Enterprise Privatization and Bankruptcy Project in the Republic of Armenia

Final Report on Bankruptcy Activities

For the period of January – June 2001

Submitted to:

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Report on Activities of the Bankruptcy Component of the USAID/IBTCI Privatization Project in Armenia For the period of January–June 2001 USAID Contract # PCE-I-00-97-00017-00 Task Order # OUT-PCE-I-804-97-00017-00

I. Introduction

In January 2001, International Business and Technical Consultants, Inc. ("IBTCI") began work on the Enterprise Privatization and Bankruptcy Project (USAID Contract No. PCE-I-00-97-00017-00) ("Project"). This activity followed up and built on tasks performed by IBTCI under a previous USAID contract that expired at the end of 2000.

This report will summarize the work of the Project's bankruptcy team during the first half of 2001. It will begin with a summary of the legal and economic environment at the initiation of the activity, then proceed to how the bankruptcy team fared against Project goals for the first half of 2001. It will conclude with recommendations for future activity.

II. Legal and Economic Environment at Initiation of Activity

As of January 2001, the bankruptcy process in Armenia could fairly be characterized as stagnant. Although the Law on Bankruptcy was a relatively coherent and progressive document, it was not being utilized to handle cases whose resolution could have a significant impact on the country's economic development.

The underutilization of the Law on Bankruptcy stemmed from numerous factors. Among them were the reluctance of the Government of Armenia to privatize through bankruptcy procedures, the opportunities of private parties to collect debt through easier and more direct methods, and the lack of legal certainty regarding the bankruptcy law. These and several other issues confronting the bankruptcy team are discussed below.

Reluctance to Privatize through Bankruptcy

Despite the insolvency of many of its state-owned enterprises ("SOEs"), the Government of Armenia appeared to be extremely reluctant to privatize them through bankruptcy proceedings. Instead, the Government, through the Ministry of State Property Management ("MSPM"), had established an extremely slow and tortuous route where bankruptcy was only a remote and distant possibility.

The MSPM's initial step usually required three rounds of auctions with minimal prices that were unrealistically high. After three failed auctions (a common occurrence), the SOEs would come under the auspices of a liquidation commission of government officials and members of the company's management. Although the exercise was labeled a liquidation, the commission often times attempted to rehabilitate the company by negotiating a direct investment or arranging some sort of debt settlement. The success rate for these liquidation/settlement efforts was quite low.

After one year with the liquidation commission, the MSPM would initiate bankruptcy proceedings. The liquidation process would thus begin again.

This lengthy process almost always guaranteed high transaction costs and unnecessarily devalued assets.

As the result of this face-saving but value-destroying exercise, many of the SOEs that reached bankruptcy proceedings were administratively insolvent. In other words, the value of their assets failed to justify the time, effort, and expense necessary to usher them through bankruptcy proceedings. The result was a plethora of cases where the administrators handling the bankruptcy cases were under-funded, out of ideas, and looking for alternative ways of getting paid.

The track record of IBTCI's frustration in working with such administrators reflected this state of affairs. The report for the previous project on bankruptcy/privatization painted a stark picture of demoralized and uncooperative administrators on the bankruptcy cases that the Ministry of Justice ("MOJ") had assigned to IBTCI. Several of the IBTCI consultants suggested that the administrators' reluctance to cooperate reflected a fear of exposure of activity that was prohibited by the Law on Bankruptcy.

In the meantime, the largest enterprises in the Government's privatization portfolio, for instance, Armenian Airlines, could not be considered a candidate for bankruptcy, partly because of the political storm that such an acknowledgment would cause.

In short, the Government's privatization-through-bankruptcy program was a recipe for failure: keep the larger, politically sensitive enterprises out of bankruptcy proceedings while sending through the smaller and less politically sensitive ones whose asset values failed to justify the costs of bankruptcy expense. The tangible results of this approach were hundreds of SOEs with significant debts and steadily deteriorating assets.

Reluctance to Choose Bankruptcy over More Direct Collection Methods

In the private sphere, the Law on Bankruptcy seemed to have little effect as well. The sophisticated creditors that would be in the best position to utilize the Law (i.e., the banks), rarely found themselves needing to use it. This stemmed partly from current lending practices. Banks, when they did lend, extended credit to entrepreneurs based on the value of their collateral rather than any cash flow analysis of their underlying business venture. In many cases, the collateral had nothing to do with the business activity being financed. Thus, when an entrepreneur found himself in financial trouble, he would work something out with the bank, or the bank would foreclose on the property he had pledged as a guarantee for the loan.[1] While this in itself was not a terrible state of affairs for a transition economy (at least the banks were getting paid back on a relatively regular basis), it left the banks with little need for a bankruptcy law.

[1] The typical arrangement involved a short-term loan (usually no longer than a year or two) with the debtor making interest payments until the end of the term, when the principal came due. A rollover of the loan could be arranged if the debtor found itself unable to repay the principal.

Countless Companies too Poor to Bankrupt

From the private debtor side of the equation, the Armenian landscape was littered with thousands of companies that were, for all intents and purposes, dead. The Ministry of Justice counted at least five thousand companies that had failed to reorganize or reregister their corporate documents to comply with the requirements of the new Civil Code. These companies, arguably, needed to be liquidated. However, it was far from clear how to do so in a cost-effective, practical matter.

Lack of Bankruptcy Professionals

Primarily because of a dearth of official bankruptcies in Armenia, few if any individuals could call themselves bankruptcy experts. The Government licensing process had only started and no formal training for bankruptcy administrators had been offered in Armenia.

Legal Uncertainty

Controversy regarding the Law on Bankruptcy also contributed to its underutilization. In January 1999, the Council of Court Chairmen (an advisory body to trial courts) had issued a ruling that suspended bankruptcy cases on grounds that it conflicted with the Civil Code. Although the Council reversed itself in a decision in August 2000, an influential judge on the Court of Cassation had vowed to overrule any bankruptcy decision by the lower courts because of this conflict.

In order to solve this judicial controversy, a legislative solution—specifically a technical amendment to the Civil Code--was needed. Yet, the Government faced powerful opponents in the National Assembly that were strong critics of the Law on Bankruptcy.

Need for Clarification over Rehabilitation

Finally, owing to some frustration of implementing bankruptcy laws in other jurisdictions through a reliance on liquidation, the AID Mission was seeking clarification on whether rehabilitation proceedings under the Law on Bankruptcy could offer a more effective route to resolving company indebtedness and privatizing SOEs.

III. Planned Activities and Goals

The scope of work for the Project called on the bankruptcy team to do the following:

Task	Tangible Result
Assist in leading five MOJ-selected pilot bankruptcy liquidations currently in progress.	Five pilot bankruptcy cases are successfully completed or are near successful completion.
Assist with identification of and initiation of bankruptcy proceedings in two to three additional pilot enterprises.	The chosen cases have made substantial progress toward successful completion.

Task	Tangible Result
Evaluate the appropriateness of enterprise rehabilitation under current Armenian conditions, providing a written report to USAID with findings and recommendations.	(1) A report was delivered to USAID by the beginning of March. (2) Several enterprises are rehabilitated if determined to be feasible by the report.
Provide recommendations for improvement and clarification of bankruptcy legislation.	(1) Bankruptcy legislation and administration are improved as vehicles for privatization of State assets. (2) Handling of bankruptcy cases by the judiciary is improved.
Facilitate the organization of a self-sustaining professional association of bankruptcy administrators and liquidation trust managers.	A professional organization of bankruptcy administrators has been created.
Assist with drafting professional regulations, certification standards, code of professional responsibility and code of ethics for bankruptcy administrators and liquidation trust managers.	Bankruptcy legislation and administration are improved as vehicles for privatization of State assets.
Provide training for bankruptcy administrators and liquidation trust managers to develop practical awareness of administering such cases.	Handling of bankruptcy cases by the judiciary is improved.
Increase public understanding of bankruptcy policy and procedures.	Significant improvements are made in public understanding of bankruptcy policy and procedures.

IV. Activities and Accomplishments

A. Providing Assistant to MOJ Pilot Projects

Reports from the prior project and discussions with various participants indicated quite clearly that further assistance to the eight pilot projects (all chosen by MOJ) would lead to very few, if any, tangible results. The majority of the cases involved companies whose assets had close to no economic value. See Summary of Cases (as of February 8, 2001) in Appendix 1.

By early January, the activities of the administrators (or, in several cases, liquidation commission members) for the pilot projects had been reduced to organizing a series of failed auctions. There was a sense that the administrators and liquidation commission members had more at stake in stretching out the cases than concluding them. Further, almost all of them had shown a profound unwillingness to cooperate with the Project. As a result, the US bankruptcy advisor, who joined the bankruptcy team in early February, instructed the Project consultants to de-emphasize this activity. A far more productive approach would be to work with counterparts that were facing unprecedented issues and that wanted the Project's advice. See Section IV-B, below.

Nevertheless, the bankruptcy team continued to support the pilot projects throughout the first half of the year. As of mid June 2001, the following "milestones" had been reached with several of the pilots:

- Dynamo Textiles (in-court bankruptcy): On May 30, 2001 the property of Dynamo Textiles was finally appraised and offered in an auction as a complete lot. The minimum price was the independently appraised market price. No bids were received. A second auction has been planned with a minimum price lowered by twenty percent.

- Construction 7 (in-court bankruptcy): The administrator, through four auctions held over a period of nine months, sold forty of one hundred and twenty items that were identified and independently appraised. A total of AMD 500,000 (USD 900) was raised.

- Artin of Talin (out-of-court liquidation): The case closed with the sale of the plant to a stone processing company. The Project was not provided any information regarding the terms of the sale

- Gyumri Grinding (out-of-court liquidation): Despite efforts of the Project to market various industrial-size grinding machines, the bids received by the liquidation commission were ultimately determined to be too low. The liquidation commission then decided to attempt to rehabilitate the company. In this effort, it had some success paying off a portion of the debt. Creditors, however, were given no formal say in the decision to pursue an informal rehabilitation.

Thus, while the pilot projects had not been brought to completion, they nevertheless served a purpose of clarifying a significant issue for USAID, the Project, and the Ministry of Justice: *Absent a direct subsidy from the government (in the form of government employed liquidators) there is no way to push forward cases where the cost of administering and selling the assets exceeded their inherent value.* This emphasis on value-based bankruptcy activity became a major theme of the Project's interaction with the Ministry of Justice on reforming the Law on Bankruptcy and related legislation (see specifically the discussion in Section IV-D and recommendations in Appendix 5).

B. Identifying and Initiating Two or Three Additional Pilot Projects

Due to the limited success with the current pilot projects described above, the bankruptcy team concluded that the current approach of partnering with reluctant administrators to privatize SOEs through bankruptcy proceedings was not likely to lead to success.[2]

[2] Nonetheless, it should be noted that the lack of success in the pilot projects themselves provided great insight to this project and the previous project regarding changes that were needed in the Law on Bankruptcy.

In early February, the team began searching for new ways to resolve the indebtedness of SOEs. It also began searching for partners who would have a similar orientation towards the goals of bankruptcy proceedings.

After discussing various options both internally and externally, the bankruptcy team developed two proposals:

Tax Payment Privatization

Discussions with MSPM officials indicated that it had hundreds of heavily indebted companies still in the privatization pipeline. As noted above, unless sold through privatization, the Government faced a drawn out disposal process for these SOEs, first through a liquidation commission and then (most likely) through bankruptcy proceedings.

The key to accelerating privatization of indebted SOEs was figuring out how to avoid drawn out liquidation and bankruptcy proceedings. But the indebtedness of these companies (much of it to the Government in the form of taxes and pension fund arrears) made them unattractive to investors. The MSPM would have to give them away or pay people to take them. Neither method was viable on political and public policy grounds.

As a solution to this dilemma, the bankruptcy team developed a proposal that it called Tax Payment Privatization ("TPP"). Under TPP, the winner of an auction or tender for an SOE would have the option of paying off the SOE's tax debt prior to settling the transaction. Evidence of such payment would be accepted by the MSPM in lieu of cash. See Proposal for Tax Payment Privatization in Appendix 2.

The approach made SOEs more attractive and relieved the tax authorities from having to enforce tax claims against these companies in the future. The only downside was that the MSPM might end up receiving less revenue. Thus, the greatest challenge was getting the MSPM to support this approach.

As of the time of writing this report, the MSPM has not signed off on this proposal. The biggest problem seems to be breaking the inertia among the officials at the MSPM. They are quite comfortable with their current go-slow formula, which serves the purpose of minimizing bureaucratic risk while maximizing the lifespan of their ministry.

Eventually, it is hoped, political pressure on the MSPM to move companies off the Government's books might prompt them to reconsider TPP.

Cooperation with the Ministry of State Revenue ("MSR")

Given the difficulties the previous project had with administrators, the Project decided to pursue a new tack. Rather than urging the administrators to adhere to rational practices in bankruptcy, it might be better to be able to demand such practices. The team could best accomplish this result by aligning itself with an influential creditor and educate it on what to demand from an administrator in bankruptcy proceedings.

After various discussions with banks and other creditors, the best candidate that emerged was the Ministry of State Revenue. It was the biggest creditor in the country. It had a clear mandate to collect debts. It had many debtors in bankruptcy proceedings. USAID had a solid track record of cooperation with it; and preliminary discussions with officials from the Legal Counsel's Office of the MSR indicated that they would welcome such assistance.

In mid-March, USAID officials obtained the consent of the Deputy Minister of Justice to pursue this initiative with the MSR. The bankruptcy team developed a draft work plan that was to be presented to the Minister of State Revenue.

Unfortunately, after these initial successes, the approval process for this initiative stalled. A management change at the USAID Mission prompted a review of whether IBTCI should continue its bankruptcy work after July 3, 2001. While USAID wanted in general to continue supporting bankruptcy work, it foresaw this activity being handled by the Commercial Law Project. USAID began doubting whether it made sense to start the MSR initiative while such a transition was in the offing.

To accommodate these concerns, the bankruptcy team recast the proposed work plan to remove any reference to IBTCI consultants working with the MSR. Instead, they were referred to as USAID consultants.

Still, no approval came through. At the time of writing this report, there remains a distinct possibility that USAID will work with the MSR on bankruptcy implementation. Nonetheless, it will only occur once it transfers responsibilities for this work to the Commercial Law Project.

C. Evaluating the Appropriateness of Enterprise Rehabilitation as a Means of Resolving Company Indebtedness and Privatizing SOEs.

In order to help resolve some internal policy debates on the extent that USAID should support rehabilitation proceedings, the bankruptcy team provided a formal assessment of rehabilitation proceedings in Armenia. A copy of the final assessment is attached as Appendix 3.

The assessment concluded that the widespread use of rehabilitation proceedings under current conditions would often lead to drawn out and unsuccessful proceedings rather than quick restructurings of enterprises. Further, and perhaps most importantly, the assessment warned of the risk that widespread use of rehabilitation proceedings posed to secured creditor rights if these procedures were carried out improperly. Unlike some other CIS countries, the right to foreclose on collateral was well established in Armenia. Rehabilitation proceedings, which could trump these rights, could potentially discourage banks and other entities from lending to enterprises.

D. Providing Recommendations for Improvement and Clarification of Bankruptcy Legislation.

Initially, USAID and the Project considered this activity as a supplement to the legal reform work undertaken by the Commercial Law Project. However, when it became clear that the

Commercial Law Project would not be able to field an expatriate bankruptcy advisor, the USAID Mission asked the Project's Bankruptcy Advisor to take the lead on this issue.

At the outset, the Advisor sought to discourage counterparts at the Ministry of Justice from undertaking amendments to the Law on Bankruptcy. The Law represented a relatively coherent and progressive approach to company indebtedness. Given the populist sentiments and lack of understanding that often accompany efforts to legislate matters concerning bankruptcy, the Advisor was concerned that efforts to amend the Law could result in less progressive legislation.

Instead, the Advisor emphasized the opportunities to effect meaningful change through the development of regulations on administrator activity, the issuance of interpretive guidelines by the Council of Court Chairmen, and changes to other legislation that would affect bankruptcy. In support of this latter approach, the bankruptcy team developed a set of comments to the Law on Joint Stock Companies. See Appendix 4. It submitted these changes to the International Finance Corporation, which was coordinating the development of amendments to this legislation.

Nonetheless, the Ministry of Justice pressed forward with its plans either to develop amendments to the Law or to introduce a new piece of legislation. Officials at MOJ expected drafting to begin in earnest sometime in late June or early July. In response to specific requests and with consent of the USAID Mission, the bankruptcy team developed the following materials for use by the Ministry:

Memorandum on Companies that Failed to Reregister under the New Requirements to the Civil Code (April 25, 2001): The MOJ had identified thousands of companies that have failed to reregister. The vast majority no longer operate. The memorandum discussed various options for these companies, emphasizing solutions that are realistic and cost effective.

Issues for Consideration in Drafting a Bankruptcy Law (May 16, 2001): This document highlighted the issues that should be addressed in developing bankruptcy legislation.

Comments on the Law on Bankruptcy (May 25, 2001): This document went through the articles of the Law, highlighting problems and suggesting changes.

Illustrative Amendatory Language for the Law on Bankruptcy (May 31, 2001): This document is a version of the current Law on Bankruptcy modified to incorporate changes discussed in the previous memoranda. Additions are underlined. Deletions are struck through.

Translation of the Executive Summary of the World Bank Principles and Guidelines for Effective Insolvency Systems (April 2001) (attached as Appendix 9): The bankruptcy team obtained a copy of this document upon its release. It also obtained permission to translate the executive summary into Armenian. This document, which took several years to develop, will give the officials at the MOJ a brief, yet informative summary of the major principles to which a bankruptcy law should adhere.

E. Facilitate the Organization of a Self-sustaining Professional Association of Bankruptcy Administrators and Liquidation Trust Managers.

As part of an arrangement with the Commercial Law Project, the bankruptcy team provided technical inputs into this effort while the Commercial Law Project provided logistical assistance. Although an association had not been formed as of the time of this writing, a group of administrators, as well as a representative of the Ministry of Justice, was meeting regularly to develop a charter and tackle other logistical issues.

F. Assisting with Drafting Professional Regulations, Certification Standards, etc., for Bankruptcy Administrators and Liquidation Trust Managers.

The bankruptcy team urged the MOJ to pursue this approach in lieu of making significant amendments to the Law on Bankruptcy. The MOJ's decision to significantly amend the current law or write a new one made this work inopportune at the current time. Such regulations should be developed after the new or amended law is passed.

G. Provide Training for Bankruptcy Administrators and Liquidation Trust Managers to Develop Practical Awareness of Administering such Cases.

The opportunity for the bankruptcy team to provide a significant amount of training to administrators was hampered by the decision of the MOJ to initiate training in February under World Bank funding, which it did without informing USAID. Nonetheless, the bankruptcy team submitted comments on the MOJ's curriculum in mid-March. See Appendix 10 for the English version. One of its main recommendations was to bring in bankruptcy practitioners from the Russian Federation and Ukraine, two countries with insolvency problems similar to Armenia, but with greater experience in handling them.

After receiving some positive feedback from the MOJ on this recommendation, the bankruptcy team evaluated several administrators from Russia, Ukraine, and Kazakhstan, reducing the number of viable candidates to two for the MOJ to decide on. As a result, an administrator from Moscow was scheduled to fly to Armenia in June to make a presentation to the aspiring bankruptcy administrators on practical approaches to handling bankruptcy cases in the CIS. Per previous agreement, the Commercial Law Project was to handle the logistics of this trip.

H. Increasing Public Understanding of Bankruptcy Policy and Procedures.

In January and February, the Project's public relations unit developed a series of television and radio shows on liquidation and bankruptcy. The bankruptcy team worked closely with the unit regarding the content and message of these productions.

Thereafter, the bankruptcy team began providing monthly presentations as a part of a corporate governance and commercial practices seminar series sponsored by the IFC. These were well received. Audiences exceeded twenty-five company managers and entrepreneurs at each of the seminars.

V. Recommendations for Further Activity

The following are areas in which USAID assistance could continue to support the development of an effective bankruptcy regime in Armenia.

Continuation of support for bankruptcy law reform: The Project, or its successor, should follow up on the various documents submitted to the Ministry of Justice in May. It should also consider assisting the MOJ in its efforts to seek opinion and input on the amendments to the Law. The recent efforts of the IFC to develop amendments the Law on Joint Stock Companies is a good model for such activity.

Pilot projects: While the successful completion of a handful of pilot projects will not have a meaningful effect on Armenia's economy, they nevertheless vest USAID consultants with a greater understanding of the practical obstacles that implementation faces. This information is crucial to developing an effective reform program. The proposed pilot project activity with the Ministry of State Revenue represents an opportunity to broaden this knowledge. It also could lead to the establishment of a bankruptcy unit at the MSR.

Association of Administrators: Low-level support for the development of this group should continue. Nonetheless, questions remain whether such a group will have enough active members and revenue opportunities to survive on a stand-alone basis. If a critical mass fails to coalesce, USAID should support the association as a sub-division of the Association of Accountants and Auditors.

On a final note, USAID should have reservations about supporting an effort by the Government of Armenia to establish a bankruptcy agency that would pay administrators to liquidate companies whose assets are insufficient to cover administrative expenses. It is doubtful that a state-oriented approach to the problem under current conditions would work very well. This issue is dealt with at length in the April 25th Memorandum on Companies that Failed to Reregister Under the New Requirements of the Civil Code (Appendix 5).

VI. Conclusion

In the second half of 2000, the previous project encountered significant difficulties in assisting the Government of Armenia in privatizing SOEs through bankruptcy proceedings. In the first half of 2001, the bankruptcy team, when not working on bankruptcy law reform, focused significantly on seeking solutions to the road blocks to privatization encountered in the previous year.

To a great extent, workable solutions acceptable to the Government of Armenia have yet to be found. While some solutions might lie in amendments to the Law on Bankruptcy, the greatest gains are likely to come through policy changes regarding privatization. Policy going forward should recognize that continued state stewardship over SOEs can only result in sub-optimal corporate governance, and either expropriation or further devaluation of SOE assets.

Until policy of the Government of Armenia begins to reflect this assumption and government officials begin searching for relatively simple, workable solutions, further USAID assistance in privatizing insolvent SOEs is likely to have limited marginal effect.

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Summary of Pilot Projects (from Project Materials) as of February 8, 2001

Name (date of bankruptcy)	Operating Status	Quality of Assets	Stage in Proceedings	Debt	Ownership
Dynamo B-12/14/99	Not since 91	Non-operational machines. Five buildings on a factory site	Inventory completed (1/20/01)	**Total 558K USD** Banks-28 Suppliers-48 Tax-14 Others-9	Min Int Affairs-100
Gyumri Grinding L-12/01/99	Currently operating at a loss.	Machinery in poor but perhaps operational condition. Factory site severely damaged by earthquake	Resistance to liquidation	**Total 10.3K USD** Banks-1 Tax-12 SS-78 Employees-7 Other A/P-3	State-80 Employees-20
Artin of Talin L 11-11-99	Not since 99. Clearly solvent.	Several buildings in decent shape very close to a site where obsidian is mined.	Offer from buyer accepted for 38KUSD	**Total 10.3K USD** Tax-26 SS-28 Employees-42 Owners-4	State-80 Employees-20
7th Construction Date of Bankruptcy decision?	Not since 95. Clearly insolvent	Obsolete, soviet era construction equipment. No value Ten premises scattered across Armenia.	Independent assessment underway	**Total 1,218K USD** Tax-41 SS-59	State-100
Arteni Wine *B May 97 (administrator appointed)*	Not since 95. Clearly insolvent.	Some decent assets. Wine and spirit processing facility. No one has expressed interest in purchasing.	Series of failed auctions	**Total 1,833K USD** Tax-88 SS-5.5 Other-6.3	Gen Mgr-21 Employees-79
Ceramic Goods Factory *B Filed 1998*	Not since 93. Clearly insolvent.	Ten buildings in poor condition	Series of piecemeal sales by non-motivated administrator	**Total 886K USD** Tax-32.6 SS-66.6	MIT-100
Luys *B December 97*	Not since 96 Clearly insolvent.	Large production facility	Told to stop working when buyer emerged.	**Total 7216K USD** Tax-33.5 SS-12.2 Employees-5.3 Others-48.9	MIT-80 Employees-20
Goris Microengines *L December 99*	Not since 98 Clearly insolvent	Some decent assets.	Hoping for a reduction in penalties through parliamentary action. LC want to convert it to a reorganization if buyer found.	**Total 1,449K USD** Tax-1.4 SS-97.3 Employees-0.6 Others-0.7	MIT-80 Employees-20

Appendix II

Proposal for Tax Payment Privatization

Introduction

The ROA has hundreds of companies whose shares are slated for eventual privatization or which are already under liquidation or formal bankruptcy proceedings. Many of these companies have large, outstanding tax and pension fund arrears.

Transferring these companies or their assets into the private sector has proven difficult. The large tax and pension fund arrears make the shares of these companies unattractive. Alternatives, such as instituting formal bankruptcy proceedings, or commencing out-of-court liquidation, have delivered disappointing results. Both types of proceedings progress slowly and almost always entail high administration and transaction costs relative to the value of the assets. Further, because liquidation or bankruptcy would wipe out the debt of these companies, the Ministry of State Revenue (MSR) has been reluctant to allow asset sales at prices less than the outstanding tax indebtedness.

The challenges posed by tax and pension fund arrears have lead various officials to seek extraordinary measures. For instance, the chairman of the liquidation commission for Goris Microengines has applied to the National Assembly for a tax amnesty. While this effort may possibly succeed, a case-by-case amnesty approach would likely prove extremely slow and would be opposed by those supporting a consistent tax collection policy.

This concept paper discusses "Tax Payment Privatization" as a relatively simple and practical solution to the problem discussed above.

How would Tax Payment Privatization work?

The proposed Tax Payment Privatization Program (TPP Program) would allow the winner of an auction or tender for the state share packet of a joint stock company to go to the MSR and/or the Social Security Foundation and pay some or all of the arrears of the company to these agencies. The winner would then be allowed to present proof of such payments to the MSPM's Auction Center. The Auction Center would be required to accept this proof of payment as a substitute for cash for up to 100% of the purchase price of the shares. Partial offsets would be allowed where the share price exceeded the amount paid to settle the arrears of the company.

Note: the minimum prices for such shares should not be adjusted upward to reflect the increased attractiveness as the result of the TPP Program. Instead, if the shares cannot be sold even with the benefits of the TPP Program, that should be taken as a clear indicator that the company is insolvent, and other measures should be taken (see final section).

What are the benefits of Tax Payment Privatization?

The TPP Program would provide numerous benefits, briefly described below:

- **The TPP Program would increase the attractiveness of state share packets of heavily indebted SOEs:** Buyers ahead of time will know that at least a portion of the funds that they use to purchase the company's shares will reduce the company's indebtedness. This can only make the company more attractive, which should then increase the amount of qualifying bids for these companies. This means fewer repeat auctions/tenders and fewer non-marketable share packets.

- **The TPP Program would avoid the high transaction costs associated with formal bankruptcies and out-of-court liquidations.** Up to now, the only alternative for heavily indebted SOE's was bankruptcy or out-of-court liquidation. These procedures are complex, lengthy, and expensive. Often times the transaction costs outstrip the value of the assets. The transaction costs under the TPP Program would be far less.

- **The MSPM would retain close control over the privatization process.** With bankruptcies and out-of-court liquidations, a bankruptcy administrator or liquidation commission takes on the task of transferring assets to the private sector. Under the proposed TPP Program, this would remain with the MSPM.

- **Newly-privatized companies will have a better chance to prosper:** Heavy indebtedness stands as an obstacle to a company functioning properly and often times deters outside investors (who do not want their money going towards the payment of old debts). The TPP Program would reduce this problem.

- **Tax collection rates will increase:** It is without question that increasing tax collection rates is a priority of the government. The resolution would increase collection rates without having the MSR or SSF spend additional time and effort doing so.

- **MSR concerns about sales of assets at prices below total tax indebtedness would be mollified.** Previously the MSR has successfully objected to sales of assets of companies in bankruptcy at prices below that necessary to cover the total tax arrears. This concern was understandable as the MSR's claim would be extinguished at the conclusion of the bankruptcy. The MSR would no longer have this objection because any tax debt remaining after the payment would follow the newly privatized company.

How will the Tax Payment Privatization Program affect privatization revenues?

By allowing purchasers to substitute proof of tax and pension fund payments for cash, this program *could* reduce the amount of money collected through privatization. Nevertheless two factors will most likely alleviate and, perhaps, make up for this shortfall.

Factor 1: Many of the SOEs would otherwise go through bankruptcy proceedings or out-of-court liquidations where the possibility of privatization revenues are remote. As an equity holder, the government is entitled to payments in a liquidation only after all other creditors have been paid in full. In most cases, payment to the government (as a shareholder) are a very remote possibility.

Factor 2: Prospective purchasers will bid higher amounts: Past experience has shown that buyers take indebtedness into account when bidding for shares of SOEs. Lower company debt will mean higher prices for company shares. Where the bid exceeds the amount of tax and pension fund arrears, the remaining amount would have to be settled through a cash payment, which would be counted as privatization revenue.

In either case, the MSPM would still reap the political benefits of moving companies into the private sector.

How would the Tax Payment Privatization Program fit within the current legislative framework?

Clearly, the transfer of state share packets envisioned in the TPP Program fall under the concept of privatization under current law. Some questions remain, however, as to the specific method under which that the TPP Program would fit.

The Law on Privatization of State Property requires auction winners to finalize the auction results through payment in "currency of the Republic of Armenia, hard currency, [or] privatization certificates."[1] Under these provisions, the use of auctions to implement the TPP Program may be subject to legal challenge. Evidence of payment of tax and pension fund liabilities are neither currency of the Republic of Armenia nor hard currency.

Payment methods are more flexible, however, when privatization occurs through a tender.[2] Nothing in the Law appears to prohibit the use of evidence of payment and tax and pension fund arrears so long as this condition is made part of the terms of the tender.

From the perspective of tax and pension fund law, the TPP Program faces no apparent obstacles. Payers of taxes and pension fund contributions are entitled to an official tax receipt upon payment. The only complication is that, absent any arrangements between the auction or tender winner and the company, the payment of taxes by the auction/tender winner will likely be imputed to the company as gross income for purposes of computing profits tax.[3]

What should happen to companies whose shares cannot be sold even through Tax Payment Privatization?

In cases when privatization efforts are unsuccessful, the Government usually establishes a liquidation commission to take control of the company, sell its assets, and pay creditors. If the company becomes insolvent during this process, the liquidation commission must initiate a bankruptcy case.

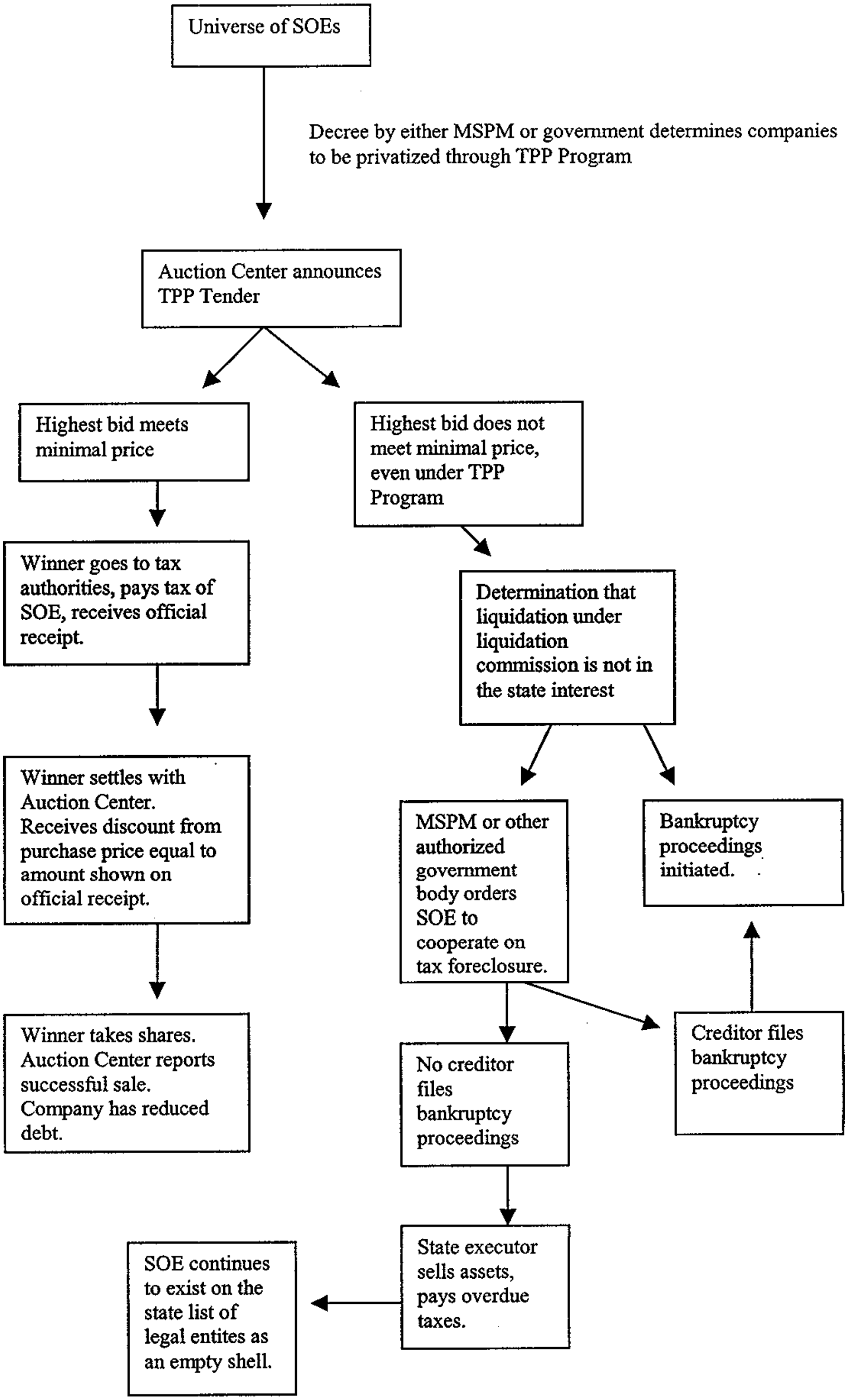
While this approach does not conflict with the Tax Payment Privatization Program, and could certainly continue if the Tax Payment Privatization Program were adopted, alternatives to this process should nonetheless be considered. For instance:

[1] Law on Privatization, Article 6.
[2] Id. Article 6, second paragraph (cross referencing to Article 14, item 1(c)).
[3] Law on Profit Tax, Article 7, item 2(k).

- *The policy of sending companies directly to Liquidation Commissions should be reconsidered if their shares cannot be sold through the Tax Payment Privatization Program.* A failure to sell the shares of the company under the TPP Program is a very good indicator that the company is insolvent. Under these circumstances, it makes sense to skip the Liquidation Commission process entirely and send the company to either bankruptcy procedures or some other alternative (discussed below).

- *The MSPM should consider, as an alternative to bankruptcy, having SOE's consent to tax foreclosures by the MSR:* Bankruptcy is an expensive, lengthy process. In many cases, the time and effort put in is not justified by the value of the company's assets. The interests of the Republic of Armenia in collecting overdue tax revenue would be better served by having SOE's fully cooperate with the tax authorities in having them seize and sell property. If any private creditor believes its rights are being violated (and a bankruptcy case is worth the effort), it can initiate bankruptcy proceedings. In short, the onus should be on private creditors to initiate such cases. This will result in bankruptcy cases that make sense from a financial point of view.

Summary of Tax Payment Privatization Program



Appendix III

Rehabilitation Procedures in Armenia: Possibilities for Resolving Indebtedness and Privatizing State-Owned Enterprises

I. Introduction

Currently in Armenia, bankruptcy procedures have primarily focused on liquidation proceedings under the auspices of a court-appointed administrator. The Ministry of State Property Management has, with mixed success, utilized these procedures to liquidate insolvent state-owned enterprises.

Liquidation, however, is not the only outcome of a bankruptcy case in Armenia. The *Law on Insolvency (Bankruptcy) and Financial Recovery of Legal Persons, Enterprises not Having the Status of a Legal Person and Individual Entrepreneurs* (December 3, 1996) (hereinafter the "Bankruptcy Law") allows for the rehabilitation[1] of a company if a proposed recovery program meets minimum statutory standards and is approved by both the creditors and the court. Rehabilitation efforts have, nonetheless, been rare.

The Task Order for the Enterprise Privatization and Bankruptcy Project[2] requires International Business and Technical Consultants, Incorporated ("IBTCI") to evaluate the potential for successful rehabilitations in Armenia. This paper will focus on whether these procedures, under current conditions, could serve as an effective means of revitalizing companies and transferring state-owned shares of companies into the private sector. Part II of this paper will review the goals and basic elements of a rehabilitation. Part III will discuss rehabilitation in Armenia both on paper and in practice. Part IV will briefly discuss how rehabilitation has fared in other CIS countries. Part V will discuss the possible use of rehabilitation proceedings in Armenia, both for privatized companies and as a means of privatizing state-owned enterprises ("SOEs"). Part VI will then briefly review how rehabilitation procedures, when abused by parties, or overseen by an ineffective judiciary, can undermine confidence in the rights of secured creditors. *The paper ends with the recommendation that USAID forego significant support for rehabilitations as a means of resolving company indebtedness or privatizing SOEs until bankruptcy professionals and creditors gain greater experience with the basic practice of liquidating companies.*

II. The Rehabilitation Process

Rehabilitation usually refers to a court-supervised process whereby a financially distressed enterprise, through a combination of operational changes and restructuring of ownership and debt, becomes a competitive and productive participant in the economy. Rehabilitation proceedings have been justified on several grounds. For instance:

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[1] Different countries use different terms to describe these types of procedures. In the United States, they are referred to as reorganizations. In several CIS countries, the term "sanation" has been used. Following a cue from a recent IMF report comparing bankruptcy procedures in different countries, this paper will refer to attempts to avoid liquidation through the formulation and approval of a recovery plan as rehabilitation.

[2] Project Number OUT-PCE-I-804-9700017-00.

- rehabilitation provides enterprise owners with a second chance or a "fresh start", thereby encouraging entrepreneurship;

- rehabilitation provides creditors with an alternative to liquidation in obtaining a return on their investment in the enterprise (especially when the transactional costs of a liquidation are high);

- rehabilitation preserves jobs and keeps assets in productive use.

An alternative and instructive means of viewing rehabilitation is to see it as a mechanism for supplementing the private "workout." Workouts are common in most developed economies. They usually refer to a debtor's effort to renegotiate the terms of its agreements with its creditors when it can no longer meet obligations as they come due. The debtor's challenge is to convince most of its creditors to accept renegotiated loan terms: better to remain a creditor (albeit for a bit less) with an ongoing enterprise than to be participant in a liquidation where the debtor's assets are sold at fire sale prices. To further push his creditors to agree, the debtor might offer them equity in the company or other means of participating in the company's management.

Workouts, however, usually require near unanimity and trust among the creditors in order to work. They are plagued by the "hold out" problem: certain (usually smaller) creditors refuse to compromise, knowing that if a sufficient number of other creditors do so, they can free ride on the cooperative spirit of others. Workouts also suffer from the "maverick" problem: a creditor, either unilaterally or in cooperation with a debtor, acts to improve his position *vis a vis* his fellow creditors when the others are negotiating. Both the holdout and the maverick scenarios cause workouts to fail.

Court-supervised rehabilitation proceedings seek to solve both of these problems. A "stay" or suspension order stops any maverick creditor from taking unilateral legal action against the debtor. After the creditors approve a rehabilitation plan, a court order binds all creditors to its terms, regardless of whether any minority, hold-out creditors refused to give their support.

Beyond these two core elements, rehabilitation proceedings employ various approaches. For instance, some countries' bankruptcy regimes require the appointment of an external administrator to displace the debtor's management, while others leave the debtor's management in place, albeit with duties to the creditors imputed upon them. Some countries allow a rehabilitation plan to be approved over the objections of creditors under certain conditions, while others do not.

Nonetheless, the fundamental bargaining pattern remains roughly consistent. The debtor's management has a period of time to prepare and present a rehabilitation plan. The plan commonly provides two key pieces of information: (1) the extent to which the plan alters the claims of creditors and shareholders, and (2) the means by which the debtor, by virtue of altered operations or a better economic environment, can meet its modified obligations.

If the creditors accept the plan, then court approval usually follows. If the creditors reject the plan, then the debtor is liquidated (through what is known as the "guillotine" rule in Canada), or the debtor seeks an override of the creditors' decision (known as "cram down" litigation in the

United States). In the case of rejection, some countries give the creditors the opportunity to produce their own plan (perhaps in conjunction with an administrator). Plans presented by creditors are far less likely to favor shareholder interests.

Often, the debtor's goal in these proceedings is to avoid liquidation while maintaining the level of the incumbent shareholders' equity in the debtor. The creditors' goal is to minimize the adjustments to their claims in the context of a realistic rehabilitation plan. Both sides seek to influence the court proceedings in one manner or another. For instance, a debtor commonly seeks to extend its deadlines for presenting a plan, claiming that a completed plan or a new investor is just around the corner. A secured creditor will often times ask for permission to foreclose on its collateral, citing to danger to its security by reason of depreciation or debtor neglect. The more discretion the court has regarding such motions, the more complicated and litigious the proceedings become.

In short, rehabilitation, in theory, is an elegant way to solve the negotiation pitfalls faced by private workouts. It allows the debtor and creditors to decide collectively on both the fate of the debtor and the allocation of losses (in the form of forgiven debt, diluted equity, etc.). In many instances, however, rehabilitation presents parties with opportunities to leverage themselves in the bargaining process by resort to delay, circumlocution, litigation, or bribery. It is for this reason that in many developed countries, rehabilitations often fail, and in transition economies they are often abused.

Nonetheless, the alternative to rehabilitation in many transition countries is quite painful. Heavy debts, high transaction costs, and depressed markets for real estate and Soviet-era equipment make the possibility of meaningful pay-out from a liquidation remote for most creditors. Given this bleak alternative, a well-planned rehabilitation, especially one that has been pre-negotiated before resort to court proceedings, has a good chance of succeeding so long as the fundamental legislative and economic elements are in place.

III. Rehabilitation in Armenia

A. Rehabilitation Proceedings under the Bankruptcy Law

The Armenian Bankruptcy Law allows for rehabilitation proceedings. A prototypical rehabilitation case under the law would likely be initiated by the debtor.[3] As set forth in the Law, this process would proceed as follows:

Opening of the case: The court appoints an administrator, establishes a date for the first meeting of creditors, and publishes a notice of its decision. This action triggers the "stay", prohibiting creditors from enforcing their claims against the debtor outside the bankruptcy proceedings.

Monitoring of the debtor: During the rehabilitation, the administrator, rather than displacing the debtor's management, takes on the role of a monitor. The management is required to cooperate

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[3] Bankruptcy Law, Art. 7(f). While creditors may initiate a bankruptcy case seeking rehabilitation, they are not likely to do so. Other options that are far less favorable to the debtor, such as simple debt collection/foreclosure proceedings or an involuntary liquidation, would put greater pressure on the debtor to repay the debt.

with the administrator and to provide him with information concerning the debtor's activities. Within twenty days of his appointment, the administrator is required to submit to the court a report on the debtor's financial situation.[4]

Formulation and presentation of the recovery plan: Several different groups may propose a plan: the debtor, the administrator, the secured creditors holding more than one third of the secured claims, unsecured creditors holding more than one third of the unsecured claims, or shareholders holding more than one third of the debtor's equity. The plan (or competing plans) must be submitted to the court no later than sixty days after the opening of the case, unless the court chooses to extend the period to ninety days.[5] After the court determines that the plan complies with the requirements of the Bankruptcy Law, it distributes the plan to the interested parties and schedules a meeting of creditors not later than forty days from the date the plan was submitted.[6]

Voting on the recovery plan: The Bankruptcy Law contemplates a meeting in which a two-thirds quorum of all claims is needed in order to make the voting effective.[7] At the meeting, the following classes of creditors vote on whether to accept or reject the plan:

- Secured creditors with secured claims greater than ten percent of all submitted claims;
- Other secured creditors;
- Unsecured creditors with claims arising after the recognition of the debtor as insolvent;[8]
- Creditors with unsecured claims (but not claims represented by obligations to the state budget).

A group is deemed to have accepted a plan if creditors owning the simple majority of claims of a particular plan vote in favor of it.[9] A least two of the defined groups are required to accept the plan.[10] If the requirement is met, the court has the right to approve the plan. The extent to which the court has discretion over this question is not clear.

Approval or rejection of the plan: The Law makes clear that the claims of creditors are modified in accordance with an approved recovery plan. As noted above, this is a key element in the rehabilitation process. If the plan is not accepted by two of the groups, the court appears to be required to order the debtor's liquidation.

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[4] *Id.*, Art. 43.

[5] *Id.*, Art. 49(3).

[6] *Id.*, Art. 51(1) and (2).

[7] *Id.*, Art. 53(3).

[8] This group of creditors is established in Section 52.4 (a), which incorporates by reference the creditors in Section 61(d) and (f). The creditors defined in Section 61(f)—creditors with claims arising from the debtor's alimony payments—are not applicable to corporations.

[9] *Id.*, Art. 53.

[10] *Id.*, Art. 51

B. Constraints on Rehabilitation Posed by the Bankruptcy Law

Although the Bankruptcy Law provides a workable avenue for attempting a rehabilitation, it nevertheless contains (or, in some cases, lacks) some important provisions. None of them are in themselves fatal. Nonetheless, they remain problematic in that they increase the risk of a failed or challenged proceeding. They also may discourage well-qualified professionals from participating in the rehabilitation. They are described below.

The absence of an appropriate provision for establishing bankruptcy tribunals or commercial courts: The Bankruptcy Law contemplated that cases would be heard by a commercial court once it was formed. In the meantime, transitional provisions in the law named specific courts where bankruptcy cases would be consolidated. Subsequent legislation rendered that scheme obsolete. Bankruptcy cases are now heard in the trial courts where the debtor is located. This decentralized system hinders the development of bankruptcy expertise among the judiciary and makes monitoring cases quite difficult.

Various provisions regarding the obligations of an administrator: As noted in previous analyses of the law,[11] the administrator is subject to several obligations that appear to be impossible to meet. Although administrators are not likely to suffer penalties from failing to comply with these deadlines, they may nevertheless discourage prudent professionals from serving as administrators.

The absence of a super-priority for post-petition financing: The Law lacks any specific status for credit provided to the debtor during a rehabilitation. The absence of such a provision makes the establishment of post-petition financing more difficult. It does not necessarily preclude such financing, however.

No guarantee for the rights of secured creditors in a rehabilitation plan: A plan under the Bankruptcy Law could be approved without the consent of the secured creditors' class so long as other specified classes agree to the plan. This voting arrangement would allow the other classes to approve a plan that significantly degrades the rights of secured creditors. Presumably the secured creditors would appeal this as being contrary to the Civil Code and the Constitution, resulting in delays until the issue is resolved.

Lack of clarity regarding the definition of classes eligible to vote for a recovery plan: Article 61 ranks creditor claims in liquidation. As shown in the table below, two differing creditor groups under Article 61 have very similar descriptions:

Creditors Defined by Article 61(c)	Creditors Defined by Article 61(d)
claims arising from "administrative expenses, including the expenses required for the maintenance and governing of the property, and all payments and expenses for the administrative personnel."	"unsecured claims arising after the recognition of the debtor as insolvent due to the functions carried out in the manner described in this Law (including resumption of activities) . . ."

[11] *See* Memorandum to David Shaehzadeyan (World Bank) from Milo Stevanovich (IBTCI Armenia) (December 12, 2001).

Article 61(d) creditors may vote on a recovery plan. Article 61(c) creditors may not. The similarity of the descriptions of the two groups will likely result in cases where a creditor, for instance a power supplier, may arguably fall into either group. This could lead to disputes in connection with voting, thereby delaying a resolution of a recovery plan.[12]

The absence of clear authority to compromise claims of the tax and pension authorities: Given that the tax and pension fund authorities do not have the right to vote on the plan, they will likely argue that they be paid in full as a condition for approval of the plan. Until this issue is resolved, few investors would put much faith in a plan that did not provide for full payment of the tax and pension fund liabilities.

C. Constraints on Rehabilitation Posed by Other Laws

Various provisions (or omissions) in the Law on Joint Stock Companies and in current tax legislation are likely to hamper the success of a rehabilitation. They are discussed below.

Joint Stock Company Law: The Law on Joint Stock Companies (JSC Law) contains several provisions that could hinder the formulation and approval of a rehabilitation plan. For instance the JSC Law:

- prohibits debt-equity swaps;
- fails to modify shareholder voting rights in approving a recovery plan;
- fails to allow changes in the membership of the board of directors through meetings other than the annual general meeting of shareholders.

While none of these provisions are fatal, they nonetheless add to the risk that negotiations over a recovery plan would fail.[13]

Tax Legislation: The greatest single problem is the absence of any provision that gives the tax or pension fund authorities the right to compromise a claim or even to recognize the binding effects of a court-approved recovery plan. This problem will plague rehabilitation attempts until resolved in the courts or the National Assembly.

D. Extra-Legal Constraints

Aside from the legal framework, several other factors reduce the likelihood of a successful rehabilitation. They are described below:

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[12] It is possible that some creditors that fall under both sections may opt for the higher priority (*sans* voting rights) that Article 61(c) offers. Offering such creditors a clear choice between the categories may reduce partially, but not completely, the potential for disputes in this area.

[13] The USAID/IBTCI Privatization Project has submitted comments to the International Finance Corporation ("IFC") on these issues. The IFC is planning to hold a forum on possible amendments to the Law on Joint Stock Companies in June of this year.

Lack of incentive for bank-driven rehabilitations: The most sophisticated players in the credit market are the larger banks. The banks, however, focus their lending efforts on individual entrepreneurs who are able to put up sizable collateral. Accordingly, when banks run into unresolvable problems with a loan, they prefer to exercise their rights against the collateral rather than initiate a bankruptcy case, let alone a rehabilitation case.

Lack of trust among non-related parties: Anecdotal evidence suggests that Armenians rely heavily on family ties and other long-established relationships in conducting business. Rehabilitation proceedings throw previously unrelated parties together into a collective process in order to come to a complex and, most likely, painful solution. There is significant reason to doubt that the parties will be able to summon up the minimal limits of trust necessary to come to rational, collective decisions.

Lack of trust in administrators: In order to overcome the mistrust described above, administrators in many countries often play the role of a respected broker. They are usually highly respected professionals who have an incentive to play somewhat fairly among the various repeat players in the insolvency arena. In Armenia, the administrator profession is still rather new. No professional associations exist, and the Ministry of Justice has yet to finalize its licensing process. IBTCI's experience with the administrators on bankruptcy pilot projects has not been encouraging.

Trepidation among potential investors due to the uncertain legal and social environment: With demand for capital in Armenia exceeding supply, private investors, and even lenders sponsored by multilateral financial institutions, are reluctant to put money into projects where the risk cannot be reasonably controlled. The various factors described above certainly leave a significant amount of room for uncontrollable risk. Given that investor money would often times serve as the "carrot" for parties to negotiate a recovery plan, the understandable reluctance of investors to commit themselves to a rehabilitation investment significantly reduces the likelihood of a successful rehabilitations becoming the norm in Armenia.

E. Experience with Rehabilitations under the Armenia Bankruptcy Law

Detailed information on rehabilitations under the Armenian Bankruptcy Law has proven elusive. The judicial branch lacks a statistical/analytical department and the Ministry of Justice has only recently begun analysis of bankruptcy cases. The Ministry of Justice had not released the results of its work at the time this draft was circulated. Efforts to obtain records directly from courts or creditors has proven to be a slow process that has yielded inconsistent results.

To date, research efforts have revealed fewer than a half dozen cases in which the debtor developed a recovery plan. None of the cases could be characterized as a successful rehabilitation. In two of the case, the proposed plan amounted to a one or two page summary of vague promises of altered production coupled with a postponement of debt.

IV. Experience with Rehabilitations in Other CIS Countries

Anecdotal evidence from various parties working in the larger CIS countries indicate that, aside from Ukraine, successful rehabilitations are the exception rather than the rule. Research performed in connection with this assessment has come across no literature to refute this finding.

For instance, the most recent EBRD Transition Report, which annually tracks the development of bankruptcy procedures in the CIS and Eastern Europe, did not report on any countries where rehabilitations are thriving.

Nonetheless, the experience in the Russian Federation and Ukraine over the past several years is worth noting, as these are the two countries where rehabilitation efforts appear most widespread.

Russian Federation

The Russian Federation enacted new bankruptcy legislation in March 1998. The Russian law allows companies to undergo "external management" (a procedure similar to rehabilitation) if so ordered by a court after the initiation of bankruptcy proceedings. The law allowed the court to order external management even if the creditors had requested liquidation.

A recent study of bankruptcies in Russia under the new law paints a bleak picture.[14] The authors observe a tendency of courts abusing their discretion to order external management despite creditor calls for liquidation. Rather than resulting in genuine restructuring of the indebted enterprise, external management is commonly used as a means of frustrating the efforts of outside creditors and the federal government to enforce their claims.

While the Armenian Bankruptcy does not provide courts with explicit discretion to override a creditor vote rejecting a rehabilitation plan, the lesson from Russia is that courts in the former Soviet Union are subject to "capture" by various interest groups that are more interested in reallocating resources than in restructuring companies.

Ukraine

Under a bankruptcy law that came into effect in January 2000, dozens of rehabilitation cases have been finalized. Apparently one of the key factors in the law that prompted this activity was a provision that required the tax authorities to forgive tax arrears in connection with a rehabilitation plan. Tax authorities are required to forgive debt that is over two years old and to stretch out repayment of the remaining arrears over the next six years.

By contrast, if a company goes into bankruptcy liquidation, tax claims remain unchanged. No unsecured creditors may be paid before payments are made in full to the tax authorities. Under these circumstances, the incentives to negotiate are very powerful.[15]

Further, this activity is in no small part the legacy of about five years of donor assistance on bankruptcy procedures. For instance, Ukraine has an established group on bankruptcy administrators that had been organized with the assistance of USAID and other donor organizations.

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[14] Capture of Bankruptcy: Theory and Evidence from Russia (Harvard University, unpublished) (March 1, 2001).

[15] Much of the information on Ukraine was provided by Olin McGill, a consultant who worked on bankruptcy procedures under a USAID project in Kyiv for several years.

V. Prospects For Successful Rehabilitations in Armenia under Current Conditions

A. Prospects for Privatized Companies

As discussed above, Armenian legislation contains a sufficient number of provisions to conduct a successful rehabilitation. However, such an effort would need to be well orchestrated, and, even then, would be fraught with risk. The scenario most likely to result in success would be as follows:

1. An investor has interest in a particular company.

2. The company's shareholders and management welcome such investment and are willing to relinquish a portion of their control over, or equity stakes in, the enterprise.

3. The investor, however, is hesitant to invest in the company with debt at the current levels.

4. With the help of consultants familiar with the Bankruptcy Law, the debtor drafts up a recovery plan which:

   - sets forth a business plan showing how the new investment will generate future cash flows;

   - calls for the reduction of secured claims (somewhat) and unsecured claims (more severe) so that altered debt service obligations can be met by projected cash flows (assuming the new investment is finalized);

   - provides for the payment of tax arrears at a schedule suitable to the tax authorities;

   - compares the projected cash flows to the creditors to the amounts likely to be collected by secured creditors and unsecured creditors should the company be liquidated;

   - makes the new investment contingent upon final approval of the recovery plan by a court.

5. The debtor obtains sufficient support for the plan from the creditors to allow approval under the Bankruptcy Law.

6. The debtor files a petition for bankruptcy, along with both the plan and evidence of sufficient creditor support (e.g., in the form of an affidavit, or signed minutes of a meeting).

7. The court is persuaded to quickly approve the plan on grounds that it results in tax collections and saves jobs.

This process is roughly similar to a "pre-packaged" bankruptcy, which has now become common in the United States. The goal is to use the bankruptcy procedures primarily to "bind in" minority dissenting creditors while minimizing the costs and uncertainties inherent in in-court proceedings.

The IBTCI Privatization project has presented this scenario to several active investment groups, notably the IFC. It has yet to find a rehabilitation scenario close to the one described above.

Given the limited scenarios for success, and given the absence of any tax incentives to undergo rehabilitation (as they have in Ukraine), it is unlikely that successful rehabilitations will become the norm in Armenia in the likely future. Indeed, under these conditions, significant support for the rehabilitation process will likely lead to companies using rehabilitation proceedings to frustrate the collection efforts of creditors.

B. Prospects for Using Rehabilitation Proceedings to Privatize SOEs

The scenario described above could also be applied to a state-owned enterprise. On one hand, this scenario is merely a more sophisticated method of conditional tenders that the Government of Armenia has performed in the past, where the new investor agrees to make a certain amount of investment and to pay off various debts of the company. In this case, however, debt is reduced by a court order. Such reductions could not be possible in a conditional tender.

Nonetheless, the politicized nature of such transactions may very well present obstacles to either initiation or completion of privatization-rehabilitation. Above all, it should be emphasized that rehabilitation proceedings should not be initiated until a sufficient number of creditors have signed off on the plan. Otherwise, rehabilitation proceedings might simply shield the SOE from creditor claims while the decision to privatize languishes. This was the unhappy result in Kazakhstan in the mid-1990's when the Kazakhstani rehabilitation bank attempted pre-privatization restructuring with very little success.

VI. Potential Conflicts with Policies Supporting the Development of Secured Lending Practices

In addition to weighing the likelihood of success, a decision on whether to support and encourage rehabilitations should take into account whether these procedures, if abused, could undermine secured creditor rights. The tension between promoting rehabilitation and protecting such interests is well recognized. A recent study by the IMF on bankruptcy proceedings puts it well:

> [I]t should be recognized that the introduction of any measures [into a bankruptcy regime] that erodes the value of security interests requires careful consideration. Such an erosion will ultimately undermine the availability of affordable credit: as the protection provided by security interests declines, the price of credit will invariably need to increase in order to offset the greater risk.[16]

The Bankruptcy Law prevents secured creditors from enforcing their claims once a proceeding has begun. To counter this, it specifically provides for the "adequate protection" of the secured claims of creditors.[17] These provisions require the debtor to demonstrate that the security interests of the secured creditors are not being eroded by depreciation or neglect during the bankruptcy proceedings. The Bankruptcy Law provides for several remedies in cases when

[16] Legal Department, IMF, *Orderly and Effective Bankruptcy Procedures: Key Issues* (pre-publication draft May 1999) at 24.

[17] Bankruptcy Law, Art. 18.2.

protection is inadequate, for instance, allowing the secured creditor to foreclose on his collateral. On paper, these provisions are quite friendly to the interests of secured creditors.

In practice, though, the protections provided to secured creditors in Armenia may prove less than satisfactory. A petition seeking adequate protection over collateral that is a key property holding of a company, may force a court to choose between protecting the rights of a secured creditor and the continuation of rehabilitation proceedings. In cases where jobs may be perceived to be at stake, the court may find this decision difficult. A benign and somewhat likely scenario in such circumstances would entail the court doing nothing. Non-action, however, is a significant threat to the claim of a secured creditor, especially when its security interest is based on collateral subject to significant depreciation over time.

Discussions with various individuals close to the banking industry indicate that banks are lending on the basis of collateral, primarily real estate. USAID is attempting to encourage lending on other types of collateral by supporting the development of an Armenian registry for security interests in movable property. USAID should carefully consider the risks to secured lending (especially on the basis of movable property) that widespread, poorly implemented rehabilitations might pose. Experience in other countries indicates that lenders secured by pledges of movable property are quite vulnerable to degradation of their security interests, either through depreciation or theft, as the result of drawn-out rehabilitation proceedings.

In short, an assessment of rehabilitation procedures needs to look beyond their potential for success. It should look to the potential consequences of their failure (in the form of stagnating proceedings) on the lending activity of banks and other financial institutions in Armenia.

VII. Recommendation

Unlike Ukraine, Kazakhstan, Kyrgyzstan, and the Russian Federation, Armenia's development of a bankruptcy practice is just beginning. USAID should be very hesitant in encouraging a broad use of rehabilitation proceedings until administrators and market participants become sufficiently familiar with the basics of bankruptcy principles and a liquidation practice under the Bankruptcy Law (or its successor legislation) has become well established. Once the threat of liquidation becomes real, both the debtor and the creditors will have incentives to realistically bargain over a rehabilitation plan. Any broad use of rehabilitation proceedings before this point is reached will result, more often than not, in stagnating cases and further erosion of creditor rights.

Appendix IV

Enterprise Privatization and Bankruptcy Project
in the Republic of Armenia
Project Funded by the United States Agency for International Development

March 2, 2001

VIA MESSENGER

Davit Karapetyan
Deputy Project Manager on Legal Issues
International Finance Corporation
World Bank Resident Mission
2 Khorhrdarani Street, Republic Square
Yerevan, Armenia

Re: Comments on Joint Stock Company Law

Dear Davit:

Enclosed please find the comments on the Law on Joint Stock Companies prepared by IBTCI's Bankruptcy Group. They focus primarily on the rights of creditors in relation to a company, both in and out of bankruptcy proceedings. We hope you find them helpful.

Sincerely,

Daniel Fitzpatrick
Bankruptcy and Privatization Advisor

CC: Alan Gobashian

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Comments on the Law on Joint Stock Companies on Issues Related to Bankruptcy Proceedings

Introduction:

In response to a request from the International Finance Corporation's Representative Office in Yerevan, the Bankruptcy Group of the USAID/IBTCI Privatization Project hereby provides its comments on the Law on Joint Stock Companies (hereinafter "JSC Law"). In line with its focus, the Bankruptcy Group's comments primarily discuss provisions in the law that could affect the efficiency and predictability of bankruptcy proceedings in the Republic of Armenia.

Caveat:

The analysis below stems primarily from the interaction of corporate governance principles with issues that are likely to arise during bankruptcy proceedings under the current *Law on Insolvency (Bankruptcy) and Financial Recovery of Legal Persons, Enterprises not Having the Status of a Legal Person and Individual Entrepreneurs (December 3, 1996) (hereinafter the "Bankruptcy Law").* The documents and provisions reviewed were limited to English translations of the JSC Law, the Bankruptcy Law, and selected provisions of the Civil Code. It is entirely possible that the recommendations contained herein could change based on an analysis of the original versions of these laws, or other legislation. If such occurs, this memorandum will be appropriately supplemented or amended as soon as reasonably possible.

Articles 28-32—Concerning Liquidation:

Article 67(5) of the Civil Code states that if the value of the property of a legal entity is insufficient to satisfy the claims of creditors, the entity may be liquidated only as the result of bankruptcy. Yet the JSC Law contemplates liquidation under circumstances where the assets are insufficient to pay creditor claims (see JSC Law, art. 31(6)).

In several countries of the former Soviet Union, management and shareholders have used out-of-court liquidations as a means of transferring assets out of the reach of the company's creditors. Article 67(5) of the Civil Code begins to address this issue. The JSC Law should be amended to support the policy goals reflected in this provision.

The liquidation provisions of the JSC Law should be limited to only those circumstances where assets are sufficient to meet the claims of all creditors. Accordingly, the provisions in Article 31, regarding the order of paying creditors and the various rights creditors have when assets are insufficient, should be deleted.

This should be replaced with a provision that would make the management of the debtor subsidiarily liable to creditors who remain unsatisfied if the company is liquidated in an out-of-court proceeding. In cases when the liquidation was initiated by the vote of shareholders, they too should be held liable for claims of creditors remaining unsatisfied. Further, such liability should be imposed regardless of the intent or knowledge of the management and shareholders (otherwise they will always obtain a valuation of the company's assets and liabilities that would give them legal protection from liability).

To some, the above provision may appear a bit harsh and perhaps contrary to principles of limited shareholder liability. If such is determined to be the case, an alternative would be to make the liquidation manager subsidiarily liable in cases where he completes a liquidation outside bankruptcy proceedings where the assets are insufficient to pay all liabilities.

Imposing such liability would provide incentive for management, shareholders, or the liquidator to comply with Article 67(5) of the Civil Code. A company would liquidate itself through the out-of-court proceedings in the JSC Law only when it was absolutely clear that the company was solvent.

Article 37(7)—Prohibition on Issuing Shares to Pay Debts:

When a company falls into financial distress and finds itself with little means to meet its obligations as they fall due, it needs to begin negotiations with creditors. One particularly effective ploy is to offer to exchange debt for equity. Such debt-for-equity swaps are common tools in almost all developed market economies. They proved particularly useful in helping various companies in Asia regain insolvency after the Asian economic crisis. Somewhat closer to Armenia, they were used to settle the mounting debts of the Eurotunnel in the mid-1990's.

Article 37(7) prohibits a company from issuing shares to pay debts incurred during its economic activity. While the exact meaning of this language is perhaps open to dispute, there can be no doubt that it would inject uncertainty into negotiations for a debt-equity swap either in a bankruptcy proceeding or in an out-of-court restructuring of indebtedness with creditors.

This provision should be deleted. Alternatively, it should be amended to allow debt-equity swaps when implemented through a court-approved recovery plan during bankruptcy proceedings.

Article 42—Issuance of Bonds:

Clause 1 of Article 42 should be amended to allow the issuance of bonds by a company pursuant to a court-approved recovery plan under the Bankruptcy Law, even when the prerequisites for issuing bonds under normal conditions (e.g., only three years after the company has been registered) have not been met.

Bonds facilitate the renegotiation of debt. In many countries recovery plans often contemplate a bond offering by the debtor in exchange for cancellation of current debt. Such bonds usually offer payment terms over longer time periods than the original indebtedness. They also might provide for greater assurances of payment. For instance, unsecured creditors might receive bonds secured by pledges of the debtor's property.

A limit on a company's right to issue bonds under normal circumstances is understandable. These limits, however, should not apply when the financial restructuring of the company's debt is crucial and the court and administrator can oversee the process to assure that creditors' rights are protected.

Shareholder Rights during the Restructuring of a Company in connection with Bankruptcy Proceedings:

The JSC Law requires minimum levels of shareholder consent to various decisions regarding the company. For instance, a "large transaction" (involving assets greater than 50% of the total assets of the company) needs to be approved by three fourths of the voting shareholders. It is possible that such provisions would impede the finalization of a recovery plan under bankruptcy proceedings. This issue needs to be discussed and clarified in connection with amendments to bankruptcy legislation that are currently being contemplated.

The Right to Dismiss Members of the Board of Directors at an Extraordinary General Meeting:

Article 88 of the JSC Law indicates that members of the board of directors may be dismissed only at the annual general meeting of shareholders. A recovery plan in a bankruptcy proceeding may call for a rearrangement of the company's board of directors in line with a restructuring of the company's equity. At an extraordinary meeting called for this purpose, a company's board member may cite to the current provision and refuse to step down unless dismissed at the annual general meeting.

It should thus be made clear that members of the board of directors can be dismissed at an extraordinary meeting of shareholders. Alternatively, it should be made clear that any issue raised at an annual meeting may be raised at an extraordinary meeting.

Limited Comments on the IFC Analysis:

Limited liability for shareholders: The IFC analysis (section 2.2) appears to endorse the Civil Code's position that a shareholder's liability should be limited to the extent of the value of his investment in the company. This appears to be too absolute. Under certain circumstances, additional liability could be justified. This issue should be a major point of discussion at the IFC roundtable session on the JSC Law.

A parent company acting as the sole founder of a subsidiary: The IFC analysis appears to favor the Civil Code provisions that allow such ownership arrangements (whereas the JSC Law appears to prohibit it). While the prohibition against a parent being the sole founder seems misplaced, attention should be given to the reasons behind this prohibition in order to identify other possible problems arising from the relationships between a parent and its subsidiary. For instance, the prohibition in the JSC Law may reflect a bias against complex corporate structures. Such structures may facilitate transfer pricing in order to evade taxes. Further, they often times pose significant obstacles to effective corporate restructuring when a group of related companies comes under financial distress.

Appendix V

MEMORANDUM

TO: Tigran Mukuchyan, Deputy Minister of Justice

FROM: Daniel Fitzpatrick, Bankruptcy and Privatization Advisor

DATE: April 25, 2001

RE: Options with Legal Entities that Failed to Comply with the Civil Code's Re-Registration Requirements

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The Law on putting the Civil Code of the Republic of Armenia into Effect (June 17, 1998) (hereinafter "Implementation Law") requires legal entities with legal-organizational forms not provided for by the Code to reregister in the form of a Code-recognized entity by January 1, 2000.[1]

According to reports by the Ministry of Justice ("MOJ"), several thousand legal entities failed to reregister by the January 1, 2000 deadline. After briefly reviewing the applicable legal rules regarding these circumstances, this memorandum will set forth some options currently available to the MOJ regarding these entities in accordance with international best practices tailored to the current situation in Armenia. It will also discuss options that would require changes in Armenian legislation.

I. Applicable Legal Rules

The Implementation Law provides some guidance for the treatment of legal entities that fail to fulfill their reregistration requirements. Legal entities with forms not recognized by the Code that fail to reregister are "subject to liquidation".[2]

Armenian law fails to provide clear answers as to the legal capacity of an entity after a deadline for reregistration expires. On one hand, the Law on State Registry of Enterprises deems that the legal capacity of an enterprise arises upon state registration.[3] From this principle, it is

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[1] Implementation Law, Art. 6.

[2] *Id.*

[3] Law on State Registry of Enterprises, Art. 3 (July 20, 1993)

not hard to argue that after the re-registration deadline has passed, the non-conforming legal entities are no longer properly registered, and hence lacking in legal capacity.

Nevertheless, arguments can be constructed to the contrary. The Civil Code indicates that such entities continue to exercise their legal capacity until the "completion of [their] liquidation."[4]

Absent a restriction on their legal capacity, the remaining restriction applicable to these entities involves their right to conduct entrepreneurial activity. The Civil Code defines entrepreneurial activity as "independent activity conducted at its own risk pursuing as a basic purpose the extraction of profit from the use of property, sale of goods, doing work, or rendering of services."[5] In turn, the criminal and administrative codes define "illegal entrepreneurship" as "entrepreneurship without state registration". Fines, forfeiture of income, or imprisonment may result from a conviction.[6]

It could thus be argued that after the deadlines in the Implementation Law expired, the non-reregistering entities were no longer properly registered. Any entrepreneurial activity by them after this date could thus be considered illegal and subject to penalty.

II. Options for MOJ under Current Law (See attached Summary Chart)

The MOJ has expressed an interest in taking action against the entities that have failed to re-register, especially those that are not operating and no longer have valuable assets. The ideal solution would be to prompt these entities into complying with the Implementation Law. Otherwise, they should be liquidated or reorganized through expedited court procedures. This would clean up the state register and would limit the possibility of legal complications arising from transactions between the public and entities of questionable legal status. Further, the liquidation proceedings that might result from taking action against these companies could free up assets (through their sale) and result in tax revenues for the state. Finally, state action against these entities would support public opinion that the requirements to reregister actually mattered.

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[4] Civil Code, Art. 52.4

[5] *Id.*, Art. 2.

[6] Administrative Code, Art. 169; Criminal Code, Art. 155.

This ideal solution, however, especially concerning expedited liquidation or reorganization procedures, is likely to prove somewhat difficult to implement. The MOJ should closely examine the costs and benefits of taking action against these entities. Three options are discussed below.

1. Forced Liquidation

Liquidation proceedings based on a court decision would provide the most comprehensive legal resolution for companies that have failed to reregister. Such proceedings would also free assets trapped in non-active companies and allow them to be put to more effective use.

Nonetheless, these benefits should be weighed against the administrative costs of initiating thousands of liquidation cases against non-reregistered entities. These costs could become an insurmountable obstacle in a situation where the value of an entity's assets is not sufficient to cover the its liquidation expenses.

2. Forced Reorganization

The Civil Code recognizes "transformation" (a change of organizational-legal form) as a type of reorganization.

Transformation would entail fewer expenses than liquidation primarily because no assets would need to be sold. Nonetheless, the paperwork involved would be considerable. The Civil Code requires the creation of a transfer document and the notification of creditors. It also suffers from clear legal rules on how to undertake reorganization when an entity's key personnel (founders, shareholders, management) are uncooperative or unavailable.

3. Identification and Referral

A more cost-efficient solution to the problem for most of the non-reregistered companies would involve clear identification and referral to the Ministry of State Revenue.

The State Registry of Legal Entities, if it has not already done so, should identify the entities that have failed to reregister and include this fact in the portions of the registry available to the public. It should then announce that entrepreneurial activities by such entities are illegal and subject to criminal and administrative penalties. The MOJ could generate additional publicity by releasing the list of such entities to the press. This action may prompt at least some of the non-reregistered companies to comply with the Civil Code and the Implementation Law. It would also give the public an opportunity to spot non-reregistered companies, which could reduce the possibility of fraud or other legal complications.

Further, the State Registry could share this information with the Ministry of State Revenue for purposes of cross-checking to see if any of the entities have continued with entrepreneurial activity. It would also give the Ministry of State Revenue information that could prompt it to bring bankruptcy cases or other tax enforcement proceedings against these entities.

While this third option lacks the completeness of the solutions offered by forced liquidation or reorganization, it might very well be the most appropriate under the current circumstances. In terms of protecting the public and maintaining the integrity of the State Registry of Legal Entities, the notation on the registry of a failure to reregister (coupled with the explanation that entrepreneurial activity by such entities is probably illegal) is probably sufficient. Many dead companies will remain on the registry, but at least they will be well-marked.

To be sure, without a program to institute widespread liquidation proceedings, the assets of many of these entities will not be officially transferred and the claims against them may never be satisfied. But this is not such a crucial threat to Armenia's interests, given that most of these assets are likely either worthless or otherwise no longer recoverable. Under these circumstances, the creditors of these entities have likely already written off their claims.

Yet, where assets are recoverable, there might be opportunities to initiate bankruptcy proceedings against some of these entities, which could eventually lead to liquidation and removal from the registry. But rather than trying to decide which cases are worth initiating, the MOJ should leave this decision up to individual creditors (including the Ministry of State Revenue). The creditors are in the best position to assess whether bankruptcy proceedings make sense, and certainly have the best incentive to make the right decision.

International Best Practices in Relation to Option 3

Although the approach described in Option 3 may not appear very thorough, they are very similar to the procedures taken against corporations that fail to comply with registration requirements in other countries.

The best-documented example of this approach is the concept of "administrative dissolution" employed by most states (e.g., Massachusetts) in the United States. A state's registry office normally requires an annual report and the payment of a nominal tax each year. If the corporation fails to comply with these requirements, the head of the registry office sends out a written notice of the violation, combined with the threat to "administratively dissolve" the corporation (that is, strike its name from the list of recognized corporations) if it fails to address the problem.

In many cases, the corporation fixes its problem. However, in numerous cases, the corporation fails to act and the head of the registry removes the corporation from the official list. As a result, the corporation loses the right to carry on business, except that which is necessary to undergo liquidation.

Under these circumstances, the state does not initiate liquidation proceedings, though other creditors are free to do so. This practice has been widely adopted because it "not only reduces the number of records maintained by the [state registry], but also avoids further wasteful effort to compel compliance by what in most cases are abandoned corporations."[7]

Unfortunately, the MOJ lacks the authority to declare entities "administratively dissolved". Nonetheless, a process described in Option 3—which gives the public notice of the entity's failure to register and makes continued entrepreneurial activity illegal—provides the same result.

III. Options for MOJ that would require Amendments to Legislation

The MOJ would appear to have at least two options if it were to pursue this problem by making changes in legislation.

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[7] Comments to Revised Model Business Corporation Act.

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1. Amending the Law on Bankruptcy to create simplified bankruptcy procedures

The bankruptcy laws of both Ukraine and the Russian Federation address the problem of inactive companies with few assets. Both laws contain provisions on "bankruptcy of the absent debtor". These provisions provide somewhat simplified proceedings for declaring a debtor bankrupt when its director may no longer be located. In such cases, both laws contemplate the use of liquidators from a state agency for bankruptcy. The laws of both countries specifically recognize such a state agency.

Thus it is certainly possible for the MOJ to introduce amendments to the bankruptcy law that would allow for bankruptcy of the absent debtor through the use of government-employed liquidators. At this point, it is not clear to us how well this system is working in these two countries and whether simplified bankruptcy procedures are indeed simple. Suffice it to say that the creation of a bankruptcy agency in Armenia is certainly possible, but would require a considerable amount of state resources and time. Closer study of this approach is recommended before making such a commitment.

2. Creating a Procedure for Administrative Dissolution

It would be possible to establish, either, through amendments to the Implementation Law or the Law on State Registation of Legal Entities (the new one (if passed) or the old one) a set of procedures for declaring a legal entity administratively insolvent.

Such a scheme would resemble the approach described earlier in this memorandum. Once a legal entity failed to comply with various deadlines regarding annual reports or payment of nominal taxes, the State Registry office would send a notice to the entity's last known address indicating that it would be "administratively dissolved" (i.e., removed from the list of active state legal entities) if it did not comply with its statutory requirements. Upon failure to comply, the State Registry would place the entity in an "administratively dissolved" list. The entity would no longer be able to carry on entrepreneurial activity and its corporate name could be taken by someone else applying for it.

The legal entity would be limited to acting only in connection with its liquidation. This might or might not occur depending on whether the assets of the legal entity are sufficient to justify a liquidation. If not, then the few assets of the legal entity will eventually find their way into the hands of people who can use them through unilateral legal action, tax foreclosure, or other methods.

Conclusion

Under current legislation, the most cost-effective means of addressing the thousands of non-reregistered companies is through an administrative process lead by the MOJ. The MOJ should identify each company that has failed to reregister and make this information part of the registry available to the public. It should further make clear that such companies no longer have the right to undertake entrepreneurial activity. Questions as to collection of debts, or disposal of assets should be addressed in proceedings initiated by creditors.

If it chooses to pursue this problem by amending legislation, the MOJ propose amendments to the Law on Bankruptcy that would establish a state bankruptcy agency that could liquidate entities under somewhat simplified liquidation procedures. In pursuing this route, the MOJ should, consider the cost and benefits of establishing a new government agency.

Perhaps a less expensive solution would be to establish through legislative amendment a means of administratively dissolving inactive legal entities by removing their names from the list at the state registry. Such an approach would leave the decision to liquidate the entity in the hands of its creditors.

Summary of Options Available to the MOJ Under Current Legislation in Addressing Legal Entities that have Failed to Reregister

Costs/Benefits → / Option ↓	Description	Costs-Problems	Benefits	Recommendation
Forced Liquidation	Initiate liquidation cases against all entities that have failed to reregister.	-This will prove to be extremely expensive to implement on a widespread scale. -The assets of many entities will not be sufficient to pay liquidation costs.	-This option will thoroughly deal with each entity that has failed to reregister. -It will result in assets being freed up and some creditors being repaid.	Do not pursue. It is an option even too expensive for even the wealthiest countries.
Forced Reorganization	Apply to court to seek an order "transforming" the non-reregistered entity into a Code-recognized entity.	-Implementing this option would be expensive, though probably less expensive than liquidation. -The basis for bringing forced "transformations" is not clear in current legislation.	-Various entities will be able to continue to operate. -Assets will not have to be sold at extremely low prices.	Do not pursue. It is an expensive option whose implementation would likely be hampered by questions of legality.
Notice and Referral	The State Registry of Legal Entities identifies those entities which have failed to reregister. It also makes clear that the failure to reregister results in a prohibition against further entrepreneurial activity.	-Non-operating entities remain on the state register. -Some assets will remain locked in these entities -Some creditors will not be able to collect their debts.	-The State Registry of Legal Entities becomes more accurate. -The public can determine whether an entity has failed to comply with the reregistration requirements. -An entity and its managers will be liable for administrative and criminal penalties if it continues to operate. -Creditors can take more aggressive measures if they choose.	Pursue. This option provides protection to the public at a reasonable cost. It does not prohibit more aggressive proceedings (liquidation, collection procedures) when circumstances justify it. The option closely resembles approaches used in other countries.

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Appendix VI

Request for Translation

May 16, 2001

VIA MESSENGER

Mr. Tigran Mouchouchyan
Deputy Minister and Head of State Registry of Enterprises
Ministry of Justice
15 G. Lusavorich Street
Yerevan
Armenia

Re: Issues for Consideration regarding the Drafting of a New Law

Dear Mr. Mukuchyan:

Enclosed please find a discussion of "Issues for Consideration in Drafting a Bankruptcy Law". IBTCI consultants prepared this paper in response to your request for general technical background materials to assist the Ministry of Justice in preparing new bankruptcy legislation. Rather than setting forth specific preferred policies, the paper was written with the goal of highlighting questions that the drafters should resolve as they prepare the law.

While we understand that the Ministry may decide to replace the current Law on Bankruptcy, we would like to emphasize that IBTCI consultants, as well as other experts on bankruptcy matters, have praised the current law for both its straightforward approach and its progressive balancing of the rights of debtors and creditors. Indeed, one former consultant has borrowed liberally from the Armenian law in preparing legislation for several jurisdictions in Southeastern Europe.

Thus in accordance with our duty of providing you with the best technical assistance possible, we are constrained to advise you to consider carrying over to the new draft, many of the provisions and principles in the current Law on Bankruptcy.

If you have any questions or comments regarding this paper, please do not hesitate to contact our offices.

Sincerely,

Daniel Fitzpatrick
Bankruptcy and Privatization Advisor

CC: Alan Gogbashian

Issues for Consideration in Drafting a Bankruptcy Law

The Ministry of Justice is in the process of drafting a new law on bankruptcy. The Ministry plans to circulate a draft in early July.

Over the past several years, bankruptcy law reform has become a crucial objective in the transition economies of the CIS and Eastern Europe. Several countries in Asia have reformed their bankruptcy laws in response to the crisis that gripped that region in the late nineties. The result has been a virtual explosion of thinking on how modern corporate bankruptcy procedures should be applied in a realistic and practical manner.

One thing that emerges from the myriad articles, speeches, and studies concerning bankruptcy in transition economies is that, in many cases, there are no easy answers. Accordingly, this paper, rather than prescribing a set of bankruptcy doctrines, sets forth a series of issues and options that the drafters should consider in developing a bankruptcy law for legal entities in Armenia.[1]

General Issues and Options

What materials should the drafters draw from?

The IBTCI project has numerous documents in Russian and English that we can provide to the drafters. A partial list (and why the items might be useful) follows:

In Russian Language:

Law of the Russian Federation on Insolvency (Bankruptcy). Although the Russian law has come under some criticism, it does represent a model that other countries (for instance Kazakhstan and Ukraine) have looked to in formulating their laws.

Law of the Republic of Kazakhstan on Bankruptcy (amended in July 1998). Although the law has some major flaws, it is an example of a variation of the Russian model.

Law of the Kyrgyz Republic on Insolvency. This law has received praise for its progressive, market-oriented approach.

Legislation on Insolvency and its Application published in "Law in Transition" by the European Bank for Reconstruction and Development.

Interview with Gregory Teil, Chief of the Russian Federation Service for Financial Healthening (December 28, 2000). Mr. Teil argues that creditors are abusing their power under the bankruptcy law, using it to steal enterprises from their owners. He recommends major changes to the law.

[1] In order to limit the length of this paper, questions regarding the bankruptcy of individuals are excluded from this discussion.

Article by V.V. Vitranski on "How to Reform Legislation on Bankruptcy." Mr. Vitranski argues that the Russian Law on Insolvency (Bankruptcy) needs only a few changes in general, and some additional changes regarding the subjects of natural monopolies and companies that are part of the military industrial complex. He believes that new regulations could result in many improvements in the application of the law.

In English Language

Orderly and Effective Insolvency Procedures: Key Issues, published by the International Monetary Fund (May 1999). This is one of the best short discussions of bankruptcy and insolvency issues available.

Report on Insolvency Law Reforms in the Asian-Pacific Region (2000 ed.), published by the Asian Development Bank. This also contains a good discussion of bankruptcy policy. It also evaluates the laws of various Asian countries with regards to various bankruptcy principles.

The Law of the Ukraine on Restoration of Solvency of the Debtor and Calling it Bankrupt (amended August 17, 1999). This is a variation, and a general improvement on, the Russian law. It appears to be working well since its amendments came into force on January 1, 2000.

What is reasonable to expect from a bankruptcy law?

Bankruptcy laws can be given very limited or very broad tasks. The limited approach might seem somewhat harsh to some, but seems to work more effectively. The broad approach sounds good on paper, but begins to run into inconsistencies upon further review, and often times fails to work well in practice. The pros and cons of each approach appear below:

The limited approach:

The limited approach starts from the assumption that contractual arrangements between the debtor and the creditor should be respected as much as possible. Because bankruptcy procedures interfere with the rights of creditors to enforce their rights upon a debtor's failure to pay, bankruptcy procedures should provide creditors with an offsetting benefit that justifies this interference.

The primary benefit of bankruptcy is a set of rules to govern a situation where a group of creditors share the same problem: a debtor than cannot pay its creditors according to the originally established schedules. Under these circumstances, bankruptcy procedures provide the creditors with one of two things: either (1) a way to allow the debtor to adjust all its claims so that he can pay back more through continued operations than he could if it were liquidated, or (2) a way to sell assets and distribute proceeds in a way that provides the creditors with more than if each creditor attempted to collect against the debtor individually. The first procedure is generally known as rehabilitation and the second is generally known as liquidation.

Broader approaches:

Several tasks are sometimes associated with bankruptcy laws. They could supplement or even replace those of the limited approach. They are discussed below:

Possible Task 1—Create an alternative to ineffective debt collection procedures.

Bankruptcy laws are sometimes used as either a substitute means of collecting debt or as a threat that can be used to force the debtor to pay. This approach is problematic in that bankruptcy procedures are inherently more complicated than simple debt collection. If everyone tried to use bankruptcy as a debt collection device, these cases would soon overwhelm the system. This has been happening in Russia, which has lead several commentators to call for a requirement that the creditor first go through regular debt collection procedures before he is allowed to file a bankruptcy claim.

Possible Task 2—Insulate strategic or otherwise socially and economically important enterprises from market realities.

A bankruptcy law that frustrates creditors from collecting on their claims or forces them to accept greatly reduced claims can help insulate companies at least temporarily from the harsher aspects of the market. The cost of such approach is that it raises the risks of lending to all enterprises, when the task was merely to help the ones in most trouble. The result is that fewer companies have access to credit at affordable terms. If the goal is to protect companies on the verge of failure, there are more transparent ways to do this, either through direct subsidies or temporary trade barriers.

If the drafters determine that an extremely debtor-friendly bankruptcy law is to be used as an indirect subsidy, they should consider having such debtor-friendly provisions applied only to clearly specified types of companies so that these policies do not hinder other companies from obtaining credit.

It should be noted, however, that even with the indirect subsidy of a debtor-friendly bankruptcy law, there is really no way to insulate company from market realities forever. If the company's customers have alternatives, the company will have to become more efficient or lose customers. This means hard decisions regarding product lines and employment levels. Perversely, in a poorly designed bankruptcy system where a proceeding can drag on for years, the company loses its customers and its best employees to competing enterprises.

Possible Task 3—Give the shareholder/owners a second chance in the event of an external event that is not their fault.

In the wake of the Asian economic crisis, many argued for bankruptcy laws that protected the shareholder-owners. These shareholder-owners, they argued, were innocent victims of the Asian crisis. It is only moral and decent to give them a second chance. Such a second chance would inevitably require delays or reductions in the rights of the creditors to repayment.

As civilized and merciful as this argument sounds, it fails to recognized the difference between shareholders and creditors. Although both are investors in the company, they have different expectations of reward and risk. If a company prospers, the shareholder gets rich. The company that lent it money simply receives repayment with interest. In the alternative scenario, if a company does poorly, the normal procedure is that shareholders do not receive dividends until the company meets its current obligations to creditors.

In short, if shareholders fare better than creditors when a company prospers, they should fare worse when a company meets adversity. The choice between these two approaches is something an investor makes each time it gives money or other forms of capital to a company. To change this bargain when a company goes into bankruptcy only hurts the investment environment for all companies.

What are the general approaches to bankruptcy that the drafters should draw from?

In recent years, the general trend for bankruptcy laws is to offer the debtor a choice between a rehabilitation attempt and a liquidation. Formerly, the United Kingdom and other members of the British Commonwealth emphasized liquidation proceedings run by the secured creditors, with the only hope for rehabilitation being an out-of-court agreement. However, even this is breaking down as several of the Commonwealth countries establish formal court-supervised rehabilitation proceedings.

So, given that the general approach allows both liquidation and rehabilitation, what choices are there within this framework? Two trends seem to be emerging:

Choice 1: A bankruptcy system that is dependent on administrators: In such systems, the administrator replaces top management and develops a rehabilitation plan on behalf of the creditors. Shareholders have little to say in this regard. Because the procedures displace management and often times dilute shareholder interests, most cases need to be started involuntarily. Further, in order to work properly, the approach requires numerous, well-qualified individuals willing to serve as administrators.

Choice 2: A bankruptcy system that encourages voluntary initiation of cases. In such systems, the debtor's management remains in place. The administrator, if there even is one, is simply a monitor. The debtor's management, and advisors it might hire, develop a rehabilitation plan. The goal of this exercise is to come up with a rehabilitation plan that is acceptable to creditors and that minimizes the dilution of the ownership rights of the current shareholders.[2]

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[2] There remains a third choice, that has been often discussed but has never been enacted into law. The third way takes the position that liquidations are inefficient because they usually dismantle the debtor's property complex. The third way also recognizes that rehabilitation proceedings are quite complicated, are expensive, and often fail.

As a compromise position, the third way contemplates a transfer of all ownership interest to the creditors, with the shareholders having an opportunity to buy out the creditors' ownership interest by paying the debt of the company. The goal is to get the company (with substantially reduced debt) into the hands of a set of long-term owners as soon as possible. This is when the tough decisions regarding the debtor company should be decided. More information on this approach is available upon request.

Regardless of these approaches, another decision point arises. To what extent should the law leave decisions in the hands of either the stakeholders, i.e., the creditors (and sometimes the shareholders) or the court. The classic situation where these two approaches clash is when the creditors reject the rehabilitation plan of the debtor. In such instances, should the court have the right to override this rejection? And if so, on what criterion? Largely, this question turns on whether the drafters trust courts or stakeholders to make better decisions.

Should the law establish a specialized bankruptcy court?

The arcane and difficult issues that arise in bankruptcy argue for judicial specialization at least at some level. No matter how much training judges receive, the best way they will learn to handle bankruptcy cases is by overseeing them on a regular basis. The drafters should thus address this issue in the new law.

If the drafters determine that the expected caseload is not sufficient to justify a separate court, it would make sense to establish a means by which specified judges within the regular system may take on the bulk of bankruptcy cases. Such an approach could also work within the context of an Economic Court if one is established by separate legislation.

Further, the drafters might wish to consider having most if not all the bankruptcy cases heard in Yerevan. Centralization of these cases would expose attorneys in Yerevan to a greater number of bankruptcy cases, thereby adding to their specialization.

The cost of centralization is that it may impose hardship to the debtor that is located in a distant region. While this argument certainly makes sense in general proceedings, where there normally are only two parties, this is less persuasive in a bankruptcy case where the parties, are numerous and scattered throughout the country. A centralized location for hearings and creditor meetings would make sense for the greatest number of affected parties.

Should the law establish a bankruptcy agency?

The best way to assess the justification for a bankruptcy agency is to set out the governmental needs regarding bankruptcy and then determine whether these needs could be met through a specialized agency or through other means.

The possible governmental needs include:

- Training, licensing, and monitoring administrators and other professionals
- Representing the state in collecting unpaid taxes and other obligatory payments against companies that are in bankruptcy
- Providing individuals (i.e., state employees) to serve as administrators in cases where the assets are insufficient to justify the costs of hiring a private administrator.
- Maintaining lists of qualified administrators for judges and creditors to utilize.

In making this determination, the drafters should keep in mind the potential conflict of interest that could arise in performing these functions. The bankruptcy agency could find itself in situations where it is a party to the proceeding administered by an individual who will soon be applying for a renewal of his license. Even if completely free of any corruption, such a situation would undermine the confidence of other creditors in the proceedings.

A further consideration is whether the number of practicing administrators justifies the establishment of a stand-alone state agency designed to oversee them.

Initiating and Administering a Case

What methods are there for initiating a bankruptcy proceeding?

Both in Russia and in Armenia several commentators have argued that creditors are using the low threshold for initiating cases for abusive reasons.

To the extent that these allegations are true, they should be looked at closely. But suffice it to say that the current standards are quite low and they should be reviewed. Various alternative standards are set forth in the comments to the Law on Bankruptcy that IBTCI submitted in December 2000.

The drafters may also wish to create incentives for unpaid creditors to file regular debt collection proceedings rather than bankruptcy cases. One way to do this would be to treat a creditor that has obtained a judgment and has had property arrested to be considered a secured creditor for the property that has been made subject to arrest.

But, regardless of whether the drafters choose to change the creditors' incentives for initiating a case, they should also consider increasing incentives for companies to file voluntary petitions. A voluntary approach is preferable to an involuntary approach for several reasons:

- The debtor's management is in a better position than its creditors to detect financial problems, hence voluntary petitions are likely to be initiated sooner into a financial crisis than involuntary petitions.

- The debtor's managers are more likely to be cooperative in voluntary proceedings than they would be in involuntary proceedings.

A new law could encourage voluntary petitions by allowing the debtor's managers to remain in place if they have submitted a voluntary petition and a financial recovery plan. Another incentive would be a provision that held the debtor's upper management financially responsible for unpaid debts of the company if the company becomes insolvent but the debtor fails to file voluntary proceedings.

What should be the role of the court?

As noted above, the court's role can be either active or passive. The law should encourage an active court if the drafters believe that the creditors cannot sufficiently organize themselves to direct the proceedings. The law should encourage a court that is more deferential to creditor interests if the drafters believe that courts are not as effective as the creditors in making business decisions that affect the outcome of the case.

What are the possible legal effects of initiating a case?

The legal effects of initiating a case are numerous and complex. Many are well described in the current law. In order to determine whether they need to be supplemented, the drafters should be asking themselves whether the current ones are sufficient to

- maintain a rough status quo while the debtor's fate is being contemplated;
- give the creditors a fair opportunity to participate in the proceeding;
- protect the special rights of secured creditors, lessors, and holders of uncompleted contracts with the debtor.
- allow for the reversal of unfair or fraudulent transactions;
- drive the process efficiently towards a point where the debtor's fate can be decided.

More detail on this issue is available.

What should be the nature and role of an Administrator?

In very general terms, the administrator's role consists of the following possible tasks:

- maintain the value of the debtor's property during the proceedings;
- keep creditors and other interested parties adequately informed of the progress of the proceedings;
- evaluate the claims against the debtor;
- develop or comment on the financial recovery plan;
- if necessary, sell the debtor's property and pay off claims.

In reviewing these functions, the drafters should account for a possible conflict of loyalty that an Administrator might face, if he is tasked with developing or shaping a financial recovery plan. On one level, the debtor has a loyalty to the creditors, to keep the debtor's property as valuable as possible during the proceeding. This is a clear, unambiguous goal. In figurative terms, it means keeping the pie as big as possible. But if the administrator also has the task of formulating a rehabilitation plan, then he needs to begin considering how to slice up the pie. No matter how he does it, he will be perceived as betraying someone's loyalty. This could undermine confidence in the system.

The drafters should thus consider separating the role of maintaining the size of the pie from proposing how to slice it up. Maintenance should be left to the administrator. Proposing a scheme for slicing should be left to the debtor and its advisors.

Of course, the drafters should also consider the possible conflicts this division of labor could cause. The administrator may want to sell some equipment in order to pay guards to keep the remainder of the debtor's property from being stolen. The debtor and its financial advisors may wish to hold onto this equipment in order to use it during the debtor's rehabilitation. A new law should recognize such conflicts and allow for their resolution.

Finally, it should be noted that the administrator should be allowed to develop a rehabilitation plan when the debtor does not plan to propose one. Here it can be assumed that the debtor no longer cares about dividing the pie. Hence, there is less likelihood of conflict of loyalty.

Should the Administrator be considered an Entrusted Manager under the Civil Code?

Greater clarity and consistency might be achieved by describing the administrator's job as a special type of "entrusted management". The provisions on entrusted management in the Civil Code (Articles 954-968) are, in general, quite well written and coherent. They could, for the most part, be applied to a bankruptcy proceeding. To facilitate this, the new law could establish a form of entrusted management that would be appropriate for bankruptcy. The Civil Code explicitly recognizes such a legislative approach (Article 968).

An additional benefit of such an approach is that it would answer concerns of critics who have criticized the current bankruptcy law as falling outside of established civil law principles.

Rehabilitation

How should one look at a rehabilitation?

Although rehabilitation has been described in many ways, it is interesting to look at it as an investment decision. On the most basic level, any decision to invest is a decision between having some money now (for current consumption) and having more money later. The promise of more money is what entices people to invest, be it in a bank account, or a lottery ticket, or a joint stock company.

The same is true for a rehabilitation. In a bankruptcy case, the creditors have a choice between some money now (the proceeds from liquidation) and the possibility of more money later (through future payments during the course of the rehabilitation). In this sense, the decision of creditors to support a rehabilitation is a decision to invest once again in the debtor. A bankruptcy law should make this decision process as free and transparent as possible.

The one complication is that this has to be a collective decision. A decision of the group needs to bind everyone. This requires some sort of voting mechanism.

What is the difference between a rehabilitation plan and an amicable agreement?

Some countries in the CIS allow for both rehabilitation plans and amicable agreements. Others, like Armenia, have simply a financial recovery plan. One commentator in Russia appears to be calling for amendments that would do away with "sanation" and simply allow for amicable agreements.

Regardless of the models the drafters follow, the information presented to creditors should contain two general sections. They could be in either separate documents or one unified document.

The first section should describe how the debtor will change its business operations or will attract new investment in order to create additional cash flows that will allow repayment of some or all of the debt of the company (this could be called the rehabilitation portion).

The second section should discuss how creditor claims will be adjusted to an amount that the company can reasonably be expected to pay back (this could be called the amicable agreement portion).

Finally, it should be noted that some laws, as well as the draft Chapter of the Armenian Civil Procedure Code on Bankruptcy, contemplate a structured kind rehabilitation where a various parties submit plans to the creditors. The submitted plan must pay off a certain amount of the creditors' claims. The planners selected by the creditors take over the debtor. While this approach was enacted in several laws in the early 1990's, more recently enacted laws have moved away from this technique, instead allowing a more flexible approach.

How much opportunity should the debtor have to present a rehabilitation plan?

Unless the debtor's managers have abandoned the company, they are usually in the best position to present a plan. As noted above, this should be done without the extensive assistance of the Administrator.

Regardless of the deadlines that are established, debtors will often complain that they need more time and usually come up with seemingly good reasons for justifying an extension. Courts find such arguments difficult to refuse. No one wants to order a liquidation. The result is often times endless proceedings.

The drafters should thus carefully consider how to weigh the need to give the debtor a fair opportunity to draft a plan, and the need to bring the case to closure.

What should be the minimum requirements of a rehabilitation plan?

At the very minimum, a bankruptcy law should require a plan to

- contain a business plan by which a creditor can reasonably understand the likely opportunities and risks the debtor would face in the future;
- establish classes of creditors in line with the classes established in a liquidation;
- mandate equal treatment of creditors within the same class (unless members within the class voluntarily agree to worse treatment);
- specifically deal with expenses that occurred during the rehabilitation process.

Should a rehabilitation plan allow creditors to convert their claims into equity in the company?

When a company falls into financial distress, one particularly effective strategy is to offer to exchange debt for equity. Such debt-for-equity swaps are common tools in almost all developed market economies. They proved particularly useful in helping various companies in Asia regain insolvency after the Asian economic crisis. Somewhat closer to Armenia, they were used to settle the mounting debts of the Euro tunnel in the mid-1990's.

Article 37(7) of the Law on Joint Stock Companies prohibits a company from issuing shares to pay debts incurred during its economic activity. While the exact meaning of this language is perhaps open to dispute, there can be no doubt that it would inject uncertainty into negotiations for a debt-equity exchange in a bankruptcy proceeding.

Although this problem could be addressed through changes to the Law on Joint Stock Companies, the drafters may wish to closely review this prohibition in drafting a new law on bankruptcy.

How should taxes be treated in a rehabilitation?

There are many ways to treat taxes in a rehabilitation. Several options are described below:

Option 1—Require full payment: This removes any threat that the tax officials will too quickly compromise their tax claims. However, it also makes a successful rehabilitation less likely.

Option 2—Allow negotiations: The tax authorities and others may find that such an approach leaves too much discretion with tax officials. If the drafters choose this approach, the law should call for the creation of a specialized department within the Ministry of State Revenue that could handle these questions in a responsible and rational manner.

Option 3—Mandatory compromise: The recent amendments to the Law of Ukraine on Restoration of the Solvency of the Debtor and Calling it Bankrupt include a somewhat novel approach to this problem. Under an "amicable agreement", the government must forgive all tax arrears older than two years. Further, the tax authorities must allow the repayment of these arrears over a six-year period. If there is a liquidation, no taxes are forgiven, and unsecured creditors only receive payment after all the tax arrears have been paid.

Of course, Option 3 may be controversial in that it may affect efforts to collect tax revenues. On the other hand, allowing continued operation of the debtor might create new revenues that would offset this loss.

What kind of influence should the creditors, shareholders, and court have over whether a rehabilitation plan is adopted?

This comment starts with the assumption that the drafters will NOT establish a system where approval of a rehabilitation plan or amicable agreement lies solely with the court. Instead, creditors and, perhaps, shareholders should be the ones to decide. The question, of course, is how such decisions should be reached. Several issues regarding this question are discussed below.

Voting by class or voting as a group?: Usually rehabilitation plans treat different classes of creditors differently. To protect each class, bankruptcy laws often times require each class to support the plan. The opposition of any one class means that the plan is rejected. The cost of this approach is that it makes voting more complicated and could result in fewer plans being approved.

Voting as a group?: This is a simpler process than voting by class. However, as mentioned above, this could cause inequalities. For instance, the unsecured creditors (who may outnumber secured creditors) could vote for a rehabilitation plan that significantly reduces indebtedness. This is fine for the unsecured creditors (who were likely to get very little in a liquidation, as is often the case). But it is not good for the secured creditors (who would have received payment in full had there been a liquidation).

The best solution to this problem would involve limiting the ranking of creditors in a liquidation to as few classes as possible. For instance a new law could contain the following rankings only:

- administrative expenses,
- secured creditors,
- tax arrears, and
- unsecured creditors.

If administrative expenses are required to be paid, and the law requires taxes to be settled according to a certain formula, then the only voting classes are secured and unsecured creditors. This would appear manageable.[3]

Finally, there remains the question on whether approval by the shareholders is a requirement for approval of a rehabilitation plan. If the debtor is proposing the plan, this requirement would appear unnecessary. However, if the creditors are proposing a plan, such an approval might be necessary to check the creditors from trampling the rights of the creditors.

Voting by number or by size of claim?: The drafters should consider the benefits and costs of each approach. Voting by number is simpler and avoids disputes over sizes of claims. However, it gives a disproportionate amount of power to small creditors and creates incentives for parties to "split" claims in order to create more votes. Voting by size of claim more closely parallels the principles of corporate governance and protects those creditors with more at risk. Disputes over the size of a claim, however, could cause problems if there are significant disputes over the amounts due to certain creditors.

Simple majority or super-majority?: The laws of several countries required two-thirds of each creditor class to approve a rehabilitation plan. The trend appears to be moving towards a simple majority standard (more than fifty percent).

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[3] Note that there are several political risks in adjusting the ranking of creditors. See the question "How should the law establish priorities among creditors" further in the paper.

What should be the effects of an approved rehabilitation plan?

The key result of an approved rehabilitation is the mandatory adjustment of the claims of the creditors in conformance with the plan (or an amicable agreement if that is used). Even creditors who voted against the plan should have their claims adjusted.

In some countries, this approach clashes with the principle of protecting contractual rights. Further, some countries civil codes prohibit the adjustment of an obligation without the consent of the creditor. Fortunately, Armenia's Civil Code appears to allow for termination of obligations on bases provided by statute (Art. 423).

If the approval of a plan does terminate or partially terminates the obligations of the creditors, then the drafters should consider whether they should be made permanent regardless of whether the rehabilitation plan fails later on.

Policy makers in some countries have adopted provisions that state that the creditors' claims spring back to full value if the plan subsequently fails. While this may give the creditors some comfort, it may actually cause a plan to fail. If there is the possibility that the claims will spring back in full, then this amounts to the imposition of significant contingent liabilities on the debtor. It is as if the debtor has agreed to pay massive penalties if he defaults on his obligations. Such contingent liabilities would likely make it more difficult to the debtor to obtain credit in the future.

As extreme as it may seem, the better policy is to make the terminations absolutely permanent as a matter of law.

What should be the effects of a rejected rehabilitation plan?

When the creditors reject a plan, should the court be required to order a liquidation? Or should the creditors be allowed a certain amount of time to submit a modified plan or to submit their own plan? The automatic liquidation approach allows for closure of the case more quickly, but might result in more liquidations that could have been avoided.

On the other hand, allowing the creditors to submit a plan may encourage creditors to reject more plans (thinking that they then can submit their own plan), and may prolong the proceedings.

Finally, if the creditors are allowed to propose a plan, this raises the question of whether the law should require the plan to be approved by the shareholders of the debtor.

Liquidation

How should liquidation treat low asset prices?

One of the biggest obstacles a successful liquidation is finding a buyer for the assets. To a certain extent, this problem cannot be legislated away.

However, it does no one good to have liquidation proceedings drag on while the administrator searches fruitlessly for a buyer.

One approach could be as follows:

1. After sale of all the liquid assets of the company, the law should require a final sale where the minimal price is the amount of unpaid claims that are senior to the tax authorities.

2. If the auction fails to obtain a price above this amount, then the auction fails and the administrator offers the property on a proportional basis to the creditors that are senior to the tax authorities. If all the senior creditors accept, then the property transfers to them and all taxes are canceled.

3. If the tax authorities are uncomfortable with this, they have the right to take the property, but only if they pay the claims of the senior creditors.

3. If any one creditor does not accept the property, then the other creditors have to pay off the rejecting creditor in order to obtain the property. If all the senior creditors fail to accept or fail to pay off the rejecting creditors, then the property is transferred to the tax authorities.[4] Tax claims are then cancelled. The tax authorities treat the property as they would any other property they foreclose upon.

4. If any creditors junior to the tax authorities are uncomfortable with this result, they have the opportunity to take the property so long as they pay off all the tax arrears and all the claims that are senior to the claims of the tax authorities.

In most cases, this approach makes disposal of the property an issue for the tax authorities, who at least have some experience in this area and have the right incentives to dispose of property quickly.

Finally, it should be noted that this would mean a significant increase in the role of the tax authorities in bankruptcy proceedings. This would likely require greater resources devoted to bankruptcy cases at the Ministry of State Revenue.

Who should control the sale of property that was used to secure claims against the debtor?

In non-bankruptcy situations, the secured creditor can, through a foreclosure proceeding, force the sale of the property used to secure his claim. If this approach were followed in a liquidation, the secured creditors would be allowed to foreclose on their property immediately upon issuance of a liquidation order. The secured creditor or the court bailiff would perform the sale, rather than the administrator. Excess proceeds from the sale would revert to the debtor.

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[4] The Law on Taxes (Art. 42) requires the tax authorities to accept payment only in drams. The new law on bankruptcy would have to allow the tax authorities to take property in lieu of payment if this scheme were to work.

Foreclosure sales, even when executed by the bailiff allow the secured creditor a certain amount of control over the sale to ensure that the property is sold at an amount sufficient to cover the debtor's obligation. A different approach, that gave less control to the secured creditor, could significantly affect the availability of credit in Armenia. Thus, any such approaches should be clearly justified and closely tailored to the results sought.

One of the best arguments for having the administrator sell the property is that he is likely to have a greater incentive to maximize the price for the collateral. A sales price greater than the secured claim means more money for the junior creditors and possibly more money for the administrator if he is working on a success fee basis.

Another good argument for this approach is that it allows the Adminstrator the opportunity to sell the asset bundled with other assets or as part of a property complex. This keeps the company together, which in general, is likely to be a positive result.

However, this approach could result in the administrator holding onto the collateral for too long as he seeks a high priced buyer.

The best compromise, perhaps, would be for the administrator to have a period of time in which he alone could sell the property. Failing this, the right to sell reverts to the secured creditor or the court bailiff.

How should the law establish priorities among creditors?

The comments that IBTCI submitted in December 2000 has already touched upon this question. Given that the current provisions are rather good, there is a significant risk that interest group politics could very well result in a complicated tier of creditors if this issue is revisited. It may also result in the subordination of the rights of secured creditors, as has happened in the Russian Federation. This could significantly harm the availability of secured credit in Armenia.

To minimize this possibility, the drafters should consider a provision that would specifically require payment of administrative expenses first and foremost. All other claims should be paid off in accordance with Article 70 of the Civil Code. This approach will harmonize the Civil Code with the bankruptcy law, plus it is less likely to result in special interests creating an overly complicated ranking that hinder both rehabilitations and the access of companies to credit.

Bankruptcy of Companies with few or no Assets

This issue has been thoroughly discussed in a memorandum from IBTCI submitted to the Ministry of Justice in April 2001.

Appendix VII

REQUEST FOR TRANSLATION

May 25, 2001

Tigran Mukuchyan
Deputy Minister and Head of State Registry of Enterprises
Ministry of Justice
15 G. Lusavorich Street
Yerevan
Armenia

Dear Mr. Mukuchyan:

As we promised in our last meeting, enclosed please find a set of comments on the Law on Bankruptcy. The comments follow the order of articles in the Law. They are meant to supplement those comments prepared by Attorney Milo Stevanovich in December 2000. We are enclosing a copy of those comments as well for your convenience.

While the combined comments form a very comprehensive set of proposals on the Law on Bankruptcy, we appreciate that changes in some areas of the Law are more crucial than others. Accordingly, we recommend that particular attention be given to the following articles:

Article 2 (regarding criteria for commencing a case)
Article 9 (regarding bases for dismissing a petition)
Article 12 (regarding dismissal of an administrator)
Articles 52 and 53 (regarding voting on a rehabilitation plan)
Article 61 (regarding distribution priorities)

In addition, we have included comments on selling the debtor's business as a going concern, and handling cases where the debtor has few if any assets. These should be closely reviewed as well.

Finally, please note that next week we will provide you with some illustrative language on how the Law could be changed to reflect these comments.

If you have any questions regarding these matters, please do not hesitate to contact me.

Sincerely,

Daniel Fitzpatrick
Bankruptcy and Privatization Advisor

Comments on the Law on Bankruptcy

The following are comments and suggestions regarding the *Law on Insolvency (Bankruptcy) and Financial Recovery of Legal Persons, Enterprises not Having the Status of a Legal Person and Individual Entrepreneurs* (December 3, 1996) (hereinafter "Law on Bankruptcy" or "Law"). As the general structure of the Law on Bankruptcy is sound, these suggestions focus primarily on improving the ability of parties to implement the Law and vindicate their rights under it.

These comments should be considered a supplement to those already submitted by Attorney Milo Stevanovich in December 2000.

The comments follow the order of articles in the Law on Bankruptcy.

Article 1. Scope of the Law

Add a provision that makes the Civil Procedural Code applicable in a supplementary manner (that is, will apply only when the Law on Bankruptcy lacks a particular applicable governing provision). This will fill in any procedural gaps left by the Law.

Article 2. Insolvency (bankruptcy) of the Debtor

Various individuals have criticized this provision because it allows a creditor holding a relatively small claim to initiate bankruptcy proceedings against a large and successful company. As noted by Attorney Stevanovich, there are several ways to address this problem. This issue was further addressed in the IBTCI Memorandum dated May 16, 2001.

Article 3. Jurisdiction of insolvency cases

As a result of the absence of a system of commercial courts and reorganization of the court system, bankruptcy cases are currently decentralized. Much could be gained in terms of efficiency and predictability by having these cases heard by a smaller number of judges who could receive additional training and, most importantly, gain expertise over time.

If establishment of an economic court is not foreseen in the near future, the MOJ should consider amendments that would establish a small group of judges to hear these cases until the commercial court is established.

But, regardless of what the drafters decide as to the court that hears these cases, it is important to clarify in the Law how decisions are appealed. To the extent possible, non-justified appeals should be discouraged. An appeal regarding the appointment of an Administrator or the approval of a rehabilitation plan can cast a shadow of uncertainty over the proceeding. For instance, the fear that the approval of a rehabilitation plan could be overturned through an appeal would likely discourage outsiders from investing in the Debtor company.

The drafters could discourage non-justified appeals by adding provisions which (1) establish very clear deadlines for filing, (2) establish standards and deadlines of the appellate court in

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hearing the appeal, and (3) state that the decision of the court is enforceable unless specifically suspended by the appellate court.

Article 7. Documents describing the financial-economic condition of the Debtor

The drafters should consider adding a provision that requires the Debtor to identify the secured claims against it and how it intends to provide "adequate protection" for these claims. See Article 18.2.

The drafters should consider adding a provision here that would require the Debtor, if he is not seeking financial recovery, to present a "bankruptcy budget" which compares the estimated cost of the proceedings (including the Administrator's salary and court expenses) to the expected liquidation value of the Debtor's assets.

Article 9. Accepting an insolvency case for proceedings in court and recognizing the Debtor as insolvent on the basis of the statement of claim of the creditor (creditors)

Additional grounds for dismissing a petition

Item 5 of Article 9 sets forth the bases for dismissing a petition filed by a creditor. In order to reduce the possibility of unjustified bankruptcy cases, the MOJ should consider two additional grounds for rejecting a petition:

- First additional ground: there is a genuine dispute whether the Debtor in fact has an obligation to the creditors for an amount at least equaling that set forth in Article 2.

  Reason for addition: creditor-led bankruptcy proceedings should not be used as a means of harassing Debtors. They should be initiated only when the amount owed is beyond question. This provision ensures that this is the case. It is also in line with provisions in the bankruptcy laws of Ukraine and the Russian Federation.

- Second additional ground: the Debtor has demonstrated that it has been generally making its payments as they come due and the failure to make payments to the petitioner is the result of excusable oversight or other reasonable grounds.

Reason for addition: It is possible that the Debtor's failure to pay is the result of something other than its financial woes. This takes such a circumstance into account.

Article 10. The consequences of recognizing the Debtor as insolvent (first issue)

Among other things, this article requires the court to publish an announcement concerning the bankruptcy (Art. 10, item 1(d)). In line with international best practices, this provision is intended to give creditors and other interested parties fair notice of the initiation of the proceedings so that they may protect their financial interests. In many countries, this requirement is closely tied with constitutional rights of a court to deprive an individual of their rights to particular piece of property.

Two concerns arise in connection with Article 10, item 1(d). First, publication in a newspaper with a print run of 1000 issues is likely not sufficient to provide many of the creditors and other interested parties with fair notice. Second, the court often does not have the funds available to publish such notice.

This issue is related to the bigger problem of the current absence of an official press or a uniform method of providing interested parties legal notice through publication. Nonetheless, amendments to the Law on Bankruptcy could improve the situation in the meantime. Possible amendments are discussed below:

Publication Requirements

It would make sense to adjust the notice requirements to take into account the development of the newspaper sector in Armenia.

IBTCI consultants performed a quick survey of the circulation and advertising expenses of five leading Armenian newspapers. The results were as follows:

Newspaper	Circulation	Price of a 1/8 page advertisement
AZG	2500	$33
Hayastani Hanrapetutyan	4000	$33-$43
ARAVOT	5000	$26-$126
ERKIR	3000	$33
DELEVOI EXPRESS	6000	$33

As noted in the above table, at least five newspapers have circulations that significantly exceed the minimum circulation of 1000. The MOJ should thus consider amendments that increase the notification requirements, such as publication in two newspapers having a circulation of at least 2500.

Payment Procedures

The Law on Bankruptcy currently requires the court to publish notification that the proceedings have begun. In practice, the court often lacks the funds to pay for publication. The result is usually some sort of informal arrangement where the court persuades either the Debtor or the petitioning creditor to pay for publication. Procedures for reimbursing the Debtor or petitioning creditor are not clear under these circumstances.

Amendments to the Law should shift the burden of publication to the Administrator (though he should be entitled to reimbursement). Indeed, publication of the proceedings should be the Administrator's first duty. Although some Administrators may not appreciate this extra burden, they should have funds available to them to make such an initial expense. Further, they should have sufficient control over the funds of the Debtor in order to obtain reimbursement in a reasonable amount of time.

Article 10. The consequences of recognizing the Debtor as insolvent (second issue)

A clear statement that the Debtor's activity has been suspended will assist the Administrator in taking control of the Debtor. The court should be required to make an explicit statement on this point in its order recognizing the Debtor as bankrupt. This should be automatic if the Debtor has not submitted as part of its statement of claim an intention regarding financial recovery (which is a required document under item (f) of Article 7).

If the creditors have submitted the statement of claim, and the Debtor has been declared bankrupt, then the Debtor should be given five days to submit a statement of intention regarding financial recovery. Upon failure to do so, the Debtor's activity should be suspended.

Articles 12-19. The General nature of an Administrator's role

These provisions primarily discuss the rights and duties of the Administrator with respect to the Debtor and its management. While these provisions are relatively coherent, they suffer from any underlying legal foundation. For instance, it is difficult to understand from the Law the actual relationship between the Debtor and the Administrator.

Greater clarity and consistency might be achieved by describing the Administrator's job as a special type of "entrusted management". The provisions on entrusted management in the Civil Code (articles 954-968) are, in general, quite well written and coherent. They could, for the most part, be applied to a bankruptcy proceeding. To facilitate this, the provisions in the Law on Bankruptcy could be amended to establish a form of entrusted management that would be appropriate for bankruptcy procedures. The Civil Code explicitly recognizes such a legislative approach (article 968).

An additional benefit of such an approach is that it would answer concerns of critics who have criticized the Law on Bankruptcy as falling outside established civil law principles.

A potential drawback of such an approach is that it would require significant rewriting of the Law, which could result in a more lengthy and risky amendatory process.

Article 12. Appointment of the Administrator
Article 17. Appeals from the actions of an Administrator and relieving him from performing his responsibilities

Appointment and Dismissal

A crucial aspect of a successful bankruptcy proceeding is the appointment of an Administrator who is genuinely loyal to the interests of the creditors and enjoys their confidence. Such a result is more likely if the creditors have an opportunity to choose the Administrator and remove him with little complication.

To a certain extent, the Law on Bankruptcy addresses this issue. Item 1 of Article 12 obligates the court to appoint another Administrator if creditors representing fifty percent or more of the claims asks for a different Administrator. Further, item 2 of Article 17 allows the court to remove the Administrator if he fails to perform his obligations properly.

These safeguards, however, may not prove sufficient to ensure that the Administrator is fully accountable to the creditors. In most cases, the creditors will not likely be able to organize themselves to nominate a different Administrator. And, once the Administrator is in place, the creditors will find it difficult to remove him if they are required to prove that he is doing his job improperly.

Instead, the MOJ should contemplate a standard similar to that for managers of corporations. In Armenia and other developed economies, the management team serves at the will of the shareholders or the board of directors. Terminating their services does not require a court order. This power to dismiss was designed to ensure maximum accountability.

The MOJ should thus consider amendments to the Law on Bankruptcy that allow the creditors to replace the Administrator at any time, without having to show fault on the Administrator's part, so long as a specified number (for example, those representing two thirds or one half the total debt) support the appointment of a replacement. In addition, it should consider excluding from such a vote a creditor that has an affiliation with the Administrator (e.g., the creditor and Administrator are business partners).

Such a removal power also reduces the need for a heavily detailed set of standards for the qualifications and disqualifications of an Administrator.

Qualifications and Disqualifications

Item 2 of Article 12 sets forth the minimal qualifications required for an Administrator's appointment. It also states the circumstances that could bar an otherwise qualified individual from serving. Comments on these provisions are set forth below.

- *Consider requiring that the Administrator be a licensed auditor or accountant.* It is extremely difficult to imagine anyone other than a licensed and experienced auditor or accountant performing this job effectively. To ensure fairness, those individuals who will graduate from the MOJ's first training program should be exempted from this requirement.

- *Consider removing the disqualification based on refusing three times to serve.* This may prohibit an Administrator well suited to a case from serving. This provision was intended apparently to force Administrators to take cases that they would otherwise refuse to take. An individual that is forced to serve as an Administrator in order to get other cases is not likely to do an effective job.

Compensation

As noted earlier by Attorney Stevanovich, the compensation scheme in the Law on Bankruptcy, which allows the Administrator to receive a salary equal to the salary of the general manager, appears to be problematic. The reasons need not be repeated here.

There are wide varieties of methods for compensating Administrators. The compensation should be structured in a way as to (1) attract sufficiently qualified individuals and (2) give them sufficient incentives to act in the general interests of the creditors and shareholders.

In coming to this arrangement, the MOJ should consider whether it makes more sense to either

- establish a scheme that cannot be deviated from;
- establish a scheme that can be overridden by creditors vote;
- authorize a government agency to set rates;
- leave this decision entirely to the creditors and the Administrator.

With regard to liquidation proceedings, many countries favor a success fee approach based on the amount of claims that the Administrator satisfies. Some countries take this further, establishing a sliding scale fee structure, where the Administrator receives a fee of ten percent of claims satisfied, say to an amount equaling the first two million drams, then five percent of the next four million drams, and so on. This approach recognizes the fact that all bankruptcy Administrators share the same "core" costs. With bigger cases, these core costs are smaller relative to the value of the claims against the Debtor. The shrinking-percentage-fee approach takes this into account.

If the Debtor is contemplating a financial recovery program, then a success fee approach is harder to structure and probably needs to be tied to a monthly fee. Such circumstances require more flexibility. The fee arrangement should be established by the Debtor and the creditors with approval by the court.

Close discussions with accountants, auditors, and other professionals could very well help clarify the right approach for Armenia.

But, regardless of the treatment of long-term compensation of the Administrator, the Law should clarify how to compensate Administrators for the services they provide *before* they come to an arrangement with creditors. Here, clear rules are more important than flexibility.

Article 17. Appeals against the actions of the Administrator

The goal of this provision is to establish a means of reversing illegal decisions of an Administrator while, at the same time, preventing the supervising judge from second-guessing the decisions of the Administrator that are clearly within the Administrator's responsibilities. Further, such review should occur quickly in order to avoid slowing down the proceedings. Specific comments on this section are below.

Time period for appealing against the action of the Administrator

The three- and five-day time periods in item 1 of Article 17 limit the rights of creditors who do not file appeals after the time period expires. In this sense, they closely resemble "Limitation of Actions" under Chapter 21 of the Civil Code.

Two amendments would be helpful. First, the time period should commence upon the day the board of creditors knew or should have known of the violation. This is quite similar to the standard set forth in Article 337 of the Civil Code. It also would encourage the Administrator to convey his actions to the board of creditors as soon as possible in order to commence the limitation period.

Second, the time period should be made slightly longer in order to give the creditors a greater chance to appeal. Ten and fifteen days is probably sufficient.

Questions that the Judge may overturn

The Law on Bankruptcy should clarify that the judge should overturn only actions that violate the law. The judge should not be able to overturn a decision of the Administrator simply because the judge disagrees with an Administrator's business decision.

Article 18. Suspension of actions of the creditors

Item 2 of this article establishes the circumstance in which a Debtor could be entitled to "adequate protection". Sub-item (a) allows for cash payments to the secured creditor to compensate him for the devaluation of the amount of the secured claim.

Two changes are likely needed here. First, the creditor should be entitled to cash payments not as a result of devaluation, but as the result of devaluation that makes him less secured. For instance if the creditor has a claim of 200,000 drams on property worth a 1,000,000 drams, he should not be entitled to cash compensation if the property depreciates in value by 300,000. In such a case, he remains fully secured. The Law should account for this possibility.

Second, it should be made clear that the creditor's claim against the Debtor is reduced to the extent cash payments are made.

Article 19. Obligation of the Debtor to cooperate

This provision correctly establishes an obligation to cooperate but does not state the consequences for a failure to do so. In order to create the proper incentive to cooperate, this provision should additionally state that failure to cooperate with the Administrator should be considered the equivalent of contempt of court, with the appropriate penalties under the Administrative and Criminal Codes.

Article 20. Suspension and resumption of the activity of the Debtor

The first paragraph should be amended to allow for the suspension of the Debtor's activities if it did not submit an intention regarding financial recovery. See comments to Article 10 (second issue).

Article 22. Public utilities

Item 1 of this article should clarify that a public utility cannot justify a refusal to provide service on grounds that the Debtor has arrears to the public utility.

Article 23. Registration and calculation of claims

The provision should be modified to make clear that the Administrator must register and calculate claims that have been received by the court.

Article 27. Evaluation of claims

Determining the value of property secured by a pledge, absent an actual sale, is very difficult and subjective. The law currently does not provide a means of determining value. One way or another this issue should be addressed, as the value of the property could determine the creditor's rights to adequate protection and his voting power in a creditors' meeting.

Attempts at legislating a formula for determining value almost never work. And, where the legislation relies on valuations performed by experts, it often turns out that no two experts can agree, even though both estimates sound reasonable.

The individuals with the greatest knowledge of the property's true value and incentives to accurately know this value are the creditors themselves. Every day creditors, such as banks, value property, or employ experts to do so, in deciding whether to provide loans to customers. Under these conditions, the banks have incentives to make their appraisals very reasonable and realistic.

But in bankruptcy proceedings, these creditors often have strong incentives to inflate, or sometimes deflate, their estimations of property value. For instance, a creditor who thinks that his collateral is not sufficiently valuable to cover his claim has an incentive to argue that the property is worth more than he actually thinks it is. He does this in order to gain the favorable treatment that secured creditors receive in bankruptcy proceedings.

The best way to test a valuation is through a sale in a competitive auction. But such sales often occur at the end of the proceedings. The court and the Administrator often need information on the value of property months before a sale takes place.

At this point, the best approach to this problem is to give the Administrator the right to sell the pledged property early in the proceedings in order to determine its value. The Administrator should also be given the right to "buy back" the property in an auction if the price is right (which would result in clearing out the secured claim on the property). This would be a very good use of the "new capital" discussed by Attorney Stevanovich in his comments to the Law on Bankruptcy.

Article 29. The contracts of the Debtor

Item 1 of this article should be amended to more specifically establish the process for rescinding contracts of the Debtor and the effect such a rescission has on the claims of the contractual counter parties of the Debtors. Possible language for a substitute item 1 (which was adapted from legislation under review in the Philippines) is set forth below.

> 1. All contracts of the Debtor with creditors and other third parties where the parties have not fully or mostly performed their obligations, shall be deemed to continue in force if the Debtor makes payments for such services and goods that are provided to the Debtor after the declaration of insolvency.
>
> Within thirty days following the declaration of insolvency, the Administrator, after consultations with the Debtor, shall notify each contractual counter-party and the court of whether the Debtor is confirming or breaching the particular contract. Contractual obligations of the Debtor arising during this period, and afterwards for confirmed contracts, shall be considered an administrative expense. Contracts not confirmed by the required deadline shall be considered breached. Obligations of the Debtor for any damages and other penalties arising as the result of the election to breach shall be considered a claim against the Debtor and shall be added to the registry of claims maintained by the Administrator.

Article 50. Contents of the financial recovery plan

Article 50 appears to provide a sufficient level of detail for what a plan should entail. Nonetheless, parties may benefit from (1) a broader list of possible procedures that could legally be used in a rehabilitation, and (2) the required elements for having a plan submitted to a court for a creditors' vote. The first list would guide the Debtor and its financial advisors as they prepare a rehabilitation plan. The second list, which should focus on making sure that the plan is reasonable and that the treatment of creditors is not unreasonably discriminatory, gives the court guidance as to whether the plan should be submitted to the creditors for their approval.

An illustrative list of possible procedures is attached as Appendix 1. An illustrative list of minimal elements is attached as Appendix 2.

Finally, two points are specifically worth mentioning:

- *Mandatory treatment of tax arrears:* The Ukrainian bankruptcy law has a very interesting mandatory provision with regard to rehabilitation plans. The Ukrainian law requires the tax authorities to (1) forgive any debts greater than two years old and (2) allow for repayment of non-forgiven tax arrears (i.e., those less than two years old) over a six-year period. In comparison, no taxes are forgiven if the company goes into liquidation, and

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unsecured creditors in a liquidation are paid only after taxes are paid in full. This creates significant incentives for unsecured creditors to agree to a rehabilitation plan.

Important Note: While the above idea appears to have worked in Ukraine, this alone is no guarantee that it will work here. Further, the Ukrainian approach, if implemented, could have some impact on tax revenues. This idea should thus be closely discussed with various affected parties before it is put in place.

- *Debt-equity swaps.* These types of exchanges are extremely useful in rehabilitating a company. This issue should be addressed in the Law on Bankruptcy or the amendments to the Law on Joint Stock Companies. If addressed in the Law on Bankruptcy, it should clarify that such a swap cannot occur without the consent of the shareholders.

Article 52. Voting on a financial recovery plan
Article 53. Adoption of the financial recovery program

Attorney Stevanovich has previously commented on this section. Nonetheless, some elaborations could be helpful. The most problematic item in Article 52 is item 3, which establishes classes of creditors with the right to vote for a rehabilitation plan. The most problematic item in Article 53 is item 1, which establishes how many classes need to vote for the plan in order to be adopted.

In considering changes to this item, several principles might prove helpful:

- The law should require the plan to define classes of creditors according to the classes established in liquidation proceedings. *Thus, changes to item 3 of Article 52 are recommended.*
- The rejection by any class should mean the rejection of the plan. *Thus, changes to item 1 of Article 53 are recommended.*
- The fewer numbers of classes that have voting rights, the more likely that a plan would be approved.
- If a class does not have voting rights, the Law on Bankruptcy should require that the plan provide for repayment of all the claims in that class in full.
- Shareholders should not vote if the Debtor is proposing the plan. In those cases, the Debtor presumably has the authority to negotiate on the shareholders' behalf. If the Debtor is not proposing, it makes sense for the shareholders to vote in order to protect their equity interest (that is, they can reject a rehabilitation plan and force a liquidation if the plan treats them too poorly).

Article 54. Consequences of adopting the financial recovery program

Item 2 states that the Administrator shall oversee the Debtor's activities "based on a decision of the court". The extent that the Administrator continues to monitor the company should be a decision of the creditors. Accordingly, this provision should be changed to "if so contemplated in the rehabilitation plan".

Article 60. Extraordinary distribution of proceeds received from the sale of property

Treatment of secured creditors when the Administrator sells their collateral together with other property

Normally, property that is the subject of pledge is sold separate from other property. This separate sale helps define if the creditor is fully or partially secured.

How should the Law on Bankruptcy treat secured creditors when the Administrator decides to sell it bundled with other property (e.g., when selling the Debtor's business as a whole)?

One route would be to have an official appraisal of the property. However, official appraisals are highly subjective and subject to lengthy dispute. The best solution to this problem is to have the Law on Bankruptcy state that the secured creditor is entitled to full payment on his claim if his property is sold bundled with other property and where the purchase price of the property is greater than the amount of the secured claim. If it is less than the amount, the creditor is considered partially unsecured to the extent the claim exceeds the purchase price.

Amendments that recognize this possibility should be incorporated into changes to this Article.

Property that is subject to arrest

Commentators in several countries have indicated that regular collection proceedings are superior to bankruptcy as a means of enforcing obligations. However, creditors who pursue this route and have property arrested are out of luck if the Debtor enters bankruptcy proceedings before the arrested property is sold. In such cases, they are considered unsecured creditors and are at the back of the line with the creditors who did nothing.

To remedy this, the Law on Bankruptcy could recognize as a secured claimant a creditor who has had property of the Debtor arrested pursuant to procedures under the Law on Compulsory Enforcement of Court Decrees. It should also be available to creditors who receive a judgment for the return of particular property, and for creditors who obtain preliminary attachment of property under the Civil Procedure Code.

Article 61. Priority in distribution of funds

As Attorney Stevanovich noted in his prior comments, the ranking of creditors in this article is acceptable. In fact, one of IBTCI's concerns with amending the Law on Bankruptcy was that Armenia could end up with a less advantageous ranking of creditors if the Law were to go through a round of amendments.

One possible means of reducing this possibility would be to adopt by reference the ranking of creditors found in Article 70 of the Civil Code. There are several reasons for this approach. First, the Civil Code's ranking is quite acceptable in terms of international best practices. Second, this change would make the Law on Bankruptcy more consistent with civil legislation. Third, special interests looking to elevate a certain category of claims may find it more difficult to adjust the ranking of creditors in the Civil Code. Finally, the ranking in the Civil Code is also quite similar to the ranking of creditors in the draft section of the Civil Procedure Code regarding bankruptcy.

Accordingly, Article 61 could be amended to read as follows:

Article 61 Priority in distribution of funds.

1. The funds generated by the sale of the Debtor's property that is not secured by pledge of property shall first be used to settle unpaid claims arising from the administration of the Debtor including, but not limited to:

a) court expenses;
b) Administrator's remuneration;
c) expenses required for the maintenance and governing of the property;
d) payments for administrative personnel;
e) current indirect tax liabilities occurring in the cases of sale of the Debtor's property;
f) other expenses specifically categorized as administrative expenses in this law.

2. After the payment of the expenses noted in item 1 of this Article, unpaid claims of the Debtor's creditors shall be satisfied in the order established in item 1 of Article 70 of the Civil Code.

3. In cases when the Debtor is an individual entrepreneur, expenses required for his/her underage children, and his alimonies shall be paid in the same order as payments for labor.

4. Claims of the subordinate unsecured creditors shall be paid only after payments in full are made to the creditors described in item 2 of this Article.

5. Claims of the Debtor's owners shall be paid only after payments in full are made to the creditors described in item 4 of this Article.

Article 63. Satisfaction of claims

The drafters may wish to address the issue of unsellable assets in this Article. The solution would follow the suggestion set forth under the question "How Should Liquidation Treat Low Asset Prices?" set forth in the IBTCI Memorandum to Mr. Mouchouchyan, dated May 16, 2000.

It should be clarified that even though the tax authorities might end up receiving property in lieu of tax payments, most likely the Ministry of State Property Management would manage the property after its taking by the Government.

Article 70. Closure of the case on insolvency at the proposal of the Administrator

This provision is aimed at a concern discussed at the end of this memorandum: cases where the assets of the Debtor are insufficient to pay the court expenses. Unfortunately, the provision leaves this to the Administrator's initiative. In many cases, an Administrator will be unwilling to close a case if it puts him out of a job.

In order to add a safeguard, creditors should be given the right to petition the court for closure of proceedings.

Other Issues:

The Ministry of Justice has expressed interest in adding provisions to the Law that would (1) facilitate the sale of the Debtor's business as a whole, and (2) provide for simplified bankruptcy procedures. These are addressed below:

Sale of the Debtor's business as a whole

If selling the Debtor's business as a whole means a bundled sale of the assets that make up the Debtor's main property complex, then the provisions of the current law on bankruptcy (Article 55) should suffice. The only problem appears to be the treatment of creditors with pledges on property that is part of the complex. This is treated in the discussion regarding Article 60.

Both Russia and Ukraine contain provisions on the sale of the Debtor as a going concern. Both recognize such a sale as more than a sale of a bundle of assets. For instance, both the Russian and Ukrainian laws recognize that the buyer of the Debtor's business has to agree to take on the labor contracts of the Debtor. In the Russian legislation, the buyer is entitled to take the license of the Debtor. In both Russia and Ukraine, the buyer takes on the labor contracts of the Debtor.

In terms of real results, we have not heard any strong indications that this approach has proved to be an all-encompassing panacea for the problems of company indebtedness in Ukraine or the Russian Federation. This issue should be considered more closely, and should be discussed with the expert from Moscow who is expected to provide training to Administrators.

Nonetheless, in reviewing this approach, the drafters should consider the following issues:

- *Labor contracts of the Debtor:* both Russia and Ukraine require that the buyer assume the labor contracts of the Debtor. While the social/labor policies behind this approach are obvious, the accompanying costs should be considered carefully. Given that part of the problem of many companies in bankruptcy is an overstaffed and underutilized workforce, forcing the buyer to take on these workers only puts off the problem for a short period—eventually the new buyer will have to cut redundant staff. Further, such an approach will depress the value of the company (and the payoff to creditors) and make it harder to find a buyer.

- *Other contracts:* The law should make it an option for the Administrator to transfer certain beneficial contracts (e.g., land and equipment leases) as part of the property complex. The law should specifically state that provisions in the Debtor's contracts that prohibit such transfers are void under these circumstances.

- *The possibility of creating a subsidiary and selling its shares:* A slightly more sophisticated approach to this problem is to have the Administrator create a new company on the basis of the Debtor's property and then sell shares of the new company rather than the property complex itself. Although perhaps more expensive and complicated than an asset sale, it allows the Administrator to be more creative in selling share packets to various buyers.

- *The possibility of issuing new shares and canceling old shares:* A final possibility is to have the Law allow the possibility of the issuance of a new set of shares that represents the entire equity in the company (and that equals the total amount of indebtedness). The old shareholders' shares would entitle them to buy the new shares, but only to the extent they pay off the debt of the Debtor. Any shares remaining could be offered to creditors in exchange for their claims, or to the public in some sort of auction. This creates the same result as the option discussed immediately above, but does not entail the cost of transferring property to a new subsidiary.

Simplified bankruptcy procedures

Unfortunately, the term "simplified bankruptcy procedures" sounds far better in theory than it works in practice. The problem is that, simplified or not, bankruptcy proceeding almost always involves starting a court case, appointing an Administrator, selling assets, evaluating claims, and distributing proceeds. It is harder to get more simple than that, and it still remains a difficult, expensive, and complicated exercise.

Russia and Ukraine attempt to deal with this issue through provisions on the "absent debtor." However, these provisions amount to regular bankruptcy proceedings with some of the extra trappings stripped out. Of particular importance are provisions that allow a case to be initiated if the Debtor does nothing in response to a petition filed by a creditor. In some countries, the absence of a response by the Debtor caused cases to remain in limbo.

In handling these cases, Russia and Ukraine rely on government-funded bankruptcy agencies. Russia further requires Administrators to volunteer for cases as part of their duties.

But relying on volunteers and government officials to do complicated and labor-intensive work rarely creates favorable results. As discussed at length in the IBTCI memorandum regarding companies that failed to re-register under the Civil Code, consideration should be given to handling these companies through regular debt collection procedures. Both regular debt collection procedures and bankruptcy liquidations result in the transfer of assets to new owners. Both regular debt collection proceedings and bankruptcy liquidations result in the repayment of some creditors. The only extra thing bankruptcy gives society is greater fairness among creditors. This fairness costs money. And it makes little sense to concern oneself with fairness in distributing proceeds when the cost of such "fair" procedures exceeds the value of the assets that are being distributed fairly.

Thus, in these times of difficult budget constraints and diminished asset values, priority should be given to simpler, more cost-effective solutions, i.e., regular debt collection procedures. If anything, the Law on Bankruptcy should simply make sure that bankruptcy procedures are not used to hinder simple debt collection procedures when the latter are a more appropriate solution. For instance, the Law should discourage a Debtor from initiating a case where it is "administratively insolvent" and its goal is to impede the rights of its creditors. The proposed changes to Article 7, which require the Debtor to present a bankruptcy budget as part of its petition should help the court distinguish the difference between the real cases and the fictional ones.

Appendix 1

List of Possible Procedures that could be used in Rehabilitation Plan (from Draft Legislation in the Republic of Montenegro)

1. Retention of all or part of the property of the estate;
2. Sale of all or part of the property of the estate, with or without continuation of lien, pledge, or security interest; or transfer of the property in satisfaction of claims;
3. Closure of unprofitable operations or changing business activities;
4. Cancellation or reformulation of burdensome or unfavorable contracts or leases;
5. Deferment of debt payments, or providing for repayment by installments;
6. Modification of maturity dates, interest rates, or other terms of a loan or security instrument;
7. Full or partial debt forgiveness;
8. Satisfaction or modification of pledges, liens or security interests;
9. Conversion of unsecured loans into secured loans;
10. Pledge of unencumbered assets;
11. Conversion of debt to equity;
12. Obtaining new credit;
13. Obtaining new investment;
14. Challenge and invalidation of claims lacking in legal validity;
15. Curing of defaults;
16. Termination of employees;
17. Transfer of unencumbered assets in satisfaction of claims;
18. Amendments of the debtor's charter, by laws or other founding or governing documents;
19. Merger or consolidation with one or more entities;
20. Transfer of all or part of the property to one or more existing or newly formed entities;
21. Cancellation or issuance of new securities by the debtor, or of any new entity created pursuant to the above paragraph; or
22. Any other measures not prohibited by law and in conformity with the restrictions of the plan requirements and plan approval process.

Appendix 2

List of Provisions Required to be in a Rehabilitation Plan

From Draft Philippine Legislation on Bankruptcy

Minimal contents of a plan -- In order to be approved by the Court, the plan shall:

a) contain information sufficient to give the various classes of creditors and shareholders a reasonable basis for determining whether supporting the plan is in their financial interest when compared to the liquidation of the debtor;

b) establish classes of voting creditors or sub-classes thereof;

c) specify the treatment of each class or sub-class described in sub-section (b);

d) provide for equal treatment of all unpaid claims within a class or sub-class unless the particular creditor voluntarily agrees to less favorable treatment;

e) disclose all payments to creditors for pre-commencement debts made during the proceedings and the justifications thereof;

f) describe the claims against the debtor still subject to dispute and the provisioning of funds to account for appropriate payments should the claim be ruled valid or its amount adjusted;

g) require the debtor and its counter-parties to adhere to the terms of all contracts that the debtor has chosen to confirm;

h) arrange for the payment of all outstanding administrative expenses as a condition of the plan's approval unless such condition has been waived in writing by a specific creditor;

i) arrange for the payment of all outstanding taxes and assessments, or an adjusted amount pursuant to a compromise settlement with the Ministry of State Revenue or other applicable tax authorities;

j) include a certified copy of a certificate of tax clearance or evidence of a compromise settlement with the Ministry of State Revenue;

k) include a valid and binding resolution of a meeting of the debtor's shareholders to increase the shares by the required amount in cases where the plan contemplates an additional issuance of shares by the debtor;

l) state the compensation and status, if any, of the conservator after the approval of the plan;

m) include opinion letters of attorneys of the rehabilitation planner certifying that the transactions and arrangements of the plan are consistent with the law; and

n) include written evidence of consent to the plan by each class or sub-class of voting creditors established by the plan.

Appendix VIII

REQUEST FOR TRANSLATION

May 31, 2001

Tigran Mukuchyan
Deputy Minister and Head of State Registry of Enterprises
Ministry of Justice
15 G. Lusavorich Street
Yerevan
Armenia

Re: Illustrative Language for Amendments to the Bankruptcy Law

Dear Mr. Mukuchyan:

As we promised in our previous letter to you dated May 25, 2001, enclosed is a version of the Armenian Law on Bankruptcy revised with language that would illustrate how the comments in our previous memoranda to you could take form of concrete changes in the Law. For your convenience, the additions have been underlined and the deletions have been struck through.

For the most part, the illustrative amendments follow the comments in the memoranda on the Law on Bankruptcy provided to you by IBTCI over the past several weeks and in December 2001. Because most of these changes have been explained previously, IBTCI felt that it was best to simply write in the language without using footnotes, etc. to describes the grounds for the change.

Nonetheless, the revised version of the Law contains several changes that were not discussed in previous memoranda. The basis for these additional changes are in Attachment 1.

Further, there are several comments for which illustrative language was not provided. For instance, see comments to Articles 27 (contracts of the debtor) and 50 (contents of the financial recovery plan). It was felt that the changes called for in these comments were too significant to insert into the Law at this stage in the amendment process.

If you have any questions regarding these matters, please do not hesitate to contact me.

Sincerely,

Daniel Fitzpatrick

AMENDMENTS TO

THE LAW

OF THE REPUBLIC OF ARMENIA

Adopted by the National Assembly
On December 3, 1996

ON INSOLVENCY (BANKRUPTCY) AND FINANCIAL RECOVERY OF LEGAL PERSONS, ENTERPRISES NOT HAVING THE STATUS OF A LEGAL PERSON AND INDIVIDUAL ENTREPRENEURS

Proposed Additions are Underlined, Proposed Deletions are Struck Through

CHAPTER 1. GENERAL PROVISIONS

Article 1. Scope of the Law

1. This Law shall preserve the grounds and procedure of recognizing legal persons, enterprises not having the status of a legal person and individual entrepreneurs (hereinafter, debtor) as insolvent (bankrupt), the procedures of financial recovery and liquidation of the debtor recognized as insolvent (bankrupt) and the rights and obligations of the participants therein.

2. This Law shall not regulate the disputes on recognizing the bodies of public administration and local self-government, budgetary organizations and institutions of the Republic of Armenia, as well as the Central Bank of the Republic of Armenia, banks and insurance companies registered in the Republic of Armenia as insolvent (bankrupt).

3. To the extent not regulated by procedures described in this Law, the Code of Civil Procedure shall regulate court proceedings undertaken pursuant to this Law.

Article 2. Insolvency (bankruptcy) of the debtor

1. According to this Law, the debtor may be recognized as insolvent (bankrupt) (hereinafter, insolvent) which has failed to perform its genuine, non-disputed obligations after 30 days following the expiration date for performing the obligation (obligations) assumed towards the creditors, or has not provided any other satisfaction acceptable for the creditors, and the total amount of debts overdue by 30 days ~~and more exceeds one million drams.~~or more and exceeds five thousand monthly salaries or a different amount established by government decree.

2. The debtors mentioned in point 1 of Article 1 of this Law are recognized as insolvent by the court in accordance with the procedure defined by this Law.

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Article 3. Jurisdiction of court of first instance and appeal of verdicts and rulings in insolvency cases

1. The insolvency case is heard by the commercial court (hereinafter, court) within the place of location of the debtor.

2. A determination of whether the debtor is insolvent shall be the verdict in proceedings under this Law.

3. The rulings of the court that are subject to appeal shall be limited to those concerning the following questions:

a) the appointment or dismissal of an Administrator;

b) the granting or denial of relief from the order suspending the actions of the secured creditors;

c) the adoption or rejection of the financial recovery program.

4. The person who brings the appeal must forward copies of the appeal to the debtor, the Administrator, and the Board of Creditors if one is formed under this Law.

5. The appeal of a ruling by the court shall not suspend the proceedings under this Law unless specifically ordered by the appellate court.

6. The appellate court shall be restricted to the question raised on appeal and shall hear the matter and adopt a ruling within one month after the beginning of proceedings.

Article 3-1. Liability for abuse of or failure to use bankruptcy proceedings

1. The individuals identified in item 2 of Article 5 of this Law shall be liable for any claims of creditors that remain unpaid after the distribution of proceeds from a liquidation under the following circumstances:

a) when the debtor has liquidated itself under proceedings other than those described in this Act,

b) when such individuals receive actual or constructive notice that the value of the debtor's assets have fallen below that of the debtor's liabilities and fail to take reasonable steps to initiate proceedings under this Law (either in court or through entrusted management) within thirty days of receiving such notice, or

c) when the debtor submits an intention to develop a financial recovery plan and fails to take reasonable and good faith efforts to participate in the proceedings and to develop and disclose a plan pursuant to the requirements in this Law.

2. For purposes of this Article, constructive notice shall mean a reasonable opportunity to determine the circumstances described in this Article.

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CHAPTER 2.
PROCEEDINGS OF AN INSOLVENCY CASE

Article 4. The ground for initiation of an insolvency case

The ground for initiation of an insolvency case is the statement of claim of the creditor (creditors) or the debtor.

Article 5. Submission and recall of a statement of claim for initiating an insolvency case

1. The following may submit a statement of claim to the court for recognizing the debtor as insolvent according to Article 2 of this Law:
a) the debtor, for the recognition of its own insolvency,
b) one and more creditors.

2. The following have the right to submit and recall a statement of claim for recognizing their own insolvency:
a) on behalf of legal persons, by the decision of their higher governing body the person (body) authorized by the latter,
b) on behalf of enterprises not having the status of a legal person the owner or one of the owners (one of them, according to the unanimous decision of full members in business partnerships),
c) on behalf on an individual entrepreneur the individual entrepreneur.

State joint stock companies and state enterprises submit the statement of claim for recognizing their own insolvency on the basis of the decision thereon adopted by the founder or the person authorized by the latter.

3. Statements of claim submitted by more than one creditor may be recalled only with the consent of all the applied creditors.

4. The statement of claim may be recalled only before the recognition of the debtor as insolvent according to the procedure defined by this Law.

Article 6.The form and content of a statement of claim

1. The statement of claim shall be submitted to the court in writing.

2. The following shall be stated in the statement of claim:
a) the name of the court where the statement of claim is submitted,
b) the claimant, his address, also the place of location for a legal person, an enterprise not having the status of a legal person or an individual entrepreneur, as well as the representative, his address and the place of location, if the statement of claim is filed by the representative,
c) the debtor's denomination (name), address and place of location,
d) the claim amount, if the statement of claim is submitted by the creditor,

e) evidence, confirming the claim of the claimant,
f) the list of the documents attached to the statement of claim.

Article 7. Documents describing the financial-economic condition of the debtor

In case the statement of claim is submitted by the debtor for recognition of its own insolvency the following documents are attached to the statement of claim, and in cases defined by Article 10 of this Law, according to the decision of the court, the debtor is obligated to submit:

a) current accounting registers of the debtor, maintained according to the procedure defined by law and other legal acts;

b) the list of property belonging to the debtor by the right of ownership, according to the results of the last inventory, including capital and financial investments, fixed and circulating assets, as well as nonmaterial assets and other assets not belonging to the mentioned composition;

c) the list of the creditors of the debtor, their names (denominations), addresses, place of location and the nature and amount of obligations, including off-balance sheet obligations, to separate creditors. The information stipulated by this point shall include also those obligations the time limit of which has not expired, as well as the guarantees provided by the debtor and other conditional obligations assumed;

d) the financial statements of the debtor for the last accounting period;

e) if the debtor is a partnership the names (denomination) and addresses (place of location) of the full members;

f) the statement of the debtor about the intention of financial recovery. If the debtor intends to undergo financial recovery, then he is obligated to submit the financial recovery program drawn up according to the requirements of this ~~Law.~~Law;

g) a description of how the debtor shall be able to provide adequate protection to those entitled to it under Article 18 of this Law;

h) a bankruptcy budget, which compares the estimated cost of the proceedings (including the Administrator's salary and court expenses) to the proceeds expected from revenues during the proceedings and, if applicable, the expected liquidation value of the debtor's assets.

Article 8. Accepting an insolvency case for proceedings in the court and recognizing the debtor as insolvent on the basis of the statement of claim of the debtor

1. The statement of claim of the debtor for recognizing its own insolvency is registered in the court at the moment of its submission.

2. In case of the absence of any of the documents mentioned in Article 7 of this Law or in case of their non-compliance with the requirements defined by this Law and other legal acts, at the recommendation of the judge made within 5 days following the moment of the registration of the statement of claim, the debtor is obligated to submit the mentioned documents within 10 days.

If all the documents complying with the mentioned requirements are submitted during that period, then on the day of submitting them the judge shall make a decision on accepting the insolvency case for proceedings in the court and recognizing the debtor as insolvent. Otherwise, the same day the judge shall make a decision on rejecting the statement of claim of the debtor.

Article 9. Accepting an insolvency case for proceedings in court and recognizing the debtor as insolvent on the basis of the statement of claim of the creditor (creditors)

1. The statement of claim of the creditor (creditors) is registered in the court at the moment of its submission.

2.Within one day after the registration of the statement of claim, the court shall send a notification to the debtor, with the copy of the statement of claim enclosed.

If the debtor does not appeal in writing against his insolvency within 10 days after receiving the notification, then at the same day the judge shall make a decision on accepting the insolvency case for proceedings in court and recognizing the debtor as insolvent or, in case of the existence of the grounds defined by point 5 of this Article, on rejecting the statement of claim.

3. If the debtor appeals against his insolvency within 10 days after receiving the notification of the court through submitting motions thereon in writing to the court, then the judge shall call a court hearing, examine the evidence presented by the parties, and the same day render a one-person decision on accepting the insolvency case for proceedings in court and recognizing the debtor as insolvent, or on satisfying the motions of the debtor and rejecting the statement of claim of the creditor.

The judge shall notify the parties – the debtor and the creditor (creditors) having submitted the statement of claim - about the day, hour, and place of the hearing, at least 2 days prior to the day of starting the hearing of the case.

4. In the case stipulated by point 3 of this Article, the court may demand from the creditor to install a banking deposit in the name of the court in any bank registered in the Republic of Armenia, to the extent of 10% of the amount of the statement of claim, but not more than 500 thousand drams, which is necessary to indemnify the court costs in case of rejection of the statement of claim.

If the judge makes a decision on accepting the insolvency case for proceedings in court and recognizing the debtor as insolvent, the bank deposit is returned to the creditor, within 2 banking days following the moment of making the decision.

If the statement of claim is rejected the court costs are indemnified from the bank deposit. After the court expenses are indemnified, the remaining part of the bank deposit is returned to the creditor within 2 banking days following the moment of making the decision.

If the creditor (creditors) submitting the statement of claim according to the procedure defined by this Law does not submit a document confirming the investment of the bank deposit, the statement of claim shall be rejected.

5. The judge shall make a decision on rejecting the statement of claim if:

a) the case is not under the jurisdiction of the given court,

b) the debtor having submitted the statement of claim has not observed the requirements of Article 6 of this Law,

c) the court is already conducting insolvency proceedings with respect to the debtor mentioned in the statement of claim;

d) at the court hearing prescribed by point 3 of this Article, it becomes known that the claims presented by the creditor are completely satisfied as of the day of calling a court hearing;

e) the grounds brought in the statement of claim do not satisfy the requirements stipulated by Article 2 of this Law,

f) the person who submitted the statement of claim on behalf of the claimant did not have the authority to submit it,

g) the statement of claim was submitted by a person recognized as lacking capacity,

h) the person having submitted the statement of claim did not pay the duty defined by law, and the court did not make a decision on exempting him from paying the duty.

i) there is a genuine dispute whether the debtor in fact has an obligation to the creditors for an amount at least equaling that set forth in Article 2 of this Law;

j) the debtor has demonstrated that it has been generally making its payments as they come due and the failure to make payments to the petitioner is the result of excusable oversight or other reasonable grounds,

k) the debtor is currently under entrusted management for the benefit of creditors under this Law and that the proceedings are commencing in a manner sufficient to protect the rights of the creditors and shareholders as established in this Law.

6. The judge may not reject the statement of claim submitted on insolvency cases on any other grounds, except the grounds defined by point 5 of this Article. The judge rejecting the statement of claim shall render a reasoned decision thereon. In his decision the judge is obligated to indicate the grounds of the rejection by noting relevant Articles of this Law.

The copy of the decision on rejecting the statement of claim, with the submitted documents, is delivered or sent to the claimant, and in the case stipulated by point 2 of this Article, to the debtor as well.

Article 10. The consequences of recognizing the debtor as insolvent

1. From the moment of accepting the case for proceedings and recognizing the debtor as insolvent, the court shall:

a) appoint an Administrator, according to the procedure and time periods, defined by Article 12 of this Law,

a-1) suspend the rights of the debtor to manage or alienate the property if the debtor has initiated the case but has not submitted a financial recovery program;

b) appoint the first meeting of the creditors, within 28 days but not sooner than 10 days after accepting the statement of claim,

c) within 2 days provide official information about accepting the insolvency case for proceedings and recognizing the debtor as insolvent, as well as about the time periods and place of calling the first meeting of the creditors, to:

- the debtor,
- all the creditors known to the court as of that date,
- the state body performing the state registration of the debtor,

- state bodies performing the state registration of immovable and other property subject to state registration,
- the tax body where the debtor is registered as a tax payer,

d) obligate the Administrator to publish the information about recognizing the debtor as insolvent, appointment of an Administrator and calling the first meeting of the creditors in ~~the press~~two newspapers each with a print-run of at least ~~1000~~2500 issues, and affix a notice in a specially designated place in the court building,

e) call a court hearing, at the motion of the Administrator or the parties, according to the procedure defined by this Law,

f) obligate the debtor to submit the documents defined by Article 7 of this Law, within 10 days, if the statement of claim is submitted by the creditor;

g) obligate the debtor to determine whether to develop a financial recovery plan and, if so, to submit a statement of intention to develop such a plan within 20 days after recognition of the debtor as insolvent, if the statement of claim was submitted by the creditor;

h) perform other actions arising from the requirements of this Law and not contradicting this ~~Law;~~Law.

Article 11. Initiation of an insolvency case on the basis of actions concerning confiscation

If two or more cases against the same debtor concerning confiscation are pending in the court, and the demands presented by the confiscation claims concerning money and time periods comply with the requirements of Article 2 of this Law, then the judge is obligated to accept insolvency case for proceeding with respect to the debtor and to recognize the debtor as insolvent on the basis of those actions by the procedure defined by this Law.

Article 12. Appointment of the Administrator

1.Within 2 days following the moment of recognizing the debtor as insolvent the judge shall appoint an Administrator and define the size of his salary. If the person appointed as Administrator refuses to take the responsibilities of an Administrator within 3 days, the judge shall appoint another person as an Administrator within 2 days. In case of motion within 5 days following the appointment of the Administrator by the creditor (creditors) known to the court at the moment of appointment and having 50% and more claims against the debtor, the judge is obligated to appoint another Administrator within 2 days.

2. The Administrator must be ~~an auditor,~~a licensed auditor or accountant ~~or~~with a license to act as an insolvency administrator ~~licensed~~issued by the body authorized by the Government of the Republic of Armenia.

A person may not be appointed in the position of an Administrator who:

a) was convicted for an intentional crime, or was deprived of the right to hold certain positions as a punishment;

b) appears as a suspect, accused or defendant in criminal proceedings at the moment of the appointment as Administrator;

c) has a claim against or obligation to the debtor of over one hundred thousand drams;

d) has been recognized as lacking capacity or of limited capacity;

e) within the last three years has been a member of governing body or chief accountant of a legal person or an enterprise without the status of a legal person liquidated and not having satisfied the claims of creditors by the procedure defined by law, or is an individual entrepreneur recognized as insolvent;

f)~~refused to be appointed to the position of Administrator for three times during the last year, if the reason for the refusal was not the circumstance of being an Administrator of another insolvency case at the given period;~~

~~g)~~ was removed early from the position of Administrator during the last year at the initiative of the court;

~~h)~~g) at the moment of recognizing the debtor as insolvent and within one year preceding appeared as a member of governing body or chief accountant of the debtor, or an individual entrepreneur recognized as insolvent, as well as is a close relative to the mentioned persons.

3. The Administrator is paid from the cash resources of the debtor or resources generated from the sale of other property, or from cash resources provided by the creditors on condition of reimbursement.

~~The~~4. In cases when the debtor is preparing a financial recovery plan, the monthly rate of payment to the Administrator is defined by the court in the amount of 1/12 of the annual salary of the person holding the position of the Administrator during the last year or the director general of the ~~debtor. By the motion of the Administrator, and with the consent of the creditor (creditors) known to the court at the moment of appointing the Administrator and having 50 % and more claims against the debtor, the court defines~~debtor, unless the Board of ~~supplementary remuneration for the Administrator by percentages, but not more than 10 %, as to the level of satisfaction of the creditors' claims and within the periods of satisfaction.~~Creditors decrees a different amount agreed to by the Administrator.

5. In cases when the court has ordered the liquidation of the debtor, the Administrator shall no longer be entitled to a monthly payment. The Administrator's payment shall be determined by the amount repaid to the creditors and shareholders according to a schedule established by the body authorized by the Government of the Republic of Armenia.

Article 13. Authority of the Administrator

The appointed insolvency Administrator is authorized to perform the following actions:

a) to distraint and put a seizure on the property of the debtor;

b) to make an inventory of the property, and take measures stipulated by law for ensuring the protection of the property belonging to the debtor;

c) to call meetings of creditors, at his discretion or by the demand of the creditors having more than 5 % of existing claims against the debtor, and to preside during these meetings;

d) to appeal to the court for issues requiring solution by judicial procedure;

e) to supervise the work of the persons hired by him during the administration of the property of the debtor;

f) to check the legality of claims presented against the debtor;

g) to submit a motion to the court for the purpose of restituting the property alienated by the debtor without equivalent reimbursement and the transferred funds, or recognizing transfers made by unlawful or false documents as invalid and applying other measures for satisfaction defined by law;
h) to supervise and administer the activity of the debtor within the framework of his jurisdiction defined by this Law;
i) to open a special insolvency account in one of the first five commercial banks, as to the size of their fixed capital, operating in the Republic of Armenia and enter to the account all funds received in the name of the debtor;
j) to convert non-cash property of the debtor into money;
k) in case the debtor fails to submit necessary information within the time period defined by this Law, to involve corresponding specialists for submitting the mentioned information and to pay them at the expense of the debtor, notifying thereon to the Board of Creditors beforehand and, in case the latter is not formed, to the 10 creditors having the largest claims;
l) to involve corresponding specialists for confirming the reliability of the information submitted by the debtor and to pay them at the expense of the debtor, notifying thereon to the Board of Creditors beforehand and, in case the latter is not formed, to the 10 creditors having the largest claims;
m) by the instruction of the court, to notify all corresponding persons for transferring all the correspondence and transfers to be addressed to the debtor to the Administrator or to the special insolvency account;
n) by the instruction of the court, to notify all the banks where the debtor has deposits on recognizing the debtor as insolvent;
o) by the instruction of the court, to notify the corresponding bodies performing the registration of immovable and other property subject to state registration about putting a seizure on the debtor's immovable and other property subject to state registration.

Article 14. Property of the debtor and its disposal

1. From the moment when the debtor is recognized as insolvent by the court, the selling or otherwise alienating, renting or pledging of the property of the debtor, including for the purpose of performing the existing obligations, is prohibited without the decision of the judge.

2. The property of the debtor shall include:
a) all movable and immovable property belonging to the debtor (including claims against third persons), to which confiscation may extend by the decision of the court,
b) inheritance, insurance and other unforeseen funds received within one year after recognizing the debtor as insolvent,
c) incomes generated from the use of the property,
d) contractual rights.

Article 15. The meeting and Board of the creditors

1. The Administrator presides during the meetings of the creditors. The meeting is called at the initiative of the Administrator, or the creditor or creditors having 5 % and more of the

claims. A meeting may be called at the initiative of creditors, if the creditors agree to cover all expenditures made for organizing the meeting. The expenses of the meetings called at the initiative of the Administrator shall be covered at the expense of the debtor.

2. The presence of the debtor is obligatory at the meetings of the creditors except for the cases of absence by the written permission of the Administrator. All the unsecured and partially secured creditors may participate in the meeting of ~~creditors.~~

creditors, voting on the basis of size of unsecured claims. The secured creditors may participate without the right to vote.

3. During the meeting of creditors, the debtor shall be obligated to answer any question of the Administrator and creditors related to his financial-economic activity.

4. The first meeting of creditors elects the Board of Creditors. The Board shall include three or five ~~creditors having the largest~~creditors, either secured or unsecured, receiving the most votes of the unsecured or partially secured claims, voting according to the size of claims (cumulative voting). The Board of Creditors shall be considered elected if the necessary number of unsecured or partially secured creditors agrees to be included in the Board. The Board shall not be considered appointed if the number of unsecured or partially secured creditors willing to be included in the Board is less than ~~three.~~

three. Members of the Board of Creditors serve for a six month period or until a creditors' meeting convenes after this period expires. There shall be no limits to the terms that members serve.

5. The Board shall act on the best interests of the unsecured and partially secured creditors, subject to the rights of shareholders and secured creditors provided by this Law. The quorum of the Board may not be less than half its members. The decisions of the Board are made by the majority votes of its members present at the meeting and shall be recorded in protocols. The actions of the Board shall have the same effect as a decision of the Meeting of Creditors unless the creditors at the meeting specifically restrict this delegation in whole or in part, or a decision is exclusively required by a creditors' meeting under this Law.

6. At its first meeting the Board shall elect a chairman who shall have the obligations and duties of a chairman of a board of a company under the Law on Joint Stock Companies.

Article 16. Restrictions of the Administrator's actions relating to the property of the debtor

The Administrator shall not have the right to sell or otherwise alienate the property belonging to the debtor, if:

a) the debtor insists on his intention of financial recovery, and the court has not adopted a decision yet on the liquidation or financial recovery of the debtor,

b) the program of financial recovery has been adopted, which does not envisage alienation of the noted property.

Article 17. Appeals against the actions of the Administrator and relieving him from performing his responsibilities

1. The debtor and the creditor (creditors) may appeal to the court against the actions of the Administrator or against non-performance of actions defined by this Law. The appeal may be submitted to the court within ~~3~~10 days after the day of performance of the action being appealed against or after expiration of the time periods defined by this Law for performing the actions. When the action or non-action being appealed against is not disclosed by the Administrator, the time periods in this Article shall commence from the day when the petitioner knew or should have known about the violation of his right.

2. Within 15 days after the moment of appealing, the court shall make a decision on accepting or rejecting the appeal and shall notify thereon to the creditors and the debtor. The court shall make a ruling for the creditors or debtor if it is shown that the Administrator violated this Law or that the otherwise legal action of the Administrator had no arguably rational basis. The appeal shall not suspend the actions of the Administrator.

3. The Administrator may be relieved of his duties and replaced with another Administrator qualified to serve under this Law under the following circumstances

~~2. The court,~~a) by court decision, at its initiative or by the motion of the debtor, a secured creditor, or the creditors having 10% and more of the total amount of unsecured and partially secured claims, ~~relieves~~if the Administrator~~from performing his obligations if the latter~~ fails to perform or improperly performs the obligations defined by this ~~Law and shall notify~~ Law;

b) by the decision of the Creditors' Meeting supported by more than fifty percent of all the claims of the unsecured and partially secured creditors;

~~thereon to the debtor and the creditors.~~c) by the decision of the Board.

Article 18. Suspension of actions of the creditors

1. From the moment of recognizing the debtor as insolvent, all the transactions, proceedings, any other actions of the creditors, aimed at satisfying the claims against the debtor, shall be suspended, including:

a) all claims presented for payments by the debtor for the supply of goods, provision of services,
b) transactions connected with the change of the subject of the right of ownership to the property,
c) actions related with proceedings or influencing its process,
d) actions affecting maintenance, seizure or pledging of the property,
e) other contracts of the debtor, if the debtor has violated his contractual obligations due to insolvency,
f) redemption of the debtor's debt (including state taxes, duties and other compulsory payments), the arrears with respect to the applied fines and penalties calculated on it, if the debt had arisen before recognizing the debtor as insolvent.

2. By the demand of the secured creditor the court shall ~~delay~~revoke the suspension defined by sup-point "b" of point 1 of this Article ~~until~~unless the Administrator or the debtor

~~shall provide~~provides adequate protection of the secured claim of that creditor. The following shall be considered as adequate protection:

a) corresponding compensation by regular cash payments to the secured creditor, for the devaluation of the amount of secured claims and against losses;
b) exchange, seizure, securing by pledge of the property,
c) ensuring of the claim of the creditors secured by pledged property or in an other way in cases, if the pledged property would yield income at the moment of recognizing the debtor as insolvent.

3. The Administrator is obligated to deliver the proceeds generated from sale, use, alienation of the collateral to the corresponding secured creditor, to the extent of the secured claim of the latter.

Article 19. The obligation of the debtor to cooperate

The debtor, during the process of his financial recovery or liquidation, shall be obligated to cooperate with the Administrator and provide him the required documents and reliable information concerning his activity and resources, including the information on payments, transfers exceeding the amount of ~~50~~___ thousand drams and alienation of the property performed by the debtor within one year of recognizing the debtor as insolvent, noting separately the payments, transfers to the members of governing body of the debtor and their close relatives and alienation of the property.

Article 20. Suspension and resumption of the activity of the debtor

1. If the debtor has not presented his intention to prepare a proposal ~~about the~~of a program on financial recovery, or the actual program of financial recovery within the ~~period defined by~~periods described in this Law, or the court has not accepted it or has made a decision on liquidation of the debtor, all the rights of the debtor to manage or alienate the property shall be suspended by the decision of the judge.

2. Before the expiration of the time period defined by this Law for submitting the financial recovery program the Administrator, the creditors, the creditors' meeting, the Board of Creditors, the debtor may submit a motion to the court for suspending the rights of the debtor. The court organizes a court hearing for examining the submitted motion. The court shall satisfy the motion in case, if the continuation of the debtor's activity has led or obviously shall lead to decreasing the value of property of the debtor, or it is obvious that the debtor is not able to present a financial recovery program acceptable for the creditors.

3. If the activity of the debtor has been suspended according to the procedure defined by point 1 of this Article, the debtor may fully or partially resume his activity for a period not exceeding one year by the decision of the court, and under the control of the Administrator, if the Administrator shall prove to the court that the resumption of the activity of the debtor on the conditions proposed by him would increase the possibility of satisfying the claims of the creditors.

The creditors and the debtor may object to the decision of the court on resumption of the activity of the debtor. The motions shall be heard in the court within 10 days after submitting them. All interested parties may participate in the hearing.

The motion submitted to the court shall not suspend the operation of the decision on resumption of the activity of the debtor.

4. If the debtor has presented his proposal on the financial recovery program within the period defined by this Law, and the court has accepted it, then the bodies of management of the debtor shall operate within their jurisdiction limited by the court, under the supervision of the Administrator, until the adoption of a decision by the court on completion or suspension of the financial recovery program and liquidation of the debtor.

Article 21. Seizure and pledging of the property

1. After recognizing the debtor as insolvent, the state registration, defined by law and other legal acts, of the seizure and pledging of the property belonging to him by the right of ownership or any change of the ownership right of the property of the debtor, the amount or the priority of the claims against the debtor is invalid without the decision of the court.

2. Seizure, pledging or any other change of the property of the debtor, which was not registered according to the procedure defined by law and other legal acts, is recognized as invalid by the demand of the Administrator and the decision of the court.

Article 22. Public utilities

1. The organizations providing public utility services (electricity, natural gas, water, telephone communication, etc.) to the debtor may not refuse, reject, cease providing these services to the debtor, because of the reason that the debtor is recognized as insolvent by the court, if the debtor after being recognized as insolvent makes current payments in time for the mentioned services and provides guarantees for future payments prescribed by point 2 of this Article.

2. By the demand of an organization providing public utility services, the court shall obligate the debtor or the Administrator to open a corresponding account in one of the commercial banks for paying the company for the services provided by it. The size of the amount transferred to this account shall not exceed the monthly payment for the utility services provided to the debtor by the corresponding company for the month preceding the recognition of the debtor as insolvent.

Article 23. Registration and calculation of the claims

The Administrator shall register and calculate the amount and priority of claims (included secured claims) presented against the debtor in accordance with the procedures in this Law.

Article 24. Secured and partially secured claims

1. Claims secured by a pledge of corresponding property belonging to the debtor or claims on which the creditor has had property of the debtor arrested prior to the commencement of the proceedings shall be considered secured. Creditors having secured claims (hereinafter, secured creditors), may demand immediate satisfaction of their claims from the resources generated from the sale of the pledged property, if the Administrator or the debtor has not provided an adequate protection of the secured claim of the creditor according to point 2 of Article 18 of this Law.

If the proceeds generated from the sale of the collateral are not sufficient to fully redeem the secured claims, then the unsatisfied part of the creditor's claim is considered as unsecured claim, and the creditor is considered as unsecured creditor to the extent of the unsecured claim.

2. The secured creditor may participate in the distribution of those funds generated from the sale of the non-pledged property belonging to the debtor that were generated before the sale of the pledged property.

The size of the amount received from this distribution shall subsequently be deducted from the amount of the proceeds generated from the sale of the pledged property.

Article 25. Increasing the size of the amount of unsecured claims

From the moment of recognizing the debtor as insolvent, no interests or other amounts shall be accrued on unsecured claims.

Article 26. Obligations with non-expired time period of performance

From the moment of recognizing the debtor as insolvent, the time periods of all his obligations with non-expired time periods of performance are considered as expired, and the claims arising therefrom are satisfied according to the procedure and extent defined by this Law.

Article 27. Evaluation of claims

1. If the value of the pledged property exceeds the amount of the claim at the moment of recognizing the debtor as insolvent, then the secured claim is included in the list of secured claims in the amount of the claim.

2. Unsecured claims or the unsecured part of secured claims are registered in the list of claims in their total amount.

Article 28. Satisfaction of claims before recognizing the debtor as insolvent

If a part ~~if~~of the claims of the creditor were satisfied before recognizing the debtor as insolvent, then only unsatisfied claims shall be included in the list of general claims.

Article 29. The contracts of the debtor

1. For increasing the resources of the debtor, the court representing the Administrator may rescind or leave in effect any contract, including those on providing a loan, leasing or other long-term contracts, if the parties have not fully or mostly performed the contracts. The Administrator is obligated to respond to the claim of the counterpart of the contract within 5 days, notifying him on rescission or leaving in effect of the contract.

2. If the owner of the given property preserves his right of ownership to the property until full redemption of the sale amount, then after full redemption of the sale amount the sale is considered performed, and the provisions of point 1 of this Article shall not extend to it.

3. The contracts on hiring employees shall be rescinded according to the procedure defined by labor legislation of the Republic of Armenia.

4. The contracts on hiring employees or leasing of property shall be rescinded only after the notification thereon within the time periods noted in this Article.

5. For the purpose of compensating the damages arisen as a result of rejection of the contract by the Administrator, persons representing the other party to the contract may submit their claims to the court according to the procedure defined by this Law.

6. If the contract stipulates regular payments by the debtor, the Administrator may execute them only after the court confirmation of the list of requirements stipulated by this Law and the sequence of their satisfaction.

Article 30. Property in the state of transition

If the property sold to the debtor by the creditor is in the state of transition at the moment of registering the claim in the court, and the debtor has not obtained ownership right to that property, then the creditor may return it. In that case the creditor shall bear all the expenses connected with return, also returning the advance payment made by the debtor, unless otherwise stipulated by the contract. If the creditor delivers the property, he may restore the amount, by demanding to include his claim in the list of general claims. The Administrator may demand the delivery of the property, if the debtor pays the total contractual amount of the transaction, at his written instruction.

Article 31. Contracts on transfer of securities and other goods

If the debtor has entered into a contract obligating him to transfer during specified time period certain goods or securities subject to trading in stock exchanges or other markets, and those time periods expire after recognizing the debtor as insolvent, the difference between the buying price and the price developed in the market or stock exchange at the moment of recognizing the debtor as insolvent shall be reimbursed to the debtor, if the transaction is of an asset nature, or shall be included in the list of general claims, if the transaction is of a liability nature.

Article 32. The agents

If the debtor recognized as insolvent is the agent (broker) of a third person, who is authorized by the latter to receive his accounts receivable and (or) perform the sale of the property belonging to him, then the person having authorized the agent (broker) is authorized to recall the power of attorney or rescind the mediation contract or demand the agent (broker) to satisfy the claims.

Article 33. Sale of the property belonging to third persons

1. If the debtor sells the property belonging to a third person then, from the moment of recognizing the debtor as insolvent, the third person is authorized to claim his property back, unless otherwise stipulated by the contract.

2. If at the moment of recognizing the debtor as insolvent it is impossible to return the property to be sold or a part of it, the owner shall include his claim in the list of the claims at the contractual price and, in case it is impossible to determine the latter, at the sale price as of the moment of recognizing the debtor as insolvent. If as of the moment of recognizing the debtor as insolvent, the debtor possesses the property to be sold, but its qualitative specifications may considerably worsen in case of the maintenance or moving (perishable goods), then the contractual price of that property, at the demand of the owner, shall be included in the list of the claims.

Article 34. Provision of professional services

1. The Administrator may perform the contracts, according to which the debtor has committed to provide services requiring professional qualification stipulated by law or other legal acts, in cases when the other party to the contract agrees to accept them from the Administrator or his authorized representative, and the latter have appropriate professional qualification or permission to perform the given activities.

2. If the Administrator fails to perform the obligations defined by point 1 of this Article, the claims of the creditor (creditors) arising therefrom shall be satisfied according to the procedure stipulated by this Law.

Article 35. Transfers to third parties and alienation of the property

1. By the permission of the Administrator or the court the Board of Creditors, or if the latter is not formed, the meeting of the creditors, within one year preceding the recognition of the debtor as insolvent may apply to the court to recognize as invalid or recall the following made by the debtor to third parties:

a) free of charge transfers and donations to the members of the governing bodies of the debtor and their close relatives, as well as the close relatives of the individual entrepreneur, made within five years preceding the recognition of the debtor as insolvent,

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b) free of charge transfers and donations to third parties, made within three years preceding the recognition of the debtor as insolvent,

c) the price difference generated as a result of transfers and alienation of property within three years preceding the recognition of the debtor as insolvent, if the price of the property transferred or alienated by the debtor at the moment of its transfer or alienation has exceeded the compensation received for it,

d) transactions performed within three years preceding the recognition of the debtor as insolvent, aiming at concealing the assets of the debtor.

2. Transfers to the persons cooperating with the debtor within one year preceding the recognition of the debtor as insolvent, which have been more favorable for the persons cooperating with the debtor than they will be to other persons, may be recognized as invalid by judicial procedure.

The following persons are considered cooperating with the debtor:

a) the owner of at least 20 per cent of the debtor's statutory capital,

b) members of the governing bodies of the debtor,

c) a person or body having the possibility of foreseeing the decisions of the debtor.

Article 36. Due transfers or alienation of the property

The court shall not recognize the due transfers or alienation of the property of the debtor as invalid, if they are made in a regular process of the activities or financial transactions of the debtor, or if it represents an equal exchange of values, or, if after the transfer, the beneficiary has provided a new loan to the debtor unsecured by property belonging to the debtor and the debtor has not redeemed it before the moment of recognizing him as insolvent.

Article 37. Return of property obtained from transactions recognized as invalid

1. The recipient of a transfer According to Article 35 of this Law is obligated to return it in the form of property, and in case of its absence in the form of money equivalent to the property at the moment of the transfer made by the debtor.

2. The person having returned the transfer of the debtor shall submit a claim in the amount equal to the compensation received by the debtor during the performance of the transaction, if the transferred property is returned in a qualitatively unchanged condition.

Article 38. Return of the succeeding transfer

The court shall claim back from the succeeding transferee the property transferred by the debtor, or the compensation equivalent to it if the latter has not returned the property or the amount equivalent to it.

A succeeding transfer is considered a transfer of the same property by the previous transferee to the succeeding transferee.

Article 39. Notification on recognizing the transfer or alienation of property as invalid and its consequences

1. A notification on the court decision on recognizing the transfer made by the debtor of immovable or other property subject to state registration as invalid shall be given to the respective body registering the above-mentioned property.

2. A person who has pledging or other rights to immovable or other property subject to state registration shall apply to the Administrator for returning the property or compensation equivalent to it.

Article 40. Distraint, sealing and seizure of the debtor's property

1. Within 7 days after the decision of the court on the liquidation of the debtor the Administrator shall distrain and seal the whole property of the debtor, and seize the property belonging to the debtor by right of ownership, except for the property upon which confiscation cannot be executed as defined by law.

2. If the debtor has property by the right of ownership in other countries, the Administrator shall, in compliance with the decision of the respective court of the Republic of Armenia, apply to the courts of those countries with a notice of distraint, seal and seizure of the mentioned property. The distraint and sealing of the property in other countries that belongs to the debtor may be carried out only according to the procedure prescribed by the legislation of those countries.

Article 41. Maintenance and sale of the debtor's property

1. While distraining and sealing the property belonging to the debtor the Administrator shall take all the measures required for the maintenance of the whole property belonging to the debtor.

2. With the consent of the court, the Administrator is authorized to sell the debtor's perishable goods, as well as property requiring significant maintenance costs. The significant maintenance costs are considered those that exceed 10% of the property value.

3. Proceeds received on transactions defined in point 2 of this Article shall be transferred to the special insolvency account of the debtor.

Article 42. Inventory of the debtor's property

1. The Administrator shall conduct the inventory of the debtor's property, within 20 days after the debtor has been recognized as insolvent. At the demand of the Administrator the respective employees (manager and chief accountant) of the debtor shall be present and assist the inventorying.

2. The inventory shall include the all property of the debtor (including the non-sealed property), with the indication of its balance sheet value at the moment of the inventorying. The Administrator may hire an expert, at the expense of the assets of the debtor, to evaluate the debtor's property, with the prior notice to the Board of Creditors, and in the event the latter is not formed, to the 10 creditors with the largest claims.

3. The results of the inventory are outlined in the inventory act, which is signed by the Administrator, the expert hired by the Administrator and the debtor's representative participating in the inventory. The signature of the latter shall evidence that he was present at the inventory and guarantee that the whole property has been inventoried. In the event the results of the inventory are disagreed by the debtor's representative he shall sign the inventory act, attaching to it his written motions.

Article 43. Analysis by the Administrator of debtor's financial situation

Within 20 days after his/her appointment, the Administrator shall submit to the court the reasons and the circumstances having led to the debtor's insolvency, explain the reasons for the failure to perform the obligations, present other related facts and information on the obligations of the debtor's governing, employees, controller, main partners, other cooperating persons and other creditors.

Article 44. Affirmation of claims

1. Within 60 days after the promulgation of the court decision on the recognition of the debtor as insolvent the creditors shall submit to the court their claims against the debtor. The claims shall be registered in the court according to the defined procedure in the registry book maintained for that purpose.

2. Within 1 day after the registration of the claims, the judge in charge of the case shall notify the Administrator, debtor and Board of Creditors, and in the event the latter is not formed, the 10 creditors with largest claims about that.

3. All the claims submitted to the court shall be recognized by the judge as valid, if the Administrator, debtor, or one of the creditors do not submit any motion to the judge within ten days after receiving the notice. If the claim is objected to, the court shall determine, in conformity with the lawfulness of the claim, the amount, priority and security of the claim by the procedure and time periods defined by this law.

Article 45. Preliminary list of claims

After the hearing of the claims registered in the court within the time periods defined under point 3 of Article 44 of this Law, the Administrator shall compile and render to the court, in the shortest possible period, a preliminary list of all the claims submitted, mentioning the secured, unsecured, conditional and priority claims, as well as his motions in regard to them.

Article 46. Motions against claims

In the event the Administrator, debtor, or any of the creditors objects to the creditor's claim, the parties shall be notified about that no later than 20 days before the motion hearing in the court.

The Administrator, debtor, or any of the creditors may object to any claim, or its priority, within the time periods and by the procedure defined by this Law.

Article 47. Final list of claims

On the basis of the decisions made by the court as a result of the hearings of motions, the Administrator shall compile and submit to the court, in the shortest possible period, the final list of all the claims, stating the secured and unsecured claims, size of the amounts and the priority.

Article 48. Report of the Administrator during the resumption of debtor's activities

The Administrator shall submit to the court twice a month a report on the activities resumed by the debtor. The reports shall be discussed at the creditors' meeting or in the Board once in every three months.

CHAPTER 3.
THE PROGRAM FOR FINANCIAL RECOVERY OF THE DEBTOR

Article 49. The Program for Financial Recovery and the Persons Eligible to Submit It

1. Any reorganization of the debtor or sale of the debtor as a whole to meet the claims of creditors, which does not lead to the liquidation of the debtor, shall be considered a program on financial recovery.

2. The program on financial recovery may be submitted by the debtor, Administrator, creditors owning at least 1/3 of the secured claims, creditors owning at least 1/3 of the unsecured claims, as well as persons owning at least 1/3 of the debtor's Charter Capital.

3. The program for financial recovery shall be recommended within 60 days after recognizing the debtor as insolvent, if by the motion of the Administrator or Creditors' Meeting (Board, if it has been formed) the court does not extend the term to 90 days.

4. Expenses for the implementation of the program for financial recovery proposed by the creditor, persons owning 1/3 of the debtor's Charter Capital, and judicial expenses required for its adoption shall be covered at the expense of the party proposing it. The expenses for the financial recovery program proposed by the Administrator or debtor shall be covered at the expense of the debtor's property.

Article 50. Contents of the financial recovery program[1]

1. The program of financial recovery shall include:

a) the procedure, time periods and amounts of the payments to be made to secured, unsecured, and other groups of creditors, the procedure on compensating of their claims, including the procedure of satisfaction of the claims through the debtor's immovable and other property subject to state registration, the procedure to receive new debts by the debtor, the guarantees to satisfy the creditors' claims according to established groups of creditors,

a-1) in the event the debtor is an individual entrepreneur, provisions for the curing and full performance of obligations for paying of expenses required for his/her underage children and his alimonies;

b) the procedure and amounts for exemption, postponement, or redrawing of the debtor's obligations,

c) the contents and implementation time periods (organizational, structural, juridical, financial, technical, and labor) of the measures targeted for the restoration of the debtor's solvency,

d) the procedure of the sale of the debtor's property and proceeds from it, justifications for increase of possibilities for the satisfaction of creditors' claims in the event of the continuation of the debtor's activities,

e) the procedure for and amount of the remuneration of the Administrator, hired specialists and compensation for administrative costs required for the implementation of the financial recovery program,

f) the procedure and amounts for the distribution of the proceeds between the creditors' groups received in the event of the debtor's liquidation due to the termination of the implementation of the financial recovery program.

2. The program on financial recovery should envisage first priority covering of current indirect tax liabilities occurred during the recovery process, after satisfying the claims of secured creditors towards pledged property.[2]

Article 51. Hearing of the financial recovery program

1. The court shall accept for hearing the financial recovery program submitted by the persons having the right to submit the financial recovery program, if it complies with the requirements defined by this Law. Prior to the hearing of the financial recovery program, the court may demand expert opinion on the contents of the program.

2. The financial recovery program shall be delivered by the court to the Administrator, the debtor, and all the creditors known to the court.

3. The decision on hearing of the financial recovery program by the court shall be published through the press with a print-run of at least ~~1000~~2500 issues, with the indication of

[1] Significant changes are possible with regard to this Article. Appendices 1 and 2 to the IBTCI Comments on the Law on Bankruptcy contain specific language that could be applied here.

[2] Added by Amendment passed on December 26, 2000.

the name (denomination) of the person presenting the program, the day for voting and procedure of voting defined by the court. In the case of voting in absentia through correspondence, the legal persons shall submit to the court the ballet ratified by their seal, and the financial persons and enterprises not having the status of legal persons submit their ballots ratified by notary procedure.

Article 52. Voting on financial recovery program

1. No later than 40 days after the program for financial recovery has been delivered, the court shall arrange for a meeting of creditors with secured, unsecured and priority claims by the procedure defined by this Law. The debtor and the Administrator shall be invited to the meeting in writing.

2. If more than one financial recovery program is to be heard, then the voting on all the programs shall be held during one meeting.

3. Only those creditors whose claims the court has accepted may participate in the voting, except for the case when the court has prior authorized other creditors to participate in the voting.

4. The following groups of creditors shall be formed and shall vote separately:

a) the ~~creditors, each of the submitted secured claims of which is 10% and more of all the claims,~~secured creditors whose collateral the debtor will continue to possess after the approval of the plan,

b) the ~~other creditors with secured claims,~~

~~c) the creditors having priority claim as defined by Article 61, points (d) and (f),~~

~~d) the creditors with main unsecured claims, except for the obligations to the state budget and community budgets of the Republic of Armenia.~~creditors to whom the entrepreneur is liable for causing of harm to life or health,

c) the creditors with claims for payment of severance allowances and payment for labor under a labor agreement, for payment of compensation under publishing contracts.

d) the state bodies to whom the debtor has indebtedness for obligatory payments to the fisc,

d) the creditors with non-subordinated, unsecured claims.

5. At the beginning of the voting, the court shall notify all the creditors about the votes received as a result of the voting in absentia through correspondence.

6. The program for financial recovery shall be considered as accepted by the group of creditors, if creditors owning the simple majority of the claims of the respective group have voted for its adoption.

Article 53. Adoption of the financial recovery program

1. The court shall accept the financial recovery program, if ~~at least two groups of the creditors~~each aggrieved group listed in Article 52, point (4) of this Law accept the financial

recovery ~~program, one of which at least is an aggrieved party.~~program. Aggrieved is considered a group, the amount and priority of claims of which are diminished by the given financial recovery program.

Otherwise the court shall make a decision on the rejection of the financial recovery program and liquidation of the debtor.

2. If more than one draft program for financial recovery is accepted in accordance with point 1 of this Article, then the court shall adopt the draft program for financial recovery submitted by the debtor.

3. Voting for a financial recovery program shall be considered as performed, if no less than 2/3 of the voters have participated in it.

The financial recovery program shall be adopted by the simple majority of votes.

Article 53-1. Consequences of failing to meet obligations under the financial recovery program.

1. Upon a failure by the debtor to abide by the provisions of an adopted plan, any creditor or other affected party may petition the court to declare the debtor as having breached the obligations of the financial recovery program. The Court shall transmit a notice to the debtor and the administrator within 5 days of receipt of the submission, and schedule a hearing on the matter within 10 days of submission of the notice.

2. Upon a finding that the debtor has committed a breach of the plan provisions, the Court shall--

a) direct the debtor to cure the breach within a specified period of time;
b) order the administrator to assume control of the debtor enterprise; or
c) initiate liquidation procedures under this Law.

Article 54. Consequences of adopting the financial recovery program

1. After the adoption of the financial recovery program, the activities of the debtor shall be correspondingly revised, and the claims and rights of the creditors and other interested parties shall be redrawn in accordance with the program. Based on the approved program, the creditors may submit those claims of theirs, which are considered as final and satisfy the requirements of the procedure defined by this Law.

2. The debtor is obligated to undertake all the measures provided by the financial recovery program. ~~Based on the decision of the court,~~If so called for in the financial recovery program, the Administrator shall oversee the debtor's activities, but no longer than for a one year period.

CHAPTER 4.
LIQUIDATION PROCEDURE

Article 55. Sale of the debtor's property

1. The sale of the debtor's property that is not subject to pledge or arrest shall be undertaken by the ~~Administrator.~~
Administrator. The Administrator shall have the exclusive right to sell the property of the debtor that is subject to pledge or arrest for ninety days from the commencement of liquidation procedures. After the expiration of this period, unless the secured creditor agrees to otherwise, the right to sell shall transfer to the court bailiff or the secured creditor. The court may extend the Administrator's exclusive right to sell property subject to pledge or arrest for an additional ninety days if the Administrator has developed a plan that calls for the sale of these assets bundled with other property of the debtor.

2. Within at least 20 days prior to the date of the sale, the Administrator shall notify all the creditors with claims exceeding 5 % of the claims submitted against the debtor, about his intention on the assumed sale of that part of the property owned by the debtor, the value of which exceeds 10% of the total value of claims filed against the debtor. The notice shall include the type of sale, either an auction or a direct transaction, starting price of the sale, payment conditions and information about the future buyers, if they have become known to the Administrator previously.

3. The sale of the property owned by the debtor shall be carried out through an auction, as well as by the proposal of the Administrator and the decision of the court through direct transaction. The Administrator shall notify the creditors, the debtor, other persons with the right of pledge or other rights, as well as other persons defined by this Law, about the sale of the property owned by the debtor through a direct transaction. If the debtor or one of the creditors objects to the sale of the property owned by the debtor though the direct transaction, the court shall hold a hearing to discuss the motion within 20 days after it has been received, with prior notice to the creditors and debtor.

4. The Administrator shall notify the court, all the creditors, the persons with the right of pledge and other rights, and the debtor on his intention to sell the property through an auction, 30 days prior to the proposed date. The notice shall include the place of location of the property being auctioned, detailed description of the property, date of registration in the immovable property register, starting price of the auction. If any of the creditors or the debtor objects against the proposed auction conditions, the court shall hold a hearing with 20 days prior notice to the creditors or the debtor.

5. The Administrator shall, at least twice, publish an announcement about the auction of the property owned by the debtor through the press with a print-run of at least 1000 issues, with shall be also affixed in a special place in the court building.

Article 56. Time periods of sale of the debtor's property

The sale of the property owned by the debtor shall be organized no earlier than 20 days after the last announcement in the official daily newspaper, by the procedure defined by the Law or other legal acts.

Article 57. Proceeds from the use of the property

The proceeds received from the governing and use of the debtor's property shall be transferred to the debtor's account and shall later be distributed among the creditors in parallel to the proceeds received from the sale of the property.

Article 58. Transfer of auction proceeds

The auction proceeds shall be transferred to the debtor's special insolvency account, and the receipts shall be delivered to the Administrator.

Article 59. Distribution of funds after liquidation

From the moment the debtor has been recognized as insolvent, the Administrator once every three months to submit to the court a report on the program of liquidation, satisfaction of the claims and distribution of proceeds to the creditors from the sale of the debtor's property. The court may extend the date for the submission of the report and the program on distribution of proceeds to creditors from the sale of the debtor's property no longer than for one month. The mentioned program shall be approved by the court and shall be delivered by the Administrator to the creditors with a ratified notice. Each creditor may object to the Administrator's report, within 10 days after it has been received. The court shall, no later than within 20 days after having received the written motions of the creditors, convene a court hearing to hear those motions.

Article 60. Extraordinary distribution of proceeds received from sale of the property

1. Proceeds from the sale of property not pledged against the debtor's obligations shall at the outset cover the sale expenses, after which the remaining funds shall be distributed in the sequence defined by Article 61 of this Law.

2. Proceeds from the sale of pledged ~~property~~or arrested property, whether or not sold bundled with non-pledged or non-arrested property, shall at the outset cover the sale expenses, after which the remaining funds shall meet the claim of the creditor or creditors secured in writing by the pledge or arrest of the given property. The remaining funds, afterwards, shall be distributed in the sequence defined by Article 61 of this Law.

Article 61. Priority in distribution of funds

~~In accordance with the liquidation program, the claims shall be satisfied by groups formed in the following order:~~

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~~a) secured claims,~~

~~b) court expenses and the Administrator's remuneration,~~1. The funds generated by the sale of the Debtor's property that is not secured by pledge of property shall first be used to settle unpaid claims arising from the administration of the Debtor including, but not limited to:

a) court expenses;
b) Administrator's remuneration;
c) ~~administrative expenses, including the~~ expenses required for the maintenance and governing of the property;
~~property, and all the~~d) payments~~and expenses~~ for~~the~~ administrative personnel;
~~personnel, *as well as*~~e) current indirect tax liabilities occurring in the cases of sale of the ~~*debtor's property.*~~[3]Debtor's property;
f) other expenses specifically categorized as administrative expenses in this law.

2. After the payment of the expenses noted in item 1 of this Article, unpaid claims of the Debtor's creditors shall be satisfied in the order established in item 1 of Article 70 of the Civil Code.

~~d) unsecured claims arising after the recognition of the debtor as insolvent due to the functions carried out in the manner defined by this Law (including resumption of activities), as well as, in the event the debtor~~3. In cases when the Debtor is an individual entrepreneur, expenses required for his/her underage children, and his alimonies shall be paid in the same order as payments for labor.

~~e) claims arising from employment contracts, preceding the 6 months before the moment of recognizing the debtor as insolvent, and which shall not exceed 15 times the minimum salary per month,~~

~~f) debtor's alimonies,~~

~~g) claims of the unsecured creditors, including the obligations arisen towards the state budget and the community budgets of the Republic of Armenia, except for the claims of subordinate unsecured creditors,~~

~~h) claims~~4. Claims of the subordinate unsecured creditors ~~in accordance with Article 62 of this Law,~~ shall be paid only after payments in full are made to the creditors described in item 2 of this Article.

~~i) claims of the debtor's owners (founders, participants or shareholders' members or partners).~~

5. Claims of the Debtor's owners shall be paid only after payments in full are made to the creditors described in item 4 of this Article.

Article 62. Subordinate unsecured claims

The group of subordinate un-secured claims shall include:

a) interests, or other incomes calculated on the unsecured claims starting from the moment of recognizing the debtor as insolvent, as well as the claims defined by sub-points "b" and "c" of this Article;

~~[3] Added by Amendment passed on December 26, 2000.~~

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b) claims generated from the loans or other advances provided to a debtor, which is a legal person, by its owners;
c) claims represented by 10 year and more bonds issued by the debtor, as well as by preferred shares;
d) claims arisen from the acceptance of donations, inherited property.

Article 63. Satisfaction of claims

Claims of the group with the same priority shall be satisfied in proportion to the amount of each claim. The satisfaction of claims that belong to a subsequent group may be initiated only after the complete satisfaction of the claims of the previous group.

Article 64. Claims generated from resumption of the debtor's activities

Claims generated from the resumption of the debtor's activities shall be treated as administrative expenses and shall be paid in accordance with Article 61of this Law.

Article 65. Satisfaction of claims not submitted to the court in the defined time period

The claims that are not submitted to the court in the time period defined by this Law shall be satisfied only after the satisfaction of all the claims of the respective group. In the event there is a justification for the claims of the creditors not having been submitted in the time period not by their fault, by the judge's decision they are satisfied according to Article 61 of this law.

Article 66. Reserve funds

By the decision of the judge resources may be reserved the amount not exceeding 5% of the amount subject to distribution against the unsecured claims. From the reserve funds satisfaction may be granted to:

a) claims of creditors, which are disputable and have not yet been approved by the court,
b) amounts subject to payment, according to submitted documents or securities, to those submitting the documents or securities,
c) those creditors included in the list of claims, who have participated in the distribution of resources only partially by the time their status is clarified,
d) funds required for the compensation of the future expenses connected with the maintenance of the property.

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CHAPTER 4-1
ENTRUSTED MANAGEMENT FOR THE BENEFIT OF CREDITORS

Article 66-1. Concept of Entrusted Management for the benefit of creditors

Entrusted management for the benefit of creditors (entrusted management) is a form of entrusted management regulated by the Civil Code and this Law, whose goal is the out-of-court liquidation of the debtor's property and the settlement of its claims to the extent possible while avoiding the costs of in-court proceedings. Activities under entrusted management shall be regulated by the body authorized by the Government of the Republic of Armenia (authorized body).

Article 66-2. Particularities of Entrusted Management

1. The following shall apply to an entrusted management arrangement under this Law:

a) the object of the entrusted management shall be the entire property (including money) and property rights of the debtor,

b) the founder of the entrusted management shall be the debtor,

c) the beneficiaries shall be the secured, unsecured and partially secured creditors of the debtor, and alternatively the shareholders if funds are available after the payment of the unsecured and partially secured creditors according to the priorities established in this Law,

d) the entrusted manager shall be a licensed Administrator not otherwise disqualified from serving as an Administrator of the debtor under this Law,

e) the actions of the entrusted manager shall be limited to the collection and preservation of the debtor's property and its sale or distribution with the objective of maximizing the extent to which unsecured and partially secured creditors of the debtor are repaid.

2. Subsequent to the contract for entrusted management coming into legal effect, all actions of unsecured creditors shall be suspended in accordance with Article 18 of this Law.

3. The transfer of property of the debtor that is subject to pledge or arrest shall not deprive the pledgee of the right to levy execution on this property. The pledgee or judgement creditor, however, may enter into an agreement with the entrusted manager for the sale of the property for the repayment of the obligation.

4. The entrusted manager shall have the rights and duties of an Administrator under this Law, taking into account the non-judicial aspect of these proceedings. The creditors shall have the right to convene a meeting of creditors and to form and act through a Board of creditors pursuant to procedures established under this Law.

Article 66-3. Initiation of Entrusted Management

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1. The debtor may initiate the process of entrusted management by submitting to the authorized body a duly executed contract of entrusted management with a licensed Administrator. The contract shall contain:

a) evidence of the consent to the choice of the Administrator and his level of compensation by at least five of the ten largest unsecured creditors,

b) the transfer of the right of the debtor to dismiss and replace the Administrator to the Creditors' Meeting, or to the Board of Creditors should one be formed.

2. The contract shall come into legal effect upon the second publication in two newspapers each with a print-run of at least 2500 issues. The notice shall indicate the name of the debtor, its location, an announcement of the initiation of entrusted management under this Law, the date and place of an initial creditors' meeting, and the opportunity to review the contract for entrusted management at the offices of the authorized body. Other particularities of the notice shall be established by the authorized body.

3. The entrusted manager shall convene the initial creditors' meeting at the place and time stated in the notice.

Article 66-4. Submission and Analysis of Claims

Within sixty days after the contract for entrusted management comes into legal effect, the creditors shall submit their claims to the entrusted manager. Review and finalization of the list of claims shall be undertaken pursuant to this Law. Disputes over claims shall be resolved by resort to procedures under the Civil Procedure Code in the commercial court of the location of the debtor, in which case the respondent shall be the entrusted manager. Such disputes shall not suspend the liquidation of the debtor's assets and the payment of non-disputed claims provided the entrusted manager sets aside sufficient funds to pay the disputing creditor in case the latter prevails on his claim.

Article 66-5. Regulation of Entrusted Management

The authorized body shall regulate the activities of parties in connection with entrusted management under this Law. The authorized body shall have the following functions:

a) to create model contracts for entrusted management,

b) to accept and make available to the public contacts that have been submitted it for the purpose of initiating entrusted management,

d) to issue, regulations opinion letters or guidelines regarding the interpretation of this Chapter of this Law and regulations established thereunder.

Article 66-6. The Termination of Entrusted Management

1. The contract of entrusted management may terminate only under the following circumstances:

a) the entrusted manager sells or otherwise disposes with the debtor's property, pays off the creditors and shareholders to the extent possible and submits to the authorized body a final

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report on the entrusted management and either distributes such report to the creditors and shareholders or provides them with notice that such report is available for review and copying,

b) in-court bankruptcy proceedings are initiated under this Law.

2. In cases when termination occurs pursuant to sub-item 1 of item 1 of this Article, the entrusted manager shall follow the procedures under Chapter 5 of this Law, in which case the authorized body shall perform the functions of the court.

3. In cases when termination occurs pursuant to sub-item 1 of item 2 of this Article, the court shall issue an order accepting the undisputed resolution of matters that occurred during entrusted management (formation of Board of creditors, acceptance of claims).

CHAPTER 5
CLOSURE OF THE CASE ON INSOLVENCY

Article 67. Final report of the Administrator

1. The Administrator, after having sold the debtor's property and satisfaction of all disputable claims, shall submit to the court a final report with the balance sheet report, the copies of which, with ratified notice, shall be delivered to all the creditors and the debtor. The creditors or the debtor may object to the final report, within 10 days after it has been submitted. No later than within 20 days after the above-mentioned notice has been delivered, the court shall convene a hearing for the discussion and approval of the Administrator's final report.

2. The claims, which are not fixed in the final report, shall not be extinguished.

Article 68. Consequences of the approval of the final report of the Administrator

After the approval by the court of the final report of the Administrator, the latter shall execute the final distribution of the debtor's property. The Administrator shall transfer all the resources, which have not been distributed within 90 days period, to the administration of the court.

Within 1 month after receiving the assets, the court shall transfer them to the debtor by the acceptance-delivery act.

Article 69. Closure of the case on insolvency

1. In the event of the debtor's liquidation the case on insolvency shall be closed, when the court approves the final report of the Administrator and by the proposal of the Administrator makes a decision on the closure of the case on insolvency. Copies of the decision shall be delivered to all the creditors and the debtor.

2. In the case of implementation of the financial recovery program the insolvency case shall be closed after the execution of the approved program, in accordance with the request of the person proposing the program. If the financial recovery program has concluded with the liquidation of the debtor, then it shall be closed in accordance with point 1 of this Article.

Article 70. Closure of the case on insolvency at the proposal of the Administrator

At each stage of the court procedure, the court shall make a decision on the closure of the case on insolvency, at the proposal of the Administrator or the creditors, if it is disclosed, that the debtor's funds are not sufficient to cover the court expenses.

Article 71. Closure of the case on insolvency after the sale of debtor's property

At the request of the Administrator, the court makes a decision on the closure of the case on insolvency, after the sale of the debtor's property and the complete satisfaction of the registered claims.

Article 72. Closure of the case on insolvency due to non-submission of claims

The case shall be closed by the decision of the court, if the creditors do not submit any claims within the time periods defined by this Law.

Article 73. Appeals against the closure of the case on insolvency

Any creditor may appeal to the court within 30 days after the decision is made on the closure of the case on insolvency. The court shall organize a hearing, to consider the application of the creditor during the sitting of the court, within 20 days after the notification of the creditors and the debtor about that.

Article 74. Consequences of from the closure of the case on insolvency

1. A debtor with a status of a legal person shall be considered liquidated and the activities of an individual entrepreneur, or enterprise not having the status of a legal person shall be considered terminated after the moment the closure of the case on insolvency has been registered in the respective state registry according to point 1 of Article 69 and Article 70 of this Law.

2. If the case on insolvency has closed in accordance with point 2 of Article 69 and Articles 71 and 72 of this Law, the debtor shall be considered financially recovered and may continue his activities.

3. After the closure of the case on insolvency, the rights and obligations of the Administrator, specialists hired by him, the debtor and the creditors defined by this Law shall be terminated.

4. From the moment of the closure of the case on insolvency, the court shall announce the debtor as exempted from the payment of all the debts, and any prosecution carried out by the court procedure in relation to the redemption of the debts shall be prohibited except for the cases defined in points 5 and 6 of this Article.

5. If the debtor is an individual entrepreneur or an enterprise not having the status of a legal person, then the mentioned individual entrepreneur or the owner of the enterprise not having the status of a legal person may not be recognized as exempted from:

a) paying of alimonies,
b) claims of the creditors on the property illegally obtained by the debtor,
c) claims of the creditors subject to submission but not submitted by the debtor by the procedure defined by this Law,
d) payments of taxes and other compulsory payments subject to payment from amounts concealed from the tax authorities during the one year preceding the moment the debtor has been recognized as insolvent.

6. If the debtor is a legal person then the debtor's obligations defined under sub-points "b", "c" and "d" of point 5 of this Article may be assigned by the decision of the court on the closure of the case on insolvency to the owners having the power to influence on the decision–making and the members of the governing body, in the event the court hearing reveals the direct liability of those persons for the arising of the mentioned obligations.

CHAPTER 6.
SPECIFIC FEATURES IN RECOGNIZING THE DEBTOR AS INSOLVENT

Article 75. Recognition of the debtors included in the privatization and denationalization program as insolvent

1. The enterprises included in the programs of privatization and denationalization of the state enterprises and incomplete construction sites and still not privatized or not denationalized are recognized as insolvent by the procedure defined by this Article.

2. The enterprises included in the programs of privatization and denationalization of the state enterprises and incomplete construction sites and still not privatized or not denationalized may not submit a statement of claim to the court to have their own insolvency recognized.

3. The statement of claim of the creditor (creditors) on the recognition of the debtor included in the programs of privatization and denationalization of the state enterprises and incomplete construction sites but still not privatized or not denationalized as insolvent is registered by the court by the procedure defined by this Law and it shall notify the Government of the Republic of Armenia about that within one day, attaching the copy of the statement of the claim.

4. The court, in the procedure defined by this Law, shall make a decision on accepting under its proceedings the case on the recognition of the debtor included in the programs of privatization and denationalization of the state enterprises and incomplete construction sites and still not privatized or not denationalized as insolvent on the basis of the statement of claim of the creditor (creditors), if:

a) within 60 days after having received the court notice the Government of the Republic of Armenia does not make any decision on the privatization or denationalization of the respective enterprise in the manner defined by law,
b) 150 days have passed after the moment the decision on the privatization or denationalization of the respective enterprise have been made by the Government of the Republic of Armenia,
c) one month has passed from the moment the enterprise has been privatized or denationalized by international tender as well as the moment the tender has not taken place, in the event a decision has been made by the Government of the Republic of Armenia on the privatization or denationalization of the respective enterprise by international tender, unless an other decision has been made by the Government of the Republic of Armenia during that period on the privatization or denationalization of the respective enterprise.

CHAPTER 7.
FINAL PROVISIONS

Article 76. Courts hearing of the cases on insolvency and appointment of the Administrator

1. The following public courts shall hear the cases on insolvency, until the economic courts provided by the Constitution of Armenia will be established:
a) The people's court of Erebuni district of the City of Yerevan: if the debtor is located (registered) in the territory of one of the Erebuni, Nubarashen districts of Yerevan, or in any of the communities of Ararat, Vayots Dzor or Syunik regions,
b) The people's court of Miasnikian district of the City of Yerevan: if the debtor is located (registered) in the territory of one of the Arabkir, Kentron, Shengavit, Avan, Nor Nork, Nork Marash, Kanaker-Zeitun districts of Yerevan, or in any of the communities of Armavir regions,
c) The people's court of Mashtots district of the City of Yerevan: if the debtor is located (registered) in the territory of one of the Ajapnyak, Davitashen, Malatia-Sebastia districts of Yerevan, or in any of the communities of Aragatsotn region,
d) The people's court of the City of Vanadzor: if the debtor is located (registered) in any of the communities of Lori region,
e) The people's court of Moskovian former administrative region of the City of Giumry: if the debtor is located (registered) in any of the communities of Shirak region,
f) The people's court of former administrative region of Sevan: if the debtor is located (registered) in any of the communities of Gegharkunik or Tavush regions,
g) The people's court of former administrative region of Hrazdan: if the debtor is located (registered) in any of the communities of Kotayk region.

2. By January 1, 1999, as defined by Article 12 of this Law, as Administrators can also be appointed persons that have at least five years of experience in working as a chief accountant during the last ten years, or persons that have higher legal, economic or technical education and have at least three years of experience in working in the governing bodies of legal persons during the last five years.

Article 77. The Law entering into the force

1. This Law shall come into effect from March 1, 1997.

2. From the moment this Law enters into force to recognize the Law of the Republic of Armenia "On Bankruptcy of Enterprises and Entrepreneurs" as invalid, except for the cases defined in point 4 of this Article.

3. From the moment this Law has been promulgated the insolvency (bankruptcy) cases initiated by the procedure defined by the Law of the Republic of Armenia "On Bankruptcy of Enterprises and Entrepreneurs", and under the court proceedings for the enterprises included in the programs of privatization and denationalization and still not privatized or not denationalized are suspended until this Law enters into the force. No new insolvency (bankruptcy) cases may be initiated against the enterprises included in the programs of privatization and denationalization and still not privatized or not denationalized as in the manner defined by Law before this Law enters into force.

4. The cases on insolvency initiated before this Law enters into force in the manner defined and the cases available under the court proceedings continue to be processed in the manner defined by the Law of the Republic of Armenia On Bankruptcy of Enterprises and Entrepreneurs except for the cases provided by point 3 of this Article.

Attachment 1

Grounds for Changes Not Discussed in Previous Memoranda

Article 9(k) and Article 66-1 (regarding entrusted management for the benefit of creditors)

The commentary memoranda raised the possibility of using entrusted management concepts under the Civil Code to clarify the role of the Administrator. The commentary memoranda, however, noted that such an approach would require significant changes in the Law.

Instead, responding to the request of the Ministry of Justice to create a less expensive bankruptcy proceeding, IBTCI is proposing that the Law be amended to allow an out-of-court liquidation process using principles of entrusted management. Rather than being overseen by the court, the process would be overseen by a body authorized by the Government of the Republic of Armenia. This could very well be the Ministry of Justice. The out-of-court proceedings envisioned under these amendments would significantly reduce the cost of liquidating smaller companies.

Article 15. The meeting and Board of the creditors

Changes here created greater clarity on how the board would work, borrowing from principles found in the Law on Joint Stock Companies. The changes also clarify that secured creditors would not vote in a meeting of creditors. This makes the provisions regarding creditor meetings consistent with the provisions on the Board (where only unsecured or partly secured creditors may serve). Note, however, that the secured creditors may vote on the approval of the rehabilitation plan.

Article 53-1. Consequences of failing to meet obligations under the financial recovery program

This section clarifies how to handle a situation where the debtor breaches the obligations in the financial recovery program.

Appendix IX

Appendix IX

THE WORLD BANK

PRINCIPLES AND GUIDELINES FOR

EFFECTIVE INSOLVENCY AND CREDITOR RIGHTS SYSTEMS

April 2001

Effective insolvency and creditor rights systems are an important element of financial system stability. The Bank accordingly has been working with partner organizations to develop principles on insolvency and creditor rights systems. Those principles will be used to guide system reform and benchmarking in developing countries. The *Principles and Guidelines* are a distillation of international best practice on design aspects of these systems, emphasizing contextual, integrated solutions and the policy choices involved in developing those solutions.

While the insolvency principles focus on corporate insolvency, substantial progress has been made in identifying issues relevant to developing principles for bank and systemic insolvency, areas in which the Bank and the Fund, as well as other international organizations, will continue to collaborate in the coming months. These issues are discussed in more detail in the annexes to the paper.

The *Principles and Guidelines* will be used in a series of experimental country assessments in connection with the program to develop *Reports on the Observance of Standards and Codes* (ROSC), using a common template based on the principles. In addition, the Bank is collaborating with UNCITRAL and other institutions to develop a more elaborate set of implementational guidelines based on the principles.

INTRODUCTION AND EXECUTIVE SUMMARY

1. Since the 1997-98 financial crisis in emerging markets, considerable progress has been made in identifying the components of the global financial system and in articulating and applying standards and assessment methodologies for core system elements. The *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* contributes to that effort as an important milestone in promoting international consensus on a uniform framework to assess the effectiveness of insolvency and creditor rights systems, offering guidance to policymakers on the policy choices needed to strengthen them.

2. The principles in *Principles and Guidelines* were developed against the backdrop of earlier and ongoing initiatives to promote cross-border cooperation on multi-jurisdictional insolvencies, modernization of national insolvency and secured transactions laws, and development of principles for out-of-court corporate workouts.[1] The principles draw on common themes and policy choices of those initiatives and on the views of staff, insolvency experts and participants in regional workshops sponsored by the Bank and its partner organizations.[2] The consultative process on the *Principles and Guidelines* has been among the most extensive of its kind, involving more than 70 international experts as members of the Bank's Task Force and working groups, and with regional participation by more than 700 public and private sector specialists from approximately 75 mostly developing countries. The Bank also included papers and consultative drafts on its website to obtain feedback from the international community.[3]

Role of Insolvency and Creditor Rights Systems

3. There are two dimensions to the global financial system. On the one hand, national financial systems operate autonomously and respond to domestic needs. On the other, national systems are tied to and interact daily with the systems of their trading partners. Insolvency and creditor rights systems lie at the juncture of this duality.

4. *The country dimension.* National systems depend on a range of structural, institutional, social and human foundations to make a modern market economy work. There are as many combinations of these variables as there are countries, though regional similarities have created common customs and legal traditions. The principles espoused in the report embody several underlying propositions:
   - *Effective systems respond to national needs and problems.* As such, these systems must be rooted in the country's broader cultural, economic, legal and social context.
   - *Transparency, accountability and predictability are fundamental to sound credit relationships.* Capital and credit, in their myriad forms, are the lifeblood of modern commerce. Investment and availability of credit are predicated on both perceptions and the reality of risks. Competition in credit delivery is handicapped by lack of access to accurate information on credit risk and by unpredictable legal mechanisms for debt enforcement.
   - *Legal and institutional mechanisms must align incentives and disincentives across a broad spectrum of market-based systems—commercial, corporate, financial and social.* This calls for an

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[1] The Addendum to this paper contains a brief survey of the leading initiatives in these fields.

[2] The *Principles and Guidelines* was prepared by Bank staff in collaboration with the African Development Bank, Asian Development Bank, European Bank for Reconstruction and Development, Inter-American Development Bank, International Finance Corporation, International Monetary Fund, Organisation for Economic Co-operation and Development, United Nations Commission on International Trade Law, INSOL International, and International Bar Association (Committee J).

[3] The papers can be accessed in the Best Practice directory on the Global Insolvency Law Database at www.worldbank.org/gild.

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integrated approach to reform, taking into account a wide range of laws and policies in the design of insolvency and creditor rights systems.

5. *The international dimension*. New methods of commerce, communication and technology are constantly reshaping national markets and redefining notions of property rights. Businesses routinely transcend national boundaries and have access to new types of credit. Credit and investment risks are measured by complex formulas, and capital moves from one market to the next at the tap of a computer key. Capital flows are driven by public perceptions and investor confidence in local markets. Effective insolvency and creditor rights systems play an important role in creating and maintaining the confidence of both domestic and foreign investors.

The Principles

6. The *Principles and Guidelines* emphasize contextual, integrated solutions and the policy choices involved in developing those solutions.[4] The principles are a distillation of international best practice in the design of insolvency and creditor rights systems. Adapting international best practices to the realities of developing countries, however, requires an understanding of the market environments in which these systems operate. The challenges include weak or unclear social protection mechanisms, weak financial institutions and capital markets, ineffective corporate governance and uncompetitive businesses, and ineffective laws and institutions. These obstacles pose enormous challenges to the adoption of systems that address the needs of developing countries while keeping pace with global trends and international best practices. The application of the principles in this paper at the country level will be influenced by domestic policy choices and by the comparative strengths (or weaknesses) of laws and institutions.

7. The *Principles and Guidelines* highlights the relationship between the cost and flow of credit (including secured credit) and the laws and institutions that recognize and enforce credit agreements (sections 1 and 2). It also outlines key features and policy choices relating to the legal framework for corporate insolvency and the informal framework for consensual debt workouts (section 3), which must be implemented within sound institutional and regulatory frameworks (section 4). The principles have broader application beyond creditor rights and corporate insolvency regimes, as well. The ability of financial institutions to adopt effective credit practices to resolve or liquidate non-performing loans depends on having reliable and predictable legal mechanisms that provide a means for more accurately pricing recovery and enforcement costs. Where non-performing assets or other factors jeopardize the viability of a bank, or where economic conditions create systemic crises, these conditions raise issues that deserve special consideration. Annexes I and II to the *Principles and Guidelines* contain a discussion of issues relevant to bank exit and restructuring strategies and management of systemic financial crises, areas in which the Bank will continue to collaborate with the Fund and the international community to develop principles.

Following is brief summary of the key elements of the *Principles and Guidelines*:

8. *Role of enforcement systems*. A modern, credit-based economy requires predictable, transparent and affordable enforcement of both unsecured and secured credit claims by efficient mechanisms outside of insolvency, as well as a sound insolvency system. These systems must be designed to work in harmony. Commerce is a system of commercial relationships predicated on express or implied contractual agreements between an enterprise and a wide range of creditors and constituencies.

[4] Effective systems rest on details as well as broad principles. The Bank is preparing a companion technical paper with more detailed guidelines on aspects of this paper. Other organizations, specifically UNCITRAL (in collaboration with INSOL International and Committee J of the International Bar Association), are also developing guidelines to help legislators design effective insolvency laws.

Although commercial transactions have become increasingly complex as more sophisticated techniques are developed for pricing and managing risks, the basic rights governing these relationships and the procedures for enforcing these rights have not changed much. These rights enable parties to rely on contractual agreements, fostering confidence that fuels investment, lending and commerce. Conversely, uncertainty about the enforceability of contractual rights increases the cost of credit to compensate for the increased risk of nonperformance or, in severe cases, leads to credit tightening.

9. *Legal framework for creditor rights.* A regularized system of credit should be supported by mechanisms that provide efficient, transparent and reliable methods for recovering debt, including seizure and sale of immovable and movable assets and sale or collection of intangible assets, such as debt owed to the debtor by third parties. An efficient system for enforcing debt claims is crucial to a functioning credit system, especially for unsecured credit. A creditor's ability to take possession of a debtor's property and to sell it to satisfy the debt is the simplest, most effective means of ensuring prompt payment. It is far more effective than the threat of an insolvency proceeding, which often requires a level of proof and a prospect of procedural delay that in all but extreme cases make it not credible to debtors as leverage for payment.

10. While much credit is unsecured and requires an effective enforcement system, an effective system for secured rights is especially important in developing countries. Secured credit plays an important role in industrial countries, notwithstanding the range of sources and types of financing available through both debt and equity markets. In some cases equity markets can provide cheaper and more attractive financing. But developing countries offer fewer options, and equity markets are typically less mature than debt markets. As a result most financing is in the form of debt. In markets with fewer options and higher risks, lenders routinely require security to reduce the risk of nonperformance and insolvency.

11. *Legal framework for secured lending.* The legal framework should provide for the creation, recognition and enforcement of security interests in all types of assets—movable and immovable, tangible and intangible, including inventories, receivables, proceeds and future property, and on a global basis, including both possessory and non-possessory interests. The law should encompass any or all of a debtor's obligations to a creditor, present or future and between all types of persons. In addition, it should provide for effective notice and registration rules to be adapted to all types of property, and clear rules of priority on competing claims or interests in the same assets.

12. *Legal framework for corporate insolvency.* Though approaches vary, effective insolvency systems should aim to:
   - Integrate with a country's broader legal and commercial systems.
   - Maximize the value of a firm's assets by providing an option to reorganize.
   - Strike a careful balance between liquidation and reorganization.
   - Provide for equitable treatment of similarly situated creditors, including similarly situated foreign and domestic creditors.
   - Provide for timely, efficient and impartial resolution of insolvencies.
   - Prevent the premature dismemberment of the debtor's assets by individual creditors.
   - Provide a transparent procedure that contains incentives for gathering and dispensing information.
   - Recognize existing creditor rights and respect the priority of claims with a predictable and established process.
   - Establish a framework for cross-border insolvencies, with recognition of foreign proceedings.

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13. Where an enterprise is not viable, the main thrust of the law should be swift and efficient liquidation to maximize recoveries for the benefit of creditors. Liquidations can include the preservation and sale of the business, as distinct from the legal entity. On the other hand, where an enterprise is viable, meaning it can be rehabilitated, its assets are often more valuable if retained in a rehabilitated business than if sold in a liquidation. The rescue of a business preserves jobs, provides creditors with a greater return based on higher going concern values of the enterprise, potentially produces a return for owners and obtains for the country the fruits of the rehabilitated enterprise. The rescue of a business should be promoted through formal and informal procedures. Rehabilitation should permit quick and easy access to the process, protect all those involved, permit the negotiation of a commercial plan, enable a majority of creditors in favor of a plan or other course of action to bind all other creditors (subject to appropriate protections) and provide for supervision to ensure that the process is not subject to abuse. Modern rescue procedures typically address a wide range of commercial expectations in dynamic markets. Though such laws may not be susceptible to precise formulas, modern systems generally rely on design features to achieve the objectives outlined above.

14. *Framework for informal corporate workouts.* Corporate workouts should be supported by an environment that encourages participants to restore an enterprise to financial viability. Informal workouts are negotiated in the "shadow of the law." Accordingly, the enabling environment must include clear laws and procedures that require disclosure of or access to timely and accurate financial information on the distressed enterprise; encourage lending to, investment in or recapitalization of viable distressed enterprises; support a broad range of restructuring activities, such as debt write-offs, reschedulings, restructurings and debt-equity conversions; and provide favorable or neutral tax treatment for restructurings.

15. A country's financial sector (possibly with help from the central bank or finance ministry) should promote an informal out-of-court process for dealing with cases of corporate financial difficulty in which banks and other financial institutions have a significant exposure—especially in markets where enterprise insolvency is systemic. An informal process is far more likely to be sustained where there are adequate creditor remedies and insolvency laws.

16. *Implementation of the insolvency system.* Strong institutions and regulations are crucial to an effective insolvency system. The insolvency 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. A number of fundamental principles influence the design and maintenance of the institutions and participants with authority over insolvency proceedings.

17. *Ongoing efforts.* Substantial progress has been made in identifying links between the corporate insolvency and creditor rights systems and bank insolvency (and restructuring) and financial crisis, and the policy issues affecting the treatment of the later. Over the coming months the Bank in collaboration with the Fund and others will engage the international community in a dialogue on principles pertaining to bank and systemic insolvency. In addition, the Bank will continue to work with its partner institutions, including UNCITRAL, on the implementation of more technical guidelines based on the principles.

18. *Next Steps.* The Bank will carry out a series of pilot country assessments in FY2001-02 in connection with the program to develop *Reports on the Observance of Standards and Codes* (ROSC), using a common template based on the principles. The criteria for the selection of countries will include regional and legal diversity and levels of financial system development. The assessments would be carried out by Bank staff supported by experts from other institutions. The assessments are expected

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to provide valuable inputs to future *Financial Sector Assessments, Country Assistance Strategies* and other Bank economic and sector work, and to eventually help governments prioritize reform needs and build capacity. The Bank will also continue to collaborate with the International Monetary fund and other organizations on the future development of complementary principles related to bank insolvency and restructuring and systemic insolvency.

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LEGAL FRAMEWORK FOR CREDITOR RIGHTS		
Principle 1	**Compatible Enforcement Systems** *A modern credit-based economy requires predictable, transparent and affordable enforcement of both unsecured and secured credit claims by efficient mechanisms outside of insolvency, as well as a sound insolvency system. These systems must be designed to work in harmony.*	
Principle 2	**Enforcement of Unsecured Rights** *A regularized system of credit should be supported by mechanisms that provide efficient, transparent, reliable and predictable methods for recovering debt, including seizure and sale of immovable and movable assets and sale or collection of intangible assets such as debts owed to the debtor by third parties.*	
Principle 3	**Security Interest Legislation** *The legal framework should provide for the creation, recognition, and enforcement of security interests in movable and immovable (real) property, arising by agreement or operation of law. The law should provide for the following features:* ▪ *Security interests in all types of assets, movable and immovable, tangible and intangible, including inventory, receivables, and proceeds; future or after-acquired property, and on a global basis; and based on both possessory and non-possessory interests;* ▪ *Security interests related to any or all of a debtor's obligations to a creditor, present or future, and between all types of persons;* ▪ *Methods of notice that will sufficiently publicize the existence of security interests to creditors, purchasers, and the public generally at the lowest possible cost;* ▪ *Clear rules of priority governing competing claims or interests in the same assets, eliminating or reducing priorities over security interests as much as possible.*	
Principle 4	**Recording and Registration of Secured Rights** *There should be an efficient and cost-effective means of publicizing secured interests in movable and immovable assets, with registration being the principal and strongly preferred method. Access to the registry should be inexpensive and open to all for both recording and search.*	
Principle 5	**Enforcement of Secured Rights** *Enforcement systems should provide efficient, inexpensive, transparent and predictable methods for enforcing a security interest in property. Enforcement procedures should provide for prompt realization of the rights obtained in secured assets, ensuring the maximum possible recovery of asset values based on market values. Both nonjudicial and judicial enforcement methods should be considered*	
LEGAL FRAMEWORK FOR CORPORATE INSOLVENCY		
Principle 6	**Key Objectives and Policies** *Though country approaches vary, effective insolvency systems should aim to:* • *Integrate with a country's broader legal and commercial systems.* • *Maximize the value of a firm's assets by providing an option to reorganize.* • *Strike a careful balance between liquidation and reorganization.* • *Provide for equitable treatment of similarly situated creditors, including similarly situated foreign and domestic creditors.* • *Provide for timely, efficient and impartial resolution of insolvencies.* • *Prevent the premature dismemberment of a debtor's assets by individual creditors seeking quick judgments.* • *Provide a transparent procedure that contains incentives for gathering and dispensing information.* • *Recognize existing creditor rights and respect the priority of claims with a predictable and established process.* • *Establish a framework for cross-border insolvencies, with recognition of foreign proceedings.*	

Principle 7	**Director and Officer Liability** *Director and officer liability for decisions detrimental to creditors made when an enterprise is insolvent should promote responsible corporate behavior while fostering reasonable risk taking. At a minimum, standards should address conduct based on knowledge of or reckless disregard for the adverse consequences to creditors.*
Principle 8	**Liquidation and Rehabilitation** *An insolvency law should provide both for efficient liquidation of nonviable businesses and those where liquidation is likely to produce a greater return to creditors, and for rehabilitation of viable businesses. Where circumstances justify it, the system should allow for easy conversion of proceedings from one procedure to another.*
Principle 9	**Commencement: Applicability and Accessibility** *A. The insolvency process should apply to all enterprises or corporate entities except financial institutions and insurance corporations, which should be dealt with through a separate law or through special provisions in the insolvency law. State-owned corporations should be subject to the same insolvency law as private corporations.* *B. Debtors should have easy access to the insolvency system upon showing proof of basic criteria (insolvency or financial difficulty). A declaration to that effect may be provided by the debtor through its board of directors or management. Creditor access should be conditioned on showing proof of insolvency by presumption where there is clear evidence that the debtor failed to pay a matured debt (perhaps of a minimum amount).* *C. The preferred test for insolvency should be the debtor's inability to pay debts as they come due—known as the liquidity test. A balance sheet test may be used as an alternative secondary test, but should not replace the liquidity test. The filing of an application to commence a proceeding should automatically prohibit the debtor's transfer, sale or disposition of assets or parts of the business without court approval, except to the extent necessary to operate the business.*
Principle 10	**Commencement: Moratoriums and Suspension of Proceedings** *A. The commencement of bankruptcy should prohibit the unauthorized disposition of the debtor's assets and suspend actions by creditors to enforce their rights or remedies against the debtor or the debtor's assets. The injunctive relief (stay) should be as wide and all embracing as possible, extending to an interest in property used, occupied or in the possession of the debtor.* *B. To maximize the value of asset recoveries, a stay on enforcement actions by secured creditors should be imposed for a limited period in a liquidation proceeding to enable higher recovery of assets by sale of the entire business or its productive units, and in a rehabilitation proceeding where the collateral is needed for the rehabilitation.*
Principle 11	**Governance: Management** *A. In liquidation proceedings, management should be replaced by a qualified court-appointed official (administrator) with broad authority to administer the estate in the interest of creditors. Control of the estate should be surrendered immediately to the administrator except where management has been authorized to retain control over the company, in which case the law should impose the same duties on management as on the administrator. In creditor-initiated filings, where circumstances warrant, an interim administrator with reduced duties should be appointed to monitor the business to ensure that creditor interests are protected.* *B. There are two preferred approaches in a rehabilitation proceeding: exclusive control of the proceeding by an independent administrator or supervision of management by an impartial and independent administrator or supervisor. Under the second option complete power should be shifted to the administrator if management proves incompetent or negligent or has engaged in fraud or other misbehavior. Similarly, independent administrators or supervisors should be held to the same standard of accountability to creditors and the court and should be subject to removal for incompetence, negligence, fraud or other wrongful conduct.*

Principle 12	**Governance: Creditors and the Creditors' Committee** *Creditor interests should be safeguarded by establishing a creditors committee that enables creditors to actively participate in the insolvency process and that allows the committee to monitor the process to ensure fairness and integrity. The committee should be consulted on non-routine matters in the case and have the ability to be heard on key decisions in the proceedings (such as matters involving dispositions of assets outside the normal course of business). The committee should serve as a conduit for processing and distributing relevant information to other creditors and for organizing creditors to decide on critical issues. The law should provide for such things as a general creditors assembly for major decisions, to appoint the creditors committee and to determine the committee's membership, quorum and voting rules, powers and the conduct of meetings. In rehabilitation proceedings, the creditors should be entitled to select an independent administrator or supervisor of their choice, provided the person meets the qualifications for serving in this capacity in the specific case.*
Principle 13	**Administration: Collection, Preservation, Disposition of Property** *The law should provide for the collection, preservation and disposition of all property belonging to the debtor, including property obtained after the commencement of the case. Immediate steps should be taken or allowed to preserve and protect the debtor's assets and business. The law should provide a flexible and transparent system for disposing of assets efficiently and at maximum values. Where necessary, the law should allow for sales free and clear of security interests, charges or other encumbrances, subject to preserving the priority of interests in the proceeds from the assets disposed.*
Principle 14	**Administration: Treatment of Contractual Obligations** *The law should allow for interference with contractual obligations that are not fully performed to the extent necessary to achieve the objectives of the insolvency process, whether to enforce, cancel or assign contracts, except where there is a compelling commercial, public or social interest in upholding the contractual rights of the counter-party to the contract (as with swap agreements).*
Principle 15	**Administration: Fraudulent or Preferential Transactions** *The law should provide for the avoidance or cancellation of pre-bankruptcy fraudulent and preferential transactions completed when the enterprise was insolvent or that resulted in its insolvency. The suspect period prior to bankruptcy, during which payments are presumed to be preferential and may be set aside, should normally be short to avoid disrupting normal commercial and credit relations. The suspect period may be longer in the case of gifts or where the person receiving the transfer is closely related to the debtor or its owners.*

Principle 16	**Claims Resolution: Treatment of Stakeholder Rights and Priorities** *A. The rights and priorities of creditors established prior to insolvency under commercial laws should be upheld in an insolvency case to preserve the legitimate expectations of creditors and encourage greater predictability in commercial relationships. Deviations from this general rule should occur only where necessary to promote other compelling policies, such as the policy supporting rehabilitation or to maximize the estate's value. Rules of priority should support incentives for creditors to manage credit efficiently.* *B. The bankruptcy law should recognize the priority of secured creditors in their collateral. Where the rights of secured creditors are impaired to promote a legitimate bankruptcy policy, the interests of these creditors in their collateral should be protected to avoid a loss or deterioration in the economic value of their interest at the commencement of the case. Distributions to secured creditors from the proceeds of their collateral should be made as promptly as possible after realization of proceeds from the sale. In cases where the stay applies to secured creditors, it should be of limited specified duration, strike a proper balance between creditor protection and insolvency objectives, and provide for the possibility of orders being made on the application of affected creditors or other persons for relief from the stay.* *C. Following distributions to secured creditors and payment of claims related to costs and expenses of administration, proceeds available for distribution should be distributed pari passu to remaining creditors unless there are compelling reasons to justify giving preferential status to a particular debt. Public interests generally should not be given precedence over private rights. The number of priority classes should be kept to a minimum.*
	FEATURES PERTAINING TO CORPORATE REHABILITATION
Principle 17	**Design Features of Rehabilitation Statutes** *To be commercially and economically effective, the law should establish rehabilitation procedures that permit quick and easy access to the process, provide sufficient protection for all those involved in the process, provide a structure that permits the negotiation of a commercial plan, enable a majority of creditors in favor of a plan or other course of action to bind all other creditors by the democratic exercise of voting rights (subject to appropriate minority protections and the protection of class rights) and provide for judicial or other supervision to ensure that the process is not subject to manipulation or abuse.*
Principle 18	**Administration: Stabilizing and Sustaining Business Operations** *The law should provide for a commercially sound form of priority funding for the ongoing and urgent business needs of a debtor during the rescue process, subject to appropriate safeguards.*
Principle 19	**Information: Access and Disclosure** *The law should require the provision of relevant information on the debtor. It should also provide for independent comment on and analysis of that information. Directors of a debtor corporation should be required to attend meetings of creditors. Provision should be made for the possible examination of directors and other persons with knowledge of the debtor's affairs, who may be compelled to give information to the court and administrator..*
Principle 20	**Plan: Formulation, Consideration and Voting** *The law should not prescribe the nature of a plan except in terms of fundamental requirements and to prevent commercial abuse. The law may provide for classes of creditors for voting purposes. Voting rights should be determined by amount of debt. An appropriate majority of creditors should be required to approve a plan. Special provision should be made to limit the voting rights of insiders. The effect of a majority vote should be to bind all creditors.*
Principle 21	**Plan: Approval of Plan** *The law should establish clear criteria for plan approval based on fairness to similar creditors, recognition of relative priorities and majority acceptance. The law should also provide for approval over the rejection of minority creditors if the plan complies with rules of fairness and offers the opposing creditors or classes an amount equal to or greater than would be received under a liquidation proceeding. Some provision for possible adjournment of a plan decision meeting should be made, but under strict time limits. If a plan is not approved, the debtor should automatically be liquidated.*

Principle 22	**Plan: Implementation and Amendment** *The law should provide a means for monitoring effective implementation of the plan, requiring the debtor to make periodic reports to the court on the status of implementation and progress during the plan period. A plan should be capable of amendment (by vote of the creditors) if it is in the interests of the creditors. The law should provide for the possible termination of a plan and for the debtor to be liquidated.*
Principle 23	**Discharge and Binding Effects** *To ensure that the rehabilitated enterprise has the best chance of succeeding, the law should provide for a discharge or alteration of debts and claims that have been discharged or otherwise altered under the plan. Where approval of the plan has been procured by fraud, the plan should be subject to challenge, reconsidered or set aside.*
Principle 24	**International Considerations** *Insolvency proceedings may have international aspects, and insolvency laws should provide for rules of jurisdiction, recognition of foreign judgments, cooperation and assistance among courts in different countries, and choice of law.*
	INFORMAL CORPORATE WORKOUTS AND RESTRUCTURINGS
Principle 25	**Enabling Legislative Framework** *Corporate workouts and restructurings should be supported by an enabling environment that encourages participants to engage in consensual arrangements designed to restore an enterprise to financial viability. An enabling environment includes laws and procedures that require disclosure of or ensure access to timely, reliable and accurate financial information on the distressed enterprise; encourage lending to, investment in or recapitalization of viable financially distressed enterprises; support a broad range of restructuring activities, such as debt writeoffs, reschedulings, restructurings and debt- equity conversions; and provide favorable or neutral tax treatment for restructurings.*
Principle 26	**Informal Workout Procedures** *A country's financial sector (possibly with the informal endorsement and assistance of the central bank or finance ministry) should promote the development of a code of conduct on an informal out-of-court process for dealing with cases of corporate financial difficulty in which banks and other financial institutions have a significant exposure—especially in markets where enterprise insolvency has reached systemic levels. An informal process is far more likely to be sustained where there are adequate creditor remedy and insolvency laws. The informal process may produce a formal rescue, which should be able to quickly process a packaged plan produced by the informal process. The formal process may work better if it enables creditors and debtors to use informal techniques.*
	IMPLEMENTATION OF THE INSOLVENCY SYSTEM
Principle 27	**Role of Courts** *Bankruptcy cases should be overseen and disposed of by an independent court or competent authority and assigned, where practical, to judges with specialized bankruptcy expertise. Significant benefits can be gained by creating specialized bankruptcy courts.* *The law should provide for a court or other tribunal to have a general, non-intrusive, supervisory role in the rehabilitation process. The court/tribunal or regulatory authority should be obliged to accept the decision reached by the creditors that a plan be approved or that the debtor be liquidated.*
Principle 28	**Performance Standards of the Court, Qualification and Training of Judges** *Standards should be adopted to measure the competence, performance and services of a bankruptcy court. These standards should serve as a basis for evaluating and improving courts. They should be enforced by adequate qualification criteria as well as training and continuing education for judges.*

Principle 29	**Court Organization** *The court should be organized so that all interested parties—including the administrator, the debtor and all creditors—are dealt with fairly, objectively and transparently. To the extent possible, publicly available court operating rules, case practice and case management regulations should govern the court and other participants in the process. The court's internal operations should allocate responsibility and authority to maximize resource use. To the degree feasible the court should institutionalize, streamline and standardize court practices and procedures.*
Principle 30	**Transparency and Accountability** *An insolvency systems should be based on transparency and accountability. Rules should ensure ready access to court records, court hearings, debtor and financial data and other public information.*
Principle 31	**Judicial Decision making and Enforcement** *Judicial decision making should encourage consensual resolution among parties where possible and otherwise undertake timely adjudication of issues with a view to reinforcing predictability in the system through consistent application of the law. The court must have clear authority and effective methods of enforcing its judgments.*
Principle 32	**Integrity of the Court** *Court operations and decisions should be based on firm rules and regulations to avoid corruption and undue influence. The court must be free of conflicts of interest, bias and lapses in judicial ethics, objectivity and impartiality.*
Principle 33	**Integrity of Participants** *Persons involved in a bankruptcy proceeding must be subject to rules and court orders designed to prevent fraud, other illegal activity or abuse of the bankruptcy system. In addition, the bankruptcy court must be vested with appropriate powers to deal with illegal activity or abusive conduct that does not constitute criminal activity.*
Principle 34	**Role of Regulatory or Supervisory Bodies** *The body or bodies responsible for regulating or supervising insolvency administrators should be independent of individual administrators and should set standards that reflect the requirements of the legislation and public expectations of fairness, impartiality, transparency and accountability.*
Principle 35	**Competence and Integrity of Insolvency Administrators** *Insolvency administrators should be competent to exercise the powers given to them and should act with integrity, impartiality and independence.*

Appendix X

Enterprise Privatization in the Republic Of Armenia
Project Funded by the United States Agency for International Development

Request for Translation

Memorandum (please put on official IBTCI letterhead)

To:	Mr. Tigran Moukuchyan, Deputy Minister of Justice
From:	Daniel Fitzpatrick, Bankruptcy and Privatization Advisor
cc:	Alan Gobashian, Daniel Bosco
Subject:	Training of Administrators
Date:	March 14, 2001

Although the training program for bankruptcy administrators under the Ministry of Justice (MOJ) has already commenced, I am submitting below some general comments on the curriculum. This memorandum will further discuss some supplementary training (to be offered through USAID) that could possibly be built into the program.

Comments on the Curriculum:

As I understand the circumstances, the MOJ is providing training roughly according to the attached program. The English translation of the attached program, provided courtesy of the USAID/Chemonics Commercial Law Project, is the basis for these comments.

General structure: The layout of the program suggests that discussions concerning bankruptcy precede the review of basic company management. To the extent that this is possible, it might make more sense to first build a foundation with discussions of company management techniques and lay upon this the particular management challenges a manager (administrator) faces.

Greater emphasis on the interaction with the tax authorities: The tax authorities are often times the largest creditor of a company in bankruptcy. They also have, in many ways, a different set of operating principles than a private creditor. Particular attention should be placed on how to relate to this creditor. It would be helpful if officials from the Ministry of State Revenue addressed the administrators sometime during the training.

Emphasis on the rights of secured creditors: The Armenian Law on Bankruptcy clearly establishes particular rights for secured creditors. It also presents numerous challenges for administrators, for instance, determining when a secured creditor is receiving adequate protection. On this issue, it would be helpful for an official from a bank that is providing secured lending to address the administrators.

Voting procedures: The Law on Bankruptcy in this regard has a number of provisions that could generate problems for an administrator. Particular emphasis should be placed on the practicalities of voting procedures. It would be particularly helpful to have the administrators go through a mock creditors meeting to vote on a rehabilitation plan.

Communications with creditors: A bankruptcy case poses numerous challenges in communicating to disparate creditors both inside and outside the country. Fortunately, new technologies, such as the Internet, is making communication easier. Current and future opportunities with communication methods should be explored.

Exercising the right to reverse fraudulent transactions: The provisions under Article 35 of the Law on Bankruptcy ("Transfer to Third Parties and Alienation of Property") are a powerful remedy for increasing

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returns for creditors. Nonetheless, they are difficult to enforce. These provisions should be closely reviewed and practical applications should be discussed.

Dealing with companies that are administratively insolvent: The administrators are likely to be asked to work on companies whose assets are not likely to be sufficient to cover the cost of a typical bankruptcy proceeding. Practical solutions to this problem should be discussed.

Obtaining working capital: Often, the administrator will be challenged to raise funds necessary to keep a company running or to preserve the value of property. The various techniques for doing this should be discussed.

Additional Training Opportunities that could be provided by USAID:

The following are initial suggestions on how USAID might be able to provide training that would supplement or be built into the current curriculum.

Regional experiences: Several countries, such as Russia, Ukraine, Kazakhstan, and Romania have been active in bankruptcy for the past several years. One Friday-Saturday set of training sessions should be set aside for a series of reports from bankruptcy experts in these countries. Given the common problems faced in these countries, it should provide numerous practical solutions. If the Ministry of Justice believes this would be a positive addition to the curriculum, USAID can likely provide assistance in bringing experts from these countries for such training. *USAID could likley provide such training in late May or early June.*

Presentation to trainers on universal bankruptcy principles: Although every country's bankruptcy regime is different, there are numerous universal principles on which most bankruptcy cases operate. I recently provided an in-depth presentation of such principles to the Armenian staff of the IFC. It was well received. I can do the same with the trainers, or alternatively with the administrators. *I could provide this lecture in late April.*

Presentation on nuances with the Law on Bankruptcy: The Law on Bankruptcy will be undergoing close scrutiny over the next several months as potential amendments to it are discussed. Some of these discussions will reveal temporary solutions to the imperfections in the Law. They should be shared with the administrators. I or one of the Armenian attorneys on the Chemonics or IBTCI staff could deliver this lecture. *This could be done as early as late April.*

Development of a liquidation analysis: A liquidation analysis projects how much each creditor class is likely to be paid under various scenarios. It is extremely helpful in encouraging creditors to take realistic positions on their demands. The IBTCI project could make a presentation on liquidation analysis, using Microsoft Excel spreadsheets. *This could be done as early as late April.*