the insolvency estate to allow equitable distribution to creditors, equitable treatment of similarly situated creditors,

ensuring transparency and predictability, recognition of existing creditor rights and establishment of clear rules for ranking of priority claims.

III. Common features of a simplified insolvency regime

1. Administrative type of proceeding

28. Recognizing that MSEs tend to have less complicated operations and financial arrangements, simplified insolvency proceedings should have fewer and simpler procedural formalities than those existing in standard business insolvency proceedings.

29. A State would need to identify the appropriate body in which to vest the functions related to simplified insolvency proceedings, whether in an existing body or in a new body created for such purpose. The body may, for example, be one that exercises overall supervision and control over insolvency proceedings in the State, a relevant body whose competence is not restricted to the insolvency matters or a special administrative body whose competence will be exclusively to deal with simplified insolvency proceedings. In those States in which this type of proceeding is already handled or can be handled through the court system, there may be little advantage in introducing another body in the system. The choice of the competent authority that can handle simplified insolvency proceedings in the most efficient and effective manner will thus depend, among other things, on the governmental, administrative and legal systems in the State, which vary widely from country to country.

30. The insolvency law should entrust such an authority with the evaluation of the application for commencement of simplified insolvency proceedings to ensure that the eligibility requirements have been met. The competent authority should also determine the type of the proceeding to commence, be able to convert one proceeding to another, be responsible for the provision of notices to creditors and public notices where necessary, exercise oversight of the insolvency estate and fulfil other tasks necessary for protection of the rights of all parties in interest and proper function of the simplified insolvency regime.

31. Decisions of the competent authority will be subject to review upon request by an aggrieved party, though the need for such review would not by itself convert the simplified insolvency proceedings into standard ones. The system of review will also reflect the legal tradition in a particular State, which may provide for a judicial or administrative review of decisions of the competent authority or a combination of both.

32. The insolvency law should allow the competent authority to engage services of an independent party where necessary. Such an independent party should be an individual of appropriate qualifications whose appointment should not lead to a conflict of interest in a specific insolvency proceeding. His or her primary functions would be to assist MSEs in fulfilment of their obligations under insolvency law, including the preparation of an application for commencement of simplified insolvency proceedings (or response to a creditor(s) application for commencement of insolvency proceedings with respect to an MSE debtor) and preparation and implementation of a liquidation or reorganization plan. Such a party may be entrusted by the competent authority with other tasks under insolvency law, including the management and operation of the day-to-day business of the MSE debtor. That person may operate pro bono or be reimbursed from public funds or the insolvency estate where appropriate. (Such a party is referred to henceforth in this [text] as the “independent party”).

2. Short time limits

33. The rules applicable to simplified insolvency proceedings should allow for expedited procedures. Shorter statutory time limits than those applicable in standard

business insolvency proceedings should apply and only narrow grounds for possible extensions of the default time limits within the maximum permissible number of requests for extensions (usually once or twice) should be specified in the law. Non-compliance with the established statutory deadlines should trigger certain consequences, including conversion of one type of proceedings to another type.

3. Reduced formalities

34. Elaborate rules on public notice, creditor committees and meetings and claims verification should be disabled or adjusted, especially where little or no value is available for distribution, and creditors may therefore be expected not to be involved in the proceedings. To overcome creditor disengagement, rules should presuppose that creditors after due notification will be bound by the outcome of the proceedings if they failed to object on time: failure to vote is regarded as a vote in favour and the absence of timely objection is regarded as a waiver of the right to review. This will considerably simplify creditor participation and voting requirements usually found in the insolvency law (see e.g., recs. 126–136 and recs. 145–151 of the Guide).

4. Templates, online procedures and the independent party's assistance

35. Other measures should be put in place to make the system easily accessible and usable, including by making available, in addition to services of the independent party, standardized forms and templates and enabling online procedures where possible. States should envisage interaction of the competent authority with other State bodies such as tax authorities and State-run registries (e.g., business registries and security interest registries). Electronic government platforms may considerably expedite that task. Those measures could facilitate collection of information about assets, liabilities and transfers of the MSE debtor and assist with channelling that information to the competent authority. They may also facilitate verification of that information by the competent authority, with the result that a decision on the application and the right course of action will be taken within a shorter time period.

5. Targeted and cost-efficient notification

36. The insolvency law should specify that the competent authority will be responsible for giving notices to creditors and the public at large. It may give discretion to the competent authority to determine the most cost-effective procedures for serving such notices depending on the circumstances of the case and the state of the MSE debtor's application and other records. For example, it may not be necessary to require publication at considerable expense in a national newspaper when the MSE business is based and conducted locally or a particular MSE has a very limited supply and creditor base. The insolvency law should require at a minimum that all known creditors (i.e., those listed in the debtor application) should be notified individually while the means of giving notice to other potential parties in interest must be appropriate to ensure that the information is likely to come to their attention. Options for achieving effective notification may include the use of standard forms, relevant public registries and electronic means of communication.

6. Clearly defined exclusions from the insolvency estate and discharge

37. The insolvency law should specify the assets that are excluded from the estate (see rec. 38 of the Guide). Assets could be excluded subject to specific ceilings or categories, or across-the-board exclusion of all assets of the MSE debtor could be permitted subject to challenge by creditors. Another approach is to include all assets of the MSE debtor in the insolvency estate, and allow the MSE debtor to request exclusion of some assets up to a specified value limit. The adoption of one approach over the other has significant ramifications for efficiency and costs of administration of insolvency proceedings. The approach based on the exemption of particular assets by the MSE debtor can be more costly than where a creditor seeks to reclaim items of excessive value. In most legal systems, the scope of assets excluded from the insolvency estate of an individual entrepreneur has been expanded over time in line

with the goal of affording a fresh start to such a debtor. The exclusion of two particular categories of assets, the family home and tools of the trade, is especially relevant for reducing the impact of insolvency on the entire household of an individual entrepreneur and the prospects of his or her fresh start.

38. The insolvency law should also clearly specify debts excluded from discharge and conditions that may be attached to a discharge (see recs. 195–196 of the Guide). See further chapter VI.5 below.

7. Accessible and affordable proceedings

39. One of the purposes of putting in place a simplified insolvency regime is to address insolvency cases of MSEs with no or insufficient assets and to prevent situations when financial distress of such MSEs would remain unresolved because the MSE application for commencement of simplified insolvency proceedings will be denied for the lack of sufficient funds. Broader public interest considerations, such as the need to ensure the observance of fair commercial conduct or to further standards of good governance, may also require the simplified insolvency proceedings to progress in such cases. Otherwise, assets can be moved from MSEs prior to liquidation with no fear of investigation or the application of avoidance provisions or other civil or criminal provisions of the law.

40. Access to simplified insolvency proceedings should thus not depend on the MSE's ability to cover the administrative costs of the proceedings. Eligible debtors that do not have enough assets to fund a proceeding should be able to commence a proceeding to address their financial difficulties and obtain a discharge.

41. There should be alternative mechanisms to meet the costs of administering the simplified insolvency proceedings when the MSE debtor cannot meet them, including using public funds or establishing a fund out of which the costs of the insolvency proceedings may be met. Some insolvency laws provide for a surcharge on creditors to pay for the administration of estates. They may in particular require creditors making an application for commencement of insolvency proceedings to guarantee the payment of the costs of the proceedings up to a certain fixed amount, to pay a certain percentage of the total of claims or to pay a fixed amount as a guarantee for costs. In some States where a payment as security for costs is required, that amount may be refunded from the estate if assets of the debtor turn out to be sufficient to cover the cost of the proceedings. Allowing payment of administrative expenses in instalments, including from the future income through the implementation of the debt repayment or reorganization plan, would allow the MSE debtor to share the costs of the proceedings at least in part.

8. Default solutions unless an alternative course of action is justified

42. To avoid delays while at the same time ensuring transparency and predictability, the insolvency law should provide for default solutions that can be overridden by the decision of the competent authority on its own motion or upon request by any party in interest.

43. For certainty, it will be important for the insolvency law to set out clearly rights and obligations of parties involved in the simplified insolvency proceedings. This will in particular be important in simplified reorganization where the modified debtor-in-possession regime is envisaged as the default solution. The MSE debtor and creditors will need to know which rights the MSE debtor will have with respect to the day-to-day operation of the business and which safeguards will be in place to ensure that those rights are not abused and the obligations of the MSE debtor with respect to the insolvency estate and the reorganization plan are fulfilled. (See further chapters VII.6 and X.B below).

9. Appropriate safeguards and sanctions

44. The insolvency law should build in appropriate safeguards and sanctions to deter abuses of the simplified insolvency regime and punish them when they have occurred. Safeguards may be contained in a range of options made available to parties in interest for deployment when justified. Those options may include replacing a debtor-in-possession with the independent party when dealing with an uncooperative, dishonest or incompetent MSE debtor or converting simplified reorganization to simplified liquidation where reorganization is used to avoid liquidation.

45. In simple cases, the competent authority will be in the position to ensure compliance with the process. The regime should permit the MSE debtor or creditors to request more intense support or supervision, including review of the competent authority's decisions. Assistance and oversight would provide accountability and give creditors a measure of confidence, in particular that all of the MSE debtor's assets have been brought into the insolvency estate, the value of assets has been preserved and maximized where possible, and the liquidation or reorganization plan and terms of discharge, as the case may be, were properly implemented.

46. Sanctions may be imposed for the improper use of the simplified insolvency regime, for acting dishonestly or in bad faith when becoming indebted, during the insolvency proceedings or during the implementation of a debt repayment plan, for being uncooperative and for failure to fulfil other obligations under the insolvency law. Sanctions may include denial of discharge, longer periods for obtaining a full discharge, other conditions attached to discharge, revocation of discharge granted and disqualification from taking up or pursuing a specific business activity or practising a particular profession.

47. The simplified insolvency regime should also address avoidance procedures that would be appropriate in the simplified insolvency context as well as procedures for closing the proceedings.

Recommendation

5. The simplified insolvency regime should:

(a) Entrust control and supervision of simplified insolvency proceedings to the competent authority, subject to constitutional and other requirements of the State, without jeopardizing the right of any party in interest to seek [review of the competent authority's decision] [judicial review];

(b) Simplify formalities for notification, submission and proof of claims and approval of liquidation or reorganization plans;

(c) Make available templates, schedules and standard forms;

(d) Enable the use of electronic means where information and communication technology of the State so permits and in accordance with other applicable law of that State;

(e) Make any required assistance and support with the use of simplified insolvency proceedings readily available and easily accessible, including by engaging services of the independent party;

(f) Allow the competent authority to assess the need for a public notice of insolvency in simplified insolvency proceedings on a case-by-case basis and, where such notice is to be served, require the use of cost-effective methods, such as an official electronic publication;

(g) [Provide for default solutions that apply *unless* a party intervenes with a different request or objection or certain circumstances apply];

(h) Stipulate short time limits, narrow grounds for their extension and the maximum number of permitted extensions;

(i) Specify the rights and obligations of the MSE debtor and of the creditors, and the role and functions of the independent party;

(j) Identify the assets that will constitute the insolvency estate and where the MSE debtor is an individual entrepreneur, assets excluded from the estate that the MSE debtor is entitled to retain;

(k) Address mechanisms for distribution of costs and expenses relating to the simplified insolvency proceedings;

(l) Address discharge, including criteria for denying a discharge or for setting aside a discharge granted;

(m) Establish the procedure for conclusion of simplified insolvency proceedings, including the conditions for converting them to standard insolvency proceedings or dismissing them on the grounds defined by the insolvency law;

(n) Impose sanctions for improper use of the simplified insolvency regime and non-compliance with other provisions of the insolvency law;

(o) [Provide for effective avoidance mechanisms that would maximize returns on avoidance in simplified insolvency proceedings] or [Ensure that avoidance mechanisms available under the insolvency law can be used in a timely and effective manner to maximize returns in simplified insolvency proceedings]; and

(p) [Address treatment of contracts entered into before the commencement of the proceedings not fully performed by both the debtor and the counter-party, of avoidable transactions and of set-off or netting rights that can be enforced or will be protected, notwithstanding the commencement of the insolvency proceeding.]

IV. Eligibility

48. Practices for determining a debtor's eligibility for access to simplified insolvency proceedings vary. It is common for States to use quantifiable criteria, such as thresholds, for such a determination. The most common thresholds are the amount of total debt or liabilities, both secured and unsecured, which should be equal to or less than a specified maximum, and the maximum number of employees (e.g., fewer than or equal to 20 people). Other quantifiable eligibility criteria may include assets and income not exceeding a certain level prescribed by law or a maximum number of unsecured creditors (e.g., 20 creditors).

49. In addition to quantifiable criteria, an insolvency law may also establish qualitative eligibility criteria. The law may specify certain types of business activity that may be covered by the procedure, excluding others (such as involving real estate). The list may be open-ended, with a competent State authority being responsible for amending the list as required. Under other laws, applicants may also be required to demonstrate that there are no claims against them arising from employment contracts and that the person in charge of the business has not been convicted of tax evasion, trafficking or racketeering or any form of fraud. Additional conditions may apply depending on the type of simplified insolvency proceeding for which a MSE applies (e.g., to be eligible for simplified liquidation proceedings, the applicant must not own any immovable property).

50. States usually introduce in the eligibility criteria safeguards against abuse of the simplified insolvency proceedings, by restricting the frequency of access by either preventing multiple applications by the same debtor within a certain period or subjecting a recurrent applicant to more intense scrutiny, with commencement permitted only in exceptional circumstances and with longer discharge periods.

51. There is however an emerging trend to limit the eligibility criteria in order to incentivize MSEs experiencing financial distress to participate in insolvency proceedings at an early stage, particularly where the businesses are viable, and to maximize the value of the assets of the estate. In particular, many States waive the

requirement for the debtor to demonstrate at the entry point "good faith", i.e., that the debts were caused by events beyond a debtor's control or that they were not caused intentionally or through gross negligence. That approach is based on the understanding that the requirement for the MSE debtor to prove good faith and for verification by third parties of good faith might be time and record-consuming; the administrative efficiency of simplified insolvency proceedings would thus not be achieved if demonstrating good faith is made a condition of access.

52. Many jurisdictions only permit eligible debtors, and not their creditors, to apply for simplified insolvency proceedings, with or without the right of creditors and other parties in interest to seek judicial review. In such jurisdictions, creditor application is usually permitted only in exceptional cases, e.g., as a safeguard against the debtor's incompetence or abuse. Where the number of creditors is more than an established threshold, some jurisdictions require that a minimum number of creditors apply to minimize risks that a single creditor will use insolvency proceedings as a substitute for a debt enforcement mechanism.

53. This [text] allows both eligible debtors and their creditor(s) to apply for commencement of simplified insolvency proceedings albeit against different commencement standards discussed in chapter V below. A main reason for allowing creditor applications is that there will be cases where the MSE debtor will not or cannot apply for commencement, and this may cause further impairment of creditors' rights and dissipation of insolvency estate assets unless creditors can seek appropriate measures, including the imposition of a stay on the MSE debtor's actions as regards its assets. In the light of a limited creditor base and high probability of the creditor disengagement in the MSE insolvency context, it would not be sensible to require that, to be eligible, more than one creditor should apply for commencement of simplified insolvency proceedings. In the MSE insolvency, it may often be the case that only one creditor may be interested in pursuing an MSE insolvency case.

Recommendation

6. The insolvency law should establish the criteria that debtors must meet in order to be eligible for simplified insolvency proceedings, minimizing the number of such criteria, and specify that creditors of the eligible debtors may also apply for commencement of simplified insolvency proceedings with respect to those debtors.

V. Application and commencement

1. Application by debtor

54. The cessation of payments test and the balance sheet test are two usual standards for commencement of insolvency proceedings. Where the insolvency law adopts a single test, the Guide recommends that the cessation of payments test and not the balance sheet test should be used. Where the insolvency law contains both tests, the Guide states that the proceedings can be commenced if one of the tests can be satisfied (see rec. 16 of the Guide).

55. MSEs will face difficulties to satisfy either of the two tests and both tests might fail to capture all assets and debts involved in MSE insolvency and may thus inadequately assess the state of solvency of a MSE. Recognizing the shortcomings of both tests in the MSE insolvency context, States may adopt a different approach by removing entirely the requirement for MSEs to declare or demonstrate insolvency, an approach that may be seen as an incentive for an early access by MSEs to the simplified insolvency regime and a measure to remove the social stigma associated with insolvency. The law may simply require MSEs to attest that it is at an early stage of financial distress, i.e., it is unable to pay debts that fall due without significantly hindering the continuation of its business or it foresees that it will not be able to pay debts that will shortly fall due unless financial difficulties are addressed. The application may include a sworn statement indicating that the conditions for simplified insolvency proceedings are met.

56. Simplified commencement standards would also remove another commonly cited disincentive for MSEs to seek timely commencement of insolvency proceedings – the challenge of collecting and filing extensive financial documents to prove insolvency. To mitigate risks of abuse of the system, MSEs seeking to access a simplified insolvency regime should nevertheless be required to provide, at a minimum, a statement of the assets they own, without having to provide details such as the value of those assets. Credit card receipts and copies of bank statements may also be required, where applicable. MSEs should also be required to disclose information relating to any transfers they might have made within a prescribed time limit before the application, which would help identify undervalued or preferential transactions or transfers otherwise prejudicial to the interests of creditors, which may in particular include transfers to related persons. Finally, MSE should be required to provide information about all liabilities and details of creditors, including names, addresses and amounts, upon application. Information about debtors, customers, contracts, and ongoing court, arbitration or administrative proceedings against MSE or in which MSE is involved, may also be expected to be submitted at an early stage of the proceedings. Standardized information forms that set out the specific information required may assist MSEs to comply with that disclosure obligation.

57. The assistance of the independent party should be made available to an MSE interested to apply for commencement of simplified insolvency proceedings sufficiently early, so as to facilitate gathering the required information and ensuring that such information is up to date, complete, accurate and reliable. The independent party may also assist MSE with evaluation of its business and chances of its rescue. MSEs should be able to avail themselves of the independent party's assistance when preparing the application for commencement of insolvency proceedings and when responding to a creditor application for commencement of insolvency proceedings.

58. Upon application by the MSE debtor, automatic commencement of simplified insolvency proceedings should occur (see rec. 18 of the Guide). The insolvency law should leave flexibility to the competent authority to decide which proceeding, simplified liquidation or simplified reorganization, would be most appropriate given the circumstances of the case.

59. The proceedings will be terminated if the competent authority finds that the eligibility criteria were not met or the information submitted with the application was false or constituted a misrepresentation, in which case sanctions will also be imposed (see recs. 18, 20 and 27 of the Guide). Incomplete application should not however lead to immediate termination of the simplified insolvency proceedings. Flexibility should be given to the MSE debtor to rectify unintentional omissions or inaccuracies at later stages of the proceedings. If material inaccuracies or omissions making the application unreliable cannot be rectified within the time limit established by the competent authority, the proceedings may be terminated or they may be allowed to proceed with consequences, e.g., conversion of simplified reorganization to simplified liquidation, imposition of additional conditions for discharge or, in simplified reorganization, replacement of the MSE debtor from the operation of the business.

2. Application by creditor(s)

60. As addressed in recommendation 6 of this [text], creditors of eligible debtors should have the right to apply for the commencement of simplified insolvency proceedings, including both simplified liquidation and simplified reorganization proceedings. However, certain safeguards should be in place to prevent abuse or harassment of the MSE debtor. First, in the event of a creditor application for commencement of insolvency proceedings, the MSE debtor should have a fundamental right to immediate notice of the application. Where the MSE debtor has disappeared or is avoiding receipt of personal notice, requirements for public notification might suffice or notice could be served at the last known address of the MSE debtor.

61. Second, the MSE debtor should be given an opportunity to respond to the application, contest the application, consent to the application, or request the conversion of the proceedings requested in the creditor application to another type of insolvency proceedings (see rec. 19 of the Guide). The deadline for a response from the MSE debtor, as established by the competent authority, must be short and strictly enforced to protect the rights of the creditor. Assistance of the independent party may be provided to the MSE debtor in the formulation of its response. If the MSE debtor agrees to the creditor application, simplified insolvency proceedings of the type specified by the creditor(s) will commence unless the competent authority decides otherwise.

62. The competent authority should also decide which type of proceedings to commence if the MSE debtor agrees to enter the insolvency process but prefers a different type of proceeding than that specified in the creditor application. For example, the MSE debtor may request the commencement of simplified reorganization instead of liquidation. In such cases, the competent authority may set forth the maximum period and other conditions under which simplified reorganization requested by the MSE debtor could be continued against the will of the creditors. Where reorganization of an insolvent MSE is not likely to, or cannot, succeed, the competent authority should commence simplified liquidation proceedings.

63. The third safeguard applies where the MSE debtor does not agree with the commencement of insolvency proceedings on the basis that it is solvent or where the MSE debtor fails to respond to the creditor application. In such cases, the simplified insolvency proceedings should not proceed without establishing the debtor's insolvency. While this [text] allows an MSE debtor to enter simplified insolvency proceedings before a state of insolvency, safeguards should be in place to prevent an MSE debtor from involuntarily doing so. The requirement to prove insolvency unless the debtor is actively agreeing to enter the insolvency process provides an essential check against abuse by the creditor(s).

64. The State may specify the test that would need to be met to prove debtor's insolvency. In MSE insolvency, it would most likely be the cessation of payments test, i.e., creditor(s) must prove to the competent authority that their rights have already been impaired because a demand for debt repayment has been made but it has not been satisfied by the debtor after a certain time period stipulated in law has expired. The competent authority will need to determine whether to commence simplified insolvency proceedings and if so, which one, taking into consideration all information supplied by the MSE debtor and creditor(s) and the rights of both creditor(s) and the MSE debtor. In establishing insolvency, focusing on the MSE's current inability to meet present debts may not adequately reflect the MSE's future financial situation, and predicting the MSE's future financial situation introduces uncertainty, especially in the rapidly fluctuating business environment. Services of an independent evaluator may be engaged for such purpose. Where insolvency is not proved, the proceedings should be terminated.

65. The parties in interest should receive notice of the competent authority's decision as soon as possible to allow them to initiate a timely review of that decision if they so wish.

66. A delay between application and commencement could have serious consequences including for creditors who continue to trade with the MSE debtor, unaware of its financial position. Sanctions should therefore be imposed on parties deliberately delaying the commencement of simplified insolvency proceedings.

3. Notice of commencement

67. Giving notice of the commencement of insolvency proceedings is central to several key objectives of an insolvency regime. It ensures the transparency of the proceedings and that all affected parties – the creditors and parties in interest in the case of an MSE debtor application, and the MSE debtor and other creditors and parties in interest in the case of a creditor application – are equally well informed.

68. Creditors will have an interest in being notified of the commencement, in order to be able to protect their interests in insolvency proceedings and make an informed decision concerning continuing provision of goods and services to the MSE debtor to avoid the accumulation of further debt. There may be other parties who will require notice of the commencement of proceedings, including the postal administration, tax authorities, social service authorities and corporate regulators.

69. It may be argued that creditors may have an interest in being notified of the creditor application, which unlike the MSE debtor application, would not automatically lead to the commencement of simplified insolvency proceedings. The need for such notification should however be balanced against risks that the business position of the MSE debtor may be unnecessarily affected where the creditor application is ultimately rejected. Taking into account general vulnerability of MSE business, it would be desirable to require that creditors and other parties in interest will be notified only of commencement of the proceedings.

70. The information required in the notice should include the effect of the commencement of proceedings (especially as to the application of the stay); the time for submission of claims; the manner in which claims should be submitted and the place at which they should be submitted; the procedure and any form requirements necessary for submitting a claim; advice as to which creditors should make claims (i.e., whether secured creditors need to submit a claim); consequences of failure to make a claim or to make a claim in the prescribed manner; and information concerning verification of claims (see rec. 25 of the Guide).

Recommendation

7. The insolvency law should provide for simplified application and commencement procedures and should:

(a) Determine criteria and procedures for commencement of simplified insolvency proceedings;

(b) Provide that eligible debtors can apply for commencement of simplified insolvency proceedings at [an early stage of financial distress] without the need to prove insolvency;

(c) Require the MSE debtor's application to contain accurate and reliable information relating to its financial position and business affairs;

(d) Provide for the automatic commencement of simplified insolvency proceedings upon application by the MSE debtor for such proceedings;

(e) Specify that simplified insolvency proceedings may be commenced on the application of a creditor of a debtor which is eligible for simplified insolvency proceedings, provided that: (i) notice of application is promptly given to that debtor; (ii) that debtor is given the opportunity to respond to the application, by contesting the application, consenting to the application or, requesting the conversion of the proceeding applied for by the creditor to a different type of proceeding; and (iii) simplified insolvency proceedings of the type to be determined by the competent authority commence without agreement of the debtor only after it is established that the debtor is insolvent; and

(f) Require at a minimum that any known creditor and other party in interest to be individually notified of the commencement of proceedings.

VI. Features of simplified liquidation proceedings

1. General considerations

71. The Guide refers to "liquidation" as proceedings to sell and dispose of assets for distribution to creditors in accordance with the insolvency law (Glossary, (w)). Liquidation in the context of limited liability MSEs usually leads to dissolution and

the disappearance of the legal entity. The owner(s) of such entity will not be liable for the residual claims. Liquidation in the context of individual entrepreneurs and unlimited liability MSEs would mean the liquidation of the insolvency estate and discharge of individual entrepreneurs who remain personally liable for unsatisfied claims following the liquidation of the insolvency estate of individual entrepreneurs or unlimited liability MSEs (in case of no assets in the insolvency estate, the closure of the proceedings and discharge). Liquidation in such cases may involve a debt repayment plan imposed on individual entrepreneurs as a precondition for discharge. Desirability of making discharge conditional on full or partial repayment of debt should be considered on a case-by-case basis with due account of individual entrepreneur's circumstances.

72. Many systems that provide for a simplified insolvency regime recognize that expedient liquidation of non-viable MSEs may be personally, societally and economically more desirable than rehabilitation of non-viable MSEs with no prospects for recovery. They therefore aim at fast track simple liquidation procedures. In addition, automatic conversion of simplified reorganization to simplified liquidation is considered to be justified where an insolvent MSE cannot reach agreement with their creditors on a reorganization plan or fails to implement the agreed plan.

73. The insolvency law should reflect the fact that in many cases when a simplified insolvency regime would apply, the insolvency estate will have no or very few assets. In the latter case, where there is no substantial dispute, realization of any assets of the insolvency estate and distribution of proceeds to creditors is all that would be required. The law should therefore allow the simplified liquidation to proceed and be completed expeditiously (within a month or few months).

2. Automatic stay upon commencement of simplified liquidation proceedings

74. Insolvency proceedings are collective proceedings, which require the interests of all creditors to be protected against an individual action by one of them. A mechanism to protect the value of the insolvency estate from individual actions by creditors as well as actions by the debtor is the imposition of a stay (see rec. 46 of the Guide). An automatic stay upon commencement of simplified liquidation proceedings ensures a fair and orderly administration of the simplified liquidation proceedings and allows the competent authority to take stock of the MSE debtor's situation and achieve a result that is not prejudicial to the interests of the MSE debtor and creditors.

75. Where actions by secured creditors are included within the scope of the stay, the insolvency law usually adopts measures that ensure that the interests of the secured creditors are not diminished by the stay. These measures may relate to protection of the value of the encumbered assets and provision of relief from the stay where the encumbered assets are not sufficiently protected.

3. Simplified procedures for submission and verification of claims

76. The insolvency law may permit claims that are undisputed to be admitted by reference to the list of creditors and claims prepared by the MSE debtor in cooperation with the independent party. Where the law requires creditors to submit claims, it may simplify submission of the supporting evidence, for example by reducing evidentiary requirements for proof of claims, by dispensing with the requirement that the claims must be certified and by allowing presentation of evidence online. The law may limit the claims that need to be verified to those that are likely to be paid.

77. In MSE insolvency, a single disputed or unpaid claim is often the main asset of the MSE debtor. The competent authority may require a creditor to provide evidence for its disputed claims. The law may permit a summary determination of the disputed claim by the competent authority, permitting it to admit or deny such a claim in full or in part, with the possibility of a review. It may allow the sale of the disputed claim at a discount or assignment of the claim to a public officer or a third party, which will be responsible for collecting the claim.

78. The competent authority may subject claims by related persons to special treatment, including subordination of the claim or reduction of the amount of the claim. The law may also require secured creditors to file claims within specified period with information substantiating the claims and define consequences of their failure to do so (see recs. 172, 174 and 175 of the Guide).

79. While creditors should be given the widest possible opportunity to submit their claims in simplified insolvency proceedings and must therefore receive timely and appropriate notice of commencement and the requirements for claim submission, the proceedings should not be delayed by creditors who are aware of the need to submit and of the applicable deadlines, but nevertheless fail to do so in a timely manner. This has the potential to increase the costs of the simplified liquidation proceedings and disadvantage other creditors. The consequences of failure to submit should be clearly specified and creditors should be made aware of them at the time they are notified of the deadlines for submission. For example, some insolvency laws provide that the debt may be extinguished or security rights may be waived or forfeited in case of the failure to submit a claim by the established deadline, provided that the creditor received the prescribed notification of commencement and of the requirements for claim submission.

80. Many insolvency laws provide that all identified and identifiable creditors are entitled to receive notice of all claims that have been made, whether personally, by publication of notices in appropriate commercial publications or by filing a list with the competent authority. That notice will enable creditors, the MSE debtor and interested parties to see what claims have been submitted and to object to any claims listed (where this is permitted under the insolvency law). The insolvency law should permit the creditor whose claims have been denied or subjected to special treatment as well as any party in interest that disputes any submitted claim to request review of the competent authority's decision (see recs. 169–171, 177, 180, 181 and 184 of the Guide). Notice and notification requirements should be simplified as discussed in chapter III.5 above.

4. Expedited procedures for realization of assets and distribution of proceeds

81. The insolvency law should recognize that in most MSE liquidation cases, the competent authority will be in the position to liquidate the MSE debtor's estate and distribute the proceeds among the creditors itself within a short time limit subject to review if any objection is raised by any party in interest. In more complex cases, the competent authority may appoint the independent party to prepare the liquidation plan or assist the MSE debtor with that task, and will file the report on the completion of the realization and distribution procedures to the competent authority. Alternatively, the liquidation may be entrusted to creditor(s) with the possibility given to the MSE debtor to contest the plan for realization of assets and distribution of proceeds proposed by creditor(s). The inability of the MSE debtor to propose an alternative plan within a specified time limit, with the assistance of the independent party where necessary, may lead to the approval by the competent authority of the creditor's plan with or without modification. Some insolvency laws may provide for the exclusive role of the competent authority to fix the time limit, form and conditions of sale.

82. The insolvency law can adopt a number of procedural protections to ensure that the proceedings are fair, that the maximum price is achieved and that, overall, the procedure for disposal of assets is transparent and well-publicized. Such protections include providing notice to creditors, the MSE debtor and prospective purchasers in a manner that will ensure that the information is likely to come to the attention of interested parties; allowing creditors and the MSE debtor to raise their objections or concerns; requiring assets to be valued by neutral, independent professionals (especially in the case of real estate and specialized property); and, in the case of auctions, requiring pre-bidding qualification and minimum prices where appropriate and preventing and punishing collusion among bidders.

83. Private sales, in addition to public auctions, may be permitted when they would best realize the value of assets (see rec. 57 of the Guide). Some insolvency laws also address issues such as sales to a creditor to offset that creditor's claim and sale of any of the debtor's assets in the possession of a third party to that third party for a reasonable market price. Special measures may be in place for assets that might be subject to rapid deterioration of value, such as where they are perishable, susceptible to devaluation or otherwise in jeopardy. The insolvency law should deal with the treatment of any asset that is burdensome to the estate, providing for a possibility to relinquish it following the provision of notice to creditors and the opportunity for creditors to object to the proposed action. Although it may be suggested that the insolvency law should specifically preclude a sale to related parties to avoid collusion, absolute prohibition of such a sale may not be necessary, provided it is adequately supervised and carefully scrutinized before being allowed to proceed, to avoid fraud and collusion. Such supervision or scrutiny may require higher standards in terms of the valuation of assets and disclosure of business relationships. (See recs. 60–62 of the Guide.)

84. Where the MSE debtor and another person own assets in some form of joint or co-ownership, different approaches may be taken to the disposal of the estate's interest. Where the assets can be divided, generally under law other than insolvency law, between the MSE debtor and the co-owners for the purposes of execution, the estate's interest can be sold without affecting the co-owners. Some insolvency laws permit selling both the estate's interest and that of the co-owners, provided certain conditions are met. These conditions may include that division of the property between the estate and the co-owners is impractical; that the sale of a divided part would realize significantly less for the estate than a sale of the undivided whole free of the interests of the co-owners; and that the benefit to the estate of such a sale outweighs any detriment to the co-owner.

85. The insolvency law may exclude encumbered assets from the insolvency estate; in such case, the secured creditor will generally be free to enforce its security interest. Where encumbered assets are part of the estate, insolvency laws take different approaches to the issue. In some cases, the approach depends upon the application of other provisions of the insolvency law, such as an imposition of the stay (while the stay applies, only the competent authority can dispose of the assets), as well as law other than insolvency law, and whether encumbered assets can be sold free and clear of interests. Other laws may provide that the competent authority may have the time-limited exclusive right to sell the encumbered asset; once that exclusive period has expired, the secured creditor may exercise its rights. Whichever approach is adopted, the insolvency law should require secured creditors to be notified of any proposed disposal and have an opportunity to object.

86. The insolvency law should provide for a simplified distribution of proceeds, particularly where the assets available are below a certain statutory limit. The law may provide that if all creditors agree on the amounts and priorities of claims, together with the timing and method of distribution, distribution may proceed on a consensual basis. Otherwise, the competent authority may make a final decision in lieu of the creditors subject to review of that decision if any party objects.

5. Discharge

87. In limited liability MSEs, the equity holders will not be liable for the residual claims and the issue of their discharge does not arise unless they also provide personal guarantees for business debts, in which case a special treatment may be accorded to them (see chapter IX below). In insolvency of individual entrepreneurs and unlimited liability MSEs, the question arises as to whether individual entrepreneurs will still be personally liable for unsatisfied claims following liquidation of the insolvency estate.

88. There are various approaches to debt discharge for individual entrepreneurs. In some jurisdictions, a complete discharge of an honest, non-fraudulent individual entrepreneur may be available immediately following distribution in liquidation or,

in case of zero-asset proceedings, following verification procedures and determination that no distribution to creditors can reasonably be expected. In other jurisdictions, an individual entrepreneur cannot be discharged until all its debts are paid.

89. In yet other jurisdictions, an individual entrepreneur remains liable for debts subject to a limitation period during which the individual entrepreneur is expected to make a good faith effort to repay its debts. Discharge may be possible only after the debt repayment plan is fully implemented unless acceptable grounds existed justifying the failure to implement the plan. The length of the debt repayment period may vary from jurisdiction to jurisdiction and within the same jurisdiction it may vary depending on circumstances. Under some laws, that period might be long, e.g., 10 years. The emerging trend is to shorten that period to incentivize timely commencement of the insolvency proceeding, to encourage a fresh start and to reduce stigma. Another approach is to provide incentives to the individual entrepreneur to comply with the debt repayment plan by making the length of the discharge period dependent on the rate of return to creditors and the individual entrepreneur's compliance with other obligations. At the same time, a predictable and consistent method of assessing disposable income may need to be provided in the debt repayment plan to leave sufficient income for domestic needs of individual entrepreneurs and their families.

90. A discharge is unavailable for an individual entrepreneur who has acted fraudulently; engaged in criminal activity; failed to provide or actively withheld or concealed information; and concealed or destroyed assets or records after the application for commencement. Certain types of debt, such as debts based on tort claims, family support obligations, fraud, criminal penalties, and taxes, tend to be excluded from discharge. The exclusion of debts from a discharge should be kept to a minimum in order to facilitate the individual entrepreneur's fresh start (see rec. 195 of the Guide).

91. A discharge of debt may be accompanied by conditions and restrictions relating to professional, commercial and personal activities, for example to start a new business or carry on the old business, to obtain new credit, to leave a country, to practise in a profession, to hold public office or to act as a company director or manager. They may take effect automatically or upon an order of the competent authority. The period of effectiveness of those conditions and restrictions may be linked to the discharge period and may be extended. It may be longer or even indefinite where the individual entrepreneur is a member of a profession to which specific ethical rules apply or where disqualifications were ordered by a court in criminal proceedings. For individual entrepreneurs who manage their own businesses or who became insolvent because of giving personal guarantees, some of those restrictions and conditions may have serious consequences, effectively prohibiting them from being involved in future business. Where the insolvency law provides that conditions may be attached to an individual entrepreneur's discharge, those conditions should be kept to a minimum in order to facilitate the individual entrepreneur's fresh start and they should be clearly set forth in the insolvency law (see rec. 196 of the Guide).

92. The discharge generally affects only debts arising before the commencement of a formal insolvency proceeding. Following discharge, claims that have not been satisfied would be rendered unenforceable.

6. Closure of the proceedings

93. Insolvency laws adopt different approaches to the manner in which a proceeding is to be concluded or closed, the prerequisites for closure and the procedures to be followed, for example that the debtor or creditor(s) should apply to close proceedings; publication of the application and the decision to close; and holding a hearing of creditors at which a final accounting of realization of assets and distribution of proceeds is presented. In the context of simplified liquidation, those steps should be

considerably simplified and replaced by communication of relevant information to creditors and the MSE debtor by the competent authority using electronic means where possible. Provided that no objection is raised, the competent authority may file the final accounts and report of the simplified liquidation proceedings with the administrative body responsible for registration of business entities so that it could make necessary entries in the State records (e.g., on dissolution of an incorporated MSE). Some laws may however require a formal application to a competent State authority for an order for dissolution of a legal entity.

7. Zero-asset proceedings

94. Further simplification of liquidation in "zero-asset" or "zero-plan" cases is justified. Those cases, depending on the insolvency law, may include cases where the insolvency estate of the debtor has zero assets or cases where the insolvency estate has assets but of a very low value (usually below a threshold established by law) and no future income or assets for repayment of debt are expected. In those cases, an eligible debtor may be required to submit to the competent authority a request to be discharged from all debts accompanied by a statement of financial position proving that it is eligible for zero-asset procedures. Mechanisms to assess whether the debtor is indeed with no assets and therefore eligible for zero-asset proceedings should be in place, such as the engagement of services of an impartial evaluator financed by public funds or other sources. After confirmation of zero assets and a notice of the zero-asset procedure with a summary of the debtor's assets and liabilities and in the absence of any objection, the competent authority discharges the debtor from debts and closes the procedure. Conversion of zero-asset proceedings to the standard or simplified insolvency proceedings should be envisaged where it is proven that sufficient assets to repay debts do exist. In addition, the insolvency law should envisage that a single creditor may ask that the liquidation follow the ordinary procedure.

95. Some laws include a procedure for cases in which assets or unexpected income are discovered post-discharge. Several systems include a mechanism for allowing creditors and other parties in interest to request reopening of such cases and collecting and retroactively distributing the new value to creditors. In other systems, finality is regarded as more important than allowing creditors to claim payment from debtor's later discovered resources. Exceptions to the finality is usually justified in bad faith cases, for example where the debtor strategically timed the filing of application to allow the escape from debt obligations while benefitting later from post-discharge income.

Recommendation

8. Simplified liquidation proceedings should incorporate the following features:

(a) An automatic stay upon commencement of simplified liquidation proceedings for the duration of the proceedings. An imposition of a stay should not affect the right to commence individual actions or proceedings to the extent necessary to preserve a claim against the debtor and should not prejudice the right of a secured creditor to protection of the value of the asset in which it has a security interest [and the right of a secured creditor to request the competent authority to grant relief from the stay] (see recs. 46–51 of the Guide);

(b) Debt submission, verification, admission and [reaffirmation] procedures, including prompt notification to the affected creditor of the reasons for denial of a claim by the competent authority and mechanisms for addressing objections to such denial (see recs. 169–184 of the Guide);

(c) A short time line for preparing a plan for realization of assets and distribution of proceeds (the "liquidation plan");[3]

[3] This term does not intend to imply that the preparation of an elaborate liquidation plan would be necessary in all simplified liquidation proceedings. The provisions of subparas. (c) to (e) intend to convey that in all such cases minimal information about realization of assets and distribution

(d) Minimum content for the liquidation plan, including the party responsible for the realization of the insolvency estate (the competent authority itself, the independent party, the MSE debtor with the assistance of the independent party, any secured creditor or other creditor), the means of realization of assets (public or private auction or other means), amounts and priorities of claims and the timing and method of distribution of proceeds from the realization of the insolvency estate and any debt repayment plan for individual entrepreneurs;

(e) Individual notification of the liquidation plan by the competent authority to all parties in interest sufficiently in advance to enable them to object in a timely manner to the proposed course for realization of assets and distribution of proceeds;

(f) Approval of the liquidation plan by the competent authority in the absence of objection by any party in interest to the liquidation plan;

(g) Possibility for the competent authority to modify the originally proposed liquidation plan in the light of any objection received from any party in interest;

(h) The opportunity for review of the contested plan, which may trigger the commencement of standard insolvency proceedings;

(i) Discharge of individual entrepreneurs from liability for pre-commencement debts. The insolvency law should set out clearly conditions for discharge, keeping them to a minimum, and any debts excluded from discharge, which may include debts in relation to the exempted assets and debts omitted from the liquidation procedure intentionally or by mistake;

(j) Procedures for full discharge, which may be conditional upon the implementation of a debt repayment plan during a certain time period (the discharge period), in which case the procedures should include verification by the competent authority (i) before the debt repayment plan becomes effective, that the debt repayment obligations reflect the situation of the individual entrepreneur and are proportionate to his or her disposable income and assets during the discharge period, taking into account the equitable interest of creditors, and (ii) on expiry of the discharge period, that the individual entrepreneur has fulfilled his or her repayment obligations under the debt repayment plan, in which case the individual entrepreneur is automatically discharged without the need to apply for commencement of any additional procedure;

(k) Automatic closure of simplified liquidation proceedings following final distribution or a determination that no distribution can be made (see rec. 198 of the Guide); and

(l) A zero-asset proceeding if the application, as verified by the competent authority, proves that the debtor is eligible for zero-asset proceedings (i.e., has no insolvency estate and income for repaying debts), in which case the debtor is discharged by the competent authority of its debts unless creditors object to that course of action after a notice of the proceedings has been served to them by the competent authority. In case of objection, liquidation may commence or the case may be referred to review.

VII. Features of simplified reorganization proceedings

1. General considerations

96. The Guide refers to “reorganization” as the process by which the financial well-being and viability of a debtor’s business can be restored and the business can continue to operate, using various means possibly including debt forgiveness, debt rescheduling, debt-equity conversions and sale of the business (or parts of it) as a

of proceeds should nevertheless be provided to the debtor, creditors and other parties in interest, to ensure transparency and protection of their interests including by seeking review of the decisions taken by the competent authority.

going concern (Glossary, (kk)). Reorganization in MSEs cases will likely translate into debt forgiveness or debt rescheduling for which complex reorganization steps usually envisaged for larger enterprises will not be necessary. For those reasons, putting in place simplified reorganization proceedings for MSEs will be justified.

2. Stay

97. Given the goals of simplified reorganization, the impact of the stay is greater and therefore more crucial than in simplified liquidation and can provide an important incentive for MSEs to initiate simplified reorganization proceedings at an early stage of financial distress. Irrespective of whether proceedings commence upon an MSE debtor or creditor application, an automatic stay should be imposed with some modifications that would allow the continued operation of the business, at the same time ensuring limited publicity of financial distress and that the insolvency estate is protected from individual enforcement actions of creditors and dissipation of assets through actions of the MSE debtor.

98. There should also be the possibility to lift the stay upon request by the MSE debtor or creditor(s), or tailor it to the needs of the specific case (as regards the debtor, its assets and its creditors and the time of application, extent and duration of the stay). For example, the stay can apply automatically to specified actions, with the possibility of extension of the stay to other actions at the discretion of the competent authority upon request by the MSE debtor or creditor(s). Such discretion should be accompanied by appropriate safeguards, in particular that the chosen approach should minimize delay and risks of abuses, help to maximize the value of the assets and ensure that the insolvency proceedings are fair and orderly as well as transparent and predictable and some type of provisional measures are available to protect interests of creditors if the imposition of a stay is delayed.

99. A growing number of States accept that in many cases, in particular in the MSE debtor reorganization, permitting secured creditors to freely enforce their rights against the encumbered asset can frustrate the basic objectives of the insolvency proceedings. For that reason, actions by secured creditors are increasingly included within the scope of the stay, subject to certain protections, in particular the right of a secured creditor to protection of the value of its encumbered asset and to seek relief from a stay where such protection is not ensured.

3. Preparation of a reorganization plan

100. Since the MSE debtor may not be able to draw up a feasible reorganization plan at an early stage, the insolvency law should allow the MSE debtor to prepare the reorganization plan with the assistance of the independent party and submit it to the competent authority within a specified period after commencement. In the simplified insolvency context, it may be that the MSE debtor will not be capable of proposing a plan. The insolvency law should allow the creditor(s) to submit a reorganization plan in such cases within the same deadline or sequentially (i.e., if the MSE debtor failed to file the plan within the established deadline) within the time limit established by law.

101. Although it may be desirable to permit the parties to propose an alternative plan, this may complicate the proceedings and lead to confusion, inefficiency and delay. For those reasons, the insolvency law may permit submitting an alternative plan only in exceptional cases where, in the assessment of the competent authority, this course of action is likely to be beneficial in a particular case. In the interests of efficiency, the competent authority should be entrusted with the power to choose the most viable plan relying on advice of an independent professional where necessary. This may be made subject to the overall time limit for agreeing on the plan.

102. The law may impose a duty on all parties in interest to cooperate in negotiating the plan. Secured creditors holding a significant portion of the debt or that are entitled to satisfy their claims from encumbered assets that are critical to the reorganization of the business would have an important role to play in the preparation of the plan.

The insolvency law may allow the reorganization plan to envisage an extension of secured debt repayment period, to accommodate MSE debtors that cannot meet their current repayment obligations but will likely be able to meet modified smaller monthly financial obligations. Alternatively, the plan could contemplate only interest payment during the first or first few years of the plan, with normal payment being resumed afterwards; or full payment of a secured portion and pro rata payment of an unsecured portion along with other unsecured claims. The reduction of the principal amount with the right to collect some of the written-off claim if the value has increased may also be allowed in exceptional cases.

103. Requirements concerning a disclosure statement to accompany the reorganization plan should be adjusted in the simplified reorganization context. Provided that the plan contains sufficient information to enable its viability to be assessed, the debtor may not be required to submit a disclosure statement, financial information or audited documents.

104. The assessment of viability may be left to the competent authority. The insolvency law may require an independent assessment of viability and the appointment for such purpose of a professional, whose services may be pro bono or remunerated from public funds or other sources. Various ratios, e.g., debt to capital or the projected liquidation value to the value of the going concern, may apply.

105. The successful reorganization of the MSE debtor may depend on key suppliers continuing their provision of work, services and goods for the MSE debtor. In simplified insolvency regimes, such suppliers could themselves be MSEs heavily dependent on the payments by their clients. Unless paid within a relatively short time limit, they may themselves become insolvent. Such suppliers may not have the skills or resources to actively participate in negotiations of a reorganization plan or challenge the proposed plan in the competent authority but may be disproportionately affected by the plan if a reduction or suspension of their claims is envisaged. The insolvency law may specify situations where such suppliers may need to enjoy priority in the distribution of proceeds for work, services and goods supplied to the MSE debtor within a specified period before the commencement of the insolvency proceeding and during the implementation of the reorganization plan.

4. Approval of a reorganization plan

106. In some jurisdictions, creditor approval of the plan may not be required: the competent authority may be authorized directly to approve the plan. The debtor, creditors and other parties in interest should however not be expected to be bound by the plan without a chance to be heard by the competent authority. Any dissenting party in interest should also be able to seek review.

107. Where creditor approval is required, simplified reorganization regime should address both the approval of a fully consensual reorganization plan and approval of the reorganization plan over creditor objection. Minimal formalities for consenting to or contesting the plan should be provided, including exceptions to the requirements to establish a creditor committee and classes of creditors and to hold disclosure statement hearings. Convening a creditor meeting may also be unnecessary if the creditors are kept informed and they raise no objections. When such meetings are convened, the quorum, voting and other requirements for adopting decisions that otherwise apply under the insolvency law may be reduced and the ability to take decisions online or by post or proxy should be provided. Tacit or implied approval mechanisms such as discussed in chapter III.3 above, may be introduced to address issues arising from the creditor disengagement.

108. The law may waive the requirement for the competent authority to approve the plan agreed to by the creditors, allowing it to take effect automatically if no dissenting creditors' interests are involved. The parties may nevertheless prefer obtaining acknowledgement, confirmation, approval or other form of validation of the plan by the competent authority. In other jurisdictions, formal approval of the plan by the

competent authority may be required in all cases before the plan becomes effective and binding upon all parties in interest.

109. For approval by the competent authority, the parties may be required to demonstrate that the plan has received the requisite support by providing the written consent of the creditors or, where a creditor meeting has been held, a report of the creditors' votes. The competent authority may acknowledge the existence of the plan and that sufficient support among creditors exists for that plan without judging its economic and financial merits, or the competent authority may need to ascertain the fairness of the plan and that the plan ensures the survival of the business.

110. Generally, the plan should be approved by the competent authority when a few conditions are satisfied: the approval process was properly conducted; creditors will receive at least as much under the plan as they would have received in liquidation, unless they have specifically agreed to receive lesser treatment; and the plan does not contain provisions contrary to law (see recs. 152 and 153 of the Guide). In MSE insolvency, the competent authority should be able to determine the outcome of an alternative liquidation scenario without the involvement of an expert opinion.

111. Where achieving a fully consensual creditor-approved reorganization plan would not be possible, the competent authority may attempt to modify the proposed plan with the goal to reflect concerns of dissenting parties and achieve agreement. If parties in interest do not seek review, they are deemed to accept the compromise reached in the plan as proposed by the competent authority.

112. To discourage frivolous complaints and minimize delays in simplified reorganization, the scope for objections may be narrowed to procedural grounds. The competent authority may be authorized to approve the plan notwithstanding the objection on such a ground, by taking into account the extent of the irregularity, the state of the debtor and other circumstances.

113. Once the plan is approved by the competent authority, it would be bound on all parties in interest unless review of the plan is involved. A challenge to the plan may trigger the commencement of the standard insolvency proceedings, and judicial review may result in the approval of the reorganization plan over creditor objection.

114. Some jurisdictions do not provide for a right of appeal against a judicial decision approving a plan. In other jurisdictions, such a right may be limited to factors such as the importance of the issue (e.g., fraud; see rec. 154 of the Guide) and prejudice to the parties. Where appeal is allowed, time limits for appeal should be short. In order to ensure that the MSE insolvency can be addressed and resolved in an orderly, quick and efficient manner without undue disruption, the insolvency law should provide that appeals in simplified insolvency proceedings should not, as a general rule, have suspensive effect (see rec. 138 and footnote 14 of the Guide).

5. Amendments of the reorganization plan

115. In simplified reorganization, the need to make amendments to the plan would rarely arise. Nevertheless, the law should not exclude the possibility of any party in interest from proposing an amendment. Such possibility is envisaged in recommendation 155 of the Guide, and recommendation 156 addresses mechanisms for approval of amendments. Amendments may be allowed only in truly exceptional circumstances, subject to the general conditions that the amendment will be in the best interest of all parties in interest and will need to be approved in the same way as the original plan.

116. Some plans could be self-modifying, e.g., those that call for fluctuating payments based on the MSE debtor's actual income. The implementation of such plans may require monitoring. Alternatively, debt repayments may be based on projected income and expenses, and the insolvency law should allow parties to modify the plan to reflect the MSE debtor's actual situation as compared to the projections embodied in the plan. There could be systems that permit reductions but not increase in payments.

117. Some systems allow retroactive adjustment of the plan to take into account late claims. Other systems consider that such modifications to the plan may make the debtor unable to fulfil new demands and for that reason deny any distribution to creditors filing claims beyond a deadline. An exception could be made in situations where late filing was caused through no fault of those creditors.

6. Debtor-in-possession subject to oversight and assistance

118. Use of the debtor-in-possession approach as the norm in simplified reorganization proceedings is usually justified by reference to the characteristics of MSEs. They include that the MSE debtor often has unique knowledge about its business, as well as ongoing relationships with creditors, suppliers and customers. In addition, the insolvency estate can be insufficient to fund the appointment of an insolvency representative. Furthermore, the risk of being displaced from the helm can create a disincentive for the MSE debtor to seek timely commencement of insolvency proceedings.

119. The debtor-in-possession approach may not be appropriate in some cases, for example where the MSE debtor was responsible for misappropriation or concealment of property or poor management that caused its financial distress. It may also be inappropriate in involuntary commencement where the MSE debtor could be expected to be hostile to creditors or where the plan was imposed on the MSE debtor by creditors. In such cases, the competent authority may appoint a third party, such as the independent party, to take on a supervisory role or even displace the MSE debtor or make an interim stay order preventing the debtor from taking certain actions (such as disposing of assets or incurring liabilities capped by a specific value).

120. In some jurisdictions, an insolvency professional may be a mandatory participant in insolvency proceedings and, although a debtor-in-possession approach may still be possible, it may need to be coupled with the involvement of an insolvency professional who will closely supervise the process and keep the competent authority continuously informed. (See recs. 112, 113 and 157 of the Guide).

7. Discharge in the context of reorganization

121. To ensure that the reorganized MSE debtor has the best chance of succeeding, the insolvency law can provide for a discharge or alteration of debts and claims that have been discharged or otherwise altered under the plan. This approach supports the goal of commercial certainty by giving binding effect to the forgiveness, cancellation or alteration of debts in accordance with the approved plan. The principle is particularly important to ensure that the provisions of the plan will be complied with by creditors that rejected the plan and by creditors that did not participate in the proceedings. Thus, the discharge establishes unequivocally that the plan fully addresses the legal rights of creditors.

122. Discharge in reorganization might be effective from the time the plan becomes effective under the insolvency law or from the time it is fully implemented. In the event that the plan is not fully implemented or implementation fails, many insolvency laws provide that the discharge can be set aside.

8. Closure of the simplified reorganization proceedings

123. In general, insolvency laws adopt one of several approaches to closing reorganization proceedings. They may be treated as closed when the reorganization plan is approved (and confirmed where this is required); the liabilities have been discharged in accordance with the plan and the plan has otherwise been fully implemented (with or without the need for a formal order); or if a competent State authority dismisses the proceedings because they constituted an improper use of the insolvency law.

124. Proceedings may also be closed in accordance with the terms of the plan or some other contractual agreement with creditors. Where the reorganization plan is not fully

implemented or cannot be implemented or there is a substantial breach of the plan by the MSE debtor, the insolvency law may provide for conversion of the simplified reorganization proceedings to liquidation. This would aim to achieve resolution of the financial situation of the insolvent MSE debtor. That option will however not be available with respect to the solvent MSE debtor. Where the reorganization proceedings close once the plan has been approved (and confirmed, where this is required), rights and obligations included in the plan will be enforced under law other than insolvency law.

Recommendation

9. Simplified reorganization proceedings should incorporate the following features:

(a) An automatic stay upon commencement of simplified reorganization proceedings for the duration of the proceedings unless it is lifted by the competent authority upon request of the MSE debtor, the independent party or creditor(s). An imposition of a stay should not affect the right to commence individual actions or proceedings to the extent necessary to preserve a claim against the debtor and should not prejudice the right of a secured creditor to protection of the value of the asset in which it has a security interest [and the right of a secured creditor to request the competent authority to grant relief from the stay] (see recs. 46–51 of the Guide);

(b) Automatic conversion of simplified reorganization proceedings to simplified liquidation proceedings where the competent authority finds that the debtor is insolvent but cannot be reorganized (see rec. 158 (a) of the Guide);

(c) In other cases, sufficient time to prepare and submit a plan. Where the reorganization plan is not submitted within the established time limit, the debtor is deemed to enter liquidation unless it proves solvency, in which case proceedings are terminated;

(d) Possibility to file an alternative plan and conditions and time limit to exercise such an option;

(e) Notification of the reorganization plan by the competent authority to each known party in interest;

(f) A short time limit for expressing any objection to the plan;

(g) Deemed approval of the plan in the absence of any objection, and, in the case of objection, possible modification of the plan by the competent authority with the aim to achieve a fully consensual plan;

(h) In the absence of agreement on the modified plan, termination of the simplified reorganization proceedings where the debtor is solvent and thus not eligible for conversion to liquidation, and conversion of the simplified reorganization proceedings to simplified liquidation proceedings where the debtor is insolvent (see rec. 158 (b) of the Guide);

(i) The opportunity for review of the contested plan, which may trigger the commencement of standard insolvency proceedings;

(j) Conditions for the approval of the plan by the competent authority or upon review, including that the approval process was properly conducted, creditors will receive at least as much under the plan as they would have received in liquidation, unless they have specifically agreed to receive lesser treatment, and the plan does not contain provisions contrary to law (see recs. 152 and 153 of the Guide);

(k) Default regime under which the debtor continues to operate the business on a day-to-day basis with the assistance of the independent party where necessary and subject to the supervision by the competent authority, in particular as regards the use and disposal of assets of the insolvency estate and post-commencement finance;

(l) A description of any circumstances under which the competent authority may decide to entrust a third party, such as the independent party, with the day-to-day

operation of the business from the outset of the proceedings or at any subsequent stage (e.g., during the implementation of the plan);

(m) Conversion to liquidation or termination of the proceedings for other reasons, including where the MSE debtor is non-compliant with the terms of the reorganization plan (see rec. 158 (c) to (e) of the Guide);

(n) Following the successful implementation of the reorganization plan, discharge from claims that were or could have been addressed in the proceedings except for any limited exceptions specified in the law, which might include debts related to the exempted assets or omitted intentionally or by mistake; and

(o) Procedures by which simplified reorganization proceedings should be closed.

VIII. Conversion and modification of proceedings

125. Aspects of conversion of a simplified reorganization proceeding to a simplified liquidation proceeding and of a zero-asset proceeding to a simplified or standard liquidation are addressed in the preceding chapters. In MSE insolvency, the need for conversion of a simplified liquidation proceedings to reorganization or for reconversion to simplified reorganization once conversion of simplified reorganization to simplified liquidation has already occurred would unlikely arise.

126. There may be a need for conversion of a simplified insolvency proceeding (other than a zero-asset proceeding) to a standard insolvency proceeding. Creditors may request conversion of a simplified insolvency proceeding to standard business insolvency proceeding, where they can demonstrate the complexity of an individual case and the need for more scrutiny. Such a need may arise in particular because of allegations of fraudulent transfers of assets of the MSE debtor to related persons or other fraudulent behaviour by the MSE debtor. A request for such a conversion would require an assessment by the competent authority.

127. The conversion of a standard business insolvency proceeding to a simplified insolvency proceeding may also need to be envisaged. Such conversion may take place for example at the decision of a competent State authority where an effective oversight of the debtor reorganization by creditors cannot be ensured because of the creditor disengagement. In such cases, a simplified reorganization proceeding may follow, which would ensure oversight by the competent authority.

128. Where the insolvency law permits conversion, a related question is how conversion can be triggered – whether it should be automatic once certain conditions are fulfilled or require application to a competent State authority by an interested party. A competent State authority could also be given the power to convert on its own motion where certain conditions are met.

129. The automatic conversion would help to avoid the delay and expense of a separate application by the party interested in conversion. At the same time, the law may allow a dissenting party to challenge such an automatic conversion. For example, in some cases, even where a plan's failure is attributable to a breach of obligation or the lack of a debtor's cooperation, creditors may prefer reorganization to liquidation to extract more value from business. Instead of conversion to liquidation, they may opt for replacement of the debtor from the operation of business with available alternatives. It may also be preferable to leave creditors to pursue their rights at law, without necessarily liquidating the debtor, in particular where the debtor commenced a reorganization proceeding to address financial difficulties at an early stage and was not necessarily eligible for liquidation proceedings. Serving a timely notice of conversion to all parties in interest is therefore an essential safeguard.

130. Whether conversion constitutes formal closing of the proceedings and commencement of new proceedings depends upon the approach of the jurisdiction in question. Where conversion is treated as a continuation of the originally filed

proceedings, adjustments would need to be made to the standard time limits that run from the effective date of commencement of proceedings since a significant period of time may have elapsed between commencement of the proceedings and their conversion.

131. The insolvency law should also address other implications of conversion, in particular the status of any actions taken prior to the conversion (e.g., the continued application of the stay; the effect of the conversion on the exercise of avoidance powers in respect of payments made in the course of the reorganization proceedings and the timing of the suspect period; the treatment of creditor claims that have been compromised in the reorganization, i.e., whether they are to be reinstated to full value or may be enforceable only as compromised in any subsequent liquidation; and the priority to post-commencement financing extended under the reorganization plan, which may need to be recognized in a subsequent liquidation in order to encourage the provision of such financing to financially distressed debtors undergoing reorganization).

132. Conversion of proceedings should be differentiated from introduction of modifications within the same proceedings, such as replacing the debtor-in-possession regime with another approach or allowing a mediation stage during insolvency proceedings to resolve disputes among creditors or between the debtor and its creditor(s). The insolvency law should preserve flexibility by allowing modifications by a competent State authority on its own motion or upon request by any party in interest where circumstances of the case so justify.

Recommendations

10. The insolvency law should provide for conversion between the different types of proceedings in appropriate circumstances and subject to applicable eligibility and other requirements.

11. The insolvency law should address procedures for conversion, including notification to all known parties in interest about the conversion, and mechanisms for addressing objections to that course of action.

12. The insolvency law should specify that where simplified reorganization proceedings are converted to liquidation, any priority accorded to post-commencement finance in the simplified reorganization should continue to be recognized in the simplified liquidation (see rec. 68 of the Guide).

13. The insolvency law should address other effects of conversion, including on deadlines for actions, effect of a stay and other steps taken in the proceeding being converted.

14. A simplified insolvency regime should preserve flexibility to introduce modifications within the same type of proceedings (e.g., recourse to mediation, displacement of the debtor from the operation of the business).

IX. Coordination of related proceedings

133. Lenders of MSEs often require guarantees to secure business loans. Such guarantees are commonly provided by individual entrepreneurs, owners of limited liability MSEs and their family members. Personal guarantors will face payment claims on the eve or after the opening of an insolvency proceeding.

134. Generally, the insolvency proceedings and discharge have no alleviating effect on the liability of the guarantor. The purpose of requiring a personal guarantee is to protect against the principal debtor’s insolvency by ensuring that the creditor will be paid. Adjusting the guarantor’s liability in the insolvency proceeding would reduce the protection for the creditor. This could, in the long run, restrict access to credit, including for MSEs many of which may not be able to obtain financing in other ways.

135. Nevertheless, where invoking a personal guarantee would likely result in, in addition to the business insolvency, the personal insolvency of individual entrepreneurs, owners of limited liability MSEs or their family members, consideration should be given to providing a procedure for addressing the position of the MSE debtor and such guarantors within the same process through consolidation or coordination of related insolvency proceedings. Allowing unrestricted enforcement of guarantees could lead to destitution of the entire family of an individual entrepreneur or the owner of a limited liability MSE debtor.

136. A stay may be imposed on the enforcement against such guarantor for a limited duration on a case-by-case basis, where that action would be necessary for the successful reorganization of the MSE debtor or would alleviate a disproportionate hardship on the guarantor. When approving or confirming a reorganization plan, the competent authority may accord special treatment to a guarantor's claim against the MSE debtor vis-a-vis other claims in the plan. It may also permit the guarantor to pay in instalments for an extended period. The insolvency law may permit MSE debtors' guarantors to petition for a reduction or discharge of their obligations under the guarantee if those obligations are disproportionate to the guarantor's revenue. The competent authority may be allowed to exercise discretion in favour of the guarantor's discharge or the reduction of the obligation to the part of the debt not covered by the MSE debtor's debt repayment obligations.

137. The civil procedure law of many States may already adequately provide for the possibility to coordinate linked proceedings, consider joint applications and use other means to take into account interests of various parties in a single proceeding. The State may nevertheless consider introducing specific requirements and procedures in the insolvency law to address the overlap of business and household assets and liabilities, home mortgages or personal guarantees to cover business debts. At the very minimum, coordination of the linked procedures to address the cross-over of commercial and personal insolvency, consumer over-indebtedness and intertwined debts of related persons should be ensured. Such coordination may involve for example: cooperation between competent State authorities, including coordination of hearings; joint provision of notice; coordination of procedures for submission and verification of claims; and coordination of avoidance proceedings. The scope and extent of coordination of linked procedures could be specified by a competent State authority.

138. Special measures of protection may be envisaged in law other than insolvency law for especially vulnerable guarantors, e.g., those who are found to have provided guarantees under duress or those who are dependent on or have strong emotional ties with the debtor. Special treatment has been accorded to such guarantors for example when the guarantee was found unreasonable or because, at the time of signing the contract, the financiers did not explain the consequences of giving a personal guarantee, in particular "all money" clauses. Some jurisdictions may impose explicit restrictions on what kinds of guarantee a spouse, child or other dependent person can give.

Recommendations

15. A simplified insolvency regime should address the treatment of personal guarantees provided for business needs of the MSE debtor by individual entrepreneurs, owners of limited liability MSEs or their family members, including through consolidation or coordination of linked proceedings.

16. The insolvency law may require close coordination of linked business, consumer and personal insolvency proceedings in order to address comprehensively intertwined business, consumer and personal debts of individual entrepreneurs, owners of limited liability MSEs and their family members. The law may specify that, in such cases, the competent authority may order coordination of linked proceedings on its own motion or upon request of any party in interest, which may be made at the time of application for commencement of insolvency proceedings or at any subsequent time.

17. The insolvency law should specify that an order for procedural coordination may be modified or terminated, provided that any actions or decisions already taken pursuant to the order are not affected by the modification or termination. Where more than one State authority is involved in ordering procedural coordination, those authorities may take appropriate steps to coordinate modification or termination of the procedural coordination.

18. The insolvency law should establish requirements for giving notice with respect to applications and orders for procedural coordination and modification or termination of procedural coordination, including the scope and extent of the order, the parties to whom notice should be given, the party responsible for giving notice and the content of the notice.

X. Pre-insolvency obligations of individual entrepreneurs and owners and managers of other type of MSE. Insolvency obligations of the MSE debtor

A. Pre-insolvency obligations of individual entrepreneurs and owners and managers of other type of MSE

139. Individual entrepreneurs and owners and managers of other type of MSE may not be aware that in the period approaching insolvency they are expected to act in the best interest of creditors and other stakeholders and take reasonable steps to avoid insolvency or to minimize its extent (see rec. 256 of the Guide). They may not be aware that civil and criminal liability, including disqualification and longer period of time for discharge, may be imposed on them for causing insolvency or failing to take appropriate actions in the vicinity of insolvency.

140. The insolvency law should clearly specify the obligations of individual entrepreneurs and owners and managers of other type of MSE in the period approaching insolvency and that such obligations will arise when the person knew or ought reasonably to have known that insolvency was imminent or unavoidable. The insolvency law should also specify reasonable steps to be taken to avoid insolvency or to minimize its extent, including seeking professional advice, an early recourse to mediation or debt counselling services, if available, and timely engaging in informal debt restructuring negotiations where those are permissible. Factors such as the loss of a key customer or supplier, departure of a key employee or adverse changes in rental, supply or loan terms may signal the need to examine viability of the business and modify expenditure, business and management practices.

141. At the time of financial distress, individual entrepreneurs and owners and managers of other type of MSE may be inclined to collaborate with related persons or powerful creditors (e.g., by repaying the debt to only one bank or transferring business assets to related persons at an undervalue) or to obtain goods or services on credit without any prospect of payment. The insolvency law should make it clear that such transactions can be avoided and lead to personal liability of persons who agreed to the transaction, regardless of whether the business operates as a limited liability MSE or unlimited liability MSE.

142. The insolvency law should also make it clear that, in the period approaching insolvency, all parties exercising factual control over the business may be under the general obligation to act in the best interest of creditors and other stakeholders and take reasonable steps to avoid insolvency or to minimize its extent (see rec. 255 of the Guide). Such clarification is particularly pertinent in the context of MSE insolvency where high influence of main creditors on MSEs during the time of financial distress is common, which may make such creditors the de facto managers of MSEs in the period approaching insolvency. As such, those creditors may face liability under insolvency law if their self-serving behaviour prejudiced the position of other creditors.

B. Insolvency obligations of the MSE debtor

143. It is desirable that the insolvency law clearly identifies the obligations of the MSE debtor with respect to the simplified insolvency proceedings, including, as far as possible, the content and terms of the obligations and to whom each obligation is owed. The obligations should arise on the commencement of the proceedings and continue to apply throughout the proceedings.

144. To ensure that simplified insolvency proceedings can be conducted effectively and efficiently, the MSE debtor should assume a general obligation to cooperate with and assist the competent authority and the independent party in performing their duties and to refrain from conduct that might be injurious to the conduct of the proceedings. The MSE debtor will also assume a continuing obligation to disclose information regarding the business to the competent authority throughout the proceedings. Commercially sensitive, confidential and private information must be accorded appropriate protection.

145. An essential part of the obligation to cooperate in simplified liquidation proceedings will be to enable the competent authority to take effective control of the insolvency estate by surrendering control of assets and business records and books. In simplified reorganization, where the MSE debtor remains in control of the business, an obligation to surrender control of the insolvency estate and business records and books will not be applicable. Other obligations may instead arise. For example, in addition to information that would need to be submitted at early stages of the proceedings, the MSE debtor may be required to report regularly to the competent authority on the implementation of the reorganization plan, the cash flow situation of the debtor and other facts related to the business.

146. Furthermore, the MSE debtor may be required to give notice to creditors or obtain advance approval of the competent authority or the independent party before any sale or other disposal of assets. Clarity as regards disposals of assets made in or outside the ordinary course of business may facilitate the continuing day-to-day operation of the business, without imposing the complexity of obtaining approvals to conduct routine activities. When the assets are subject to a security or other interest (e.g., a lease), the MSE debtor in possession will be required to take special measures to protect the economic rights of the holder of that interest.

147. The insolvency law may impose obligations that are ancillary to the MSE debtor's obligation to cooperate, assist and provide necessary information during simplified insolvency proceedings, including the duty to inform the competent authority about any expected change of the place of business or residence. Such ancillary obligations may be automatically applicable, or may be ordered at the discretion of the competent authority where necessary for the administration of the estate or other purpose of the proceedings. These obligations should be proportionate to their underlying purpose and to the overall purpose of the general duty to cooperate, assist and provide necessary information. Human rights norms will be applicable to some of them (e.g., the requirement to disclose correspondence or other requirements that may infringe on privacy or personal freedom). For those reasons, it may be required that limitations on individual entrepreneurs may only apply by order of a competent State authority.

148. Where the MSE debtor fails to comply with its obligations, the insolvency law may need to consider how that failure should be treated and the legal consequences of actions taken in violation of the obligations, taking into account the nature of different obligations and appropriate sanctions. Where the MSE debtor fails to observe the restrictions and enters into contracts requiring consent without first obtaining that consent, the insolvency law may need to address the validity of such transactions and provide appropriate sanctions for the MSE debtor's behaviour, including displacement from the operation of the business, harsher terms for discharge and conversion to liquidation, provided it is in the best interests of creditors. Where information is withheld by the MSE debtor, a mechanism to compel the

provision of relevant information such as a "public examination" of the MSE debtor by the competent authority may be appropriate. In more serious cases of withholding of information, criminal sanctions may be imposed. Consideration may also need to be given to the parties to whom the sanctions should apply, usually encompassing any person who generally might be described as being in control of the MSE debtor, including owners and managers.

Recommendations

Pre-insolvency

19. The insolvency law should clearly specify that, at the point in time when individual entrepreneurs and owners and managers of other type of MSEs (as well as any other person exercising factual control over the business) knew or ought reasonably to have known that insolvency was imminent or unavoidable, they should have due regard to the interests of creditors and other stakeholders and to take reasonable steps to avoid insolvency and, where it is unavoidable, to minimize the extent of insolvency. They in particular should:

(a) Not transfer assets out of the business at an undervalue, or confer a preference to any particular creditor or otherwise defeat, delay or hinder creditors;

(b) Not enter into any transaction that would worsen the economic situation of the business;

(c) Protect the assets so as to maximize their value and avoid loss of key assets;

(d) Ensure that management practices take into account the interests of creditors and other stakeholders;

(e) Seek professional advice where appropriate;

(f) Consider holding debt restructuring negotiations with creditors; and

(g) Apply for commencement of insolvency proceedings if it is required or appropriate to do so.

20. The law relating to insolvency should specify that where creditors have suffered loss or damage as a consequence of the breach of the obligations in recommendation 19 above, the person owing the obligations may be liable to the extent to which the breach caused loss or damage (see recs. 259–260 of the Guide).

Insolvency

21. The insolvency law should clearly specify the obligations of the MSE debtor in respect of insolvency proceedings. Those obligations should arise on the commencement of, and continue throughout, the proceedings. The obligations should include the following:

(a) To cooperate with and assist the competent authority and the independent party to perform their duties, including where applicable to take effective control of the estate, wherever located, and of business records, and to facilitate or cooperate in the recovery of the assets;

(b) To act in good faith, including in collecting and providing information relating to the business that might be requested by the competent authority or the independent party, subject to appropriate safeguards for the protection of commercially sensitive, confidential or private information;

(c) To provide notice of the change of a habitual place of residence or place of business;

(d) To adhere to the terms of the liquidation or reorganization plan; and

(e) In the day-to-day operation of the business, to have otherwise due regard to the interests of creditors and other parties in interest.

Part two

Relationship with other law and institutional framework

I. Relationship with other law

149. Not all measures aimed at mitigating the challenges facing MSEs in financial distress will fall under the insolvency law; other laws may also be relevant. Tax regulations in particular may influence debt restructuring options. They, as well as accounting regulations, may also include mechanisms for preventing insolvency, for example by requiring or incentivising tax advisors and accountants of MSEs to inform business owners and managers about financial problems. Those professionals may be in the position to identify signals of financial distress earlier than business owners or managers who would not necessarily possess the required business and financial management skills. They may also be in the position to identify signals of financial distress earlier than other third parties, such as tax or social security agencies and banks, that may discover financial distress of the business only when payments are not made, which may be too late for its rescue.

150. In the light of a close interlink between the insolvency of MSEs, on the one hand, and consumer and personal insolvency, on the other hand, other laws relevant in the context of MSE insolvency include consumer protection law and regulations, family and matrimonial law, as well as human rights instruments addressing such rights as the right to property and to privacy and the right to work and fair remuneration. In addition, business registry regulations and company law that may provide for simplified incorporation of MSEs will also be relevant, including for generating and maintaining information about MSEs throughout their lifecycle. In that latter context, data protection and banking laws and regulations would be relevant as well.

151. Banking laws and regulations may also be relevant for credit histories, treatment of guarantees and incentivising responsible lending and value-maximizing participation by creditors in a simplified insolvency regime. Property and contract law will be relevant to the treatment of secured creditors and personal guarantors in insolvency.

II. Supporting institutional framework

152. Many insolvency reforms aimed at lowering barriers for access to insolvency by MSEs are complemented by institutional reforms, in particular the creation of debt counselling services and information registries that compile information on financial situation of MSEs throughout their lifecycle from different sources. Specialized government agencies or associations of MSEs and microfinance institutions may be relevant for raising interim and post-commencement finance.

153. Insufficient knowledge of business management and financial transactions is cited as a common cause of business failure among MSEs, especially first-time starters. Some jurisdictions therefore consider mandatory training on those issues for MSEs a tool to prevent insolvency and to facilitate a fresh start. Such training usually addresses pre-insolvency aspects, including available means for addressing the situation of financial distress, obligations of business owners and managers in the period approaching insolvency and consequences of not taking appropriate actions at an early stage of financial distress.

154. Some governments also provide training to competent State authorities and insolvency practitioners with the aim of building the capacity in the public and private sectors necessary to handle specificities of MSE insolvencies.

III. Informal debt restructuring negotiations

A. General features

1. Autonomous, voluntary, contract-based nature

155. In some jurisdictions, debt restructuring agreements or arrangements between the debtor in financial distress and some or all of its creditors cannot occur outside the insolvency law. In other jurisdictions, they are permitted.

156. They are characterized by the lack of State involvement (unless the law requires approval by a competent State authority of an informally negotiated plan for restructuring debts of a financially distressed person (see below)) and proceed autonomously on a voluntary, confidential and consensual basis under contract law.

157. Some insolvency laws may require debtors and their creditors to exhaust informal debt restructuring negotiations before initiating formal insolvency proceedings. In other jurisdictions, recourse to informal debt restructuring negotiations is an option for parties to consider, and incentives are built in law to use them (for example, monthly targets may be imposed on banks to successfully restructure debts of MSEs, and tax incentives may apply for writing off bad or renegotiated debts). Sanctions may be imposed on parties acting in bad faith during those negotiations.

2. Debtor and creditor involvement

158. No eligibility or commencement standards, usually found in the context of formal insolvency proceedings, apply. These negotiations may be initiated by either the debtor or its creditor(s). Proposals that the debtor may make to its creditors for a rescue of business informally will depend on the circumstances and would reflect the applicable law. For example, a debtor may request a lender (e.g., a bank) to write down the debtor's financial obligations or may request a lessor to reduce the rental fee or waive or suspend unpaid clams. The other party can accept or reject the proposal or offer debt restructuring under different terms.

159. If more than one creditor is involved, creditors may select one of them to act as a coordinator. The coordinator may assume an administrative burden or the role of a facilitator of negotiations but usually with no authority to commit other creditors to any particular course of action. Creditors, directly or through an appointed third-party, may play an active role in evaluating debtor's assets to ascertain whether the business is worth preserving. They usually compare what may be offered to them with what they might expect from a formal insolvency or from other options open to them (e.g., the sale of their debt), taking into account also claims and entitlements of other participating creditors.

160. Creditors may agree to alter the priority of their claims in order to facilitate a restructuring plan. They may also agree to provide new funding to a debtor necessary for its rescue. That is usually done on the condition that priority status will be accorded to the new funding or additional security over the debtor's assets will be given. It would depend on provisions of insolvency law whether agreements related to creditor priority reached through the informal debt restructuring negotiations will be valid and apply in the event of a subsequent initiation of formal insolvency proceedings (e.g., liquidation if the informal debt restructuring negotiations fail).

161. Creditors that continue to be paid in the ordinary course of business (e.g., employees and trade creditors) are not considered affected and do not vote on the plan. Where, however, the rights of those creditors are to be modified by the plan, their agreement to the proposed modifications would be required.

3. Standstill

162. Negotiating a contract-based standstill is crucial for success of informal workouts. Under a standstill agreement, participating creditors usually undertake not to enforce their rights against the debtor for any default during a specified period. The standstill agreement may also oblige the creditors to keep open any existing lines of credit or allow the debtor to temporarily suspend interest payments. The debtor in turn usually agrees not to take any action that might adversely affect relevant creditors. Examples of such actions would be borrowing from non-participating creditors and offering security to them, transferring assets away from business or selling assets to a third party at an undervalue. The debtor also usually agrees to use the standstill period to draft a restructuring plan and provide relevant creditors with reasonable and timely access to all information relevant to its assets, liabilities, business so that they can assess the viability of the plan. Terms of the agreement, including the duration of the standstill period and conditions for its possible extension, are negotiated by parties under contract law.

163. Contract-based negotiated standstill arrangements have an advantage of avoiding the publicity associated with formal insolvency proceedings. Confidentiality agreements may be part of the standstill agreement or negotiated separately.

164. The length of the contractually-negotiated standstill period varies from case to case. It would typically not exceed an initial period of a few weeks but could be extended if all participating creditors agree. Although the period may be fixed for a certain period, the relevant creditors may terminate it earlier, either at their discretion, for example if it becomes obvious that no rescue is feasible, or following agreed events of default, for example where the debtor acted fraudulently.

165. In some jurisdictions an agreement by the debtor with all or some of its creditors that provides for a stay on the payment of debts may trigger formal insolvency. In such cases, creditors may agree between themselves rather than with the debtor to operate a stay on their claims against the debtor, and the debtor separately agrees not to take steps which might prejudice the relevant creditors during an agreed period.

4. Approval of the informally negotiated debt restructuring plan

166. Informally negotiated debt restructuring plans binds the parties to the plan. They may choose to seek confirmation of the plan in a competent State authority or such confirmation may be required by law for any debt restructuring arrangements between the debtor and the creditors to become effective. In addition, a competent State authority may become involved if any aggrieved party in interest challenges the plan.

167. Approval of the plan by a competent State authority may be expedited where it can be shown that the rights of unsecured creditors or others who were not involved in the negotiation of the plan would not be affected and the plan was approved by the required majority of affected creditors. Provisions of the Guide on expedited reorganization proceedings are of relevance in this respect. They have been designed to address concerns over intercreditor agreements negotiated informally without involvement of all creditors whose rights are modified by those agreements. While providing for the fast-track procedures, they build in procedures to ascertain that creditors that were not involved in negotiations are indeed not affected by the plan and also provide for safeguards for adversely affected creditors. They ensure that a competent State authority will carefully look at the substance of negotiated deals and decide whether to approve the deal or open the expedited insolvency proceedings as a result of which the plan may be imposed over objection of aggrieved creditors or modified to address concerns of aggrieved creditors. Usual conditions for the approval of the reorganization plan would apply (e.g., that all required approvals were received and that creditors are not worse off than they would have been if liquidation proceedings have been commenced). (See recs. 160–168 of the Guide.)

168. Initiation of the plan confirmation proceedings with the competent authority might mean the loss of confidentiality – considered to be one of the main advantages

of informal procedures – since at least the fact that the procedure took place and the essential terms of the agreed plan, such as new guarantees, new finance and priority ranking, may need to be disclosed.

169. The enforcement of the informally negotiated debt restructuring plan is left to contract law. A representative of creditors may be appointed to guide the debtor through the implementation of the plan. In case of disputes, a mediator may be appointed, unless such role is already assumed by a designated State authority. Where arbitration, mediation or conciliation is involved, the enforcement of awards or settlement agreements would be subject to the rules applicable to those commercial dispute resolution mechanisms.

170. Informally negotiated debt restructuring plans agreed by the parties, especially if they are approved by a competent State authority, may have far reaching consequences for any subsequent insolvency proceedings, including as regards the ranking of claims and protection of arrangements covered by the plan from avoidance.

5. Benefits and concerns with the use of informal debt restructuring negotiations

171. Unlike formal insolvency proceedings that involve all creditors and are public, informal debt restructuring negotiations usually involve a limited number of creditors, which may accommodate the need for a prompt resolution that is not always possible in formal proceedings, and allow parties to preserve confidentiality, which helps to avoid the social stigma attached to insolvency. In addition, they may provide debtors with the benefits of resolving their financial difficulties without affecting their personal credit scores, which is important for obtaining new finance and a fresh start.

172. At the same time, because informal debt restructuring negotiations are held without supervision by any competent State authority and remain confidential, abuses are possible. For example, debtors may prolong negotiations to delay the liquidation of their business to the detriment of other parties in interest, or creditors may use their bargaining power to refuse to agree to any modifications of their claims or pressure debtors into accepting onerous plans that are not viable and would not be acceptable in formal proceedings. In addition, creditors demanding enforcement of their claims may make negotiations impossible: just one participating creditor may veto a settlement, and unless the law stipulates that passive creditors are bound by a settlement, they often feel free to disregard attempts to participate in negotiations.

B. Measures to facilitate informal debt restructuring negotiations

1. Legislative

173. It is for policymakers to decide whether to promote informal debt restructuring negotiations, at the same time respecting their voluntary and consensual nature. If so, several measures could be taken. Experience with informal debt restructuring negotiations in particular suggests that the success of the negotiations often depends on the implementation of the following measures.

174. First, amendments of existing legislation other than insolvency law may be required to ensure that no legal obstacles for informal debt restructuring negotiations exist. Policymakers should in particular consider the extent to which existing competition, state aid, data protection and labour laws may create obstacles to the use of options that are usually considered in informal debt restructuring negotiations such as asset sales, discounted debt sales, debt write-offs, debt rescheduling, debt-to-debt and other exchange offerings and in-kind payments. In addition, the law concerning third party guarantees may disincentivize creditors to settle with debtors; tax relief may be available to parties only when debt restructuring takes place in formal proceedings; and with a prohibition to write down the principal, the law may eliminate any incentives for public and other creditors to participate in debt restructuring. In some jurisdictions, the tax regime may make it excessively difficult for creditors to obtain tax relief from debt write-offs. Other systems may allow creditors to claim

losses and tax deductions from debt write-offs but impose income tax on debtors whose debts are written off.

175. Second, the success of those negotiations very often depends on whether the debtor is experiencing mild or temporary financial difficulties rather than severe insolvency and whether there are financial resources in place to support the operation of the business (interim finance). Encouraging new financiers to take the risk of investing in viable debtors in financial difficulties may require protection from avoidance actions and personal liability as well as incentives, such as giving interim finance priority at least over unsecured claims. States may consider according such protection and priority to interim finance in their insolvency law. To avoid potential abuses, protection from avoidance actions and personal liability may be made available only for interim finance provided in good faith and that is immediately necessary for the rescue of the business and its continued operation or the preservation or enhancement of the value of that business.

176. Third, an obligation to file for formal insolvency within a certain period after the occurrence of certain events found in insolvency legislation of many countries creates obstacles to holding informal debt restructuring negotiations. Some jurisdictions provide in their insolvency law for a statutory stay for the duration of the informal debt restructuring negotiations that suspends that obligation. Such stay also suspends the enforcement of creditors' claims during those negotiations. This allows the negotiations to progress without a threat that any party in interest, including secured creditors, will start insolvency proceedings or proceed with enforcement actions or suspend, terminate or modify existing contracts with the debtor. In many jurisdictions, such statutory stay may however only be available in formal insolvency proceedings.

177. Finally, informal debt restructuring negotiations have proved to be efficient when they rely on other features of formal insolvency processes, such as the availability of expedited insolvency proceedings to make the plan binding on the dissenting minority and on all creditors who have been notified and did not object.

2. Institutional support

178. While any provisions on this type of negotiations would be applicable to debtors of different sizes, not only to those for which simplified insolvency regimes would typically be designed, MSEs will require special State support with holding informal debt restructuring negotiations and implementing informal workouts. In some jurisdictions, there may already be a State authority in charge of administering negotiations between the debtor and its creditors or authorized to appoint a mediator or conciliator for the process (e.g., a central bank, a central debt-counselling agency, a commission for over-indebtedness or the debt enforcement authority). There may also be an arbitration facility to resolve disputes among the negotiating parties. In other systems, debtors may rely on counselling and negotiation support from semi-private or private-sector actors.

179. Where such support is not yet available, States may consider measures to that end in the light of the importance of encouraging the early rescue of MSEs. Such measures may include making available to MSEs professional, low-cost or cost-free impartial assistance with holding informal debt restructuring negotiations. A neutral intermediary could be appointed with sufficient authority and power to involve key institutional creditors in the negotiations, such as tax authorities and banks, and persuade parties that participation in debt restructuring negotiations is in their best interests. Such an intermediary should also ensure oversight to prevent abuses.

Recommendations

22. As a means of encouraging the early rescue of MSEs, the law may provide support with identification of early signals of financial distress and may need to remove disincentives for the use of informal debt restructuring negotiations.

23. The law may need to build in incentives for the participation of creditors, including public authorities, in informal debt restructuring negotiations.

24. The law may provide for:

(a) Involvement of a competent State authority, where necessary, to facilitate informal debt restructuring negotiations between creditors and debtors and between creditors;

(b) Mediation and arbitration or other neutral forum for resolution of debtor-creditor and inter-creditor disputes; and

(c) Priority status to interim finance subject to appropriate safeguards.”