Eligibility of related parties to vote on action plan for legal protection proceedings 1/9/21

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When it comes to approving an action plan for a debtor's legal protection proceedings, it is important to know which of its creditors can vote and to properly interpret the rules that place voting restrictions on certain persons. The insights outlined in this article can help companies in financial distress, creditor representatives and supervisors of legal protection proceedings find out whether only voting creditors have approved an action plan or whether the vote includes any person ineligible to vote.

An action plan for legal protection proceedings is the single most important procedural document in legal protection proceedings and out-of-court legal protection proceedings (collectively "LPP"). Drawing up a plan is mandatory before any LPP can be carried out, and the plan requires approval from the majority of secured and unsecured creditors prescribed by the Insolvency Act. Despite the apparently clear rules in the Insolvency Act, not all of the debtor's creditors are eligible to vote on the LPP plan.

International guidance

According to the Legislative Guide on Insolvency Law issued by the United Nations Commission on International Trade Law ("UNCITRAL") legal systems tend to apply special rules to related-party claims because of the risk that related parties will receive favourable treatment and learn about the debtor's financial difficulties before other creditors. For these and other reasons the UNCITRAL guide recommends scrutinising any claims filed by related parties and, where justifiable, limiting their voting power and reducing their claims, or subordinating those to others.

Applicable Latvian legislation

Section 42(6) of the Insolvency Act lays down exclusions naming certain persons that are not eligible to vote on an LPP plan. Thus, in line with the UNCITRAL guide, the Insolvency Act takes voting rights away from persons that could be interested and therefore biased in assessing the likelihood of restoring the debtor to solvency, yet not all related parties are ineligible to vote.

A person that has any of the characteristics named in section 42(6) of the Insolvency Act is barred from exercising voting rights that are normally inherent in creditors (this is an exhaustive list of interested parties).[1]

To establish whether a related party wishing to vote on an LPP plan is eligible to do so, we need to answer the questions below:

1. Is the person in the same group with the debtor?
2. Does the person have a decisive influence over the debtor?
3. Has the person obtained its receivables against the debtor from persons that fit either (1) or (2) above?

So the Latvian legislation includes a partial voting ban on related parties – only where their relationship is consistent with a group relationship or a decisive influence.

While these questions might seem easy to answer, related parties examining their eligibility to vote on an LPP plan will sometimes wonder whether these statutory restrictions cover only an entity or extend to an individual, say, the debtor's shareholder who as a creditor has receivables from the debtor at the same time?

To answer this question we should invoke the provisions of the Groups Act defining a group and a decisive influence.

In establishing whether a person is in the same group with the debtor or has a decisive influence over the debtor, each case should be assessed on its merits. For example, a group includes a manufacturer (a public limited company) that owns a product packaging company (a private limited company in which the manufacturer holds a controlling interest) and this controlled company exists and operates in the interests of the governing company. A decisive influence within the meaning of the Groups Act would be, for instance, the ability to make decisions on behalf of another company. However, given today's complex corporate structures based on contractual and legal relationships, identifying such status is often a legally challenging task, and a single article cannot examine all possible cases.

Assessing section 42(6) of the Insolvency Act in conjunction with sections 2 and 3 of the Groups Act makes it clear that a person in the same group with the debtor and a person with a decisive influence over the debtor include an individual as well as an entity.

The significance of voting

Section 42 of the Insolvency Act provides that an LPP plan must be sent to all creditors, including ones that are ineligible to exercise creditor rights in approving it. Note that related-party claims and employee claims are excluded from the total main creditor claims used in counting the number of votes necessary to approve the plan. So the person who holds, counts or verifies a vote on the plan should carefully assess which creditors are eligible to vote and which creditor votes must be ignored in arriving at the total.

So the debtor is advised to make sure early on that the LPP plan is backed by the majority of voting creditors in each class, and to follow up with any necessary steps to win extra support from voting creditors before the plan is submitted to the officer supervising the LPP for an opinion and later to the court.

This is crucial because when issuing an opinion on the plan, the supervisor will not only examine it for statutory compliance but assess whether voting creditors have approved it. Afterwards the court will assess the plan again before deciding to approve it.

The supervisor's opinion on the plan can be one of the reasons for terminating the LPP, which in most cases results in the debtor's actual insolvency, either creating the obligation to file for corporate insolvency with the court, or the right to seek approval from the majority of voting creditors for a new plan at a later date. If a repeat LPP attempt fails within one year, the court will automatically declare the debtor's corporate insolvency proceedings.

Despite the voting ban under the Insolvency Act, if the plan or the application to the court carries a statement that the plan has the support of non-voting creditors, this can send a positive message to other parties to the LPP about the plan being comprehensively endorsed even if the support of non-voting

creditors has no legal effect.

If you have any questions please reach out to our experts.

[1] The Insolvency Authority's interpretations and findings 2008–2014. Riga: Courthouse Agency, 2015, page 28