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**Georgian Insolvency Law is on the Move**

Nana Amisulashvili, Chair, BRIPA

(Business Rehabilitation and Insolvency Practitioners Association), Georgia <amisulashvili@vbat.ge>.

*Introduction*

Georgia’s insolvency system is facing significant changes today. The new draft law is ready to be enforced and will completely change the system. The current Insolvency Law 2007 is appreciated as primarily oriented towards a rapid liquidation of insolvent corporate entities and private entrepreneurs’ businesses with the subsequent distribution of remaining assets amongst the creditors. The number of insolvency cases dealt with by the local courts is fairly limited, most probably due to insufficient assets in the insolvent entities to cover the costs of the insolvency procedure. The law leaves many aspects of insolvency procedures either unclear or unregulated.

*The Need for Reform*

In 2016, an Insolvency Reform Sustainment Plan (hereinafter – the “Plan”) was created within the framework of the project – Insolvency Reform Advocacy Campaign implemented by Association of Law Firms of Georgia (ALFG) and supported by United States Agency of International Development (USAID) project Governing for Growth (G4G). The objective of the campaign was to raise awareness about the existing shortcomings of the current insolvency system and necessity of the reform, mobilize representatives of private sector and ensure their involvement in the private-public discussions.

The Insolvency Reform Sustainment Plan provided an overview of the most significant problems and provided recommendations, principles and approaches to be taken into consideration while carrying out the reform in the respective areas. The most significant findings identified during the Campaign were as follows:

1. **Commencement of Insolvency Proceedings**

There are several material flaws in the current legislative regulation on the commencement of proceedings:

1. The creditors face unreasonably high standards for commencement of proceedings, which makes it difficult to start the process and reduces the chances for rehabilitation of the debtor and satisfaction of creditors.
2. The State, acting as a creditor, enjoys comparably low standards to be satisfied for opening the proceedings, which is unfair towards other creditors.
3. According to the current law, there is a transitional period before commencement of rehabilitation/reorganization or bankruptcy/liquidation, which significantly impedes the process, weakens business management and jeopardizes asset value. This has an inevitable reflection on creditors’ interests and the possibility of rehabilitating the debtor.

**2. Concept of Security (Collateral) within the Insolvency Regime**

Based on the existing law, collateral such as mortgage and pledge are in fact negated because all secured creditors, notwithstanding the ranking of their security right, are placed within the same rank horizontally and the claim covers the entire estate (not only the objects of security, but also other assets of the debtor). On the one hand, such regulation damages the interests of the banks that routinely use the mechanism of collateral for financing their clients and therefore, this statutory rule may result in increases in the price of bank products. On the other hand, this regulation hinders execution of subordination agreements between banks and investors provided that existence of subordination arrangements does not influence statutorily pre-determined ranking.

**3. Realization of Insolvency Estate**

Two basic problems were identified in this regard:

(a) the law does not provide for the rules for realization of products that have short shelf lives, are easily perishable or need to be sold immediately for any other objective reason; and

(b) realization of the assets is feasible only through public auction, which, in certain scenarios, diminishes the recoverable amount and damages the interests of creditors.

**4. Role of the Court**

According to the existing law, the court has a number of formal duties, which do not reflect any element of dispute resolution: to name a few, organization and chairing creditors’ meetings, recognition of creditors’ claims, maintaining creditors registry and granting consents to the trustee on entering certain transactions. Such duties, on the one hand, burden the court with extra routine and, on the other hand, can delay proceedings.

**5. Trustee**

Based on the law as it stands, an administrative body: the National Bureau of Enforcement is appointed as a Trustee during the transitional period and that state body participates in the business management to the extent that its consent is required for concluding any contract and managing the business, which may be nothing more than entering into a variety of contracts on a daily basis. Concluding contracts, nonetheless, requires some familiarity with the business and experience in business management. Also under the statute, the Enforcement Bureau is empowered to manage business, which is an entirely incompatible with its function as an agency enforcing court orders and judgments.

**6. Approval of the Rehabilitation Plan**

Only secured creditors can approve the rehabilitation plan with 100% of votes. This regulation is unfair towards the remaining creditors, although the consequences of rehabilitation primarily concern unsecured creditors to the degree that secured creditors can in any case be satisfied from the subject of security.

*The New Draft Law*

The abovementioned defects in the law make insolvency proceedings expensive and unreasonably prolonged, consequently low levels of use have been observed. In 2016, on the initiative of the Ministry of Justice of Georgia, a working group was set up to respond to all the challenges of the insolvency system and to develop a completely new business-oriented law. The new draft law offers many incentives for business with flexible and fair mechanisms meant to encourage early application. It also contains several truly bold new approaches:

**1. Commencement**

Significant changes have been made regarding the commencement of insolvency proceedings. Due to the fact that the transitional period (trusteeship) appeared to be an obstruction, the new draft law will make rehabilitation/reorganization or bankruptcy/liquidation accessible directly without any such period. Also, procedures for opening the proceedings have become simpler and more easily accessible to creditors.

**2. Moratorium**

While the current law imposes a moratorium that cannot be removed or changed until the insolvency proceedings are over, the proposed draft allows for flexibility in the moratorium and thus ensures the necessary protection of creditors’ rights across all insolvency proceedings by clarifying the position of secured creditors with respect to their right to opt out of the moratorium under recognized circumstances and ensuring that the “best interests of creditors” test is met for each individual creditor dissenting from the restructuring plan.

**3. Secured Creditors’ Rights**

The mechanism of collateral in the insolvency setting has been designed in such a way that will work in compliance with the principles and regulations of the Civil Code, meaning that the content of the right will not be materially altered due to the opening of the insolvency proceedings. Thus, the rights of secured creditors will be protected. In parallel, insolvency assets have been divided in two, forming an independent pool for unsecured creditors from assets that are not the object of security.

**4. Approval of the Rehabilitation Plan**

The issue of approval of the rehabilitation plan is directly related to the problem existing in relation to preserving security in the insolvency regime. That is why, in addition to involving unsecured creditors in the process of approving the rehabilitation plan, the rights of secured creditors towards the object of security are strengthened and protected in the draft. Voting rights are determined as per debt (claim) value. All unsecured creditors will have the right to vote. Secured creditors shall not have voting rights, except where, according to the rehabilitation plan, conditions of the agreement between debtor and secured creditor are to be changed. Nonetheless, secured and unsecured creditors are to vote on the rehabilitation plan separately. Also, a new cram down mechanism has been inserted in the draft, which is a novelty for the Georgian insolvency system. Moreover, the court shall approve the rehabilitation plan, considering different circumstances and also the fact of whether compliance with the legal procedure for calling the creditors’ meeting has taken place.

**5. Deadline for and Effect of Approval of the Rehabilitation Plan**

The draft law strictly provides a maximum 12-month period for approving the rehabilitation plan. The automatic liquidation procedure will be initiated if the set deadline has been missed. This mechanism is envisagedto motivate every participant and especially those in charge of rehabilitation plans to act effectively. After the rehabilitation plan is approved, official insolvency proceedings are closed. Under the current law, the formal insolvency procedure covers not only improvement of the plan, but the whole period of implementation.

**6. Realization of Assets**

The draft law provides a variety of mechanisms for the realization of assets. In parallel, it contains safeguards for ensuring that the right to choose will not be abused by the process.

**7. The Role of Courts**

Major policy changes were made in respect of the role of courts. They have been released from duties that were rather formal (chairing the creditors meetings) and at the same time have been granted the right to make some essential decisions (e.g. in relation to the cramdown provision, a court can ignore objections of the creditors and approve a reorganization plan if it is “fair and equitable”).

**8. Trustees**

A very dynamic political decision was made regarding the management of insolvent businesses. According to the draft law, this will be entrusted to an experienced business manager (an insolvency practitioner) from the outset. As a result of this approach in the draft law, the first professional body of insolvency practitioners was founded by leading experts in this field. The Business Rehabilitation and Insolvency Practitioners Association’s (BRIPA) purposes are to play the leading role in the regulation of profession, to promote the development of practice and to keep high professional standards in the insolvency system.

**9. Ranking**.

The draft law offers a completely new ranking, in which the Revenue Service as a creditor is relegated to a lower priority so as to give a new chance to the business.

**10. A New Voluntary Arrangement Procedure**

This is the most important change delivered by the draft law, a new third procedure within the insolvency system quite similar to pre-insolvency restructuring schemes.According to the draft law, a voluntary arrangement is an agreement between the insolvent/expected insolvent debtor and its creditors. The purpose of the voluntary arrangement is to ensure survival of the debtor as an acting business entity. The legal consequence of a voluntary arrangement is the full and irrevocable discharge of all liabilities of the debtor existing as at the moment of approving the voluntary arrangement and included in the arrangement. The procedure also includes a special moratorium. For the voluntary arrangement, it is not mandatory to meet the following conditions:

1. To adhere to the proportionality principle throughout a distribution among non-secured creditors, in respect of those non-secured creditors who agreed to the voluntary arrangement, if the voluntary arrangement provides for a distribution;
2. To identify creditors’ claims and create a list of creditors in accordance with the rules established by the law. For the purposes of a voluntary arrangement, the debtor and the nominee of the voluntary arrangement can compile a list of creditors with simplified rules, which will fully allow the creditors to submit their claims.

A voluntary arrangement will be approved through a 75% majority of votes of voting creditors present at the meeting, provided they are not parties related to the debtor. A voluntary arrangement or a modification thereto may not be approved if:

1. it affects the secured creditor’s right of enforcement, except in cases when that creditor agrees to such a provision;
2. a non-secured creditor is satisfied earlier than a preferential creditor, unless the preferential creditor agrees to such a provision; or
3. a preferential creditor, in comparison to other preferential creditor(s), is satisfied in violation of principle of proportionality, unless such satisfaction is approved by the relevant creditor.

*Summary*

These reforms are very welcome. Handing over insolvency management to private practitioners together with removing the transitional period for commencement and deadlines for approval of rehabilitation plan are all measures that will drastically reduce the time and expense of insolvency procedures. The new procedures and ranking system should serve as incentives for business to apply earlier for rescue. Thus, this brand new and innovative law will likely play a significant role in the development of the Georgian economy.