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GUIDE

What you need to know about insolvency challenges under BVI law

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Contents

Introduction 2

When is a company insolvent? 2

Netting agreements 2

Unfair preference 2

Undervalue transaction 3

Voidable floating charge 4

Extortionate credit transaction 4

Disclaimer of onerous property 5

Unlawful distributions 5

- What is a distribution? 5
- Authorisation process 6
- Grounds for clawback 6
- Breach of duty 6
- Disguised or unlawful distributions at common law 6

Fraudulent conveyance 7

Invalid security 7

Breach of directors' duties 7

- Who is a director? 7
- Duties 8

Failure of director to disclose interest 8

Misfeasance 9

Insolvent trading 9

Fraudulent trading 9

Fraudulent conduct 9

Claims against shareholders 10

- Current shareholders 10

Past shareholders 10

Anti-deprivation rule 10

Definitions 11

Contacts 12

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Introduction

Where a BVI company has been put into insolvent liquidation, the primary objective of the liquidator will be to maximise the return to the company's unsecured creditors.

This guide examines the possible grounds on which a liquidator may try to achieve this objective by challenging a transaction entered into by the company or seeking a contribution to the company's assets from a director, shareholder or other person.

The definitions used in this guide are set out at the end of it.

When is a company insolvent?

Under the Insolvency Act, a company is regarded as being insolvent if:

- cash flow insolvency: it is unable to pay its debts as they fall due;
- balance sheet insolvency: the value of its liabilities exceeds its assets; or
- technical insolvency: it is taken to be insolvent (irrespective of its actual solvency) because:
    - it fails to comply with a valid statutory demand; or
    - execution of a judgment or other order of a BVI court against it is returned wholly or partly unsatisfied.

In the case of unfair preferences, undervalue transactions and voidable floating charges (discussed below), insolvency excludes balance sheet insolvency.

For more information about liquidating an insolvent company, refer to our guide 'What a creditor needs to know about liquidating an insolvent BVI company'.

Netting agreements

Under the Insolvency Act, in the absence of fraud, misrepresentation or similar grounds, the enforceability of the netting and set off provisions in a netting agreement are not affected by any provision of the Insolvency Act, any other legislation or any rule of law.

Consequently, in the absence of fraud, misrepresentation or similar grounds, a liquidator will not seek to challenge the netting and set off provisions in a netting agreement.

For more information about netting agreements under the Insolvency Act, refer to our guide 'What a creditor needs to know about liquidating an insolvent BVI company'.

Unfair preference

Under the Insolvency Act, a transaction entered into by a company will be an unfair preference given by the company to a creditor if the transaction:

- is an insolvency transaction;
- is entered into within the vulnerability period; and
- has the effect that, in the event the company goes into insolvent liquidation, the creditor will be put in a better position than the position in which the creditor would have been had the company not entered into the transaction.

Unlike the position in the UK and elsewhere, for a transaction to amount to an unfair preference under the Insolvency Act, it is not necessary for the company to be influenced by a desire to prefer the creditor.

A transaction will not be an unfair preference if it took place in the ordinary course of the company's business.

Where, within the vulnerability period, a company enters into a transaction with a creditor who is a connected person which would be an unfair preference, the transaction is presumed to be an insolvency transaction that did not take place in the ordinary course of business unless it is proved otherwise.

Where the High Court is satisfied that a company has entered into a transaction that is an unfair preference, it may make:

- an order setting aside the transaction (in whole or part); or

- any order it thinks fit for restoring the position to what it would have been had the company not entered into the transaction, including to:
  - require any asset transferred as a part of the transaction to be vested in the company;
  - require any asset, which represents the application of either the proceeds of sale of any asset transferred or money transferred as a part of the transaction, to be vested in the company;
  - release or discharge (in whole or part) any security interest given by the company or the liability of the company under any contract;
  - require any person to pay, in respect of benefits received by the person from the company, any sum to the liquidator the court may direct;
  - provide any surety or guarantor whose obligations to any person were released or discharged (in whole or part) under the transaction to be under any new or revived obligations to the person the court thinks appropriate;
  - require:
    - security to be provided for the discharge of any obligation imposed by, or arising under, the order;
    - the obligation to be secured on any assets; and
    - the security to have the same priority as the security released or discharged (in whole or part) under the transaction;
- provide for a person affected by an order to submit a claim in the liquidation of the company in any amount the court thinks fit; and
- require the company to make a payment or transfer assets to any person affected by an order.

Except as noted below, an order may affect the assets of, or impose an obligation on, any person whether or not the person is the person with whom the company entered into the transaction.

No order will:

- prejudice any interest in an asset that was acquired in good faith and for value from a person other than the company or prejudice any interest deriving from that interest; or
- require a person who, in good faith and for value received a benefit from the transaction, to pay a sum to the liquidator, except where the:
  - person was a party to the transaction; or
  - unfair preference was given to the person when the person was a creditor of the company.

Undervalue transaction

Under the Insolvency Act, a transaction entered into by a company with a person will be an undervalue transaction if the:

- transaction is an insolvency transaction;
- transaction is entered into within the vulnerability period; and
- company:
  - makes a gift to that person or otherwise enters into a transaction with that person on terms under which the company receives no consideration; or
  - enters into a transaction with that person for a consideration which (in money or money's worth) is significantly less than the consideration provided (in money or money's worth) by the company.

A company will not enter into an undervalue transaction with a person if:

- it enters into the transaction in good faith and for the purposes of its business; and
- at the time it enters into the transaction, there were reasonable grounds for believing that the transaction would benefit it.

It has been held that, when considering whether a transaction is an undervalue transaction:

- where a company creates security over an asset, it will not normally amount to an undervalue transaction because creating security does not deplete a company's assets or diminish their value;

- it is possible that, in some circumstances, creating security over an asset to secure existing indebtedness may amount to an undervalue transaction; and
- a creditor may give consideration by refraining from enforcing its rights.

Where, within the vulnerability period, a company enters into a transaction with a connected person which would be an undervalue transaction, it is presumed to be an insolvency transaction to which the safe harbour mentioned above does not apply unless it is proved otherwise.

Where the High Court is satisfied that a company has entered into a transaction that is an undervalue transaction, it may make:

- an order setting aside the transaction (in whole or part); or
- any order it thinks fit for restoring the position to what it would have been had the company not entered into the transaction, including any of the orders mentioned under Unfair preferences above.

Except as noted below, an order may affect the assets of, or impose an obligation on, any person whether or not the person is the person with whom the company entered into the transaction.

No order will:

- prejudice any interest in an asset that was acquired in good faith and for value from a person other than the company or prejudice any interest deriving from that interest; or
- require a person who, in good faith and for value received a benefit from the transaction, to pay a sum to the liquidator, except where the person was a party to the transaction.

Voidable floating charge

Under the Insolvency Act, a floating charge created by a company will be voidable if it is:

- created within the vulnerability period; and
- an insolvency transaction.

A floating charge created by a company will not be voidable to the extent that it secures:

- money advanced or paid to the company, or at its direction, at the same time as, or after, the creation of the floating charge;
- the amount of any liability of the company discharged or reduced at the same time as, or after, the creation of the floating charge;
- the value of assets sold or supplied, or services supplied, to the company at the same time as, or after, the creation of the floating charge; and
- the interest (if any) payable on any amount referred to in the paragraphs above pursuant to any agreement under which the money was advanced or paid, the liability was discharged or reduced, the assets were sold or supplied or the services were supplied.

The purpose of the provision is to prevent a company conferring a benefit on a creditor by creating a floating charge to secure an existing debt owed to the creditor. Therefore, a floating charge will not generally be voidable where it is given to secure new consideration.

Where a company creates a floating charge in the vulnerability period in favour of a creditor who is a connected person, the floating charge is presumed to be an insolvency transaction unless it is proved otherwise.

Where the High Court is satisfied that a floating charge is voidable, it may make an order setting aside the floating charge (in whole or part).

Extortionate credit transaction

Under the Insolvency Act, a transaction entered into by a company within the vulnerability period for, or involving the provision of, credit to the company will be an extortionate credit transaction if, having regard to the risk accepted by the person providing the credit, the:

- terms of the transaction require grossly exorbitant payments to be made (whether unconditionally or if particular circumstances occur) in respect of the provision of credit; or
- transaction otherwise grossly contravenes ordinary principles of fair trading.

Where the High Court is satisfied that a transaction is an extortionate credit transaction, it may make an order:

- setting aside the transaction (in whole or part);
- varying the terms of the transaction or the terms on which any security interest for the purposes of the transaction is held;
- requiring any person who is or was a party to the transaction to repay to the liquidator any sums paid by the company to that person by virtue of the transaction;
- requiring any person to surrender to the liquidator any asset held by that person as security for the purposes of the transaction; or
- requiring accounts to be taken between any persons.

Disclaimer of onerous property

Under the Insolvency Act, a liquidator may disclaim onerous property of a company by filing a notice of disclaimer with the High Court. Within 14 days of filing the notice of disclaimer, the liquidator must give a notice to every person whose rights are, to the knowledge of the liquidator, affected by the disclaimer.

For this purpose, **onerous property** means:

- an unprofitable contract; or
- assets of a company which are unsaleable or not readily saleable or which may give rise to a liability to pay money or perform an onerous act.

Except in the case of leasehold property, a disclaimer takes effect on the date on which the notice of disclaimer is filed with the High Court.

A disclaimer of onerous property operates to determine, with effect from the date of the disclaimer, the rights, interests and liabilities of the company relating to the property disclaimed. Except to the extent necessary to release the company from liability, a disclaimer does not affect the rights or liabilities of any other person.

The liquidator's power to disclaim onerous property is subject to the limitations that a:

- contract which has been fully performed by a company cannot be disclaimed; and
- disclaimer has no effect on rights and benefits which have already vested.

A person who is interested in property which would be affected by a disclaimer may serve a notice on the liquidator requiring the liquidator to elect whether or not to disclaim the property. Unless the liquidator elects to do so within 28 days of receiving the notice (or any longer period allowed by the High Court), the liquidator may not disclaim the property.

Any person sustaining loss or damage as a result of a disclaimer is able to claim in the liquidation of the company as a creditor for the amount of the loss or damage.

Unlawful distributions

What is a distribution?

Under the Companies Act, the term **distribution** is broadly defined. It includes any direct or indirect transfer by a company of any of its assets (other than any of its shares), or the incurring by it of a debt, to or for the benefit of, a shareholder, whether made by:

- the purchase of any asset;
- the purchase, redemption or other acquisition of any of its shares;
- the transfer of any debt; or
- any other means.

A distribution includes a dividend but excludes an issue of bonus shares.

Authorisation process

The Companies Act only allows the directors of a company to authorise a distribution if they are satisfied on reasonable grounds that the company will, immediately after the distribution is made, satisfy the following tests (the **solvency tests**):

- the value of its assets will exceed its liabilities; and
- it will be able to pay its debts as they fall due.

The resolution of directors authorising the distribution must contain a statement that, in their opinion, the company will satisfy the solvency tests immediately after the distribution is made.

If, after a distribution has been authorised but before it is made, a director ceases to be satisfied on reasonable grounds that the company will satisfy the solvency tests immediately after the distribution is made, the distribution is taken not to have been authorised.

Grounds for clawback

If a distribution is made to a shareholder where the company did not satisfy the solvency tests immediately after the distribution was made, under the Companies Act, the company may recover the distribution from the shareholder unless:

- the shareholder received the distribution in good faith without knowing that the company did not satisfy the solvency tests;
- the shareholder has taken actions relying on the validity of the distribution; and
- it would be unfair to require the distribution to be repaid (in whole or part).

If, after a distribution has been authorised but before it is made, a director:

- ceases to be satisfied on reasonable grounds that the company would satisfy the solvency tests immediately after the distribution is made; and
- fails to take reasonable steps to prevent the distribution being made,
- under the Companies Act, the director is personally liable to repay to the company any part of the distribution that is not recovered from the shareholders.

Breach of duty

If a company became insolvent as a result of a distribution being made, the directors would be:

- in breach of their statutory and common law duties to the company to act with care, diligence and skill; and
- potentially personally liable to pay the company an amount equal to the distribution.

Disguised or unlawful distributions at common law

Under common law, a company may only distribute its assets to its shareholders in accordance with specific statutory provisions which allow it to do so. Consequently, a distribution that is not made in accordance with those provisions is an unlawful distribution and invalid.

Historically, this rule sought to preserve the capital of a company to ensure that it would be available to satisfy the claims of its creditors. Although the Companies Act no longer has the concept of share capital for a company, the rule is still capable of applying to invalidate a transaction which:

- is structured to appear as though it is an arm's length transaction, but which is in substance, a disguised distribution; or
- although not intended to be a distribution, is in substance a distribution and it has not made in accordance with the provisions of the Companies Act.

Examples of transactions which have been held to be unlawful distributions include:

- an exorbitant rate of interest payable under a debenture issued to a parent company;
- the transfer of an asset between commonly owned companies at less than market value; and
- the payment of remuneration to a person who was a director and shareholder of a company where the person had done no work at all for the company.

The courts have said that, in considering whether a transaction constitutes an unlawful distribution at common law, it is necessary to examine all of the relevant facts and look at the purpose and substance of the transaction rather than its form. If the transaction is:

- genuine and made at arm's length, then it will be valid, even if it is a bad bargain; and
- an attempt to improperly extract value from the company on the pretence of an arm's length transaction, it will be invalid.

A common situation to which the rule applies is where a company seeks to transfer an asset at less than market value to another company in the same group or under common control. In this situation, there will be an unlawful distribution even though the shareholder of the transferor does not directly receive the distribution.

Where the rule may apply, it is necessary for the company to treat any element of a transaction that would otherwise constitute an unlawful distribution (eg the difference between the book value and the market value of the asset) as a distribution and approve it in accordance with the requirements of the Companies Act described under the heading Authorisation process above.

Fraudulent conveyance

Under the Conveyancing and Law of Property Act 1961, every conveyance of property made with the intention of defrauding creditors is voidable at the option of any person prejudiced by it.

For this purpose:

- **conveyance** is defined as including any mortgage, charge, lease, assent, vesting declaration, vesting instrument, disclaimer, release and every other assurance of property (or an interest in property) by any instrument, except a will;
- the relevant provision does not apply to a conveyance of property made for value and in good faith to any person who did not have notice of the intention to defraud creditors; and
- it is not necessary that the person was insolvent at the time it conveyed, or became insolvent as a result of conveying, the property.

Invalid security

Where a company has created security over its assets (wherever located), the liquidator will examine the circumstances surrounding the security, and if there appears to be any irregularity, may challenge the validity of the security. Possible grounds for challenging security include:

- a failure by the company to validly authorise or execute the security document;
- a failure to validly create or perfect the security;
- a failure to register the security in any jurisdiction where registration is necessary for its validity; and
- other grounds mentioned in this guide, including breach of duty, an unfair preference, an undervalue transaction or a voidable floating charge.

Breach of directors' duties

Who is a director?

The Companies Act defines a **director** as including any person who occupies or acts in the position of director no matter the title given to the person.

The Insolvency Act defines a **director** more broadly as including any person:

- who occupies or acts in the position of director no matter the title given to the person;
- in accordance with whose directions or instructions a director or the company's board of directors may be required or is accustomed to act; and
- who exercises, or is entitled to exercise, or who controls, or is entitled to control, the exercise of powers which, apart from the company's memorandum or articles, would fall to be exercised by the board of directors.

Consequently, in some circumstances, a person who has not been formally elected or appointed as a director will be treated as a director and, therefore, will be subject to the duties and liabilities of a director.

Duties

A director owes a number of statutory and common law duties to a company, including duties:

- to exercise care, diligence and skill;
- to act in good faith in the best interests of the company;
- to exercise the director's powers for proper purposes;
- to avoid conflicts of interest;
- not to fetter the director's discretion; and
- not to misuse the company's property.

In general terms, the consequences of a breach of a director's statutory or common law duties include, depending on the duty which has been breached, an order that the:

- relevant transaction is to be set aside;
- director must return property to the company;
- director must compensate the company for any loss suffered by it as a result of the breach; and/or
- director must pay to the company any profit or gain made by the director.

Where a company is insolvent, or of doubtful solvency, the directors have a duty to consider the interests of the company's creditors as paramount. This is because the creditors are the ultimate beneficiaries of an insolvent company's assets. This duty is, however, owed to the company rather than to its creditors.

For more information about directors' duties, refer to our guide 'What a director of a BVI company needs to know'.

Failure of director to disclose interest

Under the Companies Act, a director must disclose to each other director any interest in a transaction entered into, or to be entered into, by the company immediately after becoming aware of it. A director may give a general disclosure to each other director that the director is:

- a shareholder, director or trustee or an officer of a body corporate or other person; and
- to be regarded as interested in any transaction between the company and that body corporate or other person.

A director need not disclose an interest where the transaction is:

- between the director and the company; and
- to be entered into in the ordinary course of the company's business and on usual terms and conditions.

Unlike the position in some other jurisdictions, the Companies Act requires a director to disclose any interest in a transaction or potential transaction irrespective of whether or not the director's interest conflicts with the company's interests.

If a director fails to disclose an interest in a transaction which the director is required to disclose the:

- director is liable to a fine of up to US$10,000; and
- transaction is voidable at the option of the company.

The transaction is not voidable if the shareholders approve or ratify the company's entry into it or the company received fair value under it.

However, if the company seeks to avoid a transaction due to a director failing to disclose an interest, the title or interest in company property acquired by a third party will not be affected if the third party acquired the property:

- from a person other than the company;
- for value; and
- without any knowledge of the circumstances of the transaction under which the person acquired the property from the company.

Misfeasance

Under the Insolvency Act, a director commits misfeasance if a company enters insolvent liquidation and the director:

- has misapplied or retained or become accountable for any money or other asset of the company; or
- is guilty of any misfeasance or a breach of any fiduciary duty or other duty in relation to the company.

If a director commits misfeasance, the High Court may order the director to repay, restore or account for any money or other asset (or any part of it) or pay compensation to the company in the amount, and interest at the rate, the court considers just.

Insolvent trading

Under the Insolvency Act, a director will be liable for insolvent trading if the High Court is satisfied that, at any time before the start of the company's insolvent liquidation, the director knew, or ought to have concluded, that there was no reasonable prospect that the company would avoid going into insolvent liquidation.

If a director engages in insolvent trading, the court may order the director to make a contribution to the company's assets in any amount the court considers proper. The court cannot make an order if it is satisfied that the director took every step reasonably open to the director to minimise the loss to the company's creditors.

The facts which a director ought to know or determine, the conclusions which the director ought to reach and the steps reasonably open to the director which the director ought to take are those which would be known or determined, or reached or taken, by a reasonably diligent person having both the:

- general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as those carried out by that director in relation to the company; and
- general knowledge, skill and experience possessed by that director.

Fraudulent trading

Under the Insolvency Act, a director will be liable for fraudulent trading if the High Court is satisfied that, at any time before the start of the company's insolvent liquidation, any business of the company had been carried on with the intention to defraud the company's creditors or any other person or for any fraudulent purpose.

If a director commits fraudulent trading, the court may order the director to make a contribution to the company's assets in any amount the court considers proper.

Fraudulent conduct

Under the Insolvency Act, a director commits fraudulent conduct if, at any time during the period of 12 months before the start of the company's insolvent liquidation, the director has:

- made or caused any gift or transfer of, or charge on, or caused or permitted the levying of execution against, any of the company's assets; or
- concealed or removed any of the company's assets within 60 days of the date of any judgment or order given against the company for the payment of money which remains unpaid.

Fraudulent conduct is an offence punishable on conviction by a fine of up to US$10,000, imprisonment for up to three years or both. It is a defence if the:

- conduct mentioned in the first bullet point above took place more than five years before the start of the company's insolvent liquidation; or
- director proves that, at the time of the alleged fraudulent conduct, the director did not intend to defraud the company's creditors.

Claims against shareholders

Current shareholders

Under the Companies Act:

- a shareholder of a limited company has no liability (in the capacity of shareholder) for the liabilities of the company; and
- the liability of a shareholder (in that capacity) to the company is limited to any:
  - amount unpaid on any share held by the shareholder;
  - liability expressly mentioned in the company's memorandum or articles; and
  - liability to repay a distribution paid when the company did not satisfy the statutory solvency tests (see Grounds for clawback above).

Under the Insolvency Act, where a limited company enters insolvent liquidation, the liability of a shareholder to contribute to the assets of the company is limited to any:

- amount unpaid on any share held by the shareholder (including any liability for calls); and
- liability expressly mentioned in the company's memorandum or articles.

This does not affect any liability of the shareholder to:

- pay or repay money to the company under the Insolvency Act or the Companies Act; or
- the company under any contract or any tort or other actionable wrong committed by the shareholder.

Past shareholders

Under the Insolvency Act, unless the High Court is satisfied that the current shareholders are able to discharge their liabilities to the company, any person who ceased to be a shareholder during the period of one year before the start of the company's liquidation, is liable to contribute to the assets of the company to the same extent as a current shareholder.

However, a past shareholder is not liable to contribute to the assets of the company in respect of any liability of the company that arose after the past shareholder ceased to be a shareholder.

Anti-deprivation rule

The English common law rule known as the anti-deprivation rule may also give rise to a possible ground for a liquidator to challenge a transaction entered into by a company. Although the rule has not yet been considered by the High Court, it is generally considered that the High Court would apply the rule.

Under the rule, a contractual provision is void if it requires a company to transfer an asset to another person, or its effect is to deprive the company's creditors of the benefit of the asset, upon the company's insolvency. The rule will not apply to a commercial transaction entered into in good faith which does not have a predominant or main purpose of depriving the company of its property on its insolvency.

The principle behind this rule is that, upon a company's insolvency, its assets should be distributed among its unsecured creditors in accordance with the Insolvency Act and a person cannot seek to gain an advantage by contracting out of the provisions of the Insolvency Act.

Examples of provisions which have been held to breach this rule include a clause which sought to:

- create security over assets upon the owner's insolvency;
- forfeit assets upon the owner's insolvency;
- terminate an indemnity upon the indemnified party's insolvency: and
- require a shareholder to transfer shares in a joint venture company for nominal value to another shareholder if the shareholder becomes insolvent.

The rule will not be offended by a provision which:

- requires a shareholder to transfer an asset at market value to another person if the shareholder becomes insolvent because the shareholder's creditors will not be deprived of the benefit of the asset; or

- terminates a licence or a lease upon the licensee's insolvency because it merely involves terminating a limited interest.

Definitions

The following definitions apply in this guide:

Companies Act means the BVI Business Companies Act 2004.

A **company** means a company that was originally incorporated under the Companies Act and does not carry on a regulated activity or have securities listed on a securities exchange.

A **connected person**, in relation to a company, is any:

- promoter of that company;
- director or shareholder of that company or of a related company;
- beneficiary under a trust of which that company is or has been a trustee;
- related company;
- other company one of whose directors is also a director of that company;
- nominee, relative, spouse, or relative of a spouse of a person referred to in the first three paragraphs above;
- person in partnership with a person referred to in the first three paragraphs above; or
- trustee of a trust having as a beneficiary a person who is, apart from this paragraph, a connected person.

A **floating charge** is a charge created by a company which is, or as created was, a floating charge.

Insolvency Act means the Insolvency Act 2003.

An **insolvency transaction** is a transaction which:

- was entered into at a time when the company is insolvent; or
- causes the company to become insolvent.

The **onset of insolvency** means the date on which the:

- application for the appointment of the liquidator was filed, where the liquidator was appointed by the High Court; or
- liquidator was appointed, where the liquidator was appointed by its shareholders.

A company is **related** to another company if:

- it is a subsidiary or holding company of that other company;
- the same person has control of both companies; and
- the company and that other company are both subsidiaries of the same holding company.

vulnerability period means:

- in relation to an unfair preference, an undervalue transaction or a voidable floating charge:
  - in the case of a transaction entered into with, or a preference given to, a connected person, the period commencing two years prior to the onset of insolvency and ending on the appointment of the liquidator; and
  - in the case of a transaction entered into with, or a preference given to, any other person, the period commencing six months prior to the onset of insolvency and ending on the appointment of the liquidator; and
- in relation to an extortionate credit transaction, the period commencing five years prior to the onset of insolvency and ending on the appointment of the liquidator.

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