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## **Draft text on a simplified insolvency regime**

### **Note by the Secretariat**

#### **Addendum**

#### Contents

	<i>Page</i>
III. Draft recommendations on a simplified insolvency regime not considered by the Working Group at its fifty-seventh session, with accompanying commentary .....	2

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### III. Draft recommendations on a simplified insolvency regime not considered by the Working Group at its fifty-seventh session, with accompanying commentary

#### A. Draft recommendations

7. The Working Group may wish to consider the following draft recommendations that it did not have time to consider at its fifty-seventh session. They are reproduced from working paper A/CN.9/WG.V/WP.170/Rev.1 renumbered and with minor editorial and structural changes.

#### M. Discharge<sup>1, 2</sup>

##### General provisions

###### *Conditions for discharge*

84 [65]. Where the insolvency law providing for a simplified insolvency regime specifies that conditions may be attached to the MSE debtor's discharge, those conditions should be kept to a minimum and clearly set forth in the insolvency law. (*See recommendation 196 of the Guide.*)

###### *Exclusions from discharge*

85 [66]. Where the insolvency law providing for a simplified insolvency regime specifies that certain debts are excluded from a discharge, those debts should be kept to a minimum and clearly set forth in the insolvency law. (*See recommendation 195 of the Guide.*)

###### *Criteria for denying discharge or revoking discharge granted*

86 [67]. The insolvency law providing for a simplified insolvency regime should specify criteria for denying a discharge and criteria for revoking a discharge granted, keeping them to a minimum. In particular, the insolvency law should specify that the discharge is to be revoked where it was obtained fraudulently. (*See recommendation 194 of the Guide.*)

###### *[Partial] [Phased] [Limited] [Delayed] discharge<sup>3</sup>*

###### *Option 1 [as in A/CN.9/WG.V/WP.170]*

###### *Partial discharge*

87 [68]. The insolvency law may envisage a possibility of partial discharge in simplified insolvency proceedings by allowing a discharge of only undisputed claims and referring disputed claims to separate proceedings.

<sup>1</sup> Defined in (m) of the glossary in the introduction to the Guide as "the release of a debtor from claims that were, or could have been, addressed in the insolvency proceedings".

<sup>2</sup> At its fifty-seventh session, the Working Group deferred the consideration of the suggestion that the text should address not only discharge of individual entrepreneurs but also of MSEs that are legal entities (see A/CN.9/1046, para. 98). The Working Group may wish to note in this regard that, except for draft recommendation 90 [71] that refers to individual entrepreneurs, all other recommendations in this section refer to the debtor or the MSE debtor. This term is explained in the draft glossary as encompassing any type of MSE, not only "individual entrepreneurs" (see para. 25 of the draft commentary in section II.B of A/CN.9/WG.V/WP.172).

<sup>3</sup> During the September 2020 informal consultations, concerns were expressed about the concept of "partial discharge" and including reference to disputed claims in that context. It was noted that, although a need for a phased discharge might arise in some cases, such possibility might be addressed in the commentary (e.g., with cross-references to draft recommendation 85 [66] (debts excluded from discharge) and to different categories of debt (business as opposed to private debts)). Options 2 and 3 were included further to the views expressed and suggestions made during the September 2020 informal consultations.

*Option 2**[Phased] [Limited] [Delayed] discharge*

87 [68]. The insolvency law providing for a simplified insolvency regime may envisage a possibility of partial discharge by postponing a discharge of claims excluded from discharge under recommendation [85] until timely objections to the discharge of those claims are resolved in separate proceedings.

*Option 3*

Delete recommendation 87 [68].

**Discharge in simplified liquidation proceedings***Decision on discharge*

88 [69]. The insolvency law providing for a simplified insolvency regime should specify that, in a simplified liquidation proceeding, discharge should take effect upon decision of the competent authority following the distribution of proceeds or the determination that no distribution can be made.

*Discharge conditional upon expiration of a monitoring period*

89 [70]. Where the insolvency law provides that discharge may not apply until after the expiration of a specified period of time following commencement of insolvency proceedings during which period the debtor is expected to cooperate with the competent authority (“monitoring period”), the insolvency law providing for a simplified insolvency regime should:

- (a) Fix the maximum duration of the monitoring period, which should be short;
- (b) Allow the competent authority to establish a shorter duration of the monitoring period on a case-by-case basis;
- (c) Specify that, after expiration of the monitoring period, the debtor should be discharged upon decision of the competent authority where the debtor has not acted fraudulently and has cooperated with the competent authority in performing its obligations under the insolvency law. (*See recommendation 194 of the Guide.*)

*Discharge conditional upon the implementation of a debt repayment plan*

90 [71]. The insolvency law providing for a simplified insolvency regime may specify that full discharge may be conditional upon the implementation of a debt repayment plan. In such case, it should [allow the competent authority to specify the duration of the debt repayment plan (“discharge period”) and]<sup>4</sup> require the discharge procedures to include verification by the competent authority:

- (a) Before the debt repayment plan becomes effective, that the debt repayment obligations reflect the situation of the individual entrepreneur and are proportionate to his or her disposable income and assets during the discharge period, taking into account the equitable interest of creditors; and
- (b) On expiry of the discharge period, that the individual entrepreneur has fulfilled his or her repayment obligations under the debt repayment plan, in which case the individual entrepreneur is discharged upon confirmation by the competent authority of the fulfilment of the debt repayment plan by the debtor.

**Discharge in simplified reorganization proceedings**

<sup>4</sup> The words in square brackets were added by the Secretariat to address a possible duration of the discharge period and the authority that should have the power to fix the duration of the discharge period on a case-by-case basis. The Working Group may wish to consider whether this addition should be retained and, if so, whether it should be expanded by reference to the maximum possible duration of the discharge period to be specified in the law, as is the case with the monitoring period in draft recommendation 89 [70] above.

91 [72]. The insolvency law providing for a simplified insolvency regime [should] [may] specify that full discharge in simplified reorganization is conditional upon successful implementation of the reorganization plan and it shall take immediate effect upon confirmation by the competent authority of such implementation.

## **N. Closure of proceedings**

92 [73]. The insolvency law providing for a simplified insolvency regime should specify minimal and simple procedures by which simplified insolvency proceedings should be closed. (*See recommendations 197 and 198 of the Guide.*)

## **O. Treatment of personal guarantees. Procedural consolidation and coordination**

### **Treatment of personal guarantees**

93 [74]. A simplified insolvency regime should address, including through procedural consolidation or coordination of linked proceedings, the treatment of personal guarantees provided for business needs of the MSE debtor by individual entrepreneurs, owners of limited liability MSEs or their family members.

### **Procedural consolidation or coordination of linked business, consumer and personal insolvency proceedings**

#### *Orders of procedural consolidation and coordination*

94 [75]. The insolvency law may require procedural consolidation or coordination of linked business, consumer and personal insolvency proceedings in order to address comprehensively intertwined business, consumer and personal debts of individual entrepreneurs, owners of limited liability MSEs and their family members. The law may specify that, in such cases, the competent authority or another competent State body, as the case may be, may order procedural consolidation or coordination of linked proceedings on its own motion or upon request of any party in interest, which may be made at the time of application for commencement of insolvency proceedings or at any subsequent time.

#### *Modification or termination of an order for procedural consolidation or coordination*

95 [76]. The insolvency law should specify that an order for procedural consolidation or coordination may be modified or terminated, provided that any actions or decisions already taken pursuant to the order are not affected by the modification or termination. Where more than one State body is involved in ordering procedural consolidation or coordination, those State bodies may take appropriate steps to coordinate modification or termination of procedural consolidation or coordination.

#### *Notice of procedural consolidation and coordination*

96 [77]. The insolvency law should establish requirements for giving notice with respect to applications and orders for procedural consolidation or coordination and modification or termination of procedural consolidation or coordination, including the scope and extent of the order, the parties to whom notice should be given, the party responsible for giving notice and the content of the notice.

## **P. Conversion<sup>5</sup>**

### **Conditions for conversion**

<sup>5</sup> The Working Group may wish to consider whether this section should be expanded by additional recommendations, e.g., draft recommendation 83 addressing conversion of a simplified reorganization proceeding to a liquidation (see section L of draft recommendations found in section II.A of A/CN.9/WG.V/WP.172).

97 [78]. The insolvency law should provide for conversion between different types of proceedings in appropriate circumstances and subject to applicable eligibility and other requirements.

#### **Procedures for conversion**

98 [79]. The insolvency law should address procedures for conversion, including notification to all known parties in interest about the conversion, and mechanisms for addressing objections to that course of action.

#### **Effect of conversion on post-commencement finance**

99 [80]. The insolvency law should specify that where a simplified reorganization proceeding is converted to a liquidation proceeding, any priority accorded to post-commencement finance in the simplified reorganization proceeding should continue to be recognized in the liquidation proceeding. (*See recommendation 68 of the Guide.*)

#### **Other effects of conversion**

100 [81]. The insolvency law should address other effects of conversion, including on deadlines for actions, the stay of proceedings and other steps taken in the proceeding being converted. (*See recommendation 140 of the Guide.*)

### **Q. Appropriate safeguards and sanctions**

101 [82]. The insolvency law providing for a simplified insolvency regime should build in appropriate safeguards to prevent abuses and improper use of a simplified insolvency regime and permit the imposition of sanctions for abuse or improper use of the simplified insolvency regime, for failure to comply with the obligations under the insolvency law and for non-compliance with other provisions of the insolvency law. (*See recommendations 20, 28 and 114 of the Guide.*)

### **R. [Pre-insolvency] [Insolvency prevention]<sup>6</sup> aspects**

#### **Obligations of [MSEs] [persons exercising control over management and oversight of the MSE operations]<sup>7</sup> in the period approaching insolvency of that MSE**

102 [83]. The law relating to insolvency<sup>8</sup> should specify that, at the point in time when [individual entrepreneurs and owners and managers of other types of MSEs (as well as any other person exercising factual control over the business)] [persons exercising control over management and oversight of the MSE operations]<sup>9</sup> knew or ought reasonably to have known that insolvency was imminent or unavoidable, they should have due regard to the interests of creditors and other stakeholders [such as

<sup>6</sup> The Working Group may wish to consider which of the two alternatives for the title of the section conveys better the intended scope of the provisions in this section.

<sup>7</sup> The text in the second set of square brackets is included by the Secretariat in response to the concerns expressed during the May and September 2020 informal consultations and in writing about the persons intended to be covered by the provisions.

<sup>8</sup> Reference to the “insolvency law” in this provision in [A/CN.9/WG.V/WP.170](#) was changed to “the law relating to insolvency” to make it consistent with the Guide.

<sup>9</sup> Different views were expressed during the May 2020 informal consultations on who should be covered by these provisions. Subsequently, the Secretariat received written communication from the International Bar Association expressing concern about including a reference to “owners” in this provision because the owners will not always be in control of the MSE business. The same view was reiterated during the September 2020 informal consultations with reference to part four of the Guide where such term is not used, rather reference is made to persons exercising control over the business (including shadow directors). The Working Group may wish to consider the alternative text in the second set of square brackets included by the Secretariat in response to those concerns.

shareholders]<sup>10</sup> and to take reasonable steps [at an early stage of financial distress]<sup>11</sup> to avoid insolvency and, where it is unavoidable, to minimize the extent of insolvency. Reasonable steps might include:<sup>12</sup>

- (a) Evaluating the current financial situation of the business;
- (b) Seeking professional advice where appropriate;<sup>13</sup>
- (c) Not committing the business to the types of transaction that might be subject to avoidance unless there is an appropriate business justification;
- (d) Protecting the assets so as to maximize value and avoid loss of key assets;
- (e) Ensuring that management practices take into account the interests of creditors and other stakeholders [such as shareholders];
- (f) Considering holding informal debt restructuring negotiations with creditors; and
- (g) Applying for commencement of insolvency proceedings if it is required or appropriate to do so.<sup>14</sup>

(See recommendations 255 and 256 of the Guide.)<sup>15</sup>

### Early rescue mechanisms

103 [84]. As a means of encouraging the early rescue of MSEs, a State should consider establishing mechanisms for providing early signals of financial distress to MSEs, increasing financial and business management literacy among MSE managers

<sup>10</sup> The words in square brackets were added here and in subparagraph (e) by the Secretariat further to the suggestion during the September 2020 informal consultations. The Working Group may wish to consider whether another term (e.g., “equity holders”) would be more appropriate in the MSE context.

<sup>11</sup> The words in square brackets were added by the Secretariat further to the suggestion during the May 2020 informal consultations to highlight in the provision that the listed steps were expected to be taken at an early stage of financial distress. This change, if accepted, may affect the scope of the draft recommendation (the title of the draft recommendation refers to the period approaching insolvency and the preceding part of the draft recommendation refers to imminent or unavoidable insolvency).

<sup>12</sup> Further to the suggestion made during the May 2020 and the September 2020 informal consultations, the order of the listing of reasonable steps in subparagraphs (a) to (g) has changed.

<sup>13</sup> During the September 2020 informal consultations, it was suggested to add in the commentary reference to services of an “independent professional” that may be made available to MSEs at an earlier stage of financial distress. At the same time, it was queried how the competent authority, especially if it is a judicial body, will be able to involve services of an independent professional without commencing the proceeding first. The Working Group may wish to express its position on that issue and consider in that respect paragraph 48 of the draft commentary found in section II.B of A/CN.9/WG.V/WP.172.

<sup>14</sup> Different views were expressed during the May 2020 informal consultations on the desirability of retaining this draft recommendation. One view was that it was repetitive with recommendation 256 of the Guide. The other view was that it should be retained because it considerably simplified that recommendation by adapting it to the MSE context. During the September 2020 informal consultations, those different views were reiterated. In addition, it was noted that obligations of directors of limited liability MSEs in the period approaching insolvency were already addressed in part four of the Guide. As regards obligations of individual entrepreneurs in the period approaching insolvency, it was noted that they would be addressed in domestic law in the context of debtors’ obligations to creditors. In addition, it was noted that the discharge provisions of the text envisaged consequences for individual entrepreneurs acting in bad faith.

<sup>15</sup> During the May and September 2020 informal consultations, concerns were expressed that this draft recommendation was not accompanied by any provision addressing liability of relevant persons for the failure to take the steps listed in that recommendation. The Working Group’s past consideration of that matter was recalled (A/CN.9/1006, para. 88). It was suggested that the commentary might explain that this recommendation sets out the standard for behaviour expected of persons exercising control over management and oversight of the MSE operations in order to prevent insolvency of that MSE; the consequence of the failure to adhere to that standard would be the imposition of personal liability on those persons. In that respect, the Working Group may wish to consider paragraph 365 of the draft commentary below.

and owners [and promoting their access to professional advice. These mechanisms should be easily ascertainable by MSEs].<sup>16</sup>

### **Informal debt restructuring negotiations**

#### *Removing disincentives for the use of informal debt restructuring negotiations*

104 [85]. For the purpose of avoiding MSE insolvency, the State may consider identifying and removing legislative and other disincentives for the use of informal debt restructuring negotiations.

#### *Providing incentives for participation in informal debt restructuring negotiations*

105 [86]. The State may consider providing appropriate legislative incentives for the participation of creditors, including public bodies,<sup>17</sup> [and other relevant stakeholders, in particular employees,]<sup>18</sup> in informal debt restructuring negotiations.

#### *Institutional support with the use of informal debt restructuring negotiations*

106 [87]. The State may consider providing for:

(a) Involvement of a [competent State body] [competent public or private body],<sup>19</sup> where necessary, to facilitate informal debt restructuring negotiations between creditors and debtors and between creditors;

(b) A neutral forum to facilitate negotiation and resolution of debtor-creditor and inter-creditor issues[; and

(c) Mechanisms for covering the costs of the services mentioned in subparagraphs (a) and (b) above [where the MSE concerned has no means to cover them]].<sup>20</sup>

### **[Pre-commencement]<sup>21</sup> business rescue finance**

107 [88]. The law should:

(a) Facilitate and provide incentives for finance to be obtained by MSEs in financial distress before commencement of insolvency proceedings for the purpose of rescuing business and avoiding insolvency;

(b) Subject to proper verification of appropriateness of that finance and protection of parties whose rights may be affected by the provision of such finance, ensure appropriate protection for the providers of such finance, including the payment of such finance provider at least ahead of ordinary unsecured creditors;

<sup>16</sup> The words in square brackets were added by the Secretariat further to the suggestion made during the May 2020 informal consultations.

<sup>17</sup> During the May 2020 informal consultations, the term “public bodies” was preferred to the term “public authorities” used in [A/CN.9/WG.V/WP.170](#).

<sup>18</sup> The words in square brackets were added by the Secretariat further to the suggestion made during the May 2020 informal consultations and further to the concerns expressed that the text did not address rights of employees.

<sup>19</sup> The alternative wording in the second set of square brackets is proposed by the Secretariat in response to the comments made during the May 2020 informal consultations that the mentioned functions could be delegated to private entities in accordance with the law of the relevant State, and flexibility should therefore be retained by not mentioning only State bodies in this context.

<sup>20</sup> Subparagraph (c) was added by the Secretariat further to the suggestion made during the May 2020 informal consultations that the draft recommendation should also address mechanisms for covering costs of services provided by a debt advisor. The Working Group may wish to consider whether the text “[where the MSE concerned has no means to cover them.]” is needed. A similar wording is found in draft recommendation 10 addressing mechanisms for covering costs of administering simplified insolvency proceedings.

<sup>21</sup> Added by the Secretariat to clarify that the draft recommendation addresses pre-commencement finance. Post-commencement finance is addressed in draft recommendation 15 that cross-refers to recommendations 63–68 of the Guide and also in draft recommendation 99 above.

(c) Ensure appropriate protection for those parties whose rights may be affected by the provision of such finance.<sup>22</sup>

## B. Draft commentary

8. The Working Group may wish to consider the following draft commentary to the draft recommendations contained in section A above. The draft commentary was revised from the one found in working paper A/CN.9/WG.V/WP.170/Rev.1:

### M. Discharge [draft recommendations 84–91]<sup>23</sup>

#### 1. Conditions for discharge [draft recommendation 84]

312. 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 the country, to practise in a profession, to hold public office or to act as a company director or manager. They may take effect automatically or upon an order of the competent authority. The period of effectiveness of those conditions and restrictions may be linked to the duration of the debt repayment plan (referred to in this text as the “discharge period”) and may be extended. It may be longer or even indefinite where for example the individual entrepreneur is a member of a profession to which specific ethical rules apply or where disqualifications were ordered by a court in criminal proceedings. For individual entrepreneurs who manage their own businesses or who became insolvent because of giving personal guarantees, some of those restrictions and conditions may have serious consequences, effectively prohibiting them from being involved in future business. Where the insolvency law provides that conditions may be attached to discharge, this [text] recommends that those conditions should be kept to a minimum in order to facilitate the fresh start. It also recommends that those conditions should be clearly set forth in the insolvency law.

#### 2. Exclusions from discharge [draft recommendation 85]

313. Certain types of debt, such as debts based on some tort claims, family support obligations, fraud, criminal penalties, and taxes, are usually excluded from discharge. Where the insolvency law provides that certain debts are excluded from discharge, this [text] recommends that they should be clearly identified in the insolvency law and should be kept to a minimum in order to facilitate the fresh start.

314. The discharge generally affects only debts arising before the commencement of a formal insolvency proceeding. Following discharge, claims that have not been satisfied would be rendered unenforceable. Nevertheless, so called “debt reaffirmation”, “debt reinstatement” or “ride-through”

<sup>22</sup> Different views were expressed during the May 2020 informal consultation on the desirability of retaining this draft recommendation. In support of deleting it, noting that the provision dealt not with post-commencement finance but with pre-commencement finance, it was explained that it may potentially overlap with the work of Working Group I on MSMEs’ access to credit but in any event it did not raise anything unique in the MSE context. During the September 2020 informal consultations, it was noted that, although the incentives for providing finance to MSEs in financial distress should be created, they should be accompanied by safeguards to avoid favouring some creditors.

<sup>23</sup> This section may need to be revised further to the deliberations of the Working Group on draft recommendations addressing discharge. In particular, no commentary to draft recommendation on [partial][phased][limited][delayed] discharge is provided pending the Working Group’s view on desirability of including that recommendation and, if so, its content. In addition, at its fifty-seventh session, the Working Group deferred the consideration of the suggestion that the text should address not only discharge of individual entrepreneurs but also of MSEs that are legal entities (see A/CN.9/1046, para. 98).

arrangements may reinstate those claims. Under them, the debtor reaffirms its obligation to repay a discharged debt usually in exchange for retaining an asset (a car or an office space) or to obtain a new credit following insolvency. Such reaffirmation may occur through conduct (e.g., the debtor continues paying discharged debts) or express agreement concluded before, during or after the insolvency proceedings.

315. In some jurisdictions such arrangements are unenforceable as being against the fresh start principle and the objectives of fairness and predictability since the debtor is allowed to selectively pay one or more, but not all, of its creditors. In other jurisdictions, they are enforceable but only under certain conditions (e.g., a debt reaffirmation agreement must be concluded before the discharge, relate to a secured claim, be disclosed during the insolvency proceeding and there should be no undue hardship on the debtor and its dependants as a result of the repayment of the debt).

**3. Criteria for denying discharge or revoking discharge granted [draft recommendation 86]**

316. A discharge is usually unavailable for an individual entrepreneur who has acted fraudulently, engaged in criminal activity, actively withheld or concealed information, or concealed or destroyed assets or records after the application for commencement. If granted, discharge is usually revoked retroactively upon discovery of those facts. This [text] recommends specifying in the insolvency law criteria for denying a discharge and criteria for revoking a discharge granted. It also recommends that those criteria should be kept to a minimum but emphasizes that discharge granted should be revoked if it was obtained fraudulently.

*[No commentary on draft recommendation 87 is provided at this stage pending the Working Group's view on whether it should be retained and if so, its content.]*

**4. Discharge in simplified liquidation proceedings [draft recommendations 88-90]**

317. [When the MSE debtor is a legal entity, the question of its 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.]<sup>24</sup> In limited liability MSEs, the equity holders will not be liable for the residual claims unless they also provide personal guarantees for business debts, in which case a special treatment may be accorded to them (see recommendations and accompanying commentary in section [O]). In insolvency of individual entrepreneurs and unlimited liability MSEs, the question arises as to whether individual entrepreneurs will still be personally liable for unsatisfied claims following liquidation of the insolvency estate of the debtor.

318. In some jurisdictions, an individual entrepreneur will remain personally liable for debts until all of them are fully paid. In other jurisdictions, an individual entrepreneur remains liable for debts during a certain period of time (referred to in this text as “discharge period”) during which the individual entrepreneur is expected to make a good faith effort to repay its debts. Discharge may be possible only after the debt repayment plan is fully implemented unless acceptable grounds exist justifying the failure to implement the plan. The length of the debt repayment period may vary from jurisdiction to jurisdiction, and within the same jurisdiction it may vary depending on circumstances. Under some laws, that period might be long, e.g., 10 years. The emerging trend is to

<sup>24</sup> This statement may need to be reconsidered in the light of the suggestion made at the fifty-seventh session of the Working Group (A/CN.9/1046, para. 98) to explain in the commentary that, although primarily designed for natural persons, discharge was also available to limited and unlimited liability entities under some domestic laws.

shorten that period with the objective of expediting a fresh start.<sup>25</sup> Another approach is to provide incentives to the individual entrepreneur to comply with the debt repayment plan by making the length of the discharge period dependent on the rate of return to creditors and the individual entrepreneur's compliance with other obligations. At the same time, a predictable and consistent method of assessing disposable income may need to be provided in the debt repayment plan to leave sufficient income for household needs of individual entrepreneurs and their families.

319. Recognizing that there are different approaches to discharge in different jurisdictions and also that unconditional discharge (e.g., without any debt repayment plan or prohibition from obtaining a new credit for a specified period (e.g., six months to a year)) may produce a negative impact on financial discipline and disrespect of contractual obligations, this [text] envisages various discharge options. The competent authority may be authorized to choose the most appropriate one depending on the circumstances of the case and domestic law requirements.

320. This [text] recommends that discharge should take effect upon decision of the competent authority following distribution in liquidation or determination that no distribution to creditors can take place. The monitoring period may apply in both cases to ensure an oversight by the competent authority or an independent professional over the debtor, its assets and income before discharge is granted. This [text] recommends that such monitoring period should be short and its duration should be determined by the competent authority on a case-by-case basis up to the maximum established by law. Discharge will follow upon expiration of the monitoring period fixed by the competent authority provided the debtor was cooperative and no fraud was involved. Where discharge is conditional upon the implementation of a debt repayment plan, this [text] recommends safeguards to protect interests of both the debtor and creditors, in particular that: (a) debt repayment obligations are not onerous for the debtor; and (b) no discharge is granted until the competent authority verifies and confirms that the debt repayment plan was fulfilled.

#### **5. Discharge in simplified reorganization proceedings [draft recommendation 91]**

321. This [text] recommends that simplified reorganization proceedings should remain open until the full implementation of the reorganization plan by the debtor (see recommendation [80]), after which discharge is granted. It has been considered that this approach incentivizes the debtor to fulfil the plan and protects creditors. The competent authority, upon confirmation of the full implementation of the reorganization plan, will give binding effect to the forgiveness, cancellation or alteration of debts in accordance with the approved plan. Where the reorganization plan is not fully implemented or cannot be implemented or there is a substantial breach of the plan by the MSE debtor, the insolvency law may provide for amendment of the plan or conversion of a simplified reorganization proceeding to liquidation (see recommendations [79, 82 and 83] and their accompanying commentary) with the result that terms of discharge will be addressed in that new proceeding. [The approved and confirmed reorganization plan modifies the amount owed by the debtor to creditors with the consequence that, if the debtor defaults under the approved and confirmed plan, and the proceeding may be converted to liquidation, the amount owed by the debtor to creditors is determined in conformity with the

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<sup>25</sup> This section may need to be expanded in the light of issues raised as regards the draft recommendation in footnote 4 above.

plan, not with reference to the amount originally owed to creditors, unless there are contractual provisions between the debtor and creditors to the contrary.]<sup>26</sup>

## N. Closure of the proceedings [draft recommendation 92]

322. This [text] recommends that procedures by which simplified insolvency proceedings are closed should be minimal and simple. Requirements that may apply for the closure of standard business insolvency proceedings may need to be waived or simplified for a simplified insolvency regime. In particular, hearings of a final accounting of the realization of assets and distribution of proceeds or implementation of the reorganization plan may be replaced by written records for the order of the closure of a simplified insolvency proceeding to be issued by the competent authority.

323. In simplified liquidation proceedings, the party responsible for realization of assets and distribution of proceeds (where it is different from the competent authority) may be expected to file to the competent authority a final accounting of realization of assets and distribution of proceeds. The competent authority may communicate that report to the known parties in interest using electronic means where possible. Provided that no objection or opposition is raised, the competent authority may need to file the final accounts and report of the simplified liquidation proceedings with the body responsible for registration of business entities so that the latter could make the necessary entries in the State records. Some laws may however require a formal application to that body for an order of dissolution of a legal entity.

324. Unlike insolvency regimes that envisage the closure of the reorganization proceeding upon approval and confirmation of the reorganization plan and the reopening of such proceeding if the debtor fails to implement the plan, this [text] envisages that the simplified reorganization proceeding will remain open until its closure by the competent authority after confirmation of the implementation of the plan (see recommendation [80]). It also envisages a possibility of supervision by the competent authority or by an independent professional of the implementation of the plan (see recommendation [81]). The closure of the simplified reorganization proceedings would need to reflect procedures put in place for supervision of the plan, if any.

325. Simplified reorganization proceedings may be allowed to automatically close by the order of the competent authority where the latter supervised the implementation of the plan and ascertained its full implementation. For transparency and completeness, the competent authority should be required to notify all known parties in interest about its order to close the proceeding and the steps taken by the competent authority to ascertain that the plan was fully implemented. Where the implementation of the plan was supervised by an independent professional, filing a final report by the independent professional confirming the full implementation of the plan would be a prerequisite for the competent authority to take steps to close the reorganization proceeding. In some jurisdictions, reorganisation formally ends only with a reorganisation entry made in relation to the debtor in relevant State records.

326. Where reorganization failed, simplified reorganization proceedings should be allowed to automatically close by the order of the competent authority with respect to a solvent debtor. Where it failed with respect to an insolvent debtor, the competent authority should be able, on its own motion or upon the

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<sup>26</sup> During the September 2020 informal consultations, it was suggested that the commentary should explain that, to the extent the plan has been approved but there is a default by the debtor under the plan, the default is to be determined with reference to the amount of debt approved for repayment under the plan rather than the original debt owed upon commencement of the simplified insolvency proceeding. The same point may be relevant in other contexts, such as those addressing effects of conversion. The Working Group may wish to formulate its position on this suggestion.

application by an independent professional that supervised the implementation of the plan or by any party of interest, to make a ruling declaring the debtor insolvent and initiating the debtor's liquidation. Possible implications of conversion of one simplified insolvency proceeding to another (in this case, the failed reorganization proceeding to a simplified or standard liquidation proceeding) for the closure of the originally filed proceeding are addressed in section [P] on Conversion below. In some jurisdictions, conversion may be treated as a continuation of the originally filed proceeding and would not involve the formal closure of the originally filed proceeding and the commencement of a new proceeding while in others the opposite may be true.

327. The decision to close may be notified only to parties that participated in the proceeding. Requiring the issuance of a public notice of closure of a simplified insolvency proceeding may defeat measures taken in the proceeding to reduce the stigma of insolvency. Some laws may however require issuing a public notice of closure of insolvency proceedings in all cases as a measure to prevent abuses by the debtor that may, for example, continue claiming benefits of a stay and other protective measures triggered by the insolvency proceeding.

## **O. Treatment of personal guarantees. Procedural consolidation or coordination of linked proceedings [draft recommendations 93–96]**

### **1. General**

328. The need for procedural consolidation or coordination of linked proceedings in a simplified insolvency regime may arise because of the cross-over of business and personal insolvency, the overlap of business and household assets and intertwined debts of related persons, in particular because they provided personal guarantees for business needs of the MSE debtor. Since more than one State body may be involved in handling linked proceedings, achieving procedural consolidation or coordination of those proceedings would not only be procedurally convenient and cost-efficient but would also facilitate sharing of information to obtain a more comprehensive evaluation of the situation of the various parties involved and finding the best solution for all concerned.

329. States may already adequately provide for the possibility of coordinating or consolidating linked proceedings, considering joint applications and using other means to accord proper treatment to closely linked interests of different persons. This [text] nevertheless recommends introducing specific requirements and procedures to that effect for a simplified insolvency regime. It also recommends addressing in a simplified insolvency regime the treatment of personal guarantees provided for business needs of the MSE debtor by individual entrepreneurs, owners of limited liability MSEs or their family members. Special treatment of such guarantors may be necessary in order to alleviate a disproportionate hardship and it may be achieved through procedural consolidation or coordination of linked proceedings or other means.

### **2. Treatment of personal guarantees [draft recommendation 93]**

330. Lenders to MSEs often require guarantees to secure business loans. Such guarantees are commonly provided by founders, owners or members of unlimited liability MSEs or of limited liability MSEs or by their family members or other related persons. Personal guarantors will face payment claims where the guaranteed obligation cannot be performed by the debtor, which is usually before or after the opening of an insolvency proceeding. Allowing unrestricted enforcement of guarantees could lead to destitution for the entire family of an individual entrepreneur or owners of limited liability MSEs. For these reasons, this [text] recommends addressing in a simplified insolvency regime personal

guarantees provided for business needs of the MSE debtor by individual entrepreneurs, owners of limited liability MSEs or their family members.

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

332. Nevertheless, where invoking a personal guarantee would likely result in, in addition to the business insolvency, the personal insolvency of individual entrepreneurs, owners of limited liability MSEs or their family members, consideration should be given to providing a procedure to address the position of the MSE debtor and its guarantors together. This [text] suggests that this may be achieved through procedural consolidation or coordination of linked proceedings, in this case insolvency proceedings against the MSE debtor and insolvency or enforcement proceedings against its guarantors.

333. For example, the guarantor's creditors may initiate insolvency proceeding against the guarantor where enforcement attempts failed, or the guarantor itself may apply for simplified insolvency proceedings at an early stage of financial distress under recommendation [23], where it is eligible. At the time of application, the applicant may petition for procedural consolidation and coordination of linked insolvency proceedings (see recommendation [94] in that respect]). This may trigger procedural consolidation or coordination of linked insolvency proceedings as envisaged in recommendations [94-96]. Where no insolvency proceeding but debt enforcement proceeding has been commenced against a personal guarantor of the MSE debtor, recommendation [93] suggests providing in the law for a possibility of linking also those different types of commenced proceedings (insolvency proceeding against the MSE debtor on the one hand and personal guarantee enforcement proceeding against the guarantor on the other hand).

334. Where no proceeding against the guarantor has commenced, the law may allow the guarantor to bring potential claims of creditors for consideration in the insolvency proceeding commenced against the MSE debtor so that those claims could be accorded appropriate treatment with the purpose of preventing potential insolvency of the guarantor. For example, the law may permit imposing a stay on the enforcement against personal guarantors of the MSE debtor for a limited duration on a case-by-case basis. When approving or confirming a reorganization plan, the competent authority may accord special treatment to a guarantor's claim against the MSE debtor vis-à-vis other claims in the plan. The insolvency law may permit MSE debtors' guarantors to petition for a reduction or discharge of their obligations under the guarantee if those obligations are disproportionate to the guarantor's revenue and may also permit the guarantor to pay in instalments for an extended period. The competent authority or another relevant State body may be allowed to exercise discretion in favour of the guarantor's discharge or the reduction of the obligation to the part of the debt not covered by the MSE debtor's debt repayment obligations.

335. These measures may facilitate the successful reorganization of the MSE debtor and alleviate a disproportionate hardship on the guarantor. Special measures of protection may be envisaged in law other than insolvency law for especially vulnerable guarantors, e.g., those who are found to have provided guarantees under duress or those who are dependent on or have strong emotional ties with the debtor. Special treatment has been accorded to such guarantors, for example, when the guarantee was found unreasonable or because, at the time of signing the contract, the financiers did not explain the consequences of giving a personal guarantee or agreeing on certain clauses (e.g., "all money" clauses).

Some jurisdictions may impose restrictions on the kinds of guarantee a spouse, child or other dependent person may give.

**3. Procedural consolidation or coordination of linked business, consumer and personal insolvency proceedings [draft recommendations 94-96]**

336. This [text] suggests that the law may require procedural consolidation or coordination of linked business, consumer and personal insolvency proceedings in order to address comprehensively intertwined business, consumer and personal debts of individual entrepreneurs, owners of limited liability MSEs and their family members. The order of procedural consolidation or coordination may be issued at the outset of simplified insolvency proceedings or later. Such order may originate not only from the competent authority but from another State body involved in consideration of a related case. Procedural consolidation or coordination may be initiated on the motion of the competent authority or that other State body or upon request of the debtor or another party in interest.

337. The scope of an order for procedural consolidation or coordination would generally be determined by the competent authority or other relevant State body in each case. The conduct and administration of any related proceedings could be consolidated (procedural consolidation) or could run in parallel with measures put in place to ensure close coordination between or among them (procedural coordination). Although administered in a coordinated manner, the assets and liabilities of each person involved in the procedural consolidation or coordination would remain separate and distinct. Accordingly, the effect of procedural consolidation or coordination would be limited to administrative aspects of the proceedings (e.g., coordinating deadlines) and would not involve a substantive consolidation discussed in part three of the Guide. While the need for substantive consolidation of assets of various persons involved in MSE insolvency cannot be excluded altogether, the complexities arising from the substantive consolidation will most likely necessitate commencement of a standard business insolvency proceeding in those cases.

338. This [text] also recommends envisaging in the law a possibility of modification or termination of an order for procedural consolidation or coordination. Actions and decision already taken in the proceedings should be preserved in case of modification or termination of the original order and coordination of steps of the involved States bodies should be ensured. For transparency, certainty and predictability and protections of interests of all parties involved, this [text] recommends that giving notice of all matters related to procedural consolidation and coordination should be required, and the insolvency law should specify the scope and extent of the orders for procedural consolidation or coordination, the parties to whom notice should be given and the content of such notice. Since more than one State body may be involved, the law should also clearly identify the State body responsible for giving such notices.

**P. Conversion [draft recommendations 97–100]**

**1. Conditions for conversion [draft recommendation 97]**

339. This [text] recommends that a possibility of conversion between different types of insolvency proceeding, whether simplified or standard, should be envisaged in a simplified insolvency regime. Conversion of one proceeding to another would be possible only if eligibility and other requirements applicable to that other proceeding are met. This [text] also recommends that conversion should take place only in appropriate circumstances. It notes in that respect that a single complication, complexity or difficulty that may arise in a simplified insolvency proceeding should not trigger an immediate conversion to a standard

business insolvency proceeding. All efforts should be made to preserve effectiveness of a simplified insolvency regime in resolution of financial difficulties of eligible debtors.

340. Reasons for conversion of one type of a simplified insolvency proceeding to the other and of simplified insolvency proceedings to standard business insolvency proceedings have been addressed in preceding sections of this [text]. In summary, the [text] explicitly envisages, or does not exclude the possibility of: (a) conversion of a simplified reorganization to a simplified liquidation; (b) conversion of a simplified liquidation to a simplified reorganization; (c) conversion of a simplified insolvency proceeding to a standard business insolvency proceeding; and (d) conversion of one type of a simplified liquidation proceeding to the other (i.e., one involving a sale and disposal of the assets and distribution of proceeds to the other not involving such steps and vice versa). The need for conversion in those cases will be assessed by the competent authority.

341. The [text] envisages conversion of simplified reorganization to simplified liquidation where: (a) a reorganization plan is not presented for approval by creditors within the established deadline (see recommendation [70]); (b) the presented or modified plan failed to obtain required approval by creditors (see recommendation [76 (d)]); (c) there is a substantial breach by the debtor of the terms of the plan or inability to implement the plan (see recommendation [82]); (d) a challenge of the confirmed reorganization plan was successful (see recommendation [78]); or (e) it was established that the debtor is insolvent and there is no prospect for viable reorganization (see recommendation [83]). Although not explicitly addressed in the text, such conversion may take place also if the competent authority is unable to confirm the plan approved by creditors for reasons specified in recommendation [77] or where the amended plan did not receive the required approval of creditors (see recommendation [79 (c)]).

342. A conversion of a simplified liquidation proceeding to a simplified reorganization proceeding (for example, where business rescue finance became available to the MSE debtor after the commencement of the simplified liquidation proceeding) is not explicitly envisaged in the text because such conversion would be rare. The law providing for a simplified insolvency regime may need to establish a time point in the simplified liquidation process after which conversion to a simplified reorganization proceeding would not be possible and should also address whether, and if so how, the effects of the simplified liquidation proceeding would be preserved in a simplified reorganization proceeding.

343. Conversion of a simplified insolvency proceeding to a standard business insolvency proceeding should be justified by the complexity of the case. For example, this [text] envisages such conversion in case of the need to commence avoidance proceedings (see recommendation [44]) or following verification of reasons for the objection to the closure of the proceeding as provided in recommendation [66]. Conversion of a simplified liquidation proceeding to a different type of insolvency proceeding is envisaged also under recommendation [62] where an objection is raised to a liquidation schedule. A simplified reorganization proceeding may be converted to a different type of insolvency proceeding under recommendation [78] if the confirmed reorganization plan is successfully challenged, or under recommendation [82] where there is a substantial breach by the debtor of the terms of the reorganization plan or inability to implement the plan. The phrase “a different type of insolvency proceeding” found in those recommendations should be interpreted depending on the context as encompassing not only another type of a simplified insolvency proceeding envisaged in the text but also a standard business insolvency proceeding (liquidation or reorganization).

344. Although outside the scope of this [text], the conversion of a standard business insolvency proceeding to a simplified insolvency proceeding may also need to be envisaged in an insolvency law. The need for such conversion might arise for example after commencement of a standard business insolvency proceeding and confirmation by a competent State body that the debtor is eligible for a simplified insolvency proceeding and that an effective oversight of the debtor's liquidation or reorganization can better be ensured by the competent authority in a simplified insolvency proceeding (e.g., because of creditors' disengagement).

345. Conversion of proceedings should be differentiated from modifications within the same proceeding, such as displacement of the debtor-in-possession in simplified reorganization proceedings or introduction of a mediation stage to resolve disputes among creditors or between the debtor and its creditor(s). The insolvency law should allow the competent authority to introduce modifications on its own motion or upon request of any party in interest where the circumstances of the case so justify.

## **2. Procedures for conversion [draft recommendation 98]**

346. How conversion can be triggered is the question for the domestic insolvency law to address. It may be automatic once certain conditions are fulfilled, with the law allowing a dissenting party to challenge such an automatic conversion, or conversion may require application to a relevant State body by an interested party. Such body could also be given the power to convert on its own motion where certain conditions are met. Entries may be required to be made in relation to the debtor in relevant State records. For those reasons, this [text] defers these issues to the domestic law suggesting that the insolvency law should address procedures for conversion, including notification to all known parties in interest about conversion and mechanisms for addressing objections to that course of action.

347. Automatic conversion would help to avoid the delay and expense of a separate application by the party interested in conversion. It may not however always be desirable. For example, in some cases, even where the failure to implement the reorganization plan 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 the business. Instead of conversion to liquidation, they may opt for replacement of the debtor-in-possession with an independent professional. It may also be preferable to leave creditors to pursue their rights at law, without necessarily liquidating the debtor, in particular where the debtor commenced a reorganization proceeding to address financial difficulties at an early stage of financial distress. Serving an advance notice of intended conversion to all known parties in interest to allow them to object to that course of action may therefore be considered an essential safeguard.

348. A related question is whether a conversion is treated as a continuation of the originally filed proceeding or the formal closure of the originally filed proceeding and the commencement of a new proceeding. Approaches may vary depending on jurisdictions and this [text] defers that issue to the domestic law as well.

## **3. Effect of conversion [draft recommendations 99 and 100]**

349. Regardless of approaches taken to conversion and its procedures, implications of conversion should be carefully considered. This [text] highlights possible implications on post-commencement finance, deadlines for actions and the stay of proceedings in the light of their particular importance on the debtor and other parties in interest.

350. This [text] recommends that priority accorded to post-commencement finance in the simplified reorganization proceeding should be recognized in a subsequent liquidation. This measure is recommended in order to encourage the

provision of such finance to financially distressed debtors undergoing reorganization.

351. As regards deadlines, adjustments may need to be made to the standard time periods that run from the effective date of commencement of an insolvency proceeding since a significant period of time may elapse between the commencement of the originally filed proceeding and its conversion. For example, where a simplified liquidation proceeding is converted to a reorganization proceeding, the insolvency law should address the impact of conversion on time periods for proposing a reorganization plan.

352. Clarity about the continued application of the stay and its scope in case of conversion would be essential for all parties in interest. The insolvency law should address other implications of conversion, including: (a) the effect of the conversion on the exercise of avoidance powers in respect of payments made in the course of the reorganization proceedings; (b) the effect of the conversion on the timing of the suspect period; (c) the treatment of creditor claims that have been adjusted in the reorganization, i.e., whether in any subsequent liquidation they are to be reinstated to the original value or enforced with the adjusted value as reflected in the approved and confirmed reorganization plan;<sup>27</sup> and (d) any additional costs arising from conversion (e.g., the party requesting conversion may be required to provide security to cover additional costs).

#### **Q. Appropriate safeguards and sanctions [draft recommendation 101]**

353. Implementing an effective sanctions regime to prevent abuse or improper use of the simplified insolvency regime and to impose appropriate penalties for misconduct is listed among the key objectives of the simplified insolvency regime (see recommendation [1]). Inclusion of such objective in the context of the simplified insolvency regime was considered justified because of the main features of such regime: (a) simple, flexible, low-cost, expeditious and easily accessible and available procedures; (b) debtor-in-possession as the default approach in simplified reorganization proceedings; and (c) creditor disengagement and, as a consequence, the lack of creditors' effective control over the insolvency estate and the MSE debtor's actions during simplified insolvency proceedings (those features are discussed in more detail in Introduction and section [D] of this commentary). In the light of those features, the effective system of sanctions has been considered necessary as a deterrent of possible abuses and improper use of a simplified insolvency regime and an essential means of achieving other objectives of a simplified insolvency regime such as ensuring protection of all parties in interest throughout simplified insolvency proceedings.

354. At the same time, in designing the sanctions regime, the underlying purpose of the simplified insolvency regime and the characteristics of the intended users should not be overlooked. Sanctions should not be imposed with the aim to punish an MSE for any inappropriate or negligent step that it might take, perhaps due to its low sophistication in business, financial and legal matters. Such approach would run counter the goals of promoting entrepreneurship and sound risk-taking by honest and cooperative MSEs and would discourage MSEs to resolve their financial difficulties as early as possible by using the simplified insolvency regime.

355. For those reasons, this [text] focuses on building in appropriate support measures and safeguards that might prevent mistakes from occurring. They in particular include provision of timely and affordable assistance and supervision to the MSE debtor with respect to the fulfilment of its obligations under the insolvency law before and throughout the simplified insolvency proceedings.

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<sup>27</sup> In that respect, see footnote 26 above.

They are supplemented by requirements for notices and notifications (see recommendations [18, 31 and 32] and section [G]) and the rights of any party in interest to raise objections, to be heard and request review (see recommendation [19]). In addition, a range of options is made available to the competent authority and parties in interest for deployment when justified, in particular displacement of the debtor-in-possession in simplified reorganization proceedings where necessary (see recommendation [16]) and conversion of proceedings (see section [P] above).

356. In addition to a general reference to an effective sanctions regime in the key objectives of the simplified insolvency regime, explicit references to sanctions are found in recommendations [30 and 38] that deal with denial of application for commencement of a simplified insolvency proceeding and a dismissal of the proceedings. In those cases, imposition of sanctions is listed as a possible consequence of denial or dismissal. The words “where appropriate” found in those provisions suggest that imposition of sanctions would not always be an appropriate measure. In the absence of wrongful intent, the competent authority may deny the application or dismiss the proceedings already commenced or commence a different type of insolvency proceedings than the one requested by the debtor or creditor(s) in their application for commencement of insolvency proceedings, without imposing any sanctions or costs.

357. An explicit reference to sanctions and costs only in those two recommendations should not mean that in other cases the need for imposition of sanctions or costs would not arise in a simplified insolvency regime. This commentary highlights other instances where imposition of sanctions or costs either on the debtor or creditors or other parties in interest may be appropriate in order to deter or punish inappropriate actions.

358. This [text] leaves it to the domestic law to specify when the competent authority would be required and where it will be allowed to impose sanctions and, if so, which one(s). Consideration should also be given to the parties to whom the sanctions should apply in the case of a legal person, for example, any person who generally might be described as being in control of that legal person, including directors and managers (see in that respect recommendations [20 and 102]).

359. Sanctions may include denial of discharge, longer periods for obtaining a full discharge, other conditions attached to discharge, revocation of discharge granted and disqualification from taking up or pursuing a specific business activity or practising a particular profession. Sanctions under insolvency law may be accompanied by sanctions under other law, such as criminal law sanctions for more serious misconduct such as fraudulent, dishonest or bad faith behaviour.

360 To be effective, sanctions should be appropriate and proportionate. It would be unreasonable to impose the same sanctions for fraudulent, dishonest and bad faith behaviour as for less serious non-compliance with the insolvency law especially not involving the wrongful intent. To be effective, sanctions should also be enforceable and timely imposed and enforced.

## **R. [Pre-insolvency] [Insolvency prevention] aspects<sup>28</sup> [draft recommendations 102–107]**

### **1. Insolvency prevention obligations of MSEs [draft recommendation 102]**

361. Due to their low sophistication in business, financial and insolvency matters and the lack of resources to have recourse to regular professional advice on those matters, MSEs may be unaware of their obligations during the time of

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<sup>28</sup> See the issues raised with respect to the relevant draft recommendations. This section will need to be redrafted in the light of the Working Group’s views on those issues.

financial difficulties, in particular that they are expected to exercise special care with respect to business, business assets, business transactions, creditors and employees and take actions to avoid insolvency or to minimize its extent. At the time of financial distress, MSEs 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 to secure additional loans) or to obtain goods or services on credit without any prospect of payment. As a consequence, they may face civil and criminal liability, including a longer period for discharge of their debts.

362. Recommendation [102] was included to make insolvency prevention obligations of MSEs more explicit. It draws on recommendations 255 and 256 of the Guide, adjusting obligations listed in recommendation 256 of the Guide to the specific context of MSEs. Ideally, the insolvency law providing for a simplified insolvency regime itself should list such obligations, for ease of reference and better clarity. This [text], like the Guide, recognizes however that such obligations might be found in laws other than the insolvency law (such as the law on corporations or any laws and regulations specific to MSEs). For that reason, recommendation [102] refers to the law relating to insolvency as the source of such obligations, rather than the insolvency law providing for a simplified insolvency regime.

363. Some obligations listed in recommendation [102], such as evaluating the current financial situation of the business (subparagraph (a)) or seeking professional advice (subparagraph (b)), are continuous, i.e., they exist throughout the operation of an MSE regardless of whether MSE is in financial difficulty or not. Reference to professional advice may include pro bono, debt counselling services, mediation or other professional advice and services that may be made available specifically to MSEs by public or private entities in a given State. Other obligations listed in the recommendation will arise at an early stage of financial distress (e.g., holding informal debt restructuring negotiations) or they will arise only during the period approaching insolvency (e.g., protecting and maximizing the value of assets, avoiding loss of key assets and transaction that may be avoided).

364. An obligation listed in subparagraph (g) (applying for commencement of insolvency proceedings) is relevant to both early and late stages of financial distress. This is because recommendation [23] allows eligible debtors to apply for commencement of a simplified insolvency proceeding at an early stage of financial distress without the need to prove insolvency. The use of that option may allow the debtor to restructure debt and avoid insolvency. For some MSEs, applying for commencement of insolvency proceedings will be the measure of the last resort for reasons discussed in the Introduction part of this commentary. They will have no choice but to apply for commencement of insolvency proceedings when insolvency is actual, imminent or unavoidable at the risk of facing civil and criminal liability under applicable domestic insolvency law. The general obligation at such late stage, as stated in the chapeau of recommendation [102], would be to have due regard to the interests of creditors and other stakeholders, such as employees and equity holders, and to take reasonable steps to avoid insolvency and where it is unavoidable to minimize the extent of insolvency.

365. Recommendation [102] sets out the standard of behaviour with the consequence that, if such standard is not adhered to, personal liability may be imposed on persons exercising factual control over the management and oversight of MSE operations. The behaviour of such persons will be judged against knowledge, skills and experience actually possessed by such person, or reasonably be expected of such person. The obligations discussed above would attach to any person who exercised factual control over the management and oversight of MSE operations at the time the business was facing actual or imminent insolvency, and may include persons who subsequently resigned. It

would not include a person appointed after the commencement of insolvency proceedings.

366. Different persons may exercise factual control over the management and oversight of MSE operations. In the case of individual entrepreneurs, this will be an individual entrepreneur herself or himself; in the case of entities, such persons may include the owners, actual or formally appointed managers or directors<sup>29</sup> and individuals and entities acting as de facto<sup>30</sup> or “shadow” directors,<sup>31</sup> as well as persons to whom the powers or duties of a manager or director may have been delegated by the managers or directors.

367. Persons exercising factual control over the management and oversight of MSE operations may also include special advisors and in some circumstances, banks and other creditors, when they are advising an MSE on how to address its financial difficulties. In some cases, that “advice” may amount to determining the exact course of action to be taken by the MSE and making the adoption of a particular course of action a condition of extending credit. Nevertheless, provided that the MSEs retains discretion to refuse the course of action dictated by outside advisors and the outside advisors are acting at arm’s length, in good faith and in a commercially appropriate manner, it is desirable that such advisors not be considered as falling within the class of persons subject to any obligations listed in recommendation [102]. If self-serving behaviour of such advisors prejudiced the position of other creditors, they may however face liability under insolvency law.

## 2. Early rescue mechanisms [draft recommendation 103]

368. This [text] recommends putting in place early rescue mechanisms with the aim to prevent MSE insolvencies. Those mechanisms may be different but this [text] highlights three: (a) providing MSE with early warning signals about their financial difficulties; (b) increasing financial and business management literacy among MSEs; and (c) promoting MSE access to professional advice.

369. Early warning tools may be put in place by States or by private entities to detect circumstances that could give rise to the likelihood of insolvency and can signal to an MSE the need to act without delay. Information technology solutions may in particular be helpful in automatically generating alert mechanisms, for example, when an MSE has not made certain types of payment (e.g., taxes or social security contributions). Non-payment of those contributions may, however, be the consequence of already serious financial problems. Certain

<sup>29</sup> There is no universally accepted definition of what constitutes a “director”. A person might be regarded as a director when charged with making or do in fact make or ought to make key decisions with respect to the management of a company. They may be independent outsiders or officers or managers of a company serving as executive directors, referred to as “inside directors”.

<sup>30</sup> A de facto director is generally considered to be a person who acts as a director but is not formally appointed as such or there is a technical defect in their appointment. A person may be found to be a de facto director irrespective of the formal title assigned to them if they perform the relevant functions. It may include anyone who at some stage takes part in the formation, promotion or management of the company. In MSEs, that will most likely include family members. Typically, more than simply involvement in the management of the company would be required. A de factor director status may be determined by a combination of acts, such as the signing of invoices or payment orders; signing of business correspondence as “director”; allowing customers, creditors, suppliers and employees to perceive a person as a director or “decision maker”; and making financial decisions about the future of business with banks, creditors and accountants.

<sup>31</sup> A “shadow” director may be a person not formally appointed as a director but in accordance with whose instructions the MSE is accustomed to act. Generally, shadow directors would not include professional advisors. To be considered a shadow director, the person should have the capacity to influence business decision making and to make financial and commercial decisions which bind the business. In some cases, the management may cede some or all of its management authority to the shadow director. In considering the conduct that might qualify a person to be a shadow director, it may be necessary to take into account the frequency of the conduct and whether or not the influence was actually exercised.

professions, such as tax advisers and accountants, may be in a position to identify signals of financial distress considerably earlier. The domestic law may build incentives for those professionals to flag signals of financial distress to MSEs once they are identified.

370. Insufficient knowledge of business management and financial transactions is cited as a common cause of business failure among MSEs, especially first-time starters. For this reason, this [text] recommends making available to MSEs educational tools to increase financial and business management literacy and skills among MSEs. Training on usual factors that lead or contribute to financial distress, such as the loss of a key customer, supplier or contract, departure of a key employee or adverse changes in rental, supply or loan terms, may be supplemented by training on examination of the viability of the business and changes that may be required in expenditure, business and management practices.

371. MSEs may also benefit from professional advice on their financial situation, debt restructuring options and preparation of an application to commence insolvency proceedings or response to an application for commencement of an insolvency proceeding launched by a creditor. Mediation and conciliation services may also be helpful for resolution of disputes between MSE debtors and creditors and among creditors. For this reason, this [text] recommends promoting and facilitating MSE's access to professional advice. Such advice may be provided by public or private organizations, such as tax authorities, banks, chambers of commerce, professional associations as well as law and accounting firms in their pro bono programs.

372. This [text] recommends making these mechanisms easily ascertainable by MSEs. Otherwise, they will not achieve the desired objective. Information about them may be made available, for example, on a dedicated website or web page of relevant State authorities in charge of MSE issues.

### **3. Informal debt restructuring negotiations [draft recommendations 104-106]**

#### *General*

373. Unlike formal insolvency proceedings that involve all creditors, informal debt restructuring negotiations usually involve a limited number of creditors, which may accommodate the need for a prompt resolution that is not always possible in formal proceedings. They also allow parties to preserve confidentiality, which helps to avoid the stigma attached to insolvency. In addition, they may provide debtors with the benefit of resolving their financial difficulties without affecting their personal credit scores, which is important for obtaining new finance and a fresh start. As an alternative to the need to file for formal insolvency proceedings every time MSEs want to restructure all or some of their debts at an early stage of financial distress, informal debt restructuring negotiations can effectively supplement a simplified insolvency regime and prevent it from being overwhelmed and not being able to fulfil its objectives.

374. For these reasons and also in the light of the expected advantages of informal debt restructuring negotiations in preventing the build-up of non-performing loans and over-indebtedness of MSEs, this [text] invites States to consider creating an enabling environment for holding informal debt restructuring negotiations. It recommends certain measures that would be conducive to creating such environment.

#### *Removing disincentives for the use of informal debt restructuring negotiations [draft recommendation 104]*

375. First, this [text] recommends that States may consider removing any explicit or implicit prohibitions or disincentives for engaging in those negotiations. While in some jurisdictions informal debt restructuring

negotiations are permitted or required to be exhausted by a debtor and its creditors before they can initiate formal insolvency proceedings, in other jurisdictions debt restructuring agreements or arrangements between a debtor in financial distress and some or all of its creditors cannot occur outside formal insolvency proceedings. In particular, an obligation found in the insolvency legislation of many countries to file for formal insolvency within a certain period after the occurrence of certain events creates obstacles to holding informal debt restructuring negotiations. Another common disincentive to holding them is insolvency law provisions on avoidance of transactions concluded during a certain period before filing for insolvency (a suspect period).

376. Disincentives for using informal debt restructuring negotiations may be found also in other laws. For example, tax regulations may allow writing off only those debts that were discharged in formal insolvency proceedings. They may permit only creditors to claim losses and tax deductions from debt write-offs but impose income tax on debtors whose debts are written off.

*Providing incentives for participation in informal debt restructuring negotiations [draft recommendation 105]*

377. Second, this [text] recommends that incentives may be built into the law for participation in those negotiations. For example, monthly targets may be imposed on banks to successfully restructure debts of MSEs. Tax incentives may apply for writing off bad or renegotiated debts. Sanctions may be imposed on parties acting in bad faith during those negotiations and the law may stipulate that passive creditors will be bound by a reached settlement if they disregard attempts to hold negotiations.

378. In addition, informal debt restructuring negotiations have proved to be efficient when they rely on some features of formal insolvency processes, such as the statutory stay on enforcement and other proceedings against a debtor and its assets. Such statutory stay would allow the negotiations to progress without the threat that a single creditor may disrupt the entire process by filing for insolvency proceedings, commencing enforcement actions or suspending, terminating or modifying existing contracts with a debtor. A contract-based standstill arrangement may be less effective since creditors usually preserve the right to terminate it at any time at their discretion, bringing uncertainty and unpredictability to parties involved in informal debt restructuring negotiations. In addition, a negotiated stay on the payment of debts may trigger formal insolvency in some jurisdictions.

379. The insolvency law may also build in incentives for holding and participation in informal debt restructuring negotiations. In particular, it may exempt transactions arising from such negotiations from avoidance. It may also provide for an expedited mechanism for the approval of a debt restructuring plan resulting from informal debt restructuring negotiations if such approval is required by law or desired by negotiating parties. Usual safeguards would apply to ascertain that creditors that were not involved in negotiations are indeed not affected by the plan and that adversely affected creditors are properly protected. Recommendations 160–168 of the Guide are relevant in that context.

*Institutional support with the use of informal debt restructuring negotiations [draft recommendation 106]*

380. Third, this [text] recommends that the involvement of a competent public or private body as a facilitator of such negotiations may be necessary in the MSE context. Such body should have sufficient authority and power to persuade key institutional creditors, such as tax authorities and banks, to participate in informal debt restructuring negotiations with MSEs. It should also have capacity to ensure oversight to prevent abuses (e.g., creditors may use their bargaining power to refuse to agree to any modifications of their claims or pressure debtors into accepting onerous plans that are not viable and would not

be acceptable in formal proceedings). Such body should also be expected to ensure that non-viable businesses with no prospect of survival enter liquidation as quickly as possible to avoid the acceleration and accumulation of losses to the detriment of creditors, employees and other stakeholders, as well as the economy as a whole.

381. Such body could be a State authority in charge of administering negotiations between a debtor and its creditors (e.g., a central bank, a central debt-counselling agency, a commission for over-indebtedness or the debt enforcement authority). In other systems, debtors may rely on counselling and negotiation support from semi-private or private sector actors.

382. There may also be a need for a neutral forum to facilitate negotiation and resolution of debtor-creditor and inter-creditor issues. It could be an existing arbitration or mediation facility or small claim tribunals. Alternatively, a State authority in charge of administering negotiations between a debtor and its creditors may be authorized to appoint an ad hoc mediator or conciliator for the process.

383. This [text] recommends putting in place mechanisms for covering the costs of services of the facilitator of negotiations or neutral forum facilities, recognizing that MSEs will most likely not have means to cover such costs. Some mechanisms discussed in the commentary to recommendation [10] may be relevant in this context (e.g., creating incentives for pro bono services to MSEs).

**4. [Pre-commencement] business rescue finance<sup>32</sup>[draft recommendation 107]**

384. The success of any insolvency prevention measure very often depends on whether there are financial resources in place to support the operation of the business. Financial resources for MSEs during insolvency prevention attempts are likely to come from existing lenders, clients or suppliers who are interested in an ongoing relationship with the MSE. Those parties may be interested in advancing new funds or providing trade credit in order to enhance the likelihood of recovering their existing claims. This [text] recommends that the law should create inducements and incentives for such creditors to make new funding available to MSEs. Without them, an MSE's access to fresh credit is substantially hindered.

385. Creditors usually agree to provide new funding on the condition that priority status will be accorded to the new funding or additional security over the MSE's assets will be given. Those creditors who participate in informal debt restructuring negotiations may agree among themselves that, if one or more of them extends further credit, the others will subordinate their claims to enable the new credit to be repaid ahead of their own claims. In those cases, as among those creditors, there will be a contractual agreement for the repayment of new money where the informal debt restructuring negotiations are successful and the business is rescued.

386. If a business rescue fails despite that additional funding and, as a consequence, insolvency proceedings must be commenced, creditors would want to see some protection of their pre-commencement finance in the law, in particular that the provision of such finance would not be declared void, voidable or unenforceable, which could leave the creditor who has provided it with an unsecured claim (unless a security interest was provided) and with only partial repayment along with other unsecured creditors. They would also want to avoid facing civil, administrative or criminal liability for providing such finance, such liability being often imposed on lenders for extending new finance to businesses in financial distress.

<sup>32</sup> See the issues raised with respect to draft recommendation 107.

387. To encourage creditors to provide new finance, this [text] recommends that the law should ensure appropriate protection for the providers of such finance. In particular, giving to providers of pre-commencement business rescue finance priority in payment at least over unsecured claims in any subsequent insolvency proceedings could create a strong incentive to existing creditors to provide fresh finance to MSEs since they could otherwise be subordinated to new lenders providing such finance.

388. At the same time, this [text] recognizes that measures to encourage the provision of new finance to avoid insolvency should be balanced against other considerations, such as the need to uphold commercial bargains; protect the pre-existing rights and priorities of creditors; and minimize any negative impact on the availability of credit, in particular secured finance, that may result from interfering with pre-existing security rights and priorities. It is also important to consider the impact on unsecured creditors who may see the remaining unencumbered assets disappear to secure new lending. This [text] therefore recommends that the law should ensure appropriate protection for those parties whose rights may be affected by the provision of such finance.

389. Safeguards may take different forms, including ex ante or ex post controls over such finance by public and private institutions, such as regulatory bodies overseeing the banking and credit sector or those that are tasked with assisting MSEs in raising finance. Such controls should give confidence and comfort to affected parties that protection for the providers of pre-commencement business rescue finance, including from avoidance and personal liability, is extended only for new funding provided in good faith and immediately necessary for the rescue of the business and its continued operation or the preservation or enhancement of the value of that business. They should also receive assurances that the prospect of continued operation of the business will benefit them.