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Insolvency of micro, small and medium-sized enterprises

Note by the Secretariat

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I. Introduction

1. At its forty-sixth session (2013), the Commission requested Working Group V to conduct a preliminary examination of issues relevant to the insolvency of MSMEs, and in particular to consider whether the UNCITRAL Legislative Guide on Insolvency Law (the Guide) provided sufficient and adequate solutions for MSMEs.

2. At its forty-fifth session (April 2014), Working Group V agreed that (i) the issues facing MSMEs were not entirely novel and solutions should be developed in light of the key insolvency principles and the guidance provided by the Guide (see A/CN.9/WG.V/WP.121); (ii) it was not necessary to wait for the results of the work being done by Working Group I in order to commence the study of insolvency regimes for MSMEs; and (iii) while the work might form an additional part to the Guide, no firm conclusion on that point could be reached in advance of a thorough analysis of the issues.

3. At its forty-seventh session (2014), the Commission gave Working Group V a mandate to undertake work on the insolvency of MSMEs as a next priority, following completion of the work on the cross-border insolvency of enterprise groups and recognition and enforcement of insolvency-related judgments.

4. At its forty-ninth session (May 2016), Working Group V (i) noted the importance of MSME insolvency and the wide support that had been expressed in favour of work being undertaken on that topic; and (ii) recommended that the Commission clarify the mandate given at its forty-seventh session to Working Group V as follows: "Working Group V is mandated to develop appropriate mechanisms and solutions, focusing on both natural and legal persons engaged in commercial activity, to resolve the insolvency of MSMEs. While the key insolvency principles and the guidance provided by the UNCITRAL Legislative Guide on Insolvency Law should be the starting point for discussions, the Working Group should aim to tailor the mechanisms already provided in the Legislative Guide to specifically address MSMEs and develop new and simplified mechanisms as required, taking into account the need for those mechanisms to be equitable, fast, flexible and cost efficient. The form the work might take should be decided at a later time based on the nature of the various solutions that were being developed."

5. At its forty-ninth session (2016), the Commission clarified the mandate of Working Group V in accordance with the wording quoted in paragraph 4.

6. At its fifty-first session, Working Group confirmed that work could proceed by examining each of the topics addressed in the Guide and considering whether the treatment provided was appropriate and necessary for an MSME insolvency regime, building upon the brief outline provided in A/CN.9/WG.V/WP.121. If such treatment was not appropriate, consideration should be given to how it might need to be adjusted for MSME insolvency. Additionally, consideration should be given to issues not covered by the Guide that should nevertheless be addressed in an MSME insolvency regime. The Working Group also expressed interest in considering how the modular approach might contribute to the arrangement of the elements required for an effective and efficient insolvency regime for MSMEs.

7. This note, which should be read in conjunction with A/CN.9/WG.V/WP.121 and A/CN.9/WG.V/WP.147 addresses issues relevant to the insolvency of MSMEs, by reference to the Guide. Given that MSMEs can be found across a very wide and heterogeneous spectrum, no common definition is attempted here. Nonetheless, it is clear that all forms of MSMEs would fall within the scope of the Guide, which covers all debtors, whether legal or natural persons, engaged in economic activity.[1]

[1] Legislative Guide, introduction, para. 1.

II. Core provisions of the Guide as they relate to MSME insolvency

A. Liquidation

8. In order to identify, protect and liquidate the limited assets of the MSME debtor while minimizing further losses, key issues for consideration include:

(a) Access to low-cost and swift liquidation proceedings;

(b) Treatment of assets that may constitute or be excluded from the insolvency estate;

(c) Funding the administration of liquidation proceedings; and

(d) Resolving the above issues to provide a fresh start.

1. Access by MSME debtors

9. Recommendation 15 of the Guide presents two alternative standards for commencement of liquidation proceedings: the debtor is or will be generally unable to pay its debts as they mature (the cessation of payments test); or the debtor's liabilities exceed the value of its assets (the balance sheet test). Where a single test is adopted, it should be based on the cessation of payments test and not the balance sheet test.

10. Since many informal MSMEs do not maintain proper records, the balance sheet test may be impractical and the inconvenience of filing financial documents can act as a disincentive for MSMEs to seek timely commencement. Moreover, personal assets and liabilities are likely to be mingled with business assets and liabilities, particularly where the MSME debtor is a natural person. Where the business is doing poorly but the individual debtor is asset-rich, a balance sheet analysis could preclude access to liquidation. Given the prevalence of personal guarantees used for borrowing by MSMEs, the balance sheet analysis could be under-inclusive if it fails to reflect the liabilities of the individuals behind MSMEs.

11. The cessation of payments test may be more workable in comparison. As discussed in the Guide (part two, chapter I, paras. 23, 33 to 34), the law may accept a financial declaration from the debtor that it is unable or does not intend to pay its debts; specify the indicators of the debtor's inability to pay its debts; or establish a presumption to that effect when the debtor suspends payment of its debts. However, the cessation of payments test may face the same problem with accurately assessing an MSME's state of solvency if it fails to capture personal debts that may be intertwined with business debts.

12. Several alternative approaches to determining access, involving objective or subjective indicators, may be considered. Objective indicators may be tied to debt levels, the value of income and/or assets available, or debt-to-income ratios, using minimum and/or maximum thresholds that differ from State to State. Subjective indicators may require the debtor to demonstrate "good faith", reasonableness, or that the debts are caused by events beyond a debtor's control or not caused intentionally or through gross negligence. Access may also be dependent on factors such as the debtor's ability to cover the administrative costs of the proceedings (see paras. 23–25 below).

13. Whichever test is adopted, the overarching consideration is that the burden of proving insolvency should not be so time-consuming or difficult that MSME debtors would avoid or delay seeking commencement of liquidation proceedings. Moreover, an holistic approach to assessing MSME insolvency is desirable, so that personal assets, liabilities or guarantees used by natural persons to support MSME business are included. Likewise, as noted in the Guide (part two, chapter VI, para. 12), where a legal system distinguishes business debts from personal debts, it may not be feasible to apply different rules. This is particularly true in the context of natural persons

operating MSMEs, where business and personal debts are often intertwined. A procedure dealing with both types of debts might therefore be desirable. A procedure for joint application for commencement and procedural coordination of related proceedings might also be useful where MSME involves family members.

14. The most liberal approach would be to enable MSME debtors to access liquidation proceedings without having to declare or prove any particular financial state.[2] Lowering the barriers to access and removing the stigma of declaring insolvency can encourage timely action, provided safeguards against abuse are in place.

15. One safeguard might be to restrict the frequency of access by either preventing multiple applications by the same debtor within a certain time period or subjecting a repeated applicant to more intense scrutiny, with commencement permitted only in exceptional circumstances. Other solutions involve review and potential sanction of the debtor's conduct by permitting creditors and other interested persons to raise objections with the court.[3]

2. Assets constituting the insolvency estate

16. The Guide (recommendations 38 and 109) deals with assets that might be excluded from the estate where the debtor is a natural person. Those recommendations are not only applicable to a MSME debtor who is a natural person, but should also apply where the MSME debtor is a legal person but its business assets are intertwined with the personal assets of a natural person. In the latter case, the natural person conducting MSME may be effectively exposed to personal insolvency and should, therefore, be afforded the same protection.

17. Three possible approaches to asset exclusion might be identified.

18. First, the law may set aside a range of assets with a total value up to a specified limit, which the debtor may seek to have excluded from the estate. This means that all of the debtor's qualified assets automatically become property of the estate, and the burden is on the debtor to apply to the court for exclusion. The range of assets available for exclusion may include, for example, furniture, household equipment, bedding, clothing and tools of trade.

19. Second, the law may establish different categories of excluded assets, respectively capped at certain values. This approach may be more flexible than the first approach. The categories of assets that are relevant may differ according to the individual situation of the debtor. In some systems, if the debtor does not use up the exclusion limit in one category of assets (e.g., the family home), the law may allow application of the unused amount to other categories of assets. Other systems allow the debtor to sell off some assets to buy excluded assets.

20. Third, the law may take a more general standards-based approach that, unlike the other two approaches, excludes the debtor's assets from the estate by default and places the burden on the insolvency representative to object to the exclusion of particular assets. The court may order those assets to be reclaimed for the estate. Because the insolvency representative would only need to intervene if the debtor had particular assets that could be of value to creditors, it may be more efficient in some cases where there are few assets available for distribution. In other cases, however, it may require the insolvency representative to investigate the debtor's assets, especially where personal and business assets are mingled or assets have been hidden or transferred in close proximity to insolvency.

21. The use of reasonable limits with an emphasis on rehabilitating the debtor is to be encouraged and the law might grant the court discretion to increase the scope of excluded assets beyond the default limits to meet the needs of individual debtors.

[2] Ibid., part two, chap. I, para. 33.
[3] Ibid., chap. III, rec. 137.

Where there is evidence of bad faith or unfair conduct by the debtor, the law could allow the court to claw back assets that would otherwise be excluded.[4]

22. The law may permit business assets to be sold before personal assets. Private sales, in addition to public auctions, may be permitted to provide a choice for best realizing the value of the debtor's assets.

3. No-asset cases

23. In practice, MSMEs are more likely than other debtors to have insufficient or no assets to fund the administration of liquidation proceedings. While these "no-asset cases" are a regular phenomenon, responses have differed, as indicated in the Guide (part two, chapter I, paras. 72–75). Some laws require the court to refuse commencement or terminate the proceedings, while others provide specific mechanisms for the administration of the proceedings, including levying a surcharge on creditors to fund administration; establishing a public office or using an existing office; establishing a fund out of which the costs may be met; or appointing a listed insolvency professional on the basis of a roster or rotation system. Such mechanisms could be coupled with other measures to reduce the costs of liquidation proceedings for MSME debtors (see paras. 26–29 below).

24. Because a large number of no-asset MSME cases involves debtors who are natural persons, the treatment of those cases should address the possibility of granting a fresh start. If the court declines to commence or terminates liquidation proceedings because of lack of assets, the debtor's financial situation will remain unresolved.

25. An exception for individuals with limited assets who may otherwise be eligible for discharge could be considered.[5] In one jurisdiction, for example, an individual debtor's application for liquidation is deemed to be an application for discharge, and even if the debtor is unable to cover the costs of the proceeding, the termination of the liquidation proceeding leads to the immediate commencement of the discharge proceeding, thereby providing a speedy exit option for the debtor. The court can reduce the amount to be prepaid by the debtor to cover the costs of the proceeding. In other jurisdictions, alternatives in the form of debt relief schemes have been established, where qualifying no-asset debtors may seek discharge from their debts after a short time period (e.g. one year). However, the potential for serial bankruptcy may need to be addressed.

4. Simplified proceedings

26. Several legal systems provide a simplified or expedited form of liquidation proceedings, which tend to include shorter timelines[6] and procedural formalities, and less court supervision to save time and costs.

27. Measures to simplify the process of claims admission include reducing evidentiary requirements for proof of claims; limiting claims that need to be verified to those that are likely to be paid; referring submitted claims to an immediate creditor meeting for verification; eliminating the need for a court hearing to verify claims; and accelerating timelines for expressing objections and resolving disputed claims.[7]

28. A common problem for MSME liquidation is that a single disputed or unpaid claim is the main asset of the business. One straightforward solution might be for the court, another institution or an insolvency representative to perform a summary determination of the disputed claim, with the possibility of a full review on appeal to the court. Other options may include permitting the sale of the disputed claim at a discount, provided there is a secondary market for small claims or assigning the claim to the insolvency representative or public office, which will then be responsible for litigating and collecting the claim. The proceeding could be completed after the

[4] On avoidable transactions, see ibid., chap. II, rec. 87 and paras. 170–179.
[5] Ibid., chap. I, rec. 26(a) and para. 74.
[6] Greece: A/CN.9/WG.V/WP.147, para. 23; India: A/CN.9/WG.V/WP.147, para. 26.
[7] Greece: ibid.

MSME debtor has handed over other assets for liquidation, and not only after the litigation and collection of the disputed claim.

29. A simplified process may be achieved for distribution, particularly where the assets available are below a certain statutory limit, by, for example, reducing notice requirements; permitting the court to make a final decision in lieu of the creditors; or establishing one-time distribution as the norm, provided that additional dividends may be distributed on a discretionary basis. In the event that all creditors agree on the amounts and priorities of claims, together with the timing and method of distribution, the court may order distribution to be carried out on a consensual basis.

B. Reorganization

30. The design of a reorganization framework may be adapted and modified from part two, chapter IV of the Guide to promote MSME reorganization and could address:

(a) Early access to reorganization proceedings;

(b) Limiting costs and delays involved in reorganization; and

(c) Reducing requirements for creditor participation to address creditor passivity.

1. Early access

31. Given its preventive aim, reorganization should be available before MSME debtors become insolvent. As stated in the Guide (part two, chapter I, para. 46), the standard for commencing reorganization proceedings should be more flexible than the standard for commencing liquidation proceedings. The law may not require the MSME debtor to declare a state of insolvency when applying for reorganization, but permit commencement when there is a risk or likelihood of insolvency. This may be proved if, for example, the MSME debtor can demonstrate it is unable to overcome the economic, financial or legal difficulties it is facing.

32. There is, however, no consensus on whether MSME's viability should be a precondition for seeking reorganization. Some laws require the debtor to demonstrate that it is unable to pay debts that fall due without significantly hindering the continuation of its business, while others leave the assessment of viability to be made by creditors. To provide the court with an independent assessment of viability, the law may require the appointment of an insolvency representative or another person to investigate the debtor's affairs. In one jurisdiction, an individual self-employed debtor with no income and no assets is legally entitled to propose a "zero-plan" providing for no payments to his or her creditors (effectively a proposal to be discharged from all debts).[8]

33. The Guide (recommendation 139) addresses proposal of a reorganization plan on or after commencement of the insolvency proceeding, rather than as a first step. As the MSME debtor may not be in a position to draw up a feasible plan at an early stage, allowing proposal after commencement could facilitate early access to reorganization.[9] It may also give the debtor some "breathing space" to negotiate with creditors if a stay of enforcement actions comes into effect upon commencement.[10] These benefits are particularly significant for MSMEs, which are more susceptible to financial distress than larger businesses and less likely to recover from an extended period of financial distress once it occurs.

34. There are varying approaches to the role of creditors in the proposal of a plan, as noted in the Guide (part two, chapter IV, paras. 10, 11 and 13). These include giving the debtor an exclusive opportunity to propose a plan without the involvement of

[8] Germany: A/CN.9/WG.V/WP.147, para. 21.
[9] Legislative Guide, part two, chap. IV, para. 7.
[10] Ibid., part two, chap. II, para. 28.

creditors; giving the debtor a chance to propose a plan within a time limit, failing which the creditor(s) may propose a standalone plan; or permitting parties to propose competing plans at the same time. Other options may involve both the debtor and some or all of its creditors: the law may permit the debtor to propose a plan with the support of a creditor holding a certain proportion of the debt; or impose a duty on parties to cooperate in negotiating and proposing a plan.[11] The extent of creditor involvement at the proposal stage is closely linked to the procedure for approval of the proposed plan by the creditors or the court (see para. 47 below). In addition, it may be helpful to shorten the time period for MSME debtors to propose a plan, since they tend to have less complicated operations and financial arrangements

2. Debtor-in-possession

35. Recommendation 112 of the Guide notes that different approaches may be taken to the debtor's continuing role in the business during reorganization.

36. The emerging trend favours debtor-in-possession with an emphasis on rehabilitation of MSMEs. The justifications include that MSME owners and managers often have private knowledge about the business as well as ongoing relationships with creditors, suppliers and customers; the value at stake can be insufficient to fund the appointment of an insolvency representative; and the risk of being displaced from the helm can creates a powerful disincentive for small, family-run businesses to seek timely intervention.

37. The benefits of a debtor-in-possession approach should be weighed against the potential hazards of irresponsible or fraudulent conduct by the debtor. That may be addressed by providing, in certain circumstances, for the court to appoint an insolvency representative or other person to supervise the debtor-in-possession. In one jurisdiction, the court appoints a supervisor to oversee the debtor-in-possession's management in almost all cases of MSMEs that are not stock companies (in those cases a trustee is mandatorily appointed), while in another, the law enables the court to appoint a custodian where the individual debtor or the debtor's representative(s) was responsible for misappropriation or concealment of property or poor management that caused the MSME's financial distress.

38. The confidence of creditors should also be considered. Where the law permits involuntary commencement, the debtor may be hostile to creditors and should not be allowed to frustrate the proceeding. In such a scenario, the court may appoint an insolvency representative to take on a supervisory role or even displace the 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) for a limited period of time. In considering these options, a balance may be needed between the incentives provided for the debtor to act in good faith while in control of the business and potential for abuse by creditors. Safeguards may include requiring the measure to be supported by a certain proportion of creditors. Other situations where debtor-in-possession may not be appropriate might include where the plan needs to be confirmed by the court by way of a cram-down on creditors (see para. 46 below).

3. Simplified plans

39. To meet the needs of MSMEs, basic forms and models may be provided as templates for designing a reorganization plan. Where an insolvency representative is appointed by the court, the plan should be prepared by the debtor with the insolvency representative's assistance.[12]

40. Provided the plan contains sufficient information to enable its viability to be assessed, the MSME debtor may not need to submit a disclosure statement[13] or

[11] Ibid., chap. IV, para. 8.
[12] OHADA: A/CN.9/WG.V/WP.147, paras. 29 and 30.
[13] United States of America: A/CN.9/WG.V/WP.147, para. 27; *C.f.* Legislative Guide, part two, chap. IV, recs. 141–143 and paras. 23–25.

financial information or audited documents.[14] The law may also permit an MSME debtor to use business and personal assets for the purposes of reorganization.

41. The parties affected by the plan will largely depend on the size and structure of MSME. 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, should be involved in the plan, as should family members or close friends who have given personal guarantees or provided their personal assets as security for the MSME's debts. The need to modify shareholder rights, which may be restricted in some jurisdictions, is generally reduced in the case of MSMEs, since they may be unincorporated or, though incorporated, may be conducted through sole owners or as family businesses.

42. However, not all creditors will take an active role in ensuring their claims are included in the plan. To overcome passivity, the law may include a presumption of accuracy of the claims in the debtor's plan. For instance, one regime for rehabilitation of individuals requires the debtor to submit a list of claims to the court at the time of commencement; any claims not included are not subject to the proceeding. The burden is upon creditors to verify correct reflection of their claims and to raise objections within a stipulated time period. In the absence of timely objection, creditors are deemed to have waived their right to object, and the claims listed by the debtor will be confirmed with final and conclusive effect. Thus, deemed waiver raises the costs of creditor non-participation. Alternatively, if the law requires creditors to submit their claims, it can make participation easier by dispensing with submission of supporting evidence of the claims, unless specifically requested by the debtor, the insolvency representative (if appointed) or the court.

4. Quick approval

43. The Guide discusses (recommendations 145–154; part two, chapter IV, paras. 26–65) the process of voting on, approval or confirmation of, and challenges to a plan. Not all considerations involved in those steps will be applicable to the reorganization of MSMEs and the entire process could be simplified and shortened.

44. Requirements for the approval of the plan by creditors may be relaxed by eliminating the need for a creditor committee;[15] reducing the quorum required for a creditor meeting; dispensing with the need to convene a creditor meeting if adequate information has been provided by the debtor;[16] accepting a creditor's written consent to a plan without the need to attend a creditor meeting; permitting creditors to approve a plan by written resolution; permitting informal agreement to replace a formal voting process; or lowering the approval threshold of the plan.

45. Nonetheless, creditor apathy in MSME cases can make creditor approval difficult to obtain or a "majority" vote may reflect the decision of a random majority if most creditors did not participate. To incentivize creditor participation, a few systems rely on deemed approval, which interprets a lack of creditor opposition as implicit acceptance of the plan, rather than excluding those creditors from the quorum.[17] In other words, the plan may be approved by the actual and deemed votes of all creditors.

46. Where a plan has been approved by the requisite majority of creditors, the law may provide that the plan takes effect automatically, or require court confirmation before it becomes effective and binding upon all relevant parties. A middle ground is to require court confirmation in limited circumstances, such as where the plan affects the interests of dissenting parties. While there may not be many MSME cases in which a plan is actively opposed, the law may permit a cram-down mechanism for the court

[14] OHADA: A/CN.9/WG.V/WP.147, paras. 29 and 30.
[15] Argentina: A/CN.9/WG.V/WP.147, para. 18; United States: A/CN.9/WG.V/WP.147, para. 27. *C.f.* Legislative Guide, part two, chap. IV, rec. 129.
[16] United States: A/CN.9/WG.V/WP.147, para. 27. *C.f.* Legislative Guide, ibid., rec. 128.
[17] Germany: A/CN.9/WG.V/WP.147, para. 21.

to bind dissenting creditors to the plan, subject to certain safeguards[18] (see paras. 48–55 below). The law may also permit the court to take a more proactive role in facilitating the cram-down; in at least one civil law regime, the court may approve the plan by modifying its terms to protect the rights of dissenting creditors.

47. The need for creditors to vote on a plan may be replaced with court approval.[19] However, consistent with recommendation 137 of the Guide, affected creditors should be entitled to be heard if they wish to object to the plan. In one reorganization regime for individual debtors, unsecured creditors have the opportunity to be heard, but are not required to vote on a payment plan, and the plan becomes effective following court approval. Because both debtors and creditors that are MSMEs may not be well informed about the reorganization process and may have limited or no access to advice, the court may be the best placed decision-maker.

5. Conditions for approval

48. Recommendation 152 of the Guide sets out certain conditions to be satisfied before the court can approve or confirm a plan. Those conditions may apply whenever the court reviews a plan, or only in limited instances, such as a cram-down on dissenting creditors or a challenge to an approved plan.[20]

49. To discourage frivolous complaints and minimize delays in MSME reorganization, some laws have narrowed the scope for objections to be made on procedural grounds and the court can authorize a plan that does not strictly satisfy those grounds. For instance, the court may approve or confirm a plan, notwithstanding an objection that the approval process was not properly conducted or that the plan contains a provision contrary to law, by taking into account the extent of the irregularity in the process or the plan, the state of the MSME debtor, or other circumstances.

50. Other conditions serve to protect the interests of creditors, including that they should receive at least as much under the plan as they would have received in liquidation, unless specifically agreeing to lesser treatment (the best interest test).[21] While that test can be applied to MSME cases, the law could permit the court to determine the outcome of an alternative liquidation scenario without the involvement of expert opinion.

51. As an alternative, a more general test of fairness could be considered to simplify the reorganization proceeding and remove any need for the court to evaluate and compare alternative scenarios. Instead, the court assesses whether the interests of all creditors are sufficiently protected under the plan, such as whether the minority creditors were fairly represented at the meeting, whether the majority creditors acted in good faith, and whether the plan would be approved by a reasonable and honest person who was affected. At the same time, the court should not have to examine the substance of the commercial terms to which the majority creditors have agreed.[22] Such a test may be suitable for MSME cases, provided it can be applied with certainty.

52. Application of the absolute priority rule may need to be considered in MSME reorganization.[23]

53. The strict application of the rule may hinder implementation of the plan. Because the aim is to rescue the MSME debtor, the plan may provide for payment to creditors over several months or even years, using both current assets and future income. If senior creditors must be paid in full ahead of junior creditors, the debtor's

[18] Legislative Guide, part two, chap. IV, paras. 54–55.
[19] *C.f.* ibid., recs. 127, 145.
[20] Ibid., recs. 151, 153.
[21] Ibid., rec. 152(b).
[22] Ibid., para. 63.
[23] On the priority of tax claims, see ibid. chap. V, paras. 69 and 74; see also para. 72 below. On the special treatment of claims by related persons, see ibid., chap. V, paras. 48 and 77 and chap. IV, rec. 152(e); see also paras. 82–84 below.

assets may be exhausted all at once, before there is even a chance of rescue. It may thus be desirable for junior creditors to be paid before senior creditors are paid in full, provided the plan observes the relative priority between the creditors. That may create more flexibility for the parties and the court, particularly where a cram-down is needed to give effect to the plan.

54. Second, the absolute priority rule renders creditors that are MSMEs (MSME creditors) especially vulnerable since, as noted above, they may require payment during the reorganization in order to continue trading. That could, in turn, jeopardize the plan where the successful reorganization of the MSME debtor depends on the survival of those creditors as its transaction partners. The law can recognize the vulnerable status of MSME creditors by placing them in a class separate from other unsecured creditors. Where the law permits court approval by way of a cram-down, that class of MSME creditors may be exempted from the cram-down. Alternatively, the law may carve out specific exceptions to the absolute priority rule by granting priority, in limited circumstances, to those creditors' claims, for instance, for goods supplied to the debtor within a specified time period before commencement of the reorganization proceeding. The law may also give the court discretion, on a case-by-case basis, to order preferential payment of MSME creditors' claims, such as where necessary for continuation of those creditors' businesses. Another approach excludes MSME creditors' claims from the plan.

55. Third, the absolute priority rule may create a disincentive for owner/managers of incorporated MSMEs to seek reorganization, because they risk losing their ownership of the business to creditors with higher priority. Consistent with the debtor-in-possession approach, MSME owners should usually be allowed to continue running the business without surrendering their ownership interests under the plan. At the same time, the law may stipulate that the plan should not allow payments to MSME owners as long as there are payments outstanding to creditors, thus respecting the priority of creditors ahead of shareholders. The court would need to assess the funds required for the MSME's survival and the disposable income available for payment. However, a wholly discretionary approach may lead to inconsistent outcomes in practice. A different approach may be a bright-line standard. For example, to protect creditors in the absence of absolute priority, the law may permit the plan to be approved or confirmed only if it provides a minimum level of payment to creditors over a certain time period. Alternatively, the law could establish a minimum standard of protected income for MSME.

6. Expedited proceedings

56. As discussed in the Guide (recommendations 160–168 and part two, chapter IV, paras. 76–94), expedited reorganization proceedings may be used to give effect to an informally negotiated plan at greater speed and lower cost.

57. The documentary requirements for commencement would differ from those applicable to full reorganization proceedings. In addition to submitting the negotiated plan, the MSME debtor would need to demonstrate the plan has received the requisite support by providing the written consent of the affected creditors or, where a creditor meeting has been held, a report of the creditors' votes.[24] As to disclosure requirements, (see para. 40 above), the same approach as taken in simplified proceedings should apply in expedited proceedings.[25]

58. The law may also reduce court supervision and waive certain requirements leading to the approval of the plan. Claims included in the plan may be admitted without examining proof of those claims;[26] the plan may be referred to an immediate creditor meeting or court hearing (as the case may be);[27] or the court may directly confirm the plan with final and binding effect. Once the plan is confirmed by

[24] Ibid., part two, chap. IV, rec. 162(d).
[25] *C.f.* Ibid., recs. 162(a) and (e).
[26] *C.f.* Ibid., recs. 165(b)-(c).
[27] Ibid., rec. 164(d).

the court, affected creditors would be bound in the same manner as in full reorganization proceedings.

7. Appeals

59. The possibility of an appeal against a court decision (e.g., on the confirmation or approval of a plan) will be influenced by concerns about certainty, delay and costs. Some jurisdictions do not necessarily provide a right of appeal, whereas other jurisdictions permit an appeal, but it does not have the effect of suspending implementation of the plan. The latter can be crucial for MSMEs, since the success of the plan will often depend greatly on prompt implementation. Any risk of irrecoverable loss caused by implementation of the plan may be balanced by the provision of security or other provisional measures.

60. Should the appeal succeed after the plan is implemented, however, setting aside or unravelling the plan may cause more harm than good to all parties involved. As an alternative, the court may be authorized to order the debtor to pay monetary compensation to dissenting creditors or creditors who voted in favour of the plan.

8. Conversion to liquidation

61. Recommendation 158 of the Guide states that the law should permit the court to convert reorganization to liquidation proceedings on five grounds.

62. In the event that full reorganization proceedings are unsuccessful due to grounds (a)–(d), it may be appropriate for the law to allow automatic conversion to liquidation proceedings, avoiding the delay and expense of a separate application by either the MSME debtor or creditors. However, as noted in the Guide (recommendation 168 and part two, chapter IV, para. 91), conversion may not be appropriate where MSME commenced expedited reorganization proceedings to address financial difficulties at an early stage, but was not necessarily eligible for liquidation proceedings.

63. The possibility of allowing a creditor to pre-emptively apply for conversion, on the ground that the debtor's plan is doomed to fail, may also be considered.

64. There may be other circumstances which could affect the debtor's ability to implement the plan. One State provides that, if an individual debtor has paid at least 75 per cent of their debts according to the plan and it becomes difficult to continue payment for reasons beyond the debtor's control, the court may grant a "hardship discharge".

C. Discharge

65. Discharge is another core element of MSME insolvency. As noted in the Guide (part two, chapter VI, para. 1), several States have recognized the need to focus on facilitating a fresh start for insolvent debtors after resolving their financial difficulties and reducing the stigma associated with business failure.

66. Recommendations 194 to 196 of the Guide concern discharge where the debtor is a natural person. These recommendations are generally applicable to MSMEs conducted through natural persons, whether as sole proprietors or in a group, such as a partnership, association or other unincorporated entity, which exposes them to personal liability for unpaid debts. As for MSMEs conducted through companies and other legal entities with limited liability, the owners and managers of the liquidated entity will not be personally liable for unsatisfied claims per se.[28] Nonetheless, many of these individuals may have incurred personal debts for their business activities by taking personal loans to start and run the business or may have guaranteed business loans with personal assets. In such cases, the question of discharge arises as a result of the mixing of business and personal debts.

[28] Ibid., chap. VI, para. 3.

1. Quick discharge

67. The most debtor-friendly approach is to permit a full discharge (or "straight" discharge) of debt immediately following distribution in liquidation. This is offered in some legal systems and grants complete debt relief to the debtor without requiring a payment plan. For example, the law may provide for an immediate discharge following a brief evaluation and possible liquidation of the debtor's assets or if the court determines the debtor's circumstances make it clear no distribution to creditors can reasonably be expected.

68. The need to balance the interests of the debtor and creditors has led many insolvency regimes to stipulate a period of time that must elapse before an honest and cooperative debtor can obtain a full discharge. This approach can be combined with a reorganization plan, which ensures that the discharge is conditional on partial repayment or, at least, on good faith efforts to make repayment. The starting point of the discharge period may differ; it may be pegged to the commencement of the liquidation proceeding, to conversion of a reorganization into a liquidation (see paras. 61–64 above) or, where there is a reorganization plan, to the court's approval of the plan or to its commencement or completion date. The length of the discharge period varies from jurisdiction to jurisdiction, but the emerging trend is to shorten the discharge period to encourage entrepreneurial activities and reduce stigma.

69. Where the discharge is conditional on partial repayment, the law may ensure the repayment obligation is not overly onerous by requiring, for example, that the repayment obligation is based on each debtor's situation and is proportionate to disposable income over the discharge period. Another approach is to establish a sliding scale which calibrates the length of the discharge period according to the rate of return to creditors; the more the debtor is able to pay, the sooner they will obtain a discharge. The law may also provide for exceptional circumstances in which a debtor may apply to the court for a discharge (see para. 64 above).

70. In terms of procedure, discharge may take place either automatically or upon application to the court. The former is more expeditious, eliminating the need for judicial intervention. The latter may be required if automatic discharge is unconstitutional or if some judicial supervision is preferred. Following discharge, claims that have not been satisfied would be rendered unenforceable.

71. The benefits of a quick discharge are more pronounced in the context of MSME insolvency, particularly where the debtor is towards the "micro" end of the spectrum. Due to MSMEs' limited resources, creditors often do not expect to receive substantial returns and may have written off the claims long before the expiry of the discharge period. At the same time, a shorter discharge period incentivizes the debtor to seek timely commencement of the insolvency proceeding and to comply with obligations to creditors as far as possible in order to obtain an early discharge.

2. Scope of discharge

72. The effectiveness of a discharge regime in achieving the debtor's rehabilitation depends on the scope of debts covered by the discharge. Certain types of debt, such as debts based on tort claims, maintenance obligations, fraud, criminal penalties, and taxes, tend to be excluded from discharge.[29] Some countries, however, have eliminated special treatment for taxes and other public revenue claims, which are often among the largest debts of small business owners. This is in line with recommendation 195 of the Guide, which states that the exclusion of debts from a discharge should be kept to a minimum in order to facilitate a fresh start.

73. Given the likelihood that business and personal debts are intertwined, it may be burdensome for an MSME debtor to apply for separate procedures to discharge all debts, especially if they have different criteria and discharge periods. As noted above (see para. 13), it is desirable that both types of debt can be dealt with in a single

[29] Ibid., chap. VI, para. 7.

discharge regime or, at least, that separate proceedings may be consolidated. It may also be possible to consider a reduction of the debtor's personal guarantee as a de facto discharge, without necessarily declaring the debtor bankrupt, so as to facilitate the debtor's fresh start.

3. Conditions for discharge

74. To provide safeguards against abuse, the insolvency law can regulate the availability of a discharge or the length of a discharge period in specific circumstances, although such conditions should be kept to a minimum, as stated in the Guide (recommendation 196). In addition, a key feature of the MSME-specific approach is a presumption of honesty. This grants the debtor the benefit of a discharge unless they are proven to have acted fraudulently or in bad faith. The experience of some jurisdictions with debtor-friendly discharge regimes shows that it does not result in a rise in unpaid claims or widespread misuse of discharge options by debtors.

75. A discharge of debt may be accompanied by disqualification, which precludes the debtor from starting or carrying on a business, practising in a profession, or acting as a company director or manager. The disqualification period may be long or even indefinite or may be linked to the discharge period. Disqualification could occur automatically or upon a court order, and may be subject to carve-outs to prevent abuse. The disqualification period may be extended in exceptional situations if the debtor's conduct justifies such a sanction, such as where the debtor was guilty of criminal misconduct or otherwise ordered to be disqualified by a court in criminal proceedings.[30] For sole traders or entrepreneurs who manage their own businesses or who entered into insolvency after giving personal guarantees, a blanket disqualification may be inappropriate, since it would effectively prohibit them from being involved in future enterprises, defeating the concept of a fresh start.

76. Restrictions on obtaining new credit can also have a major impact on the debtor's ability to start afresh, particularly if the impact lasts long after the debtor's discharge. In many countries, borrowers are required to disclose whether they are or have been subject to insolvency, which can lower their credit scores or be reflected as negative entries in their credit histories, leading to discrimination against former debtors. To mitigate this, restrictions on borrowing should be imposed carefully and the period of such restrictions reduced. Such measures can be coupled with efforts beyond the formal insolvency framework, such as out-of-court restructuring with financial institutions, to provide individual debtors with the benefits of discharge without affecting their personal credit scores or the use of data protection laws to regulate the collection and retention of personal information by credit providers or bureaux.

D. Related persons and third party guarantors

77. Third parties related to the natural person conducting MSME, such as family members or close friends, can be drawn into the MSME's insolvency because they have taken on personal loans, given personal guarantees or provided their property as collateral security for business loans.[31] Since the involvement of related persons tends to be more ubiquitous in MSMEs than in larger enterprises, their position under insolvency law merits consideration in greater detail.

78. In addition, competing policies have to be weighed in the treatment of third party guarantors in MSME cases. On one hand, the purpose of requiring a personal guarantee or security is precisely to hedge against the principal debtor's insolvency by ensuring the creditor will get paid. Adjusting the guarantor's liability in the insolvency proceeding would reduce the protection for the creditor. This could, in the

[30] Ibid., para. 9.

[31] Ibid., Introd., see subpara. 12(jj): for the definition of a "related person". On levels of connection to the debtor see part two, chap. II, para. 183.

long run, restrict access to credit for MSMEs, many of which may not be able to obtain financing in other ways. On the other hand, where the MSME's insolvency implicates family members or household assets, allowing unrestricted enforcement of guarantees could leave an entire family destitute.

79. Several aspects of the Guide deal with related persons, recommending that the law should specify the categories of persons with sufficient connection to the debtor to be treated as related persons;[32] any proposed disposal of an asset to a related person should be carefully scrutinized before being allowed to proceed;[33] the suspect period for avoidable transactions involving related persons may be longer than for transactions with unrelated persons;[34] related persons may not be eligible for appointment to a creditor committee;[35] claims by related persons should be subject to scrutiny and, where justified: (a) the voting rights of the related person may be restricted; (b) the amount of the claim of the related person may be reduced; or (c) the claim may be subordinated;[36] and the related persons whose claims have been denied or subjected to such treatment should be permitted to request the court to review their claims.[37] The Guide does not address third party guarantors, apart from noting that the discharge of a natural person debtor generally does not affect the liability of the guarantor.[38]

80. One issue for consideration is whether the law should permit a court to extend the reach of a stay (Guide, part two, chapter II, recommendation 46; paras. 30–34) to protect the guarantor of an MSME debtor. Staying enforcement against the guarantor, whose role is often crucial to the financing of MSME, can assist in the successful reorganization of the MSME debtor. It would extend the scope of the "breathing space" for a rational decision to be made collectively about the entirety of the MSME debtor's obligations and affairs.

81. Any extension of a stay to guarantors would, however, be an extraordinary departure from the usual approach in business insolvency cases and should be restricted to appropriate circumstances. For example, the benefit of a stay may be granted by the court on a case-by-case basis where it is deemed necessary to protect a related person guarantor that has provided a personal guarantee without receiving any consideration. Further, the stay of enforcement against guarantors may be limited to a short time period, following which creditors are free to take action. In any event, to protect the rights of creditors, the court may permit enforcement against guarantors who demonstrate bad faith or unfair conduct, such as by hiding property.

82. As to the treatment of claims by related persons, the Guide acknowledges (part two, chapter V, para. 48) that the mere fact of a special relationship with the debtor may not be sufficient in all cases to justify special treatment of a creditor's claim. In some cases, the claim will be entirely transparent and should be treated in the same manner as similar claims made by creditors who are not related persons. In other cases, the special relationship may give rise to doubts regarding whether the related person creditor will be impartial when voting on a reorganization plan or whether the debtor unfairly favoured the related person creditor over other creditors before the onset of insolvency. In one system, the claim of a related person who received a cash loan from the MSME debtor or became a guarantor for the MSME debtor may be subordinated to other claims in the plan.

83. Considerations of proportionality and potential hardship to the MSME debtor's guarantor may, however, justify giving the court discretion to favour the guarantor's claim when approving or confirming a reorganization plan, or permitting the guarantor to apply for an extended payment period to alleviate the guarantee

[32] Ibid., chap. II, rec. 91.
[33] Ibid., rec. 61.
[34] Ibid., rec. 90.
[35] Ibid., chap. III, rec. 131.
[36] Ibid., chap. V, rec. 184.
[37] Ibid., rec. 181.
[38] Ibid., chap. VI, para. 13.

obligation. Such measures may be appropriate where the guarantor has made great sacrifices to pay the debt and the other creditors are institutions. Similar considerations may support an exercise of discretion in favour of the guarantor's discharge.

84. The need to provide debt relief to related persons who face insolvency because they provided personal guarantees for the MSME business, especially in cases where a reduction or discharge of their obligations was not achieved through a reorganization plan, could be factored into the discharge regime. Although the guarantor can apply for relief separately, providing standing to apply for relief in the proceeding concerning the MSME debtor could be a more cost-efficient approach and more consistent with the aim of providing a fresh start to the MSME debtor, particularly if it mitigated the potentially undesirable consequences of enforcing the guarantee. One legal system permits natural persons and gratuitous sureties to petition for a discharge of the surety's obligation that is implicated in the principal's insolvency if that obligation is disproportionate to the surety's revenue and patrimony.

III. MSME issues not considered in the Guide

85. As noted above (para. 4), the Working Group's mandate includes, in addition to considering the applicability of the Guide to MSMEs, the development of new and simplified mechanisms for MSMEs as required. Document A/CN.9/WG.V/WP.121, paragraph 33 raises several issues not addressed in the Guide, such as personal insolvency, treatment of group debt, use of informal insolvency processes and debt adjustment mechanisms. The Working Group may wish to identify additional issues relevant to MSME insolvency that should be addressed in any work product to be developed.