NORTON ROSE FULBRIGHT

TA 8998-REG: Development of Armenia's Insolvency Legal Framework

POLICY REPORT

Development of Armenia's Insolvency Legal Framework

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INDEX

1	INTRODUCTION	3
2	IDENTIFICATION OF GUIDING PRINCIPLES APPLICABLE TO A MODERN INSOLVENCY LEGAL FRAMEWORK	5
3	CONTEXT RELEVANT TO DEVELOPMENT OF ARMENIA'S INSOLVENCY LEGAL FRAMEWORK	10
4	SUMMARY OF DUE DILIGENCE CONSULTATIONS AND FEEDBACK	19
5	CORPORATE RESCUE	31
6	MSME INSOLVENCY AND UNFUNDED LIQUIDATIONS	39
7	RELATIONS BETWEEN DEBTOR AND LENDER	51
8	INSOLVENCY PROFESSIONALS – CAPACITY DEVELOPMENT AND REGULATORY OVERSIGHT	56
9	JUDICIAL SUPERVISION OF INSOLVENCY REGIME	62
10	CROSS BORDER INSOLVENCY	65
11	OTHER MATTERS	68
12	REVIEW OF LEGAL FRAMEWORK - RECOMMENDED REFORM PROCESS AND STRATEGY	73
APPENDIX B		88

1 INTRODUCTION

1.1 Norton Rose Fulbright Australia is pleased to submit this policy report identifying the guiding principles and recommended framework for the development of Armenia's Insolvency Legal Framework. It is submitted to the Ministry of Justice of Armenia (**MOJA**) and the Asian Development Bank (**ADB**), pursuant to the requirements of the Terms of Reference for TA 8998-REG (**TA**).

1.2 This Report has been jointly prepared by both the National Insolvency Specialists and the International Insolvency Specialists appointed under the TA. The National Specialists were responsible for the preparation of Chapters 3 and 4 and Appendix A, and the International Specialists were responsible for the preparation of the balance of this Report.

1.3 The Report commences (**Chapter 2**) with an identification of the key established and respected principles that guide the development of a modern insolvency legal framework. **Chapter 3** then examines the relevant legal context within Armenia, and outlines the recent policy work undertaken in connection with Armenia's insolvency laws, so that the views expressed in those earlier reports can be taken account of in this Policy Report. There is also a brief comparative review of the laws of relevant central Asian countries.

1.4 **Chapter 4** summarises the feedback received from the extensive consultation process undertaken by the National Specialists. (**Appendix A** contains a more detailed record of the feedback received by the National Specialists during the extensive consultation process.)

1.5 The balance of the report addresses specific aspects of the proposed corporate insolvency laws, namely:

(a) recommended reforms to establishing a modern and effective corporate rescue process - **Chapter 5**;

(b) the recommended introduction of an MSME insolvency process tailored to the specific needs of an MSME – **Chapter 6**;

(c) the reform process in relation to the relations between debtor and lender is then addressed - **Chapter 7**;

(d) the proposed means for both capacity development and regulation of insolvency practitioners is set out in **Chapter 8**;

(e) opportunities for capacity development regarding the judiciary are addressed in **Chapter 9**;

(f) our recommendations regarding the adoption of the United Nations Commission on International Trade Law (**UNCITRAL**) Model Law on Cross-Border Insolvency are set out in **Chapter 10**; and

(g) other important issues raised during the consultation process are addressed in **Chapter 11.**

1.6 The report finishes with a recommended process and framework for the reform of Armenia's insolvency laws, so that feedback received during the extensive consultation process can be addressed in a way that is reflective of best practice tools and processes. It also examines opportunities for capacity development to be undertaken among the key stakeholders in the insolvency process (**Chapter 12**).

1.7 Throughout this report reference is made to relevant guiding principles for a modern, effective insolvency law. In this regard there are 4 publications to which particular reference is made in the identification of those principles. Those 4 publications are:

- Promoting Regional Cooperation in the Development of Insolvency Law Reforms, **Asian Development Bank**, 2008 (referred to in the report as "**ADB Law Reform Guide**");

- Legislative Guide on Insolvency Law Part 1 and 2 (2005) and Part 4 (2013), **United Nations Commission on International Trade Law** (together referred to in this report as "**UNCITRAL Legislative Guide**");

- Principles for Effective Insolvency and Creditor/Debtor Regimes, **The World Bank**, 2015 (referred to in this report as "**World Bank Principles**"); and

- Creditor Rights Insolvency Standard based on the World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes and UNCITRAL Legislative Guide on Insolvency Law, **International Monetary Fund**, 2011 (referred to in the report as "**IMF Creditor Rights Insolvency Standard**").

1.8 Most of the chapters in this report commence with an identification, sourced from these 4 reference sources, of the principles relevant to the subject matter of that chapter. Each chapter concludes with a summary of our principal recommendations.

1.9 Finally, we wish to record that we have been greatly assisted in our work by carefully reading the detailed law reform and policy work already undertaken over the last couple of years, and which is set out in the 3 documents that we have summarised in Chapter 3 of this Report. We would, however, offer the observation that we have approached the issues the subject of our review slightly differently to the approaches evident in those reports. We recognise that the issues faced by Armenia that are the subject of our review are not unique to Armenia. They have arisen - and been addressed – in many countries across the world at various times. International “best practice” principles, and the experiences of other jurisdictions in addressing the same or similar issues, present in our view a useful perspective, and often an appropriate starting place in identifying options for addressing the issues facing Armenia in the insolvency field. Clearly, options **must** be assessed by reference to Armenia’s own individual circumstances and traditions, but international practices and solutions do present useful guidance.

2 IDENTIFICATION OF GUIDING PRINCIPLES APPLICABLE TO A MODERN INSOLVENCY LEGAL FRAMEWORK

Key Principles

An effective insolvency regime will:

(a) provide certainty to the market to promote economic growth and stability[1];

(b) maximise the value of a firm's assets and recoveries by creditors;[2]

(c) provide a transparent procedure that contains, and consistently applies, clear risk allocation rules;[3]

(d) facilitate the timely, efficient and impartial resolution of insolvency;[4] and

(e) integrate with a country's broader legal and commercial systems.[5]

Introduction

2.1 A credit based market economy necessarily involves the assumption of risk, including financial risk. That risk will, on occasions, materialise in the form of financial distress. This can occur due to poor management, and sometimes fraud, but more often than not, it is the outcome of the competitive marketplace, or structural changes in consumer behaviour (eg online shopping) or sudden impacts such as a pandemic. In many such cases, the financial distress is properly attributable to the natural attrition experienced in a market economy.

2.2 Insolvency laws are there to address such financial distress, and their effectiveness in doing so will be to the advantage of the economy generally, and to the stakeholders involved in a specific insolvency in particular. Saving a distressed business will advantage the employees of that business, and creditors who have dealt with it, and wish to continue dealing with it into the future. Sometimes entire villages or towns depend on the continuing operation of a particular business in the town.

2.3 Insolvency laws have always sought to balance two objectives, as was summarised in relation to an early Insolvency law in Britain in the following terms by the President of the Board of Trade in 1883:

> *Every good bankruptcy law must have in view two main, and at the same time, distinct objects. First, the honest administration of bankrupt estates, with a view to the fair and speedy distribution of the assets among the creditors whose property they were; secondly, following the idea that prevention was better than cure, to do something to improve the general tone of commercial morality, to promote honest trading, and to lessen the*

1 United Nations Commission on International Trade Law (**UNCITRAL**), "Legislative Guide on Insolvency Law Part 1 and 2" (2005) at pg 14.
2 Ibid at pg 10.
3 The World Bank, "Principles for Effective Insolvency and Creditor/Debtor Regimes", 2015 at pg 20; UNCITRAL, above n 1 at pg 14.
4 UNCITRAL, above n 1 at pg 14.
5 Ibid at pg 10.

number of failures. In other words, Parliament had to endeavour, as far as possible, to protect the salvage and also to diminish the number of wrecks.

2.4 That is, a balance must be struck between having a fair and efficient winding up process where companies have irretrievably failed, but at the same time providing a framework for corporate rescue that will diminish the number of failed companies. These two objectives remain true today, and many tools and practices have developed over the years to ensure that an insolvency law is both effective and efficient in striking this balance.

2.5 There is considerable international guidance as to "best practice" in drafting an insolvency law. In particular, there are the 3 publications referred to in Chapter 1 of this Report, being those issued by UNCITRAL, the World Bank and the International Monetary Fund (**IMF**). Set out below is a high level summary of the contribution made by each publication in discussing the key principles, followed by a more general description of the guiding principles extracted from these important texts on several of the more significant issues that need to be addressed.

UNCITRAL Legislative Guide on Insolvency

2.6 The purpose of the UNCITRAL Legislative Guide is to assist the establishment of an efficient and effective legal framework to address the financial difficulty of debtors. It is intended to be used by national authorities and legislative bodies when preparing new laws and regulations, or reviewing the adequacy of existing law and regulations.

2.7 It states that legal systems need to provide adequate legal mechanisms to address the situation where a debtor is unable to pay its debts and other liabilities as they become due.

2.8 A range of interests need to be protected when achieving this outcome, including the interests of the parties affected by the proceedings, creditors, guarantors, as well as legal, commercial and social institutions that are crucial to the operation of insolvency law.

World Bank Principles

2.9 This publication was developed to make clear the benchmarks that exist for evaluating the effectiveness of insolvency laws. The publication identifies a number of aims and objectives that are essential to an effective insolvency system, including:

(a) proper integration with the country's broader legal and commercial systems;

(b) ensuring that the value of a company's assets are maximised, so that the recovery by creditors is similarly maximised;

(c) providing an efficient liquidation process for non-viable businesses, and also for viable businesses where liquidation will achieve a higher return for creditors;

(d) striking a careful balance between liquidation and corporate rescue;

(e) providing equitable treatment between similarly situated creditors;

(f) providing timely, efficient and impartial resolution of insolvencies;

(g) preventing improper use of insolvency systems;

(h) recognising existing creditor rights with respect to priorities; and

(i) establishing a framework for cross-border insolvencies.

IMF Creditor Rights Insolvency Standard

2.10 The IMF has become increasingly involved in the promotion of orderly and effective insolvency systems among its members. Insolvency reform can be particularly relevant for economies in transition, where it can play a critical role in addressing the problems, for example, of insolvent state-owned enterprises.

2.11 In their report, the IMF highlight the following key points:

(a) without effective procedures that are applied in a predictable manner, creditors may be unable to collect their own claims**, which will adversely affect the future availability of credit**; and

(b) without orderly procedures, the rights of debtors (and their employees) may not be adequately protected, and different creditors may not be treated equitably.

Transparency and predictability

2.12 Effective insolvency laws and institutions can assist states in integrating their national financial systems with the international financial system.[6] The ability to predict, with a reasonable level of confidence, the outcome of insolvency proceedings and the treatment of the various interests and stakeholders in that context, is an important element in facilitating access to the global market.[7] One of the key benefits of an effective insolvency regime is in providing certainty to participants, which in turn facilitates economic stability, investment and growth.[8]

2.13 An effective insolvency regime must allow parties to anticipate how their legal rights will be affected in the event that a party to a transaction cannot meet their payment obligations.[9] The transparency and predictability of a regime directly impacts on the ability of participants to understand how insolvency proceedings will operate.[10] An effective regime will therefore allow creditors to accurately assess their risks when initially considering lending and investments, and both debtors and creditors to reliably determine and evaluate their options in the event of financial difficulties.

2.14 In this way, the development of a clear and effective regime can assist in creating a certain and predictable trade environment which, in turn**, will expand the availability of credit**[11] as creditors have confidence that the rights that they had with respect to the debtor and its assets prior to insolvency will be recognised and enforceable after the commencement of any insolvency proceeding.[12]

2.15 Conversely, weaknesses or perceived unpredictability in the effect or application of insolvency regimes can be a disincentive to lending and the provision of credit generally, and should therefore be avoided.[13] There is therefore substantial benefit in ensuring that rights

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6 Ibid at pg 10.

7 Asian Development Bank, "Promoting Regional Cooperation in the Development of Insolvency Law Reforms", 2008 at pg 3.

8 UNCITRAL, above n 1 at pg 10; International Monetary Fund, "Creditor Rights Insolvency Standard based on the World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes and UNCITRAL Legislative Guide on Insolvency Law" 2011.

9 UNCITRAL, above n 1 at pg 15.

10 Ibid at pg 13.

11 Asian Development Bank, above n 7 at pp 1-2.

12 UNCITRAL, above n1 at pg 13.

13 Asian Development Bank, above n 7 at pg 1.

and obligations under insolvency regimes are clear, and applied in a consistent, transparent and efficient manner.[14]

Efficiency and impartiality

2.16 An effective insolvency regime should seek to maximise the value of the assets available to creditors, employees, shareholders and all other parties affected by a debtor's insolvency.[15] This is achieved not only through specific powers relating to the control, realisation and recovery of assets, but also through the transparency and efficiency of the operation and administration of the insolvency process itself.

2.17 Efficiency is facilitated by laws that are clear and consistent in their effect and application, including mechanisms that:

(a) provide initial access to the insolvency procedures by reference to clear and objective criteria, so as to minimize the risk of delay and disputes relating to commencement;

(b) provide convenient means of identifying, collecting, preserving and recovering a debtor's assets;

(c) facilitate creditor and stakeholder participation in the insolvency procedure with minimal cost and delay;

(d) provide an appropriate structure for the supervision and administration of proceedings; and

(e) provide predictable and consistent outcomes for parties involved in the proceeding.[16]

2.18 An efficient regime that operates by reference to clear criteria is likely to facilitate a better return to creditors by minimising the risk of disputes, facilitating the efficient liquidation of the assets of failed companies, and providing opportunities for the timely rehabilitation of viable businesses.[17] An inefficient or unpredictable application of the law undermines not only confidence of the participants in the insolvency regime but also their willingness to extend credit and make other investment decisions.

Integration

2.19 An insolvency regime interacts closely with a country's broader legal and commercial systems.[18] The insolvency regime is dependent on these broader systems for many of the mechanisms which underpin the regime, including:

(a) labour laws;

(b) corporate governance and the operation of enterprises within the jurisdiction; and

(c) mechanisms which facilitate the taking of security over a debtor's assets, including systems of registration and notification in relation to such security.

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14 World Bank, above n 3 at pg 11.
15 UNCITRAL, above n 1 at pg 10; Asian Development Bank, above n 7 at pg 2.
16 Ibid at pg 12.
17 Ibid at pg 10.
18 World Bank, above n 3 at pp 8-10.

2.20 A well designed insolvency law must therefore operate and fit within the broader commercial systems within the jurisdiction, so as to facilitate certainty of outcome when an enterprise moves from the commercial regime into insolvency proceedings.

2.21 Further, given the range of interests that need to be accommodated by the legal mechanisms designed to deal with the financial distress or insolvency of a debtor,[19] a balance must be struck not only between the various interests at play in the transactional environment, but also with the relevant jurisdiction's broader cultural, economic, legal and social context.[20] These considerations may also occur at a regional level.[21] Whilst certain key principles can be identified which underpin a successful regime, whatever approach is ultimately taken, the insolvency law must be sympathetic to and compatible with the legal and social values of the jurisdiction in which it is to operate.[22]

2.22 Each of these broad principles are closely interrelated, and together they underpin the approach that is to be taken when considering the provisions to be included within an insolvency regime.

19 UNCITRAL, above n 1 at pg 9.
20 World Bank, above n 3 at pg 2.
21 Asian Development Bank, above n 7 at pg 3.
22 World Bank, above n 3 at pg 10.

3 CONTEXT RELEVANT TO DEVELOPMENT OF ARMENIA'S INSOLVENCY LEGAL FRAMEWORK

Existing corporate insolvency laws

3.1 The legal system of the Republic of Armenia is traditionally considered within the framework of the Romano-Germanic (continental) legal family, in which, however, a significant role is given to the precedents of the Court of Cassation. The main act regulating private law in Armenia is the Civil Code, which is adopted in 1998 and based on the Model Civil Code developed for the Commonwealth of Independent States (CIS).

3.2 The Civil Code of the Republic of Armenia in contrast to the Civil Code of the Armenian Soviet Socialist Republic, which was in force after the independence of Armenia until 1999, partly refers to bankruptcy, reserving the regulation of bankruptcy relations to other laws.

3.3 Before discussing the current legislation regulations of bankruptcy relations, it should be noted that first of all in 1995 the Law on Bankruptcy of Enterprises and Individual Entrepreneurs in the sphere of bankruptcy was adopted, which soon was replaced by the Law on Insolvency (Bankruptcy) and Financial Recovery of Legal Entities, Enterprises without Legal Entity Status and Individual Entrepreneurs, adopted in 1996.

3.4 The next amendments in the sphere of bankruptcy were made in 2003, when the Law on Insolvency was adopted. Unlike the previous two laws, it had a more comprehensive structure, including a number of new mechanisms, such as fraudulent or intentional bankruptcy, compensation for damages caused by the bankruptcy case administrator and simplified proceedings.

3.5 In 2005 the Law on Insolvency was replaced by the Law on Bankruptcy, which is still in force and has been amended 25 times. During both the adoption and the amendments of the Law, international experience and international documents were also partly examined, such as the UNCITRAL Legislative Guide on Insolvency Law. However, the current law is not based on the experience of a specific country and includes institutions regulated in the legislations of different countries.

3.6 Within the framework of the development of the current legislation on bankruptcy, it is worth to mention the extensive amendments made on the Bankruptcy Law and a number of legal acts adopted by the Minister of Justice based on the Law in 2020, aiming to make the institution of bankruptcy transparent, more accountable and effective. Moreover, the EBRD report on the bankruptcy legislation of Armenia, "Bankruptcy Research Report" and "Bankruptcy reform roadmap and action plan" prepared by the Good Governance of the Government of the United Kingdom in 2019, as well as World Bank "Doing Business" Methodology and Doing Business reports on Armenia of different years were the taken for consideration during these amendments.

3.7 In addition, the necessity of continuous reforms in the sphere of bankruptcy is considered as among the priorities for Armenian Government, provided in the 2019-2023 Strategy of Judicial and Legal Reforms of the Republic of Armenia, approved by the Government on 10 October, 2019, including the action on development of a new draft Code of Bankruptcy.

3.8 Meanwhile, it should be noted that the Law on Bankruptcy of Banks, Credit Organizations, Investment Companies, Investment Fund Managers and Insurance Companies provides the provisions on the bankruptcy of the mentioned financial institutions, which, fortunately, has no practical application at present.

3.9 Unlike other judicial proceedings, bankruptcy proceeding is not limited only to the proceeding initiated on the basis of an application for declaring the debtor bankrupt, but also includes proceedings directed to resolving all the issues that may arise during the examination of the application for declaring the debtor bankrupt or related to the legal consequences of satisfying the application for declaring the debtor bankrupt. Moreover, bankruptcy

proceedings are primarily directed to the financial recovery of the debtor, and then, in case of its impossibility, to the satisfaction of creditors' claims by the way of sale of debtor's assets (property) within the framework of debtor's liquidation proceedings.

3.10 Based on the abovementioned, the Law on Bankruptcy envisages a series of processes, which are independent, subsequent or parallel to each other, for example:

(1) The procedure of examination of the application for declaring the debtor bankrupt, which is initiated upon the application of creditor or debtor, is being examined during a court sitting or without it and ends with a judgement on declaring bankruptcy or a judgement of rejecting the application for declaring bankruptcy.

(2) The procedure of the threat of bankruptcy (bankruptcy risk proceeding), which is initiated on the basis of debtor's application, in order to prevent its insolvency and to carry out corporate rescue, is being examined during a court sitting and ends with a judgement of satisfying the debtor's application on the risk of bankruptcy and approving the financial recovery or a judgement of rejecting the application.

(3) The procedure of the registration of claims, within which creditors, including secured creditors (except, when they have withdrawn from bankruptcy proceedings), submit their claims to the court within one month from the date of publication of the announcement on declaring the debtor bankrupt, on the basis of which the court makes a decision to approve final list of claims and includes the creditor, the amount of its claim and the order of its satisfaction in the list of claims.

(4) The procedure of authorizing the sale of the subject of secured right (secured assets), which is initiated on the basis of the application submitted to the court by the secured creditor within one month from the date of publication of the announcement on declaring the debtor bankrupt. The Application is being examined during a court sitting or without it and ends with a decision to approve the amount of the secured creditor's claim and to authorize the sale of the subject of the secured right or a decision of rejecting the application.

(5) The procedure of financial recovery of debtor, in connection with which the following should be mentioned:

- the requirements for the content of the financial recovery plan are provided by the law and only the debtor, the bankruptcy administrator (insolvency office holder), the creditors holding at least 1/3-rd of the secured claims, the creditors holding at least 1/3-rd of the unsecured claims, as well as the persons holding at least 1/3-rd of the debtor's authorized (share) capital can submit the financial recovery plan;

- the financial recovery plan may be submitted before the first meeting of creditors or, in case of extension of this term by 30 days by the court decision, within that period;

- before the court can consider the financial recovery plan, it must be approved by the meeting of creditors;

- the financial recovery plan may be approved for a period of 36 months, which may be extended for another 36 months;

- after the completion of the financial recovery plan, the bankruptcy administrator submits a report to the court, on the basis of which the court makes a judgement to approve the report and to complete the bankruptcy proceedings or a decision to reject the approval of the report and to liquidate the debtor.

(6) The proceeding of debtor's liquidation, which starts in case the proceeding of the financial recovery has not started or has been unsuccessful for some reason, considers collection and sale of the debtor's assets, and as a result if all the claims are satisfied a judgement is rendered on completion of the bankruptcy case; or a judgement to complete the bankruptcy case as a result of debtor's liquidation.

(7) The proceeding of the bankruptcy of a natural person, within which the above-mentioned proceedings are applicable, unless otherwise provided by law.

(8) Simplified proceedings, which are carried out in cases when the legal entity is in a state of voluntary liquidation or when the debtor is absent or when the bankruptcy administrator submits a motion for early completion of the case on the grounds of insufficiency of property.

Armenian Judicial System

3.11 There is a three-tier judicial system in the Republic of Armenia, consisting of Courts of first instance of general jurisdiction, Courts of Appeal, the Court of Cassation. At the same time, the Constitutional Court is not included in the hierarchy of the judicial system and has an exclusive mission to administer constitutional justice.

3.12 The courts of first instance are as follows: Courts of general jurisdiction and specialised courts. Now two specialised courts operate in Armenia- Administrative Court and Court of Bankruptcy. The courts of appeal are classified according to the type (branches) of proceedings and the Criminal Court of Appeal, the Civil Court of Appeal and the Administrative Court of Appeal operate now.

3.13 In the Republic of Armenia, the highest instance is the Court of Cassation, which has these two essential powers – ensure the uniform application of regulatory legal acts and eliminate the fundamental violations of human rights and freedoms. These missions are operated by the Criminal Chamber and the Civil and Administrative Chamber of the Court of Cassation.

3.14 It should be noted that until 2019 the examination of bankruptcy cases was performed by the specialised judges of the Courts of general jurisdiction, and after establishing the Court of Bankruptcy all cases now are examined by the specialised court.

3.15 Judicial acts rendered by the Court of Bankruptcy may be appealed to the Civil Court of Appeal and the acts rendered by the Civil Court of Appeal may be appealed to the Civil and Administrative Chamber of the Court of Cassation.

3.16 At the same time, the need to establish Bankruptcy Court of Appeal is discussed by 2019-2023 Strategy of Judicial and Legal Reforms of the Republic of Armenia, approved by the Government on 10 October, 2019.

Interaction between insolvency law and other laws

3.17 The bankruptcy legislation is a complex system of legal norms, which is associated with the complex nature of relations arising in this sphere. For that reason, both the Law on Bankruptcy and a number of other normative legal acts are among the legal sources that regulate these relations.

3.18 From these acts, first of all the Civil Procedure Code of the Republic of Armenia is worth mentioning, which regulates procedural relations arising in the bankruptcy proceedings, in cases when such relations are not regulated by the Law on Bankruptcy.

3.19 The next main legal source is the Civil Code of the Republic of Armenia, which regulates relations on the legal status of the participants of civil turnover, including legal entities, the property law and other pecuniary rights, the grounds for the origin and the procedure for the implementation of the exclusive rights to the results of intellectual activity (intellectual property), the contractual and other obligations, as well as other proprietary and non-

proprietary relations related to them, including the pledge law, and regulation of the relations between or with the participation of entrepreneurs.

3.10 There are also provisions in the Judicial Code of the Republic of Armenia, the Criminal Code of the Republic of Armenia, the Law on Public Auctions, the Law on Public and Individual Notifications in the Internet and many other normative legal acts regulating bankruptcy relations.

Comparative review of a sample of other Central Asian insolvency regimes

3.11 In Uzbekistan the main legal act regulating bankruptcy relations is the Law on Bankruptcy adopted in 1994, which includes 192 articles. In Tajikistan the bankruptcy legislation is based on the Law on Bankruptcy (Insolvency) adopted in 2003, which includes 100 articles, and in Kazakhstan that role is reserved for the Law on Rescue and Bankruptcy adopted in 2014, which includes 128 articles.

3.12 The analysis of the abovementioned laws and the Law on Bankruptcy of the Republic of Armenia allows us to conclude that there are quite a of lot similarities between them. At the same time, from the institutional legal-comparative analysis with the Law on Bankruptcy of the Republic of Armenia it becomes clear that in some cases the legislations of these countries provide such legal regulations that don't exist in the bankruptcy proceedings of Armenia.

3.13 Thus, the following regulations in the law of Uzbekistan are noteworthy:

- the Chapter 2 of the Law is dedicated to the pre-trial corporate rescue of the debtor and it defines the grounds for initiating this process, the procedure, subjects of the process and the object, as well as the scope of measures carried out during this process;

- the institution of appointing external governance, which enshrines the termination of the powers of the governing bodies of the debtor and the appointment of an external administrator in order to carry out anti-crisis measures. The relations related to this institution are regulated in the Chapter 6 of the Law;

- the mechanism of the sale of debtor's enterprise (business) as a single property complex (article 110);

- Chapter 8 of the Law, entitled as "Friendly Settlement" (mediation), provides not only the possibility of concluding a friendly settlement, but also defines the requirements for the form and content of the friendly settlement, the features of the friendly settlement in different bankruptcy processes, the terms and consequences of the approval of friendly settlement by the court, the grounds and consequences of the rejection to approve the friendly settlement, the declaring of the friendly settlement as void, as well as the consequences for the breach of friendly settlement;

- the different bankruptcy procedures for different categories of legal entities, which are envisaged in the Chapter 9 of the Law. In this regard, the provision of features of bankruptcy for urban development and agricultural enterprises are worth special emphasizing.

3.14 The following regulations should be mentioned in the law on insolvency (bankruptcy) of Tajikistan:

- the institute of the pre-trial rescue of the debtor, which is regulated in the Chapter 2 of the Law;

- Chapter 6 of the Law, entitled as "External governance", provides the possibility to appoint external governance of debtor and details of its realization;

- Chapter 8 of the Law, entitled as "The Conciliation Agreement" (friendly settlement, mediation), and provides the requirements of the form and content of the conciliation agreement, the terms and consequences of approval of the conciliation agreement by the court, the grounds and consequences of the rejection to approve the conciliation agreement, the procedure of declaration of the conciliation agreement as void and its resolution.

3.15 The distinctive regulations in the bankruptcy legislation of Kazakhstan are the following:

- provisions on the sale of the debtor`s enterprise as a going concern (single complex) (article 99.1);

- the conciliation agreement (friendly settlement, mediation), provides the requirements of the form of the conciliation agreement, the terms of concluding the conciliation agreement, the procedure for concluding the conciliation agreement by a state body, the terms and consequences of approval of the conciliation agreement by the court, the grounds of the rejection of approval of the conciliation agreement, the procedure of the resolution of the conciliation agreement, as well as the initiation of new bankruptcy procedure after concluding the conciliation agreement (Chapters 6.1);

- bankruptcy procedures of city-forming enterprises, which includes provisions of conducting such kind of procedures, and provisions of discharging the registered claims from state budget within such proceedings (Chapter 8);

- bankruptcy procedures of agricultural enterprises, which are regulated by the Chapter 9 of the Law.

3.16 In comparison with the bankruptcy legislation of Armenia, the bankruptcy legislation of Uzbekistan, Tajikistan and Kazakhstan, in addition to their institutional advantages, also have some successful solutions in terms of legislative technique. For example, the definitions which are used in the law, are envisaged in the laws.

3.17 Another noteworthy solution is the establishment of the circle of the rights and responsibilities of the participants in the specific bankruptcy procedures. These detailed regulations certainly make the legislation of these countries more definite and predictable and they are important in the context of ensuring the uniform application of laws.

Existing policy work and recommendations

3.11 In undertaking our task, we have been very mindful of the considerable work that has already been undertaken by various experts over the last couple of years in considering possible reform to Armenia's insolvency laws. Specifically, we have closely reviewed the following three publications (collectively, the **Publications**):

- *EBRD Armenia Insolvency Law Review*, prepared by DLA Piper UK LLP and Hovhannisyan & Partners LLC (**the EBRD Review**);

- *Bankruptcy System Assessment Report*, funded by the UK Good Governance Fund (**the Assessment Report**); and

- *Road Map with Action Plan for Bankruptcy System Reform*, funded by the UK Good Governance Fund (**the Road Map Report**).

3.12 These documents have been very helpful in understanding the perceived issues relating to Armenia's insolvency laws, and we note that the views and recommendations contained within the reports similarly represent the outcome of detailed consultations with key stakeholders within Armenia.

3.13 We set out in the paragraphs that follow a *short summary* of the key observations in and recommendations of those three reports, in relation to the specific issues that are the subject of our review.

Corporate Rescue

3.14 The Publications acknowledge that a functional corporate rescue process is fundamental to an effective bankruptcy system. The Road Map Report noted this goes beyond simply liquidation and debt discharge to include restructuring and reorganising.

Practitioner conduct and regulation

Qualifications of practitioners

3.15 The Publications commented on the absence of adequate qualifications or ongoing professional development of practitioners, also known as Insolvency Officer Holders (IOH) and Bankruptcy Administrators (BA).[23] At present, to gain entry into the profession, any individual with a higher education background in any subject and at least six months work experience at the SRO, or three years work experience in a position of organising or managing economic activities, can sit the entrance exam. Those who score 90% or above are invited to interview. Once admitted to the profession, ongoing professional development is not monitored or tailored to Armenian issues. Consequently, the SRO does not have a competency matrix or due diligence database of its members to ensure practitioners are assigned cases suited to their qualifications or a way to monitor complaints.

3.16 The collective solution posed entailed tailoring entry requirements to education in a relevant subject. It was also recommended that the MoJ consider revising the exam and amend the criteria for sitting it to ensure that those entering the profession are adequately trained.[24] The Road Map Report observed the 2011 Decision provides for an appeals process but is silent on a conflict of interest mechanism. Such a mechanism should be incorporated.

3.17 The Road Map Report expanded on this recommendation by suggesting the following:

(a) create comprehensive guidelines, manuals, practical commentary which takes into account judicial practice and procedure, and other educational materials;

(b) amend the accreditation to require practitioners to complete a minimum number of training hours per year;

(c) review and update current training programmes with a view of tailoring them specifically for practitioners and ensure each reflects current law and relevant case studies. The training programmes should be multifaceted to provide for specialisation, professional responsibility and ethics, and a gender-sensitivity module to account for specific needs of female creditors; and

(d) update the e-bankruptcy platform to include the proposed materials, online training sessions and seminars conducted by international experts.

[23] See Assessment Report, page 45; Road Map Report, page 13; EBDR Report, page XX.

[24] The MoJ has the power to do so per Government of Armenia Decision 2011, 'Regulation on the Bankruptcy Administrator Qualification', (18 August 2011) N 1179-N (the **2011 Decision**).

Conduct and remuneration of practitioners

3.18 A consistent theme throughout the Publications was the absence of transparency and fairness from the appointment of practitioners to their remuneration, and concerns over their general conduct.

3.19 The Publications found the way in which practitioners are currently remunerated encourages a preference for liquidation over financial recovery.[25] For example, the EBRD Report found the current law "provides a scale rates of 10% to 3% from realisations to creditors in liquidations, which is significantly greater than the potential fees for reorganisations".[26] Similarly, the Road Map Report found "53.5% of debtor respondents felt that a 'disreputable and non-transparent bankruptcy system' was a significant problem".[27] Practitioners are bound by a code of conduct which stipulates behavioural standards. However, the Road Map Report found, "in practice, there are risks in upholding such levels".[28]

3.20 In response, the Road Map Report suggests as follows.

3.21 Under the current system, practitioners are allocated to cases at random. This invites several complications should practitioners that aren't particularly suited to one case be assigned to it. The Publications recommend judicial discretion be reduced by giving more power to creditors through increased participation in the process and the introduction of a case management process to alleviate the consequences of random allocation.

3.22 The EBRD Report made several recommendations to promote an efficient remuneration system that links to strong performance and focuses on re-organisation over liquidation, where viable. These included lowering remuneration rates for practitioners and incorporating a bonus scheme that encourages timeliness in bankruptcy proceedings.

3.23 The Road Map Report expands on these but notes that legislating is not sufficient. Rather, careful consideration should be given to the way in which remuneration recommendations are implemented. Before selecting a path forward, consideration should be given to the cultural and historical environment in the country. Given this, the Road Map Report recommends a "recovery / complicity-based system with sufficiently high fees in all types of cases".

3.24 Accountability mechanisms for expenses be introduced and implemented. This should incorporate the EBRD Report recommendations such as considering creditor approval for all administrative expenses and consulting with the SRO to publish guidance notes, an expenses policy and an external audit procedure.

3.25 The SRO revise the practitioner's code of conduct to reflect international best practice. The revisions should particularly focus on strengthening the objectivity and independence of practitioners, competency standards of practitioners, and incorporate guidelines for conflicts of interest and gender-bias. Training guides relating to the code of conduct should also be introduced.

Regulation

3.26 Another common finding in the Publications was that there appears to be little understanding of roles and responsibilities of actors in the bankruptcy system. This is complicated by the

[25] Road Map Report, page 31; Assessment Report, page 45.
[26] EBRD Report, page 12.
[27] Road Map Report, page 29.
[28] Road Map Report, page 29.

fact that relevant bodies have limited powers and enforcement capabilities to ensure compliance with standards.

3.27 The recommendations put forward included:

(a) updating the legislation and rules with a view of clarifying and strengthening supervisory powers of the regulatory bodies;

(b) establish a new complaints procedure and ensure the MoJ has adequate capacity to implement and oversee it. This recommendation seeks to rectify the challenges associated with the present situation whereby complaints received by the MoJ are then referred to the SRO but not actioned;[29]

(c) increase involvement of professional consultants and consider appointing specialist companies an opportunity to step in as bankruptcy administrators; and

(d) introduce a legal monitoring system that will enable the MoJ to remain involved and sufficient up to date with any issues or challenges in the bankruptcy system.

Judicial capacity

3.28 The Road Map Report found that despite the inception of a bankruptcy court in January 2019, "there are still significant issues with the judicial component to the bankruptcy system. Of all the major actors… judges were the least trusted".[30] Further, the Publications drew attention to effectiveness and timeliness of the judicial process.

3.29 The Road Map Report sought to improve the role and effectiveness of judges in the bankruptcy court to ensure better and fairer outcomes for both creditors and debtors through the following recommendations:

(a) update the e-bankruptcy platform, as discussed above, to ensure judges are well versed in the subject matter and have access to all the resources (such as practice and procedure) required to hear bankruptcy matters. It is anticipated this would also limit their discretion by stipulating a clear process to be followed;

(b) appoint additional judges to assist with the workload of existing judges and minimise the potential for delay;

(c) incorporate a requirement that judges undergo continuous professional training. It is recommended this training be for both the Bankruptcy Court and the Court of Appeal. This should be two-fold: first an assessment of the current level of understanding of the sitting judges be undertaken, followed by a training programme implemented which fills the gaps and ensures judges are well versed in the key areas. For the Bankruptcy Court, it is suggested the training programme particularly focus on the e-bankruptcy system and case management, financial recovery positions both at law and in practice;

(d) update the Bankruptcy Court technology, such as computers and other digital equipment, and provide training to increase the technical knowledge of judges and support staff. In doing so, the Road Map Report recommends considering upgrading its current technology by way of a transparent public tender;

[29] See, for eg, Road Map Report, page 19.
[30] Road Map Report, page 26; see also Assessment Report, page 61.

(e) increase the accountability of practitioners before the court by way of introducing sanctions for practitioners who fail to comply with a court decision. Further, in the interests of transparency, a requirement should be introduced that reports be filed with the court and made available on the e-bankruptcy platform; and

(f) consider establishing a Bankruptcy Court of Appeal to assist with case management and ensure fairness in light of the rapidly developing legislative environment.

Cross-border insolvency

3.30 The Publications are silent on this issue.

Sale of inventory

3.31 The Publications found the current valuation and auction processes to lack transparency and regulation, particularly with regard to price and methodology.

3.32 The Road Map Report, with a view of "attracting the highest price for the debtor's assets while minimising the transaction costs associated with the auction",[31] recommended the following:

(a) introduce regulations around the valuation and auction process to minimise the discretion of bankruptcy administrators. Such regulations should be designed to improve accountability as well as transparency;

(b) consider moving the auction process online. This will increase the pool of bidders and assist with transparency concerns; and

(c) consider setting a minimum price for auction items to prevent items being sold below market value.

[31] Road Map Report, page 33.

4 SUMMARY OF DUE DILIGENCE CONSULTATIONS AND FEEDBACK

4.1 The consultation process undertaken in order to prepare this Report has canvased the following issues:

- **Gaps or deficiencies** - What gaps or deficiencies exist in the currently available processes under the existing bankruptcy law to address financial distress? Is there sufficient focus on corporate rescue, and are the rescue mechanisms adequate (and if not, what are the deficiencies?) Is there a specific MSME process?

- **Lending practices** - What are the practices of lenders and borrowers when there is financial distress?

- **Insolvency practitioners** - How are insolvency professionals regulated? How are they made accountable for misconduct? How can their level of competence be improved? For example, what training or capacity building could be undertaken, and how can access to reference materials, guides, and training materials be provided?

- **Judicial capacity** – Is capacity development desirable? How can training and capacity building be provided or improved?

- **Sale of inventory** - What improvements can be made to the process of taking an inventory of, evaluating and placing on auction, the property of the debtor? Should guidance notes and templates be used?

- **Cross borders laws** - Assess the potential and suitability for introduction of cross border insolvency laws within Armenia's legislative framework. For example, do international companies conduct business in Armenia, and how does the existing law address cooperation with other countries' courts and practitioners in relation to an insolvent overseas company that has business operations in Armenia?

- **Additional feedback** - Any additional themes or issues identified during the consultation process.

4.2 In order to discover the existing legislative and practical problems in the sphere of bankruptcy, comprehensive surveys were developed together by the experts and representatives of the Ministry of Justice, which included the following questions:

(a) What legislative and other kinds of issues can be identified in the sphere of bankruptcy, including regarding the effective application of corporate rescue (financial rehabilitation) mechanisms, as well as the process of taking inventory of debtor's assets, the organization of the valuation and auctions of assets and how they can be improved?

(b) Is it expedient to provide the possibility of selling debtor's assets by the decision of creditors in order to ensure the current activity of debtor before the liquidation process? If yes, then in which cases and by what procedure?

(c) The development and use of standard forms of which documents (for example, corporate rescue plan (financial rehabilitation), inventory act, etc.) will contribute to the efficiency of the bankruptcy proceedings?

(d) Is there a need to develop guidelines or advisory documents on different bankruptcy procedures or separate processes under them? If yes, on which procedures or processes?

(e) What is needed for ensuring the continuous development of the professional skills of judges and bankruptcy case administrators (insolvency office holders) (development of educational and informative materials, guidelines etc.)?

(f) What issues of bankruptcy procedures need urgent public awareness, and why?

(g) What other proposals can be made in terms of the improvement of the legal practice in the sphere of bankruptcy?

4.3 On 17 October, 2020, the surveys were distributed on behalf of the Ministry of Justice among the following stakeholders:

(1) Self-Regulating Organisation (SRO) of bankruptcy administrators /included all bankruptcy administrators/.

(2) Chamber of advocates /included all advocates/.

(3) Union of Banks /included all banks/.

(4) Union of Manufacturers and Entrepreneurs.

(5) Justice Academy.

(6) Ombudsman Office (Human Rights Defender).

(7) Central Bank of Armenia.

(8) Ministry of Economy.

(9) Ministry of Finance.

(10) State Revenue Committee.

(11) Supreme Judicial Council /included all courts.

4.4 In order to receive information on statistical data in the sphere of bankruptcy, including the dynamics of application for voluntary bankruptcy and the amounts of obligation of the applications on declaring the debtor bankrupt, drafts of comprehensive surveys were developed by the experts and representatives of the Ministry of Justice and on 19 October, 2020 were sent to the following bodies:

(1) Judicial department.

(2) SRO.

(3) Union of banks.

(4) State revenue committee.

4.5 In Appendix A, we detail the result of the research, from the answers of the surveys (about 130 pages).

4.6 Based on the results of the survey, the experts have raised numerous issues in the sphere of bankruptcy, which were grouped according to their nature and are summarised below.

Legislative issues in the sphere of bankruptcy

On financial recovery

4.7 The mentioned legislative issues related to the financial recovery come to the point that in some cases the law contains such regulations, obstacles and restrictions, which on the one hand, do not meet the purpose of financial recovery, and, on the other hand, do not comply with modern, effective regulations of financial recovery proceedings, thus making financial recovery non-attractive. Namely:

4.8 One of the main reasons for the low efficiency of financial recovery is the realization (use) of the pledge for financial recovery. According to the current legislation, the property secured for the claim may be used in the course of the financial recovery plan only with the consent of the secured creditor. On the other hand, the secured creditor can realise the pledge in extra-judicial procedure before discussion of the financial recovery plan. Although the institution of the adequate protection should balance this issue but it has no practical application. Therefore, it is necessary to provide regulations that, on one hand, will protect the interests of the secured creditor, and, on the other hand, will not affect the effectiveness of financial recovery when the pledge will be needed for the financial recovery.

4.9 The MOJA has suggested that, if the time for a financial recovery through a plan process can be shortened, secured creditors may be more amenable to participating in that process rather than proceeding to realise pledged assets which may be essential to the survival of the business. This important suggestion should be explored with secured creditors as part of the next phase of the reform process.

4.10 The legislation imposes certain restrictions on some categories of subjects (participants in bankruptcy proceedings) such as secured creditors, which creates risks for the violation of the rights of secured creditors by abusing the rights by the debtor and other creditors. In substance, it contradicts with the essential principle of bankruptcy proceedings, according to which, in case of financial recovery of the debtor, the creditors should not be deprived of what they would receive in case of debtor`s liquidation. Therefore, in this context the principle of maintaining maximum balance between the interests of the debtor and all creditors should be respected during the review of the mechanisms of financial recovery. The MOJA argues that this would be facilitated by use of secured or pledged property within the recovery plan. The best mechanism for this to occur, with all stakeholder rights protected, should be addressed as part of the next phase of the reform process.

4.11 The next issue concerns the maximum terms of financial recovery plan provided by the current legislation, which is problematic in practice, especially in the case of long-term financing or investment programs. As a result, a debtor`s real opportunity to recover by a viable financial recovery plan may be missed due to the long-term nature of the plan. Although this is intended to protect the creditors` interests by ensuring that their claims will be satisfied within the shortest possible timeframes, the creditors should also be allowed to consider long-term plans as an alternative to the debtor liquidation.

4.12 It is necessary not only to review the regulations for decision-making in the case of financial recovery of natural person, but also the mechanisms of financial recovery of natural person, as they cannot be identified with the financial recovery of legal person which are examples of classic financial recovery. The recovery of natural person, in substance, can be implemented through debt restructuring and in the case of a bankrupt natural person, as a rule, this possibility no longer exists.

4.13 The regulations about the implementation of financial recovery measures should also be clarified. Although the Law does not provide a list of such measures and the implementation of these measures left for the regulation by the recovery plan, it is necessary to consider providing definite legislative regulations on the implementation of these measures and their consequences which will relate to the calculation of the interests and penalties during the financial recovery, the duration of breach of the schedule for the discharge of liabilities and other issues. Otherwise, there are risks of making discretionary decisions.

4.14 One of the main tools to increase the attractiveness of financial recovery is the incentive of the bankruptcy administrator. Although the current law provides such mechanisms (e.g., bonuses in case of successful completion of financial recovery plan), other forms of incentives should be considered, though care will need to be exercised to ensure such incentives do not lead to outcomes designed to satisfy the incentive criterion. Theses issues will need to be carefully explored as part of the next phase of the reform process.

4.15 The legislation does not currently provide the mechanisms to be used by the state for promoting the financial recovery of entrepreneurs who play an important role in the

economy. The modernisation of the legislation, and its incorporation of international best practice, will provide the necessary support for entrepreneurs, supplying the opportunity to emerge from financial distress. The state should also have the ability, confirmed in the law, to be heard on the decision for a particular debtor company to enter into a recovery plan.

4.16 The regulations allowing the sale of the debtor's property before initiating liquidation proceedings should also be reviewed, especially in cases the sale of the property may foster the recovery of the debtor and not lead to liquidation.

On inventory

4.17 The legislative issues raised about the inventory mainly come to the point, that there is a necessity to provide regulations, which:

- will effectively prevent the obstruction of the inventory works by participants of bankruptcy proceedings, including in cases when the Compulsory Enforcement Service is involved in the inventory procedure and the actions of Compulsory Enforcement officer are being appealed in order to hinder the inventory procedure;

- will solve the issue concerning terms of inventory works in order to ensure the implementation of inventory by bankruptcy administrators within legally established certain terms on the one hand, at the same time providing certain consequences for not implementing the inventory, and on the other hand will ensure the flexibility of inventory terms as much as possible in case of large volumes of inventory or in case of obstacles created during inventory works.

On the valuation of debtor's property

4.18 A significant issue raised about the regulations related to property valuation concerns to the absence of certain terms for that activities. As a consequence, there is a situation, when in the case of absence of main regulations on the valuation of the property the interests of a debtor and a creditor might be violated, because the fate of the property and the possibilities to satisfy the claims of creditors in case of sale of the property depend on the proper valuation of the property.

4.19 The MOJA notes that, although Article 57 of the Law does not regulate the valuation of property, it should be done taking into account the deadlines provided for in Article 58 regarding the analysis of the financial situation, which is not reasonable if inventory terms are taken into account. Therefore, the MOJA believes that this issue should be considered in the organic connection with the deadlines for both inventory and analysis of the financial situation, ensuring the effectiveness of these processes, as well as the sale of property.

On auctions

4.20 The issues raised about auctions are as follows:

- one of the main problems of auctions in bankruptcy proceedings is the sale price, which always leads to abuses both to the detriment of debtor and creditor. Although the practice, when during several auctions the initial price at the first auction was significantly decreasing, have been prevented by recent changes to the law, however, there are still risks about determining the auction price, including risks of abuses by offering bidding higher than the starting price;

- despite the fact that the law defines the requirement to conduct the auction electronically, until the introduction of an electronic auction system it is carried out in the classical way, which in many cases requires the bankruptcy administrator to have legal mechanism to properly organize the auction, for example, when participants obstacle the process of an auction. In addition, it is important to provide such regulations, which will make it possible to hand the property to the person who

won the auction in a "clear" condition, e.g., to exclude existing or potential influences on the property by other persons, which is very common in Armenian reality.

- the effectiveness of auctions also depends on how flexible they are in cases when they are being conducted in different stages and different intervals, especially, when it comes to the sale of large amount of property;

- it is necessary to provide certain regulations about the time and cases of interruption of an auction. Consideration should also be given to reform of the Law of Public Auctions;

- it is necessary to review the mechanisms of sale of a debtor's property before starting the liquidation process, to clarify the cases and the criteria in case of which creditors will have possibility to make decisions on the sale of debtor's property before its liquidation, especially, in cases when the debtor has an active business, the company's assets exceed the amount of liabilities (claims) and the sale of property will let to satisfy all the claims, as a consequence of which the complicated procedures of financial recovery and liquidation will not be applied. For example, the sale of the debtor's assets before the start of the liquidation procedure may be provided in cases when that property cannot be used in the scope of financial recovery, for example, perishable property or the assets, which maintenance costs are disproportionately higher than its value;

- the effectiveness of auctions also depends on the safeguards provided for the protection of the right of a person who won the auction. Therefore, in this context it is important to implement such mechanisms, which will exclude the abuse of rights concerning to the transactions concluded as a result of the auction;

- parallel with the revision of regulations on the sale of property it is necessary to clarify the issues related to tax liabilities arising as a result of sale, their correct calculation and satisfaction, at the same time ensuring that the interests of other creditors will not be violated as a result.

Issues of judicial character

4.21 As in the context of general civil procedure in the bankruptcy proceedings also the issue of proper notifications, including the service of judicial documents deserves attention as a process conducted by the order of civil procedure. This is one of the priority issues, which is specific to all types of court procedures in Armenia. In case of bankruptcy proceedings this issue is more than acute, because the effectiveness of bankruptcy proceedings depends on the proper awareness and active involvement of all participants of the proceedings and on the short terms of the case examination. In this regard, it is necessary to review the regulations that do not allow case participants to communicate electronically, at the same time implementing proper mechanisms for electronic notifications.

4.22 In order to increase the efficiency of bankruptcy proceedings it is necessary to implement effective mechanisms to prevent abuse of judicial rights by participants of the proceedings. Precedent here may be derived from international best practice in this regard. This especially regards to cases when at the start of bankruptcy proceedings, in order to question the liability under the insolvency of a debtor and its indisputability, several civil cases related to the bankruptcy case are being initiated, which artificially affects the examination of a bankruptcy case. For example, the dispute of liability in another case during the examination of the issue of declaring the debtor bankrupt must be not a ground for rejection of the claim, but there should be a possibility in the Law to suspend the proceedings on that ground. Putting in the same place the obligations established by a court act that has entered into legal force with similar obligations, however, not established by a court act can also lead to the abuse of rights.

4.23 The MOJA wishes it to be noted that the court has developed the point of view that acceptance of the lawsuit cannot be considered as sufficient evidence for considering liability

as disputable in cases when, for example, the claim is based on invalidation of contract. Taking into account the fact that most of the claims concern the invalidation of contract and, on the other hand, in the case of the satisfaction of the claim, the judicial consequence is the bilateral restitution (if the contract price exceeds two million), the court does not reject the claim to declare the person bankrupt. International best practice requires the debtor to not only raise a lawsuit or dispute a claim, but in addition to prove to the satisfaction of the Court that the claim is *bona fide* and capable of defeating the claim on which the bankruptcy is based.

4.24 The rights and obligation of participants of the proceedings (debtors and creditors), including the issue when the creditor acquires such right and obligations are also subject to clarifications. The separation of rights and obligations of a debtor and a bankruptcy administrator in situations when the latter acts on behalf of a debtor is of sensitive character too.

4.25 In the context of abovementioned, it should also be clarified which judicial acts in the frames of a bankruptcy case can be appealed, by developing criteria based on which it would be possible to determine the scope of acts to be appealed based on their nature and purpose. Accordingly, the nature of a number of judicial acts should be clarified, for example, the court decision on approving the final list of claims of creditors.

4.26 The prevention of groundless appeals of the actions of bankruptcy administrators is also important. Regarding the appeal of judicial acts, the effectiveness of the new authority given to the Court of Appeals by recent amendments, which allows the latter to suspend the execution of an appealed judicial act, should also be assessed.

4.27 In regard to procedural terms, it is necessary to define by Law the terms of several processes and actions taking place during bankruptcy proceedings, especially the term for approving of the final list of the claims of creditors, as well as the examination of motions of the bankruptcy administrator on the completion of the case. It is also necessary to review the procedure of calculation of judicial terms in bankruptcy proceedings, bringing it in line with existing civil procedure solutions.

4.28 The bankruptcy legislation also does not regulate issues related to further course of bankruptcy proceedings in cases of a debtor's death, inheritance and the consequences of a debtor's death on bankruptcy proceedings. In this regard, the issues on the correlation of inheritance of a debtor's property and its bankruptcy are also noteworthy, especially, when it comes to the composition of a debtor's property.

4.29 The death of a third party pledgee is considered by the MOJA to raise similar issues.

4.30 Analogical issue also arises in the case of death of a person who at the same time was the only founder (participant) and the chief executive officer of a legal entity. In this case, the clarification of a person who can replace the chief executive officer is important to ensure the participation of a debtor in bankruptcy proceedings.

4.31 The provision of regulations that are directed to ensure the certainty of judicial acts (res judicata) is also a subject to discussions, taking into account, that after declaring the bankruptcy disputing the circumstances underlying the judgement of declaring the debtor bankrupt in practice affects the bankruptcy proceedings.

Secured creditors, guarantors, persons who gave assurance

4.32 First of all, conceptually, it is necessary to eliminate the existing confusion in the bankruptcy legislation and to distinguish between secured rights, secured creditors, secured claims on the one hand and liabilities (claims) secured with guarantee or assurance on the other hand.

4.33 There is a necessity to clarify the role of mortgagors, guarantors and persons who gave assurance, as participants of bankruptcy proceedings, and to introduce special regulations to emphasize their legal and procedural status, to define their rights and obligations in

bankruptcy proceedings. On the other hand, it is necessary to reconsider the expediency of calculating fines and penalties against guarantors during bankruptcy proceedings.

4.34 In addition, it is necessary to clarify in detail the process of takin into ownership of the mortgage by the secured creditor in regard to the terms and conditions of the process, price (value) of property, a bankruptcy administrator's payroll issues resulting from this process. Besides, in order to effectively distribute proceeds from the sale of the object of secured rights (secured assets), the order and sequence of the compensation of maintenance costs, sale costs and administrative costs need to be clarified.

4.35 In some cases, it is necessary to distinguish between limitations that have a nature of secured rights and secured rights themselves and to regulate their relationships, for example, can the seizure on a taxpayer's property by the tax authority before initiating bankruptcy proceedings be regarded as a secured claim in the amount of seizure? If yes, what regulations are applicable to that case?

4.36 Issues related to the use of object of secured rights (secured assets) including the management of the proceeds from it during bankruptcy proceedings, need to be regulated.

Moratorium

4.37 There is a necessity for flexible regulations within the framework of moratorium, in order to prevent abuses and satisfaction of the claims of creditors bypassing bankruptcy proceedings and as a result violating the interests of other creditors. Moreover, in many cases third parties bypass bankruptcy proceedings as a consequence of which the interests of creditors are being violated too. There are also other issues needed to be clarified in the framework of this institution, such as the issue of refunding state fee in case of termination of proceedings of other court cases as a result of moratorium. The MOJA considers that consideration of the grounds on which the civil case was terminated is essential; in particular, was the case terminated on other grounds provided by law or was the case terminated, because the dispute was not subject to civil proceedings? In the latter case the state duty is subject to return according to the provisions provided by law. Consideration should be given to not only refunding the state fee but also the possibility of registering it as a claim in a separate queue within the framework of bankruptcy proceedings.

Creditor’s meeting, Board of creditors

4.38 Issues related to voting and decision-making at the Creditor’s meeting need to be reviewed, so that besides the number of creditors, the vote (weight of votes) of creditors of different classes will also be taken into account and become decisive. It is also necessary to establish mechanisms that will force creditors to participate in the sittings of Creditor’s meeting and not to hinder the holding of meetings if creditors are absent. Besides, the rights of creditors present at the first meeting should be reviewed in comparison with rights of other creditors, including obtaining the right to vote. The changes in the order of formation of the board of creditors need to be discussed, in order to include in it secured creditors too.

The registration of claims

4.39 With regard to the issues of registration of claims, it is necessary to clarify the issues related to the procedure for submitting the documents justifying the claims, obtaining full data describing the claim and the creditor.

Remuneration of the bankruptcy administrator

4.40 As a result of recent legislative amendments in the remuneration of the bankruptcy administrator, in a number of cases the remuneration rates have been reduced, bonuses have been provided for completion of the bankruptcy case in a timely manner, and in some cases the procedures for receiving remuneration have been clarified. However, in this context there are still unresolved issues such as the calculation of remuneration provided for the satisfaction of tax liabilities related to the realization of the debtor's property, the basis for

remuneration in case of interim distribution plan, as well as the issue related to the remuneration of the bankruptcy administrator in case of paying by the person who is not participated in the proceedings.

4.41 In addition, the law considers the closure of the bankruptcy case if the property is absent or if the property's value is less than 50 thousand AMD. As a basis for receiving compensation from the state budget in such, it is necessary to provide an authorizing provision for the Government to define this procedure. The MOJA notes that currently the bankruptcy administrators do not receive any remuneration if they are not appointed as the main administrators and the bankruptcy proceedings end on the grounds that the debtor does not have any property. Discussion of the issue of how the right of temporary bankruptcy administrators are to receive payment is suggested.

Disputing the transactions

4.42 It is necessary to review the mechanism of retrieval of the transfers to third parties (disputing the transactions), especially clarifying the debtor`s intention to evade to fulfil their liabilities, providing clear standards and the legal consequences of disputing the transactions, especially the invalidity of those transactions and the termination of registered rights. At the same time, the rights and obligations of the bankruptcy case administrator and the debtor should be clarified during such procedures to ensure that submitting lawsuits on behalf of the debtor should be an incentive for the bankruptcy administrator too and should not cause inadequate unfavourable consequences for the latter.

Extra-judicial proceedings

4.43 The law provides the possibility to conclude a conciliation agreement as an extra-judicial procedure in the bankruptcy proceedings. This mechanism needs to be fully reviewed and expanded, as extra-judicial procedures out of bankruptcy proceedings are highly welcomed in international practice. In this context, the term for concluding the conciliation agreement should be reviewed, as well as the law should provide mechanisms for concluding extra-judicial conciliation agreement between the state and local self-government bodies and a debtor. The possibility of applying such mechanisms in higher courts should also be considered.

Activities of the debtor in the bankruptcy procedure

4.44 In this context, although the law provides a number of mechanisms related to the activities of the debtor, the regulations are rather superficial and do not allow to understand the current procedures more detailed. For example, the issues on how the property is managed, possessed, suspended, or the resumption of the debtor`s activity in the liquidation proceedings, etc. are not clarified.

Bankruptcy of natural person

4.45 In general, the institution of bankruptcy of natural person should be reviewed and regulated in more details, in contrast to the current regulations when the bankruptcy proceedings of natural person are mainly regulated by the provisions of bankruptcy of legal person and only some issues are specific.

Selection and appointment of the administrator

4.46 Although the selection of the bankruptcy administrator`s candidates is now more regulated and free from the risk of interference, there is a need for the current procedure of selecting and appointing bankruptcy administrators to be reviewed in general. Here the solutions should be introduced which, on the one hand, do not violate the interests of the creditors and the debtor, on the other hand, exclude the regulations that can create a risk of dependence of the bankruptcy administrator from the creditor or the debtor.

Tax issues

4.47 Tax issues arising within bankruptcy procedure relate to the calculation of the penalties and interests to secured liabilities in case of selling the object of secured right through extra-judicial procedure, the clarification of the subjects for submitting tax reports before the suspension of the activities of the debtor, the clarification of the priority list for the income tax and mandatory social payments, stamp duty generated from payments of employment contracts, as well as the income tax and mandatory social payments generated from payments of employment contracts and copyrights contracts.

Other issues

4.48 The legislative issues include:

- issues related to the procedure, amount and terms of collections from the debtors' salary in bankruptcy proceeding.
- issue on exemption from paying court fee for bankruptcy administrator carrying out the actions for which it is necessary to pay court fee, e.g., for inquiries.
- raising the role of the creditors during the bankruptcy risk proceeding, as well as the issue about flexible regulations to fix the amount of the debt.
- review the amount of the liability for declaring the debtor bankrupt, whereas from January 1, 2017 to April 15, 2020, the amount of the liabilities for declaring the debtor bankrupt does not exceed 2.000.000 AMD in 56-57 percent of the case.
- issue related to the separation of the part of a property from debtor's common property by the bankruptcy administrator.
- issue of revision of the priority list for judicial costs and costs made in other cases by the participants of the bankruptcy proceedings.
- issue of introduction of alternative methods of realization of inquiries for discovery of the property during submitting the application of voluntary bankruptcy in case of the absence of property.
- issue related to the limitation period of calculations of the liability stated in the application and the limitation period of the valuation act of the property attached to the application.
- issue related to the period of submitting the declaration by the debtor.
- issue of revision of the grounds for termination of the powers of the bankruptcy administrator.

New Bankruptcy Law

4.49 The scope and content of the mentioned issues, the numerous amendments made in the law over the years, different research reports in this sphere, including "Bankruptcy Research

Report" and "Bankruptcy reform roadmap and action plan" prepared by the Good Governance of the Government of the United Kingdom in 2019, as well as the comparative analysis of the legislation of other countries, including the countries of Central Asia, presented in this report, indicates the urgent necessity to develop a new Bankruptcy Law (Code), which should comprehensively regulate all procedural and material relations arising in the sphere of bankruptcy.

Practical issues in the sphere of bankruptcy

4.50 The effectiveness of the institution of bankruptcy and its public trust depend not only on the quality of legislative regulations, but also on the level of the institutional capacity and legal awareness of stakeholders. Namely:

On the development of standard forms of documents

4.51 There is urgent necessity to develop standard forms of all documents in the bankruptcy proceedings and make them available electronically. The following documents among them are noteworthy:

- financial recovery plan,
- inventory report,
- valuation act,
- preliminary list of creditors` claims,
- creditors` meeting`s decision and protocol,
- interim distribution plan,
- reports submitting by the bankruptcy case administrator,
- the protocol about the results of an auction.

On the development of guidelines for bankruptcy proceedings

4.52 A number of bankruptcy proceedings and individual actions need to be made more available and detailed through methodological guidelines. From this point of view, the development and publication of the guidelines of the following processes is priority:

- inventory of debtor’s property, which among other issues will determine how to start the inventory, which property is subject of inventory, which bodies shall discover the debtor’s property and by which tools, as well as when it is necessary to search the debtor’s property.
- the holding of the creditor`s meeting, which will define the continuity of the actions related to holding and convening of the creditors` meeting.
- sale of the property of the debtor, which will address the issues related to the choice of ways of realization of the debtor’s property, the organization and holding each of them, as well as the realization of the property belonging to the debtor with common property right.
- analysis of the debtor`s financial standing, which will provide the scope of materials required for the analysis of the financial standing, the sources of origin and the procedure of acquisition, the methodology for carrying out the analysis, including issues related to discovering the fraudulent and intentional bankruptcy cases.

On the existing needs for ensuring the continuous development of professional skills in the field of bankruptcy

4.53 The solution of the following issues is vital for acquiring professional knowledge and ensuring the continuous development of professional skills:

(1) The development and adaptation of legal and non-legal courses (e.g., about the analysis of the debtor`s financial standing, submission of tax reports) and study programmes (both regular and remote) on the sphere of bankruptcy.

(2) Carrying out the trainings on more targeted topics and effective formats.

(3) The development of educational materials (comments according to the articles of the Law, manuals, guidelines, didactic materials, etc) for educational and training processes.

(4) The development of scientific-practical materials on the issues of intellectual property, invalidity of contracts and the sale of debtor's property abroad, in order to overcome the most problematic situations in law enforcement practice.

(5) The development of a database of cases of the Court of Cassation in the sphere of bankruptcy and its regular updates.

(6) Conducting regular working meetings and discussions with participation of stakeholders (bankruptcy administrators, judges, advocates, etc.).

(7) Organization of reciprocal visits of bankruptcy administrators and judges to countries with standing traditions of bankruptcy institutions, in order to exchange experience.

On public awareness events

4.54 Increasing public awareness and legal awareness intends regular implementation of awareness-raising activities through various media means (videos, TV shows, provision of notice sheets in some processes, for example, during lending, etc.) about the bankruptcy. These, inter alia, should apply to:

- the essence of the bankruptcy, including the grounds and the order of declaring a debtor bankrupt, as well as the possibility of exemption from liabilities as a consequence of bankruptcy proceedings;
- intentional and fraudulent bankruptcy, as well as other acts considered as crimes in the sphere of bankruptcy;
- the institutions of financial recovery and moratorium;
- the possibility to confiscate the salary of a natural person;
- the scope and authorities of the bodies supervising the legality of bankruptcy proceedings.

On other practical issues

4.55 In order to ensure timely application of the consequences of bankruptcy, transparency of bankruptcy cases, to increase the efficiency and accountability of bankruptcy administrators it is necessary to introduce an e-justice platform for bankruptcy proceedings, which, among other functions:

- will ensure the exchange of information about a bankruptcy case to relevant persons and bodies, including to other courts and to the Central Bank;

- bankruptcy administrators will have quick and complete access to the necessary databases, including to the civil status registration data.

4.56 In order to satisfy the claims of employees, it is urgent to establish guarantee funds in the Republic of Armenia, which also follows from the international obligations undertaken by Armenia.

4.57 In order to ensure the efficiency of the inquiries into the debtors' means of transportation, it is important to provide Road Police officers with such cameras, which will allow them to identify the wanted transport in the traffic and to provide the relevant information to the competent authorities.

4.58 In order for bankruptcy institution not to serve as a means of exemption from liabilities it is necessary to promote the detection of intentional and fraudulent bankruptcy cases, in which bankruptcy administrators should play a significant role.

5 CORPORATE RESCUE

UNCITRAL Recommendations

The purpose of provisions relating to corporate reorganization are:

(a) to facilitate the rescue of businesses subject to the insolvency law, thereby preserving employment and, in appropriate cases, protecting investment;

(b) to identify those businesses which are capable of reorganization;

(c) to maximize the value of the estate;

(d) to facilitate the negotiation and approval of a reorganization plan and establish the effects of approval, including that the plan should bind the debtor, creditors and other parties in interest;

(e) to address the consequences of a failure to propose an acceptable reorganization plan or to secure approval of the plan, including conversion of the proceedings to liquidation in certain circumstances; and

(f) to provide for the implementation of the reorganization plan and the consequences of failure of implementation.[32]

Introduction - Guiding Principles

5.1 Not all debtors experiencing financial difficulties should ultimately be liquidated. Recognising this, an effective insolvency regime should seek to strike a balance between the advantages of near-term debt collection through liquidation, and the preservation of the business through reorganisation.

5.2 While these dual objectives have long existed, it may be observed that it is only in more recent times that greater emphasis has been given to rehabilitation as a key objective, where it is feasible. With that objective in mind, many countries have over the last 20 years or more (and, particularly, since the global financial crisis in 2008) amended their laws so as to provide the necessary tools to ensure that where the business operations of an enterprise remain viable, that any insolvency (or impending insolvency) of the enterprise could be appropriately addressed to rehabilitate the business. The objective here was, through preserving the value of the enterprise, to restructure it into a viable solvent enterprise, while at the same time treating all stakeholders fairly. Indeed, the rehabilitation process will only succeed if the majority of creditors are supportive of it.

5.3 With these observations in mind, it is important that the country have appropriate corporate rehabilitation and rescue processes within its law to enable viable businesses that are insolvent, or are approaching insolvency, to restructure their affairs so as to preserve economic value and, where possible, remain in operation. It is equally important that these corporate rescue laws include the modern tools that have been demonstrated in multiple countries to operate effectively to fully address the financial distress and allow the company to re-emerge from the process.

[32] UNCITRAL, above n 1 at pg 233.

5.4 Corporate rescue proceedings are therefore designed to save a debtor from insolvency, either through the rehabilitation of a viable business, or the restructuring of the business in order to address inefficiencies. The ultimate purpose is to allow the debtor to overcome its financial difficulties and resume or continue its business operations in one form or another.[33] The economic and commercial benefits of an effective corporate rescue regime may include quicker resolution of the debtor's financial issues, reducing costs to the estate and providing the opportunity to effect a long term rehabilitation of the debtor entity.[34]

5.5 Reorganization proceedings are also designed to give a debtor some breathing space whilst addressing its financial position and, where appropriate, provide the opportunity to restructure debt and commercial relationships with creditors. Whilst renegotiation with creditors may involve a reduction of the outstanding indebtedness, the benefits of reorganisation are also derived where the value gained through the continued operation of the debtor's business enhances the value of creditor's recoveries.[35]

5.6 It is also essential that the corporate rescue regime include an element of flexibility allowing movement from reorganisation into liquidation if necessary or appropriate.[36] It is also important that an enterprise that is subject to a liquidation process have, in appropriate circumstances, the ability to move into a reorganisation process where opportunities for corporate rescue present themselves. This flexibility, in both directions, ensures that the method most suitable to the circumstances of the debtor is able to be employed, and helps to avoid abuse of the protections offered by the insolvency regime.

Key policy choices - control

5.7 In terms of control of a company during a corporate rescue procedure, there are generally four alternative approaches:

(a) **Debtor in possession proceedings**, where the company's management remains in place with the power to continue running the business whilst preparing a rehabilitation plan to be put to creditors. The debtor may or may not be subject to independent supervision whilst the plan is developed. Japan's Civil Rehabilitation regime is an example of this approach, where, in most cases, the debtor is subject to supervision of the court or its appointed supervisor.

(b) **Insolvency practitioner in possession proceedings**, where a third party administrator or trustee is appointed to manage the company, develop a proposal and facilitate the rehabilitation. This form of rehabilitation forms the basis of the administration regimes in common law countries such as Australia and the United Kingdom, as well as the judicial management procedure in Singapore and Malaysia. With the directors removed from control of the company, there is less need for constant judicial supervision. Nevertheless, the court has a role is dealing with certain issues and resolving disputes as indicated below.

(c) **Creditor led proceedings**, where financial creditors (generally banks or other authorised lenders) lead the restructuring process either with the assistance of a third party administrator appointed to the company or with the management remaining in place. This form of rehabilitation forms the basis of South Korea's *Corporate Restructuring Promotion Act*, and has recently been included in India's *Insolvency and Bankruptcy Code*.

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33 Ibid at pg 27.
34 Asian Development Bank, above n 7 at pg 3.
35 UNCITRAL, above n 1 at pg 27.
36 Ibid at pg 11.

(d) **Supervision by insolvency practitioner,** where the company's management remains in place and responsible for the business during the term of the procedure, but subject to supervision of the insolvency practitioner, and requiring approval from the advisor to undertake certain corporate actions.

5.8 Having regard in particular to Armenia's civil law legal traditions, we regard the model (b) or (d) to be appropriate, subject to what is set out below and in the next chapter relating to MSMEs. Where the line is to be drawn between the authority of the company's management/directors, and that of the insolvency practitioner is a matter for further close consultations, with the balance perhaps leaning more towards the insolvency practitioner being granted control rather than mere supervision. There can be greater trust in the integrity of the process when an independent insolvency practitioner, who is subject to regulation (including discipline for misconduct), is in control of the corporate rescue process. The regulatory environment will also ensure she or he has the requisite skills and training to properly carry out the procedures involved in the process.

5.9 The selection between these four options also need to be considered in the context of the next policy choice, namely the involvement of the Court in the rescue process. The lesser the involvement of the court, the greater the need for an experienced (and regulated) insolvency practitioner to have a level of control or influence over the business of the enterprise, in order to ensure that the insolvency processes are carried out efficiently and are not being abused by the debtor.

Key policy choices – role of the court

5.10 Corporate rescue procedures can also be either "in court" reorganisation proceedings, where the process is commenced by court application and overseen by a court, or an "out of court" process where a procedure established by statute is in place to facilitate engagement with creditors with no necessary involvement of the court, though always with the ability to bring a dispute before the court.

5.11 Often, countries will adopt at least 2 forms of rescue procedure which combine elements of the above in different degrees. The principal benefits of an out of court procedure are that it may be quicker and cheaper than a court based procedure. However, an out of court procedure may not be appropriate in complex, high value or contentious proceedings, in which case the assistance of and independent supervision of the court may be valuable. Therefore the general approach taken by many jurisdictions is to provide options for both court supervised and out of court rehabilitation procedures.

5.12 Reference here is made to the discussion in Chapter 9 as to the role of the Court in supervising insolvency proceedings. In particular, those paragraphs raise the policy choice between the Court having a paramount approval and supervisory jurisdiction at most stages of the various processes (as is currently the position), or alternatively having the statute structure the various processes, and leave them to proceed consistently with the provisions of the statute, with the Court role being there to address complex matters, questions brought before it, and disputes. On this alternative model, the Court is there to assist when required, but the process, under the control of a licenced and regulated insolvency practitioner, proceeds generally without the intervention of the Court. (The Court is, however, always available and it is open to any stakeholder in the process at any time to bring any dispute or contested issue before the Court to adjudicate.)

5.11 There is particular advantage to this approach where timeframes are short, and success in rescuing a company depends on swift action. We would wish to further explore with the MOJA the advantages and disadvantages to taking this alternative approach with the corporate rescue process, and whether it is worthy of consideration. It must be observed,

however, that the viability of such an approach requires a skilled and well regulated insolvency practitioner profession.

Commencement of procedure – Simplicity and cost effectiveness

5.12 Commencement of the rehabilitation process should be simple and cost effective, to encourage its use in a timely manner. We suggest that the application process be wholly administrative, and comprise, at a minimum:

(a) the lodgement of an application with the appropriate authority for commencement of corporate rescue proceedings;

(b) lodgement of financial records and a list of creditors of the debtor, setting out the name, address and approximate value of the debts owed to each; and

(c) a consent to act signed by an independent insolvency practitioner which confirms that they have reviewed the records provided by the debtor and are satisfied that the reasons for commencement and the creditor list are accurate to the best of their knowledge. The Insolvency Practitioner should undertake reasonable investigations into the debtor's position, in order to satisfy himself or herself of the accuracy of the information provided and the basis for the rehabilitation application.

5.13 The right to apply for commencement should also be subject to limitations so as to prevent abuse of the process, including limitations on the number of applications that can be made within an identified time period.

Commencement of procedure – who should be permitted to commence?

5.14 We strongly recommend that Armenia's corporate rescue process be only available for commencement by the debtor. We make this recommendation for several reasons:

(a) The purpose of corporate rescue is to rehabilitate the company so it can continue to trade on a solvent basis, and this purpose is supported by the moratorium that prevents payment of debts. Unpaid creditors, however, take action for the purpose of seeking payment of their debts. For the system to allow this purpose to be served as part of the rescue process is to divert from its true purpose, and to bring into play considerations other than the possibilities for rescue of the business.

(b) It would be unusual for the creditor to have sufficient information to form the view that a corporate rescue process was feasible in the individual circumstances of the company. A creditor placing a terminally insolvent company into a rescue process, rather than straight into liquidation, causes a waste of resources and will ultimately reduce the return to creditors.

Commencement of procedure – Solvency or simple debts?

5.15 Another threshold issue is the qualifying condition for the commencement of the process. In most (though not all) countries the requirement is that the directors consider the company to be insolvent, or likely to become insolvent in the future, where "insolvent" means unable to pay its debt when they fall due.

5.16 We recommend that this this cash flow solvency test be the qualifying condition. This is again because the principal purpose of a corporate rescue process is to restore the solvency of the company so as to be able to continue its business. That is the purpose, and the qualifying condition should match the purpose sought to be achieved by the process.

Breach of rehabilitation plan

5.17 One issue raised during the stakeholder consultation process was the concern with implementation of rehabilitation plans where there is a breach of the terms of the plan, for example in making payments to creditors. It is consistent with international best practice for the insolvency law to have some requirements around the content of rehabilitation plans, and one of those requirements should be that any material breach of the terms of the plan should require either a review by the court to determine the continued operation of the plan, or the calling of a further creditor meeting to determine whether to either amend the plan or place the company into a liquidation process. These matters should not be left for a discretionary decision, except for perhaps to what may be regarded as a minor or immaterial breach of the terms of the plan (for example, a slightly delayed payment of the amount due). Even here, as with all other elements of the insolvency law, any creditor or other stakeholder aggrieved by decisions during the insolvency process should have the right to bring their grievance before a court for determination as to whether the process is proceeding in accordance with the legal framework.

Approval of rehabilitation plan

5.18 In order for a rehabilitation plan to be implemented, it must be approved by the creditors whose rights will be affected by it.

5.19 Before a plan, or plans, are put to creditors, the insolvency practitioner will be required to undertake a consideration of the plan in order to determine whether or not it should be recommended to creditors. In doing so, the insolvency practitioner will have a duty to conduct reasonable investigations into the proposed plan in order to form an opinion as to:

(a) the likelihood that the plan will be able to be effected;

(b) whether creditors are likely to receive a better outcome under the plan than they would in a liquidation; and

(c) whether the plan should be recommended to creditors.

5.20 Prior to a vote being conducted, the insolvency practitioner should be required to put a written recommendation to creditors setting out the reasoning in relation to each of the above issues.

5.21 The most common approval mechanism for a corporate rescue plan is via a vote at a meeting of creditors called or the purpose of considering the rehabilitation plan.

5.23 A reorganisation plan approved by the requisite majority of creditors should bind the debtor, creditors and any other parties that have an interest in the business, with the exception of any secured creditor. The position of any secured creditor itself involved important issues of principle to be determined, that are discussed in the following paragraphs.

5.24 Many countries also provide for ultimate approval by a court of the plan. We recommend that court approval not be made a necessary requirement for implementation of the plan. However, in order to avoid abuse of process, an aggrieved party should have a right to challenge the approval and substance of the plan in court within a short timeframe after the meeting has granted approval. The definition of aggrieved party should be broad. The plan should also be capable of being challenged in court if it was only approved by virtue of the voting support of Insiders[37].

[37] "Insiders" are persons closely connected to the shareholders or directors.

Position of Secured creditor

5.25 Feedback received as part of the stakeholder consultation process observed that current procedures did not allow a secured creditor to vote but nonetheless allowed other creditors to restructure the secured liabilities without the consent of the secured creditors.

5.26 This is highly problematic. If no change is made here, it will continue to adversely affect the preparedness of banks and other lenders to lend money, even on a secured basis. There are two separate issues to be addressed here in order to deal with this important feedback. The first is whether to allow secured creditors to vote on a restructuring plan. The second is to determine the extent, if at all, a restructuring plan can affect the position of the secured creditor.

5.27 In terms of voting processes, there are 3 alternatives, being to exclude the secured creditor, include the secured creditor for the full amount of its debt, or include the secured creditor only to the extent of the amount of its debt that exceeds the value of the security (ie for the unsecured portion). The choice between these alternatives should largely be guided by the answer to the second issue, namely the effect of the restructuring plan on the position of the secured debt and secured creditor. On this question, some countries provide that the plan cannot affect the position of secured debt, and others allow the secured debt to be affected but only in two circumstances. The first is if the secured creditor votes in favour of the plan. The second is if a court approves the plan, but only where the law also provides that the court must not approve the plan unless the interests of the secured creditor in relation to the security it holds are “adequately protected”. Adequate protection means that although the plan has, in theory, affected the secured creditor’s security rights, as a practical matter the secured creditor is in no worse position because of that change. (For example, the benefits to the secured creditor under the plan equal or exceed the value of the security, or there is surplus value in the security and the plan only affects that surplus so that the secured creditor remains, in effect, fully secured.)

5.28 Our recommendation is to take the second option, namely allowing a rehabilitation plan to affect secured debt, but only if the secured creditor votes in favour of the plan, or a court approves the plan after ruling on the evidence that the security rights of the secured creditor have been adequately protected. Consistently with this approach, we consider that the secured creditor should be given a vote on the rehabilitation plan, given the secured creditor will only be bound by the plan if they vote in favour of it or a court makes the order referred to above.

5.29 It follows from our recommendations on this issue that there should be no requirement for the consent of the secured creditor in order that a plan becomes effective. The protection to the position of the secured creditor comes from it only being bound by the plan if it is has expressly consented by voting In favour of the plan, or if the court has so ordered, on the basis that the court is persuaded that the position of the secured creditor is adequately protected. This should provide sufficient protection to the position of the secured creditor, and will otherwise allow plans to be given effect even without the active support of the secured creditor.

5.30 We have mentioned towards the end of this Policy Report the importance of clarifying in the revised law all of the areas relating to insolvency that are not clearly addressed. This recommendation is pertinent in the field of secured creditors because the feedback received during the stakeholder consultations indicated that many aspects of the treatment of security during an insolvency process are not currently addressed in the insolvency law. This deficiency needs to be addressed.

Timelines

5.31 The aim of rehabilitation proceedings is to rescue the business, protect investment and preserve employment, and so in all case the procedure should be conducted efficiently and in a timely manner. We suggest that there be a time limit for the preparation and approval of plans, including:

(a) a period of 3 months within which a rehabilitation plan is to be prepared and voted upon, with the option to make an application to court to extend this period for no more than 9 months in circumstances where the insolvency is very large or complex; and

(b) where a plan is approved and entered into, a deadline on the implementation of the plan of no more than 3 years from the date of approval by creditors. (There may be cause to permit an extension of this period where a Court is persuaded of the necessity for that additional period.)

5.32 Concerns were raised in the consultation process as to the problems associated with the law setting a maximum time period for a rehabilitation plan. A means for addressing this issue is for the law to also permit a time period in excess of the specified maximum where the court makes such an order. The court's jurisdiction to make such an order would be confined to unusual or extraordinary circumstances, so that this was not seen as a common order that a court should make.

5.33 The MOJA has expressed the opinion that long periods of financial recovery do not ensure the attractiveness of this institution. It is argued that setting shorter deadlines can be an incentive for secured creditors to participate in any proposed recovery plan. However, this may be a matter for debtor companies and their administrators to address when drafting a particular plan that requires the participation of the secured creditor rather than for a reduction in the legislated maximum time periods. A balance needs to be struck between encouraging short deadlines, and enabling longer periods of financial recovery where that is necessary.

Best practice tools for addressing restructuring

5.34 As part of the reform process, consideration should be given to the adoption of best practice tools applicable in other countries. They include the ability to shed unprofitable contracts, and to "cram down" dissenting creditors in particular classes that are "out of the money". There are international precedents, including recently introduced provisions into the UK and Singapore's insolvency laws, to be considered for inclusion into a revised rescue process so as to make it as effective and efficient a corporate rescue process as it can be.

MSME insolvency

5.35 We also recommend that where a company qualifies as an MSME, it should also have available to it the quicker, less expensive and more streamlined processes for corporate rescue that are set out in Chapter 6.

Key Recommendations

It is recommended that the new (or revised) corporate rescue process be introduced, and include the following characteristics:

- Only the debtor can commence a rescue process.
- In order to commence a rescue process, the debtor must be in a position where it either cannot, or is likely in the future to be unable to, pay its debts when they fall due.
- Consideration should be given to whether the role of the Court should be reduced, so that it may largely focus on disputes and complex issues that arise.
- The approval process for the rehabilitation plan, and the implementation period for the plan itself should continue to be subject to strict timelines, but with the Court having power to extend those deadlines in appropriate circumstances.
- There be a set of requirements around what must be included in a rehabilitation plan, including consequences where the terms of the plan are breached.
- Best practice tools for an effective restructure be included within the revised rescue process so that it reflects international best practice.
- For qualifying MSME companies, the MSME specific rescue process set out in Chapter 6 be available as well.

6 MSME INSOLVENCY AND UNFUNDED LIQUIDATIONS

Key Principle

MSME-specific restructuring and insolvency regimes should aim to provide for a simple, cost effective and flexible system, including provision for:

(a) a rehabilitation process for distressed, but viable MSMEs;

(b) the liquidation and foreclosure of nonviable MSMEs; and

(c) provision of a discharge and fresh start for honest entrepreneurs.[38]

Importance of MSME-specific insolvency

6.1 Micro, small and medium enterprises (**MSME**) represent the majority of global business, and are key drivers of employment, economic growth and development, particularly in emerging economies. Globally, MSMEs comprise 90% of businesses,[39] contribute an estimated 60% of private sector employment,[40] and represent 52% of private sector value added.[41]

6.2 Due to their small size, MSMEs invariably have less capital, greater difficulties in accessing credit and less ability to address financial challenges.[42] They tend to be less diversified in their operations and therefore more vulnerable to financial shock.[43] If an MSME does encounter financial difficulties, these enterprises are less likely to be able to access credit or alternative funding, and legal and financial advice, and as a result, MSMEs comprise a significant proportion of private sector insolvencies.

6.3 One of the key difficulties that has been identified in relation to MSMEs is the inability of existing corporate and insolvency frameworks to adequately address the specific needs of smaller enterprise.[44] Insolvency laws are often designed with the complexity of larger operations in mind and, as such, may ill suit the particular circumstances and needs of MSMEs. Limitations on access, complex and costly commencement provisions and loss of control by management upon commencement mean that MSMEs may avoid engaging with

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38 Wolfgang Bergthaler, Kenneth Kang, Yan Liu, and Dermot Monaghan, March 2015, "IMF Staff Discussion Note: Tackling Small and Medium Sized Enterprise Problem Loans in Europe", International Monetary Fund, <https://www.imf.org/external/pubs/ft/sdn/2015/sdn1504.pdf> at pg 20 (accessed 16 January 2017).

39 Global Partnership for Financial Inclusion, "G20 Action Plan on SME Financing - Joint Action Plan of G20 GDFI SME Finance Sub-Group and IIWG", <http://www.gpfi.org/sites/default/files/documents/01-G20%20Joint%20Action%20Plan%20on%20SME%20Financing.pdf> at pg 1 (accessed 16 January 2017).

40 Edinburgh Group "Growing the global economy through SME" <http://www.edinburgh-group.org/media/2776/edinburgh_group_research_-_growing_the_global_economy_through_smes.pdf> at pg 7 (accessed 16 January 2017).

41 Ibid.

42 Khrystyna Kushnir, Melina Laura Mirmulstein and Rita Ramalho, "Micro, Small and Medium Enterprises Around the World: How Many Are There and What Affects the Count?" 2010, The World Bank / IFC, <http://www.ifc.org/wps/wcm/connect/9ae1dd80495860d6a482b519583b6d16/MSME-CI-AnalysisNote.pdf?MOD=AJPERES> (accessed 16 January 2017).

43 Organisation for Economic Co-operation and Development, "The Impact of the Global Crisis on SME and Entrepreneurship Financing and Policy Responses" 2009, <http://www.oecd.org/cfe/smes/43183090.pdf> at pg 6 (accessed 17 January 2017).

44 International Finance Corporation, "Scaling-up SME Access to Financial Services in the Developing World (2010) <http://www.ifc.org/wps/wcm/connect/bd1b060049585ef29e5abf19583b6d16/ScalingUp.pdf?MOD=AJPERE S> (accessed 17 January 2017).

the formal insolvency regime, and creditors may lack confidence in the ability of the regime to adequately protect their interests.

6.4 MSMEs and their creditors may also be hampered by a lack of assets available to fund proceedings.[45]

6.5 On 4 May 2017, the World Bank released its *Report on the Treatment of MSME Insolvency* in which it emphasised the importance of addressing the issues arising in respect of this sector:

> "The combination of challenges that MSMEs commonly face makes it more difficult for MSMEs to manage the complexities normally required for insolvency procedures. Perhaps unsurprisingly, MSMEs are one of the business structures that most often undergo insolvency proceedings.
>
> Having an efficient, expeditious insolvency system in place that rescues MSMEs or swiftly reallocates their productive assets to more efficient activities is paramount."[46]

6.6 Given the above circumstances, a principal feature of modern insolvency laws is to design within the insolvency law an insolvency process that is specifically tailored to the needs of MSMEs. The objectives here are largely threefold, being:

(a) including a tailored rehabilitation process for distressed, but nonetheless viable MSMEs;

(b) having a quick and efficient process for liquidation where the MSME is non-viable; and

(c) providing a discharge and fresh start for honest entrepreneurs.

Broader benefits of an MSME-specific regime

6.7 A functional insolvency regime plays a crucial role in facilitating access to credit, as it contributes to a certain and predictable trade environment which, in turn, expands the availability of credit.[47] Access to finance is a significant issue facing MSMEs generally.[48] It has been estimated that one-half to two-thirds of formal MSMEs lack proper access to finance,[49] and the number of informal MSMEs lacking access is likely to be even greater. Further, it is estimated that small and medium enterprises globally face a credit gap in the order of USD2.1 to USD2.6 trillion.[50] Further, it is estimated that 90% of the MSMEs that lack adequate access to credit are formal micro-enterprises or informal SMEs.[51] These estimates illustrate the financing difficulties faced by MSMEs operating outside the formal economy. In order to facilitate economic development, it is critical to ensure that MSMEs have access to

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45 UNCITRAL, above n 1 at pg 57.

46 The World Bank, "Report on the Treatment of MSME Insolvency", 2017 at pages 1-2

47 The World Bank, International Monetary Fund and Organisation for Economic Cooperation and Development, "Capital market instruments to mobilize institutional investors to infrastructure and SME financing in Emerging Market Economies - Report for the G20", <http://www.oecd.org/daf/fin/financial-markets/WB-IMF-OECD-report-Capital-Markets-Instruments-for-Infrastructure-and-SME-Financing.pdf> (accessed 12 January 2017); Asian Development Bank, above n 7.

48 Kushnir, Mirmulstein and Ramalho, above n 40.

49 International Finance Corporation "Access to Credit Among Micro, Small and Medium Enterprises" (2013) <http://www.ifc.org/wps/wcm/connect/1f2c968041689903950bb79e78015671/AccessCreditMSME- Brochure-Final.pdf?MOD=AJPERES> (accessed 13 January 2017).

50 Global Partnership for Financial Inclusion, above n 36.

51 Ibid at pg 4.

the credit that they need to expand.[52] Increased access to finance correlates with an increased number of MSMEs operating in the economy, thereby compounding the benefits to all parties involved.[53]

6.8 The informal nature of many MSMEs is a further challenge. In emerging market countries, it is estimated that MSMEs operating outside of the legally regulated economy provide 48% of all jobs in those countries, but account for only 37% of GDP.[54] MSMEs are significant economic participants and therefore a regime that facilitates the growth of individual MSMEs and formalises their operations, has the potential to create jobs, contribute to the creation of wealth, broaden the tax base of the states in which those enterprises operate. Therefore, there are significant benefits for all parties in seeking to bring MSME business within the formal economic regime.

6.9 Importantly, as the World Bank has noted:

> "By replacing out-of-date insolvency legislation with a more effective regime, lender confidence is increased because the improved insolvency process provides lenders with more certainty and predictability in regard to the recovery of defaulted loans. This increases the amount of credit available in an economy and reduces the credit gap."[55]

6.10 It is our recommendation that an MSME-specific insolvency process be introduced into Armenia's insolvency laws to take account of all of the above considerations and secure the identified benefits for the country's economy. We set out below a set of observations that address the key decision points that must be addressed in properly constructing the MSME process.

6.11 The corporate rescue and liquidation processes we recommend apply to the MSME sector have an emphasis on speed, efficiency and a potential substantial saving of the costs associated with the process. This latter point is particularly important. Where it is expensive to undertake a corporate rescue or liquidation process, such processes will be outside of the reach of many financially troubled MSMEs. To reduce cost in the proposed MSME corporate rescue process we recommend having the insolvency practitioner role as an advisor to, rather than as the manager of, the business. In this way, their valuable advice can be provided to the MSME, without the cost of the exercise of itself defeating the prospect of rescue.

Approaches to MSME insolvency

6.12 Broadly, insolvency regimes tend to take one of three approaches to the issue of MSME insolvency. These are:

(a) **No special treatment**: In many jurisdictions, MSMEs are subject to the same insolvency regime as all other corporate enterprises. As set out above, the difficulty with this approach is that the general insolvency laws are likely to be ill-suited to the particular circumstances and needs of MSMEs.

(b) **Modification of the general insolvency regime**: In order to better address the specific needs of MSMEs, some jurisdictions, including India, Germany and Greece, have implemented modifications to their general insolvency regime with a view to providing a simplified procedure for smaller enterprises. In these cases, MSMEs are

52 Ibid.
53 Kushnir, Mirmulstein and Ramalho, above n 40.
54 United Nations Commission on International Trade Law, Working Group I (MSMEs), above n 31 at [7].
55 The World Bank, "Report on the Treatment of MSME Insolvency", 2017 at page 7

subject to the general insolvency legislation but with some modifications and/or simplification of the provisions or procedure to accommodate their needs. Modifications may include:

(i) reducing or eliminating certain fees;

(ii) reducing or eliminating certain documentary requirements;

(iii) allowing for flexibility in the preparation of documents in circumstances where information is not available;

(iv) providing for faster processing time, reduced deadlines and shorter timeframes for rehabilitation proceedings; and

(v) allowing more flexibility in terms of the timing of certain aspects of the insolvency process.

(c) **MSME specific insolvency regime**: An alternative to modification of an existing regime is the creation of a standalone regime specifically targeted at MSME debtors. In recent years, certain jurisdictions, including Korea, Thailand, Japan, Australia and (as recently announced) Singapore have adopted comprehensive insolvency regimes specifically adapted to MSMEs. These regimes are intended to provide an efficient and cost effective regime for dealing with the financial difficulties of MSMEs. The focus is on providing a simplified rehabilitation process for distressed but viable MSMEs, as well as facilitating the cost effective liquidation of non-viable businesses. Key features include:

(i) an expedited route for MSME debtors to commence insolvency or rehabilitation procedures;

(ii) simplified provisions and requirements during the term of the proceeding; and

(iii) access to external assistance and supervision, either through an appointed advisor or the court.

6.13 In order to encourage the use of the insolvency framework in a timely manner, MSME specific insolvency regimes should facilitate:

(a) a clear and transparent process by which proceedings can be commenced, including moratoriums on enforcement, stays of proceedings and methods for putting forward plans of arrangement;[56]

(b) clear methods for liquidating businesses, repaying creditors and discharging debts in the event that the business fails;[57]

(c) clear punishments for fraudulent or negligent behaviour by directors in the lead up to the commencement of the proceedings;[58]

(d) a reduced dependence on formal court procedures in favour of out of court solutions;[59] and

[56] International Finance Corporation, above n 42.
[57] Ibid.
[58] Ibid.

(e) where possible, meaningful priority and protection for post-commencement financing to enable the financing of working capital.[60]

Application of MSME regime - What qualifies as an MSME?

6.14 MSMEs vary from micro enterprises such as informally arranged sole traders or single employee businesses right through to medium sized enterprises which may have many employees and a more formalised organisational structure. MSMEs can also be classified as formal MSMEs, which are registered in the economy within which they operate, and informal MSMEs which are unregistered and operate outside the formal economic regime.[61] Despite the significant variation in the size and in organisational structure of the enterprises captured by the term, MSMEs tend to face similar challenges, which are fundamentally different to those faced by larger enterprises.

6.15 Further, special MSME provisions generally seek to accommodate the particular circumstances of MSMEs and achieve a quick and inexpensive return to creditors by sacrificing requirements for the appointed insolvency practitioner to thoroughly investigate the company's affairs and to pursue litigated recovery actions. This is because such investigations and actions are often time consuming and expensive. It is, therefore, important to protect against the abuse of these special provisions by companies or proprietors seeking to avoid investigation of the company's affairs, by ensuring that they are only available to properly qualifying MSMEs. Consequently, an appropriate definition of MSME is essential.

6.16 Various approaches have been taken to the question of how to classify MSMEs for the purposes of bringing them within an insolvency regime. Examples of the definitions adopted in other jurisdictions include:

(a) defining a small company as one whose annual turnover and balance sheet totals do not exceed certain thresholds, and which has no more than 50 employees, as has been adopted in the United Kingdom; or

(b) application of an MSME specific procedure to all businesses with total debts under a defined cap, as has been adopted by Korea and Japan.

6.17 The threshold question is how to limit the application of the regime to small enterprise only. We recommend that the broad application of the regime be limited by reference to the total amount of debt outstanding, as has been adopted in Japan, Korea and Thailand. As detailed above, MSME operations are often informal and subject to inadequate record keeping, therefore an application threshold that relies on balance sheets or turnover calculations is likely to be inappropriate for Armenia's circumstances.

6.18 Our brief is limited to corporate insolvency laws, but we acknowledge that "a particular issue that arises for MSME insolvency is the overlap and conflicts between regimes for insolvency of businesses and regimes for the insolvency of natural persons."[62] Accordingly, we recommend that consideration be given to extending the MSME regime to include individuals, partnerships and registered entities, who have accumulated business related debts. If this recommendation is accepted, the MSME specific regime should apply to the following:

59 Ibid.
60 Bergthaler, Kang, Yan, and Monaghan, above n 35 at pp 20-21.
61 Kushnir, Mirmulstein and Ramalho, above n 40.
62 The World Bank, "Report on the Treatment of MSME Insolvency", 2017 at page 14-16

(a) natural persons who have accumulated business related debts over a minimum threshold, with no maximum threshold;

(b) registered and unregistered partnerships that have accumulated business related debts over a minimum threshold, with no maximum threshold; and

(c) registered companies that have accumulated debts over a minimum threshold but below a maximum threshold.

6.19 The exact value of the threshold applicable to each type of debtor are likely to vary over time due to inflation and other factors, for example a policy desire to expand the availability of the process to slightly larger enterprises if the process is seen as working well. We therefore recommend that the requirement to meet a threshold be implemented by statute, but the precise definition of the threshold be specified via regulations, to allow for subsequent amendment as necessary.

Moratorium and mediation

6.20 By their nature, MSMEs may lack the sophistication to identify and react to financial distress,[63] which may result in their failing to initiate insolvency proceedings in a timely manner. In order to preserve the value of a financially distressed enterprise, it is important that MSMEs are able to, and encouraged to, access the protections of the insolvency regime quickly when required. A temporary moratorium on enforcement by creditors in circumstances where the MSME cannot, or may not be able to pay its debts as and when they fall due, allows the MSME breathing space whilst it determines the most appropriate approach to take.

6.21 Most regimes provide for the application of a moratorium upon commencement of insolvency proceedings, and for the duration of the procedure. We agree this is the appropriate course.

6.22 The application of the moratorium to MSMEs should be subject to strict limitations to prevent abuse of the procedure (such as strictly limiting the frequency of moratorium applications). For example, the United Kingdom approach provides that an enterprise will not be entitled to obtain a moratorium if it is already subject to a formal insolvency procedure or has been subject to a moratorium in the previous 12 months which has not resulted in a rehabilitation plan, or where a rehabilitation plan has ended prematurely.

6.22 We also recommend that the MSME regime legislate an encouragement to engage in the process of mediation where that is helpful. Very often, the insolvency of an MSME arises out of a relationship with just one other creditor, often the landlord, the bank or the tax authority. Arriving at a compromise with that single creditor can hold the key to a successful rescue, and deploying the specific skills of a mediator to facilitate compromise can save the enterprise.

Rehabilitation and liquidation

6.23 An effective MSME regime must provide for both the rehabilitation of viable businesses and the liquidation of non-viable businesses. Whilst there are significant benefits to having a rehabilitation regime to assist viable businesses to continue to trade, it is also important that non-viable businesses can be efficiently liquidated so as to minimise the adverse impact on creditors. We therefore recommend that the MSME regime provide for a simple rehabilitation procedure and a low cost, simplified liquidation regime. We set out below our observations on both these processes and how they ought be tailored to the specific circumstances of an MSME.

63 Organisation for Economic Co-operation and Development, above n 41.

Rehabilitation regime

6.24 For viable but financially distressed MSMEs, we recommend that the existing management of the MSME remains in place and in control throughout the negotiation and implementation of the plan, subject to supervision by, and advice from, an independent advisor who is a regulated insolvency practitioner. The role of this practitioner, who will be referred to in this report as a "Rehabilitation Advisor" is primarily to supervise the procedure, provide assistance in the preparation of the rehabilitation plan, and keep creditors informed of the progress of the negotiation and implementation of the plan.

6.25 Commencement of the rehabilitation process should be simple and cost effective, so that MSMEs are encouraged to access the regime in a timely manner. Noting the importance for MSMEs to have an incentive to access a regime that might facilitate the rescue of viable businesses,[64] we recommend that MSMEs that are insolvent or nearing insolvency, be given the opportunity to commence a rescue and rehabilitation process which places a moratorium on debt repayments while providing them with access to advice from an experienced insolvency practitioner (acting as a Rehabilitation Advisor). They should have the opportunity to take this step before a creditor steps in and removes them from control of their business by the appointment of a liquidator.

6.26 We recommend that the appointment process be wholly administrative, and comprise, at a minimum:

(a) the lodgement of an application with the appropriate authority for commencement of rehabilitation proceedings setting out the reason for the application;

(b) lodgement of a list of creditors of the MSME setting out the name, address and approximate value of the debts owed to each;

(c) a written consent to act as Rehabilitation Advisor, signed by an independent insolvency practitioner, which confirms that they have reviewed the records provided by the company and are satisfied that the reasons for commencement and the creditor list are accurate to the best of their knowledge.

6.27 In providing the consent, the Rehabilitation Advisor is not required to undertake any independent investigation of the company's position, and is permitted to rely on the information provided by the company unless he or she has reason to doubt the accuracy of the information provided.

6.28 Upon lodgement of the application, a moratorium will come into effect so as to protect the assets of the MSME whilst the rehabilitation procedure occurs. While the moratorium is in effect, directors of the company must not dispose of the assets of the MSME except in the ordinary course of business.

6.29 Creditors listed in the application must be notified of the lodgement of the application by the advisor shortly after it has occurred.

6.30 The World Bank has pointed to *creditor passivity* as one of the challenges confronting MSME insolvencies.[65] Accordingly, the development of an MSME insolvency regime which allows the creditor to opt out of active participation without undermining the overall process is important. Consequently, the regime we recommend provides that if creditors are satisfied that their claim has been accurately recorded in the lodgement documents then they are not required to do anything further to prove their claim. In the event that a creditor objects to the

64 Refer the World Bank, "Report on the Treatment of MSME Insolvency", 2017 pages 10-12.

65 The World Bank, "Report on the Treatment of MSME Insolvency", 2017 at pages 12-14 and *Box 3.4*.

assessment of their claim they may object first to the independent advisor, who will seek to mediate any dispute and, in appropriate circumstances, may resolve the dispute or the dispute may be brought before the court.

6.31 The modified lodgement procedure is intended to address the difficulties that may be encountered when seeking financial and other information in relation to the MSME debtor, which may be attributed to the informal nature of the enterprise, a lack of transparency, inadequate record keeping and lack of financial literacy.[66]

6.32 Within an identified short period of lodgement of the application, the MSME and the advisor must prepare and present to creditors a plan of rehabilitation. The advisor must include a comparison of likely return between the plan and a liquidation process, and make a recommendation to creditors.

6.33 The rehabilitation plan must provide that all unsecured creditor claims are treated in an identical manner, save for priorities determined in accordance with the liquidation regime. Consideration could also be given to the subordination of all Insider claims. Should differential treatment of creditors out of the resources of the enterprise be contemplated in the plan, the more formal rehabilitation regime will need to be engaged.

6.34 The rehabilitation plan must provide that it will complete within an identified period, with a maximum period specified by statute, after the date of approval.

6.35 Voting on the plan can either occur in a meeting of creditors, or by administrative process. One example of a possible voting requirement is that a plan will be approved if:

(a) creditors who reject the plan are owed less than half of the value of the total accepted claims and comprise less than half of the creditors in number; but

(b) Insider claims will not be counted towards the total in either value or number of creditors voting on the plan.

6.36 This proposed modified voting procedure (inspired by the Japanese MSME insolvency regime) is intended to address the issue of creditor passivity. By providing for an approval process where a plan will be approved unless more than 50% of eligible creditors object to it, the issue of lack of engagement is mitigated.

6.37 If:

(a) a plan is not put forward within the specified short deadline after the date of commencement; or

(b) the plan is rejected by creditors; or

(c) the approved plan fails to be successfully implemented,

then the MSME will automatically move into the liquidation procedure detailed below.

6.38 At any stage of the proceedings, any aggrieved party may apply to the court for review.

66 International Finance Corporation, above n 42 at pg 16.

Liquidation regime

6.39 With regard to the recommendation that there be an MSME specific liquidation regime, we recommend an adaptation of the generally applicable regime to simplify and streamline its application. The regime should include the following elements:

(a) a statutory demand procedure and presumption of insolvency will be available for creditors who wish to commence liquidation proceedings;

(b) the debtor may voluntarily appoint a liquidator. If so, the appointment must be accompanied by a consent to act from the insolvency practitioner;

(c) alternatively, a creditor may lodge a petition with the court seeking the liquidation of the MSME. Any lodgement fee should be reduced from that applicable under the general regime, and be nominal;

(d) the petition may nominate an appropriately qualified liquidator, and include a consent from the liquidator;

(e) the realised assets of the debtor are to be applied in accordance with the priority regime established in the general liquidation regime, and then distributed pro rata to unsecured creditors, excluding Insider creditors;

(f) consideration should be given to whether the claims of Insider creditors are subordinated to all other claims; and

(g) avoidance provisions do not apply, save in relation to transactions with Insiders.

6.40 At any stage of the proceedings, a creditor who is dissatisfied with the proceedings may apply to the court for review. In addition, there need to be safeguards in the legislation to prevent abuse of process.

Role of the Court

6.41 A principal driver of the success of the MSME procedure is minimising cost. For this reason, the involvement of a court should be avoided where possible. In short, where proceedings in a court are involved, the cost of this court proceeding will need to be funded and may of itself cause the failure of the process. That said, it is an important risk mitigant that any stakeholder in the process who considers the legal framework is being breached or abused has the right to approach the court for relief, with the court empowered to make orders necessary to enforce the law. Thus, the key issue here is not to entirely remove the court from an MSME process, but to ensure there is no role for the court to play other than in enforcing the law where it is alleged there has been a breach. The court should only become involved if a specific application alleging a breach of the law is filed. Other than that, the MSME process should operate without court involvement.

Issues for Tax authorities

6.42 One final matter for consideration that has particular impact on MSMEs, which has been raise in the World Bank's Report in the following way:

> "… *In many countries taxation authorities [do] not actively contribute to the objectives of the insolvency framework of maximising value and saving viable enterprises. Instead, many tax authorities participated purely to recover debts owed. For example, some tax authorities cannot provide debt forgiveness, which may stifle attempts to resolve insolvency and rehabilitate*

> *a viable enterprise. Certain countries also do not provide tax incentives for tax write-offs for bad or renegotiated debts, leaving less incentive for creditors to agree to restructuring. This is particularly important for MSMEs …*"[67]

6.43 This is not an issue to be addressed in insolvency legislation drafted under this retainer, but is one that might be raised with Armenia's tax authorities at an appropriate time.

The issue of unfunded liquidations

6.44 Many companies that are facing insolvency, particularly MSMEs, do not have sufficient assets to pay the reasonable fees and expenses incurred by a private insolvency practitioner appointed to conduct the winding up of the company.

6.45 The World Bank's *Report on the Treatment of MSME Insolvency* draws attention to "no-asset cases" and comments:

> "*… no-asset cases not only present issues relating the preservation of economic value and creditor recovery, but also relate to the integrity of the insolvency system and its role in setting the right incentives for debtors by promoting responsible risk taking and encouraging fair commercial conduct*."[68]

6.46 Similarly UNCITRAL has made the following observation:

> "*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… Where an insolvency law does not provide for exploratory investigations 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."*[69]

6.47 There are a number of ways this issue may be addressed, which are outlined below.

First option - Liquidator funded winding up

6.48 In some countries, the private insolvency professional is willing to attend to the basic statutory requirements to wind up such companies (even though they will not recover their fees and expenses) on the basis that such work is effectively subsidised by more profitable insolvency work they receive from appointments arising from court liquidations.

6.49 The basis of this system is one of shared risk and reward. Those practitioners registered as liquidators run the risk that they may be appointed to a company that has insufficient assets to fund the cost of conducting the liquidation. In these cases, the liquidator is required to personally fund the basic cost of the liquidation. Conversely, there is also the possibility that they will be appointed to a company with sufficient assets to fund appropriate costs and disbursements, which, over time, will balance out with the unpaid work.

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67 The World Bank, "Report on the Treatment of MSME Insolvency", 2017 at page 34

68 World Bank, ibid at page 17

69 UNICTRAL, above n 1 at pp 61-62.

6.50 Having regard to the preponderance of MSME businesses in the Armenian economy, which have low levels of assets even when solvent, we are of the opinion that this model would most likely not be commercially feasible for private practitioners in Armenia.

Second option - State funded winding up

6.51 Some countries have an officer who is appointed by default as the liquidator of companies where no private practitioner is nominated, but who is publically funded to perform the liquidation task. Where no funds are available, the minimum work required to advance the liquidation of the enterprise towards deregistration is performed.

6.52 This officer is often known as the "Official Receiver".

6.53 We are of the view that a publically funded role such as that of an Official Receiver is appropriate in principle, but recognising that this option may not be viable at present due to the cost it would impose on the state, we outline below some further options.

Third option - Payment of filing fees as a prerequisite to liquidation

6.54 Some jurisdictions require payment of a fee upon filing of a winding up petition, to cover the basic costs of the liquidation. If the debtor, or the petitioning creditor, cannot afford the filing fee, then winding up will not be able to commence. Although this avoids the cost of funding assetless liquidations, the difficulty with this approach is that it does not provide an option for all companies that are clearly insolvent and should be wound up. An effective insolvency regime must provide for the efficient winding up and deregistration of non-viable companies. In this scenario, if a debtor cannot pay the commencement costs of the liquidation then it is effectively required to continue as a registered shell.

Fourth option - Creditor funded liquidation

6.55 An alternative procedure is to allow creditors a period of time following commencement of the liquidation process to determine whether or not they wish to provide their own funds to assist in the funding of the liquidation process. Some jurisdictions permit creditors to enter into an agreement with the liquidator to fund investigations, in return for the right to participate in the recovery.

6.56 However, whilst this may be an effective approach where creditors hope to participate in improved recoveries (in circumstances where the debtor may have disposed of assets or entered into uncommercial transactions in the lead up to the commencement of the insolvency) it is unlikely to provide any assistance in a genuinely assetless scenario.

Fifth option - Deregistration with option of reinstatement

6.57 An alternative approach to assetless liquidation is to provide for the deregistration of assetless companies without undertaking a formal insolvency process. By way of example, under the Japanese insolvency regime, a trustee is appointed to the company when the court makes the liquidation order. However, in circumstances where the company does not have sufficient assets to fund the expenses of the liquidation process, the winding up procedure is immediately terminated. This can occur immediately upon appointment, or at any stage after commencement.

6.58 Creditors or other stakeholders would then be provided with the opportunity to have the company reinstated, at their own cost, in the event that recoveries or claims were subsequently identified. The benefit of this is that the creditors are able to make a

commercial decision as to whether to incur the costs of reinstating the company in order to recover the assets.

6.59 However, the risk inherent in this approach is that it has the potential to encourage poor corporate behaviour. By ensuring that a company is left with no assets upon its insolvency, a director may in this way seek to avoid proper investigation into the failure of the company and any possible breach of duties. It nonetheless represents, in our opinion, the best option if fiscal pressures prevent the funding of an Official Receiver to undertake unfunded liquidations.

Key Recommendations

It is recommended that that Armenia's insolvency legal framework be amended to include a new MSME specific insolvency regime that includes the following characteristics:

- There law should create a specific regime applicable to MSMEs only, with tailored provisions designed to implement a streamlined and simplified rehabilitation process for viable enterprises, and an efficient liquidation process where the enterprise is not viable, even in a restructured form.
- The availability of the regime to an enterprise should be determined by reference to the amount of total debt outstanding at the time of lodgement of the application.
- In order to commence either the rehabilitation or liquidation proceedings, the MSME debtor must be in a position where it either cannot, or is at risk of not being able to, pay its debts when they fall due.
- Our views on the nature and characteristics of the MSME regime have been set out above in broad terms.
- Unfunded liquidations be allocated to an Official Receiver to act as liquidator, being an official of the court.
- If there is insufficient funding to set up and implement the functions of an Official Receiver, the approach providing for automatic deregistration with the option of reinstatement is the preferred course.

7 RELATIONS BETWEEN DEBTOR AND LENDER

7.1 The manner in which insolvency laws address the relations between the debtor and its lender when insolvency intervenes is highly relevant in determining the preparedness of lenders to extend credit. Deficiencies here can, at a macro level, impact adversely on the availability of credit in the country's economy, and this can have substantial adverse economy wide impacts.

7.2 Lenders provide credit to a debtor on either a secured or unsecured basis. There is clear international guidance as to the treatment of financier debt – both secured and unsecured – in an insolvency of the debtor. The discussion below will first address secured debt, and will be followed by a discussion of best practice principles in relation to unsecured loans and other financial accommodation.

SECURED DEBT

UNCITRAL Recommendations

The insolvency law should specify that a secured claim should be satisfied from the encumbered asset in liquidation or pursuant to a reorganization plan, subject to claims that are superior in priority to the secured claim, if any. Claims superior in priority to secured claims should be minimized and clearly set forth in the insolvency law. To the extent that the value of the encumbered asset is insufficient to satisfy the secured creditor's claim, the secured creditor may participate as an ordinary unsecured creditor.

Introduction - Guiding Principles

7.3 The provision and taking of security is an important element of a credit based economy.[70] A debtor's ability to grant security may mean that they can access credit at more affordable prices, as the laws governing secured credit mitigate a lender's risk in relation to such lending.[71]

7.4 Secured creditors must be confident that their commercial rights will be respected and treated in a transparent manner in the event that the debtor becomes insolvent. Such rights have little value if the secured party cannot be confident that their treatment in an insolvency scenario will be reflective of the commercial bargain struck with the debtor prior to the commencement of the proceedings.

7.5 An effective insolvency regime should therefore incorporate efficient, transparent and reliable methods for recovering secured debt,[72] including:

(a) providing reliable and affordable means of protecting credit and minimising risks of non-performance and default, including the recognition of security over a variety of assets;

(b) setting out reliable procedures that enable credit providers and investors to assess, manage and resolve default risk, and promptly respond to the financial distress of a party to a transaction; and

70 World Bank, above n 3 at pg 5.
71 Ibid at pg 5.
72 Ibid at pg 5.

(c) promoting affordable, transparent and predictable mechanisms to enforce credit claims, whether through individual enforcement steps or collective action.[73]

7.6 Clear rules for ranking of priorities and post commencement creditor claims, such as where a creditor provides financial support post commencement, are also an important element, as these increase the options available to the debtor post insolvency, whilst allowing the financing parties to adopt procedures to manage risk.

Importance of honouring security rights

7.7 The rights given to secured creditors under their security are honoured in most jurisdictions as such provisions are considered important to facilitating the flow of working capital within an economy. Financiers are considered more likely to lend greater amounts, on more generous terms, if they know their position is secured and that they will have priority in the event of insolvency. Without such provisions, the amount of capital financiers are willing to make available to borrowers may be limited and more expensive than it might otherwise be. The terms on which finance will be made available may become more restrictive.

7.8 Ensuring that secured creditors are given appropriate protections and priorities will deliver positive benefits to Armenia's economic growth. Promoting the growth of credit (which frequently means borrowing by a company on a secured basis) appears to us to be an important objective, and one which insolvency laws must not impede. This means that the law should not generally prevent a secured creditor from ultimately having recourse to its security to obtain payment of its debt.

Enforcement of security during corporate rescue process

7.9 The policy considerations appear to us to be finely balanced when it comes to the question whether secured creditors should be prevented from enforcing its security for the period that a corporate rescue plan is being formulated and considered. On the one hand, allowing enforcement in such a context is likely to provide a more supportive environment to secured lending in Armenia. On the other hand, the pursuit of enforcement processes will often inhibit or prevent a rescue process from succeeding. This will occur if the secured creditor takes control of the business conducted by the company, or an asset integral to the success of that business. The interests of the company and its unsecured creditors will be subordinated to the interests of the secured creditor.

7.10 A variety of different approaches are taken internationally in relation to this issue. The approaches include the following:

(a) Historically in many jurisdictions, a secured creditor was not prevented, even when a corporate rescue process was on foot, from taking enforcement action;

(b) Upon the appointment of a Voluntary Administrator under Australian law, a creditor with security over the whole or substantially the whole of the assets of the debtor company may appoint a receiver under its security, but only if that appointment occurs within 13 days of the Voluntary Administrator's appointment; or with the consent of the Voluntary Administrator or leave of the court.

(c) In England, secured creditors are no longer generally permitted to appoint an administrative receiver, but may appoint an Administrator whose role is corporate rescue focussed. Enforcement of a charge fixed to a particular tangible asset may however be permitted.

[73] International Monetary Fund, above n 8 at pg 5.

7.11 These last two approaches adopted in Australia and England are intended to favour rescue and rehabilitation opportunities. These restrictions on the enforcement of security serve the policy of both encouraging, and facilitating the success of, corporate rescue processes.

7.12 Importantly, where there are enforcement prohibitions, there are generally safeguards, including permitting the secured creditor to select the insolvency practitioner, protection of the assets the subject of the security during the course of the corporate rescue process, and the ability to apply to the court for permission to enforce, provided a compelling case to enforce immediately can be presented by the secured creditor.

7.13 A policy choice must be made between these competing approaches, and the identification of appropriate safeguards.

7.14 We have already set out in chapter 5 our views regarding the ability of the secured creditor to vote on a proposed rehabilitation plan, and the important question whether the plan, if adopted, should bind secured creditors.

Financing during an insolvency process

7.15 An important policy issue is whether finance raised during an insolvency process should not take priority over existing secured debts. In principle the answer should be "yes", but safeguards need to be built in to ensure adequate protection of existing secured creditors.

Employee priorities

7.16 Just as employees should have a special priority in a liquidation, so too should they enjoy a priority against the proceeds of realisation of the security. Although this approach serves to impair the value of the security, it is well understood by banks and other secured financiers, is a common feature of many insolvency systems, and serves to protect the higher policy consideration that employees, who do not have the same credit assessment processes of a bank, should be protected by this priority.

UNSECURED FINANCIER DEBT

Introduction

7.17 Financiers also often lend on an unsecured basis, and can frequently be a debtor's largest creditor. In many insolvencies, it is an inability to pay interest or repay principal (or instalments of principal) that precipitate the insolvency of the debtor. For this reason, facilitating the reaching of a compromise between the debtor and its financier can lead to a restoration of the solvency of the debtor. Insolvency laws, practices and procedures that can facilitate such an outcome are essential to an efficient and effective insolvency system.

Informal rescue

7.18 Informal rescue is essentially a restructuring process that takes place through negotiations between the debtor company and its creditors, with the support of an expert restructuring adviser, prior to the commencement of formal insolvency proceedings. In view of the observations set out above, this most frequently involves a negotiation between the debtor and its financier (or syndicate of financiers).

7.19 The key underlying principles that now reflect best practice in informal workout processes across the world can be traced back to the so-called "London Approach". This approach was first developed by the Bank of England in the 1970s as part of a design for banks to become more actively involved in insolvency processes by assessing the prospect of viability and pursuing rehabilitation when appropriate to improve recovery prospects and the overall

position of its loan portfolios. The main principles of the London Approach were minimising losses through coordinated negotiations, and avoiding unnecessary liquidations of viable companies.

7.20 The London Approach has since been refined and superseded by INSOL International's International Statement of Principles for a Global Approach to Multi-Creditor Workouts (the second edition of which was published in April 2017). This Statement of Principles has been endorsed by the World Bank and other international bodies.

7.21 The INSOL Principles provide the following key guidelines to inform best practice in informal workout processes:

- the interests of all creditors are best served by coordinating their response to a debtor in financial difficulty;
- all creditors should agree to a standstill period on enforcement so they can properly evaluate the debtor's financial position and investigate the potential for a workout;
- conflicts of interest in the creditor group should be identified early and dealt with appropriately;
- one or more creditor committees ought to be established, with the benefit of professional workout advisers, as the potential for a workout is investigated and progressed;
- the debtor should provide, and allow relevant creditors and professional advisers reasonable and timely access to, all relevant information relating to its assets, liabilities, business and prospects, to enable proper evaluation to be made of its financial position and any proposal to be made to relevant creditors; and
- any new financing provided should be accorded super-priority status.

7.22 The INSOL Principles are currently in the course of being refined again as part of the Asian Principles of Business Restructuring, currently being drafted in a partnership between the International Insolvency Institute and the Asian Business Law Institute, and are expected to be published in their refined form in early 2021. It is expected that they will become the best practice standard for informal rescue for all nations in the Asian region upon their release.

7.23 We are currently seeing countries, including Singapore, introducing court ordered moratoria in support of such attempts to negotiate an informal restructure. We see merit in such legislative support being provided as part of a country's insolvency legal structure.

Key Recommendations

It is recommended that there be the following characteristics in Armenia's insolvency laws:

- The principles set out above regarding secured debt and the encouragement of informal work out with lenders should be embodied in all insolvency processes drafted as part of the proposed new Bankruptcy Code.

- Finance raised during an insolvency process should take priority over existing secured debts, provided the secured creditor's position is adequately protected.
- Employee priorities that arise in a liquidation should similarly be respected out of the proceeds of realisation of the security.

8 INSOLVENCY PROFESSIONALS – CAPACITY DEVELOPMENT AND REGULATORY OVERSIGHT

World Bank Principles

The bodies responsible for regulating or supervising insolvency representatives should:

(a) be independent of individual representatives;

(b) set standards that reflect the requirements of the legislation and public expectations of fairness, impartiality, transparency, and accountability; and,

(c) have appropriate powers and resources to enable them to discharge their functions, duties, and responsibilities effectively.[74]

Introduction

8.1 Institutional and practitioner capacity is critical to the success of an insolvency regime. Specifically, the role of the judiciary, the regulator and the insolvency practitioner profession, are critical to the success of the insolvency processes. They are essential in order that the system operate effectively and efficiently. The integrity of the system, and its ability to withstand the transparency that integrity requires, makes it important that:

(1) the Court exercise an important supervisory jurisdiction, with the judges assigned to insolvency cases having specialised skills in insolvency, and the ability to hear and determine cases expeditiously;

(2) insolvency practitioners who are assigned to undertake the restructuring and liquidation work be skilled and effective in undertaking what can be quite complex work;

(3) the regulator have the capability and capacity to regulate the marketplace, including the insolvency practitioner profession, so as to ensure the integrity of this important aspect of the system.

8.2 The *UNCITRAL Legislative Guide on Insolvency Law* (**UNCITRAL Guide**) makes the following general comment about the qualifications of an "insolvency representative":

> "*In determining the qualifications required for the appointment of an insolvency representative, it is desirable that a balance be achieved between stringent requirements that lead to the appointment of a highly qualified person, but which may significantly restrict the pool of professionals considered to be appropriately qualified to add to the costs of the proceedings, and requirements that are too low to guarantee the quality of the service required*."

8.3 The UNCITRAL Guide goes on to state that "the insolvency representative [should] be appropriately qualified, with knowledge of the law (not only insolvency law, but also relevant commercial, financial and business law), as well as adequate experience in commercial and

[74] World Bank, above n 3.

financial matters, including accounting" and notes that "if further or more specialised knowledge is required in a particular case, it can always be provided by hired experts". The UNCITRAL Guide also emphasises the need for such a representative to possess personal qualities such as "integrity, impartiality, independence and good management skills".

Duties of insolvency practitioners

8.4 In view of the importance of the roles to be played by insolvency practitioners in the various insolvency processes, both liquidation and corporate rescue, it is prudent that insolvency practitioners be subject to duties akin to those of officers of the company. Those duties should be specifically defined so that there is no scope for uncertainty. They should be:

(a) the duty to exercise care and diligence;

(b) the duty to act honestly and in good faith, and to exercise their powers and undertake their duties for the proper statutory purpose; and

(c) the duty not to improperly use their position to gain an advantage for themselves or someone else.

Regulation of insolvency practitioners

8.5 Statutory regulators are often given specific oversight of insolvency practitioners who accept appointments under the applicable insolvency laws. This oversight is essential to the regulation and monitoring of ongoing compliance with the duties and obligations imposed on insolvency practitioners under the law. However, professional organisations are often called upon to play a significant role in this area.

8.6 Examples of regulatory regimes adopted in other jurisdictions include:

(a) India's new *Insolvency and Bankruptcy Code* provides that only registered "Insolvency Professionals" may carry out the tasks allocated to such professionals under the Code. Membership of an Insolvency Professional Agency approved by a Board (the Insolvency & Bankruptcy Board of India established under the Code) is a prerequisite to an individual Insolvency Professional's registration. Adopting a model described as "regulated self-regulation", a competitive market of Insolvency Professional Agencies is provided for, which will induct members, develop professional standards and a code of ethics, audit and discipline members within standards defined and monitored by the Board.

(b) In Hong Kong, the Official Receiver (who is an independent appointee of the Chief Executive) has responsibility, along with the courts, to supervise the conduct of insolvency practitioners and can take action against those failing to conduct themselves in accordance with the relevant Ordinances. Professional bodies set standards and publish codes of practice, with which their members are expected to comply.

(c) In Singapore, the supervision and discipline of insolvency practitioners is primarily the responsibility of professional bodies such as the Insolvency Practitioners Association, the Institute of Singapore Chartered Accountants and the Law Society of Singapore. ACRA also has a role in establishing and enforcing professional standards in relation to insolvency practitioners who are accountants, and the Official Receiver, a public officer within the Ministry of Law, is responsible for monitoring liquidators in the conduct of winding up proceedings.

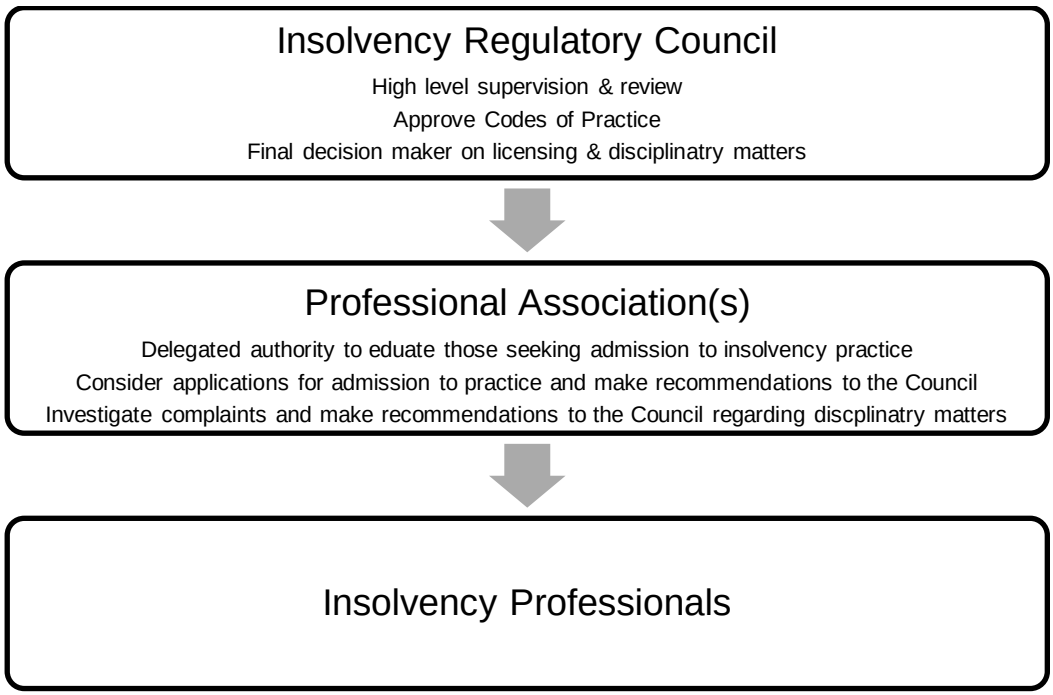
8.7 Key feedback was received as part of the consultation process, largely supporting the introduction of regulatory processes and measures to regulate the practitioner profession.

8.8 The structure to be adopted by Armenia on the regulation of insolvency practitioners is largely a policy decision and must be made by balancing:

(a) the need for capable and comprehensive regulation that ensure that the financial and business communities have faith in the integrity of the system; and

(b) the limitations of available resources and the capacity of existing institutions and structures within Armenia.

8.9 We recommend consideration of the following regulatory structure, which we explain below:



8.10 Sitting immediately above the collection of insolvency practitioners in this structure would be the Professional Association(s) to which they must belong as members. It would be a requirement that to practice as an insolvency practitioner, one would need to be a member of a properly accredited professional association. To both be admitted as a member, and retain that membership, the person would need to have sufficient knowledge and experience in the insolvency field, and would, by being a member, subject themselves to the ethical, competence and disciplinary standards and procedures required by their Professional Association.

8.11 The proposed Regulatory Council, which would regulate the Practitioner Associations, would be administered by the relevant government department, or could be comprised of the various government and industry officials and representatives who are considered to have a stake or interest in the effective and efficient regulation of the insolvency practitioner profession.

8.12 The Regulatory Council should, in our view, play an important role in ensuring the disciplining of non-compliance with duties and obligations, as well as in educating and licensing practitioners. It may be appropriate that the Professional Association(s) be

delegated the task of carrying on those activities subject to the general supervision the Regulatory Council. Findings and recommendations could be referred to the Council for its final decision. It should also have the option to conduct its own enquiry should it consider that the complaint has not been fully investigated.

8.12 It would be an important role of the Regulatory Council to approve and regulate the Professional Associations. By this we mean that to become a Professional Association, and to remain accredited to perform that role, the Professional Association's constitution, and its various codes of practice (eg ethical guidelines), programs (eg education program) and disciplinary procedures would need to be in place, be consistent with minimum standards set by the Regulatory Council, and be consistently and properly performed. If, for example, a disciplinary investigation was not undertaken when requested by a court, or if the investigation was defective, accreditation as a Professional Association could be withdrawn.

8.13 The investigation of serious misconduct, and the administering of appropriate sanctions for proven misconduct, are important outcomes sought to be achieved by the proposed structure. It would be necessary for there to be written guidance, either in the legislation or in guidelines issued by the Regulatory Council, to define misconduct.

8.14 Such guidance might include a non-exhaustive list of matters such as the following:

(a) where there is evidence of fraud;

(b) where the insolvency practitioner (or a person or entity closely associated with that practitioner) has benefited from the administration of the company's affairs;

(c) where there is evidence of a non-disclosed conflict of interest from which a benefit has accrued to the insolvency practitioner (or a person or entity closely associated with that practitioner);

(d) where there is evidence of gross negligence resulting in a substantial loss of the value of the estate;

(e) where there is evidence that the interests of one party (be it the director(s) of the insolvent company, one or more particular creditors or a third party with an interest in acquiring assets of the company) has been unfairly or inappropriately favoured by the insolvency practitioner.

8.15 We would wish to further explore the appetite for the Professional Associations to perform the roles allocated in the above chart. If this was not thought feasible, an alternative structure would be to eliminate the middle box of "Professional Associations", and allocate all of those responsibilities to the Insolvency Regulatory Council". What is important is the performance of each of the regulatory functions; the identity of the party performing the functions is less important, so long as the functions are performed diligently and effectively.

Capacity Development

8.16 The capacity of practitioners to perform their role skilfully and in a cost effective manner was also raised during the consultations. This can be achieved by the mandated introduction of educational and experience requirements in order to be admitted as an insolvency practitioner, and continuing educational requirements to retain membership. The educational component here could be provided by the Professional Associations.

8.17 There could also be seminars provided by agencies such as the ADB.

8.18 The issue of practice notes by the Commercial Court, and the development of precedents for use in many aspects of the work of practitioners should also be considered. We have included a list of areas where guidelines should be developed and published so as to achieve the same beneficial outcomes.

8.19 In Chapter 4 of this Report is a listing of capacity development initiatives that will similarly assist in ensuring the continuous development of the professional skills of participants in the bankruptcy processes and, in particular, those of insolvency practitioners. We have set out in Chapter 4 a number of documents for which standard forms can be prepared. This enables participants to understand what is required in each of those areas, and it also serves to reduce cost by the availability of a precedent document.

8.20 We also record our agreement with the recommendations set out in the Road Map Report regarding the steps that should be taken in order to identify the required qualifications and education of practitioners.

Fees charged by Practitioners

8.21 Feedback was received as part of the stakeholder consultation process that the issue of the insolvency practitioner's remuneration needed to be regulated "*as a matter of priority*". We therefore express the following views, both for their professional costs, and for third party charges incurred and passed on to the company.

8.22 For both types of charges, significant "overcharging" must be regarded as professional misconduct, regulated as part of the practitioner's general conduct, as practitioners are in a trusted position and overcharging results in a lower return to creditors.

8.23 With respect to third party costs reimbursed to the practitioner, a common response in countries is to only allow the actual external cost to be claimed. This means there can be no "mark-up" or profit added to the charge before reimbursement, and similarly no "overheads" of the practitioner's practice or office added to the cost. In examples of expenses commonly charged, there can also be a specification in practice guides of what cannot be reimbursed, for example the costs of non-professional employees, or for photocopying beyond an identified permitted charge per page of paper.

8.24 With respect to professional fees, the position is more challenging, and concerns similar to those raised during the consultations are a common occurrence. Some countries allow practitioners to charge on a time cost basis, but this can produce unacceptable outcomes when work is undertaken (and charged on a time basis) that is out of proportion to the value of the estate. This is called "over-servicing". Other countries permit charging a percentage of the estate, but this can produce inappropriate outcomes where the estate is very large and the work required to be undertaken is not complicated – for example the sale of land. Different charging scales for different types of work can create unhelpful biases.

8.25 There is no perfect solution, but there are a range of options to address such matters. For example, creditors should be given the responsibility to approve remuneration before it is paid to the practitioner, and even if it is approved, any creditor should be given the right to challenge it by application to the court. (The court might then refer it to an expert to assess the reasonableness of the charge.) The practitioner would need to provide sufficient detail and information to enable an assessment of the charge to be made on an informed basis. (There are precedents from other jurisdictions for the required detail that can be adapted for use in Armenia.)

8.26 It is also important to apply a proportionality lens to the charges. One way to do this is to permit a time-charge basis to apply, but require the figure produced to be then considered against a range of factors to assess its reasonableness, for example the value of the estate.

(There are precedents from other jurisdictions for the range of identified factors that can be adapted for use here.)

Key Recommendations

It is recommended that a regulatory structure consistent with what has been set out above be established:

- Insolvency practitioners should be subject to specific statutory duties akin to those of officers of the company. These duties are:

  (a) the duty to exercise care and diligence;

  (b) the duty to act honestly and in good faith, and to exercise their powers and undertake their duties for the proper statutory purpose; and

  (c) the duty not to improperly use their position to gain an advantage for themselves or someone else.

- In terms of setting standards, training professionals, accrediting them to practice as insolvency practitioners and (where appropriate) disciplining them, we recommend a structure similar to that set out in this section of this report.

- The structure must also include obligations on professional associations of the type identified above, with sanctions applicable if those obligations are not met.

- Capacity development be undertaken in the manner recommended

- Charging by practitioners be addressed by reference to international practices of the type outlined above.

9 JUDICIAL SUPERVISION OF INSOLVENCY REGIME

Key Principles

Strong institutions and regulations are crucial to an effective insolvency system. The institutional framework has three main elements: the institutions responsible for insolvency proceedings, the operational system through which cases and decisions are processed, and the requirements needed to preserve the integrity of those institutions—recognizing that the integrity of the insolvency system is the linchpin for its success...[75]

An insolvency law is a part of an overall commercial legal system and is heavily reliant for its proper application not only on a well-developed commercial legal system, but also on a well-developed institutional framework for administration of the law.[76]

In most jurisdictions, insolvency proceedings are administered by a judicial authority, often through commercial courts or courts of general jurisdiction or, in a few cases, through specialized bankruptcy courts. Sometimes judges have specialized knowledge and responsibility only for insolvency matters, while in other cases insolvency matters are just one of a number of wider judicial responsibilities. In a few jurisdictions, non-judicial or quasi-judicial institutions fulfil the role that, in other jurisdictions, is played by the courts.[77]

Introduction

9.1 The judiciary has a very important role to play in the success of any country's insolvency system. Armenia is no exception.

Role of the court

9.2 The involvement of the court will be an essential part of many aspects of the insolvency processes. By way of example, creditors and other stakeholders will have the ability to seek an order from the court that an insolvent company be liquidated.

9.3 The court will also exercise an important supervisory jurisdiction in these areas. For example, the following types of matters will be able to be brought before the court:

(a) where there is a dispute in an insolvency proceeding, court proceedings may be commenced to resolve that dispute;

(b) where a stakeholder is aggrieved by a decision of the insolvency practitioner, the stakeholder may have the right to challenge the decision before the court;

(c) any stakeholder may challenge any of the insolvency processes if they are being abused - for example, the counting of votes at a creditors meeting.

9.4 As can be seen from the above, the court retains a vitally important supervisory jurisdiction.

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75 World Bank, above n 3 at pg 8.
76 UNCITRAL, above n 1 at pg 33.
77 Ibid.

Judicial Capacity

9.5 The Road Map Report expressed concerns with the judicial component to the bankruptcy system, primarily around the issue of judicial training and capacity. We agree with a number of their recommendations (which are summarised in paragraphs 3.18-3.19 of this Policy Report), particularly the need to appoint additional judges to assist with the workload and minimise delay, the need for continuous professional training of judges and upgrade of computer and other digital technology available to the judiciary, and the establishment of a bankruptcy court of appeal. (If this latter recommendation is not feasible, then, as a matter of practice, the appellate bench should, where possible, comprise judges who have commercial experience, ideally in the bankruptcy field.)

9.6 A common theme that emerges from the feedback received as part of the stakeholder consultations was the perceived prevalence of attempted abuses of process, using the judicial system to delay and frustrate an insolvency process. If this perception is well-founded, it can have the effect of destroying confidence in the integrity of the insolvency systems. It is therefore very important to ensure that such abuses are not tolerated.

9.7 The primary means for addressing such attempted abuses is in having the judiciary provide swift and predictable judgments. By "predictable", we mean that there is consistency across the country as to how parts of the Bankruptcy Code are interpreted and applied, so as to ensure there is no uncertainty as to what the law means. As to "swiftly", we mean that there must be sufficient specialist bankruptcy judges to enable matters brought before the court to be listed for hearing promptly, and for orders to be made promptly after the hearing of the matter. As soon as it becomes apparent that attempted abuses of process will not delay the insolvency processes set out in the insolvency law, it is likely that those abuses will stop, as there will simply be no incentive for parties to take that course.

9.8 In addition, when actions brought before the court are considered frivolous and lacking in any merit whatsoever, there should be available to the court the sanction of ordering the unsuccessful litigant to pay the legal costs of the company and its administrator associated with the frivolous action. While this remedy should be rarely exercised, its availability will act as a deterrent to frivolous actions.

Key Policy Choice – Role of the judiciary in supervising insolvency proceedings

9.9 We raise for consideration one other alternative for reducing the burden on bankruptcy judges. The Court currently has a paramount approval and supervisory jurisdiction at most stages of the various insolvency processes. An alternative is to have the statute structure the various processes, and allow the processes to proceed consistently with the provisions of the statute, and with the Court role being limited to addressing complex matters, questions brought before it, and disputes. On this model, the Court is largely there to assist when required, but the process, under the control of a licenced and regulated insolvency practitioner, proceeds generally without the intervention of the Court. That is, there is no *automatic* requirement for Court approval of all steps. The Court is reserved for what it does best – adjudicate complex or disputed issues.

9.10 Regardless of the approach taken, it is imperative that at any stage of an insolvency proceeding that any aggrieved party may apply to the court for review of the conduct of the proceeding, and adjudication of any dispute.

9.11 In addition, there need to be safeguards in the legislation to prevent abuse of the process, and the ability to bring the alleged abuse before the Court.

9.12 Our intent in raising this option for consideration is to minimise the risk of increased costs and delays involved in the various insolvency processes, by increasing the role of the insolvency practitioner, and correspondingly reducing the approval role of the Court by removing that role where there is no real dispute or contestable issue.

9.13 This approach is taken in many countries as it lessens the workload on the judiciary, and some commentators consider some of the decisions are better made by practitioners whose commercial judgement is based on greater business experience.

9.14 The policy choice here is not between the extremes of no Court involvement, or heavy Court involvement. It may instead be seen as an exercise in considering all matters that must presently be brought before the Court, and deciding if some of these matters (and if so, which ones) can be removed from the mandatory requirement to be approved by the Court, and instead have such matters only be brought before the Court if there is a dispute or issue of great significance.

Key Recommendations

The following recommendations are made:

- Specialisation of insolvency judges, including in appellate processes, should continue to be encouraged by whatever means are available.
- Steps be taken to discourage frivolous actions being brought before the Court.
- The recommended judicial capacity initiatives be introduced.
- Consideration be given to whether any of the matters that currently must be listed before the Court for review or approval can instead be addressed by a vote of creditors or a decision by the appointed insolvency practitioner (on the proviso that any *dispute* relating to the issue, or *guidance* sought by the insolvency practitioner, is able to be brought before the Court for decision).

10 CROSS BORDER INSOLVENCY

World Bank Principles

Insolvency proceedings may have international aspects, and a country's legal system should establish clear rules pertaining to jurisdiction, recognition of foreign judgments, cooperation among courts in different countries, and choice of law. Key factors to effective handling of cross-border matters typically include:

(a) a clear and speedy process for obtaining recognition of foreign insolvency proceedings;

(b) relief to be granted upon recognition of foreign insolvency proceedings;

(c) foreign insolvency representatives to have access to courts and other relevant authorities;

(d) courts and insolvency representatives to cooperate in international insolvency proceedings; and

(e) non-discrimination between foreign and domestic creditors.[78]

Cross-border insolvency

10.1 International trade continues to increase. This requires insolvency processes to operate efficiently across borders, when financial distress results in one of the participants in international trade to become insolvent. In the absence of efficient and cooperative processes within a country's laws that address the international aspects of the insolvency, the process becomes cumbersome, expensive and the resolution is frequently delayed as a result.

10.2 According to the key international texts[79], given that insolvency proceedings may have international aspects, a country's legal system should establish clear rules pertaining to jurisdiction, recognition of foreign judgments, cooperation among courts in different countries and choice of law. Key factors to effective handling of cross-border matters typically include:

(a) a clear and speedy process for obtaining recognition of foreign insolvency proceedings;

(b) relief to be granted upon recognition of foreign insolvency proceedings;

(c) foreign insolvency representatives to have access to courts and other relevant authorities;

(d) courts and insolvency representatives to cooperate in international insolvency proceedings; and

(e) non-discrimination between foreign and domestic creditors.

78 World Bank, above n 3; International Monetary Fund, above n 8 at pg 46.

79 The World Bank, above; International Monetary Fund, above at page 46.

Historical Context

10.1 On 30 May 1997, the UN General Assembly recommended that all States review the cross-border aspects of their insolvency laws to determine whether they meets the objectives of a modern, efficient insolvency system and give favourable consideration to adopting the Model Law that UNCITRAL had developed, bearing in mind the need for internationally harmonised legislation governing cross-border insolvency. Since then, the Model Law has been adopted by 51 jurisdictions (as at 1 December 2020).

10.2 Our recommendation is that any insolvency law reform undertaken by Armenia should include the adoption of the Model Law. Such a law will bring greater certainty and efficiency to addressing the international aspects of a cross-border insolvency affecting Armenia, and will for these reasons be attractive to foreign investment in the country.

Purpose and Content of the Model Law

10.2 The purpose of the UNCITRAL Model Law on Cross-Border Insolvency (**Model Law**) is to facilitate:

- co-operation between courts & foreign representatives;
- legal certainty for trade and investment;
- fair and efficient administration of cross-border insolvencies;
- the protection and maximisation of the value of the debtor's assets; and
- the rescue of distressed businesses.

10.3 The Model Law's principal themes are to:

- provide direct access to courts for foreign representatives;
- set out principles & procedures for recognition, relief and assistance;
- establish a framework for co-operation between courts;
- provide a framework for co-ordination of concurrent proceedings; and
- respect international origins, promote uniformity and good faith.

10.4 The core structure of the Model Law provides for:

- inbound requests for recognition;
- direct access to courts for foreign representatives and creditors;
- outbound requests to foreign courts;
- co-operation between courts and office-holders; and
- co-ordination of concurrent proceedings.

10.5 The recognition of foreign proceedings is the central premise and key to all benefits under the Model Law. The process for recognition and obtaining relief involves an application and foreign order, the identification of a centre of main interest (or **COMI**), and the recognition of main or non-main foreign proceeding (**FMP** or **FNMP**). The granting of interim relief may also be involved.

10.6 The identification of a COMI begins with the rebuttable presumption that a debtor's registered office or habitual residence is its COMI. The objective criteria ascertainable by third parties to test this presumption, includes:

- where debtor is registered and incorporated or resides
- where directors are located and meet
- nature of the operations and business of the debtor

- where administrative functions of debtor are carried out

10.7 Article 19 of the Model Law provides for the granting of interim relief until determination of a FMP or a FNMP is made and Article 20 establishes automatic relief by way of a stay on the commencement or continuation of actions against debtor, as well as a stay of execution and of right to transfer or encumber [FMP only].

10.8 Article 21 provides for final relief to protect the assets of debtor or interests of creditors & includes powers such as public examination and compulsory production of documents [FMP & FNMP]. Article 22 provides adequate protection of creditors and other interested persons. Provision is made for cooperation between courts & office-holders in Articles 25 to 27, which establish framework of international cooperation in insolvency matters.

10.9 Article 25(1) imposes a duty upon courts to cooperate to maximum extent possible with foreign courts & representatives and Article 25(2) permits court-to-court communication.

10.10 Articles 28 and 29 provide for the coordination of concurrent proceedings once a FMP has opened. A local proceeding may only be commenced if the debtor has local assets. Where foreign and local proceedings are taking place concurrently, there is to be cooperation (as envisaged by Articles 25, 26 & 27) and consistency in the relief granted under Articles 19 & 21.

Recommendation

10.11 It is our strong recommendation that the Model Law be adopted by Armenia, and be included in the proposed corporate insolvency laws. There are 2 reasons for our recommendation. First, the existence of the Model Law as part of the domestic law of Armenia will be an attractive part of the legal infrastructure compatible with foreign investment in the country. Secondly, the Model Law provides clear and inexpensive means, consistent with international best practice, for addressing international insolvencies that have an element in Armenia. In this regard, the Model Law will promote greater certainty and efficiency in such matters.

Key Recommendation
It is recommended that the UNCITRAL Model Law on Cross-Border Insolvency be adopted within Armenia's insolvency laws.

11 OTHER MATTERS

Introduction

11.1 Other significant matters have arisen during our diagnostic work, and are mentioned below.

Sale of Inventory

11.2 Very considerable feedback was received in relation to all processes around the sale of inventory. That feedback may be summarised (as it has been in the previous Publications) as a lack of transparency and regulation, particularly with regard to price and methodology.

11.3 Stepping back from the specific aspects of the feedback that has been received, we consider there to be 2 alternative approaches to the question of sale of inventory:

(a) the first is to introduce detailed regulations around the valuation and auction process so as to in effect design minimum standards that must be observed and in this way improve accountability as well as transparency. (This is the approach recommended in the Road Map Report);

(b) seek to achieve the same outcome by different means - by leaving it to the insolvency practitioner (when selling on behalf of the company) or the secured creditor (in relation to pledged assets) to observe general, rather than specific, standards and obligations when selling the inventory. That is, in the case of a sale by the insolvency practitioner, to rely on the general obligations imposed on an insolvency practitioner set out in paragraph 8.4 to exercise care and diligence, to act honestly and in good faith and to not improperly use their position to gain an advantage for themselves or someone else. Any breach of any of these obligations would leave the insolvency practitioner exposed to an action to compensate the company for any loss – for example selling below market price - sustained by the company as a result of the breach. A breach would also render the insolvency practitioner liable to disciplinary proceedings if the conduct was improper rather than just negligent. In the case of a secured creditor selling assets the subject of a pledge, a further obligation could be inserted into the law obliging them to exercise reasonable care to ensure, if the asset has a market price, that sale process enables the asset to achieve the market price, and if there is no market price, to ensure proper steps are taken to obtain a reasonable price in the circumstances. Again, a breach of any of these obligations would render the secured creditor liable to compensate the company for any loss.

11.4 In a properly regulated, properly operating insolvency environment, the second approach is to be preferred as the obligation is on the insolvency practitioner (or the secured creditor, in relation to a sale of the secured assets) to act properly and achieve a market price, and any breach of this obligation will leave them liable to an action for compensation by the company and, in the case of the insolvency practitioner, sanctions under the regulatory regime.

11.5 However, if insolvency practitioners lack the training and capacity to undertake these functions properly, or if the regulatory processes around insolvency practitioners do not operate effectively, the former approach would appear to be the preferred option, at least until practitioner and regulatory capacity is sufficiently developed and operating effectively. Regulation to address in detail the feedback received regarding sale of inventory should in this scenario be put in place on an interim basis, but with the practitioner conduct model prepared and ready for introduction when considered appropriate.

Insolvency law as a debt collection tool

11.6 The use of insolvency laws to enable uncontested overdue debts to be efficiently collected is a valid purpose for an insolvency law, provided it does not impede rescue attempts. Generally it is to be found in parts of the law dealing with liquidating the company.

11.7 That process generally requires a demand in a specified form to be served on the company requiring that a debt owed to the creditor be paid within a reasonable period - 21 days is one example of a deadline. If payment is not made within that period, and there is no genuine dispute in relation to the debt (and no counterclaim by the company against the creditor for the same or a greater amount), at the expiry of the 21 days there will be a presumption that the company is insolvent. The creditor can commence liquidation proceedings in the court and rely on the presumption, with the effect that the company will be wound up unless the company can itself prove to the satisfaction of the court either that there is a genuine dispute in relation to the debt, or that the company is in fact solvent.

11.8 This statutory demand process serves three principal purposes:

(a) to provide an effective means for the collection of debts owed by a financially stressed company;

(b) to simplify most court proceedings seeking an order for winding up a company, by establishing a presumption of insolvency, and providing clear guidance as to when that presumption of insolvency arises and can be rebutted; and

(c) to encourage a debtor that is insolvent (or approaching insolvency) to consider whether it should itself commence a corporate rescue process.

11.9 It is our recommendation that a statutory demand process be included in the new Bankruptcy Code.

Unclear and inconsistent provisions of the Insolvency Law and other laws and policies

11.10 Chapter 4 and Appendix A record a number of issues of inconsistency and uncertainty in applying the existing insolvency laws. There are also provisions of the existing insolvency law that are unclear or ambiguous. These issues are problematic, as it leads to uncertainty as to the application of the law, and to the potential for inconsistent decisions on the issue in different matters and in different courts.

11.11 The drafting of a new Bankruptcy Code presents the opportunity to address these issues and ambiguities by providing clarity in the new Code. The Code can state that its provisions apply despite any inconsistency with other existing laws.

11.12 We provide below an example of how this may be addressed in the field of distribution priorities.

Distribution priorities

11.13 The assets of the company recovered by a liquidator are generally distributed in the following order of priority:

(a) the costs and expenses of the liquidator;

(b) employee entitlements (for example outstanding wages, superannuation contributions, leave entitlements and retrenchment pay); and

(c) unsecured creditors, on a pro rata basis.

11.14 There may sometimes be scope for uncertainty as to the nature and extent of priority employee entitlements. This uncertainty can be addressed by specifying clearly in the revised Bankruptcy Code the precise nature and extent of the priority, and providing that the priority applies despite any specification in any other existing law.

11.15 Some jurisdictions include a priority for uncollected tax. This is a matter of public policy rather than a legal drafting matter. However, we note that paragraph 74 of the *UNCITRAL Legislative Guide on Insolvency Law* makes the following observations:

> "*Priority is often accorded to government tax claims to protect public revenue, but has also been justified on a number of other grounds. These grounds include that it can be beneficial to reorganization because tax authorities will be encouraged to delay the collection of taxes from a troubled business on the basis that eventually they will be afforded a priority for payment under insolvency and that, because the government is a non-commercial and unwilling creditor, it may be precluded from some commercial debt recovery options. Providing a priority to such claims, however, can be counterproductive because failure to collect taxes can compromise the uniform enforcement of tax laws and may constitute a form of state subsidy that undermines the discipline that an effective insolvency regime is designed to support. It may encourage tax authorities to be complacent about monitoring debtors and collecting debts in a commercial manner that otherwise would assist to prevent insolvency and the depletion of assets ...*"

11.16 A similar statement can be found in the International Monetary Funds' paper on *Orderly & Effective Insolvency Procedures* (1999). In paragraph 146 of the 2001 edition of its *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems*, the World Bank cautioned against the "*tendency to increase the categories of debts enjoying … priority, for example by giving this status to each new form of tax or duty or each additional employee entitlement*".

11.17 Whether Armenia should have a priority for uncollected tax is a socio-economic policy issue for Armenia. From a drafting perspective, the policy decision should be incorporated into the revised code in clear language.

Transparency of Information

11.18 Transparency in information during insolvency proceedings has been identified as an issue. From a best practice perspective, there must be information mechanisms that enable creditors and other stakeholders to be informed of material matters relating to the debtor and the conduct of its insolvency process. A register containing prescribed information should be accessible to members of the public. In addition, all documents and electronic communications issued on behalf of a company the subject of an insolvency filing should include a statement to the effect that the company is the subject of an insolvency filing.

Availability of Mediation

11.18 Often an insolvency is a consequence of the relations between the debtor and just one creditor, for example its banker, landlord or the tax authority. Mediation can assist here in particular, but can also assist more generally, for example when a plan is being negotiated with creditors. Mediation should be entrenched and encouraged in a revised Code.

Electronic Communication

11.20 Another important issue raised during the consultation process is the issue of proper notifications. For example, the regulations do not currently allow case participants to communicate electronically. To address this concern, best practice guidance can be taken from other jurisdictions that effectively require all creditors to be notified, including electronically, as soon as an insolvency process has commenced, and which permit electronic notification.

Creditor Meetings

11.21 It is also apparent from the feedback received during the stakeholder consultations that a set of regulations need to be drafted in order to ensure that creditor meetings are held properly. Particular attention would need to be given to the manner of voting at creditor meetings. In this later regard, there are multiple different counting thresholds that may potentially be used for voting.

11.22 We have addressed in this report how votes should be cast and counted (and how creditor meetings should be held) in the context of the insolvency of an MSME. We recommend that different voting majorities should be applied in relation to other creditor meetings required under the revised Bankruptcy Code. Particular attention here needs to be given to the manner in which votes are counted. That is, is it one vote per creditor, or is the vote counted by reference to the value of each claim, or are both majorities counted (and, in which case, what is the outcome if the number of creditors votes one way and the majority in value votes a different way). There are various international precedents that both identify regulations around creditor meetings and also different voting majorities, and these issues can be resolved as part of the law reform process recommended in chapter 4.

Other feedback

11.23 There was considerable further feedback that also needs to be considered and addressed in a revised Bankruptcy Code. We list below three of the more important aspects raised during the stakeholder consultations that have not already been addressed in this Report:

- during a liquidation process, it would be appropriate to enable a plan for a consensual resolution of liabilities to be submitted to and considered by creditors at any stage of the liquidation;

- in Chapter 4, reference is made to the establishment of a funds to ensure the unsatisfied claims of employees can be met by the state. If the Republic of Armenia is amenable to establishing such a fund, the manner of its operation could be determined by reference to international precedents, and its existence could be accommodated within the revised bankruptcy Code;

- in Chapter 4 there is reference to the need to promote the detection of intentional and fraudulent bankruptcy cases. International precedents in this area achieve this objective by the law imposing an obligation on the insolvency practitioner to report such cases of intentional and fraudulent activity to appropriate law enforcement agencies. This obligation could be included in the revised Bankruptcy Code as an obligation of the insolvency practitioner.

Key Recommendations

It is recommended that the new Bankruptcy Code include the following characteristics:

- A statutory demand process to facilitate the collection of undisputed debts.
- Clarity around all issues currently considered uncertain or inconsistent, or where there is a clash of laws.
- Establishment of a publically accessible register containing prescribed information regarding an existing insolvency process.
- Entrenchment within the proposed new Bankruptcy Code of mediation processes.
- The other issues identified in this chapter similarly be addressed.

12 REVIEW OF LEGAL FRAMEWORK - RECOMMENDED REFORM PROCESS AND STRATEGY

12.1 This Policy Report includes a review of Armenia's legal traditions, its civil law system, and its judicial hierarchy, and contains a description of Armenia's existing insolvency laws.

12.2 This Report also sets out the extensive feedback on the existing insolvency laws received from the stakeholder consultations, with a detailed summary in Appendix A, and a short summary contained in Chapter 4 of this Report.

12.3 This material provides very important context, as does the recent policy work that is summarised in chapter 3, to the law reform recommendations that are set out in the various chapters to this Report, and the proposed strategy that is set out below.

12.4 It is, however, important to repeat what is recorded in Chapter 4, namely that a theme of the feedback was "*the urgent necessity to develop a new Bankruptcy Law (Code), which should comprehensively regulate all procedural and material relations arising in the sphere of bankruptcy*". This conclusion is reinforced by the sheer number of issues of uncertainty and perceived gaps in the existing insolvency law that must be addressed to provide clarity and consistency in the law in this area.

12.5 The due diligence inquiries and our desktop review lead us to make the following recommendations:

(a) it is strongly recommended that consideration be given to undertaking a formal insolvency law reform process to amend (or enact a new law in substitution for) the existing insolvency laws in the respects set out in this Report. Both the feedback from stakeholders, and our own view, is that the reform process should be comprehensive, and be comprised in a new Bankruptcy Code, rather than seeking to amend and add additional provisions to the existing law;

(b) it is consistent with international best practice, and strongly recommended, that consideration be given to the introduction of modern corporate rescue processes as an essential part of Armenia's insolvency laws;

(c) it is consistent with international best practice, and strongly recommended, that consideration be given to the inclusion within Armenia's insolvency laws of a regime applicable to, and tailored specifically to, the needs of the MSME sector;

(d) it is consistent with international best practice, and strongly recommended, that consideration be given to the inclusion within Armenia's insolvency laws of the UNCITRAL Model Law on Cross Border Insolvency;

(e) it is strongly recommended that consideration be given to:

(i) capacity development initiatives regarding regulators, the judiciary and members of the insolvency practitioner profession; and

(ii) the adoption of international practices regarding the regulation of insolvency practitioners;

(f) it is strongly recommended that consideration be given to reforming the law to address many of the other issues identified in the stakeholder feedbacks and set out in its Appendix A, which can readily be addressed as part of the law reform process recommended in (a) above.

12.6 To ***implement*** the above recommendations, we recommend that the steps set out below be taken.

First Step – Decision to Reform Armenia's Insolvency Laws

12.7 A decision in principle needs to be made as to whether, based on the conclusions and supporting material set out in this Policy Report, there should be steps taken to reform Armenia's insolvency laws. The following implementation decisions then need to be made if the answer to this question is "yes".

Second Step – Decision whether to undertake ad hoc reform, or alternatively the preparation of a comprehensive Bankruptcy Code

12.8 Reform may take the form of ad hoc reform (ie amendments and additions to the existing provisions), or the preparation of a comprehensive Bankruptcy Code that replaces the existing law (though would retain some parts of it where changes are not considered necessary).

12.9 Both approaches would work, and serve to address the issues raised in this Report. However, a comprehensive new Bankruptcy Code would likely be more coherent, comprehensive and internally consistent, as each component of the Code will have been drafted so as to coordinate and be consistent with the balance of the Code.

12.10 Accordingly a decision should be made at the commencement of the further law reform work as to which of these two alternative processes is to be adopted.

Third Step – Decision as to which new structural components to include in the law reform process

12.11 There are several recommendations as to proposed new structural components to be added to the law (either as part of a new Bankruptcy Code or by way of addition into the existing law). These are:

- Introduction of an MSME regime
- Revision to Corporate Rescue regime
- Adoption of the UNCITRAL Model Law on Cross-Border Insolvency
- Embed modern processes to address the interactions between lenders and borrowers
- Provide a regulatory regime applicable to the insolvency practitioner profession
- Provide reform of the processes applicable to the sale of inventory
- Provide reform of other areas and processes identified as a result of the stakeholder consultation process

12.12 There are several recommendations seeking to support the integrity and effectiveness of the operation of the law. These are:

- Capacity development initiatives for insolvency professionals
- Capacity development initiatives for the judiciary

12.13 Decisions in principle need to be made as to which of the above recommendations are to be pursued and progressed as part of this reform process. To be clear, this step does not necessarily decide whether to adopt a specific recommendation into law. It is to take the issue forward to the next steps, outlined below, for a decision to be made at the end of the process as to whether to adopt the particular recommendation. However, if it is clear that a recommendation will not be accepted, that issue can be excluded from the continuing process.

Fourth Step – Establishment of working group (or granting of continuing mandate to existing working group) to work with the national and international consultants towards implementing the recommendations

12.14 It will be essential moving forward that the national and international consultants have a duly authorised working group with whom to engage, and that the working group is able to progress the reform project with the benefit of decisions having been made on the issues outlined above.

Fifth Step – Preparation of structure of new Code (or amendments to existing law) and the proposed characteristics of each element of the law

12.15 The National and International consultants will work with the working group to prepare an outline of the new Code (or the proposed amendments to the existing law) as well as the detail comprised within each element identified in the outline. While not a drafting of the proposed new code, it will be sufficiently detailed as to what is proposed as to enable the Code to be drafted based on the detail, should the decision to take that final step be made. There will also be an explanation, suitable for circulation, that discusses significant inclusions or changes, in order to enable feedback to be received on the proposed changes. (This will include a reproduction of some of the material in this Report, which explains the rationale for some of the proposed reforms.)

12.16 What will emerge from this part of the process will be an outline of the proposed bankruptcy code that includes the structure, as well as a detailed outline of the important components of each aspect included within the structure. This will be accompanied by the proposed explanation. Once the outline and explanation is acceptable to the working group, the process is ready for the sixth step.

Sixth Step – Stakeholder consultation on specific changes proposed

12.17 The outline and explanation will then be circulated to key stakeholders to enable a final consultation process to be undertaken on the proposed changes to the law.

12.18 Following that consultation process the consultants will engage with the working group to decide which changes, if any, to the outline should be made as a result of the feedback received during the consultations. This may involve a report from the consultants outlining the feedback, and discussing whether to accommodate suggested changes, and if so how.

Final Step – Drafting of revised Code (or changes to existing law)

12.19 This step involves drafting a new Bankruptcy Code (or amendments to the existing law), based on the outline and detail previously circulated, and incorporating changes considered appropriate as a result of the consultation process.

12.20 This step also involves the implementation of capacity development initiatives for both practitioners and the judiciary.

PowerPoint Presentation

12.21 Attached as Appendix B is the PowerPoint Presentation delivered in January 2021 that outlines the recommended steps in the proposed reform process.

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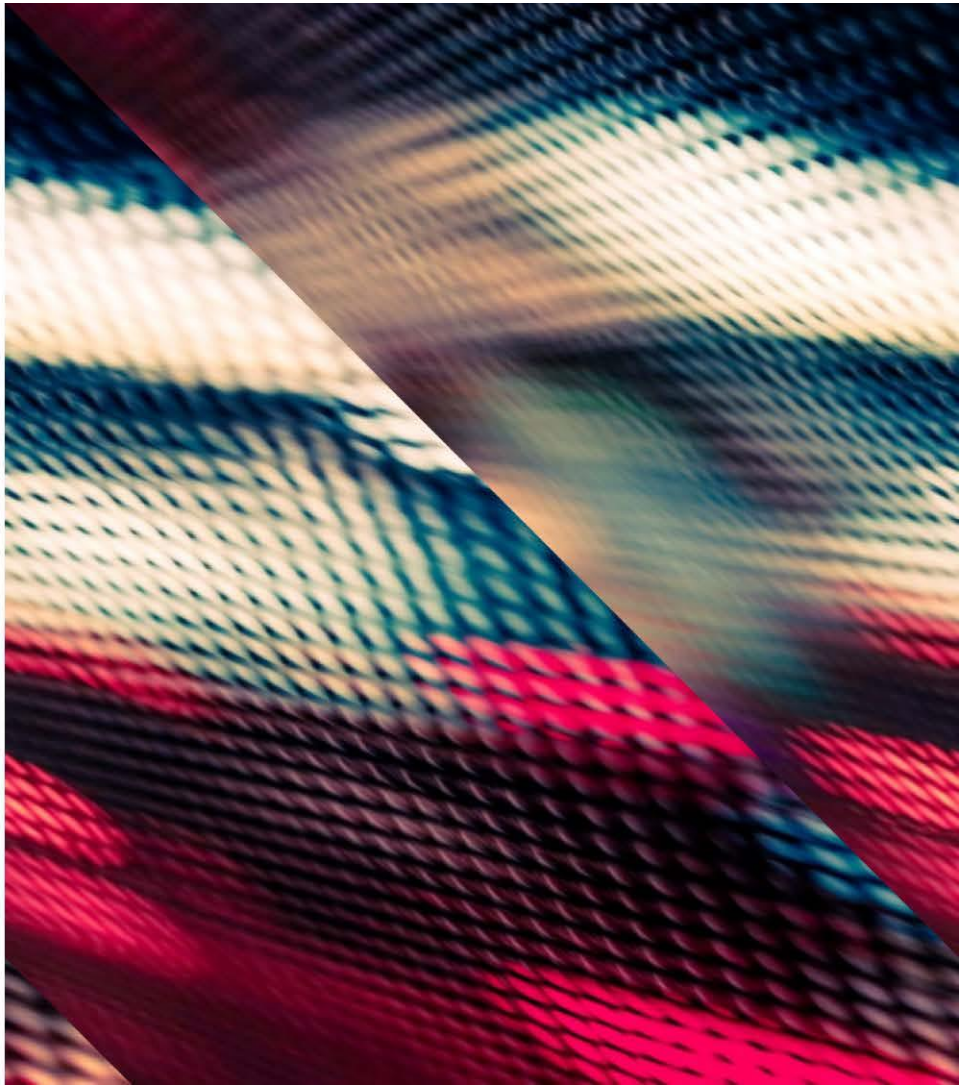
Appendix B

Republic of Armenia

Development of Insolvency Legal Framework

International Experts:
John Martin
Scott Atkins
Rod Bretag

Norton Rose Fulbright Australia



Introduction

- **Comprehensive approach to reform**
  - Recognition of civil law tradition, historical policy and culture - see Diagnostic Report (**DR**)
  - Lessons from international best practice and international texts such as World Bank's Doing Business Survey - see Policy Report (**PR**) Ch 2
  - Feedback from key stakeholders – see DR
  - Understanding of existing law reform work and studies – see PR Ch 3
- **Objective is to identify:**
  - Framework for development of modern, effective insolvency legal framework (PR Ch 4)
  - Key tools and processes for inclusion in revised Bankruptcy Code (PR Chs 5-11)
  - Key capacity development initiatives to support and implement the reform program (PR Chs 8 and 9)

NRF

Corporate Rescue

- Best practice tools for an effective restructure should be included within law
- Significant level of control/supervision of enterprise by insolvency professionals (ie model (b) or (d) in para 5.5 of PR)
- Only the debtor should commence a corporate rescue process
- Threshold for commencement is that debtor cannot pay its debts, or is likely in the future to be unable to pay its debts
- Strict timelines for approval of rehabilitation plan by creditors, and implementation period. (Court should be given power to extend in unusual or extraordinary circumstances.) Must be a report to creditors from insolvency professional with analysis of plan and a recommendation. Must be minimum requirements for plan, including consequences for breach of terms of plan.

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Corporate Rescue (cont)

- Balance the protection of secured creditor rights with importance of corporate rescue process
  - Secured creditors only bound by plan if voted in favour or if Court orders they are bound
  - Court may only make order binding secured creditor if evidence proves their secured position is adequately protected
  - Secured creditors allowed to vote on plan
- Role of court in rescue process needs to be reassessed – see later slide.

NRF

MSME Insolvency

- MSME sector critical to economy
  - Key drivers of growth and employment
  - In ASEAN, MSMEs represent 99% of enterprises and contribute 30%-60% of GDP
- MSME insolvency is particularly challenging due to lack of resources and lack of experience
- We recommend a specific chapter comprising a tailored process for MSMEs that:
  - includes a rescue process for distressed but viable enterprises
  - includes a quick and efficient process for liquidation where enterprise is not viable
  - provides a discharge and fresh start for honest entrepreneurs
  - achieves all of the above goals with quick, simple and inexpensive processes
- Qualification to be treated as an MSME should be based on the total amount of debt outstanding

NRF

Debtor Lender Relations

- Feedback from stakeholder consultations

  SECURED LENDER

- In a liquidation, there should be no restriction on enforcement of security rights
- In a rescue process, there should be restrictions, though subject to timeframes and balanced by adequate protection of the security interest
- In a rescue process, fresh finance may take priority over existing security, but only where that existing security is adequately protected
- Employee priorities should have priority over security

  UNSECURED LENDER

- Adoption (upon their publication) of the Asian Principles of Business Restructuring recommended
- Introduction of court ordered moratoria in support of informal restructures recommended

NRF

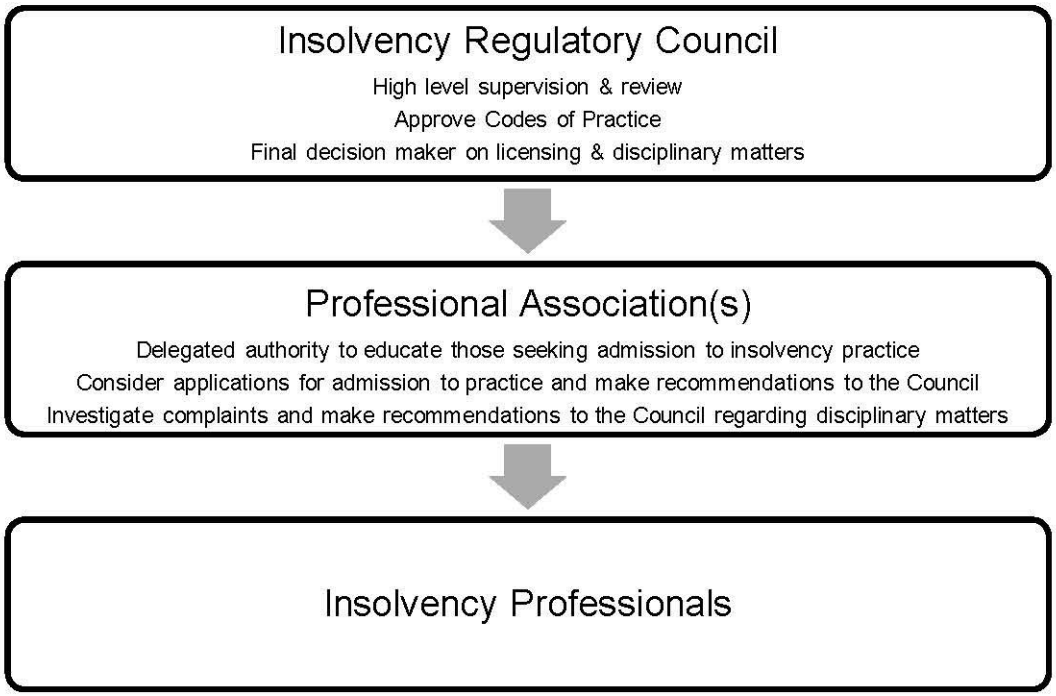
Cross Border Insolvency

- Recommended that UNCITRAL Model Law on Cross-Border Insolvency be adopted.
- The Model Law will promote:
  - Co-operation between courts
  - Legal certainty for trade and investment
  - Fair and efficient administrations of cross-border insolvencies
  - Rescue of distressed businesses.

NRF

Insolvency Professionals

- Set up regulatory structure:



Insolvency Professionals (cont)

- Insolvency professionals should be subject to statutory duties to:
  - exercise care and diligence
  - act honestly and in good faith for proper purposes
  - not improperly use their position to gain advantage
- Regulations regarding charging of professional fees can be based on international best practice, including full transparency
- Capacity development initiatives would include:
  - Minimum education and experience requirements
  - Attendance at education seminars required in order to renew accreditation
  - Professional associations (and ADB) can run educational seminars
  - Commercial Court can issue practice notes (see para 5.47 of DR)
  - Precedents can be developed (see para 5.46 of DR)

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Judicial Supervision

- Specialisation of insolvency judges, including appellate processes, should be encouraged Training for new or inexperienced insolvency judges should be prioritised
- Additional insolvency judges, with modern technological support
- Consideration be given to the removal from the requirement of Court sanction:
  - routine matters
  - uncontroversial matters

  but only where such matters can be addressed by a vote of creditors or a decision by insolvency professional. (If it is disputed, it can then be brought before the Court.)

  Need for abuses of insolvency processes to be brought swiftly before the Court.

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Other Matters

- Insolvency law as a debt collection tool
- Clarification of unclear or ambiguous provisions, interaction with other laws
- Clarification of distribution priorities
- Transparency of information, electronic communication
- Importance of mediation
- Sale of inventory
- Creditor meetings
- Compromises during liquidation
- Establish fund to meet employee claims
- Reporting fraud and intentional misconduct
- Response to Covid pandemic

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Recommended Reform Process

- **STEP 1**
  - Whether to undertake insolvency law reform?
  - **Recommendation: Yes**

- **STEP 2**
  - Whether preparation of new comprehensive Bankruptcy Code, or ad hoc reform?
  - **Recommendation: New comprehensive Bankruptcy Code**
    - More coherent, comprehensive and internally consistent

NRF

Recommended Reform Process (cont)

- **STEP 3**
  - Identify the structural components for inclusion in code
  - These are “in principle” decisions
    - Introduce MSME process
    - Revisions to corporate rescue process
    - Introduce regulatory regime applicable to insolvency professionals
    - Introduce UNCITRAL Model Law on Cross-Border Insolvency
    - Introduce modern best practice processes to address interactions between lender and borrower
    - Address other feedback recommended in Chapter 11
    - Capacity development initiatives for the judiciary and insolvency professionals

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Recommended Reform Process (cont)

- **STEP 4**
  - Mandate to working group to undertake reform process
    - Is there an existing working group that has that mandate?
    - Essential to have anchor member

- **STEP 5**
  - Preparation of structure of new Code (or amendments to existing law)
    - Not formal drafting of Code, but a detailed outline
    - Preparation of explanatory document for consultations

NRF

Recommended Reform Process (cont)

- **STEP 6**
  - Final consultation process
  - Then amendments, if any, to the outline if thought appropriate
- **STEP 7**
  - Formal drafting of new Bankruptcy Code (or amendments to existing law) for submission to Parliament
  - Implementation of capacity development initiatives

NRF

Conclusion

- A new Bankruptcy Code would:
  - promote clarity and consistency
  - remove uncertainty and ambiguity
  - embed “best practice” tools and processes that would work effectively (and be highly regarded in World Bank’s doing business survey)
  - provide benefits to MSME sector
  - promote lender confidence and cross border investment
  - rescue viable businesses suffering financial distress
  - be part of Armenia’s economic response to Covid pandemic
- NRF would be honoured to continue working with the mandated working group to attain these important goals

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