EBRD Core Principles of an Effective Insolvency System

September 2020

European Bank
for Reconstruction and Development

Background

The purpose of these Core Principles is to provide legislators and national authorities in European Bank of Reconstruction and Development (EBRD) jurisdictions with high-level guidance on key objectives and international best practices with respect to business insolvency.

There have been many developments in best practices since these principles were first published 15 years ago. In particular, there has been an increasing focus on the importance of statutory restructuring tools, consensual out-of-court restructuring solutions and early 'pre-insolvency' action to support business continuity. These developments have been partly in response to the 2007-9 financial crisis and they represent a trend that is likely to continue, owing to the depth and severity of the global economic recession caused by the Covid-19 pandemic. Furthermore, there has been increasing recognition by policymakers of the importance of tailoring insolvency systems to the needs of micro, small and medium sized enterprises. These businesses are more affected by any economic downturn than their larger counterparts, owing to their smaller operating margins and lack of reserves.

Within the European Union (EU), minimum harmonisation measures have recently been introduced in respect of restructuring procedures for both corporates and entrepreneurs, as well as other general areas of insolvency law and practice affecting the efficiency of insolvency procedures. These include the demand for insolvency office holders and judges overseeing insolvency proceedings to have sufficient expertise and a requirement for digitalisation of communications between parties to an insolvency case. Nevertheless, insolvency laws continue to be predominantly determined at national level and remain closely connected with other areas of national legislation, such as secured transactions, company, employment and tax laws.

These Core Principles thus aim to contribute to the further development and harmonisation of countries' insolvency legislation by clearly articulating the general objectives of any commercial insolvency law reform, which may be adapted to the specific national context.

The Covid-19 crisis has highlighted the vital importance of digital information and communication systems. Future reforms in many countries will focus on the development of electronic case management systems, online courts and electronic auction platforms. These measures will contribute to the time-efficiency of insolvency procedures and, if used appropriately, will help to monitor insolvency proceedings and contribute to better decision-making on insolvency policies. Online platforms will also significantly increase transparency and access to information by stakeholders and reduce the opportunities for misuse of the insolvency process.

Some principles below apply only to corporate insolvency. Links to more detailed guidance are included in the Annex to this document.

These Core Principles do not deal with financial institutions. A country's legal system should provide a special insolvency regime to deal effectively with financial institutions that are likely to become insolvent, following the use of any recovery and resolution tools. Financial institutions may be systemically important due to the functions that they perform, such as in relation to payment systems, and may have depositors as creditors. They are usually interconnected with other institutions, often operating on a cross-border basis. Accordingly, different policy objectives apply in respect of financial institution failure.

Terminology

References in these principles to ‘liquidation’ should be interpreted as reference to a formal insolvency procedure pursuant to which an insolvency office holder (the liquidator) is appointed to realise the assets of the company, distribute the proceeds of such assets among creditors and dissolve the company.

Unless specified otherwise, references in these principles to ‘reorganisation’ should be interpreted in its broadest sense to include references to any reorganisation procedure(s) for restoring financial stability, including any early, preventive or pre-packaged reorganisation procedure or general reorganisation-type insolvency procedure, which involves the restructuring of the debtor’s assets and liabilities or any other part of its capital structure.

In some jurisdictions, administrative authorities are involved in supervising insolvency proceedings as an alternative to the courts. Any reference in these principles to courts or judicial authorities should be interpreted as including such administrative authorities.

References to ‘Insolvency office holders’ should include any practitioner involved in liquidation or reorganisation procedures as defined above.

Core Principles[1]

1 |

A country's insolvency law should meet the needs of its major market participants, including micro, small and medium sized enterprises.

The law should have the procedural flexibility to meet the needs of different participants. Some elements of a modern insolvency system may only be suitable for larger businesses, which have more complex capital and financing arrangements and the financial resources to engage relevant advisory support. Simplified insolvency processes with fewer formalities, shorter deadlines and lower costs may be beneficial for smaller businesses and can be supplemented with practical online documentation templates and checklists. The law should set out clear eligibility criteria that identify which businesses should benefit from any simplified arrangements.

2 |

Insolvency procedures should be designed and implemented to preserve and maximise the total value ultimately available to creditors, while taking account as far as possible of the interests of the debtor and its employees.

This requires strict adherence to the goal of procedural efficiency. An effective insolvency system should provide a transparent, certain and predictable legal regime to deal with debtors that are already insolvent and debtors that are likely to become insolvent. It should, at all times, promote the efficient, speedy and early treatment of financial distress with a view to minimising financial loss and reducing the disruption to the debtor, its creditors and the economy as a whole. The insolvency law needs to strike a fair balance between the competing interests of the debtor and its creditors. It should ensure that any distribution of proceeds from the insolvency estate should be consistent with the differences in priority among creditors, including unsecured, preferential and secured creditors.

Special consideration may be given to the interests of employees and tax authorities, whose claims often have preferential status. Nevertheless, it is important to assess and balance carefully the need for prioritisation of such claims since this may have negative consequences for other creditors, particularly unsecured creditors. While there are important socio-economic and political reasons for the prioritisation of employee claims, the prioritisation of tax claims is often more debated. The law and legal system should strive to ensure that foreign creditors are treated on a par with domestic creditors of similar status.

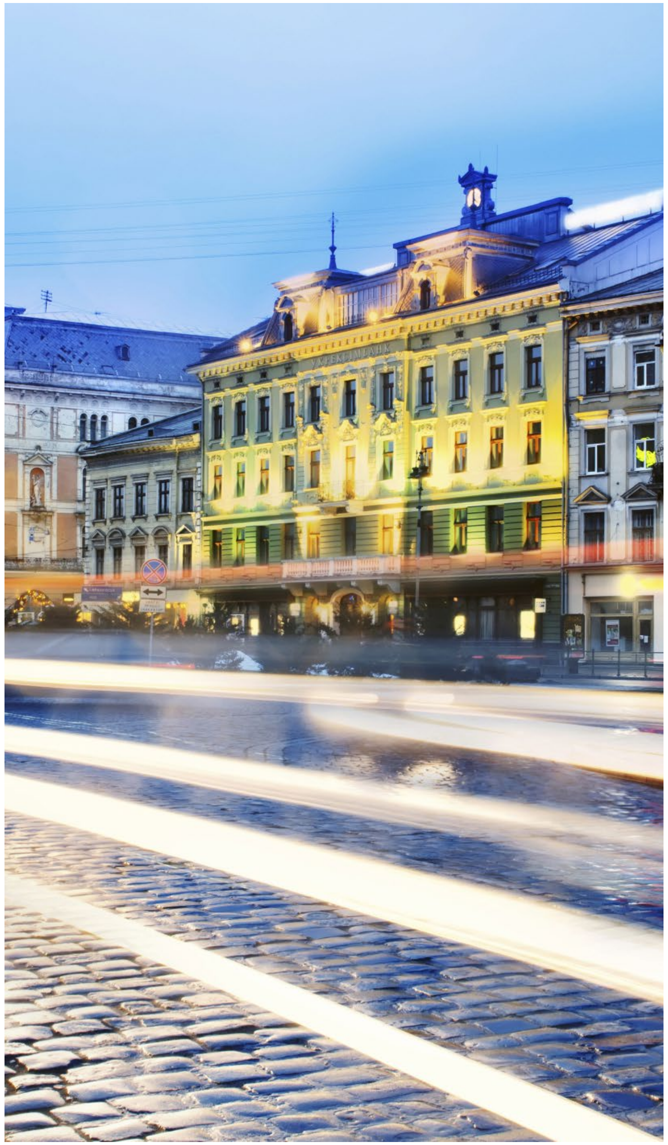
[1] With special thanks to INSOL Europe, the World Bank Group and UNCITRAL for their comments.

3

An effective insolvency law should provide for both liquidation and reorganisation, while also allowing for a conversion between the two types of procedures.

Liquidation should aim at an orderly resolution of insolvent entities by providing for the sale of assets, including any sale of the business as a going concern, and the subsequent distribution of the proceeds. This solution allows non-viable companies a smooth and timely exit from the marketplace. A reorganisation procedure should facilitate the rehabilitation and financial and operative restructuring of financially distressed, but viable, companies. The insolvency law should recognise the various forms of restructuring available, which may include changing the composition of the debtor's assets and liabilities, the sale of all or part of the business, as well as operational changes and different forms of creditor satisfaction, including debt for equity swaps.

A reorganisation procedure is critical to avoid the liquidation of economically viable companies, to prevent unnecessary job losses and to preserve going concern value of distressed businesses. Any conversion between liquidation and reorganisation proceedings should be subject to conditions and carefully reviewed. While the overall objective of the law should be to promote the use of a reorganisation procedure where feasible, it should restrict any conversion of a liquidation proceeding into a reorganisation proceeding, where the main purpose of such conversion is to delay the consequences of insolvency. At the same time, the law should ensure that a reorganisation proceeding cannot be converted too easily into a liquidation proceeding, without providing the debtor with a reasonable opportunity to restructure its business.



4

A country's legal system should support the consensual financial restructuring of businesses outside of a formal insolvency law procedure.

Completely out-of-court restructuring based on private agreement offers a flexible, speedy and discreet treatment of the financial distress. A consensual solution is an ideal way to restore financial soundness in a cost-effective manner. Where a critical minority of affected creditors does not support an amicable solution agreed by the debtor and the majority of its creditors in an out-of-court context, recourse to the court may be necessary to bind the minority of creditors to the terms of the deal. Even where such recourse is needed, efforts to reach a consensual agreement among creditors should continue.

The insolvency system should thus recognise a hybrid "pre-packaged restructuring" approach, where a reorganisation plan is developed privately out-of-court with majority creditor support and is subsequently confirmed by the court. This solution offers the parties the flexibility to agree on the terms of a restructuring prior to the commencement of a formal procedure, reduces the time spent in such procedures and minimises the damage to the debtor's business from negative publicity, such as the loss of customers and suppliers, as well as the departure of highly skilled employees. Parties benefit from judicial intervention and confirmation of a reorganisation plan, which ultimately makes the plan binding on all creditors. Nevertheless, the court should only confirm a plan where it has diligently reviewed the plan and is satisfied that any protections for dissenting minority creditors have been met. Judicial approval of a reorganisation plan may also be necessary to protect the terms of a restructuring from challenge by third parties.

5 |

Debtors and creditors should both have the right in certain circumstances to initiate reorganisation and liquidation procedures.

Entry requirements for both procedures need to be clear. Debtors should have wide access to both reorganisation and liquidation. Creditors should be able to file for liquidation where the debtor has become insolvent. Insolvency is most frequently determined according to a cash flow or illiquidity test and, in some countries, alternatively according to a balance sheet or over-indebtedness test. Creditors may also be given the right to initiate a reorganisation procedure when the debtor is insolvent but, where the debtor remains in possession, this is likely to require the consent or cooperation of the debtor.

While liquidation may be initiated because of actual insolvency, a reorganisation procedure should also be available at an earlier stage when the business is still viable, without the requirement for technical insolvency. Early restructuring allows preservation of the going concern value of the business and maximises the possibility of success. However, a reorganisation procedure should not be used to delay an inevitable liquidation. Unlike liquidation, reorganisation procedures may occur more than once in relation to the same debtor, however the insolvency law should restrict the ability of a debtor to access a reorganisation procedure multiple times within a short period. An excessive use of reorganisation proceedings may amount to an abuse of the insolvency system to the potential detriment of creditors.

6 |

Generally, the insolvency law should enable the suspension of individual enforcement actions by creditors in order to preserve the debtor's estate and ensure the equal treatment of creditors in a liquidation or reorganisation procedure.

A stay for all creditors at the outset of a liquidation proceeding provides the opportunity of a going concern sale, while a stay once a reorganisation proceeding has commenced grants the business the protection it needs to negotiate a reorganisation plan with its creditors. Nonetheless, the law should provide for the fair and effective management of any secured assets by the insolvency office holder during such a stay. The insolvency office holder should be empowered during the stay to dispose of secured assets under the supervision of the court for the benefit of the insolvency estate, subject to the proper recognition of secured creditors' rights. The insolvency law should ensure that those secured creditors who are unfairly prejudiced by the suspension of their collection and enforcement rights are adequately protected. In these circumstances, a court should be able to lift the application of the stay in respect of all or part of the secured assets. Furthermore, consideration should be given to whether to exclude certain categories of financial collateral arrangements from any stay or set-off restrictions to preserve the stability of the financial markets.

7

The insolvency system should ensure equal treatment among creditors with similar economic and legal interests in the debtor's estate and should protect secured creditors from an erosion in the value of their security.

The insolvency law should respect the agreements reached between creditors and the debtor before the occurrence of insolvency, subject to clear rules relating to the ranking of creditor claims and the avoidance of certain transactions. It should also seek to preserve the position of secured creditors, with a view to minimising the cost of obtaining secured credit. In this regard, it should limit, insofar as possible, a deterioration in the value of the security, which may result from lengthy proceedings and high costs of management or sale by the insolvency office holder. If there are residual claims after the realisation of any security by secured creditors, such claims should be treated as unsecured claims. Secured creditors should be able to prove for any unsecured portion of their debt in an insolvency procedure.

8

The insolvency system should provide for the independent review of actions undertaken by the debtor and its management in the period immediately prior to an insolvency procedure.

This should include the ability to reverse fraudulent, undervalue or preferential transactions in order to maximise the total value available to all stakeholders. The period in which any such transactions may be reversed should be clearly defined and, absent fraud, should not be excessively long. In order for any review to be effective, the law should provide insolvency office holders with adequate investigatory powers and should set out corresponding duties of cooperation and disclosure by debtors.

There should be clear rules governing directors' duties in the case of insolvency or likelihood of insolvency of the company. Where insolvency is likely or imminent, there should be a requirement for directors to act so as to protect the interests not only of the business and its owners, but also its creditors. In the case of an insolvent debtor, there should either be a duty to file for a formal insolvency procedure without delay and/or an obligation to take steps to mitigate any losses to creditors that may be caused by the business continuing to trade. Directors' duties should be accompanied by a sanctioning regime for any director misconduct. This may include in addition to any criminal and pecuniary sanctions, the possibility of disqualification or restriction on the ability of persons to act as directors.

9 |

The insolvency law should contain a reorganisation procedure where the debtor is able to remain in control of its assets and business.

The principle of debtor-in-possession incentivises an increased use of reorganisation procedures by debtors, since it removes the threat of loss of control and ownership of the business. It also incentivises management of the debtor to act earlier for the benefit of their business and creditors. Any removal of the debtor from possession may be restricted to instances of detrimental conduct by the debtor, such as fraud, dishonesty and incompetence. An insolvency office holder may provide some supervision of the debtor in possession, as well as specialist assistance to the debtor to prepare and negotiate a reorganisation plan with its creditors. During a reorganisation procedure, certain important or material decisions about the debtor's business may require the approval of the insolvency office holder or the court. For smaller businesses, it may be appropriate, subject to appropriate judicial safeguards, to reduce the level of insolvency office holder supervision and also to limit the fees chargeable by the insolvency office holder.

10 |

A reorganisation procedure should be capable of encompassing all types of creditor claims, including secured and preferential creditor claims.

Secured creditors should be included in a reorganisation procedure, as their exclusion would require the debtor to rely on individual secured creditor consents and forbearance, which could potentially undermine any majority creditor-led reorganisation plan. Furthermore, the reorganisation plan should be capable of compromising tax claims, by restricting the circumstances in which the tax authorities are able to exercise a right of veto on the restructuring. As a matter of flexibility and pragmatism, an early or preventive reorganisation procedure initiated by the debtor should enable the debtor to propose a reorganisation plan to certain creditors only, leaving other creditors unaffected. The concept of "affected parties" would require corresponding exceptions for unaffected parties with respect to enforcement and voting rights.

Grouping of creditors for voting purposes, as well as respective majority thresholds for the adoption of reorganisation plan, should be part of any reorganisation regime and set out clearly in the insolvency law. In general, secured and unsecured creditors should vote in separate groups, given their different interests and priority ranking. Where possible and to the extent they are affected, shareholders' support should be sought. A country's legal system may disapply existing shareholder pre-emption rights for any proposed capital measures under the reorganisation plan, particularly where the shareholders do not retain any value in the debtor business.

11 |

An effective insolvency system should, where possible, facilitate the continuation of the debtor's day-to-day operations during a reorganisation procedure by protecting new financing and limiting termination of contracts by contractual counterparties.

Many reorganisation proceedings are unsuccessful because the necessary funding is not available to allow the enterprise to operate for the duration of the proceedings. As day-to-day operation of the business and its rescue will often require the provision of new financing, any financing provided in good faith and on commercial arm's length terms should be protected from any avoidance actions in a subsequent liquidation procedure.

Additionally, express provisions should be introduced that recognise the priority of new financing before existing unsecured creditors and allow new lenders to take security over any existing unencumbered assets and agree a higher priority contractual ranking with other existing creditors. At the same time, certain contracts relating to utilities, communication and essential goods should be protected from termination solely because of application for, or commencement of, a reorganisation procedure. Furthermore, the application of clauses purporting to terminate any non-essential contracts because of commencement of insolvency proceedings, including any reorganisation procedure, should be restricted.

12 |

An effective insolvency system should ensure that the courts concerned with insolvency proceedings have the necessary expertise to deal with proceedings in an efficient and expeditious manner.

The requisite degree of expertise will increase stakeholder confidence in insolvency proceedings and is particularly important for the assessment of reorganisation plans. Where possible, only specialised members of judicial authorities should be appointed to oversee insolvency cases. This may require the establishment of a separate court list or division of specialised judges. Specialised insolvency judges should be part of any commercial court system where this exists. Relevant national authorities should ensure that judges overseeing insolvency cases receive the necessary training. Greater quality and integrity in judicial decision-making should be encouraged to promote the successful use and outcome of insolvency proceedings.

13

The insolvency law and any secondary legal provisions should establish clear rules on the qualifications, obligations, liabilities, supervision and remuneration of insolvency office holders.

They should set out a system for the appointment of an insolvency office holder, which balances the interests of all stakeholders involved, depending on the objective of the insolvency procedure and whether this involves a liquidation or reorganisation of the debtor business. The appointment system should take into account the qualifications and previous professional experience of an insolvency office holder with respect to a particular insolvency case and should facilitate the selection of the best professional. The insolvency office holder should report regularly on the conduct of the case and should be accountable to the debtor, to the general body of creditors and to the court.

14

A modern, forward thinking business insolvency system should adopt digital tools to increase the transparency, efficiency and cost-effectiveness of insolvency procedures.

Such tools would facilitate the monitoring of insolvency proceedings and help to guide the further development of law and policy. The insolvency system should provide for electronic insolvency registers that maintain publicly available information about insolvency procedures, subject to rules on data protection and privacy. It should also promote online case management systems and, as a minimum, permit the filing of claims and submission of documents to the court by parties to the proceedings and insolvency office holders using electronic means of communication. Electronic auctions should be used where appropriate for the sale of assets in insolvency and should be designed to ensure full transparency and accessibility by interested participants, with a view to delivering the maximum return to the insolvency estate.

15

Given the transnational nature of modern businesses, an effective insolvency system should facilitate the smooth conduct and resolution of cross-border insolvencies.

It should set clear rules on the recognition of foreign court orders. Ideally, it should incorporate the UNCITRAL Model Law on Cross-Border Insolvency. In the European Union, the UNCITRAL Model Law on Cross-Border Insolvency may be adopted in addition to the European Regulation on insolvency proceedings, which applies directly to cross-border insolvency procedures where the debtor has a centre of main interests in the European Union. This may be supplemented by adoption of the UNCITRAL Model Law on Recognition and Enforcement of Insolvency-Related Judgments, which further assists the conduct of cross-border insolvency proceedings and increases the potential for successful reorganisation or liquidation. The UNCITRAL Model Law on Enterprise Group Insolvency may provide a useful framework for the management of the insolvency of companies within a corporate group.

Annex

Any use of these EBRD Core Insolvency Principles should be supplemented by the review of more detailed guidance contained in the EU, IMF, INSOL Europe, UNCITRAL and World Bank materials referred to below. With regard to insolvency office holders, further guidance is provided by the EBRD Insolvency Office Holder Principles.

General Guidance and Benchmarks

1. The World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes

   http://documents.worldbank.org/curated/en/518861467086038847/pdf/106399-WP-REVISED-PUBLIC-ICR-Principle-Final-Hyperlinks-revised-Latest.pdf

   Click here

2. The World Bank Group and UNCITRAL, Report on Treatment of MSME Insolvency

   http://www.uncitral.org/pdf/english/workinggroups/wg_5/51stWG5/FINALMSME_UNCITRAL_Slides.pdf

   Click here

3. The World Bank Guide on Out-Of-Court Debt Restructuring

   http://documents.worldbank.org/curated/en/417551468159322109/pdf/662320PUB0EPI00turing09780821389836.pdf

   Click here

4. The International Monetary Fund, Orderly & Effective Insolvency Procedures

   https://www.imf.org/external/pubs/ft/orderly/index.htm#:~:text=An%20orderly%20and%20effective%20liquidation%20procedure%20addresses%20the%20inter%2Dcreditor,to%20be%20distributed%20to%20creditors

   Click here

5. INSOL Europe – Guidance note no.1 on the implementation of preventive restructuring frameworks addressing claims, classes, voting, confirmation and the cross-class cram-down

   https://www.insol-europe.org/publications/guidance-notes

   Click here

6. INSOL Europe - Guidance note no. 2 on the implementation of preventive restructuring frameworks addressing stay of individual enforcement actions

   https://www.insol-europe.org/publications/guidance-notes

   Click here

7. EBRD Insolvency Office Holder Principles and the Report on the Insolvency Office Holder Assessment

   https://www.ebrd.com/downloads/legal/insolvency/ioh_principles.pdf **and** https://www.ebrd.com/what-we-do/sectors/legal-reform/debt-restructuring-and-bankruptcy/sector-assessments.html

   Click here

Legislative Guidance

1. UNCITRAL Legislative Guide on Insolvency Law

   https://uncitral.un.org/en/texts/insolvency/legislativeguides/insolvency_law

   Click here

2. UNCITRAL Model Law on Cross-Border Insolvency

   https://www.uncitral.org/pdf/english/texts/insolven/1997-Model-Law-Insol-2013-Guide-Enactment-e.pdf

   Click here

3. UNCITRAL Model Law on Recognition and Enforcement of Insolvency-Related Judgments

   https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/ml_recognition_gte_e.pdf

   Click here

4. UNCITRAL Model Law on Enterprise Group Insolvency

   https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en mlegi_-_advance_pre-published_version_-_e.pdf

   Click here

5. Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt

   https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32019L1023

   Click here

6. Regulation (EU) 2015/848 of the European Parliament and of the Council 20 May 2015 on insolvency proceedings (recast)

   https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32015R0848

   Click here

Contact

Business Reorganisation Assessment Team
info@ebrd-restructuring.com

Catherine Bridge Zoller
Senior Counsel
Legal Transition Team
European Bank for Reconstruction & Development
BridgeC@ebrd.com

European Bank
for Reconstruction and Development