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Insolvency of micro, small and medium-sized enterprises

Draft text on a simplified insolvency regime

Note by the Secretariat

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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) is provided in the provisional agenda of the fifty-fifth session of the Working Group (A/CN.9/WG.V/WP.164, paras. 8–11). This note sets out in chapter II a draft commentary and recommendations focusing on features of a simplified insolvency regime that may in particular be suitable to the insolvency of micro and small business debtors. It would be left to States to define conditions for access to such a simplified insolvency regime.

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

3. Pending the final decision on the form that a text on simplified insolvency regime should take (see A/CN.9/966, para. 117), the draft commentary and recommendations set out in this note were prepared, as a working assumption, as a supplement to the *UNCITRAL Legislative Guide on Insolvency Law* (i.e., its part five). Accordingly, the draft recommendations in this note were numbered sequentially after recommendation 270, the last recommendation in the draft text on obligations of directors of enterprise group companies in the period approaching insolvency (A/CN.9/990), which upon adoption by the Commission at its fifty-second session in 2019 will form an additional section of part four of the *Guide*. The glossary found in other parts of the *Guide* may need to be supplemented by an additional glossary of terms specific to a simplified insolvency regime.

4. Alternatively, it may be decided that a text on simplified insolvency regime should form part of an overarching document addressing legal aspects of MSMEs throughout their business lifecycle, starting with simplified incorporation and ending with simplified insolvency. In such case, the style and structure of a text on a simplified insolvency regime will be adjusted to the style and structure of such an overarching document.

II. Draft commentary and recommendations on a simplified insolvency regime

“Introduction

1. The *UNCITRAL Legislative Guide on Insolvency Law* (the “*Guide*”) focuses on insolvency proceedings commenced under the insolvency law and conducted in accordance with that law, against a debtor, whether a legal or natural person, that is engaged in economic activity. Informal insolvency processes, which are not regulated by the insolvency law and will generally involve voluntary negotiations between the debtor and some or all of its creditors, briefly introduced in part one, and discussed in more detail in the context of expedited reorganization proceedings in part two, of the *Guide*, are outside the scope of the legislative chapters of the *Guide*.

2. “Insolvency proceedings” covered by the *Guide* are collective proceedings, subject to court supervision. The term “court” is explained in the glossary of the *Guide* as a judicial or other authority competent to control or supervise insolvency proceedings. The *Guide* notes that alternatives to court supervision may be considered in designing the insolvency law, in particular where the capacity of the courts is limited (whether for reasons of lack of resources or lack of requisite experience). It invites States to consider whether the role of the courts can be limited with respect to

different parts of the proceedings or balanced by the role of other participants, such as the creditors and the insolvency representative.[1]

3. The *Guide* also presupposes, as a general rule, reliance on an insolvency representative throughout the insolvency proceedings. Unlike other UNCITRAL texts in the area of insolvency law, the term "insolvency representative" in the *Guide* is construed narrowly and does not encompass a debtor in possession. The debtor-in-possession approach is not addressed in detail in the *Guide*. The *Guide* notes that the debtor-in-possession approach depends upon strong corporate governance rules and institutional capacity and affects the design of a number of provisions of an insolvency regime, including preparation of the reorganization plan, exercise of avoidance powers, treatment of contracts and obtaining post-commencement finance.[2]

4. This document was prepared in recognition of the fact that in some cases the application of elements of the standard business insolvency processes described above, in particular the central role of the court and extensive involvement of an insolvency professional who replaces the debtor in the management of the insolvent business, may be less appropriate. That may in particular be the case in insolvency of individual entrepreneurs and micro and small businesses of an essentially individual or family nature with intermingled business and personal debts (collectively referred to in this document as "micro and small business debtors").[3] Such debtors may be discouraged by standard business insolvency processes because of their length, procedural inflexibility and costs, as well as the inherent risks of loss of control over the business. Micro and small business debtors might prefer less costly, faster and simpler proceedings and those that facilitate a fresh start through discharge and provide for confidentiality, which would, among other things, alleviate concerns over the social stigma of insolvency.

5. Efforts are being made at the international, regional and national levels to find solutions tailored to the needs of micro and small business debtors in insolvency, recognizing the impact of their insolvency on job preservation, the supply chain, entrepreneurship and the economic and social welfare of society. In particular, there is a growing recognition of the negative consequences of unresolved financial difficulties for micro and small business debtors that, burdened by old debt, may be discouraged from taking new risks or become trapped in a cycle of debt or driven to the informal sector of economy. Solutions are being sought to allow micro and small business debtors to remain in the labour market by preserving their know-how and skills and restarting entrepreneurial activity, drawing on lessons from the past.

Purpose

6. This document focuses on the features of a simplified insolvency regime, such as out-of-court procedures and fast-track in-court insolvency proceedings, so as to develop workable alternatives to standard business insolvency processes. The key insolvency principles and the general guidance provided in the *Guide* remain relevant in the context of simplified insolvency regimes. The substance of the *Guide* is therefore applicable to simplified insolvency regimes with some variations noted in this document.

7. This document recognizes that the positions of States with respect to both the desirability of developing a simplified insolvency regime and the conditions for access to that regime and its features vary greatly. Some commonly found features include a presumption of good faith, quick discharge, debtor-led and debtor-in-possession processes and appropriate safeguards against abuse of a simplified insolvency regime. Those safeguards may be contained in a range of options made

[1] The *UNCITRAL Legislative Guide on Insolvency Law*, Introduction, para.7, and part one, chap. III, Institutional framework.

[2] Ibid., part two, chap. III.A, para. 18.

[3] See A/CN.9/966, paras. 118–119 and 127.

available to parties in interest[4] for deployment when justified. Those options may include replacing a debtor in possession with an insolvency professional when dealing with an uncooperative debtor, converting one type of proceedings to another in order to accord an appropriate treatment to a viable as opposed to non-viable business and vice versa, refusing or imposing a longer period for discharge and applying different types of disqualification of various duration.

8. In some States a simplified insolvency regime may focus on reorganization, while in others it may focus on liquidation. Some States may create incentives for out-of-court debt restructuring negotiations, including procedures for quick court approval of agreements reached out-of-court while other States may favour putting in place specialized in-court proceedings for micro and small businesses debtors. Some States may favour a liberal approach to discharge while other States may be concerned about the effect of such approach on their economies. Constitutional, cultural, social and economic norms of the State as well as regional integration dynamics and "forum shopping" considerations, i.e., situations when micro and small business debtors would consider relocating their business to other jurisdictions to access more friendly regimes, will dictate policy choices on these matters.

9. In addition, approaches to developing a simplified insolvency regime may be different. In some jurisdictions, while there is a single insolvency framework applicable to all business enterprises, certain requirements of such a framework are not made applicable to insolvency of micro and small business debtors (such as those regarding the formation and functions of a creditor committee). In other jurisdictions, two separate insolvency regimes may exist: one for micro and small business debtors and the other for larger enterprises. Some States have enacted laws to deal with the insolvency of micro and small business debtors that include both consumers and micro and small businesses. Other States make available household insolvency provisions to micro unincorporated businesses without employees.

10. This document offers a range of tools, from purely contractual out-of-court debt restructuring negotiations to standard business insolvency proceedings, for use by States that may decide to include 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 is for policymakers in each jurisdiction to identify features of such a regime and eligible debtors that might not be served well by the standard business insolvency regime and would thus benefit from access to a simplified insolvency regime. Each cluster of issues includes cross-references to the applicable recommendations of the *Guide.* Additional recommendations specific to a simplified insolvency regime are offered where necessary.

Glossary

11. The following terms relate specifically to a simplified insolvency regime and should be read in conjunction with the terms and explanations included in the glossary of the *Guide*:

(a) [*to be completed at a later stage*];

[4] The *Guide* explains the term "party in interest" as referring, in addition to a debtor and a creditor, to the insolvency representative, an equity holder, a creditor committee, a government authority or any other person affected by insolvency proceedings, excluding persons with remote or diffuse interests affected by those proceedings. (See Introduction, Glossary, 12 (dd)).

I. Background

A. Reasons for establishing a simplified insolvency regime

12. The establishment of a simplified insolvency regime for micro and small business debtors is usually justified because of (a) the specific characteristics of micro and small business debtors, and (b) features of the existing insolvency regimes (business, consumer and personal) that are not suitable to accommodate those characteristics.

1. Specific characteristics of debtors intended to be covered by a simplified insolvency regime

13. Micro and small business debtors tend to be relatively undiversified as regards creditor, supply and client base. As a result, they often face the cash flow problems and higher default risks that follow from the loss of a significant business partner or from late payments by their clients. Micro and small business debtors themselves could be the clients of other micro or small businesses that would share the same characteristics and may heavily depend on payments from their clients, with the consequence that one business failure may cause additional business failures in the supply chain (see further chap. VII, sect. A, below).[5]

14. Micro and small business debtors 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. Excessive collateral requirements in comparison to the amount of the loan (referred to as "over-collateralisation") are often imposed because of the asymmetry of bargaining power and the lack of financial information about micro and small businesses making the assessment of business risks more difficult.

15. Access to credit by micro and small business debtors is often made subject to the granting of personal guarantees by the owners or their relatives and friends whose personal assets could be of equal or greater value than that of the micro and small business. A personal guarantee will typically extend liability for the debts of the micro and small business to those individuals, affecting both personal effects (such as the family home) and business assets. Owners thus frequently provide not just equity, but also debt funding. It is also not unusual for owners to use personal assets for business purposes with the result that it is often difficult to separate business from personal assets.

16. Any physical assets of micro and small businesses, which may be the main or the only assets of the value to creditors, may already be encumbered to one or a very limited number of secured creditors, e.g., a bank holding a mortgage on the residential property or other physical assets of the debtor. Those secured creditors are usually able and willing to use enforcement methods available to them under law; hold-outs by such secured creditors in a position of influence are thus common in the context of negotiating a solution to financial difficulties of the micro and small business debtors.

17. Unencumbered assets are usually of little or no value for distribution to unsecured creditors. Those creditors may not be interested in participating in the insolvency proceedings because the costs of participating may outweigh the return. This may jeopardise reorganization of micro and small business debtors, leaving liquidation as the only option.

18. Micro and small business debtors often have poor or non-existent records in respect of transactions and relationships between owners, family members, friends and other individuals involved in the operation and financing of the business. There may be no clearly established ownership of key commercial assets (such as tools or

[5] A/CN.9/966, para. 143(a).

other essential equipment), work for the micro and small business may not be documented or remunerated in accordance with typical commercial practices and the owner may use their own finances to fund or support the business without necessarily documenting that expenditure.

19. Micro and small business debtors are also characterized by a centralized governance model in which ownership, control and management overlap (often within a family). 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. The management may be unwilling to request the commencement of insolvency proceedings at the risk of losing control over the business. Micro and small business debtors 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 to the micro and small business debtors addressing financial difficulties too late when liquidation of the business might be the only solution left.

2. Unsuitability of the existing insolvency regimes (business, consumer and personal) for micro and small business debtors

20. In most cases, micro and small business debtors would be looking for fast and simple debt forgiveness, debt restructuring and debt repayment options or liquidation and discharge, which existing insolvency regimes (business, consumer and personal) may not provide.

21. Few existing insolvency regimes have been designed with the needs of micro and small business debtors in mind. [6] Most standard business insolvency regimes reflect the complexity and sophistication of larger companies. They assume that the business liabilities and debts of a company debtor are clearly separated from the personal liabilities of the company’s owners and managers, whereas even in incorporated micro and small businesses with limited liability, shareholders, managers or family members of such persons are often personally liable for company’s debts because they have given personal guarantees for the loans of the company, as stated in paragraph 15 above.

22. Micro and small business debtors that do not have a corporate form or are sole proprietorships may not enjoy legal personality or limited liability protection in most jurisdictions. They may be in a similar situation as artisans, craftsmen, traders or farmers who earn living by providing services to a small number of different clients. Electronic commerce has indeed transformed many providers of low-skill services from employees into self-employed service-providers. Natural persons who engage in small scale business activity in their own name or in a partnership in which the partners have personal liability for the debts of partnership may be treated in the case of business insolvency as individual defaulters and as such 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 a discharge is available, 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.

23. In some jurisdictions, consumer insolvency laws may address insolvency of unincorporated micro and small business debtors [7] but those laws may treat the business aspects of the distress inadequately.

24. Standard business insolvency regimes may also assume the presence of an extensive estate of significant value and the active engagement of interested stakeholders, particularly creditors, which is usually not the case in the micro and

[6] A/CN.9/966, para. 143(b).

[7] In some countries, the consumer bankruptcy provisions apply to individual entrepreneurs whose business debts comprise 50 per cent or more of their total debts.

small business debtor context, as noted in paragraphs 16 and 17 above. In addition, standard business insolvency regimes usually presuppose the active involvement of courts, the engagement of an insolvency representative for administration of the insolvency estate, various filing requirements, including to file audited balance sheets, and rigid procedural steps for liquidation or reorganization. They may be too complex, lengthy and expensive for micro and small business debtors, which are characterized by low value, low sophistication and low complexity and often have insufficient or no assets to cover the costs of standard business insolvency proceedings. Micro and small business debtors may fail to meet commencement standards under those insolvency laws that would require the court to refuse commencement of proceedings, or terminate proceedings that may have commenced, in insufficient or no-asset cases.

25. Even where sufficient assets exist, the involvement of professionals and the automatic separation of owners and management from the ordinary administration of business may operate as a disincentive to apply for insolvency. Many micro and small business debtors may also have difficulties collecting and distributing relevant information because of inefficient or non-existent record keeping systems (see para. 18 above), whether due to a lack of resources, of formal obligations to maintain such records or of an understanding of any need for them. The uncertainty of costs generated by the insolvency process may also deter micro and small business debtors from applying for insolvency. Where a single disputed or unpaid claim is involved, most provisions of insolvency law devised to ensure protection of different categories of creditors and different classes of claims would be inapplicable (see further para. 92 below).

B. Key objectives of a simplified insolvency regime

26. A significant number of micro and small business debtors avoid seeking relief or may seek relief far too late, for reasons discussed in section A above. Overarching goals of a simplified insolvency system would thus be: (a) to put in place an expeditious, simple and low cost insolvency regime capable of providing quick relief and a fresh start to deserving debtors while deterring re-entry into the market of dishonest or incompetent entrepreneurs; (b) to encourage, facilitate and incentivize early access to such a regime by micro and small business debtors; and (c) to reduce the social stigma and personal risks of individuals who create businesses.

27. Those objectives are pursued in particular by minimizing the complexity of insolvency procedures and the associated costs, providing for fast-track procedures, favouring a debtor-in-possession approach and presumption of good faith and creating conditions for an early rescue, including out-of-court, of viable businesses, and a quick exit of non-viable businesses. The social stigma of insolvency is addressed through exceptions to public disclosure of insolvency-related information (although these measures raise sensitive policy issues), identification of appropriate commencement standards [8] and reduction of the number of restrictions, disqualifications and prohibitions imposed on a discharged debtor.

28. At the same time, simplified insolvency regimes usually include safeguards against abuse, fraud and irresponsible behaviour. One of the commonly found safeguards is to restrict 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.

29. The *Guide* addresses 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 will be applicable in the simplified insolvency context. In addition, each cluster of recommendations in the *Guide* is

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[8] A/CN.9/966, para. 131.

preceded by the statement of the purpose of those recommendations. To the extent that those recommendations are applicable to the simplified insolvency regime, the stated purposes will be equally applicable. For example, the *Guide* states that the purpose of provisions on commencement of insolvency proceedings (recs. 14–29) is to facilitate access for debtors and creditors to the remedies provided by the law and to establish safeguards to protect both debtors and creditors from improper use of the application procedure. It may therefore be considered that the overarching goals of a simplified insolvency system described in paragraph 26 above are already reflected in the key objectives and the stated purposes of the *Guide*. There may however be a need for some simplification of means to achieve those key objectives and stated purposes as well as for some supplemental provisions.[9] Hence the following additional recommendation may be considered:

Recommendation

271. In addition to recommendations 1–7 of this *Guide* and stated purposes of other applicable recommendations, the following considerations should be taken into account in designing a simplified insolvency regime:

(a) To establish expeditious, simple and low-cost procedures to address financial difficulties of micro and small business debtors;

(b) To encourage, facilitate and incentivize early access by micro and small business debtors to those procedures;

(c) To establish appropriate criteria for access by micro and small business debtors to those procedures;

(d) To devise measures aimed at reducing the social stigma associated with business failure and the personal risk of individuals who create businesses; and

(e) To establish favourable conditions for early discharge and a fresh start.

II. Mechanisms for resolving micro and small business debtors' financial difficulties

A. Out-of-court debt restructuring negotiations

1. General characteristics

30. Out-of-court debt restructuring negotiations are held between the debtor and its creditors without any involvement of the court. Some such negotiations may be based or reliant upon the provisions of the insolvency law that may require debtors and their creditors to exhaust out-of-court debt restructuring negotiations before initiating in-court insolvency proceedings (see para. 72 below). The insolvency law may provide for an institutionalized debt negotiation and settlement framework. In some jurisdictions, there may 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 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.

31. Requirements for creditor's participation in out-of-court debt restructuring negotiations may be built in other law, for example monthly targets may be imposed on banks to successfully restructure debts of micro and small business debtors, and tax and social security authorities may be required to participate in the negotiations. Sanctions may be imposed on parties acting in bad faith during those negotiations.

[9] A/CN.9/966, paras. 120–124.

32. Some jurisdictions allow debtors to proceed directly into the formal court-based insolvency system if they fulfil entry requirements. Recourse to out-of-court debt restructuring negotiations remain an option for parties to consider, and incentives are built to use them, in particular tax incentives for banks to hold voluntary debt restructuring negotiations with micro and small business debtors in financial difficulties (e.g., tax write-offs for bad or renegotiated debts). In-court insolvency proceedings are in turn made simpler for micro and small business debtors.

33. In yet other jurisdictions, the insolvency law does not provide for out-of-court debt restructuring negotiations leaving voluntary negotiations to contract law, company or commercial law or civil procedure law, or in some cases relevant banking regulations. Some jurisdictions do not allow debt restructuring agreements or arrangements to occur outside the court system or the insolvency law. Some laws would regard the steps associated with any voluntary debt restructuring negotiations as sufficient for the courts to make a declaration of insolvency.

2. Usual steps in out-of-court debt restructuring negotiations

34. The out-of-court debt restructuring negotiations may be initiated by either the debtor or its creditor(s). No eligibility or commencement standards, usually found in the context of formal insolvency proceedings, apply.

35. The negotiations usually proceed on a voluntary, confidential and consensual basis. Proposals that the debtor may make to its creditors for a rescue of business 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 decrease 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.

36. The debtor remains in possession and control of its business and is expected to pay its debts when they become due to all creditors that are not participating in the negotiations. A stay on creditor enforcement actions is often essential for a successful out-of-court workout.

37. Some laws may provide for an automatic statutory stay for the duration of the negotiations to allow 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 the suspension, termination or modification of its rights under existing contracts with the debtor. Such a stay also suspends the obligation to file for insolvency.

38. In the absence of a statutory stay, the debtor and the creditors may negotiate a standstill agreement. A contract-based standstill has an advantage of avoiding the publicity usually associated with a formal statutory stay. Confidentiality agreements may be part of the standstill agreement or negotiated separately.

39. Under a standstill agreement, the 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. In the absence of court involvement, terms of the agreement, including the duration of the standstill period and conditions for its possible extension, are negotiated by parties under contract law.

40. 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.

41. 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.

42. 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 the 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.

43. 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 micro and small business 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 micro and small business debtor's assets will be given. Provisions of insolvency law on priority for post-commencement financing[10] may not necessarily extend to those arrangements. It would depend on provisions of insolvency law whether agreements related to creditor priority reached in the out-of-court procedures will be valid and apply in the event of a subsequent conversion of the out-of-court procedures to formal insolvency proceedings (e.g., to liquidation if the out-of-court workout attempts fail). (See further chaps. IV and VII.C below.)

44. Plans negotiated out-of-court are usually binding if approved by all affected creditors. 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.

45. The parties may choose to seek confirmation of the plan in the court or such confirmation may be required by law for any debt restructuring arrangements between the debtor and the creditors to become effective. In addition, the court may become involved if any aggrieved party in interest challenges the plan in the court. Expedited proceedings discussed in chapter III, section C, below may apply to the court confirmation of the plan negotiated out-of-court. The approval of the plan by a majority of affected creditors may be sufficient for the court to confirm the plan. Initiation of in-court plan confirmation proceedings might mean the loss of confidentiality – considered to be one of the main advantages of out-of-court procedures (see para. 47 below) – 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.

46. The enforcement of the plan agreed upon by affected parties in out-of-court procedures 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

[10] See the *UNCITRAL Legislative Guide on Insolvency Law*, part two, chap. II.D, paras. 94–107 and recs. 63–68.

of awards or settlement agreements would be subject to the rules applicable to those commercial dispute resolution mechanisms.

3. Factors that contribute to the success of out-of-court debt restructuring negotiations

47. Unlike in-court insolvency proceedings that involve all creditors and are public, out-of-court 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 court-supervised proceedings, and allow parties to preserve confidentiality, which helps to avoid the social stigma attached to insolvency. [11] 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. At the same time, because out-of-court debt restructuring negotiations are held without court supervision 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 court 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.

48. Experience with out-of-court debt restructuring negotiations suggests that the success of the negotiations often depends on a number of factors. In particular, those negotiations often succeed where debtors are experiencing mild or temporary financial difficulties rather than severe insolvency. The involvement of an effective intermediary (a central bank or a central debt-counselling agency) that can persuade parties that participation in debt restructuring negotiations is in their best interests may also be necessary. Such an intermediary may offer professional, low-cost or cost-free impartial assistance with debt restructuring negotiations, facilitate debt restructuring through its existing arrangements with such key institutional creditors as tax authorities and banks, and provide supervision to prevent abuses. Furthermore, out-of-court debt restructuring negotiations have proved to be efficient when they include features of in-court processes, such as a stay to stop enforcement of claims and filing for insolvency while the negotiations are ongoing and procedures to make the plan binding on the dissenting minority and on all creditors who have been notified and did not object.

49. It is for policymakers to decide whether their insolvency regime should be devised in a way that would encourage parties to avoid filing for formal insolvency proceedings by commencing out-of-court debt restructuring negotiations. A policy decision to promote out-of-court debt restructuring would need to be underpinned by a number of actions, including amendments of existing legislation to ensure that no legal obstacles for out-of-court 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 out-of-court 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.

50. In addition, the law concerning third party guarantees may disincentive creditors to settle with debtors; tax relief may be available to parties only when debt restructuring takes place in formal court-supervised 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

[11] A/CN.9/966, para. 131.

from debt write-offs but impose income tax on debtors whose debts are written off. In addition, 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 out-of-court debt restructuring negotiations (see para. 33 above). While certain jurisdictions provide for a statutory stay that suspends that obligation as well as enforcement of creditors' claims during out-of-court debt restricting negotiations (see para. 37 above), in many jurisdictions a statutory stay may only be available in the context of a formal insolvency process.

51. As noted in paragraph 1 above, the *Guide* does not address out-of-court debt restructuring negotiations in detail. Hence the following additional recommendations may be considered:

Recommendations

272. Where the early rescue of micro and small business debtors is to be encouraged, the law relating to insolvency should remove disincentives for the use of preventive out-of-court debt restructuring negotiations and facilitate the participation of all creditors, including public authorities, in those negotiations on equitable terms. The following measures may contribute to the success of out-of-court debt restructuring negotiations:

(a) Government support in the form of an agency that takes the lead in facilitating negotiations between creditors and debtors and between creditors;

(b) Mediation and arbitration for resolution of debtor-creditor and inter-creditor disputes;

(c) Allowing parties to preserve confidentiality of out-of-court debt restructuring negotiations; [12] and

(d) Allowing parties to accord priority status to interim finance subject to appropriate safeguards (see rec. 285 and the accompanying commentary below).

273. Where alternatives to formal in-court insolvency proceedings for micro and small business debtors are made available, the insolvency law should stipulate conditions for their use and specify whether they should be exhausted before commencement of in-court proceedings.[13]

B. In-court simplified proceedings

1. General characteristics

52. Simplified insolvency proceedings are a variation of the formal insolvency proceedings. They may be made mandatory or optional for use by eligible debtors. Unlike out-of-court procedures discussed in section A above, they are collective proceedings and would trigger more formalities, such as requirements for publicity, notifications and protection of dissenting creditors. Nevertheless, they are characterized by fewer and simpler procedural formalities than those existing in standard business insolvency proceedings, as described in the *Guide*. In particular, elaborate rules on public notices, creditors' committees and meetings and claims verification are 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.

53. Unlike what is stated in recommendation 169, creditors may not be required to file their claims with the court. Instead, a micro or small business debtor submits a list of claims to the court at the time of commencement; any claims not included are not subject to the proceeding. The law may include a presumption of accuracy of the claims on the debtor's list; any claims that have been intentionally omitted by the

[12] Ibid.

[13] Ibid.

debtor may be excluded from a discharge. This approach is closer to what is provided in recommendation 170 as regards undisputed claims, which states that the insolvency law may permit claims that are undisputed to be admitted by reference to the list of creditors and claims prepared by the debtor in cooperation with the insolvency representative or the court or the insolvency representative may require a creditor to provide evidence of its claim.

54. Several steps can be taken to lower creditors' participation costs through online, postal and proxy consultation and voting, which is line with recommendations 145 and 169. 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, dispensing with the requirement that the claims must be certified and by allowing presentation of evidence online,[14] which will be in line with recommendation 170 that states that the insolvency law should not require that in all cases a creditor must appear in person to prove its claim. The law may limit the claims that need to be verified to those that are likely to be paid.

55. At the same time, the costs of non-participation may be raised to address the passivity of creditors, which is a common feature in the insolvency of micro and small business debtors, as noted in paragraphs 16 and 17 above. This is achieved through rules that presuppose that the creditors will contribute to decision-making through objections. Under those rules, 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 judicial review. This is unlike the *Guide* that envisages more formal participation of creditors in insolvency proceedings (recs. 126–136 and 145–151).

56. In addition, recognizing that micro and small business debtors tend to have less complicated operations and financial arrangements, simplified insolvency proceedings tend to be fast-track proceedings. Shorter statutory timelines than those applicable in standard business insolvency proceedings may apply and only narrow grounds for possible extensions of the default timelines within the maximum permissible number of requests for extensions (usually once or twice) may be specified in the law. Non-compliance with the established statutory deadlines may lead to deviations from default procedures, such as debtor-led and debtor-in-possession approaches, or conversion of one type of proceeding to another (see chap. IV below). Decisions may be taken by the court in summary rather than plenary proceedings and court hearings may be held only when necessary (e.g., upon request of dissenting creditors).

57. The *Guide* emphasizes the need for prompt actions (e.g., recs. 18, 19, 21, 43, 163 and 193) and provides for fast-track procedures in recommendations 160–168 addressing expedited reorganization proceedings. Specific timelines are expected to be established in domestic insolvency law; the *Guide* only notes in some cases considerations that need to be taken into account for fixing such timelines (e.g., that an adequate time should be provided to creditors for submission of their claims (rec. 174)).

58. To save costs and time, many simplified insolvency proceedings envisage the involvement of insolvency professionals only in exceptional cases. A third party (an experienced court clerk, an accounting firm or an insolvency professional) may be involved by the court for limited procedural steps, such as for examination of the debtor's business and property and supervision of notification, proper valuation and distribution of claims and compliance with other legal requirements. That person may operate pro bono or be reimbursed from public funds. An additional recommendation was included in this document to address the fact that the debtor-in-possession regime is often the norm in the simplified insolvency context although other options listed in recommendation 112 are not excluded, including limited displacement (i.e., the debtor retains the role in the day-to-day operation of the business subject to supervision by

[14] A/CN.9/966, para. 143(h).

a third party) or total displacement of the debtor from the operation of the business (see para. 104 below). Other additional recommendations were included to address the need for simplified procedures and shorter timelines in the context of a simplified insolvency regime.

2. Eligibility

59. Unlike what is stated in recommendation 14, many jurisdictions permit debtors, but not their creditors, to apply for simplified insolvency proceedings, with or without the right of creditors and other parties in interest to raise objections with the court. Creditor application is usually permitted only in exceptional cases, e.g., as a safeguard against the debtor's incompetence or abuse. In particular, unviable debtors may try to misuse a simplified reorganization to delay inevitable liquidation or viable debtors may avoid taking action, impeding rescues.

60. 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 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., less than or equal to 20 people).[15] Other quantifiable eligibility criteria may include the turnover not exceeding a certain threshold in a defined period (e.g., 12 months before the commencement of the proceedings), assets and income below a level prescribed by law or a maximum number of unsecured creditors (e.g., 20 creditors).

61. In addition to quantifiable criteria, an insolvency law may also establish qualitative eligibility criteria. In some jurisdictions, a simplified insolvency proceeding may only be available to individual micro and small business debtors engaged in self-employed activity (business income earners as opposed to wage earners), while in other jurisdictions, such a procedure is available only to proprietorships, partnerships and other entities without limited liability protection. 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 micro and small business debtor applies (e.g., to be eligible for simplified liquidation proceedings, the applicant must not own any immovable property).

62. Recommendations 8 and 9 of the *Guide* state that the insolvency law should govern insolvency proceedings against all debtors that engage in economic activities (whether or not those economic activities are conducted for profit) and that exclusions from the application of the insolvency law should be limited and clearly identified in the insolvency law. Those recommendations do not prevent States from establishing specific eligibility criteria for access to simplified insolvency regimes or for conversion of a standard business insolvency proceeding to a simplified one. Additional recommendations were included in this document to address issues raised in this section (see in particular recs. 274 and 275 below).

3. Presumption of good faith

63. There is an emerging trend to 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 micro and small business debtor's control or that they were not caused

[15] Although the number of employees may not be indicative of the financial complexity of business. In addition, a sole proprietorship may not employ anyone but rather hire contractors.

intentionally or through gross negligence. That approach is based on the understanding that the requirement for the 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.

64. Rather, the debtor's cooperation with creditors, the insolvency professional (if appointed) and the court will be considered relevant in the choice of options that may be employed during the insolvency proceedings and, in particular, to the availability of discharge and conditions upon which it might be provided. Standard debtor's obligations as reflected in recommendation 110 of the *Guide* include: (a) assisting the insolvency professional (if appointed) to perform its duties including by enabling the insolvency professional to take effective control of the estate and facilitating or cooperating in the recovery of assets; (b) providing accurate, reliable and complete information regarding the debtor's financial position and business affairs to the insolvency professional (if appointed), the court and creditors; and (c) notifying the court about any pending change of the debtor's habitual residence or headquarters. In a simplified reorganization discussed in chapter III below, the debtor's obligations of transparency, good faith and full disclosure of information about debtor's business and affairs will continue throughout the reorganization and implementation of the reorganization plan. Nevertheless, bad record keeping and consequently the failure to provide accurate, reliable and complete information regarding the debtor's financial position and business affairs does not give rise alone to a presumption of bad faith, considering the difficulties that micro and small business debtors face with comprehensive record keeping, as noted in paragraphs 18 and 25 above.

65. Good faith is also presumed during the proceedings and at the exit point in the absence of substantiated assertions to the contrary. Investigation into the debtor's affairs may nevertheless be warranted where there is a reasonable basis to suspect fraud, tax evasion or other abuses. In such cases, the creditors and other parties in interest should have the opportunity to request the court to set aside default features of simplified insolvency proceedings, such as debtor in possession and the full discharge (see chaps. III.D and VI below). Additional recommendations were included in this document to address issues raised in this section (see in particular rec. 283 below).

4. Commencement standards

66. Recommendation 15 of the *Guide* presents two alternative standards for commencement of insolvency 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, the *Guide* recommends that the cessation of payments test and not the balance sheet test should be used.

67. The balance sheet test may be impractical for micro and small business debtors because they may not maintain proper records as noted in paragraph 18 above. Moreover, their personal assets and liabilities may be mingled with business assets and liabilities, as noted in paragraphs 15 and 21 above. Given the prevalence of personal guarantees used for borrowing by micro and small business debtors, as noted in paragraph 15 above, the balance sheet analysis could be under-inclusive if it failed to reflect the liabilities of the individuals behind the debtor.

68. The cessation of payments test may be more workable in comparison. As discussed in the *Guide*, the law may accept a 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.[16] However, the cessation of payments test may be inadequate for accurately assessing the state of solvency of a micro or small business

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[16] The *UNCITRAL Legislative Guide on Insolvency Law*, part two, chap. I.A, paras. 23–24 and 33.

debtor if it fails to capture personal debts that may be intertwined with business debts. In addition, focusing on the debtor's current inability to meet present debts may not adequately reflect the debtor's future financial situation, while predicting the debtor's future financial situation introduces uncertainty, especially in the rapidly fluctuating business environment.

69. Recognizing the shortcomings of both tests in the context of micro and small business debtors, an insolvency law may adopt a different approach. There may be no requirement in the law for micro and small business debtors to declare or demonstrate insolvency, an approach that may be seen as an incentive to take advantage of the simplified insolvency regime by removing the social stigma associated with insolvency. Some laws may require the micro and small business debtor to attest that it is unable to pay debts that fall due without significantly hindering the continuation of its business.

70. Simplified filing requirements may apply, thus removing another commonly cited disincentive for micro and small business debtors to seek timely commencement of insolvency – the inconvenience of filing extensive financial documents. To mitigate risks of abuse of the system, some jurisdictions require a micro and small business debtor seeking to access a simplified insolvency regime to provide, at a minimum, a statement of the assets they own, without having to provide details such as the value of those assets. They might also be required to disclose information relating to any transfers they might have made to related persons[17] within a prescribed time period before the application and include a sworn statement indicating that the conditions for simplified insolvency proceedings are met.

71. Balance sheet records, where they exist, may be used to determine the appropriate process for distribution of assets of the micro and small business debtor or, in no-asset cases, for discharge. In some jurisdictions, they may be relevant to considerations of good faith although the prevailing trend, as noted in paragraph 64 above, is not to attribute the fact of bad record keeping to bad faith. In other jurisdictions, although documents relating to the financial situation of a micro or small business debtor may have to be submitted (e.g., the most recently prepared balance sheet, statement of operations, cash flow statement and tax returns), those documents do not need to be audited and there is no requirement for comprehensive financial or cash flow disclosure statements, unlike in the standard business insolvency proceedings.

72. Under some laws, other formal requirements might be applicable for commencement of simplified insolvency proceedings. Some laws may require an attempt of an out-of-court procedure (see sect. A above) before applying for the commencement of formal insolvency proceedings. In such cases, a micro and small business debtor may be required to submit a certificate issued by a competent person or authority attesting that an unsuccessful attempt has been made to settle out-of-court with creditors and explaining the reasons for failure. Additional recommendations were included in this document to address issues raised in this section (see, in particular, recs. 272, 273 and 276).

5. Fees

73. The *Guide* notes that many debtors that would satisfy the criteria for commencement of insolvency proceedings are never formally liquidated, either because creditors are reluctant to initiate proceedings where it appears that the debtor has no, or insufficient, assets to fund the administration of insolvency proceedings or because debtors in such a position will rarely take steps to commence proceedings. In practice, micro and small business debtors are more likely than other debtors to have

[17] The *Guide* explains the term "related person" for a debtor that is a legal entity as (i) a person who is or has been in a position of control of the debtor; and (ii) a parent, subsidiary, partner or affiliate of the debtor. As to a debtor that is a natural person, the *Guide* considers a related person as persons who are related to the debtor by consanguinity or affinity (see Introduction, Glossary, 12 (jj)).

insufficient or no assets to fund the administration of proceedings. Responses to address "no-asset cases" have differed among States. Some insolvency laws provide that where an application for commencement is made in these circumstances, it will be denied on the basis of an assessment of insufficiency of assets by the court,[18] while other laws provide a mechanism for appointment and remuneration of an insolvency representative. Some other laws provide for a surcharge on creditors to pay for the administration of estates.[19]

74. In some jurisdictions, access to simplified insolvency proceedings does not depend on the micro and small business debtor's ability to cover the administrative costs of the proceedings. Micro and small business debtors that do not have enough assets to fund a proceeding in those jurisdictions can commence a proceeding to address their financial difficulties and obtain a discharge (so called "zero-asset proceedings" discussed in chap. III, sect. A, below). Other jurisdictions provide for various types of insolvency proceedings and establish a scale of fees that depends on the complexity of proceedings. The level of assets available will determine the type of proceedings: the ability to pay the prescribed minimum may lead to a small administration proceeding while the ability to pay within a higher threshold range may trigger a standard business insolvency proceeding. Alternative mechanisms for financing simple insolvency proceedings may be in place for those debtors that cannot pay even the minimum. In some jurisdictions, following verification, the court or another competent authority may decide to reduce or waive the amount to be prepaid by the debtor to cover the costs of the proceeding or allow payment of administrative expenses in instalments.

75. Some insolvency laws require creditors making an application 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 laws 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 costs of the proceedings.

76. Recommendation 26 states that the "insolvency law should specify the treatment of debtors whose assets and sources of revenue are insufficient to meet the costs of administering the insolvency proceedings. Different approaches may be taken, including: (a) Denial of the application, except where the debtor is an individual who would be entitled to a discharge; or (b) Commencement of the proceedings, where different mechanisms for appointment and remuneration of the insolvency representative may be available."

77. In the context of a micro and small business debtor's insolvency, appointment of the insolvency representative is not the norm and therefore the question of the remuneration of the insolvency representative should not arise. Denial of the application may not be the optimal solution since the micro and small business debtor's financial situation would remain unresolved. In addition, the *Guide* refers to other reasons, in particular of a public interest nature, for devising a mechanism to enable the administration of a debtor with apparently few or no assets under a formal proceeding. Where an insolvency law does not provide for a possibility to investigate the financial situation of insolvent companies with few or no assets, it does little to ensure the observance of fair commercial conduct or to further standards of good governance of commercial entities. Assets can be moved out of companies or into related companies prior to liquidation with no fear of investigation or the application of avoidance provisions or other civil or criminal provisions of the law.[20] The *Guide*

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[18] Some systems in this group 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 debtors stricken by specific, compelling, exceptional circumstances (hardship relief).

[19] The *UNCITRAL Legislative Guide on Insolvency Law*, part two, chap. I.B, para. 72.

[20] Ibid., para. 73.

discusses possible mechanisms such as using public funds or establishing a fund out of which the costs may be met.[21]

78. In the light of those considerations, the insolvency law may provide for a special treatment of micro and small business debtors whose assets and sources of revenue are insufficient to meet the costs of administering the insolvency proceedings, in particular by allowing the proceedings to progress and putting in place different mechanisms to cover administrative expenses (see an additional recommendation to that effect below (rec. 274 (d)).

6. Stay

79. In some jurisdictions, the opening of a simplified insolvency proceeding may trigger an automatic stay as in a standard business insolvency proceeding. Some laws may provide for an automatic stay but not for the entire duration of proceedings, rather for a short period that may be extended in exceptional cases up to the maximum limit defined by law.

80. In jurisdictions where no automatic stay is envisaged, the micro or small business debtor may be allowed to apply to the court for a temporary stay of individual enforcement actions, e.g., if a creditor applies to the court for commencement of insolvency proceedings against the debtor, initiates a civil law procedure for recovery of debt from the debtor or gives the debtor a formal notice to pay. The debtor may be required to demonstrate to the court that the individual enforcement action in question may adversely affect ongoing restructuring efforts and hamper the prospects of a successful outcome. Before ordering any stay against a specific creditor or group of creditors, the court may require an in-depth non-discrimination test, which would ascertain whether the stay is necessary to support the restructuring efforts or whether the debtor is acting in bad faith and the stay may thus unfairly prejudice creditors and have an adverse effect on the value of the insolvency estate. The duration of a temporary stay of individual enforcement actions is usually short but extensions by the court are possible upon submission by the debtor of evidence that restructuring is progressing, that there is a strong likelihood of success and that creditors will not be unfairly prejudiced. The law may establish the maximum duration of a stay.

81. Any stay may be lifted at the request of creditors when it becomes apparent that there is no support from the required majority of creditors for ongoing restructuring efforts. Any creditor could also challenge the order of a stay on the grounds that the conditions for a stay were not met, e.g., that the stay unfairly prejudices them compared to other creditors. The court could limit the scope of the stay by lifting it partially for the negatively-affected creditor or group of creditors.

82. Any approaches to a stay usually need to balance interests of the debtor with those of creditors. Some creditors of micro and small business debtors could themselves be micro or small businesses relying on payments of their clients for survival of their businesses, as noted in chapter VII, section A, below.[22] Any restrictions on the right to enforce claims may thus cause insolvencies in the supply chain.

83. Recommendations 46–51 address various measures available on commencement, including an automatic stay, their duration, exceptions to the application of the stay and relief available to a secured creditor from measures applicable on commencement. Those recommendations would be generally applicable in the context of micro and small business debtors.

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[21] Ibid., para. 75.

[22] A/CN.9/966, para. 143.

Recommendations

274. For simplified insolvency proceedings the insolvency law should provide:

(a) Shorter timelines, narrow grounds for their extension and the maximum number of permitted extensions;[23]

(b) Simplified commencement standards;

(c) Simplified procedures, including for submission, verification and admission or denial of creditor claims and distribution of proceeds;[24] and

(d) Mechanisms for commencement of insolvency proceedings for micro and small business debtors whose assets and sources of revenue are insufficient to meet the costs of administering the insolvency proceedings.[25]

275. The insolvency law should specify instances where only the debtor, as a general rule, could initiate a simplified insolvency proceeding and exceptional circumstances that would justify the commencement of the simplified insolvency proceeding by any other party in interest. The insolvency law may provide for sanctions if parties in interest abuse their right to commence a simplified insolvency proceeding.[26]

276. The insolvency law could provide exceptions to the cessation of payment and balance sheet tests referred to in recommendation 15 of the *Guide* for the commencement of simplified insolvency proceedings.

III. Types of in-court simplified insolvency proceedings

A. Zero-asset proceedings

84. To make discharge of debts available to debtors that cannot afford covering administrative costs of proceedings, some jurisdictions introduced “zero-plan” or “zero-asset” procedures. Other jurisdictions adjusted standard business insolvency proceedings by allowing the summary procedure for zero-asset debtors or special rules on the closure of the proceeding due to the lack of assets. Such a procedure may be made available only once and special eligibility criteria in addition to insufficiency of assets to cover the costs of proceedings may apply (e.g., the debtor does not own real estate). Other jurisdictions do not provide for zero-asset procedures and do not accept or approve zero-asset plans.

85. Some systems that envisage “zero-asset” or “zero-plan” procedures require an eligible debtor to submit an application to the court requesting to be discharged from all debts and a statement of financial situation proving that it is eligible for zero-asset procedures. The application is accepted when the court serves a written notice to that effect to the debtor. The court notifies the creditors about the zero-asset procedure with a summary of the debtor’s assets and liabilities, makes a public notice and includes an entry in the business registry. If creditors do not object to the plan, it will be deemed approved and binding upon the parties. If the majority of the creditors object to the plan, the standard or simplified business insolvency proceeding may start. In some jurisdictions, a single creditor may ask that the liquidation follow the ordinary procedure and in such a case the creditor has to furnish sufficient security for the expenses to be covered. Upon acceptance of a “zero-plan” by the court, the debtor can be immediately discharged or the law may specify a period (e.g., 6–12 months) during which a debtor has to fulfil certain obligations (e.g., undertaking mandatory training on business management) and the discharge is conditioned upon

[23] A/CN.9/966, para. 133.

[24] See recommendations 169, 174, 177, 179 and 182 of the *Guide* for comparison and assessment of the need for simplification.

[25] See recommendation 26 of the *Guide* for comparison and assessment of the need for a different regime.

[26] A/CN.9/966, para. 134.

fulfilment of those obligations. In other systems, a declaratory statement that the insolvency estate has zero assets may alone produce automatic legal consequences (e.g., discharge) with the proceedings immediately closed.[27]

86. Those systems that provide for this type of procedure may include mechanisms to assess whether the debtor is indeed with no or insufficient assets and therefore eligible for zero-asset proceedings. Services of an impartial evaluator for such a purpose may be engaged, financed by public funds. Conversion of zero-asset proceedings to the standard business insolvency proceedings is envisaged if it is proven that sufficient assets to repay debts do exist.

87. 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 to escape from debt obligations while benefitting later from post-discharge income.

88. The *Guide* does not address zero-asset proceedings specifically. Considerations raised in chapter II above with respect to fees and a recommendation that was added in that context (rec. 274(d)) apply to zero-asset proceedings.

B. Simplified liquidation

89. Many systems that provide for a simplified insolvency regime recognize that speedy liquidation of non-viable debtors or debtors that could not agree on a reorganization plan may be personally, societally and economically more desirable than rehabilitation of non-viable business with no prospects for recovery. They therefore aim at fast-track simple liquidation procedures.

90. Some jurisdictions that provide for simplified liquidation require the appointed liquidator, within a short period after the appointment (e.g., 30 days), to prepare and file a report with the competent court, on the basis of which the court can commence a simplified liquidation procedure, after having heard or summoned the debtor. In other jurisdictions, once insolvency proceedings commence, the court appoints an insolvency representative who liquidates the debtor's estate and distributes the proceeds among the creditors. In some jurisdictions, simplified liquidation proceedings could be completed after the micro and small business debtor has handed over its assets for liquidation.

91. Private sales, in addition to public auctions, may be permitted to provide a choice for best realizing the value of assets owned by micro and small business debtors. A simplified distribution of proceeds is common, particularly where the assets available are below a certain statutory limit. The law may reduce notice requirements; permit the court to make a final decision in lieu of the creditors; or establish one-time distribution as the norm, provided that additional dividends may be distributed on a discretionary basis. If all creditors agree on the amounts and priorities of claims, together with the timing and method of distribution, the court may order distribution on a consensual basis.

92. Where a single disputed or unpaid claim is the main asset of the debtor, which is typically the case in insolvency of micro and small business debtors, some jurisdictions allow 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. Some jurisdictions allow the sale of the disputed claim

[27] A/CN.9/966, para. 143(f).

at a discount or assignment of the claim to the insolvency representative or a public office, which will be responsible for litigating and collecting the claim.

93. The *Guide* does not address simplified liquidation proceedings specifically. Considerations raised above with respect to simplified commencement standards and simplified procedures for verification and admission of claims and distribution of proceeds and recommendations that were added in that context (recs. 274–276) apply to simplified liquidation.

C. Expedited proceedings

94. Some jurisdictions provide for expedited proceedings to give effect by the court to a plan negotiated and agreed by a micro and small business debtor with relevant creditors in out-of-court debt restructuring negotiations discussed in chapter II above. Those proceedings are essentially the same as expedited reorganization proceedings discussed in part II, chapter IV.B, and addressed in recommendations 160–168 of the *Guide*. Since the considerations raised in that part of the *Guide* are generally applicable in the simplified insolvency context, they are not repeated in this document. Those provisions are however subject to further simplification discussed in this document (in particular as regards the disclosure statement (see para. 100 below)). [28]

D. Simplified reorganization

95. Reorganization in micro and small business debtor cases will likely translate into debt forgiveness or debt rescheduling for which complex reorganization steps usually envisaged for larger businesses will not be necessary. For those reasons, some jurisdictions envisage simplified reorganization proceedings for micro and small business debtors.

96. The *Guide* addresses full reorganization proceedings in recommendations 139–159. Those recommendations are generally applicable in the context of simplified reorganization proceedings, subject to further simplification discussed in this document.

1. Commencement: a reorganization plan and viability test

97. The application for commencement of reorganization proceedings may be subject to requirements in addition to those listed in chapter II.B above. They may include requirements to file a reorganization plan and to prove viability of business. [29]

98. As the micro or small business debtor may not be able to draw up a feasible reorganization plan at an early stage, some laws allow the submission of such a plan within a specified period after commencement, which is in line with recommendation 139 of the *Guide*. The micro and small business debtor may be given an opportunity to propose a reorganization plan without the involvement of creditors within that period, failing which other parties in interest may become involved or the court may appoint a representative to assist with the negotiation and preparation of a plan, supervise that stage, compel the parties to settle and report to the court about the progress of negotiations. Such representatives may work pro bono or be compensated from public funds.

99. The pool of other parties in interest will largely depend on the size and structure of the micro and small business debtor. 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, as would also persons who have given personal guarantees

[28] A/CN.9/966, paras. 127–128.

[29] Ibid., para. 136.

or provided their personal assets as security for business debts. They may be allowed to propose a standalone plan or appoint a professional to support the debtor in preparing the plan. The law may impose a duty on all parties in interest to cooperate in negotiating and proposing a plan.

100. Requirements concerning a disclosure statement to accompany the reorganization plan, found in recommendation 143, are usually relaxed 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.[30] It may however be particularly difficult for micro and small business debtors to prove viability of the proposed plan. Some laws leave the assessment of viability to be made by creditors or the court; various ratios, e.g., debt to capital or the projected liquidation value to the value of the going concern, may apply. To provide the court with an independent assessment of viability, the law may require the appointment of a competent person to investigate the debtor's affairs and stipulate terms of remuneration for those services.

2. Debtor in possession

101. Use of the debtor-in-possession approach as the norm in simplified reorganization proceedings pursues the goal of rehabilitation of micro and small business debtors. Such an approach is usually justified by reference to the characteristics of micro and small business debtors discussed in chapter I above. They include that owners and managers of micro and small business debtors often have unique knowledge about their 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 powerful disincentive for micro and small business debtors to seek timely intervention.

102. The debtor-in-possession approach may not be appropriate in some cases, for example where the debtor or the debtor's representative(s) was responsible for misappropriation or concealment of property or poor management that caused the debtor's financial distress. It may also be inappropriate in involuntary commencement where the debtor could be expected to be hostile to creditors or where the plan was imposed on the debtor by creditors. In such cases, 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).[31]

103. 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 court continuously informed. Supervision of the debtor by the court, by a court-appointed supervisor, by the insolvency representative or by a creditor-appointed supervisor may be necessary in other cases. Mechanisms should be put in place to achieve such supervision in a manner that minimizes costs, including by subsidization of third-party services by public funds.[32]

104. Although the *Guide* presupposes an active involvement of an insolvency representative throughout the insolvency proceeding (as stated in paragraph 3 above), deviations are possible. Recommendation 112 in particular envisages the debtor-in-possession approach, and recommendation 113 states that the insolvency law should specify those functions of the insolvency representative that may be performed by the debtor in possession. Recommendation 157 envisages that the law may establish a mechanism for supervising implementation of the plan, which may include

[30] Ibid.

[31] Ibid.

[32] Ibid.

supervision by the court, by a court-appointed supervisor, by the insolvency representative or by a creditor-appointed supervisor, noting that where the proceedings involve a debtor in possession, or where the proceedings conclude on approval of the plan, it may not be necessary to appoint a supervisor. An additional recommendation is proposed below (rec. 278) that makes the debtor-in-possession approach the norm in simplified reorganization proceedings.

3. Approval of the plan by creditors

105. Requirements for creditor approval are usually lower in simplified reorganization proceedings than in full reorganization proceedings addressed in recommendations 145–151. For example, it may be unnecessary to establish a creditor committee and create classes of creditors if the creditor base is limited, which is usually the case with micro and small business debtors. Convening a creditor meeting may also be unnecessary if the micro and small business debtor keeps all creditors 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. Decisions may be taken online or by post or proxy but some jurisdictions may require formal meetings with the supervisor appointed by the court and the affirmative acceptance of the plan by a required majority of creditors. Tacit or implied approval mechanisms such as discussed in paragraph 55 above, may be introduced to overcome creditor passivity.

106. In some jurisdictions, creditor approval may not be required: the court may be authorized directly to approve the plan submitted by the debtor. Any objecting party in interest would be able to challenge the approval in court. The opposite could also be true: the law may waive the requirement for the court to approve the plan agreed by the creditors, allowing it to take effect automatically if no dissenting creditors' interests are involved, as envisaged in recommendation 153. The parties may nevertheless prefer obtaining court acknowledgement, confirmation, approval or other form of validation of the plan even in those cases. In other jurisdictions, the formal court approval of the plan may be required in all cases before the plan becomes effective and binding upon all parties in interest.

4. Approval of the plan by the court

107. The debtor may be required to demonstrate to the court that 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.

108. The court 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 court may need to ascertain the fairness of the plan and that the plan ensures the survival of the business.

109. Generally, the plan is approved by the court when a few conditions are satisfied. Those conditions are listed in recommendation 152, including that creditors will receive at least as much under the plan as they would have received in liquidation, unless specifically agreeing to lesser treatment. In micro and small business debtor cases, the court should be able to determine the outcome of an alternative liquidation scenario without the involvement of expert opinion. Alternatively, a more general test of fairness may apply, e.g., the ascertainment that the interests of all creditors are sufficiently protected under the plan, the minority creditors were fairly represented at the meeting, the majority creditors acted in good faith, and the plan would be approved by a reasonable and honest party in interest. That would alleviate the need for the court to compare alternative scenarios and to examine the substance of the commercial terms to which the majority of creditors has agreed.

110. If parties in interest do not bring a challenge to the court, they are deemed to accept the compromise reached in the plan as approved by the court. To discourage frivolous complaints and minimize delays in simplified reorganization, some laws have narrowed the scope for objections to be made on procedural grounds. In some

jurisdictions, the court may approve a plan notwithstanding an objection that the process of preparation and approval of the plan by creditors was not properly conducted, by taking into account the extent of the irregularity, the state of the debtor and other circumstances.

111. The law may envisage mechanisms for the court to bind dissenting parties. In some jurisdictions, the court may modify the plan submitted for approval to protect the rights of dissenting parties. Once the plan is approved by the court, it would be bound on all parties in interest in the same manner as in standard reorganization proceedings.

5. Challenges to an approved plan

112. Some jurisdictions do not provide a right of appeal against a court 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) and prejudice to the parties.

113. The appeal, where permitted, would not necessarily suspend implementation of the plan. Should the appeal succeed while the plan is being implemented, the interests of all parties involved are taken into account in deciding whether the plan should be suspended or annulled. As an alternative, the court may order the payment of compensation to the party whose appeal succeeded.

114. Such an approach is in line with the *Guide*, which specifies that, although any party in interest may appeal from any order of the court, the insolvency law should provide that appeals in insolvency proceedings should not have suspensive effect unless otherwise determined by the court, in order to ensure that insolvency can be addressed and resolved in an orderly, quick and efficient manner without undue disruption. Time limits for appeal should be in accordance with generally applicable law, but in insolvency need to be shorter than otherwise to avoid interrupting insolvency proceedings (rec. 138 and footnote 64).

6. 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, 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 version of the plan.

116. Some plans could be self-modifying, e.g., those that call for fluctuating payments based on the debtor's actual income. The implementation of such plans may require monitoring. Alternatively, debt repayments may be based on projected income and expenses. The law usually allows parties to modify plans to reflect the 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, e.g., the debtor omitted those debts.

Recommendations

277. The insolvency law may require the debtor to demonstrate the value of continuation of business for a simplified reorganization proceeding to commence or to proceed.[33]

278. Notwithstanding recommendations of the *Guide* that presuppose the active involvement of the insolvency representative,[34] the insolvency law may provide for the debtor-in-possession approach, with or without supervision, as the norm in simplified reorganization proceedings and specify instances when exceptions to that approach would be justified, provided that any alternatives are implemented in a manner that minimizes costs. Such alternatives may in particular include the appointment of an administrator subsidized by public funds to closely supervise the process and keep the court continuously informed. In line with recommendation 113, the insolvency law may explicitly specify those functions of the insolvency representative that may be performed by the debtor in possession.

279. The insolvency law may provide for exceptions to some procedural requirements involved in reorganization proceedings with the goal of providing less formal requirements, including as regards: (a) a disclosure statement to accompany the reorganization plan and its contents and the contents of the reorganization plans referred to in recommendations 141–144; and (b) the approval of the plan by creditors referred to in recommendations 145–151.

IV. Conversion of proceedings

118. There may be a need for conversion of one type of proceedings to another, including from a simplified insolvency proceeding to a full insolvency proceeding or vice versa. Some jurisdictions allow a creditor to request conversion of a simplified reorganization proceeding to a simplified liquidation on the ground that the debtor's plan has little chance of succeeding.

119. In addition, a simplified reorganization proceeding may fail if the micro and small business debtor is unable to implement the reorganization plan. As a default, the law may, in such cases, permit automatic conversion to simplified liquidation proceedings, avoiding the delay and expense of a separate application by the micro and small business debtor or other parties in interest. The law may also allow parties in interest to challenge such an automatic conversion. 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-in-possession approach 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 simplified reorganization proceeding to address financial difficulties at an early stage and was not necessarily eligible for liquidation proceedings. In cases where a micro or small business debtor is a natural person, liquidation will not be an option.[35]

120. There could also be cases when a simplified insolvency proceeding may need to be converted to standard business insolvency proceeding, for example at the request of creditors where they can demonstrate the complexity of an individual case and the need for more scrutiny. Such a need, in the context of micro and small business debtor

[33] Ibid.

[34] See e.g., recommendations 54, 58, 59 and 62 that address the use and disposal of assets, recommendations 72–86 that address the treatment of contracts, recommendation 93 that allocates the principal responsibility to commence avoidance proceedings on the insolvency representative and recommendations 115–125 that describe the terms of participation of the insolvency representative in the insolvency proceedings.

[35] A/CN.9/966, para. 137

insolvency, may arise in particular because of allegations of fraudulent transfers of assets of the debtor to related persons or other fraudulent behaviour by the debtor (see also para. 87 above). A request for such a conversion would require an assessment by the court. In some cases, failure to abide by the fast-track deadlines imposed by law for simplified insolvency proceedings may lead to conversion to standard business insolvency proceedings, as noted in paragraph 56 above.

121. Some jurisdictions envisage the conversion of a standard business insolvency proceeding to a simplified insolvency proceeding at the decision of the court, usually upon advice of the insolvency representative. In at least one jurisdiction, such conversion is possible when a committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor. In such cases, a simplified reorganization proceeding may follow that provides for simplified voting requirements and shorter deadlines but more stringent oversight by a competent government body and reporting obligations of the debtor to the court.

122. Recommendation 158 states that the court may convert reorganization proceedings to liquidation where: (a) a plan is not proposed within any time limit specified by the law and the court does not grant an extension of time; (b) a proposed plan is not approved; (c) an approved plan is not confirmed (where the insolvency law requires confirmation); (d) an approved or a confirmed plan is successfully challenged; or (e) there is substantial breach by the debtor of the terms of the plan or an inability to implement. The *Guide* also envisages conversion of liquidation to reorganization proceedings (see e.g., rec. 140) although no specific grounds for such conversion are mentioned. An additional recommendation below recognizes that there could be possible additional grounds for conversion of one proceeding to another, in particular of standard business insolvency proceedings to simplified insolvency proceedings and vice versa.[36]

Recommendation

280. In addition to what is provided in recommendation 158, the insolvency law may stipulate other grounds for converting one type of proceeding to another, including that avoidance proceedings referred to in recommendations 87-99 may justify the conversion of a simplified insolvency proceeding to a standard business insolvency proceeding.

V. Assets constituting the insolvency estate of micro and small business debtors

123. In most legal systems, the scope of assets excluded from the insolvency estate has been expanded over time in line with the goal of affording debtors a fresh start. The exclusion of two particular categories of assets, the family home and tools of the trade, is especially relevant for reducing the social stigma of insolvency and its impact on the entire household and the prospects of a fresh start of a micro and small business debtor.

124. Three approaches to asset exclusion can be found in legislation providing for simplified insolvency regimes:

(a) *Requests by the debtor for exclusion of some assets up to a specified value limit*. Under this approach, 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. That approach would mean that all of the debtor's qualified assets automatically become part 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. The limits on the range and value of assets that a micro and small business debtor may retain will

[36] A/CN.9/966, paras. 136 and 137.

reflect the policy choice made in each jurisdiction. Special treatment may be accorded to the right or interest of the debtor in the family home, including the right to continue residing in the family home after commencement of insolvency proceedings;

(b) *Exclusion of some categories of assets subject to specific ceilings*. The second option is for the law to establish different categories of excluded assets, respectively capped at certain values, which may be a more flexible approach than the first one. The categories of assets that are relevant may differ according to the individual situation of the debtor. Where the law places emphasis on rehabilitating the micro and small business debtor, it might grant the court discretion to increase the scope of excluded assets beyond the default limits to meet the needs of debtors. Where there is evidence of bad faith or unfair conduct by the debtor, however, the law may allow the court to include assets in the insolvency estate that would otherwise be excluded. In some systems, if the debtor does not use up to 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. As noted in paragraph 91 above, private sales may be permitted, and the law may also permit business assets to be sold before personal assets. In some situations where the value of an asset is only partially exempt, leaving some value available for creditors, the insolvency representative may sell such an asset and pay the debtor up to the amount of the exemption that the debtor has in the asset. To avoid costs associated with a forced sale, the debtor may be allowed to pay the insolvency representative the amount above the exemption and keep the asset;

(c) *Across-the-board exclusion subject to challenge by creditors*. Lastly, the law may exclude the micro and small business debtor's assets from the estate by default and place the burden on the creditors to object to the exclusion of particular assets. The court may order those assets to be reclaimed for the estate. Because the creditors would intervene if the debtor had certain assets that could be of value to creditors, this approach may be more efficient in cases where there are few assets available for distribution. In other cases, however, it may require the creditors to investigate the micro and small business debtor's assets, especially where personal and business assets are intertwined or assets have been hidden or transferred in close proximity to insolvency.

125. 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 debtor can be more costly than where the insolvency representative or a creditor seeks to reclaim items of excessive value.

126. The *Guide* addresses assets constituting the insolvency estate in part two, chapter II, section A and recommendations 35–38. Considerations raised in that part of the *Guide*, in particular with reference to assets excluded from the insolvency estate where the debtor is a natural person,[37] are generally applicable in the simplified insolvency context. Recommendation 38 in particular envisages that the insolvency law would specify the assets that are excluded from the estate where the debtor is a natural person. It is supplemented by recommendation 109 that entitles the debtor who is a natural person to retain the assets excluded from the estate by the law.

127. In order to facilitate a fresh start for all types of micro and small business debtors, an additional recommendation below invites States to consider expanding measures envisaged in recommendations 38 and 109 to micro and small business debtors that are legal persons, recognizing that regardless of the form in which micro and small businesses operate, and whether limited liability protection is offered to them,[38] business and personal assets may be comingled in micro and small business

[37] The *UNCITRAL Legislative Guide on Insolvency Law*, part two, chap. II.A, paras. 18–21.

[38] Approaches to making limited liability available to micro and small businesses vary across jurisdictions. Mechanisms for asset partitioning and limited liability with or without a legal personality are currently being discussed in Working Group I (MSMEs), particularly in the context of an UNCITRAL Limited Liability Organization (UNLLO).

debtors to such extent that creditors might still claim personal assets of owners of business and other related persons.[39]

Recommendation

281. The insolvency law might stipulate conditions for expanding measures envisaged in recommendations 38 and 109 to micro and small business debtors that are not natural persons and enlarging the pool of assets that are excluded from the insolvency estate of a micro or small business debtor, in particular where business and personal assets are closely intertwined.

VI. Discharge

128. In the context of discharge following liquidation, the *Guide* explains that "when the debtor is a limited liability company, the question of discharge following liquidation does not arise; generally the law provides for the disappearance of the legal entity or, alternatively, that it will continue to exist as a shell with no assets. The equity holders will not be liable for the residual claims and the issue of their discharge does not arise. If the debtor's business takes a different form, such as a sole proprietorship, a group of individuals (a partnership) or an entity whose owners have unlimited liability, the question arises as to whether those debtors as individuals will still be personally liable for unsatisfied claims following liquidation."[40]

129. In the context of discharge of debts and claims in reorganization, the *Guide* states that "[t]o ensure that the reorganized debtor has the best chance of succeeding, an 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. It also gives certainty to other lenders and investors that they will not be involved in unanticipated liquidation or have to compete with hidden or undisclosed claims. Thus the discharge establishes unequivocally that the plan fully addresses the legal rights of creditors."[41]

130. The *Guide* thus addresses both discharge of the debtor that is a natural person, and debt forgiveness, cancellation or alteration for debtors that are legal entities. Considerations raised in that part of the *Guide* are generally applicable to micro and small business debtors with some exceptions.

131. The first consideration is that the owners of an insolvent micro or small business, whether that business takes the form of a limited liability company or not, may need a discharge if the failure of the business led to their personal insolvency because they were directly liable for business debt (e.g., based on personal guarantees or company law rules). They could benefit from a quick discharge unless reasons precluding discharge are present (e.g., owners might have managed the business in person and as managers violated obligations usually imposed on directors of companies in the period approaching insolvency (see chap. IX below)). When this is not the case, liquidation of a business or its reorganization may need to run in parallel with rehabilitation of the once owner of a failed business (see chap. VIII below).

132. Rehabilitation includes three elements: (a) the debtor has to be freed from excessive debt; (b) the debtor should be treated on an equal basis with non-debtors after receiving discharge (the principle of non-discrimination; in some jurisdictions, data protection regulations prohibiting the registration and use of information on completed payment plans enforces that principle); and (c) the debtor should be able

[39] A/CN.9/966, para. 138.

[40] The *UNCITRAL Legislative Guide on Insolvency Law*, part two, chap. VI.A, para. 3.

[41] Ibid., para. 14.

to avoid becoming excessively indebted again and for such purposes measures are taken to change debtor's behaviour (including through debt counselling or imposed training on business management).

133. As noted in the *Guide*, there are various approaches to debt discharge: in some jurisdictions, a debtor cannot be discharged until all its debts are paid; in other jurisdictions, a debtor remains liable for debts subject to a limitation period during which the debtor is expected to make a good faith effort to repay its debts, after which a discharge may be given; yet in other jurisdictions, a complete discharge of an honest, non-fraudulent debtor may be available immediately following distribution in liquidation.[42] In some jurisdictions that provide for zero-asset proceedings (see chap. III, sect. A, above), a debtor's application for commencement of those proceedings may be treated as an application for discharge while risks of abuse are mitigated by verification procedures. Following those verification procedures and the court's determination that no distribution to creditors can reasonably be expected, an immediate discharge is granted.

134. In simplified reorganization, a straight discharge or a fresh start (i.e., the possibility to be freed from debt without a payment plan) is uncommon. Most systems require at least a partial payment of debt (e.g., 75 per cent of debt) from future income during a certain period running from the time the reorganization plan becomes effective under the insolvency law. In other jurisdictions, discharge is possible only after the plan is fully implemented. In the event that the plan is not fully implemented, the discharge can be set aside.

135. The length of the debt repayment period may vary from jurisdiction to jurisdiction and even within the same jurisdiction it may vary depending on circumstances. As noted in the *Guide*, under some laws, that period might be long, e.g., 10 years.[43] 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 debtor to comply with debt repayment and other obligations imposed on the debtor in the reorganization plan by making the length of the discharge period dependent on the rate of return to creditors and debtor's compliance with other obligations.

136. The discharge generally affects only debts arising before the commencement of a formal insolvency proceeding. A special regime may be established for debts incurred during the insolvency proceedings and the implementation of the reorganization plan (see chap. VII below). Following discharge, claims that have not been satisfied would be rendered unenforceable.[44]

137. The *Guide* notes that all laws restrict the availability of a discharge for the debtor that has acted fraudulently (although it is often difficult to draw a line between irresponsible risk taking and fraud); 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.[45] The *Guide* also notes that a discharge can be given at an early stage of the proceedings but be suspended if for example fraud was involved.

138. The effectiveness of a discharge regime in achieving the micro and small business debtor's rehabilitation depends on the scope of debts covered by the discharge. Recommendation 195 of the *Guide* states that the exclusion of debts from a discharge should be kept to a minimum in order to facilitate the debtor's fresh start. In the context of micro and small business debtors, there might also be the need to leave enough income in order to meet domestic needs for the debtors and their families. A predictable and consistent method of assessing disposable income may need to be provided in the reorganization plan.

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[42] Ibid., paras. 4 and 5.

[43] Ibid., para. 4.

[44] Ibid., paras. 11 and 15.

[45] Ibid., para. 6.

139. As noted in the *Guide*, 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.[46] Some countries have eliminated exclusions for taxes and other public dues, except for egregious cases of tax evasion and fraud, recognizing in particular that priorities for tax and social security claims in insolvency may not only cause weak tax enforcement but also remove any incentives for debt restructuring by other creditors. Such measure may be particularly important for micro and small business debtors whose tax and other public debts may constitute a substantial portion of their overall debts. More flexibility may also be envisaged in the reorganization plan for repayment of such debt (e.g., instalment payments within a specified period). Some jurisdictions may allow agreements between the debtor and individual creditors to exempt individual debts from the operation of the discharge, subject to court's discretion. In other jurisdictions, such agreements may be forbidden and even constitute a criminal act as violations of the principle of equality of creditors.

140. The *Guide* notes that 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 a court order.[47] 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 debtor is a member of a profession to which specific ethical rules apply or where disqualifications were ordered by a court in criminal proceedings.

141. An emerging trend is to assess carefully the impact of those restrictions on the objectives of simplified insolvency regime (see chap. I above). Especially for sole traders or 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. Recommendation 196 states in that respect that where the insolvency law provides that conditions may be attached to a debtor's discharge, those conditions should be kept to a minimum in order to facilitate the debtor's fresh start and should be clearly set forth in the insolvency law.

142. Recommendations on discharge found in the *Guide* (recs. 194–196) are applicable only to a discharge of a natural person debtor in liquidation. An additional recommendation below invites States to consider expanding measures envisaged in those recommendations to micro and small business debtors that are not natural persons. That recommendation is proposed to be accompanied by safeguards against abuse of the discharge regime.[48]

Recommendations

282. The insolvency law might stipulate conditions for expanding measures envisaged in recommendations 194–196 to micro and small business debtors that are not natural persons.

283. The insolvency law should provide sanctions for abuses of a discharge regime.

VII. Special treatment of certain claims and persons

A. Small claim creditors

143. In simplified insolvency regimes, special treatment may need to be accorded to interest of vulnerable creditors, such as small claim creditors, which themselves could

[46] Ibid., para. 7.
[47] Ibid., paras. 4 and 8.
[48] A/CN.9/966, para.140.

be micro and small businesses.[49] They may not have the skills or resources to actively participate in negotiations of a reorganization plan or challenge the proposed plan in court but may be disproportionately affected by the plan if a reduction or suspension of their claims is envisaged.

144. The successful reorganization of a micro and small business debtor may depend on those creditors continuing their provision of works, services and goods for the debtor, expecting to be paid within a relatively short period of time. Keeping that line of credit open may be a precondition for the rescue of a viable micro or small business debtor. At the same time, the very existence of those creditors may depend on the payments by their clients with the result that the insolvency of one client may cause insolvencies in supply chain.

145. For those reasons, the law may specify situations where small creditor claims may enjoy priority in the distribution of proceeds for works, services and goods supplied to the debtor within a specified period before the commencement of the insolvency proceeding and, where applicable, during the implementation of the reorganization plan.

146. Recommendations 185–193 addressing priorities and distribution of proceeds are generally applicable in the simplified insolvency context and would accommodate special treatment of small claim creditors where such treatment is required. Recommendations 187 and 188, while stating that the insolvency law should minimize the priorities accorded to unsecured claims and claims superior in priority to secured claims, recommends specifying in the insolvency law limited circumstances in which a special priority regime in distribution may be permitted. The notion that similarly situated creditors should be treated and satisfied proportionately to their claim out of the assets of the estate available for distribution to creditors of their rank ("pari passu" principle[50]) is mentioned as the general principle in recommendation 191, without excluding the possibility of setting out exceptions to that principle in the insolvency law.

B. Secured creditors

147. Any perspectives of successful reorganization of viable micro or small business debtors may depend on secured creditors' stance as regards the enforcement of their security interest. For that reason, some jurisdictions allow a stay on the enforcement of security interests during out-of-court debt restructuring negotiations (see para. 37 above) and in-court simplified insolvency proceedings. The *Guide* envisages such a stay upon commencement of insolvency proceedings (rec. 46) and as a provisional measure between the time an application to commence insolvency proceedings is made and commencement of the proceedings (rec. 39). It is intended that the stay should apply to secured creditors only for a short period of time, such as between 30 and 60 days, and that the insolvency law should clearly state the period of application. At the same time, the *Guide* envisages appropriate measures of protection of a secured creditor from diminution of the value of the encumbered assets (rec. 50) and allows a secured creditor to request the court to grant relief from a stay (rec. 51). Various grounds may justify such request, such as the fact that the encumbered asset is not necessary for reorganization (which however will be rarely the case in the insolvency of a micro and small business debtor); that the value of the encumbered asset is diminishing as a result of the commencement of insolvency proceedings and the secured creditor is not protected against that diminution of value; or that the organization plan is not approved within applicable time limits (rec. 51).

148. Some jurisdictions impose alternative dispute resolution mechanisms independently or jointly with a stay as procedural devices to slow down the enforcement of the security interest. In addition, the law may allow the reorganization

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[49] Ibid., para. 143(g).

[50] The *UNCITRAL Legislative Guide on Insolvency Law*, Introduction, Glossary, 12 (cc).

plan to envisage an extension of secured debt repayment period, to accommodate micro and small business 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 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, which would be in accordance with recommendation 188. 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. As the plan clearly affects their rights, secured creditors should not be bound without a chance to be heard in the court, in line with recommendations 67 and 137–138 of the *Guide*.

C. Interim and post-commencement finance

149. The success of a reorganization plan may depend on whether there are financial resources in place to support the operation of the business during negotiation of the plan (interim finance) and during the implementation of the plan (post-commencement finance). As opposed to post-commencement finance, which is approved as part of a reorganization plan, interim finance is extended when the parties do not know whether the plan will be approved.

150. The *Guide* addresses only post-commencement finance (recs. 63–68), stating that the insolvency law should facilitate and provide incentives for post-commencement finance (rec. 63) and should establish the priority that may be accorded to post-commencement finance, at least ahead of ordinary unsecured creditors (rec. 64). By extension, under recommendation 68, any priority accorded in one proceeding would continue upon conversion of that proceeding to a different type. Those recommendations will be generally applicable in the simplified insolvency context with some adjustments. In particular, references to the insolvency representative in those recommendations may be read as encompassing also references to the debtor in possession taking into account that the debtor-in-possession approach is the norm in simplified reorganization as stated in paragraphs 101–104 above and additional recommendation 278. In line with recommendation 113, the insolvency law may explicitly specify those functions of the insolvency representative that may be performed by the debtor in possession, including as regards post-commencement finance. In addition, as a general rule, creditors' consent would not be required for obtaining the post-commencement finance in the simplified insolvency context.[51]

151. Limiting the protection of finance to cases where the plan is approved may discourage the provision of interim finance. Encouraging new financiers to take the risk of investing in a viable micro and small business debtor in financial difficulties may require protection from avoidance actions and personal liability as well as incentives, such as giving such finance priority at least over unsecured claims. To avoid potential abuses, protection from avoidance actions and personal liability may be made available only for interim finance provided in good faith 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, pending the approval of that plan.

152. Additional recommendations below invite States to consider expanding the protection accorded to post-commencement finance to interim finance[52] and provide for an exception to the requirement of creditors' consent for obtaining the post-commencement finance in the simplified insolvency context, where such requirement is imposed in all cases.

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[51] A/CN.9/966, para. 139.

[52] Ibid., para. 142.

Recommendations

284. With reference to recommendation 63, the insolvency law may provide for an exception in the simplified insolvency context to a requirement to seek creditors' consent to the provision of post-commencement finance where such a requirement exists.[53]

285. The insolvency law may extend recommendations 63–68 to interim finance needed for reorganization of viable micro and small business debtors, subject to conditions specified in the law.

D. Personal guarantors

153. Lenders of micro and small businesses often require guarantees to secure business loans. Such guarantees are commonly provided by owners or managers of the micro and small business or individuals related to them, such as family members, or close friends. Personal guarantors will face payment claims on the eve or after the opening of an insolvency proceeding.

154. Generally, the insolvency proceedings and discharge have no alleviating effect on the liability of the guarantor. That approach is reflected in a number of insolvency laws that explicitly exclude the guarantor from the scope of application of a stay and provide that the discharge does not affect the liability of third-party guarantor. The *Guide* similarly states in the context of discharge of a natural person debtor that "it should be noted that discharge of a natural person debtor does not generally affect the liability of a third party that has guaranteed the obligations of that debtor."[54]

155. Nevertheless, some jurisdictions allow adjusting the treatment of guarantees in simplified insolvency proceedings in the light of the expected impact of the enforcement of the guarantee on guarantors as well as on the debtor. For example, a stay may be imposed on the enforcement against a guarantor for a limited duration on a case-by-case basis, where that action would be necessary for the successful reorganization of the micro and small business debtor or would alleviate a disproportionate hardship on the guarantor. When approving or confirming a reorganization plan, the court may accord special treatment to a guarantor's claim against the micro and small business debtor vis-a-vis other claims in the plan. It may also permit the guarantor to pay in instalments for an extended period. Some jurisdictions permit micro and small business 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 court 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 debtor's debt repayment obligations under the reorganization plan.

156. Special measures of protection in those jurisdictions may be envisaged 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. A 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 consequences of giving a personal guarantee, in particular "all money" clauses. Some jurisdictions impose explicit restrictions on what kinds of guarantee a spouse, child or other dependent person can validly give.

157. Competing policies have to be weighed in the treatment of guarantors. On the one hand, 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 for micro and small

[53] A/CN.9/966, para. 139.
[54] The *UNCITRAL Legislative Guide on Insolvency Law*, part two, chap.VI, para. 13.

business debtors, many of which may not be able to obtain financing in other ways. On the other hand, allowing unrestricted enforcement of guarantees could lead to the insolvency of the guarantor and, where that guarantor is a family member (e.g., a spouse, parent or sibling), could leave an entire family destitute.

158. Since the *Guide* does not address the treatment of guarantors, an additional recommendation below invites States to consider according special treatment to the micro and small business debtors' guarantors.[55] Conditions for making such treatment available may be specified in the law. Where abuses of the special treatment occur (e.g., if the guarantor hides the property), the court can give the creditor the right of enforcement under usual terms.

Recommendation

286. The law may provide for a special treatment of guarantors in the context of insolvency of micro and small business debtors, specifying conditions for according such a treatment.

E. Related persons

159. The *Guide* discusses transactions directly with a related person or via a third party to a related person in some detail in the context of avoidable transactions and treatment of creditor claims, listing them among the types of transaction where bad faith is deemed or may be presumed to exist (i.e., transactions with the intention to defeat, hinder or delay creditors, transactions at an undervalue and transactions with certain creditors that could be regarded as preferential). At the same time, the *Guide* acknowledges that the mere fact of a special relationship with the debtor may not be sufficient in all cases to justify special treatment of related persons. In some cases, their claims for example 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, they may give rise to suspicion and will deserve special attention.[56]

160. Since the involvement of related persons tends to be more common among micro and small businesses than in larger enterprises, risks of inappropriate dealings with related persons, especially in the period approaching insolvency and during insolvency, might be higher. Many systems build various safeguards to mitigate those risks. Those safeguards are similar to the measures suggested in the *Guide*. They may include requiring careful scrutiny of any intended disposal of an asset to a related person before it is allowed to proceed (rec. 61); providing a longer suspect period for avoidable transactions involving related persons (rec. 90); restricting the voting rights of related persons; and subjecting claims by related persons to scrutiny, subordinating those claims or reducing their amount (rec. 184). Those measures will be generally applicable in the simplified insolvency context and are therefore not repeated in this document.

VIII. Coordination of related proceedings

161. In the context of micro and small business debtors, it may not be feasible to apply different rules to business debts as opposed to personal or consumer debts. Since the entire micro and small business debtor household may be involved in the business (family members may use consumer credits to buy business assets), as noted in chapter I above, business insolvency may lead to personal or consumer insolvency once a business fails even if the business is a separate legal entity. Separate procedures with different access conditions and discharge periods for discharge of different types

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[55] A/CN.9/966, para. 142.

[56] The *UNCITRAL Legislative Guide on Insolvency Law*, part two, chap. II, paras. 170–184, and chap. V, para. 48.

of debts involved in micro and small business debtor's insolvency may thus not be an optimal solution.

162. The *Guide* notes in this respect: "One issue that may need to be taken into account in considering discharge of natural persons engaged in a business undertaking is the intersection of business indebtedness with consumer indebtedness. Recognizing that different approaches are taken to the insolvency of natural persons (in some States a natural person cannot be declared bankrupt at all, while in others there is a requirement for the person to have acted in the capacity of a "merchant") and that many States do not have a developed consumer insolvency system, a number of States have insolvency laws that seek to distinguish between those who are simply consumer debtors and those whose liabilities arise from small businesses. Since consumer credit is often used to finance small business either as start-up capital or for operating funds, it may not always be possible to separate the debts into clear categories. For that reason, where a legal system recognizes both consumer and business debt, it may not be feasible to have rules on the business debts of natural persons that differ from the rules applicable to consumer debts."[57]

163. In addition, as discussed in chapters I and VII above, family members or other related persons and third parties may guarantee business loans of micro or small business debtor with personal assets. The enforcement of their guarantee may lead to insolvency of those individuals who would need to apply for relief under the personal insolvency law. Another approach could be to provide the guarantor a standing to apply for relief in the insolvency proceeding concerning the micro and small business debtor, which could assist to assess the potentially undesirable consequences of enforcing the guarantee.

164. Many insolvency regimes do not 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 may be desirable. Such coordination may involve for example: cooperation between the courts, 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 the court.

165. 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 interest in a single proceeding.[58] Some requirements found in insolvency laws may however hinder such coordination. Among them are the requirements that an applicant to a simplified insolvency proceeding must not be subject to any procedure under the law relating to the restructuring of debts of natural persons, must be active in business and not subject to any formal insolvency procedure. An additional recommendation is therefore included below that invites States to consider encouraging coordination of linked proceedings in the simplified insolvency context, in order to address insolvency of micro and small business debtors and persons affected by it (e.g., personal guarantors, owners and managers) comprehensively.[59] That recommendation draws on the discussion in the *Guide* of joint applications for commencement and procedural coordination in the context of the treatment of enterprise group insolvency and recommendations 199–210.

Recommendation

287. 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 the micro and small business debtor and

[57] The *UNCITRAL Legislative Guide on Insolvency Law*, part two, chap. VI, paras. 12 and 13.

[58] Ibid., para. 126.

[59] A/CN.9/966, paras. 115 and 142.

related persons, including those providing personal guarantees. The law may specify that in such cases the court may order coordination of linked proceedings at its own motion or upon request of any party in interest, which may be made at the same time as an application for commencement of insolvency proceedings or at any subsequent time. Recommendations 208 and 210 of this *Guide* will be applicable to modification or termination of an order for coordination of linked procedures and to notice with respect to such coordination.

IX. Obligations of managers of micro and small businesses in the period approaching insolvency

166. The *Guide* addresses obligations of directors of a debtor company and of a natural person debtor in the period approaching insolvency in part IV. It notes in that respect that civil and criminal liability may be imposed on managers for causing insolvency or failing to take appropriate actions in the vicinity of insolvency. The managers may be required to compensate creditors for losses and may face sanctions, including disqualification from assuming managerial roles in the future. The owners may remain undischarged for a longer period of time.

167. The *Guide* identifies parties who owe those obligations, noting that there is no universally accepted definition of a "director". They may be owners of the business, formally appointed directors and any other person exercising factual control over the business and performing the functions of a director (rec. 258). The *Guide* also notes the increased risk of unexpected liability for banks and others who might be deemed to be directors by reason of their involvement with the company particularly at the time of insolvency.[60] 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 (rec. 255).

168. As noted in paragraph 19 above, in the micro and small business debtor context, there is often no clear separation between ownership and management (owners are often managers regardless of whether they have been formally appointed as managers). Managers of micro and small businesses at the time of financial distress 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. These transactions would be considered fraudulent or otherwise improper and can thus be avoided and lead to personal liability of persons who agreed to the transaction, regardless of whether the business operates as a separate legal entity with limited liability. In addition, high influence of main creditors on micro and small business debtors during the time of financial distress may make such creditors the de facto managers of the micro or small business 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.

169. The *Guide* illustrates steps that the management may take at times approaching insolvency to discharge the obligation to act in the best interest of creditors and other stakeholders and take reasonable steps to avoid insolvency or to minimize its extent (rec. 256). Some of those steps will be less relevant or too expensive for micro and small business debtors, such as holding regular board meetings to monitor situations, calling a shareholder meeting or seeking professional advice of insolvency professionals, lawyers or auditors. Other steps listed in recommendation 256 will be equally applicable to micro and small business debtors. For example, 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. Appropriate steps may

[60] The *UNCITRAL Legislative Guide on Insolvency Law*, part four, section one, chap. I, para. 10.

also include an early recourse to mediation or debt counselling services, if available, and timely engaging in out-of-court debt restructuring negotiations where those are permissible.

170. The recommendations and accompanying commentary of the *Guide* addressing directors' obligations in the period approaching insolvency are generally applicable in the context of micro and small business debtors with additional considerations discussed above.[61]

X. Relationship with other law and institutional framework

A. Relationship with other law

171. Not all measures aimed at mitigating the challenges facing micro and small business debtors in insolvency will fall under the insolvency law; other law may also be relevant. Tax regulations in particular may influence debt restructuring options, as noted in paragraph 50 above. They, as well as accounting regulations, may also include mechanisms for preventing insolvency, for example by requiring or incentivizing tax advisors and accountants of micro and small businesses to inform business owners and managers about financial problems. Those professionals may be in the position to identify signals of financial distress earlier than managers of micro and small businesses who would not necessarily possess required business and financial management skills while other third parties, such as tax or social security agencies and banks, may discover financial distress of the business only when payments are not made, which may be too late for its rescue.

172. In the light of a close interlink between the insolvency of micro and small business debtors, on the one hand, and consumer and personal insolvency, on the other hand (as discussed in chap. VIII above), other laws relevant in the context of micro and small business debtor 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 the right to work and fair remuneration.[62] In addition, business registry regulations and company law that may provide for simplified incorporation of micro and small businesses will also be relevant,[63] including to efforts to generate and maintain information about micro and small businesses throughout their lifecycle. In that latter context, data protection and banking laws and regulations would be relevant as well.

173. 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, as discussed in chapter VII above.

B. Supporting institutional framework

174. Many insolvency reforms aimed at lowering barriers for access to insolvency by micro and small business debtors are complemented by institutional reforms, in particular the creation of debt counselling services and information registries that compile information on financial status of micro and small businesses throughout their life cycle from different sources. In addition, government support may be provided for a fresh start through specialized government agencies or associations of micro and small businesses and microfinance institutions.[64]

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[61] A/CN.9/966, para. 125.

[62] A/CN.9/966, para. 143 (c).

[63] See in that respect the *UNCITRAL Legislative Guide on Key Principles of a Business Registry.* [UNCITRAL Working Group I (MSMEs) is currently working on simplified incorporation aspects.].

[64] A/CN.9/966, para. 141.

175. Insufficient knowledge of business management and financial transactions is cited as a common cause of business failure among micro and small business debtors, especially first-time starters. Some jurisdictions consider therefore mandatory training on those issues for micro or small businesses owners and managers 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 managers in the period approaching insolvency and consequences of not taking appropriate actions at an early stage of financial distress.

176. State support during insolvency usually includes provision of financial and other assistance to micro and small business debtors in relation to insolvency proceedings, government support or subsidization of effective dispute resolution mechanisms (such as mediation and arbitration) and enforcement of settlement agreements. Introducing automated and standardized processes and documentation, for example model reorganization plans, and enabling electronic means of communications for certain procedural steps in insolvency proceedings, such as filing claims or serving notifications, also helps to reduce the costs and the length of procedures.

177. Some governments also provide training to the judiciary and insolvency practitioners with the aim of building the capacity in the public and private sectors necessary to handle specificities of micro and small business debtor insolvencies.[65]"

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[65] A/CN.9/966, para. 130.