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The Modular Approach to Micro, Small, and Medium Enterprise Insolvency

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I. THE MODULAR APPROACH TO MSME INSOLVENCY: AN OVERVIEW

Micro, small and medium enterprises ("MSMEs") constitute the bulk and beating heart of virtually all of the world's economies. They are a primary means by which entrepreneurs bring new business propositions to the market, and deliver a range of products and services to local economies.[1] They often constitute the most accessible route to employment, and typically provide the majority of private sector jobs. They thus deepen and diversify the economy, enhance its resilience, and are key engines of entrepreneurial dynamism and creativity, of wealth and employment.

Whereas larger businesses tend to be robust in a variety of legal and regulatory climates, MSMEs' ability to survive and thrive is highly sensitive to the quality of their environment. Insolvency regimes, in particular, can have profound effects on whether the social wealth that MSMEs represent is increased, preserved, or destroyed; and on the fairness with which that wealth and those losses are distributed. There are knock-on secondary effects on the efficiency with which an economy's commercial lending sector can work through distressed assets, and, in turn, on that sector's ability to successfully perform critical financial intermediation functions.

Insolvency laws are especially relevant at three critical stages in a MSME's financial life. One key challenge arises when the personal funds of the entrepreneur no longer suffice to meet the enterprise's growth potential. Another is when the MSME lacks the resources, financial or technical, to weather a crisis. A third is when the business has failed, often leaving its entrepreneur personally burdened with its obligations. An efficacious insolvency regime would sift through distressed businesses to identify those that remain viable, and would provide cost-effective means for their preservation. Non-viable distressed businesses would be expeditiously dismantled and their assets recycled to more promising uses. Creditors would receive the highest feasible returns on their claims over an appropriate period, and their resulting confidence in the insolvency regime would *pro tanto* incentivize them

---

[1] Different jurisdictions use different terms for small business operators. In this report, the term "entrepreneur" is used generically to refer to natural persons who design, organize, manage and/or operate a business enterprise. It includes service providers, tradespeople, products providers and other individuals who are the principals in a MSME.

to lend more and on more affordable terms. Honest and cooperative entrepreneurs would be extricated from the ruins of a failed business, liberated from obligations that can no longer reasonably be met, and promptly returned to economic productivity. There would be due accountability for any wrongdoing connected with the insolvency.

Historically, insolvency systems have been designed with larger enterprises in mind. They assume an extensive insolvency estate of significant worth, and the presence of creditors and other stakeholders with sufficient value at stake that they participate in and oversee the process. These assumptions undergird mechanisms by which creditors and other stakeholders may ensure that the insolvency process faithfully serves their interests, for an independent professional to run the business undergoing an insolvency process, and for extensive judicial oversight.

These assumptions and features are incongruent with the reality of MSMEs. Mirroring the general population of businesses and reflecting the particular fragility associated with smaller asset bases and relative absence of risk diversification, the vast majority of businesses entering insolvency proceedings are MSMEs. On MSME insolvency, little or no value is available for distribution to anyone other than secured creditors in a significant proportion of insolvency estates, and secured creditors tend to have effective collection methods under non-insolvency law. Correspondingly, most secured and unsecured creditors, as well as other stakeholders, are rationally disinterested in the insolvency process. In many cases, it is not worthwhile for either the estate or most stakeholders to engage lawyers to represent them in court. Estates may possess inadequate value even to pay an independent insolvency professional.

Such incongruence between the design of insolvency regimes and the nature of most of the businesses to which they apply leaves the insolvency process unbalanced, inadequately supervised, non-efficacious, and sometimes, simply unfeasible. Policy-makers and legislators have often responded through *ad hoc* changes to the 'standard' regime, such as by shearing some elements of the insolvency process when applied to smaller businesses, by shortening statutory timelines, and by dispensing with the necessary participation of certain stakeholders. The resulting processes have been marked by arbitrary boundaries, rigid preconditions for availability, and limited effectiveness.

The Modular Approach described in the following pages systematically rethinks the treatment of MSME insolvency. It shares with 'standard' insolvency regimes the core objectives of preserving and maximizing the value in the insolvency estate, ensuring distribution over an appropriate period of time of the highest feasible proportion of that value to those entitled to it, providing due accountability for any wrongdoing connected with the insolvency, and enabling discharge of over-indebted natural persons. The Modular Approach differs in the way it pursues these objectives. Its basic assumption is that the parties to a particular insolvency case are best placed to select the tools appropriate to that case. The role of the legal regime should be to provide these tools in a maximally flexible way, while creating the correct incentives for their deployment.

Traditionally, insolvency regimes provide particular 'packages' or combinations of these tools and label them 'liquidation' and 'restructuring'. The Modular Approach unpacks those combinations. It assumes a core process, geared towards enabling the entrepreneur to propose a restructuring of the business' liabilities and to obtain discharge of any unrepayable obligations. The entrepreneur may access any of the full range of insolvency law mechanisms to enable attainment of these objectives. At the same time, creditors and other stakeholders have the right to adequate notification of each step in the process, coupled with the power to override the entrepreneur's choices where a sufficient proportion of them consider it appropriate to do so. The process may obtain and retain momentum by virtue of the presumptions that stakeholders who have not positively objected to a step in the process have consented to that step, and that the non-exercise of procedural rights within the process precludes the relevant stakeholders from objecting to the part of the process to which the unexercised rights relate. Stakeholders are divided into appropriate classes; they must act by stipulated majority by value; and stipulated majorities by value of a class may bind dissenting minorities.

The Modular Approach also responds to differences in the economic, social and legal circumstances of different countries. It does so by guiding national policymakers with respect to the factors relevant to determining the proper boundaries between 'standard' and MSME insolvency regimes, and by identifying three functions: management, administrative and judicial. The approach explains the costs and benefits of assigning those functions to different entities.

The Modular Approach is designed to provide appropriate incentives for the entrepreneur and other stakeholders alike. Entrepreneurs have positive incentives to commence the insolvency process in a timely manner: they do not have to declare the business insolvent; they may, in principle, retain its management; and they have the right to propose how the insolvency should proceed. Entrepreneurs also face negative incentives that discourage non-timely commencement of insolvency proceedings, in that the Modular Approach imposes personal liability for any additional loss suffered by the business' creditors because of blameworthy delay in commencement. The Modular Approach acknowledges that in many MSME insolvencies, unsecured creditors are rationally disinterested, given their limited economic stake and the very limited likelihood of any recovery in the process. They need not actively participate in the process if, upon due notification, they do not consider it worth the time and expense of participating. As noted, their abstention is deemed approval, and the insolvency process may continue apace. Negative incentives for creditors arise because the non-exercise of procedural rights amounts to a waiver of such rights. Positive incentives arise in creditors' ability, acting with others who together hold a sufficiently large proportion of the claims against the enterprise, to override the entrepreneur's choice of tools and to select a destiny for the business different to the one favoured by the entrepreneur. The Modular Approach is aimed at MSMEs, whether incorporated or operated as sole trader/entrepreneurs.

The structure of this report is as follows. Part II briefly examines the place of MSMEs in the global economy, including challenges for defining MSMEs, and the significance of MSME economic activity. Part III examines the particular needs of MSMEs in financial distress, analyzing why MSME insolvency should provide a fresh start for natural person entrepreneurs, foster the rehabilitation of viable businesses, prevent further loss of value, and provide cost-effective strategies and mechanisms. Part IV examines the policy objectives and key components of the Modular Approach, which are aimed at the core objectives of insolvency law and create incentives for timely commencement of proceedings, the rescue of viable businesses, the liquidation of non-viable businesses, and the devolvement of choice on stakeholders with the best information and most appropriate incentives for value-maximizing outcomes. Part V canvasses in detail the design of a Modular Approach, including the basic procedural framework and the due protection of stakeholder rights. It offers a menu of modules that

allow national policy makers to choose from a range of options for resolving MSME insolvency and for the involvement of appropriate institutions. Finally, Part VI discusses the implementation of the Modular Approach, including the position of various stakeholder groups involved, and the regulatory and implementation challenges that insolvency systems may face when applying the Modular Approach. The report includes an Annex with summary examples of MSME regimes from several jurisdictions, including Greece, Argentina, US, India, Croatia, Republic of Korea, Germany, Japan and OHADA [Annex still being developed].

This research report represents the ongoing collaboration of seven scholars in six jurisdictions and one member of the Canadian judiciary. In formulating the ideas and proposals, we met as a group four times during 2015-6 in Madrid Spain, Bowen Island Canada, London UK and Tokyo Japan. The report draws on and refers to a wide range of sources, including international standards, reports and measures available in domestic jurisdictions.

II. MSMES IN THE GLOBAL ECONOMY

- Varying definitions for MSMEs focus on:
  - revenue
  - value of assets/liabilities
  - value of sales
  - legal structure
  - number of employees

  Such definitions suffer from lack of data, and may vary for different purposes.
- MSME structures vary, but the ubiquity of personal guarantees means that an effective insolvency regime must deal with all of the debts of the natural person entrepreneur.
- MSMEs have immense significance to the global economy and their numbers are growing.
- MSMEs employ more than 1/3 of the world's labour force.

A. NO GLOBALLY CONSISTENT DEFINITION OF MSME

There is no globally accepted definition of a MSME. Across jurisdictions, factors taken as relevant to the identification of this type of business include, among others, annual gross or net revenue, value of assets and/or liabilities, value of sales, legal structure, or number of employees.[2] The chart below illustrates several approaches.

Country	Micro/Small	Medium
European Union	Small is fewer than 50 employees and turnover ≤€ 10m or balance sheet total of ≤€ 10m Micro is fewer than 10 employees and turnover ≤€ 2m or balance sheet total of ≤€ 2m	Medium is fewer than 250 employees and turnover ≤€ 50m or balance sheet total of ≤€ 43m

[2] Janis Sarra, "Micro, Small and Medium Insolvent Enterprises: Do We Need Statutory Reform in Canada? First the Data… then the Reform", in J Sarra and BE Romaine, Eds, *Annual Review of Insolvency Law 2015* (Toronto: Carswell, 2016).

Country	Micro/Small	Medium
United Kingdom	Small: meet two or more of the following requirements— Turnover not more than £5.6 million Balance sheet total not more than £2.8 million Number of employees not more than 50 Micro: not defined	Meet two or more of the following requirements— Turnover not more than £22.8 million Balance sheet total not more than £11.4 million Number of employees not more than 250
United States	Engaged in commercial or business activities other than primarily owning or operating real property, with total non-contingent liquidated secured and unsecured debts of $2,490,925 or less. The threshold specified in the Bankruptcy Code adjusts every three years.Micro: not defined	Not defined
Canada	Small: employing 5 to 99 employees, or in the service industry, employing 5 to 49 employees. Micro: employing 1 to 4 employees	Medium: employing 50 to 499 employees
World Bank	Small: employing 5 to 30 employees Micro: employing 1 to 4 employees	Medium: employing 21 to 100 employees

Sources: European Commission, 2014; UK Companies Act, c. 46; US Bankruptcy Code; Canada, Market Framework Policy Branch, Industry Canada, 2015; World Bank, 2014; United States Bankruptcy Court services, 2016.

Ardic *et al* found that the most common definitions used by regulators are based on the number of employees, sales, and/or loan size. The most common among the three is the number-of-

employees criterion.[3] Of 68 countries for which Ardic *et al* had data, 50 countries use the number-of-employees criterion, and 29 out of these 50 also use the other two criteria.[4] A total of 41 regulators use maximum sales value criteria and 15 use maximum loan value criteria to define an SME.[5]

Ardic *et al* conclude that number of employees and sale volumes are likely the most accurate parameters to define an SME, but these data are not always available from lenders. They note that while banks may collect this information at the time of evaluating loan applications, they often do not retain it in their systems.[6] Their study found that some countries choose to rely on loan size as a proxy for MSME finance. *Financial Access 2010* reports that only 15 countries use loan size as relevant to defining an SME; and within this criterion, there is considerable variation among countries.[7] Ardic *et al* also observe that even when MSME data are available, it is extremely difficult to perform a cross-country analysis in the absence of a standard definition as to what constitutes an MSME, given the extent to which definitions vary from country to country.[8]

Different departments of a national or state government may use different definitions for different purposes. In Canada, for example, Industry Canada defines small business as in the chart above, reporting that 98 percent of the 1.08 million small businesses in Canada in 2013 had 1 to 99 employees.[9] In contrast, Canada's Office of the Superintendent of Bankruptcy ("OSB") defines businesses differently for purposes of Canada's insolvency legislation as "any commercial entity or organization other than an individu-

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[3] Oya Pinar Ardic, Nataliya Mylenko, Valentina Saltane, "Small and Medium Enterprises a Cross Country Analysis with a New Data Set", The World Bank Financial and Private Sector Development Consultative Group to Assist the Poor, Policy Research Working Paper 5538, January 2011 at 6 – 8 ("Ardic *et al*").

[4] *Ibid.*

[5] *Ibid* at 8.

[6] *Ibid.*

[7] *Ibid*.

[8] *Ibid.* An OECD conference on SME in 2004 made two key policy recommendations to both member and non-member economies: (i) develop greater international comparability of SME statistics, and (ii) develop a common definition of an SME, citing Second OECD Conference of Ministers Responsible for Small and Medium-Sized Enterprises, Istanbul, 2004) at 4. They observe that they are commonly defined as registered businesses with fewer than 250 employees (IFC, 2009); the definition still varies from country to country.

[9] Industry Canada, Key Small Business Statistics, June 2016.

al, or an individual who has incurred 50 percent or more of total liabilities as a result of operating a business."[10] Hence an individual consumer debtor is characterized by the OSB as a business for purposes of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, as amended ("*BIA*") where his or her business-related debts comprise 50 percent of total debts. This definition is important for the kind of process to which the debtor has access under the *BIA.*[11]

Also of note is that some jurisdictions use, or are in the process of developing, new definitions that are responsive to particular types of MSME activity. For example, the OHADA countries (*Organisation pour l'Harmonisation en Afrique du Droit des Affaires)* have introduced new terminology for small entrepreneurs in an effort to promote migration of informal businesses into the formal MSME sector.[12] With support from the World Bank Group, OHADA has revised its general commercial law to introduce the *"entreprenant"* status. The status can apply to a natural person running a small business who practices any type of limited turnover activity, civil, commercial, artisan, or agricultural.[13]

A crucial definitional issue in respect of micro businesses is that of sole proprietorships. Many jurisdictions define "business" as having at least one employee on the payroll.[14] Thus, small business statistics may not count sole proprietorships that do not employ

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[10] OSB, *Insolvency Statistics in Canada—August 2015,* https://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/br03457.html#tbl3. Consumer insolvency is defined as an individual for whom 50 percent or more of total liabilities relate to consumer goods and services. This lack of alignment of definition has resulted in problems with data analysis.

[11] For a discussion of the Canadian treatment of MSME, see Janis Sarra, "An Opportune Moment — Retooling the Bankruptcy and Insolvency Act to Address Micro, Small and Medium Enterprise (MSME) Insolvency in Canada, in JP Sarra and BE Romaine, eds, *Annual Review of Insolvency Law 2016* (forthcoming, Toronto: Carswell 2017, 1193-1303).

[12] International Finance Corporation, "An Incentive Package to Encourage Small Business Registration in Benin", http://search.worldbank.org/all?qterm=definition+ percent22small+business percent22&title=&filetype=, March 2014. ["International Finance"]

[13] *Ibid*.

[14] Khrystyna Kushnir, Melina Laura Mirmulstein and Rita Ramalho, "Counting MSMEs Across the World", IFC at 7, http://www.ifc.org/msmecountryindicators. This database is current as of August 2010 and updates and expands on the January 2007 "Micro, Small, and Medium Enterprises: A Collection of Published Data", http://www.ifc.org/msmecountryindicators ("Kushnir *et al*")

anyone or that employ people as contractors.[15] Many small businesses are owned and operated by the same person, and may or may not be incorporated. Incorporation of the micro business typically occurs because someone has advised the entrepreneur that incorporation would better protect the entrepreneur's personal assets. This protection, in reality, is partial only. Incorporation of a limited liability entity usually precludes the entrepreneur's personal liability for business tax claims, tort claims against the incorporated entity, and contract counter-party claims, etc. At the same time, the reality is often that micro and small businesses ("MSEs") cannot get financing unless their owners guarantee the debt with personal assets.[16] Such guarantees effectively blur the distinction between personal and business debt. It follows, as a matter of practical necessity, that a regime governing MSME insolvency would often be required to address the entrepreneur's personal liability. For the same reasons, a MSME insolvency regime would have to address the entrepreneur's non-business or 'consumer' obligations as well. The boundary between business and consumer obligations is often vague – as when personal credit card loans are invested in the business – and it would not be cost-effective to distinguish between them by investigating the purposes for which a loan was made and/or the way in which it was spent. In any case, a regime that provided differential treatment for obligations depending on the purposes for which they were incurred would create perverse incentives for the obligations to be disguised. The sensible response is to enable a MSME insolvency regime to deal with all the debts of the natural person entrepreneur. The definition and character of MSMEs are that they require a flexible approach in the design of the insolvency regime.

B. SIGNIFICANCE OF MSME ECONOMIC ACTIVITY

While it has proven difficult to arrive at consistent definitions for MSMEs, there is no denying their immense significance to the global economy. They are a major source of jobs, economic growth, and dynamism in the economy, not least through their potential for utilizing new technologies.[17] The European Economic

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[15] Sarra, *supra* note 2.

[16] *Ibid*.

[17] International Finance, *supra,* note 12.

Area alone has approximately 20 million MSMEs,[18] and over the 2004 to 2006 period, small and medium-sized enterprises ("SMEs") were the primary drivers of economic growth.[19] In the United States, SMEs make up 99 percent of all firms,[20] employ over 50 percent of private sector employees, and generate 65 percent of net new private sector jobs.[21] Similarly, UK MSMEs account for 99.9% of the country's businesses, provide 60% of all private sector employment, and account for 47% of private sector turnover.[22] The immense significance of MSMEs to the US and European economies is broadly representative of the global picture.

Kushnir *et al* report that there are 125 million "formal" MSMEs in 132 countries for which data are collected by the International Finance Corporation ("IFC"), including 89 million in emerging markets.[23] Formal MSMEs are more common in high-income economies, but in low-and middle-income economies, MSME density is rising at a faster pace.[24] The overwhelming majority of formal MSMEs globally, 83 percent, are micro enterprises.[25] The data collected in most jurisdictions cover only the formal registered sector;[26] and it is important to note that informal MSMEs, particularly in emerging countries, often outnumber formal MSMEs. For example, in India in 2007, there were fewer than 1.6 million registered MSMEs and 26 million unregistered MSMEs.[27]

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[18] European Commission, "Declaring your enterprise to be an SME", Commission communication — Model declaration on the information relating to the qualification of an enterprise as an SME, *Official Journal C 118, 20/05/2003 P. 0005 – 0015,* http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52003XC0520(02)

[19] M. Schmiemann (2009). SMEs were the main drivers of economic growth between 2004 and 2006, *Eurostat Statistics in Focus* 71/2009.

[20] Defined in their study as firms with fewer than 500 employees, Shahin Firoozmand, Philip Haxel, Euijin Jung, and Kati Suominen, "State of SME Finance in the United States in 2015", Tradeup and Nextrade Group, March 2015.

[21] *Ibid.*at 2.

[22] UK Department for Business, Innovation, and Skills, Statistical Release: Business Population Estimates for the UK and Regions 2015 (14 October 2015).

[23] By formal is meant recognized within the regulatory structures of a country, such as for taxation purposes. Kushnir *et al*, *supra*, note 14.

[24] *Ibid*.

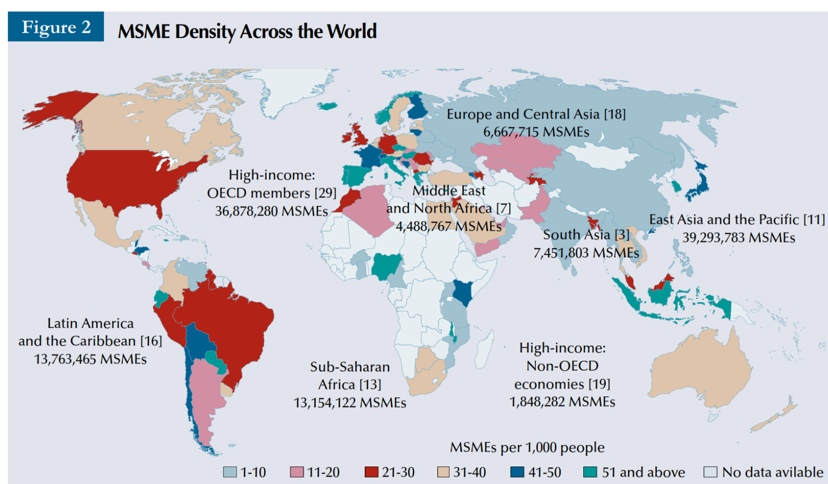
[25] *Ibid,* the authors defining micro as 1 to 9 employees.

[26] *Ibid,* except for 16 economies where data is available.

[27] *Ibid* at 2.

Globally, studies indicate that there are 31 MSMEs per 1,000 population over the 132 economies for which the IFC collects data.[28] Economies with higher per capita income tend to have more formal MSMEs per 1,000 people. Latin America and the Caribbean have more MSMEs per 1,000 people than non-OECD high-income economies. However, if one excludes the countries that are heavily dependent on mineral resources, such as United Arab Emirates and Saudi Arabia,[29] the MSME density for non-OECD high-income economies is at a similar level to that for Latin America and the Caribbean.[30] Globally, the number of MSMEs per 1,000 people grew by 6 percent per year from 2000 to 2009, with Europe and Central Asia experiencing the biggest increase.[31]

The figure below, based on the IFC data, illustrates MSME density per 1,000 population.



Sources: MSME Country Indicators.
Note: Name of region [#] signifies the number of economies from the region included in the analysis. The figure uses the most recent data available after the year 2000. The figure use data for 116 economies.[5]

Formal MSMEs employ more than one-third of the world's labour force.[32] In Canada, for example, small businesses employ 7.7 million employees, comprising 69.7 percent of the total private sector labour force and account for 78 percent of all private jobs cre-

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[28] *Ibid*.

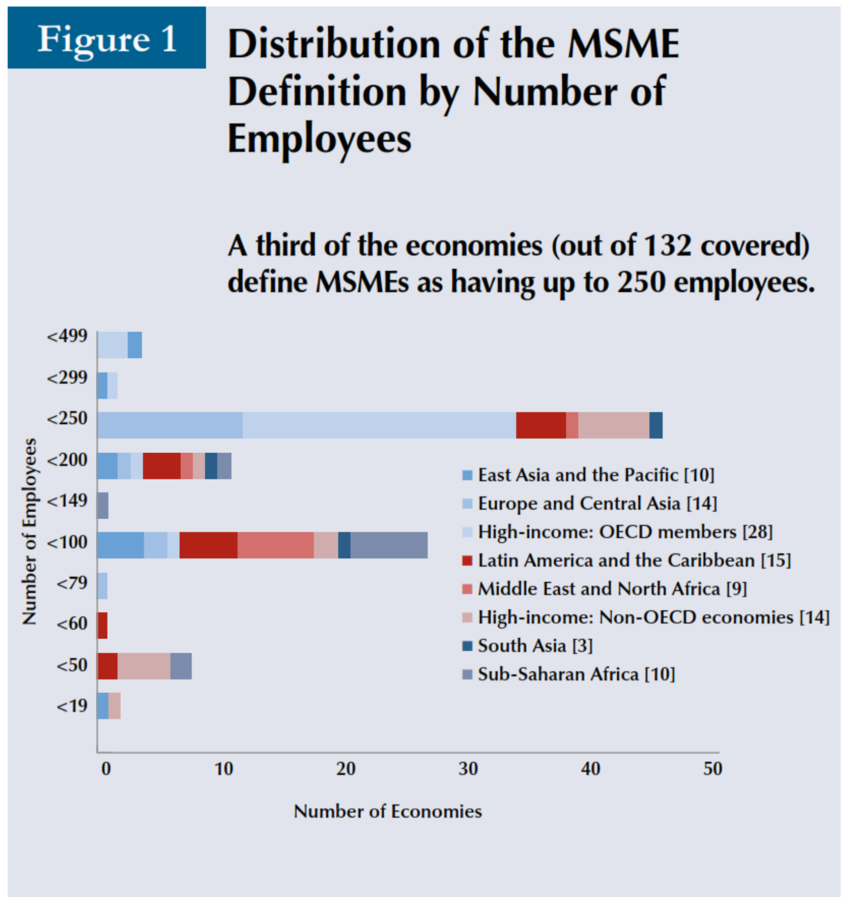
[29] The full list is: United Arab Emirates, Qatar, Oman, Kuwait, and Saudi Arabia, *Ibid.*

[30] *Ibid*.

[31] *Ibid.* They suggest that a possible contributing factor may be the accession of the Eastern European economies to the European Union.

[32] *Ibid*.

ated in Canada.[33] In the European Union, 9.4 million jobs were created in the MSME sector in 27 European Union countries between 2002 and 2008.[34] From a regional perspective, East Asia and the Pacific have the highest ratio of MSME employment to total employment, driven largely by China, where formal MSMEs account for 80 percent of total employment.[35] The OECD countries report that MSMEs with fewer than 250 employees account for two-thirds of the formal work force.[36]



[33] Industry Canada, *Key Small Business Statistics August 2013,* at 8, figures are for 2012, and job creation figures represent the period from 2002-2012; https://www.ic.gc.ca/eic/site/061.nsf/vwapj/KSBS-PSRPE_August-Aout2013_eng.pdf/$FILE/KSBS-PSRPE_August-Aout2013_eng.pdf [Industry Canada], discussed in Sarra, *supra*, note 2.

[34] Ardic *et al, supra* note 3.

[35] Kushnir *et al, supra* note 14 at 2.

[36] Ardic *et al, supra* note 3*,* citing Beck *et al,* 2008b; Dietrich, 2010.

Source: MSME Country Indicators. *Note:* Name of the region [#] signifies the number of economies from the region included in the analysis. The figure uses data from 103 economies.[37]

[37] *Ibid.* at 1.

III. MSME INSOLVENCY – PARTICULAR VULNERABILITY, PARTICULAR NEEDS

MSMEs tend to:

- fail in significant numbers and are vulnerable to macroeconomic and financial shocks
- lack collateral, are undiversified, and suffer higher default risk
- lack suitable internal governance mechanisms
- suffer from restricted access to credit across their life-cycle.

MSME insolvency needs to:

- provide a fresh start for natural person entrepreneurs
- foster the rehabilitation of viable businesses
- prevent further loss of value
- provide cost-effective strategies and mechanisms for use throughout the process.

One size or strategy will not fit all.

A. SIZE AND SUSCEPTIBILITY

Just as MSMEs are significant contributors to the global economy, they also fail in significant numbers. The OECD has observed that MSMEs are particularly vulnerable to macroeconomic and financial shocks, observing that MSME insolvencies in Denmark, Italy, Spain, and Ireland exceeded 25 percent in 2007-2008.[38] A US study found that in 1999, 80 percent of US firms that filed for bankruptcy reported assets under 1 million USD, and 88 percent reported having fewer than 20 employees.[39]

One reason why most insolvency proceedings concern MSMEs is simply that they constitute the largest proportion of private sector businesses. In addition, however, smaller businesses may lack the types of physical assets acceptable to financial lenders as collateral. MSMEs tend to be relatively undiversified as to both suppliers and customers, and suffer higher default risk upon the loss of a significant counterparty, or even from late payments. MSMEs

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[38] Organization for Economic Co-operation and Development, "The Impact of the Global Crisis on SME and Entrepreneurship Financing and Policy Responses", 2009 ("OECD").

[39] E Warren, J L Westbrook, "Financial characteristics of business in bankruptcy." (1999) *American Bankruptcy Law Journal*, 73: 499–589.

also tend to be overrepresented in economic sectors characterized by discretionary spending, such as hospitality and construction. They may lack suitable internal governance mechanisms, and may be unable to afford specialist credit and risk management expertise. These limitations not only constrain MSME growth potential, but constitute a significant vulnerability in times of stress or crisis. They may result in untimely filing of insolvency proceedings, failure to prevent further downward spiralling of finances, failure to deal with operational and financial deficiencies, and a lack of resources to hire effective expertise to deal with the insolvency. Such diseconomies of small scale likely explain MSMEs' particular vulnerability to insolvency.

In addition to internal factors contributing to financial distress, there are also issues external to the MSME itself, in particular, the issue of the obligations of institutional lenders *vis-a-vis* MSME finance, as discussed in Part VI.B.1, "Creditor Behaviour at the Origin and Restructuring of Credit".

B. THE IMPORTANCE OF INSOLVENCY LAW

Insolvency regimes that are responsive to the needs of MSMEs are particularly important. Insolvency law is broadly recognized as an essential tool in a well-functioning economic framework.[40] A balance of mechanisms that allow for timely and effective liquidation, but also for a "fresh start" for entrepreneurs and rehabilitation of viable businesses tends to enhance creditor recoveries and confidence. In turn, they can stimulate greater volumes of lending,[41] at longer maturity periods,[42] at lower cost[43] and lower levels

[40] The Financial Stability Board, which monitors the global financial system, recognizes "Insolvency and Creditor Rights" as one of fourteen policy domains "designated as key for sound financial systems", in which internationally recognized 'best practice standards' are considered as "deserving of priority implementation depending on country circumstances." Financial Stability Board, *Key Standards for Sound Financial Systems* (http://www.fsb.org/what-we-do/about-the-compendium-of-standards/key_standards/, accessed: 7 March 2016).

[41] J.P. Fan, S. Titman, and G. Twite, "An International Comparison of Capital Structure and Debt Maturity Choices", (2012) 47(01) *Journal of Financial and Quantitative Analysis* 23-56.

[42] *Ibid*.

[43] See e.g. J. Qian and P.E. Strahan, "How laws and institutions shape financial contracts: The case of bank loans" (2007) *The Journal of Finance.* 2007 Dec 1;62(6):2803-34.

of collateral.[44] Such mechanisms can also offer an effective framework for the creation of new business activity.[45] Credible restructuring schemes can ensure that businesses with viable going-forward business plans can survive, in turn preserving jobs, supply contracts, customer goodwill, and economic stability more generally.[46] From a macro financial perspective, effective insolvency laws enable financial institutions to resolve problem assets more efficaciously, thereby freeing up provisioning resources, strengthening investors' perception of financial sector stability, *pro tanto* improving banks' ability to lend, and thus particularly benefitting small and medium enterprises in many economies where such businesses are particularly dependent on bank funding.[47] The World Bank has observed that effective insolvency systems enhance predictability and thus lender confidence in loan recovery on default, which encourages more lending and leads to financial inclusion for more businesses.[48]

Of significance for MSMEs globally are both the formal legal rules and informal societal rules and practice norms that affect entrepreneurs, including the design of bankruptcy laws, the structure of capital markets, and the perception of stigma related to personal responsibility.[49] Cost-effective insolvency proceedings can encourage inefficient firms to exit, encourage greater entrepreneurial activity and new firm creation, and can result in greater

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[44] S.A. Davydenko and J.R. Franks, "Do bankruptcy codes matter? A study of defaults in France, Germany, and the UK" (2008) *The Journal of Finance*, Apr 1;63(2):565-608.

[45] See e.g. J. Armour and D. Cumming, "Bankruptcy law and entrepreneurship" (2008) *American Law and Economics Review,* Sep 21;10(2):303-50, and S.H. Lee, Y. Yamakawa, M.W. Peng, and J.B. Barney, "How do bankruptcy laws affect entrepreneurship development around the world?" (2011) *Journal of Business Venturing,* Sep 30;26(5):505-20. ["Armour and Cumming"]

[46] See e.g., E.S. Hotchkiss, K. John, R.M. Mooradian and K. Thorburn, "Bankruptcy and the Resolution of Financial Distress", in *Handbook of Empirical Corporate Finance: Empirical Corporate Finance.* 2011 Oct 13; 2:235.

[47] S. Aiyar, W. Bergthaler, J.M. Garrido, A. Ilyina, A.A. Jobst, K. Kang, D. Kovtun, Y Liu, D. Monaghan, and M. Moretti, "A Strategy for Resolving Europe's Problem Loans" (IMF Staff Discussion Note, SDN/15/19, September 2015).

[48] World Bank, *supra,* note 3 at 3.

[49] S. Lee, M.W. Peng, and J.B. Barney, "Bankruptcy law and Entrepreneurship Development: a real options perspective", (2007) *Academy of Management Review*, 32(1): 257–272 ("Lee et al"); M.W. Peng, "Institutional transitions and strategic choices", (2003) *Academy of Management Review,* 28(2): 275-296. ("Peng")

returns to creditors.[50] Timely resolution of financial distress can reduce uncertainty for entrepreneurs, creditors and management, and improve asset value and transparency.[51] A well-functioning MSME insolvency regime can heighten the salience of the down-side risk of a venture, in turn increasing the number and variety of people pursuing entrepreneurial activities.[52] It can benefit lenders because of the certainty in recovery rules, in turn increasing con-fidence in lending.

The efforts of organizations such as UNCITRAL and the World Bank have contributed significantly to creating model insolvency legislation, best practice guidance, and to helping governments implement reforms.[53] The effectiveness of insolvency laws never-theless varies among countries around the world.[54] According to a survey on debt enforcement in 88 countries, referenced by a World Bank Research Paper, bankruptcy procedures are time-consuming, costly and inefficient in being able to preserve the business as a going concern; in only 36 percent of countries is the business preserved as a going concern; and an average of 48 per-cent of the business's value is lost in debt enforcement.[55] The World Bank Group *Doing Business* report for 2014 found that among 38 selected indicators/measures of the regulatory and institutional environment, the secured creditor recovery rate in distress scenarios was the single most valuable measure.[56]

The World Bank also examined MSMEs that had defaulted on bank loans and found that differences in the level of creditor rights in bankruptcy in the different jurisdictions had an impact on

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[50] Elena Cirmizi, Leora Klapper, and Mahesh Uttamchandani, "The Challenges of Bankruptcy Reform", Policy Research Working Paper 5448, The World Bank Development Research Group Finance and Private Sector Development Team, 2010, at 4. ["Cirmizi *et al*"]

[51] *Ibid* at 5.

[52] Lee *et al, supra* note 49.

[53] United Nations Commission on International Trade Law (UNCITRAL), *Legisla-tive Guide on Insolvency Law, 2005*, United Nations Publication No.E.05.V.10; World Bank, *Principles on Effective Insolvency and Creditor/Debtor Regimes* (revised May 2015).

[54] See e.g. O. Couwenberg, "Survival rates in bankruptcy systems: overlooking the evidence", (2001) *European Journal of Law and Economics* Nov 1;12(3):253-73; and S. Claessens and L.F. Klapper, "Bankruptcy around the world: Explana-tions of its relative use", (2005) *American Law and Economics Review* Mar 20;7(1):253-83.

[55] Cirmizi *et al, supra* note 50 at 6.

[56] *Ibid* at 4, citing Kray and Tawara (2014).

lending terms, particularly terms used by bank creditors; and that legislative reform regarding liquidation led to a decrease in interest rates, although reorganization reform had the opposite effect.[57] Moreover, a research study for the International Monetary Fund reports that six years since the global financial crisis, the problems of high levels of corporate debt and nonperforming loans ("NPLs") persist in several European countries.[58] It found that SMEs in general are more leveraged and reliant on bank financing than large firms and have significantly higher nonperforming loan ("NPL") ratios. It also found that given the large number of SMEs, their small size and heavy reliance on collateral, SME loan restructuring is more costly and riskier for large firms than for banks, and current frameworks are ill-suited for SMEs, both in the ways they limit restructuring options and how they prevent speedy liquidation and exit.[59]

C. One size or strategy for MSME insolvency will not fit all

The public policy in many jurisdictions is to encourage the formation and growth of MSMEs, yet that policy does not necessarily align with treatment during financial distress. Insolvency processes in many countries are too expensive and unwieldy for MSMEs. As noted previously, the broad range of definitions for MSMEs in various jurisdictions is highly problematic for the types of issues facing MSMEs. One size does not fit all.

Often, on MSME insolvency, there are few or no assets to realize. Liquidation is the most prevalent outcome, which can result in loss of value to creditors and debtors. Insolvency regimes not designed to address MSME failure can fail to distinguish viable businesses from non-viable ones.

As noted above, the owners of small businesses usually need to secure business loans with their personal assets or personal guarantees, creating a convergence and blurring of distinctions between personal and business liability in practice, a factor not accounted for in most insolvency law regimes globally. Researchers have observed that while the personal guarantee of a firm's own-

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[57] *Ibid* at 3.

[58] Wolfgang Bergthaler, Kenneth Kang, Yan Liu, and Dermot Monaghan**,** *Tacking Small and Medium Sized Enterprise Problem Loans in Europe,* European Department, Legal Department, and Monetary and Capital Markets Department, International Monetary Fund, March 2015 at 6.

[59] *Ibid*.

er might encourage a level of financial discipline, in countries without a personal bankruptcy framework, a single business failure can doom an owner to a lifetime of outstanding debt;[60] effectively preventing such individuals from re-entering the market as experienced.[61] Evidence suggests that exactly the opposite approach better serves standard public policy objectives. One study that compared self-employment in 15 countries in Europe and North America from 1990-2005 found that the more forgiving the personal bankruptcy laws, measured particularly in reference to the time a bankrupt individual has to wait to be discharged from pre-bankruptcy debts, combined with ready access to limited liability protections, the more entrepreneurial activity was enhanced.[62]

The failure to recognize this convergence of personal and business debt means that debtors may have access to effective liquidation or rehabilitation schemes only if they fit within very specific criteria. For example, in Canada, there is a highly-streamlined mechanism for MSME businesses under Division II consumer proposal provisions of the *BIA*, which are accessible to self-employed individuals and sole proprietors whose debts are less than 250,000 CAD, excluding a mortgage or hypothec on the individual's principal residence, if 50 percent or more of their debts are business-related.[63] But these mechanisms are not available where the individual has incorporated the business.

Nor are insolvency regimes only relevant to one end of the MSME lifecycle. Access to credit is particularly important for MSMEs. The global MSME lending volume is estimated to be 10 trillion USD, of which 70 percent is in high-income OECD countries.[64] On average, small and medium enterprise loans constitute 13 percent of gross domestic product ("GDP") in developed countries and 3 percent in developing countries.[65] In a survey of 130,000 firms in 135 countries, the World Bank Group found that there is unmet demand for bank loans and lines of credit in developing regions, particular-

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[60] Uttamchandani, M. & Menezes, A., (2010). Freedom to Fail: Why Small Business Insolvency Regimes are Critical for Emerging Markets, International Corporate Rescue, No. 4, Vol. 7. Chase Cambria.

[61] Armour and Cumming, *supra* note 45.

[62] *Ibid,* citing John Armour (2008).

[63] Sarra, *supra* note 2.

[64] Ardic *et al, supra*, note 3.

[65] *Ibid*.

ly Africa.[66] The survey found that while almost 60 percent of businesses require a loan at some point, just over a third of businesses have a loan or line of credit.[67] The survey results revealed that well-designed insolvency laws are a factor in accessing credit, directly related to creditor confidence in the ability to recover.[68] In turn, access to credit can assist with fostering entrepreneurship and the creation of new business activity.

D. THE INTERNATIONAL REGULATORY AND POLICY CONTEXT

Internationally, there are currently insufficient tools to address MSME insolvency. UNCITRAL, which has led international policy development in the insolvency area, only makes brief mention of small businesses in its four-part *Legislative Guide on Insolvency Law.* [69] The *Legislative Guide* is aimed at providing a comprehensive statement of the key objectives and principles that should be reflected in a State's insolvency laws. While it provides a valuable reference tool for national legislative authorities in reviewing the adequacy of their laws and regulations or enacting new ones, and discusses the obstacles facing small creditors in terms of barriers to participation,[70] there is virtually no attention paid to MSME. Part one of the *Legislative Guide* discusses the key objectives of an insolvency law, the types of mechanisms available and the institutional framework required to support an effective insolvency regime. It does not address the particular challenges facing MSME that are highlighted in this report, aside from brief note that the costs and fees associated with accessing insolvency proceedings may be of particular importance in the case of small- and medium-size businesses.[71]

Part two of the *Legislative Guide* deals with core features of an effective insolvency law, including standardized commencement

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[66] The World Bank Group, "Debt Resolution and Business Exit", *Viewpoint* July 2014, www-wds.worldbank.org/.../PDF/907590VIEWPOIN003430Debt0Res at 3.

[67] *Ibid*.

[68] *Ibid.*

[69] UNCITRAL *Legislative Guide on Insolvency Law,* Parts One and Two (2004,) UNCITRAL *Legislative Guide on Insolvency Law,* Part Three (2010). UNCITRAL *Legislative Guide on Insolvency Law*, Part Four (2013). The *Legislative Guide*, together with the World Bank Principles on Creditor-Debtors Regimes 2015, form the insolvency standard.

[70] *Ibid* at 25.

[71] *Ibid* at 57.

criteria, stays, post-commencement finance, participation of creditors, expedited reorganization proceedings, simplified claims procedures, conversion of reorganization to liquidation, and clear rules for discharge of the debtor and closure of insolvency proceedings. While these elements are directly relevant to MSME, they assume that debtor companies have the financial and human resources to undertake the processes envisioned, which is not the reality for the vast majority of insolvent MSME. The *Guide* does make reference to cost burdens that will deter creditors and discourage commencement of proceedings, "of particular importance in the case of insolvency of small and medium-size businesses".[72] It does note the issue of overlap of consumer and small business debt as follows:

> One issue that may need to be taken into account in considering discharge of natural persons engaged in a business undertaking is the intersection of business indebtedness with consumer indebtedness. Recognizing that different approaches are taken to the insolvency of natural persons (in some States a natural person cannot be declared bankrupt at all, while in others there is a requirement for the person to have acted in the capacity of a "merchant") and that many States do not have a developed consumer insolvency system, a number of States have insolvency laws that seek to distinguish between those who are simply consumer debtors and those whose liabilities arise from small businesses. Since consumer credit is often used to finance small business either as start-up capital or for operating funds, it may not always be possible to separate the debts into clear categories. For that reason, where a legal system recognizes both consumer and business debt, it may not be feasible to have rules on the business debts of natural persons that differ from the rules applicable to consumer debts.[73]

Part three of the *Legislative Guide* addresses the treatment of enterprise groups in insolvency, both nationally and internationally; it is not directly applicable to the overwhelming majority of MSMEs and there is no specific reference to smaller debtor companies in this part. Part four of the *Legislative Guide* focuses on the obligations that might be imposed on the directors

[72] *Ibid* at 63, repeated at 162.

[73] *Ibid* at 284, 6.

and officers responsible for making decisions when an enterprise faces or becomes insolvent. In this part, the only reference is to family members and senior employees of small family-owned companies being considered *de facto* directors, some criteria for that assessment, and potential resultant liability.[74] The UNCITRAL Model Law on Cross-Border Insolvency (1997) and its *Guide to Enactment* make no reference to MSME.

Hence, the UNCITRAL legislative guides and other policies, while comprehensive, reflect very much how insolvency systems have been designed in many States. As noted earlier in this report, such systems have been designed with larger enterprises in mind, assuming an insolvency estate of significant worth, and the presence of creditors and other stakeholders with sufficient value at stake that they actively participate in the workout process.

In April 2014, after an extensive and thorough preliminary analysis, UNCITRAL's Insolvency Working Group V declared that "the mechanisms provided by the Legislative Guide were not sufficient to address all of the needs of MSMEs; thorough treatment of the issues would require both a consideration of matters not yet addressed in the Legislative Guide as well as the tailoring of solutions already in the Legislative Guide to specifically address MSMEs".[75] It observed, as an example, that "the application of elements of the insolvency law, such as creditor committees, the central role of the courts and extensive involvement of insolvency professionals, might not be appropriate for MSME regimes"[76]

The World Bank, while it has dedicated considerable resources to the finance and education of MSME, also does not have a specific approach to MSME insolvency that addresses some of the problems identified above. Its extensive studies acknowledge that MSME are collectively the largest employers in many low-income countries, facing barriers in access to capital and financial services. The World Bank has developed a wide range of available instruments to help meet the challenge of MSME finance, including data analysis, financing, risk-sharing, technical assistance, a financial inclusion support framework, and working globally with

[74] UNCITRAL *Legislative Guide,* Part IV, at 16.

[75] https://documents-dds-ny.un.org/doc/UNDOC/LTD/V14/011/39/PDF/V1401139.pdf?OpenElement.

[76] https://documents-dds-ny.un.org/doc/UNDOC/GEN/V14/028/64/PDF/V1402864.pdf?OpenElement.

standard-setting bodies to develop guidelines, standards and good practices.[77] To date, there has not been the development of similar instruments and policies expressly aimed at MSME insolvency. The World Bank Insolvency and Creditor/Debtor Regimes Task Force, Report of the Working Group on the Treatment of the Insolvency of Natural Persons very briefly mentions small business in the context of overlap of consumer and business credit in small businesses. However, the World Bank will convene a Task Force in autumn 2016, which will consider developing instruments and approaches to MSME insolvency that could address the core problems with the current framework.

[77] The World Bank Principles on Creditor-Debtor Regimes 2015 that, together with the UNCITRAL *Legislative Guide, supra* note 69, form the insolvency standard, do not contain any specific principles concerning MSMEs.

IV. THE MODULAR APPROACH: POLICY OBJECTIVES AND KEY COMPONENTS

The Modular Approach aims at:

- preservation and maximization of value
- fair and reasonable distribution of value
- accountability for wrongdoing
- discharge where appropriate of over-indebted natural persons.

The Modular Approach seeks to incentivize:

- timely commencement of proceedings
- rescue of viable businesses
- liquidation of non-viable businesses
- devolvement of choice on stakeholders with the best information and most appropriate incentives for value-maximizing outcomes

The Modular Approach recognizes and addresses rational creditor indifference and the need for financing through the process.

The Modular Approach allows national policy makers to choose a range of available options and the involvement of appropriate institutions.

At the highest level of generality, insolvency laws have four core objectives:

- Preservation and maximization of value in the insolvency estate
- Distribution of that value in a normatively defensible manner
- Providing for accountability for any wrongdoing connected with the insolvency, and
- Providing for the discharge of over-indebted natural persons.

These objectives partially overlap. For example, the manner of distribution of the insolvency estate and the form of accountability for timely commencement of the insolvency process may each create incentives more or less conducive to the preservation of value in that estate. At the same time, the four objectives are essentially irreducible one to the other, and may compete amongst themselves. For example, a part of the insolvency estate devoted to investigating the circumstances of the insolvency may be lost to the particular debtor’s creditors and other stakeholders. Similarly, creditors of a particular insolvent natural person may lose the

entire value of their claims upon that person's release from further liabilities, even though such release may be required by fairness to that person and also be in the broader social interest in fostering entrepreneurial risk-taking.

The Modular Approach has several key components that enable pursuit of each of these core objectives. It is designed to respond to the differences amongst economies, legal regimes, and the varying types of business that comprise MSMEs. The Modular Approach seeks to generate incentives for relevant parties to bring about timely commencement of the insolvency process; to sift through distressed businesses to identify and rescue viable ones and liquidate non-viable ones, to do so without making unrealistic demands on parties' capabilities and knowledge; to respond to the rational indifference to the process of creditors and other stakeholders; to provide for the funding of the business undergoing the process; to provide for accountability for any wrongdoing related to the insolvency; and to enable over-indebted natural person entrepreneurs to be discharged.

A. RESPONDING TO THE DIFFERENCES AMONGST ECONOMIES AND LEGAL SYSTEMS

The Modular Approach recognizes the importance of enabling national policy-makers and legislators to design insolvency regimes responsive to the economic, social and legal specificities of their country. It meets two particular challenges: to accommodate differences in the scope of insolvency regimes in various jurisdictions, and to offer options for the allocation of management, administrative and decision functions during the process.

First, while the development of a definition of MSMEs that could be consistently applied is a laudable goal, a number of efforts undertaken to harmonize SME and MSME definitions at the OECD and elsewhere have not, to date, produced a uniform result.[78] Ardic *et al* observe that the heterogeneity of MSMEs themselves and the nature of the economy in which they operate might mean that establishing a global definition is not feasible.[79] From the insolvency perspective, a globally uniform definition may be positively undesirable. MSMEs require special insolvency treatment because 'standard' insolvency proceedings are self-defeatingly resource- and time-intensive. The question is how to balance the

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[78] See discussion in Part II.A.

[79] Ardic *et al, supra* note 3 at 8.

costs of features such as extensive mandatory creditor, insolvency professional and court involvement against the benefits. Where this balance lies would be highly likely to be sensitive to the attributes of the economy and legal system. With that in mind, the Modular Approach assumes that national authorities would draw upon some combination of the above-described parameters to define the types of enterprise that would be required or permitted to make use of the special features described in this report, and also those which would fall beyond the ambit of this approach.

Second, the operation of any insolvency system requires the performance of three types of function. Someone must manage the business through the insolvency process. This *management function* includes ordinary commercial decisions, commercially informed choices about which of the available legal tools to deploy, and negotiations with creditors and other stakeholders to obtain a desirable conclusion to the insolvency process. It is also critical for there to be oversight of the process, to ensure that deadlines are being met, notifications duly provided, and disclosures duly made. This oversight is the *administrative function*. Finally, there is the *judicial function* of ensuring that the law has been correctly applied, reasonable findings of fact have been reached, and that the parties have all been treated fairly.

The Modular Approach enables national policy makers to choose the range of options described in Part V. A. and B. to make available to parties in the individual case. One legal system may require certain decisions in every individual case to be vested in the court. Another jurisdiction may, by contrast, allow court involvement to be dispensed with altogether in the individual case, unless fraud is suspected or a critical party is being uncooperative. Instead, the judicial function might be vested in an administrative agency, or in a regulated insolvency professional, in each case acting in a quasi-judicial capacity. National legislators would make the decision in view of their own constitutional arrangements, and their own assessment of the relative abilities of courts, administrative bodies, and private sector professionals. Similarly, a national legislature may decide to vest the management function in an administrative agency, or alternatively, permit the entrepreneur to remain in place. Finally, the administrative function may be vested in a public body or a private sector official.

B. Responding to MSME heterogeneity

Subject to national authorities' design decisions, the Modular Approach devolves choices about the precise form of the insolvency process applied to a particular business to those stakeholders with the best information about the business and an appropriate stake in a value-maximizing outcome. The Modular Approach provides an essential 'core' process in each case, and allows relevant stakeholders to invoke additional tools or 'modules' if and when the benefits of wielding those tools in the particular case outweigh the costs. For example, the legislature may provide for the management function to be performed by the entrepreneur. In a simple case, the entrepreneur will steer the business through the process. In less straightforward cases, however, a requisite proportion of stakeholders may express their distrust in the entrepreneur's competence or integrity by seeking to obtain the entrepreneur's removal and replacement by an independent insolvency professional. Similarly, a legal system may envisage no court involvement in the standard case, while permitting stakeholders to invoke the court's help if and as considered necessary. Again, the assumption is that the stakeholder would only do so if the dispute is of sufficient value to it to make the costs of instructing legal professionals worthwhile. A description of these stakeholder-initiated modules is set out in Part V. B.

C. Providing for timely commencement of process

The efficacy of an insolvency process may turn on the timeliness with which the process is commenced. Delayed commencement may result in the destruction of value and perhaps of the going concern, as the debtor's assets are seized by secured and judgment creditors and/or misapplied by the debtor's managers, in either case unimpaired by insolvency moratoria. Premature commencement, on the other hand, may destroy the most realistic options for turning around the distressed business by 'stigmatizing' it in the eyes of its counterparties, who might assume that it was no longer viable and might therefore refuse to do business with it on ordinary commercial terms or at all.

In principle, it is the debtor's managers who have the best information about its prospects and solvency, since they are dealing with counterparties who might threaten the business's solvency by cancelling important contracts or toughening business terms. It is thus the debtor's managers who are best placed to take the commencement decision in a timely manner. The Modular Approach creates positive incentives for them by enabling them to

commence the process without necessarily having to prove/declare insolvency;[80] by presumptively letting them remain in charge of the business through the insolvency process; and by giving them the best opportunity of proposing how the insolvency should be addressed, such as through determining the content of a restructuring plan to be put to the creditors. The Modular Approach also generates negative incentives by imposing personal liability on the managers of corporate debtors for non-timely commencement, and/or by delaying or otherwise hardening the conditions on which the natural person debtor may obtain discharge of debts. These negative incentives are addressed in more detail in Part VI.

D. DETERMINING VIABILITY

An insolvency framework should be designed to prevent further loss of value from the insolvency estate. Such a loss may occur in two scenarios: (1) a viable business is liquidated in a piecemeal liquidation, which results in the loss of any remaining going concern value; (2) a non-viable business is restructured and subsequently fails, which results in additional losses of the reinvested value that should have been invested in viable businesses instead.[81] In order to prevent both types of errors, any insolvency framework is confronted with the task of designing a decision-making procedure that identifies viable business models and facilitates rescue of viable businesses while ensuring that non-viable businesses are speedily wound up.

Viability is determined by vesting the decision whether to rehabilitate or liquidate the business, and how to do so, in principle, in the parties who possess the best information about the business, its management, its competitors, and the state of the economic sector in which it operates. Such information is likely to be critical to the assessment of the distressed enterprise's viability.

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[80] Depending on the modular approach adopted. See the discussion in Part V.

[81] See Robert G. Hansen & Randall S. Thomas, Auctions in Bankruptcy: Theoretical Analysis and Practical Guidance, (1998) 18 *Intl Rev. L. & Econ* 159 at 177, describing both types of errors. The second scenario additionally involves a transfer of value from creditors, whose legal rights are not fully honoured in the insolvency, to other stakeholders (particularly managers, employees, and perhaps equity owners), none of whom has legal rights to the continuation of their particular positions in the non-viable distressed business, yet who benefit from its continuation.

The process may be conceptualized as consisting of two steps. The first is to propose the best way in which the value in the insolvency estate may be maximized. This step includes not merely deciding whether to liquidate or to restructure the business, but if the latter, also identifying the optimal terms on which the restructuring may occur. The debtor and/or its management often possess private information as to the business's viability. The Modular Approach seeks to capitalize on this private information by giving the debtor and/or its managers the opportunity of proposing how the insolvency should be addressed, while, presumptively, running the business and thus retaining the most current information about its status and prospects.

The second step in determining viability is to make the ultimate decision whether to pursue rehabilitation on the basis of one or more proposed plans, or to consign the business to liquidation. In general, the business's creditors, considered as a group, possess the debtor- and sector-specific information required for this task to a greater degree than any other stakeholder group. Creditors as a group also have legal rights to repayment, which are unlikely to be honoured fully by the distressed enterprise. In this important sense, they have the residual claim against the business, and stand to gain from the maximization of its value and to lose out if a chance to maximize that value is missed. Creditors as a group thus possess incentives to pick whichever option – liquidate or rehabilitate – likely maximizes the value of the business. Crucially, however, a well-designed insolvency regime would acknowledge and respond to the fact that not all types of creditor possess such value-maximizing incentives.[82]

Also in general, no other stakeholder group meets the characteristics described above. Equity owners, employees *qua* employees,[83] and management can be expected to have a bias in favour of rehabilitation, which for them is a one-sided bet. These groups tend to have little to lose and something to gain from opting for the continuation of the business regardless of whether it remains viable. Courts and other state authorities have no direct incentive to choose the value-maximizing option, and they, like employees

[82] A well-known example is secured creditors whose collateral has sufficient value to ensure full repayment regardless of the maximization of the overall value of the business.

[83] Distinguishable from employees as creditors, who have all the rights of creditors as set out in the relevant insolvency, employment and other related legislation.

and many equity owners, may lack knowledge of the business, its competitors, and/or the relevant economic sector. Similarly, management cannot be expected to make a credible decision about whether it bears some responsibility for the business's distress nor about their own ability to turn around the business's fortunes. Since there is significant overlap between ownership and control in most MSMEs, the same points carry over to equity owners. Further, no other stakeholder group has legal rights at risk in the debtor's insolvency: equity holders are not entitled to payment from the business unless creditors are paid in full, and neither management nor employees are entitled to maintain their status once they are redundant to their employer's requirements.

In summary, the decision whether to attempt a rehabilitation of the business or to provide for its speedy liquidation is, in principle, best vested primarily in creditors as a group. In the MSME context in particular, however, most creditors are likely a dispersed group with small individual stakes in the outcome. MSME insolvency regimes must be built on the understanding that it would often be rational for such creditors not to participate actively in their debtor's insolvency proceedings. Whether the debtor should be rehabilitated should not be allowed to be hostage to such participation. The Modular Approach responds to these considerations in a number of ways, described in Part V.

E. REDUCING THE BURDENS ON PARTIES' KNOWLEDGE AND CAPABILITIES

Most stakeholders in any insolvency process are unlikely to have extensive expertise in restructuring or liquidation. In larger estates where significant value is at stake, the debtor and some stakeholders can address such deficiencies through the engagement of appropriate expertise. However, such services are often prohibitive financially for MSMEs, and the Modular Approach responds by providing for 'off-the-shelf' rehabilitation and liquidation plans requiring minimal customization to be proposed, by the debtor in the first instance, for creditors' consideration. The plans provide both for the deployment of the business's assets with a view to value maximization, and for the distribution of that value to those entitled to it. The creation and presentation of these plans are discussed in Part VI.A.2. Entitlements are provided for by law, and must be respected unless the relevant claimants have agreed to different treatment, subject always to requirements in the particular jurisdiction regarding majority voting, class cram down, and deemed approval, etc.

F. RESPONDING TO CREDITOR PASSIVITY

The limited resources in MSME insolvencies lead to very limited expectations for unsecured creditors regarding any substantial distribution in right of their claims. Thus, unsecured creditors often have little incentive to incur further costs with regard to the insolvent debtor by participating actively in negotiations or proceedings (e.g. travel costs, communication costs, investment of time). Overall, it is often rational for a creditor not to participate unless it has a special interest in the result of the proceedings – most notably because it is personally connected to the debtor (family, employees) or, in the case of secured creditors, to limit participation to the enforcement of its collateral. The potential for incentivizing participation is discussed in Parts V.A.2. a) iv) and VI.B.2.

G. FUNDING THE BUSINESS THROUGH THE INSOLVENCY PROCESS

Even a business that was, in principle, viable at the point of commencement of the insolvency process may wither on the vine unless watered with adequate funding. The Modular Approach responds both by reducing the need for financing, and by ensuring the flow of value through the insolvency estate. The most significant drain on an insolvent entity's resources arises from the fees of insolvency and legal professionals. As described in Part V, the Modular Approach dispenses with both to the extent practicable, leaving it to the parties in the given case to seek involvement of such professionals if the benefits exceed the costs. As to funding the business undergoing the insolvency process, the Modular Approach invalidates counterparties' attempts to terminate both financial and trade contracts, so long as their interests can be adequately protected. In practice, this prohibition means that the financial lender or trade supplier may not exercise an *ipso facto* clause entitling it to terminate its relationship with the now insolvent business nor to demand higher 'ransom' rates for its finance, goods, or services, so long as the insolvent entity is able to muster sufficient funds to cure existing contractual breaches and to meet future obligations on time. Such an approach gives the insolvent business the best practicable chance of trading out of its insolvency. Further, the Modular Approach includes mechanisms to protect financing provided to distressed businesses, differentiating the different stages of the business and addressing both out of court and in court situations, discussed in Part VI.B.4.

H. PROVIDING FOR DUE ACCOUNTABILITY

Insolvency, by definition, involves breach of creditors' rights, and typically also results in destruction of productive capacity and loss of employment. Cost-effective investigations of the circumstances of the insolvency serve both private and public interests. They ensure that the creditors and other stakeholders in the given case recoup what they are owed to the maximum extent practicable. They also reinforce commercial morality by assuring market participants that legal processes, including limited liability and insolvency law itself, are not being abused.

Small business insolvency cases are typically cases with few or no unencumbered assets, which leaves little or no resources for any kind of a thorough investigation from an outsider. At the same time, any emphasis on rescuing such a business for the sake of benefits to society, to the debtors and their family, or to employees creates a debtor-friendly regime that may incentivize entrepreneurs to act carelessly or even fraudulently when causing a business failure. More than any other regime, a MSME insolvency framework must therefore ensure that it provides an effective mechanism to detect fraud or other impropriety. Dishonest or reckless entrepreneurs do not deserve to remain in business or to benefit from a quick discharge, as discussed below.

The limited resources in MSME cases require a mechanism that unearths fraudulent or reckless behaviour of the entrepreneur without a lengthy and costly public investigation. Any public agency or trustee would be overburdened by the sheer number of cases to work through, especially in times of an economic crisis with insolvencies mounting up. As discussed in Part VI.A.1, possible options in terms of who might initiate proceedings for misbehaviour include creditors, insolvency practitioners or other agencies. Part VI also includes a discussion of challenges to access to information and funding limitations.[84] While any public investigator and any court investigation would require efforts to detect such information, such cases could be properly handled by a framework that allows and incentivizes all those who possess relevant facts to present them before a decision to rescue a business or discharge a debtor is made. In addition, the decision to discharge should be reversible for a period of time if such information emerges after proceedings have ended.

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[84] See Part VI.A.1. d).

I. PROVIDING FOR DISCHARGE OF OVER-INDEBTED NATURAL PERSONS

Opinion has changed as to the treatment of natural person entrepreneurs who have taken risks and suffered insolvency. Previously stigmatized and excluded from productive activity, such people are now increasingly sought to be incentivized to bring their experience and expertise back to productive use.[85] Quick and predictable debt relief is a powerful incentive for people who run a troubled business to do the right thing. It provides for an exit option in a distress situation, which allows entrepreneurs to either shut down or restructure their business at an early stage and, thus, reduces the incentive to take excessive risks in a final attempt to turn the business around. Debt relief is a powerful incentive for informed entrepreneurs to address the situation of their business early and efficiently (for more details see Part VI.C.). At the same time, the threat of denying debt relief works as a powerful disincentive for those entrepreneurs who act fraudulently or attempt to misuse the regime, e.g. by forging or concealing information about their business or their assets.

[85] See for the latter: The combined UNCITRAL Legislative Guide on Insolvency Law and the World Bank Principles on Insolvency and Creditor-Debtor Regimes. ("Legislative Guide"), Part two (III, A., para. 32). See also EU Commission Recommendation on a new approach to business failure and insolvency, Brussels, 12.3.2014 ["EU Recommendation"] (Recitals 3, 20, Art. 30-33); The World Bank Natural Persons Report, at 25-40.

V. DESIGNING A MODULAR APPROACH

The Modular Approach consists of a default "core", complemented by a combination of additional mechanisms or "modules" selected in each case by relevant stakeholders.

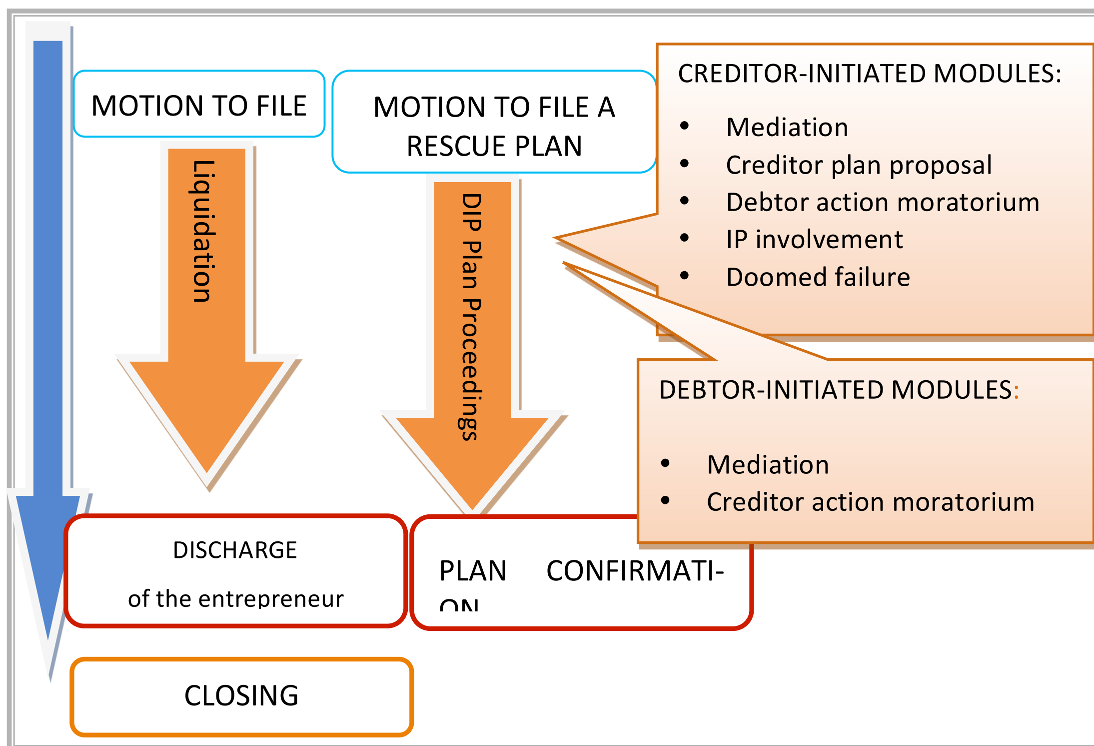
The Modular Approach unpacks the many tools traditionally available under workout, restructuring and liquidation processes. Starting from a core of presumptively essential elements, it enables parties to the given case, acting with appropriate incentives, to select whichever combination of modules is suitable to that case, given the nature and type of debtor and assets, the causes of distress, and the perceived prospects for viability and rehabilitation of the debtor.

The Modular Approach is modular in two aspects. First, it provides for a simple, clear cut default process to liquidate or rescue a small business. This process can be altered wherever stakeholders select specific modules to adapt the process to their specific needs. Second, the approach also leaves a choice of modules and their allocation to local lawmakers. Based on their cultural background and political agenda, legislators may choose not to enact all of the offered modules. They may also make decisions about the most suitable venue for liquidation or rescue proceedings in their jurisdictions.[86] Overall, the Modular Approach offers a flexible framework for small businesses in financial difficulties with limited complexity and costs.

The following images map the Modular Approach process by presenting a visual outline of the overall approach for both liquidation and rescue procedures; and then offering an illustration of each procedure, followed by a diagram of how the various modules interact with the rescue procedure:

[86] The relevant factors influencing a legislator's decision on the venue of proceedings have been and will be discussed in detail in Part IV.A. and Part V.C.2.

The Modular Approach - Overview

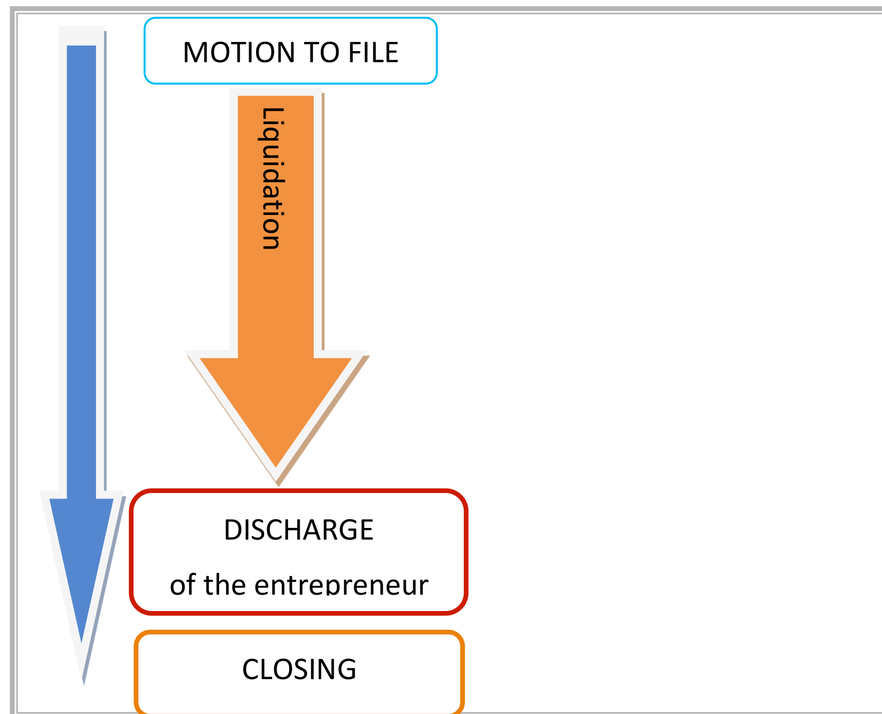


A. THE BASIC PROCEDURAL FRAMEWORK

The Modular Approach is based on a specific procedural framework that consists of two basic options: *automatic liquidation* and *rescue proceedings*.

1. Automatic liquidation proceedings and statutory discharge

Option 1: Automatic Liquidation Proceedings - Overview



a) Function and effects

The foundation of a rescue-oriented approach for viable businesses is a cost-efficient liquidation process for non-viable businesses. This procedural option works as a fallback or default option.

- *Automatic liquidation*: If the debtor is insolvent and no rescue plan is brought forward by either the debtor or any creditor, or if a proposed plan does not obtain the requisite approvals, and unless the appropriate authority considers that a modified plan may obtain approval, the liquidation of the debtor's business remains the only option. Here, the business can be sold on a going concern base or can be wound up in a piecemeal liquidation.
- *Stay if requested:* Liquidation proceedings are only protected by a short stay if such a stay is requested with the motion to commence proceedings. The need for a court involvement to order a stay in many jurisdictions is a source of costs that seems unnecessary in many MSME cases where a lack of unencumbered assets would cause rational creditor passivity due to the probability of unrecovered collection costs.

- *Discharge of natural person debtor*: In most economies, a great majority of micro and small businesses take the form of sole proprietorships and partnerships with no separate legal personality. The natural person entrepreneurs at the heart of such businesses are personally liable for the enterprise's obligations. Fraud and bad faith apart,[87] and as long as such debtors cooperate with the bankruptcy process in a timely manner, there are both economic and fairness-based reasons for affording them an early discharge from their liabilities. Such discharge is a core element of the Modular Approach. Where the business is incorporated, but owned and operated by one individual, often the individual has guaranteed the debt and is likely to become personally bankrupt as a result of the failure of the business. The Modular Approach allows for a mechanism to link the individual's bankruptcy and discharge with the company's insolvency, as discussed below in part d.

b) Motion

The debtor, as well as creditors, may be entitled to initiate proceedings according to the relevant test under local law.[88] Commencement of proceedings presumptively puts the enterprise on the route to liquidation. In the case of a conversion of failed rescue proceedings, liquidation proceedings would be initiated automatically.

c) Decision on liquidation

After a motion, an automatic stay on all debtor and creditors' actions comes into effect and the competent institution[89] may seize the debtor's assets and seek their value-maximizing disposal, as a going concern if possible or else piecemeal. Proceeds of such a sale or auction would be used to (a) cover administrative costs of the acting institution and subsequently (b) distribute to the secured creditor(s). A process of filing claims would only be initiated if a distribution to other classes of creditors is possible.

A common problem in the liquidation of a MSME business is that a single disputed or unpaid claim is the main asset of the business. Litigating and/or collecting the claim could significantly delay the completion of proceedings and raise costs. If a discharge is to depend on the termination of liquidation proceedings, such dis-

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[87] For further discussion, see Part VI.A.1.c)iii).

[88] There should be no duty to file – for a discussion see Part VI.B.2.

[89] For a discussion again see Part V.C.1.

charge would also be delayed. The solution to the latter problem is simple: the order to discharge a debtor must not require a completed liquidation of all assets, but should be available after the debtor turns all of its seizable assets over to the liquidating authority. Several options can be considered for handling the disputed claim:

- The most natural solution in a liquidation process would be to sell the claim, which would probably mean accepting a significant discount on the nominal value, provided that there is a buyer at all, but would be consistent with the idea of a quick and low cost procedure.
- The second legislative option would be to allow for a quick, and, if required by constitutional law or culture, preliminary, judicial determination and subsequent collection by the liquidating authority.
- A separation of assets would be the third option. Here, pursuit of the disputed or unpaid claim would be assigned to an insolvency practitioner or agency or returned to the debtor, which would allow the termination of formal liquidation proceedings. The assignee would afterwards be responsible for litigating and collecting the claim as well as for the distribution of received payments to creditors (or the liquidating authority if the debtor collected the payment.

Each of these options would allow for a speedy liquidation despite the fact that the value of the main asset is uncertain. It would be up to the specific jurisdiction to decide on a preferred option. In the absence of a secondary market for small claims and a competence of the insolvency court to decide on such issues, the third option would become the default solution.

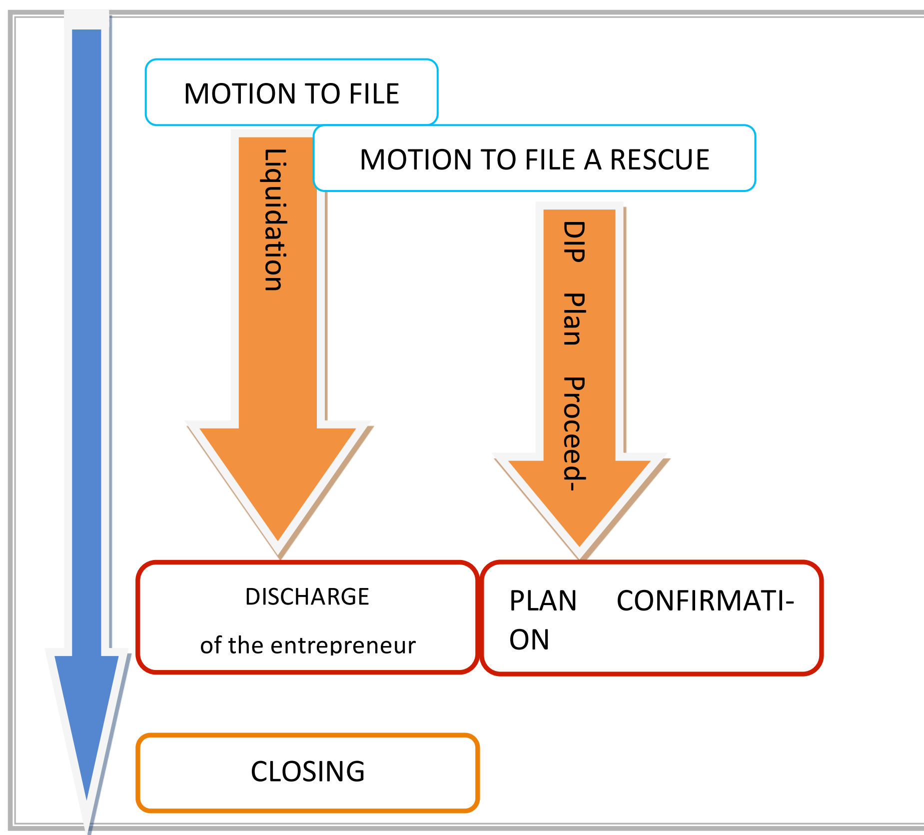
d) Discharge of entrepreneur

The Modular Approach creates the presumption that an honest and cooperative entrepreneur would be personally discharged from liabilities, automatically and without the need for judicial intervention, upon lapse of a stipulated period (e.g., twelve months) from the commencement of the insolvency process. Discharge may be opposed by the institution performing the management function. In jurisdictions in which such automatic discharge is unconstitutional or is considered undesirable, the entrepreneur herself or the institutional performing the management function may, upon the lapse of the stipulated period, apply to the judicial authority for discharge. In either case, discharge oc-

curs unless the judicial authority finds the entrepreneur to have been fraudulent, or to have acted in bad faith, or to have culpably made incomplete disclosure or to have been uncooperative.

2. Rescue proceedings

Option 2: Rescue Proceedings - Overview



a) Function and effects

If the debtor[90] (or a creditor) intends to prevent liquidation proceedings, they may opt for rescue proceedings, even before a motion for liquidation proceedings is filed. This would enable the debtor to remain in possession of the assets and to continue the business, propose and enforce a rescue plan that has sufficient creditor support following a process that is cost efficient and creates positive incentives while respecting creditors' fundamental rights.

i) Debtor remains in possession

The debtor remains at the helm of the business after commencement, making day-to-day decisions about the deployment of the

[90] The 'debtor' in these sections means the natural person debtor or the decision makers and/or equity holders of the indebted legal entity; see Part IV.

constitutive productive factors. This option has three primary justifications.

- First, experience indicates that the concern that they would be displaced from the helm creates a powerful disincentive for debtors to commence the bankruptcy process in a timely manner.
- Second, the continuing presence of the debtor's pre-distress decision-makers may be critical to the MSME's viability, because of private information, existing relationships with counterparties, and/or the necessity of combining the costs of decision-making and residual risk-bearing.
- Third, a significant reason that MSMEs call for a distinctive bankruptcy treatment is that the value at stake is often not sufficient to justify the full panoply of bankruptcy mechanisms, including an administrator.

ii) Plan for restructuring or sale (Rescue Plan)

The core assumption of the Modular Approach is that the debtor would propose a plan to some or all of its creditors. The plan's intended objective is to rescue the business and, by doing so, to maximize its value for the benefit of all relevant stakeholders as a group.

- *Content:* The plan may propose ways of enabling the debtor and/or its business to trade out of distress by providing, for example, for the deferral of payment obligations, a write-down of principal and/or interest, debt for equity swaps, asset disposals or other downsizing measures, and/or provision for new funding, etc. Alternatively, the plan may simply propose a value-maximizing sale of the business, as a going concern or piecemeal.
- *Designing the plan*: Based on the assumption that the debtor possesses private information about its business state, prospects, and viability, a rescue plan should be drafted by the debtor him or herself. This task may, however, overstrain the capacity of many individuals running small businesses. The legal framework should, therefore, offer advice and education on this matter.[91] Assigning the task of plan design to a third party instead would contradict the objective of cost-efficiency, as this party would deserve remuneration. Instead, the use of official stand-

[91] For further details, see Part VI.A.2.b).

ardized forms and interactive templates that automatically generate a plan content (e.g. classes or lists) from the information entered offer a modern and cost-efficient alternative that most MSMEs should be able to use as they typically have a very limited number of creditors, business partners, employees and a simple capital structure.

- *Classes of creditors and equity holders:* Where creditors are to be treated differently, the plan must separately address and explain the definition and treatment of each class of creditor whose interests it proposes to affect, placing in separate classes creditors who have different types of claim (e.g. those holding security interests on par with each other, statutory preferential creditors, general unsecured creditors, etc.), as well as those creditors holding the same type of claim whom the plan proposes to treat differentially *inter se*. *Mutatis mutandis* for equity rights affected by a plan.

iii) Minimization of costs

MSME debtors and most creditors of such entities are characteristically unable to spare many resources to commence the insolvency process and to participate in it. In recognition of this reality, the Modular Approach seeks to minimize commencement and participation costs. The process is designed to minimize complexity, to vest discretion in decision makers only where it is conducive to achieving the objectives of the Modular Approach, and thereby to maximize predictability.

- *Administrative costs of the procedure:* The process may be initiated and continued (e.g. through voting on a proposed plan) online in those economies in which an Internet-based process is a realistic low-cost possibility. Parties participate in the first instance by using standard forms, including a standard statement of affairs and/or a financial statement.
- *Length of the procedure:* The institution discharging administrative functions for the rescue proceedings should enforce strict brief timelines.

iv) Incentivizing participation

MSME insolvency proceedings are prone to cause creditor apathy. The Modular Approach addresses this challenge by providing two types of consequences if duly notified parties fail to respond:

- Creditors and other stakeholders confronted with a plan must check whether the plan reflects their claims

or rights correctly and object if that is not the case. If no objection is raised within the stipulated period, the content of the plan is presumptively regarded as being correct and any creditor whose claim is not listed is regarded of having waived their claim (“scream or die”).

- In addition, when creditors and other stakeholders are invited to vote on a plan, any creditor and stakeholder who fails to vote within the stipulated period is deemed to have voted in favour of the plan (“deemed approval”). Court approval of the plan would only be required if the plan is not accepted by all creditors and shareholders according to their actual or “deemed” votes.

Such incentivizing measures respond to the disinterest of unsecured creditors in rescue proceedings of MSMEs by raising non-participation costs.

- Where the debtor is a company, private information about the state of the business prospects, and viability of the business is not only in the hands of the debtor’s management but may also be with their shareholders. At the same time, a rescue plan may need shareholder support because the rescue strategy relies on shareholders’ continued participation or investments. Shareholders are relevant stakeholders and should therefore be allowed to participate actively in the process. However, shareholders are not necessarily entitled to veto a plan that has gained creditors’ support, because, for example, it provides for a sale of the business or a dilution of shares. Here, a cram down rule must balance conflicting creditors’ and shareholders’ interests.

v) Fundamental rights

The position of creditors and equity holders is protected under fundamental rights relating to protection of property, due process or fair trial in most jurisdictions. Such safeguards need to be respected.

- *Involvement of judicial authority:* The infringement of property rights of creditors does usually require the consent of the property owner or judicial involvement. These safeguards are reflected by the Modular Approach. Those jurisdictions that do not necessarily provide a right to appeal a decision affecting legal rights (e.g. Germany) should

not provide for an appeal in MSME cases in order to streamline the process and limit the cost burden. For parallel reasons, jurisdictions that permit an appeal should not automatically require suspension of the insolvency process on the launch of an appeal.

- *Publication and notices*: Public notice of the commencement of rescue proceedings must be given through publication, as appropriate, in an official gazette, news media, the relevant online sources and in edicts in court houses/business chambers, etc. In addition, the debtor, and each known creditor, equity holder, and any other relevant stakeholder must be individually notified through an appropriate, cost-efficient method (postal services and/or electronic mail) about a rescue plan that impairs their legal position. Notice given through reasonably cost-effective methods, including publicly and (where appropriate) to the last reasonably known address of a stakeholder, should be deemed to have been received by that stakeholder.

b) Motion

i) Debtor commences rescue proceedings

The debtor, in principle, possesses private information about its business state, prospects and viability. The Modular Approach seeks to create positive and negative incentives for the debtor to capitalize on this information to make a timely commencement decision. Control over commencement timing may itself constitute a positive incentive.

The Modular Approach allows jurisdictions to consider two different thresholds for debtors to commence rescue proceedings. One option is to require that the motion of the debtor must be supported by the proposal of a rescue plan, in order to ensure that initiating rescue proceedings is useful and not just an attempt to escape pressure from creditors. The other approach is to recognize that it may be too difficult for the MSME owner to draw up a plausible plan prior to commencing the proceeding, and the MSME may need a short "breathing space" created by a moratorium, to work with creditors to devise a rescue plan.

ii) Creditor commencement

It may be expected that some debtors, because of incompetence and/or perverse incentives, may not commence the bankruptcy process in a timely manner. The possibility of creditor commencement creates additional incentives for the debtors to take

the initiative, especially since the commencing creditor may select modules that are costlier to the debtor. Some creditors, particularly institutional lenders with a significant stake in the particular debtor, may also possess non-public information about the debtor's state and prospects, on which this module capitalizes in aid of timely commencement. A creditor may commence the procedure if:

- it has a claim above a moderate threshold (say, 10 percent of per capita GDP, with this threshold figure explicitly specified by law or regulation),
- the claim has come due;
- the creditor has made a demand for repayment; and
- the debtor has failed to meet this demand within a short stipulated period (e.g., 10 business days).

After a creditor motion has initiated rescue proceedings, the competent authority would give the debtor a chance to present a rescue plan within a short timeframe. If the debtor does not propose a plan, the authority may convert proceedings and initiate a liquidation unless a creditor files a stand-alone (rescue or liquidation) plan.

iii) Where to file

The Modular Approach does not prescribe the specific venue for rescue proceedings. Options are proposed for consideration in terms of possible competent authorities in Part V.C.

c) Decision

The competent authority would need to decide on (a) a motion to initiate rescue plan proceedings, and (b) whether to confirm a rescue plan.

i) No requirement to declare or demonstrate insolvency

Legislators may consider the removal of requirements to declare a state of insolvency by MSME debtors, to incentivize filing and minimize negative stigma. To require the debtor to declare insolvency as a precondition to making use of the insolvency process can inflict reputational harm on the debtor and/or its business, and may thus retard the prospects of its rehabilitation and create disincentives for the debtor to commence the process. The rationale for requiring a declaration of insolvency is to minimize abuse of the bankruptcy process, but this objective can be accomplished through better targeted, less harmful means, including, in particu-

lar, the critical role of creditors, of the judicial authority, the provision for automatic liquidation, and for the denial of discharge.[92]

ii) Rescue Plan confirmation

When asked to confirm a Rescue Plan, the judicial authority would examine whether the plan complies with the legal requirements regarding plan content and plan proceedings, especially with respect to plan acceptance and cram down.

- *Accepting a plan:* The plan would be approved upon receiving actual or deemed consent by all affected creditor and equity classes.
- *Majority voting and cram down:* Where a proposed plan faces active opposition, which might not often be the case in a MSME context, judicial involvement is required under constitutional law as well as fundamental rights if the plan seeks to bind dissenting stakeholders against their will.
    - Where an opposing stakeholder is part of a class that supports the plan by a majority of value (claims or shares), the plan should be confirmed as long as the dissenting stakeholder receives the same return as others in that class ("equal treatment within class") *and* at least as much as they could expect in an alternative liquidation ("no creditor worse off" principle or "best interest test"). In a small business case, a judge should be able to determine the outcome of an alternative scenario without the lengthy and costly involvement of expert witness testimony.
    - Where a majority of stakeholders by value in a class rejects the plan, a cram down rule may be considered that would allow the confirmation of the plan. Here, the court should apply the "equal treatment within class" and "no creditor worse off" principles, and also ensure that the plan does not overturn the relative priorities, as at the commencement of the insolvency process, of that class and each class junior to it.[93]

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[92] For a more detailed discussion – see Part VI.

[93] For the 'new value exception' to the absolute priority rule under US bankruptcy law see *Case v. Los Angeles Lumber Co.*, 308 U.S. 106, 121 f. (1939); *Norwest Bank Washington v. Ahlers*, 485 U.S. 197 (1988) and *Bank of America*

- The judicial decision to approve a plan may be subject to review under local procedural law, but any appeal should not stay the implementation of the plan.

d) Implementation and amendment

The implementation of the plan basically means that the debtor fulfills the duties described in the plan. Payments are made as they fall due; shares are issued or transferred. Claims that are not

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Nat'l Trust & Say. Ass'n v. 203 LaSalle St. Partnership, 526 U.S. 434 (1996). NOTE: A later draft of this report may include a specific example, set out in a box within the document. For example, possible text is [left here as a placeholder]: If there are, for instance, five different classes of stakeholders to be impaired by the plan (a secured creditor; preferred creditors such as tax authorities or employees' salary claims; unsecured creditors; two shareholders – one of them the director and entrepreneur of the small business) and the secured creditor actively opposes the plan, the plan could nevertheless be confirmed (crammed down) if the judge finds that the secured creditor receives at least what it would receive in an alternative liquidation, including compensation for deferred payments. In relation to classes of creditors, the common absolute priority rule would indicate a fair distribution of a going-concern value, meaning that an opposing class of preferred creditors (e.g. tax authorities) could veto a plan that would pay them a liquidation value of their claims while distributing the rescue premium to unsecured creditors only. There may, however, be a reason not to apply such a strict rule to a class of shareholders in an MSME context. As a plan would usually allow them to continue the business, it could be interpreted as a distribution to shareholders, which, under a 'classic' (US style) absolute priority rule, would allow any higher ranked class (which is any creditor class) to veto the plan unless shareholders provide new value in return. Instead, a plan should be considered fair and equitable if it obtains the actual support of a majority of the classes (in our example 3 of 5 classes would be required to actually vote in favour of the plan), if only equity holders' residual rights (shares) remain unimpaired under the plan, and if the plan does not provide for any dividend payments to equity holders for as long as the plan provides for distributions to creditors (thus, respecting the priority of paying creditors ahead of shareholders). If a plan, however, provides for a transfer of shares and meets opposition from the impaired class of shareholders, a "fair and equitable" test would not only consider whether shareholders are worse off under the plan than in an alternative liquidation scenario,[93] but also whether the transfer or dilution of shares under the plan was necessary for the rescue of the business (principle of proportionality). In most MSME cases, a plan might suffice that bars shareholders from receiving any dividends as long as payments to creditors are to be made under the plan (e.g. for 3 or 5 years), For a discussion of the merits of a strict absolute priority rule see S. Madaus, "Reconsidering the Shareholder's Role in Corporate Reorganizations under Insolvency Law", (2013) 22 *Int. Insolv. Rev.* 61-73.

to be paid are discharged. Alternately, the plan may also provide for an auction mechanism.[94]

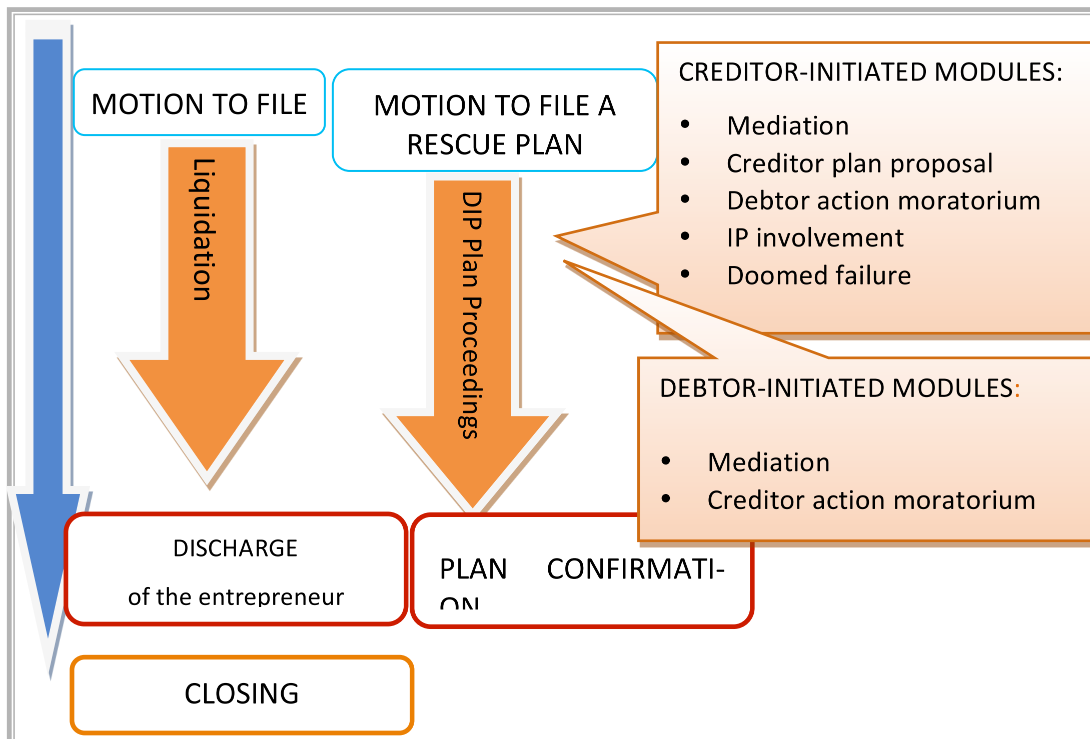
If the debtor is not able to meet its obligations as they fall due, plan obligations can be altered if the affected stakeholders agree to postpone or reduce the payment. Where this agreement is not possible, the debtor may re-initiate rescue proceedings or file for liquidation.

B. THE MODULES

This section of the report describes the various modules that may form part of the MSME insolvency regime.

[94] The ACCORD scheme provides an example. See Donald Hausch and S. Ramachandran, "Systemic Financial Distress and Auction-based Bankruptcy Reorganization", (2009) 18 *Int'l Rev. Econ & Fin.* 366 ff.

Potential Debtor-Initiated and Creditor-Initiated Modules – An Overview



The effects and principles of rescue proceedings under the Modular Approach are very debtor-friendly and rescue-oriented because they work to incentivize early action from the debtor in the situation of a deteriorating business. If the debtor requires additional protection (e.g. a moratorium), the Modular Approach contains additional modules. On the other hand, the Modular Approach also reflects the procedural rights of creditors by providing for optional modules that allow creditors to increase their control over the process. The task of balancing these competing interests would be assigned to a competent authority.

The modules are optional for the stakeholders in a MSME rescue proceedings. In addition, they are also optional for legislators as they provide for a menu of policy choices that allow for the adaption of MSME rescue proceedings to the respective peculiarities of their socio-economic environment.

1. Creditor-initiated modules

The creditor-friendly modules recognize the reality that the role of creditors is critical. Apart from the debtor itself, its creditors possess the best information about its business and prospects. Where the debtor is distressed, its creditors, rather than equity holders, presumptively constitute the residual owners of its busi-

ness, and thus stand to gain or lose in line with the fortunes of that business. As a group, they therefore also have the best incentives to get the liquidate/restructure decision right. Finally, and importantly, creditors have legal claims that the distressed debtor is presumptively unable to satisfy. In recognition of these facts, the Modular Approach accords them a critical role in the insolvency process. By way of using their modules, creditors, by stipulated value, may extend their control over the rescue process or even cause conversion back to a liquidation.

Overview:

CREDITOR-INITIATED MODULES:

- Mediation
- Creditor plan proposal
- Debtor action moratorium
- IP involvement
- Doomed failure

a) Mediation

The *mediation module* is the least intrusive module a creditor can use. Resources permitting, a stipulated proportion (e.g., 20% by value) of creditors[95] may seek mediation concerning the admissibility or quantum of claims, the formulation of a plan, the treatment of guarantees, or any other issue in dispute between the parties. In general, the failure of mediation should not have adverse consequences to any party, so as not to discourage their participation in the process in the first place.

A mediation motion would be available anytime during the process. Mediation would be ordered if all disputing parties agree and the extra costs of a mediator are covered, either by the estate or by parties.

The parties should be required to agree to forebear from any further proceedings during the course of the mediation. To avoid the risk of improper invocation of mediation, the parties should have a very limited time to agree on a mediator. If they are unable to do so quickly, a mediator should be appointed, preferably by a mediation professional organization such as the International Institute for Conflict Prevention & Resolution (US), the ADR Institute of Canada Inc. or a similar organization. Alternatively, the media-

[95] The mediation module is also available for debtors, see debtor-initiated mediation in Part V.B.2.

tor should be appointed from an approved list. Many jurisdictions have credentialing agencies. The mediator should be involved in decisions regarding timing and information dissemination from the beginning of the process, and should have the authority to terminate the process if, in the mediator's opinion, either party is not acting in good faith with a view to resolution.

b) Creditor plan proposal

The *creditor plan proposal module* simply is the right of a single creditor, or a stipulated majority of creditors, to propose a competing plan. Any creditor dissatisfied by the credibility or viability of a debtor-proposed plan may put forward its own alternative using the same forms and format. An important scenario would involve a creditor putting forward a liquidation plan in competition with a debtor's proposal for its own rehabilitation. Both plans may be put to the relevant creditors for a vote, and the plan that obtains greater support will be accepted.

c) Debtor action moratorium

i) Function and effects

The *debtor action moratorium module* affects the right of the debtor in possession to administer the estate without replacing him/her. A stipulated proportion of the creditors would be able to veto the disposal of specific assets or the incurring of specific liabilities by the debtor in possession. This module responds to the risk of the destruction and/or misapplication of value in the debtor's estate resulting from perverse debtor incentives. It may also incentivize creditors to commence bankruptcy as a way of disabling the debtor's ability to diminish or misapply the value in its own estate. The effect of the module may, however, interfere with the debtor's ability to continue the business. It must be handled with care.

An example of attempting to maintain the balance between the debtor's ability to carry on the business and preventing undue diminishment or misapplication of value can be found in Canadian model interim orders under the *Companies' Creditors Arrangement Act,* R.C.S. 1985, c. C-36, as amended.[96] These orders allow

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[96] e.g. Restructuring

> 10. The Applicant shall subject to such requirements as are imposed by the CCAA…have the right to:
>
> > (a) permanently or temporarily cease, downsize or shut down any of its business or operations and to dispose of redundant or non-material assets not exceeding $* in any one transaction or $* in the aggregate, provided that any sale that is ei-

the debtor to pay necessary employee expenses, reasonable expenses incurred in carrying on business in the ordinary course, payments required by law such as employment insurance and income taxes, but preclude payments to pre-filing creditors except in limited circumstances and also preclude any further encumbering of assets. They prevent the debtor from disposing of assets of a value above a cap tailored to the specific day-to-day requirements of the business.

ii) Motion

Given the possible indirect costs of a debtor action moratorium, the motion should only be available to creditors who together hold in excess of a stipulated proportion of the claims against the debtor (e.g. 20%), with this threshold figure explicitly specified by law or regulation. Where the threshold is reached, the stay would be granted automatically for a short specified period, with the ability of other creditors or the debtor to demonstrate to the competent authority that its imposition was unnecessary.

iii) Decision

Where the threshold proportion of claims is not reached or the other creditors or debtor objects, the competent authority would only order a debtor action moratorium or its continuation if it is necessary to protect the interest of creditors from specific debtor action, such as disposing of assets under value or signing a contract that could harm any business rescue effort. The stay order must be specific and may be limited in time.

d) Insolvency practitioner involvement

i) Function and effects

The *insolvency practitioner involvement module ("IP module")* allows creditors to not only veto specific debtor actions but to displace the debtor's pre-distress decision makers (thus overturning the debtor-in-possession default). It can also be used to oversee and thus give credibility to the implementation of an approved plan (supervised debtor-in-possession).

Where the IP works as a trustee, the debtor's right to remain in possession of the assets and to run the business ends. Here, the module removes the debtor from the process, which is why it

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> ther (i) in excess of the above thresholds, or (ii) in favour of a person related to the Applicant…shall require authorization by this Court…;

Alberta Template CCAA Initial Orders. https://albertacourts.ca/docs/default-source/Court-of-Queen's-Bench/ccaa-initial-order-template-(pdf).pdf?sfvrsn=4

goes beyond the scope of a debtor action moratorium. The involvement of an IP is common in many jurisdictions, either instead or in combination with a debtor-in-possession, but, due to the costs of involving an insolvency practitioner, it may not a feasible in the economic reality of many MSME cases.

ii) Motion

The IP's involvement may, in principle, be sought at any stage of the process by any creditor with a claim above a significant threshold (e.g. 25 percent of per capita GDP, with this threshold figure explicitly specified by law or regulation) or a group of creditors with claims exceeding the threshold.

iii) Decision

The competent authority will order a replacement or supervision of the debtor by an IP only if creditors holding claims of a specified value (e.g., 20%) indicate their desire to do so. The debtor may oppose the appointment to the competent authority. The selection of the IP should follow common local insolvency rules.

e) Doomed-to-failure module

i) Function and effects

The *doomed-to-failure module* is the most intrusive module because it terminates debtor-initiated rescue proceedings. The use of the module must, therefore, be reserved for cases where any continuation of rescue efforts is an obvious waste of time and assets or an obvious misuse of procedural options. The module allows creditors to shut down debtor-initiated plan proceedings very early to save costs and delay based on the argument that the debtor's plan is doomed to fail.

ii) Motion

The module may in principle be sought at any stage of the process by any creditor that is able to demonstrate that the debtor's plan is doomed to fail. Such a failure is obvious if the motion is supported by a majority of creditors with claims large enough to veto a debtor's plan.

iii) Decision

The competent authority orders that the plan proceedings convert to liquidation proceedings.

2. Debtor-initiated module: mediation and creditor action moratorium

DEBTOR-INITIATED MODULES:

- Mediation
- Creditor action moratorium

a) Mediation

The debtor may file for the involvement of a mediator under the *mediation module* described above. The issue with debtor-initiated mediation is that a party seeking to delay the bankruptcy process improperly – characteristically, the debtor – may have nothing to lose and time to gain from an improper invocation of mediation. Thus, mediation should only be allowed as long as the conflicting parties agree to this type of structured negotiation.

b) Moratorium function and effects

The Modular Approach provides for debtor-friendly business rescue proceedings. It does not, however, provide for an automatic stay. Such a *creditor action moratorium* would only be available on request.[97] The *creditor action moratorium* would affect creditor claim enforcement as well as *ipso facto* clauses and set-off rights. It is a critical bankruptcy tool that signals the transition from the individual non-bankruptcy to the collective bankruptcy process, and creates a space in which rational decisions may be made about maximization of the value of the debtor's estate and about its fair distribution. In systems with an effective non-bankruptcy creditor claim enforcement regime, the availability of this moratorium creates incentives for the debtor to commence the bankruptcy process in response to initial creditor pressure, and thus towards the onset of distress. It may be expected that most cases under the Modular Approach would involve the moratorium. The moratorium does have costs, however, including the provision of an adverse signal about the debtor's status and prospects, the impairment of the debtor's relationships with stayed creditors, and also the potential for debtor abuse and thus of value destruction. The Modular Approach treats the moratorium as an option in recognition that incurring these costs may not be necessary in all cases.

c) Motion

A *creditor action moratorium* would only be available if requested by the debtor. Where liquidation proceedings had already provided for such a stay following a creditor's motion[98], the moratorium

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[97] In this aspect, the approach follows the EC Recommendation of 12.3.2014 that also recommends a moratorium if requested by the debtor only; see Art. 10.

[98] See Part V. A. 1. a).

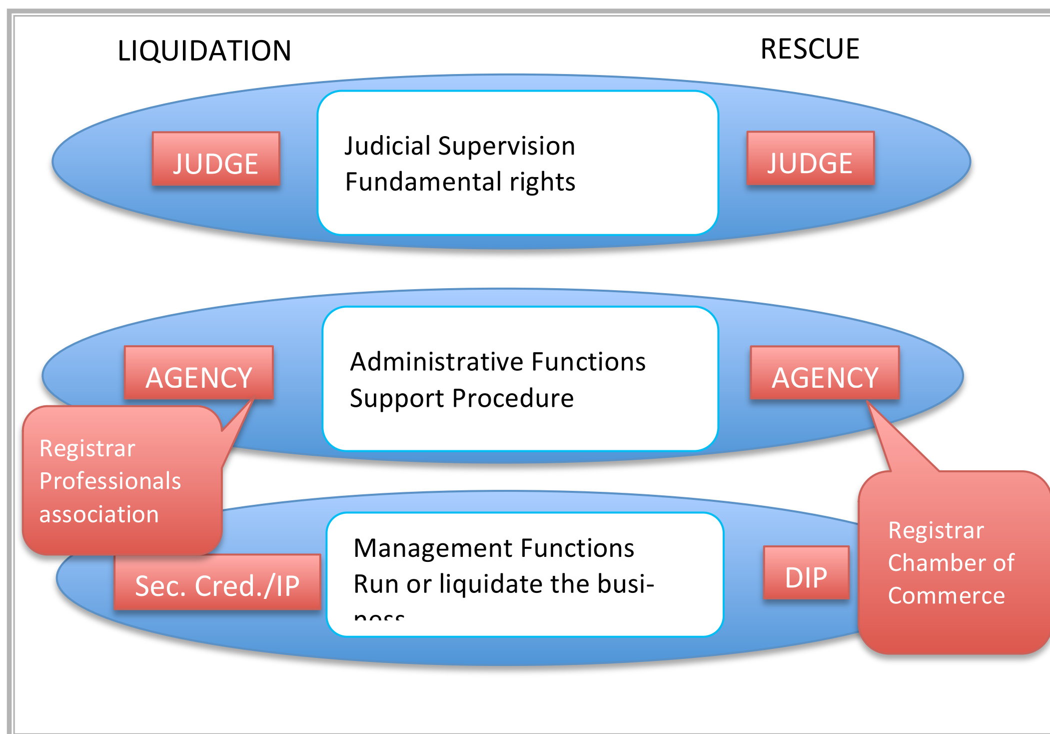
would only extend to business rescue proceedings by a debtor's request – done simply by checking the box on the motion template with the request of a stay. Still, a non-automatic stay leaves the option to continue the business with as little interruption as possible during a restructuring process where no stay is required.

d) Decision

The competent authority would order a moratorium if it is necessary to protect the decision making process and if rights of affected creditors are sufficiently protected (e.g. compensation for the continued use of collateral is guaranteed). The moratorium should be ordered for a limited time only.

C. INSTITUTIONS

Overview:



The efficiency of any liquidation or rescue procedure under the Modular Approach depends on the people assigned to run it. The institutional framework is essential and must consider two basic principles:

- *Low cost approach*: MSME insolvencies are characterised by a lack of assets; no asset cases are a regular phenomenon. Any involvement of additional institutions must, therefore, be given careful consideration and duly justified.

- *Four-eyes-principle for key decisions:* The Modular Approach provides for means to impair creditor claims (plan, discharge) as well as debtors' assets (liquidation). Any impairment of fundamental rights would usually require the involvement of a second level of authority that would review the decision following on an appeal by an interested party. Often, such a function would require the involvement of a judge.

1. Levels of institutional tasks

Based on these principles, three tasks or functions are to be assigned to institutions under the Modular Approach.

a) Management functions

The first and basic level is characterized by those measures that are required to manage the debtor's business through the insolvency and rescue process or to manage the liquidation of the debtor's business. Such management functions include ordinary commercial decisions but also commercially informed choices about which of the available legal tools to deploy. It would also comprise the task of negotiating with creditors, other investors and stakeholders (e.g. shareholders, employees, government officials like tax authorities) to obtain a desirable conclusion to the insolvency process.

b) Administrative functions

Insolvency proceedings are a legal procedure that requires oversight to ensure that motions are being taken care of, deadlines and formalities are being met, notifications are duly provided, and disclosures duly made. Such administrative functions must not necessarily be assigned to a judge, but can often also be handled by other institutions.

c) Judicial supervision

Finally, there is the judicial function of ensuring that the law has been correctly applied, reasonable findings of fact have been reached, and the parties have all been treated fairly.

The Modular Approach originates from existing insolvency proceedings and it seems an obvious choice, therefore, to opt for court proceedings. For MSMEs, such a design is debatable. Courts are a precious and scarce resource. Judicial processes can be lengthy, and recourse to them also characteristically requires the involvement of sometimes expensive legal professionals. Given the significant number of possible MSME cases, the scarcity of court resources generally, and the lack of both time and value in

many MSME bankruptcies, the Modular Approach would favour the recourse to courts only if and to the extent necessary. Subject to the jurisdiction's constitutional requirements, the Modular Approach recommends that anytime the liquidation or restructuring process leads to an infringement of a stakeholder's legal right without their consent, access to judicial review is guaranteed.

Following the "scream or die" principle, this approval does not require a judge to be present and to supervise proceedings nor does it indeed seem appropriate to impose a mandatory sanctioning hearing and order to conclude plan proceedings. Instead, a hearing and decision by a judge would only and always be available where a stakeholder calls for the involvement of a court. Specifically, payment plans that are consensually supported by active creditors could thus be approved and implemented without court involvement under the "deemed approval" of passive creditors. In addition, payment plans that are rejected could be implemented under a majority rule or cram-down rule without court involvement whenever the rejecting creditor (possibly after recognizing the extend of support by other creditors) does not file a motion to a court. As a result, the Modular Approach would only require judicial action where it is actually demanded by law and by affected stakeholders in a specific case.

2. Assigning the tasks

The functions at each of the three levels described above could be assigned to:

- an IP, appointed by the debtor, a creditor, a court or statute,
- a private organization (e.g. professional association of insolvency practitioners 99),
- an administrative agency,
- a court official (registrar), or
- a judge.

Further, the debtor or even a secured creditor could also be assigned with some of these functions.

a) Liquidation proceedings

Selling the debtor's assets in a quick liquidation should not be entrusted to the debtor at the management level because the basis of the Modular Approach to a MSME insolvency is an effi-

[99] An example would be the UK´s R3.

cient liquidation where a debtor is insolvent and not willing or able to produce a plan proposal.

Where all or almost all assets of the debtor are subject to a lien of a single secured creditor (e.g. based on a floating-charge-type of agreement or statutory right), non-insolvency law would allow such a creditor to enforce its rights. In such a case, there is little need to involve another institution at the management level.

The secured lender solution, however, is not sufficient where such a secured creditor is either non-existent or not willing to act, or where there are other assets not subject to security or subject to the security rights of different creditors. In such cases, the management task could be assigned to an IP or a public authority (e.g. a specialized government agency or a court registrar) or self-regulatory organization (e.g. a professional insolvency association). Preferably, a specialist (probably an IP) should act in these cases.

If a major secured creditor or an IP appointed by such creditor acts at the management level, supervision would only be necessary where a stakeholder is unhappy with the way the auction process or any other type of liquidation action is being conducted by the secured lender who may only be interested in realizing a sale that covers its outstanding debt but not the best price achievable. A motion for supervision would be directed to and handled by a public authority (e.g. a specialized government agency or a court registrar) or self-regulatory organization (e.g. a professional association) that could supervise the auction process but also investigate the behaviour of the managing creditor or the debtor with respect to a requested discharge (administration level). Instead of acting on its own behalf, the public or self-regulatory agency could also entrust an IP with the supervision in cases where a creditor is in charge of the auction or generally the liquidation process. Any wrongdoing discovered would either lead to denying a discharge (in case of fraud by the debtor[100]) or claiming damages against the secured lender acting as a liquidator.

The legislative decision about whether to assign management or administrative functions either to an IP or a public or self-regulatory authority should consider the following arguments:

[100] For a discussion, see Part VI.A.1.c.iii)

i) Insolvency practitioners' involvement

Insolvency practitioners play a leading role in most insolvency systems. With perhaps the conspicuous exception of the United States,[101] the appointment of technically qualified, independent professionals is commonplace in all kinds of insolvency proceedings. International experience shows that MSME cases are no exception. Most of the elements that define a good system of insolvency representation are common to proceedings irrespective of the size of the debtor; and yet, the smaller cases present some peculiarities that would merit a closer look:

- On the face of it, the tasks to be performed by insolvency practitioners in MSME cases will be simpler –albeit relatively no less important- than in the larger insolvencies. The liquidation of a small estate will involve the reception, analysis, treatment and provision of information to a normally smaller crowd of creditors through the use of predefined templates or the technical opinion on a non-complex business plan. Yet, the IP´s tasks will often be complicated by the lack of sufficient or of adequately drafted information and by the lack of collaboration of the debtor and/or the management/shareholders. MSMEs are often family-run businesses, where not uncommonly owners and directors take proud, non-collaborative positions all through the process. As a result, but also in general, mediation gains importance amongst the tasks to be performed by the insolvency practitioners in the smaller cases. Mediation in its most strict sense (relationship between the debtor/its ownership/management and creditors); but also in a more persuasive, informative way, as if counselling by an independent specialist must be provided to the parties in a conflict.
- Fees have to be limited. While, as in any other profession, a market-based determination of fees is normally to be preferred, the limited value of the assets, the passivity of creditors and the lack of interest of the more sophisticated professionals may justify the pre-determination of the fee in MSME cases. This pre-determination should not be a lump sum, but rather the regulation of criteria that would

[101] The appointment of insolvency representatives in the US is rare in reorganization (Chapter 11) cases. However, even in this system, trustees are necessary for the liquidation of the business (Chapters 7 --), and, in the case of individuals the US Trustee Office plays a highly relevant role.

allow the judge/agency to determine the fee. The criteria ought to be linked with the complexity of the case, the value of assets, and should provide for the increase of the fee based on successful events (approval of a plan, sale as a going concern, etc.). In many jurisdictions, a minimum fixed amount for the insolvency practitioners is also set by regulation/law.

- The professionalization of IPs active in MSME insolvency may be highly complicated: less economic gains can be expected, no less complexity in the personal relationships involved in the case, and often straightforward, repetitive work from a technical standpoint. Combined with the necessary limitation of fees, these factors hamper the creation of a body of professionals sufficient in number to cater for the entire market. The professionalization must be understood in a non-strict sense, and professionals must be allowed to perform other related professions if they so wish.[102] Good practice would be boosted by the existence and implementation of codes of conduct, and control and discipline by professional bodies. As an alternative, and in those countries where the formation of an adequate system of professional IPs is not possible or would take too much time/cost, public agencies might fill the gap in a number of ways: either by strengthening the profession *via* control of access requirements and implementation of correct professional standards; or by providing a body of public –or publicly trained, selected and funded- professionals. Whatever the model chosen, IPs in charge of MSME insolvencies must complement the general technical skills demanded from the profession with special knowledge of mediation, family law and other directly applicable disciplines directly related to the issues that may arise in these types of cases. In countries with an already created, robust-enough profession, the professional body could separate its constituents depending on the type of cases they specialize and are licensed to practice in. The access requirements, system of fees, code of conduct, need for insurance and training would be adapted to the different circumstances of the professional practice.

[102] In some jurisdictions, the attempt to create a market of insolvency professionals has led authorities to limit severely any alternative work that the professionals included in a registry may perform.

- In the vast majority of systems, insolvency practitioners are appointed either by the judge/insolvency agency or by creditors. There are pros and cons for both systems, but the direct selection by creditors in MSMEs gives rise to additional problems due to the common passivity of unsecured creditors in the smaller cases. An appointment by the judge or an insolvency agency (or, as in some jurisdictions, by notaries or registrars) is the most common solution. Even if the decision-maker is a judge or a public agency, the selection of candidates must be based on their technical abilities and their special suitability to a given case (for example, because of previous experience in the sector of the debtor´s activity). However, in smaller cases, a system that provides for the automatic selection based on turns is more acceptable, as long as the list of candidates only includes candidates generally qualified for the job.

Overall, however, the involvement of insolvency professionals may not add net value in some cases. Experience from systems that severely constrain the remuneration of insolvency professionals[103] indicates that the IP's involvement is in practice nominal only, the debtor does not receive the benefit of genuine independent expertise, and the creditors do not receive the benefit of genuine independent oversight of the debtor. By contrast, in systems where the IP has greater control over their remuneration, even when subject to challenge by a dispersed and 'apathetic' creditor group, [104] perverse incentives arise for the IP to inflate fees, engage in value-destructive collusion with repeat-player institutional lenders (and sometimes with the debtor itself), and shirk on the primary responsibility to find the value-maximizing solution to the insolvency. Either the design of a proper system of remuneration (that neither pays too little nor creates perverse incentives), or the involvement of a public authority would mitigate such incentives.

In MSME insolvency, the appointment of a committee of creditors is uncommon, which leaves insolvency representatives without direct control by a body of creditors. Monitoring insolvency representatives in the smaller cases is a limited problem, since the tasks will be relatively straightforward and the possibility of caus-

[103] e.g. Turkey.

[104] e.g. UK.

ing damage very limited. In any case, the system ought to provide for control mechanisms. Insolvency practitioners may be controlled by a public agency or the self-regulatory organization (or, as it is the case in some jurisdictions, by an "ombud"[105] that creates accountability within the profession).

ii) Public or self-regulatory organization involvement

While the involvement of an agency is necessary for the supervision of IPs, such an agency would also be highly important in cases with no or insufficient assets to cover for the costs of proceedings. This situation is very common in developing economies and in jurisdictions where there is a weak insolvency culture (*i.e.,* the insolvency carries a strong stigma and/or the system is not perceived as a proper instrument to handle business financial distress): insolvency is declared too late, when there are hardly any assets left. This scenario is even more common in MSME cases. The problem can be tackled by the direct intervention of a public agency. The agency would provide the specialists that take charge of the liquidation of the insolvent business and look into the behaviour of the debtor and its management. The UK system of official receivers could be a model of this approach. The public agency could also simply fund the execution of the said –limited- tasks by professional IPs, a solution that would prevent the jurisdiction from having to create a body of public employees. But this situation can also be solved by resorting to market mechanisms. For example, IPs appointed for these cases would be guaranteed the payment of a minimum amount out of a fund nurtured with a percentage withheld from the fees of ordinary cases or with the fees of entry to the professional body. This form of mutualization could be appeased by the introduction of other sources to the fund: a percentage of the fees paid to the register of companies for the use of the registry or a percentage of the money paid to notarize commercial documents (*i.e.,* loans), could be possible examples. The payment of public money into this fund would be a way in between directly paying the fees by the public agency and letting the costs be fully borne by market participants.

Finally, a third alternative might also be considered. In jurisdictions with a strong culture of public intervention in insolvency

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[105] An "ombud" or "public advocate" is a professional, often appointed by government or a professional entity, with a significant degree of independence, who is charged with representing the interests of the public by investigating and addressing complaints.

proceedings, with a scarce use of the insolvency system and with insufficient level of formality, consideration is being given to the creation of a strong mixed private/public agency (hosted, though, by a Ministry) that plays the following roles:

- The agency receives notifications by the debtor/related parties (managers, partners with a certain percentage of the capital), all public administrations (tax/social security/registrars/etc.) and professional lenders of a debtor´s early situation of distress (for example, when a debtor deposits accounts at the registrar with losses that account for ¾ of the share capital);
- It is staffed with highly qualified specialists, both in the fields of insolvency and in business valuation;
- It will start an insolvency procedure, preferably one aimed at the rehabilitation of the business;
- It shall inform the court whenever asked to do so on specific topics (valuation of plan proposals, etc.). This agency would aim to solve the problems of late filings, of lack of information and lack of technical independent advice to decision makers within proceedings. This solution has its set backs; it may be costly and not always easy to create and staff adequately.

b) Business rescue proceedings

Rescue or plan proceedings under the Modular Approach are principally debtor-in-possession proceedings. As they would basically comprise negotiations and vote casting on a proposed payment plan, there is little need for additional administrative structure or costs on the management level.

The requirement of notice of the debtor's motion or plan proposal and disclosure of information about the debtor and their business (mostly by the debtor) would suggest, however, that a supporting structure at the administration level be established that provides for online templates for plan proposals, information on the procedure and available advisors. Such an institution could also be entrusted with verifying the completeness of the information supplied, following up where necessary to obtain further input, ensuring the provision of appropriate notices, and certifying the completion of each procedural stage. Being independent from the debtor, the institution would also receive motions to add a module and decide about the necessary involvement of a court.

The administrative task of a supportive institution could be assigned to a public agency, which could be part of a court organiza-

tion, e.g. judicial clerks or registrars, but also an independent government agency instead, or, depending on the institutional environment in a jurisdiction, an independent private organization (e.g. a part of a Chamber of Commerce). Three considerations combine to motivate the default choice of a government entity to discharge this function.

- First, there is a public interest in effective pursuit of the restructuring process, both to enable suitable investigation of the circumstances of the bankruptcy to ensure that any wrongdoing is detected and wrongdoers held to account, and subject to this, to permit any indebted natural persons to be discharged.
- Second, many MSME bankruptcies are 'no asset' cases in the sense that their estates do not contain sufficient value to fund their own winding up. Taken together, these considerations justify the allocation of public funds to address MSME bankruptcy.
- Third, in a proportion of those MSME bankruptcies where the estate can fund its winding up, there might nevertheless be insufficient value to make it worth independent IPs taking responsibility for overseeing the process. In such cases, a not-for-profit process may maximise returns to stakeholders as a group.

These considerations suggest that, as a default, a government entity may be best placed to oversee the process. This agency may be funded, explicitly or through an implicit premium in business taxes or rates, by a levy on all or a subset of solvent businesses. This approach would also more effectively cause business to internalize the costs imposed by them on society.

The involvement of a judge would only be required where it is actually demanded by law *and* by affected stakeholders in a specific case.

VI. IMPLEMENTATION OF THE MODULAR APPROACH – THE POSITION OF THE STAKEHOLDERS

This part of the report deals with the regulatory and implementation challenges that insolvency systems may face when applying the Modular Approach, particularly its usage by the different stakeholders involved. Problems may arise with regard to the obligations of the debtor subject of the MSME regime; the involvement of the creditors in the process; the position of connected-persons/guarantors, and the position of the workers of the MSME. The separate issues that may arise with regard to each of these stakeholders are discussed below. This part identifies possible barriers to the successful implementation of the MSME insolvency system and proposes certain solutions to address these barriers. Solutions may require tailoring to the specific circumstances of different legal systems, and therefore, in relevant places, alternative solutions are provided to reflect different policy choices.

A. THE DEBTOR'S POSITION, ROLE AND OBLIGATIONS IN MSME INSOLVENCIES

In many countries, the insolvency system is infrequently used, and in the cases where it is used, cases are often limited to value-destructive piecemeal liquidation or even to no-asset cases. This tendency generates a negative reputation for the insolvency system, which is perceived by the market as an inefficient tool, to be avoided at all costs. A country with a non-functional market exit system sees its credit affected and its economy grows—if at all—at a rate under its potential. The legislator needs to break the vicious circle by active measures that modernize the system and by creating incentives for market stakeholders to start using insolvency as a tool to heal sick but viable businesses, not as an ineffective way to bury dead ones. In the field of MSMEs, where often individuals—and families—are involved, the legislator must often consider social problems, such as reputational damage or the involvement of the entire household in the entrepreneurial project. These circumstances act as an additional barrier to the use of the system.

The absence of a rescue culture and the aforementioned social constraints requires a double system of sanctions and incentives to ensure the use of the system at adequate levels, as illustrated

by the incentives discussed above. Yet, experience shows that incentives are often not enough. More drastic measures have to be implemented in the form of sanctions and compensation for damages when certain circumstances accrue. In this section, these sanctions are analyzed in some detail, with particular regard to wrongful trading/duty to file rules, which serve the double purpose of ensuring an early filing of insolvency and protecting creditors from a management of the business that undermines their legitimate expectations to the benefit of shareholders.

The problems, however, do not only lie with the lack of use of the insolvency system. If and when the lack of rescue culture, the social stigma, and poor market perception are overcome, problems may nonetheless arise concerning the manner in which debtors utilize the MSME insolvency regime. If not properly designed and implemented, the specifically MSME-tailored insolvency system may be prone to misuse and/or abuse, particularly where a Modular Approach is implemented that allows for a significant degree of choice and flexibility. Thus, insolvent debtors may have the incentive to opt for "modules" that protect their own interest to the detriment of creditors or the long-term health of the enterprise. Further, in the realm of MSMEs, the inadequacy of information on the debtor´s affairs and financial situation and a low level of interest by creditors may pave the way for debtor misbehaviour. This section considers ways to tackle debtor moral hazard issues, without undermining the benefits of a Modular Approach for MSME insolvency.

1. MSME obligations at times approaching insolvency

In the design of the Modular Approach for MSMEs, a critical point in time to consider is when the MSME is approaching insolvency, but is not necessarily already in a state of actual insolvency and has not yet entered formal insolvency proceedings of any sort. Addressing irresponsible behaviour by debtors and misuse of the system requires that the Modular Approach is supported by a well-designed regime concerning the obligations of debtors at this "twilight zone" period of imminent insolvency.

Indeed, when insolvency is imminent, debtors should have greater regard to the interests of creditors and should attempt to address the distress situation. Yet, at that time, small entity debtors may be very reluctant to access the insolvency system, concerned about stigma, about losing their business, which is likely their only source of income, and being overly optimistic about the business' prospects. Debtors may also be prone to adopt more high-risk

strategies, attempting to avoid at all costs losing their business or the business' assets. They may be inclined to collaborate with related persons or powerful creditors, hide or dispose of assets. The problem is particularly acute where debtors use the corporate form for their MSMEs. Incorporated MSME managers, who are likely to also be the business owners, may consider that they are safe from the outcomes of insolvency as they are protected by limited liability. Small debtors are also likely to be less concerned about returning to the managerial labour market and thus more prone to act self-servingly. Unincorporated MSMEs may take excessive risks if they consider that they will be released from liabilities through an insolvency discharge.

A regime that focuses on the period of imminent insolvency is particularly important for encouraging action at an early stage and for facilitating rescues of viable businesses, aspects that are critical to the procedural framework contemplated for MSME insolvencies. Therefore, a regime for pre-insolvency obligations can complement the procedural framework and enhance it. It can provide an educational tool for MSMEs with regard to the proper means for addressing the situation of financial distress and the proper use of the module options.

A regime that addresses the obligations of debtors at times approaching insolvency can respond to such concerns as debtor moral hazard. It can deter irresponsible behaviour at times of financial distress and provide guidance to debtors with regard to the appropriate actions they should take.

a) A balanced regime

The regime for MSME debtors' obligations at times approaching insolvency should carefully balance the need to protect creditors from debtors' mismanagement and irresponsible behaviour on the one hand, and the need to incentivize entrepreneurship as well as the rescue of distressed businesses, on the other. An overly draconian regime of pre-insolvency obligations would run the risk that debtors will be deterred from running businesses; debtors will avoid accessing the insolvency system; or alternatively, being concerned with a personal liability regime, debtors might be fast to close down their business prematurely. A regime based on severe punishment of debtors is also likely to be less effective and to be invoked very rarely. Imposing sanctions may be perceived as a criminal or pseudo-criminal, rather than an insolvency matter, and it might require a very high level of proof that liquidators may rarely be able to establish.

Thus, the key remedy for addressing mismanagement in the vicinity of insolvency should generally be a civil sanction for wrongful behaviour. The regime should provide for possible recovery of the damage or loss from persons who did not have due regard to the interests of creditors and other stakeholders at the time leading up to insolvency, or impose other sanctions in cases of unincorporated entities. Importantly, the focus of the provisions should be on providing a clear exposition of the debtors' duties at the time leading up to insolvency and the manner in which the obligations can be complied with effectively and swiftly. The regime for debtor obligations should also match the procedural framework proposed for MSME insolvency. Thus, it should provide protection to debtors from any personal liability in circumstances where they attempted in good faith any of procedures in the module, including informal negotiations. The regime should also complement and be supported by an adequate institutional framework, and debtors should be incentivised to take full advantage of the institutional framework that the system provides for MSMEs in distress.

b) A regime based on "wrongful trading"

Many insolvency systems recognize that the focus of the management obligations regime shifts to prioritizing value maximization and preservation of the estate, primarily for the benefit of the creditors as a whole, once insolvency proceedings commence. However, there is greater diversity regarding the governance of debtors when the debtor experiences financial distress but is not yet in insolvency proceedings.[106]

Some regimes impose a duty on managers to initiate insolvency proceedings within a short period after the occurrence of an insolvency event.[107] Other systems adopt "wrongful trading" provisions that essentially impose a duty on directors to give due regard to the interests of creditors when they realize that insolvent liquidation (or administration) is inevitable. Some laws provide additional remedies aimed at compensating creditors for fraudulent behaviour or at deterring mismanagement.[108]

[106] Legislative Guide, *supra* note 69.

[107] This is a common approach in civil law jurisdictions. See, for Germany, e.g. Insolvenzordnung § 15a, or, for Spain, art. 5 of the Insolvency Law (*Ley Concursal*).

[108] Legislative Guide, *supra* note 69, Part IV, I(7).

The approach adopted in the insolvency standard[109] is akin to the wrongful trading regimes, albeit not identical to any of the existing domestic laws. This standard is prescribed in a recent addition to the UNCITRAL Legislative Guide on Insolvency Law (Part IV from 2013) and recent amendments of the World Bank Principles on Creditor-Debtor Regimes (amendments from 2015).[110] The Legislative Guide states that:

> "[T]he rationale of such provisions is to create appropriate incentives for early action through the use of restructuring negotiations or reorganization and to stop directors from externalizing the costs of the company's financial difficulties and placing all risks of further trading on creditors."[111]

The standard focuses on tackling mismanagement that falls short of fraud in the period approaching insolvency, while acknowledging that legal regimes may impose additional measures to deter misconduct. It favours flexibility and deference to directors' judgment over the more restrictive approaches. It aims to encourage directors to consider rescue possibilities in times of financial crisis, while providing a regime that mitigates directors' concerns about the risks that accompany attempts to rescue the business. It further states that provisions addressing the obligation of directors and remedies for breach of duties should be implemented in a way that does not adversely affect successful reorganization, does not discourage participation in the management of companies, and does not prevent the exercise of reasonable business judgment or the taking of reasonable commercial risk. At the same time, the standard acknowledges that creditors may be at risk in the period leading up to insolvency and therefore that directors must consider creditors' interests when making decisions during this time.[112]

The insolvency standard thus recommends that when insolvency is imminent or unavoidable, the legitimate interests of creditors, as well as those of other stakeholders, should be protected and that appropriate remedies for breach of duties to consider these interests should be provided. Specifically, it is recommended that directors take reasonable steps to avoid insolvency, or minimize

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[109] *Ibid*.

[110] *Ibid*, Part IV; Principle B2 of the World Bank Principles.

[111] *Ibid*, Part IV, Section I(7).

[112] *Ibid*, Part IV, Purpose of Legislative Provisions.

its extent when it is unavoidable.[113] A range of steps may be reasonable in the relevant circumstances. These steps might include the initiation of formal insolvency proceedings. However, the standard does not suggest that directors should be obliged to file for insolvency within a specific period of time. Furthermore, the time at which the obligations arise is not defined in precise terms. Rather, it generally corresponds to a state of factual insolvency, actual or imminent, before insolvency proceedings have begun. The obligation to take steps to avoid insolvency or minimize its effect arises when directors, defined broadly,[114] knew or ought reasonably to have known that insolvency was imminent or unavoidable.[115] The steps that should be taken by directors are not prescriptive and they may vary depending on the circumstances, though the standard usefully provides a list of possible reasonable steps.[116]

Where creditors have suffered loss or damage because of a breach of the obligations, the person owing the obligation may be liable subject to possible defences, including that the director took reasonable steps to avoid or minimize the extent of insolvency. Liability should be limited to the extent to which the breach caused loss or damage.[117] Yet, the law may specify additional remedies to deter wrongful or fraudulent behaviour.[118]

A similar nuanced approach that incentivizes appropriate actions at times of financial distress, including through rescue options and not necessarily through filing, would be appropriate in the MSME context. It will ensure consistency and compliance with international standards that apply to business entities. Furthermore, as noted above, an effective regime for MSMEs should be largely based on quick actions taken by debtors. A debtor obligations regime that similarly incentivizes early action and rescue, even before the debtor is in actual insolvency, is therefore most adequate in the MSME context. A duty to file regime, on the other hand, is overly narrow. It might not inform MSME debtors about

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[113] *Ibid*, Part IV, recommendation 256.

[114] Persons, subject to the obligation regime, include any person formally appointed as a directors and any other person exercising factual control and performing the functions of a director (Legislative Guide, Part IV, Recommendation 258), see further below.

[115] Legislative Guide, *supra* note 69, Part IV, recommendation 257.

[116] *Ibid*, Part IV, recommendation 256.

[117] *Ibid*, Part IV, recommendations 259 and 260.

[118] *Ibid*, Part IV, recommendation 266; World Bank Principle B2.3.

their general obligations at times of financial distress and may also drive debtors to commence insolvency proceedings prematurely.

Legal systems that adopt this type of debtor obligations (akin to wrongful trading systems and to the insolvency standard) would ensure that debtors are not deterred from entering negotiations, not penalized for doing so, and are encouraged and expected to take such steps. If, however, the legal system prefers to nonetheless follow the "duty to file" approach, it is particularly important that it includes a "safe harbour" that protects debtors from liability where they engage in negotiations with creditors in good faith.

c) Tailoring the standard to MSMEs circumstances

The insolvency standard regarding directors' obligations at times approaching insolvency, although generally appropriate for MSMEs, may be modified to better reflect MSMEs' circumstances. The standard has been designed for companies and their directors, while MSMEs may operate as unincorporated entities. Generally, the standard provides a relatively sophisticated regime, and therefore may require simplification to ensure that the regime is not too cumbersome for MSMEs; that it is clear; and that it does not require seeking sophisticated and expensive professional advice.

Additionally, although the insolvency standard is balanced and is primarily focused on civil liability for (limited) compensation, it is important to ensure that the regime does not deter starting up small businesses or addressing MSMEs' financial distress. Small debtors should not be overly concerned about the consequences of failure. Thus, the regime may require some relaxation in terms of the expectations from small debtors, at times approaching insolvency. At the same time, the potential application of the regime to persons other than the debtors, lenders in particular, who might have been party to reckless trading or fraud, may be further enhanced to support responsible behaviour by lenders of MSMEs.

i) The obligation and the steps to discharge it

The delineations of the obligation and the steps to discharge it should be simplified, removing such steps that may be less relevant in MSME cases. As noted above, the insolvency standard usefully provides specific details on the steps that management may take at times approaching insolvency in order to discharge their obligations. However, the list of steps is extensive:

> "… Reasonable steps might include: (a) Evaluating the current financial situation of the company and ensuring prop-

> er accounts are being maintained and that they are up-to-date; being independently informed as to the current and ongoing financial situation of the company; holding regular board meetings to monitor the situation; seeking professional advice, including insolvency or legal advice; holding discussions with auditors; calling a shareholder meeting; modifying management practices to take account of the interests of creditors and other stakeholders; protecting the assets of the company so as to maximize value and avoid loss of key assets; considering the structure and functions of the business to examine viability and reduce expenditure; not committing the company to the types of transaction that might be subject to avoidance unless there is an appropriate business justification; continuing to trade in circumstances where it is appropriate to do so to maximize going concern value; holding negotiations with creditors or commencing other informal procedures, such as voluntary restructuring negotiations; (b) Commencing or requesting the commencement of formal reorganization or liquidation proceedings."[119]

In the MSME context, some of the measures may be less relevant. Specifically, "holding regular board meetings to monitor the situation; seeking professional advice, including insolvency or legal advice; holding discussions with auditors; calling a shareholder meeting" are likely to be steps that are either too cumbersome or irrelevant in an MSME context.

The regime for MSMEs may provide simply and straightforwardly that at times approaching insolvency, the debtor should operate in the interests of the general body of the business' stakeholders, and actively attempt to avoid insolvency or minimize its effect. The manner to discharge the obligation is, on the one hand, through proper consideration of the alternative solutions (mediation, debtor-in-possession, supervised rescue process etc.) provided in the MSME insolvency framework and, on the other hand, avoidance of use of the MSME's resources in a way that is not beneficial for the general body of creditors. The regime may specify typical important examples of misconduct, including the use of employee wages to subsidize the running of the business at times of distress or in order to pay the bank or another creditor. It should also provide assurance to debtors that there is no obliga-

[119] *Ibid*, Part IV, recommendation 256.

tion to file in circumstances where other routes are explored such as a workout, and the debtor may be liable only if the workout attempt was abusive.

To the extent that the debtor requires assistance, in order, for example, to be able to enter negotiations with creditors or to produce a rescue plan, he/she should seek such assistance provided by relevant institutions, such as mediators or counselling services.[120] In other words, the regime for debtor obligations in the vicinity of insolvency, in particular the delineation of the obligation and the steps to discharge it, should correspond and be complementary to the MSME insolvency procedures and the supporting institutional framework.

ii) Knowledge of imminent insolvency

The obligation to take the steps to avoid insolvency or minimize its effect should arise when the debtor knows or ought reasonably to have known about the financial distress, in accordance with the insolvency standard for directors' obligations. However, the tailored regime for MSMEs may further clarify how such knowledge will be established. Thus, small debtors should be expected to be informed about their financial situation through monitoring of their accounts, which should be properly maintained and be up to date. No other sophisticated knowledge or special skills expected from directors of larger enterprises should be anticipated by the regime.[121] The institutional framework should support this requirement through the setting up of debt counselling services and through proper campaigns about means to address MSME financial distress.[122]

iii) Consequences of breach

The emphasis of the regime for MSMEs' obligations should be on civil remedies in the form of compensation to creditors for the losses they suffered, in accordance with the insolvency standard.

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[120] See Section Part V.B.1.a)

[121] See e.g. how the wrongful trading regime is applied in the U.K. with regard to small companies ("much less extensive in a small company in a modest way of business, with simple accounting procedures and equipment, than it will be in a large company with sophisticated procedures… Nevertheless, certain minimum standards are to be attained. Notably there is an obligation laid on companies to cause accounting records to be kept which are such as to disclose with reasonable accuracy at any time the financial position of the company at that time…"; *Re Produce Marketing Consortium Ltd* (No 2) [1989] BCLC 520).

[122] See Part VI.A.2.

The regime should specify this primary consequence clearly, ensuring that small, incorporated, debtors are aware that the protection of limited liability might be removed in circumstances of breach.

It should be further explained that more severe sanctions may be imposed in more serious cases of misbehaviour. As noted in the insolvency standard, the liability to compensate creditors for damage caused due to the breach of the obligation does not preclude imposing other remedies in addition to the payment of compensation, for example the disqualification of a director from acting as company director for a specified period of time. It also does not preclude holding directors accountable for fraudulent activities, including through taking criminal actions against directors.[123]

The regime should also accommodate the cases of unincorporated entities, by including the bankruptcy-related restrictions discussed later in this Part,[124] within the regime for debtor obligations at times of distress. Measures such as disqualification from taking directorship roles in the future, restrictions on borrowing and inclusion of negative information in the credit history agencies could be imposed in relevant circumstances of breach of the debtor pre-insolvency obligations. In relevant circumstances, the debtor may remain undischarged for a longer period of time, or he/she may not be allowed to stay in possession.[125]

iv) Lender's liability

The regime should also specify clearly the possible obligations by persons other than the debtor and its appointed managers. In the MSME context, often the managers and owners will be the same persons. It is also often the case, though, that MSMEs have close relations with a single or a few major lenders. Such creditors may have perverse incentives to pressurize the debtor to pay their debts (and the debtor may have incentives to cooperate) at the expense of other creditors. Lenders may also put pressure on the debtor to opt for insolvency solutions that may be effective from the lender's perspective (e.g. piecemeal liquidation) but may not

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[123] World Bank Principles, Principle B2.3. See e.g. in the UK, s. 213 of the Insolvency Act (civil liability for fraudulent trading) and s. 993 of the *Companies Act* (criminal liability for fraudulent trading).

[124] See Part VI.A.2.

[125] See Part VI.A.2.

be the most beneficial solution for the general body of stakeholders.

This risk of lenders' self-serving behaviour can be mitigated by applying the MSMEs-tailored debtor obligations regime to lenders and by specifying their obligations at times approaching the insolvency of MSMEs.

The insolvency standard also captures persons other than the appointed directors within the regime. Thus, it applies to: "any person formally appointed as a director and any other person exercising factual control and performing the functions of a director."[126] It is thus possible that lenders will be subject to the obligations in circumstances where they have exercised pervasive control over the business.

However, lenders are not mentioned specifically in the standard. It might also prove difficult to establish the required level of control by lenders if the regime indicates some reluctance to expand the obligations beyond the debtor's own management.[127] Indeed, commentary to the insolvency standard notes the: "… increased risk of unexpected liabilities for banks and others who might be deemed to be directors by reason of their involvement with the company, particularly at the time of the insolvency." It then states that: "[I]t is desirable that relevant legislation provide due protection for such parties when they are acting in good faith, at arm's length to the debtor and in a commercially reasonable manner."[128]

Indeed, the regime should be well balanced. It is important not to deter the granting of credit to MSMEs. At the same time, there is room, in the MSME context, to apply the regime more robustly to lenders. Thus, the regime may specify that lenders of MSMEs may be liable if they took part in actions detrimental to the stakeholders as a whole at times approaching the MSME insolvency. Lenders may be mentioned explicitly in the law on debtor obligations and lenders should be aware that at times approaching insolvency, the obligation of the debtor is to the general body of stakeholders.

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[126] Legislative Guide, *supra*, note 69 Part IV, recommendation 258.

[127] See in the U.K. the difficulty of applying the "shadow director" concept to lenders; Re PFTZM Ltd [1995] 2 B.C.L.C. 354.

[128] See Legislative Guide, *supra*, note 69 Part IV I(10).

d) Enforcement

A key weakness of existing regimes that regulate the behaviour of directors on the eve of insolvency is their limited effectiveness. Provisions on debtors' obligations at times approaching insolvency are enforced quite sparingly, largely due to problems of funding such litigation.[129] In small entities proceedings, the problem of funding is even more pronounced since it is likely that there will be insufficient funds available in the estate to pursue the debtor or other persons. It is, therefore, particularly important that the regime considers ways to address funding issues.

The insolvency standard on directors' obligations at times approaching insolvency delineates certain means for obtaining alternative funding, in particular the assignment of claims for value to a third party.[130] It also recommends that the law specify that the costs of an action against the person owing the obligations be paid as administrative expenses.[131] This approach, in the case of liability for wrongful trading or for the breach of a duty to file, is the solution in jurisdictions where an insolvency representative is a mandatory figure. The representative has the duty to execute its functions to the best interest of creditors. If it is in such interest that directors be made liable and contribute to the insolvency estate, the representatives must start the actions. The problem of the cost of pursuing these actions is part of the general cost of funding insolvency proceedings where there are few or no assets to cover for the cost of proceedings.[132]

To expand the possibility that the duties will be enforced, the regime may allow invoking the provisions in the course of processes other than formal liquidation proceedings and may also expand the right to invoke the regime to agencies other than just the insolvency representative, to include, for example, the court taking

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[129] *Ibid*, Part IV, para. 43. In the U.K., this realization led to amendments introduced to the Insolvency Act in 2015 aimed at broadening funding possibilities of actions against directors (see s. 246ZD of the Insolvency Act).

[130] *Ibid*, Part IV, para. 44.

[131] *Ibid*, Part IV, recommendation 264.

[132] There are different ways to tackle this problem. Some systems do not open proceedings when there does not appear to be enough assets to cover for the cost of proceedings. In those systems where proceedings are nevertheless opened with a view to perhaps swell the estate by means of liability/avoidance actions and ultimately expel the business from the market, funding may come from public agencies (that pay a professional or appoint a public receiver) or through setting up of a fund to pay the remuneration of the insolvency representative.

action on its own motion. The regime may also permit the creditors to bring such actions, in the collective interest of creditors.

Importantly, the regime should be viewed and be utilized as an educational tool, complementing the general framework for MSME insolvency and ensuring that debtors make full and proper use of the regime. It is crucial that reform in the area of MSME insolvency include training and education programs, in particular in regimes less familiar with the concept of wrongful trading and the nuanced approach it entails regarding the obligations of debtors at times approaching insolvency.[133]

e) Alternative approaches based on a duty to file

While the wrongful trading approach is the preferred approach where there is sufficient level of information, a developed market and, especially, a technically prepared judiciary, other alternatives might be more suitable to the circumstances in jurisdictions that lack such features. The main alternative approach would be the implementation of a duty to file. Poor corporate governance and insufficiently trained and skilled directors, a rather widespread phenomenon in the MSME context, might require a clear-cut, and even easier to apprehend rule on which to base the liability of directors. Indeed, the insufficiency and inadequacy of accounting information, particularly common in the context of MSME, makes it difficult to judge retrospectively what the correct behaviour of the director should have been, and when it should have been executed. Judges in jurisdictions with little practice of holding directors liable for misbehaviour, again, a not uncommon situation, could find it difficult to conduct an assessment, on the merits, of the actions of the debtor´s management on the eve of insolvency. While more rigid, the duty to file constitutes a somewhat clearer rule that works as a stricter *ex ante* corporate governance incentive, although the experience in systems that subscribe to the duty to file regime (e.g. Germany) show that uncertainty still exists with regard to the point in time when the duty arises. When opting for one system or the other, the legislator would do well to take all considerations into account.[134]

Duty to file systems have different designs:

- In some countries, the breach of the duty to file is treated as a criminal offence (e.g. Germany, Poland). While this approach would seem like a very powerful incentive, practice shows that it does not always work effectively. In Germany, the involvement of a district attorney introduces complexity to insolvency cases

[133] See further Part VI.A.4. on education and advice to debtors.

[134] See also the regime in Germany, where the duty only extends to directors of limited liability companies.

that might hinder the insolvency professional pursuing the civil liability following a breach of the duty, since relevant documents are seized by law enforcement agencies and not available for the insolvency professional for a significant period of time. In other jurisdictions, the rule might not be implemented because the criminal offence requires a more stringent test (criminal liability usually carries a higher burden of proof than civil liability), and hence the system backfires. Ineffectiveness of criminal law based regimes is also possibly linked with the fact that this type of offence does not often bring about a duty to compensate the damage caused, and hence there is not sufficient incentives for the parties to act (*i.e.,* inform the public prosecutor, or request the judge to do so).

- When the breach of a duty to file brings about the need to compensate and pay damages, there are again different approaches in disparate systems. In some jurisdictions (e.g. Germany[135]), the debtor or the directors in breach may be made accountable only for the damage caused by the delay, while, in other cases, defaulting parties may be made liable to compensate creditors for the amount they did not receive following the liquidation of the business. This latter approach constitutes a civil sanction and is therefore more akin to the criminal law based solution.
- Systems also vary with regard to the legal effect of breaching the obligations. While in some jurisdictions the mere breach of the duty to file is sufficient to trigger the liability or the sanctions, in other systems (e.g. Germany[136]), the breach only creates a presumption of "negligence", that the debtor, or directors, may rebut if they proved that their behaviour was objectively conducted with a view to minimize the damage to creditors.[137] This approach may also be used to foster adequate corporate governance, by linking the presumptions to certain misbehaviour, such as not having fully complied with the accounting duties or any other corporate law rule aimed at protecting the market and

[135] GmbH-Gesetz § 64, but also BGB § 823(2) in connection with InsO § 15a.

[136] *Ibid*.

[137] Articles 164-162 and 172 of Spain´s *Insolvency Act*.

market participants. In these systems, the party in default may also prove that the delay caused no damage to creditors or to the value of the business. This approach, while more balanced, might be difficult to handle for courts and stakeholders, and again would require sophisticated legal professionals and an effective legal system.

2. Addressing debtor moral hazard and lack of information

The Modular Approach provides tools for debtors to address their financial distress at an early stage. In the usual case, the debtor may be able to remain in control over the process and resolve the distress situation with minimal or no involvement of insolvency professionals and minimal or no court intervention. This situation is the default position of the regime. This way, costs are minimized, the debtor expertise and valuable private information is not lost and the debtor is able to recover from the distress situation more smoothly.[138] In particular, the debtor-in-possession approach provides an important incentive that can encourage debtors to utilize the MSME framework and possibly rescue the business if it is still viable. For natural persons, the framework also offers a discharge releasing the individual from his/her debts and from bankruptcy restrictions. The discharge also incentivizes debtors to utilize the system and provides an opportunity of a "fresh start".

However, as noted above, there is some risk that the system will be abused or misused by debtors and that it will drive debtors to act irresponsibly with regard to their debts and their creditors. In particular:

- Debtors may be overly incentivized to access a "friendly" regime, at the expense of the creditors. They may opt for a rescue process that allows them to stay in control even where they lack the skill to address the financial distress. Although in the usual MSME case, the small business will be managed by a single or a handful of individual owner/managers whose expertise is crucial for the business,

[138] The Legislative Guide, *supra* note 69 considers in commentary a range of important advantages in the debtor's continued involvement in the process, in particular noting the debtor's immediate and intimate knowledge of the business especially in the case of sole traders and small partnerships (see the Legislative Guide, Part two, III, A., para. 5).

these individuals may not have the means to address the situation of distress. Small businesses might not be able to afford the services of professional advisers to assist in making appropriate decisions at times of financial difficulties. They may, therefore, make decisions regarding the relevant insolvency solution (the options available under the Modular Approach) that could be detrimental to creditors. The *doomed-to-failure module* discussed above[139] addresses this risk by allowing a majority of creditors with claims large enough to veto a debtor's plan to terminate debtor-initiated rescue proceedings.

- Generally, debtors may have a strong incentive to file if they know that they remain in control. 'Wishful thinking' may drive debtors to attempt a reorganization path, in particular, if they know that they remain in possession, and even if it is not a viable solution in the circumstances, where it might merely prolong an inevitable liquidation outcome.
- In other circumstances, creditors may have close relationship with one creditor, likely the main lender, and may seek a process that is to that creditor's benefit, neglecting the interests of the creditors as a group.
- MSMEs may attempt to exploit the benefits of the insolvency framework, the discharge in particular, without providing sufficient information on their affairs and activities. Generally, MSMEs are prone to operating with limited transparency and limited monitoring of the accounts and financial affairs in their ordinary course of business due to restricted resources and laxer disclosure regulation. They may also deliberately conceal information or engage in other type of abusive or fraudulent behaviour, such as hiding assets from creditors or lying about their financial situation.[140]
- Individual debtors may also be driven to incur excessive debt at the expense of creditors, knowing that they can be discharged in insolvency. Incorporated entities may also

[139] See Part V.B.1.e), "doomed-to-failure-module".

[140] Although, as noted in the World Bank, Report on the Treatment of the Insolvency of Natural Persons ["the World Bank Natural Persons Report"]: "one should not overemphasize the danger that such fraud represents. Empirical observation of many existing insolvency systems has confirmed repeatedly that the instances of real fraud are vanishingly low" [para. 118].

take excessive risks on the assumption that they will be protected by limited liability in the event of insolvency.

All of the above represent typical situations of debtor moral hazard in cases of MSME insolvency. The next section addresses these issues and proposes solutions to enhance the governance regime of the insolvency process, address information gaps and consider enforcement and sanctions.

a) Effective governance regime: oversight of the insolvency options

A robust governance regime that can mitigate the risks noted above is critical for the proper functioning of the MSME insolvency regime. In the absence of an effective governance regime, creditors may have limited trust in debtor-led solutions and may be quick to request displacement of the debtor and supervision by professionals, which might eventually lead to an increase of costs. The insolvency standard stresses the importance of an effective governance regime in the course of insolvency proceedings. In this respect, a system that is perceived too debtor-friendly may result in creditor apathetic behaviour and lack of interest in the process.[141]

In this regard, it should first be acknowledged that although the proposed approach for MSME insolvency contains some degree of granularity, it leaves room for jurisdictions to adopt different forms of debtor-led processes, in particular, in terms of the level of court involvement, to address specific challenges in the system. It is important that jurisdictions consider the manner in which a debtor-in-possession procedure might be implemented and how it is integrated with other aspects of the system.

Additionally, while the debtor-in-possession process is, in principle, the preferred default approach, the framework for MSMEs should also contemplate means to address the risks it entails. The flexibility of the Modular Approach should be accompanied by measures to counter reckless or otherwise improper choices by the debtor.

Indeed, inherent to the Modular Approach is the fact that it contains a range of tools to achieve full or partial rescue or liquidation in the relevant circumstances. The choice between the procedures is primarily in the hands of the debtor, yet it is intended to be monitored by the creditors. Thus, even where, as contemplat-

[141] See Legislative Guide, *supra* note 69 Part two (II.A., para. 7).

ed by the modular framework, debtors will have the option of staying in possession, the regime would also allow the creditors to object to such approach. Creditors should be able to:

- require that the debtor rescue process is monitored or supervised;
- seek the involvement of the court in the process;
- require that the debtor is displaced.

In addition to these three measures, the law—or, in some jurisdictions, a court decision—should limit the debtor´s scope of administration of the business for the period the procedure is ongoing and a decision is to be adopted on the final exit to the business crisis. Typically, this limitation, which will apply to the different typology of the debtor-in-possession situations, will not allow the debtor to enter into transactions outside the ordinary course of its business activity. In other words, until the destiny of the business is decided, the debtor must observe a low risk profile in its activity. In cases where an extraordinary act of disposition is necessary, it should only be carried out under the authorization of the court or the relevant insolvency agency.

b) Addressing information gaps

One of the main obstacles to the proper implementation of a MSME system, and a major contributing cause of debtor misbehaviour is the absence of adequate information in the MSME insolvency process. An effective MSME insolvency system would work substantially better if the debtor provides the necessary information and is willing and available to collaborate throughout the entire procedure. In some cases, and in some jurisdictions, however, particularly in the less developed economies, the very existence of the information cannot be taken for granted. This section discusses both the issue of the debtor obligations to cooperate and provide information and the issue of absence of such information, suggesting means to enhance the availability of information, including through the involvement of third parties in information gathering.

i) Information and collaboration duties of the debtor

The MSME insolvency regime should clearly prescribe the obligations of MSME debtors and properly match these obligations to the different types of procedures contemplated by the Modular Approach. Importantly, the regime should be premised on cooperation in good faith between the debtor and the creditors, the insolvency professional or the court (depending on the type of

process taking place), and the provision of complete and correct information regarding the debtor's finances and activities to the extent and in the measure designed by the jurisdiction.

As noted above, the insolvency standard stresses the importance of a robust governance regime in the course of the insolvency proceedings. The standard further delineates the recommended debtor's obligations, to the insolvency representative, the court or the creditors, after the commencement of and throughout the insolvency process. These obligations are relevant in the MSME context as well and would include: assisting the representative to perform its duties; providing accurate, reliable and complete information regarding the financial position and business affairs; cooperation to enable the representative to take effective control of the estate and to facilitate or cooperate the recovery by the representative of the assets; and notifying the court about any intention to leave the habitual residence or move the debtor's headquarters.[142]

In particular, the standard stresses that a reorganization option should be conditioned on the continuing obligation to provide adequate information about the debtor's business and affairs.[143] To the extent that the MSME debtor lacks the means to comply with this obligation, he/she should seek the appointment of an adviser who could assist in the process. The institutional framework for MSME insolvency should support and complement this obligation through the setting up of debt counselling services and through requirements imposed on relevant agencies to provide information about troubled businesses, as further discussed below.

Requirements concerning transparency, good faith and full disclosure should be embedded in all the procedures in the Modular Approach, including business rescue proceedings.[144] Workout guidelines designed for the MSME cases should also include principles concerning the debtor's duties and obligations. Such guidelines should provide that negotiations between the creditors and the debtors should take place in good faith and that the debtor must communicate and provide information to the creditors re-

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[142] *Ibid*, Part two, recommendation 110.

[143] *Ibid*, Part two (III.A., 24). Under the US Chapter 11 *Bankruptcy Code* process for SMEs, the small business debtor must file periodic financial and other reports regarding its cash flow and its profitability.

[144] See Part V.A.

garding any relevant aspect of the restructuring. The communication should be honest and the debtor should be obliged to provide all requested information in a timely and accurate manner.[145]

ii) Financial information in MSME insolvency

Financial information is a key element in the mechanics of a market economy. Without proper, reliable, comparable financial statements, stakeholders cannot make investment decisions and the *ex post* control of the behaviour of market agents is not possible. This risk exists for all market participants, including –and in no less degree- MSMEs.

Experience shows that information problems are more important the smaller the business is. Especially in developing economies, the level of informality is high: sometimes entrepreneurs and small entities do not have a legal duty to file proper accounts, or the duty is only rarely enforced; owners and managers have little or no knowledge of account drafting; and public training courses and awareness campaigns are very scarce.[146] MSMEs conduct their activity "the way it's always been", with, at best, home-based accounting practices. This situation is incompatible with the proper development of the MSME sector, and, hence, of the economy of a given jurisdiction. An adequate level of formality and, more precisely, sufficient financial information, are key to a workable system to tackle MSME insolvency. Without it, access to finance is limited, risk seems higher, and therefore the price of financing is also more expensive. In case of financial difficulties, out of court agreements are hindered, many insolvency tools are useless (liability of directors, avoidance actions, etc.), and there are perverse incentives to destroy value by owners of distressed MSMEs. The entire system to tackle business distress might be thwarted. Even in those countries where there is a proper system of debt discharge, the fresh start of the debtor is hampered by the impossibility of making a proper assessment of the discharge test, given the lack of information, at least in those systems where the discharge is based on an *ad hoc* analysis of the debtor's behaviour.

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[145] Requirements concerning honest communication of relevant information should also be imposed on the creditors, party to the negotiations.

[146] A good indication of the level of formality of developing economies can be found in the database of the Accounting and Auditing Report on the Observance of Standards and Codes of the World Bank, available at http://www.worldbank.org/ifa/rosc_aa.html.

iii) The need to strike a balance when imposing accounting duties

Despite its importance, there is a downside to the implementation of a fully-fledged system of accounting and financial information: it is expensive. The smaller the business, the less reasonable it is to impose excessive accounting duties. These objectives can act as access barriers, as well as demand an investment of time and training that the smaller economic units may not be able to afford. Too much across the board increase in the accounting duties of MSMEs may place an excessive burden on some of these businesses and be counterproductive. It is necessary to design a system of financial information that maximizes the amount of information while minimizing additional costs; one that identifies the key information to be provided, makes it compulsory, and leaves other information as optional; a system that is able to properly segment the spectrum of businesses into different groups with duties of diverse intensity.

This approach is well consolidated in the accounting profession. The International Financial Reporting Standards ("IFRS") take into consideration the size and complexity of the business to gauge the accounting needs,[147] and most countries with well-developed systems include lower information standards for the smaller market participants. However, the differences reflected in IFRS and international practice do not always cover the specifics of the smaller businesses (often, the vast majority), and, in any case, their level of effective implementation is often weak. In addition, problems do not always come from the type of information that needs to be included, but from the costs that are incurred in generating and sustaining the information documentation.

iv) Possible solutions to the problem of insufficient information

The solution of this wide-spread problem concerning lack of information in MSME cases may come from the combination of

[147] The International Accounting Standards Board has published a specific document for the accounting of SMEs: IFRS for Small and Medium-Sized Enterprises (http://www.iasplus.com/en/standards/other/ifrs-for-smes). Some of the simplifications of the IFRS for SMEs are the following: the elements of the full IFRS that are not relevant to typical SMEs are removed; some accounting policy options are not available to the smaller businesses; many of the recognition and measurement principles are simplified; there are substantially fewer disclosures required; and redrafting duties are reduced.

measures that involve the debtor, the creditors and the institutional framework generally. Furthermore, the measures may not only stem from the insolvency or pre-insolvency framework, but also involve a number of general corporate and commercial laws and the institutions in charge of implementing them.

In particular, the information-enhancing system needs to be cheap, efficient and have the capacity of offering bespoke solutions to different businesses, depending on size and the level of complexity. The following are possible solutions to be considered in this respect:

- The use of templates and other mechanisms of simplification. These templates could be prepared by the agency in charge of the implementation of the insolvency system, but it would be more efficient if the pre-defined information models are prepared for the general accounting requirements of businesses, not just for the preparation of an insolvency petition. Templates should be free of cost and be openly available—downloadable— from the relevant website. The business/companies registrar is a clear candidate for the provision of the templates. Digitalization and on line solutions, even for delivery of the accounts, would also reduce costs and increase the flow of information.[148] While implementation may pose difficulties in the short/mid-term for most developing nations, it is also true that assistance from donors in this regard is easier to channel and implement. In order to bridge the gap between on-line technology and the reality of certain jurisdictions, specialized agencies/government bodies could provide physical copies of the templates

[148] A number of associations of the banking and financial services industry of the UK have developed an interesting model called the *Common Financial Statement* (CFA), which provides standardised, simplified accounting and budgeting models. The organization collects information about spending patterns and average living expenditures that help debtors plan and creditors assess and negotiate. The CFS has two parts. The first part is a detailed budget sheet that includes details of a client's income, assets, spending and debts; and the second part is a summary financial statement containing a condensed overview of the client's financial situation. This system is actually aimed at advice agencies, debt management companies, creditors and debt collection agencies. Although it is conceived for household and consumer activity, the model could be emulated to cover the ordinary activities of the smaller businesses in the market. It includes also codes of good practice that affect creditors. For more information: http://www.cfs.moneyadvicetrust.org.

and assist in their compilation. The utilization of templates could also be enhanced by creating the duty to inform of their existence and the need to utilize them at the time of granting the credit by banks and financial institutions, or at the starting up stage of the business (business register).

- Legal requirements of financial information may be subdivided into more groups of businesses based on their size and complexity. Instead of having just two types of legal requirements, as is the case in many jurisdictions: general and abbreviated financial accounting duties depending on size, having more divisions would allow for a more bespoke solution and may help maximize the equation referred to above. This granulation would be especially relevant for MSMEs, the smallest part of the business spectrum. Legal obligations and templates would be designed for these businesses. In order to mirror banking practice with non-performing loans, segmentation of debtors would also favour restructuring options and bespoke solutions.
- In any case, the main elements of financial accounting of MSMEs should be public and openly accessible. Most commonly, business/company registries are the places tasked with this duty. At least yearly, a full balance sheet and the year´s financial results ought to be made public, having been previously deposited in the registry or any other public agency entrusted with the task. Non-compliance with this duty ought to bring about sanctions and other consequences in case of business failure, as discussed below.

v) The involvement of third parties in information gathering

The existence of sufficient and adequate financial information should not only lay on the shoulders of debtors. The active participation of other stakeholders, directly involved with the business life of debtors, is paramount in this regard. Information on troubled businesses needs to flow from the places where it will normally exist:

- Financial institutions: Banks and other lending institutions are responsible for the inception of a good portion of MSME credit. When the debtor approaches its

bank/financial institution, the risk assessment should be based on the provision of sufficient information by the debtor. Further, financial institutions have the ability to contractually impose reinforced information duties on debtors during the life of the loan/financing instrument. They can also track performance and lower debtor moral hazard using financing instruments that are periodically renewed against good business behaviour, or by the use of banks' current accounts and other financial products that allow for the daily monitoring of financial positions. The inclusion of "early warning" signs in their tracking of the debtor´s performance constitutes a very useful tool to avoid value destruction and late insolvency filings. Their risk management practices could, therefore, if properly designed and implemented, contribute greatly to enhancing the financial information of the debtor. Hence, banking supervisors have the key to contributing to the market system by ensuring adequate risk management and monitoring practices. Often banks, especially in the MSME and retail sectors, have granular information about the debtor´s assets and additional liabilities. However, this information is privately kept and there are often no mechanisms envisaged for sharing it with the appropriate insolvency institutions. Further, bank secrecy is often used to deny collaboration with insolvency representatives, public agencies, other creditors or even insolvency courts. The establishment of appropriate exceptions to bank secrecy in certain cases and under adequate controls should be explored.

- Financial information systems:[149] Credit history contained in credit information systems is not only important for the moment of credit origination. It can constitute a key informational tool when the business reaches a state of distress, either to allow for its restructuring or for the retroactive assessment of mal-

[149] See the World Bank´s *General Principles for Credit Reporting* (2011) and, especially, the more recent and SME referenced *Facilitating SME financing through improved credit reporting,* available at http://siteresources.worldbank.org/EXTFINANCIALSECTOR/Resources/282884-1395933501015/Facilitating_SME_financing_through_CR_public_comments_web.pdf.

practices. A comprehensive credit report would include trading references, public record filings (court actions, suits, etc.), banking and other financing references, or significant elements that may have impacted the performance of the business. It is not uncommon that the information recorded in credit information systems is kept within the circle of financial institutions. The information, or some of it, could benefit other credit providers, including suppliers and other operational creditors. These information registers should include information on utilities and other liabilities different from financial liabilities. As a result, the amount of information in the system would be greatly enhanced.

- Tax authorities: Tax agencies often have substantial information about the debtor´s business. Goods and services and value-added taxes and corporate taxes should provide indications and warning signs of the state of a debtor´s business. Even the lack of information (*i.e.,* delays in filing tax returns) is, in itself, a very useful warning sign of trouble. In some countries, yearly declaration of the value of certain assets is required, and even, from time to time, a mandatory universal declaration of goods. The existence of investigation concerning misbehaviour (untaxed services rendered, untaxed payments, etc.) is also relevant information for the insolvency of the debtor and the assessment of the behaviour of its directors or controlling shareholders.
- Other government entities: In those countries where there is a public system of social security, all information concerning compliance with the debtor´s duties in this regard can be substantial. It should also serve as an early warning sign of business trouble. Other entities that hold relevant information are those public registries where security rights over assets of the debtor are registered.
- Financial and governance education: Finally, government agencies can play a key role by ensuring there is a proper system of financial education to the MSME sector, including training of entrepreneurs and company directors on good corporate governance, briefing on financial accounting duties and where and how to obtain valuable resources, awareness creation cam-

paigns, etc. This type of action and campaigns could be also run by chambers of commerce and other collective organizations in the private sector.

Thus, even in the most extreme cases where it seems that no financial information exists for the relevant MSME, it is likely that, through the channels described above, some important information can actually be obtained. The main problem is locating the information, collating it and centralizing it in the right institution. There is a need to devise a system that allows for the relevant information to flow and be shared. Mechanisms should be designed to ensure that information from public agencies (e.g. tax authorities), registries, credit information systems and the banking sector are made available to the insolvency court in insolvency cases, or even, under adequate control, to the parties in out-of-court solutions. These mechanisms will require, among other changes, the inclusion of exceptions to bank secrecy and personal data sharing rules.

Adequate financial information ought to be available throughout the business life of the debtor. The inclusion of strict information requirements to access insolvency or hybrid pre-insolvency proceedings may have counterproductive effects. If a debtor has not been producing the financial accounts on a regular basis, having to reconstruct his/her accounting profile dating years back might constitute an obstacle that could have the perverse effect of delaying the opening of insolvency proceedings and the destruction of the business as a consequence. Further, during formal bankruptcy proceedings, the debtor´s effort to produce adequate financial information could arguably be less necessary, where there is an insolvency representative whose task is, precisely, to work on the debtor´s inventory, creditors and business history. Consequently, the legislator must be aware of the need to amend company and business laws to ensure adequate financial information as an ordinary requirement of business activity, rather than resolving such issues through insolvency law.

3. Sanctions for misconduct during the insolvency process

The risk that debtors will exploit the MSME framework and act self-servingly, recklessly or with insufficient skill should be addressed primarily through the proper design of the procedural framework. As discussed above, the regime should prescribe strict timeframes, duties to cooperate and to provide information and opportunities for creditors to object to the process proposed by

the debtor or to the manner in which the process is administered. Through the enforcement of deadlines and other conditions, and through creditor monitoring, the debtor will not be able to prolong the procedures and creditors will be able to address problems of mismanagement.

Yet, the system should also include sanctions that may be imposed on the debtor in order to ensure compliance with the prescribed duties, to address instances of misuse of the framework, deter certain type of misconduct and protect the public from repeat abuse.[150] Sanctions may be imposed on the individuals controlling an incorporated MSME, including directors and management. In cases of unincorporated MSMEs (i.e. MSMEs not operating through a legal entity), sanctions will be imposed on the sole trader or partners in a partnership.[151]

Sanctions should not be overly draconian, though, and should be well-tailored to the type of misconduct and circumstances of the case, to ensure that the sanctions can achieve their aims and that they do not prevent asset maximization. For example, a failure of the debtor to deliver on projections concerning a rescue plan or his/her lack of cooperation during the process may result in conversion to liquidation. Yet, in relevant circumstances, creditors may prefer to proceed with a reorganization to extract more value from the business, notwithstanding the breach of debtor duties, though creditors may require that the process is administered by a professional and that the debtor is displaced.[152]

In cases of misconduct and abuse of the system, additional sanctions may be imposed in the form of restrictions, personal liabilities or even criminal sanctions. In particular, forging and concealing information should be punished with severity, given the difficulties to access reliable information.

As a general rule, though, the system should strive to provide a "fresh start" to insolvent debtors. The focus of the MSME insolvency regime should be on debtor rehabilitation, rather than on

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[150] The inclusion of sanctions for breach of debtors' obligations is consistent with the general insolvency standard that recommends that: "the insolvency law should permit the imposition of sanctions for the debtor's failure to comply with its obligations under the insolvency law." see Legislative Guide, *supra*, note 69 Part two (III, A., para. 33).

[151] *Ibid*.

[152] *Ibid*, Part two (VI, A., para. 1).

punishment for failure.[153] The regime should encourage entrepreneurial activity and risk-taking and combat the negative stigma associated with bankruptcy. At the same time, the sanctions included in the regime should be imposed in a robust manner in the appropriate circumstances, and should not be mere "dead letters" in the law. The court should be able to compel debtors to meet their obligations and effectively address circumstances of irresponsible, reckless or dishonest behaviour.

As noted previously, one of the key incentives of the MSME procedural framework as it applies to individuals is the provision of a discharge. Yet, the availability of the discharge should be restricted in circumstances of misconduct,[154] as also contemplated in the insolvency standard.[155] Thus, the discharge may be refused or suspended in circumstances of breach of accounting duties.[156] Furthermore, certain categories of debts may not be released on discharge, including debts incurred by fraud.[157] However, excluded debts should be kept to the minimum.[158]

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[153] *Ibid*, Part two (III, A., para. 32). See also EU Commission Recommendation on a new approach to business failure and insolvency, Brussels, 12.3.2014 ["EU Recommendation"] (one of the key objectives of the recommendation is to give honest bankrupt entrepreneurs a second chance across the Union); The World Bank Natural Persons Report, at. 25-40 (delineating the host of benefits to debtors and to society from providing relief to honest but unfortunate debtors).

[154] *Supra* note 105, notes that all laws that provide for a discharge, restrict its availability in various circumstances of misconduct (see Part two, IV.A, para. 6).

[155] *Ibid*, recommendation 194.

[156] In this regard, legal regimes may consider different policy options, depending on the extent to which good accounting practices have become the norm in the system. Thus, for example, where an entrepreneur sought a discharge for the first time with inadequate or no accounts, the system may allow granting the discharge if there were no allegations of fraud or bad faith and subject to the condition that a second discharge would be suspended or refused where the accounts were non-existent or clearly inadequate, even in the absence of fraud or bad faith. In this way, the MSME insolvency regime can incentivize good behaviour and educate entrepreneurs, albeit on the basis of threatened sanctions. At the same time, such an approach can avoid a blanket sanction that might result, at least in certain systems, in denying discharges to most debtors.

[157] See the Legislative Guide, *supra*, note 69 Part two, IV, A. para. 7 listing: debts arising from tort claims; maintenance agreements; fraud; penalties and taxes. The EU Recommendation provides that Member States may exclude specific categories of debt, such as those rising out of tortious liability, from the rule of full discharge (EU Recommendation, para. 33).

[158] *Ibid*, Part two, IV, A. para. 7.

Where the debtor does not comply with the requirements of the MSME framework and breaches his/her duties during the process, the discharge may be suspended and the debtor may remain un-discharged for a longer period of time. Such sanction may be appropriate in circumstances where debtor conduct adversely affects the proceedings (e.g. where the debtor fails to deliver property or to provide information) and the discharge may be suspended for an undefined period until the debtor fulfils certain conditions (but not indefinitely).[159] Regard may be given to circumstances where it is clear that the debtor is not in a position to provide the information or property, or where it is not cost efficient to further delay the discharge.[160]

Further restrictions may be imposed on the debtor during the process, as well as post-discharge, for a certain period of time, where the debtor acted dishonestly or is blameworthy in some other way.[161]

Restrictions may include:[162]

> *Restrictions on obtaining new credit:* The debtor may not obtain credit of more than a prescribed amount without disclosing his/her status as a person subject to bankruptcy restrictions to the credit provider, or without obtaining the

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[159] The EU Recommendation, *supra*, note 85, states that: "a full discharge after a short period of time is not appropriate in all circumstances and that Member States should be able to maintain or introduce more stringent provisions which are necessary to: (a) discourage entrepreneurs who have acted dishonestly or in bad faith, either before or after the bankruptcy proceedings were opened; (b) discourage entrepreneurs who do not adhere to a repayment plan or to any other legal obligation aimed at safeguarding the interests of creditors; or (c) safeguard the livelihood of the entrepreneur and his family by allowing the entrepreneur to keep certain assets." (EU Recommendation, para. 32).

[160] See also the World Bank Natural Persons Report that notes that: "[A]n overarching goal of any insolvency system is striking a careful balance between two competing considerations: first, demanding much of those who incur obligations; but second, not demanding more than can be reasonably borne by the victims of economic volatility and other common dangers of life." (para. 115).

[161] For example, in England and Wales, a bankruptcy restrictions order (BRO) may be imposed on debtors for a period of 2-15 years after the order is made. Alternatively, the debtor may be subject to a bankruptcy restrictions undertaking (BRU) where he/she agrees to be subject to certain restrictions until a specified date.

[162] The restrictions may be wide ranging and may also include restrictions on leaving the country, practice the debtor' profession for a period of time etc. There may also be a limitation on the number of times a debtor can be discharged (see also Legislative Guide, *supra*, note 69, Part two, IV, A. para. 8).

approval of the court or of another relevant agency or quasi-judicial authority.[163]

Restrictions on taking part in company management: Debtors (individual sole traders or managers of incorporated MSMEs) may be restricted or disqualified from acting as directors of companies or from taking part in company promotion, formation or management, for a specified period of time.[164] As noted in the insolvency standard, it is desirable that such a restriction is not too broad, prohibiting the debtor generally from engaging in business activity, so that it does not defeat the concept of providing a fresh start.[165]

Information in credit history records: Information about the debtor insolvency may be kept for a specified period of time in the records at credit history bureaus. Credit bureaus can also have a major impact on the debtor's ability to start afresh, and therefore, the restriction should be imposed carefully, in circumstances of misconduct.

The system should further include, either within the MSME insolvency legislation or in criminal legislation, criminal sanctions for insolvency offences for which the punishment may be a fine, or in some instances, imprisonment for up to a certain number of years. Such sanctions may be imposed in circumstances of serious offences such as falsification of documents in a material manner, serious contraventions of bankruptcy restrictions and concealment of property.[166] It is important that such offences are drafted

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[163] Under the bankruptcy regime applicable in England and Wales, debtors may be required to disclose the fact that they are subject to bankruptcy restrictions when attempting to borrow £500 or more.

[164] See e.g., the UK company directors' disqualification regime. Under this regime, disqualifications of between two and 15 years may be ordered where the individual is found to be "unfit" to act as a director (including because of breach of a fiduciary duty, misapplication of moneys, making misleading financial and non-financial statements or failure to keep proper accounts). See also the Legislative Guide, *supra*, note 69, Part IV, paras. 34-35.

[165] *Ibid*, Part two, VI.A, para. 10.

[166] Under the regime of England and Wales, any person guilty of a bankruptcy offence is liable to imprisonment, a fine or both. A sentence of up to seven years can be made in some instances.

with precision and specificity and are limited to severe misconduct.[167]

The court should also have the power to address reckless and fraudulent behaviour of the debtor at the time approaching insolvency,[168] and to undo transactions entered into by the MSME with a view to dissipating or reducing the value of its assets in the period before insolvency.[169] Insolvency law could include a presumption of misconduct or a presumption that the debtor´s behaviour has contributed to the aggravation of insolvency in cases where the accounting duties were not complied with. Note that this rule would not affect all cases of insolvency, but only those in which the debtor's behaviour is to be analyzed with a view to establishing liability or disqualification in accordance with a jurisdiction's legislation or regulation concerning directors and/or shareholders. Consequently, this rule would not discourage a filing for insolvency in those cases where there has not been misbehaviour, and, at the same time, it constitutes a powerful *ex ante* incentive for company directors to comply with their accounting obligations.

4. Education and advice to debtors

Entrepreneurs are typically people with a certain mindset and spirit. They do not always, however, possess the education and skills to monitor the financial situation of their business and to react accordingly. With regard to the MSME framework, they would usually not be capable of designing a proper rescue plan. They might not even be aware that there is a chance to turn their business around by using mechanisms under insolvency law. In all these areas, education is a useful, although certainly not exclusive, remedy. Specific knowledge in insolvency law or accounting cannot be taught to every small entrepreneur. Instead, a combination of affordable educational counselling and legal advice should be established.

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[167] Forging/concealing information should be punished with severity. Many jurisdictions have rules that punish misbehaviour, but they are often not enforced. Enforcement should be encouraged if the system is to work effectively. The duty to ensure enforcement could be assigned to the insolvency representative or, in some cases –those involving criminal liability- to the public prosecutor (notified of the case by the insolvency representative, the insolvency judge or the insolvency agency, as the case may be).

[168] See Part VI.A.1.

[169] See Legislative Guide, *supra* note 69, Part two (II.F).

On the educational side, every entrepreneur must be made aware of the mechanisms available to rescue a viable business in times of crises. Here, local business clubs or boards appear well-suited to spread the news by organizing presentations, or disseminating emails and brochures. TV ads and shows have proven to be quite effective in presenting ways to rescue a troubled business to a broad audience as well, at least in Germany. In those developing nations where cell phone penetration is quite broad, using social media or text campaigns through the cell phone service provider might be useful.

Company law could be drafted to include minimum requirements for director qualification with regards to basic knowledge in accounting, risk management and rescue options. For sole entrepreneurs, proper financial and legal education could be incentivized by tax deductibility of educational efforts.

At the same time, the educational framework should encourage any entrepreneur to seek expert advice in times of trouble or crisis. Such advice must be easily accessible and affordable to a small business owner (free if possible). Private business clubs or public agencies could provide for experts or, at least, establish a connection to possible experts. They should also disseminate brochures and online information about available options under the framework's Modular Approach.[170]

B. CREDITORS AND MSME FINANCIAL DISTRESS

The Modular Approach and its supplementary governance regime puts great focus on the position of the debtor. Indeed, the success of the MSME insolvency system is largely based on its early, voluntary use by the debtors themselves. However, both the inception and the ensuing solution for the business in distress might be heavily influenced by the behaviour of creditors, with particular regard to financial creditors, which, in most cases of MSME financing, will be only one or two institutions.[171] The Modular Ap-

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[170] See e.g. Germany where several local Chambers of Commerce and Chambers of Crafts provide online information and individual consultations about how to handle the insolvency of a business. There is mixed evidence about the efficacy of adult financial literacy education; see e.g. J.M. Collins, C.M. O'Rourke, "Financial education and counseling—Still holding promise" (2010) *Journal of Consumer Affairs* 1;44(3):483-98; and A. Lusardi and O.S. Mitchell, "The economic importance of financial literacy: Theory and evidence" (2014) *Journal of Economic Literature* Mar 1;52(1):5-44.

[171] Unlike medium-sized businesses, some of which may feel attracted by the prospect of seeking competing forms of financing from a plurality of banks,

proach takes account of and aims to protect the interests of creditors through the design of its options.[172] Yet, in addition to the operation of the modular framework, consideration should also be given to creditor behaviour and the influence of their practices on the ability of the MSME system to function properly.

Experience in recent crises shows that creditors, particularly financial creditors, do not always observe good risk management practices when granting credit. Reckless lending, at one extreme, or overcollateralization, at the other, have contributed significantly to the amplification of the crisis of the non-financial economy, with severe social consequences.

In addition, the behaviour of financial institutions *ex post*, namely when the debtor is already financially distressed, requires specific attention. Often, banks show little interest in getting involved in the rescue of a failing business. Indeed, creditor passivity constitutes one of the main problems of any system to tackle the distress of MSMEs. One strategy to address this apathy, discussed in part 3 below, is to devise new tax incentives.

Third, and also affecting creditors, albeit from a different perspective, it is often the case that MSMEs find it extremely difficult to obtain financing when they are in a situation of financial distress, be it outside or inside formal insolvency proceedings. Without the support of creditors, viable businesses are not able to survive and value is unnecessarily lost for the economy.

These problems of creditor lending practices, creditor passivity, tax disincentives and creditor financing are considered below, noting the specific problems arising in this respect for MSMEs and considering ways to address these issues with a view of enhancing the effectiveness of the MSME insolvency regime.

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virtually all micro and small businesses will work with one bank only. Furthermore, even in those rare cases where a business belonging to the MSME field is a non-sporadic customer of several banks, there will still be a privileged relationship with one of them, called to play a leading role vis-a-vis the others: it may thus be safely stated that most MSMEs fall either within the scope of the one-bank relationship model or within the scope of the leading-bank relationship model. Hence, the sole bank or the leading bank, together with the debtor, are, in the field of MSMEs, optimal addressees of the law reform suggestions that are considered by this paper to have, if implemented, the best chances to minimize the negative social impact of MSME insolvencies.

[172] See Part V, on the procedural framework and the governance regime.

1. Creditor lending practices

In a standard case, a MSME will have commercial creditors, "legal" creditors (*i.e.,* those creditors whose claims arise as a consequence of the law such as tax authorities and social security obligations) and one—sometimes more—financial creditors. Commercial creditors provide credit to MSMEs by supplying goods that will be repaid within a relative short period of time. The essence of commercial credit is that it should be repaid with the revenues generated by the operation of the business, so that the existence of this type of credit should be a sign of the viability of the business. At the same time, keeping this line of credit open is a precondition of the rescue of viable businesses. Because this credit is normally unsecured (or secured with collateral linked to the operation of the business), it is directly linked with trust in the continuation of the activity, and, therefore, based on reputation. Few or no recommendations in this report relate to commercial creditors. They should be allowed to operate under the ordinary rules of the market and manage their risk as they see fit. It would not make sense for a legislator to impose certain behaviours on commercial creditors, whose very existence may often be jeopardized by the financial distress of one of their debtors.

The situation is different with respect to financial creditors. Their size, their degree of sophistication, their type of activity, and their often privileged legal position puts them in a situation where they may be able to destroy value for the economy if they act inappropriately. Thus, it may be prudent for the legislator or the banking supervisor to ensure good practices. The following are areas where financial creditors´ behaviour may impede the rescue of distressed but viable businesses.[173]

> *The structure of lending:* Good banking practice stipulates that the decision to lend a business ought to be primarily based on the viability of the business project.[174] Often in respect to MSMEs, this practice is not strictly observed. Banks may lend only where the debtor provides collateral and/or personal guarantees. However, often MSMEs do not have sufficient collateral to finance their activity, both at inception or during the life of the business. Unsecured lending is scarce and expensive. It is not uncommon that

[173] The problem of the lack of financing to distressed MSMEs is treated separately in Part VI.B.4.

[174] Bank Lending to Business, Canadian Banker's Association, available at http://www.cba.ca/contents/files/backgrounders/bkg_banklending_en.pdf .

shortage of affordable credit exists even for good business projects. This situation is sometimes exacerbated by policies imposed by supervisors.

The problem of shortage of affordable credit not only arises at the time of granting credit, it also influences behaviour at the time of distress of the borrower. Thus, the higher the proportion of the loan covered by the value of the collateral, the fewer incentives banks have to engage in a restructuring of the business. The type of security also matters: floating charges and any other type of security where economic value is linked with the operation of the business (and not of a particular asset) align the interests of lenders and the debtor, creating incentives to rescue viable businesses. However, many loans involve fixed charges. One way to improve this situation is by enacting a workable system of security over movable assets, increasing the types of security (an issue which is beyond the scope of this report).

The regulatory framework: Banking regulations, especially those aimed at strengthening the position of banks as debtors, may exert a strong influence on banking behaviour towards distressed loans. The provisioning rules of a country constitute the point where the two sides of banks, as debtors and creditors, most clearly collide. A very strict application of provisioning rules may undermine the incentive of banks to restructure, while, on the other hand, excessive regulatory forbearance could favour the implication of banks in restructuring operations at the cost of endangering the credibility of the banks' balance sheet. A balance needs to be struck in this regard, a balance that will necessarily lay with a segmented, granular analysis of distressed loans, followed by an active involvement in restructuring of viable businesses. In line with this approach, for example, a country may include rules that allow for the reclassification of loans following the approval of a restructuring agreement, so long as it is a credible agreement, and evidence has been provided by, for example, the successful implementation of the plan for a given period of time.

- *Banking passivity and reckless lending/enforcement:* A notable problem for distressed MSMEs is where there is a lack of interest by banks in engaging in negotiations with a view to reaching an agreement that could rescue the busi-

ness where it is viable. At times, the amount of exposure or the over-collateralization of a loan will deter a bank from engaging actively in the restructuring, even where the business is viable. The following section of this report further elaborates on the general problem of creditor behavior at times where the MSME debtor is in distress.

2. Creditor passivity and reckless behaviour

Limited resources in MSME insolvencies lead to very limited expectations for unsecured creditors regarding any substantial distribution in respect of their claims. Thus, unsecured creditors often have little incentive to incur further costs (e.g., travel costs, communication costs, investment of time) with regard to the insolvent debtor by participating actively in negotiations or proceedings. Overall, it is rational for a creditor not to participate unless it has a special interest in the result of the proceedings – most notably because it is personally connected to the debtor (by family ties, or as an employee), or where it appears that some value may be recoverable.

Secured creditors, on the other hand, are interested in the enforcement of their security, which usually occurs through sale of the debtor's assets. This interest may result in the liquidation and winding up of the debtor's business. This type of enforcement often does not require any court proceedings or supervision; it could as well be done using out of court auctions or transactions. Aiming at saving the cost and delay of court hearings, it is rational for secured creditors to argue in favour of quick out–of-court auctions.

The Modular Approach seeks to overcome these rational obstacles by counteracting the non-existing (unsecured creditors) or negative (secured creditors) incentives to participate in court proceedings, while preserving the positive incentives of the beneficiaries (debtor, connected persons). The default assumption is that, absent insolvency proceedings, a secured creditor may promptly enforce its rights under the general law and as agreed between the parties. This possibility incentivizes the debtor to invoke a preliminary stay of enforcement, and to propose a rehabilitation plan. Such a set of rules would also mean that the task of designing and preparing a plan is assigned to the debtor because the debtor is the stakeholder best incentivized and informed for this task. Further, creditor inaction may also be tackled by the approval and monitored implementation of codes of conduct. The supervising authority should ensure that financial lend-

ers do not contribute to the destruction of viable businesses by not even taking the time and effort to consider the case.

Confronted with a plan, creditors must not be bound without a chance to be heard, for constitutional and due process reasons in most jurisdictions. The Modular Approach seeks to lower creditors' participation costs through online, postal, and proxy consultation and voting. At the same time, the Modular Approach raises the costs of non-participation through "deemed approval", whereby a creditor's failure to vote is regarded as a vote in favour of the rehabilitation plan, and through "deemed waiver", by which the absence of timely objection, such as to the suggested amount of their claim or right, is treated as a waiver of the right to judicial review. In sum, creditors' passivity after due notification binds them finally to the legally stipulated outcome of the proceedings.

3. Tax law incentives and disincentives

The challenge of MSME insolvency could also be understood as an opportunity to explore an effective set of tools aimed at promoting responsible credit borrowing and lending, responsible credit monitoring and responsible credit collection, including, if need be, credit restructuring.

Inspiration for a possible approach can be drawn from the legal regulation of workplace accidents. The previous unregulated situation was replaced with a system that compensates workers for harms experienced in the workplace and places responsibility on employers for creating safe workplaces, most effectively promoting aggregate social welfare.[175] Similarly, a comprehensive approach to MSME insolvency suggests that professional lenders have some responsibility in lending practices to MSMEs, as they are relatively well-positioned to assess risk and monitor early

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[175] The initial approach of worker occupational health and safety, whereby losses arising from such accidents should be solely and directly borne by the individual worker whenever it could be shown that the accident was imputable to his or her negligence or contributory negligence, was ultimately abandoned by most of the more developed legal systems. and no one today would seriously advocate the reinstatement of that old approach. The reason is clear: since society has a vital interest in encouraging people to work, risks arising from work and the consequentially occurring losses must be legally handled in a conscious social perspective, *i.e.* by providing rules other than the mere imputation of the loss to the author/victim of the accident on grounds of negligence or personal bad luck.

warning signs of financial distress.[176] One option under the Modular Approach is to require the observance of prudential rules in the performance of lending activities, especially designed to reduce the risk of MSME insolvencies or to govern as much as possible their occurrence. Non-compliance with such especially designed prudential rules could be sanctioned by using taxation as a leverage to discourage inappropriate conduct. Desirable conduct could be encouraged by affirmative tax benefits.

The two proposed lines of action—providing special prudential rules and using tax leverage to induce compliance—must be seen as linked, since, unless they are taken together, their impact might fail to be significant.

Virtually all national legal systems have banking regulations whose institutional goal is to prescribe the observance of prudential, technical rules in the granting of credit; the monitoring of credit granted and still outstanding; and the collection of due and payable amounts or the measures to be taken in respect of defaults. These national regulatory and supervisory systems, however, should provide an adequate linkage with the fiscal consequences of non-observance. Briefly stated, tax deductibility of losses arising from bad claims against MSMEs should not be automatically available to professional lenders. Tax deductibility should, rather, be conditional on the individual professional lender acting responsibly in the handling of the credit relationship that originated the non-performing loan.

Lenders should not be threatened with the prospect of entering into null and void transactions or arrangements in the event of non-compliance with prudential rules. The heart of this proposal is a tax sanction or the loss of a potential tax benefit in the event of non-compliance with such rules, not the imposition of mandatory forms or conditions of credit contracts or of compulsory schemes of arrangement. Accordingly, the legal format of these rules should continue to be issued on the basis of the rule-making power entrusted to central banks or other top central regulators, permitting the much-needed technical flexibility that statutory rules cannot provide. In addition, this approach would make it

[176] In this respect, professional lenders may be expected to be much better candidates than their less structured counterparties for the purpose of becoming the object of a regulatory framework institutionally designed to prevent, whenever possible, and to efficiently administer, whenever unavoidable, the insolvency of MSMEs.

easier to achieve forms of international informal cooperation among regulators.[177]

More specifically, tax deductibility of banking losses arising from credit granted to MSMEs should be made conditional on evidence provided by the bank claiming the deduction of having properly complied with: (i) prudential rules on the initial granting or extension of the credit; (ii) prudential rules on the monitoring of the credit while outstanding, including *inter alia* proper classification of it in cases of threatened difficulty of reimbursement; and (iii) prudential rules on, initially, collection attempts and, subsequently, promotion of or participation in a serious workout arrangement prior to the filing of any involuntary bankruptcy petition and/or prior to enforcement that would result in the destruction of the business.[178]

Difficulties in application, and potentially negative effects of this type of reform, should not be underestimated. In practical terms, difficulties in application might arise depending on how banks would be required to give evidence of compliance with the insolvency-related prudential rules at the time of claiming the relevant tax deduction. It would be unreasonable and impracticable to require a bank to provide a detailed history of any credit in respect of which the tax deduction is claimed. Basically, it should be enough for the bank to provide evidence (as it would have to in the case of a central bank inspection) that the credit was properly analyzed, classified and granted at the time of granting and that it was kept under proper classification and surveillance during the subsequent stages of the credit life. Lastly, but most importantly, with reference to the insolvency or pre-insolvency stage, the bank

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[177] Including also the "spontaneous" observance by them of uniform policy standards that may be recommended at the international level, e.g., by the Financial Stability Board.

[178] None of these "conditions precedent" to deductibility of losses would directly interfere with the ordinary contract rules or the ordinary creditors' rights regime under the applicable national law. Compliance with the aforesaid prudential rules would be, as is already the case today, a duty of the bank *vis-à-vis* the banking supervisory system and a conduct, whose observance or non-observance would determine the entitlement to or the forfeiture of a potential future tax advantage. No actionable private right would, at least in principle, be vested in the debtor counterparty or in the latter's creditors in the event of non-compliance. The situation, again, would be no different from the one that already prevails as of today in the generality of legal systems, where bank liability for abusively granting or extending credit is sometimes found to subsist, but only in exceptional circumstances and certainly not on the mere ground of non-compliance by the bank with the internal prudential rules.

should be required to show that it either (i) promoted one of the solutions permitted under the applicable national law to exit the situation; or (ii) participated in the attempt, promoted by others, including but not limited to the debtor, to arrive at one of such solutions.[179]

There would be certain costs and benefits inherently associated with this advocated proposal. The introduction of a change in the traditional regulatory philosophy, with the inclusion of a pro-active pursuit of a particular MSME credit policy in addition to the traditional goal of ensuring the banking system's stability, and strong linkage between prudential supervisory rules and tax deductibility, are likely to initially cause an increase of regulatory costs.[180] Such costs would be of the same nature as that which is typically associated with changes in the contents of applicable legal rules. After an initial period of cultural adaptation, the benefits of the new rules tend to exceed the weight of the initial incremental costs.

The conditional tax deductibility proposal may initially be viewed by professional lenders as a source of higher costs of doing business in that there would be the possibility of denial of expected tax relief. However, to the extent that such threat may incentivize the restructuring of old indebtedness and the consequential re-classification of the "rehabilitated" restructured part of "old bad claims", it may provide a new opportunity for professional lenders to retain more value in the reclassified treatment of their original non-performing loans than the more drastically reduced value

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[179] It is impossible to articulate what should be considered *bona fide* promotion of or *bona fide* participation in a solution providing a recognized exit from the insolvency or pre-insolvency situation. For the purposes of this report, suffice it to say that (a) a strong presumption in favour of tax deductibility should be fiscally provided whenever a plan of resolution of the insolvency or pre-insolvency, of any nature and irrespective of its judicial or extrajudicial nature, is shown to have been approved by the required creditors' consent; (b) an outright tax deductibility should be recognized whenever any such plan is shown to have produced a recovery for the creditors in excess of certain levels, whether pre-determined by insolvency law or by tax law; (iii) in the absence of an approved plan or a certified minimum level of recovery for the creditors, tax deductibility should only be granted on the basis of a judicial finding, in the order granting personal discharge of the individual/s, to the effect that the insolvency had not been caused or worsened by the bank's recklessness.

[180] In particular, in as much as the regulatory and connected fiscal changes would require more robust or more sophisticated or more frequent inspections by the banking supervisory authorities and/or by the tax authorities, more or less open (or hidden) cost increases would ensue.

that would otherwise be assigned to such claims as a result of write-offs.

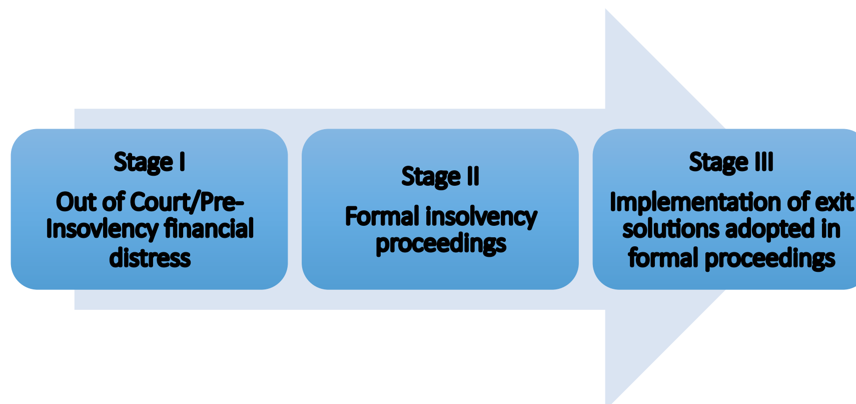
Finally, what remains to be considered is the supply of new finance, without which a rescue plan is nearly always doomed to fail. If new finance is provided by a new bank, an affirmative tax incentive should be made automatically available by the fiscal legislation (e.g., non-taxability of the income obtained from the new finance for a specified number of years). If the new finance comes from a sole or leading bank, the issue of the tax incentive might be treated differently, that is, by articulating an appropriate scale of solutions, so as to ultimately avoid inconsistencies with the objectives and the regime of the deductibility of "old" losses.

4. Financing MSME Proceedings

In many jurisdictions, MSMEs have difficulties accessing sufficient levels of financing. This situation particularly arises at the inception of the business life and, even more intensely, when the business suffers liquidity tensions and financial distress. The rescue of viable MSMEs may only happen if the business receives financing. Otherwise, the activity comes to a stop and piece-meal liquidation is the only real alternative. In most jurisdictions, but particularly where the market still needs development, the absence of a rescue culture and the stigma associated with it, the lack of an enabling legal framework, the lack of real possibilities to lower the risk of lending for small debtors (e.g., no assets free for collateral, limited ability to offer personal guarantees), and the passivity of creditors, thwart the continuation of the business activity, frustrating chances of business recovery and value preservation. In this light, the legal and institutional frameworks of a country need to provide the mechanisms to ensure that troubled but viable businesses are able to access financing with a view to trading out of their difficulties. Possible mechanisms to enhance access to finance at times of distress, with reference to relevant key stages of MSME insolvency and with particular consideration of the specific problems encountered in the MSME context, are discussed below. The position of the debtor that went through the insolvency process and how the financing framework can enhance the concept of "fresh start" and encouragement of new businesses is also discussed.

It should be stressed, however, that there does not appear to be a single effective strategy for financing of MSMEs in distress, given the size and range of such businesses. The universal features to consider when designing the framework must be efficiency and

affordability. Implementation should be left to national variations, based on different socio-economic contexts and variety of legal traditions.



Stage I: During the initial stages of financial distress of MSMEs, before formal insolvency proceedings have been petitioned (and precisely with a view to avoiding that), the debtor often faces a number of challenges. On the one hand, as noted above, the debtor may face lack of interest of financial creditors, especially creditors that enjoy fixed as opposed to floating security over valuable assets. The passivity will be even worse whenever the financial creditors have securitized their SME loan portfolios. Further, debtors, due to their size and urgency of the financial distress, are placed in a very weak position *vis-à-vis* the financial creditor, with very limited leverage in the negotiation. This situation is particularly problematic, since, often, the key to overcoming the problem of distress is to keep the business operating smoothly to retain the trust of commercial suppliers and other similar operational creditors. Generally, at this stage it is important to keep the financing of the business at the same operational level that the debtor had before the distress arose (day zero level). That would prevent suppliers and other commercial creditors from "smelling the trouble" and preserve the going-concern value of the business momentarily until an agreement, with an adequate restructuring, is worked out.[181] The situation needs to be handled with the main creditors of the MSME: one (or, rarely,

[181] In any case, trade creditors would be unlikely to provide credit to their trade counterparties in excess of what is strictly needed for keeping afloat the ordinary level of current transactions, thus making a great fragmentation of the aggregate indebtedness into a plurality of claims likely, each of which relatively unimportant for the individual holder.

more) financial creditors and the public creditor (tax authorities and social security).

The first challenge will be to get the attention of the financial creditors, especially in cases where the exposure is low and sufficient collateral has been provided.[182] In some cases, an additional problem that stems from the internal allocation of tasks within the financial institution is that the claim is sent to the recovery department; there is no longer communication with the commercial/business origination department and the new department managing the loan may no longer have an interest in keeping the business relationship alive. Its only focus will be on recovery, making additional finance, or even a rescheduling, not a beneficial option. These problems may be tackled by means of codes of conduct, approved and implemented for the entire MSME lending sector by banking associations or, more effectively, by the financial sector supervisor. The code of conduct would make it compulsory for financial creditors to actively consider solutions on a case by case basis, basing the analysis on the viability of the business project, irrespective of their holding sufficient collateral or not. That way, viable businesses may be rescued and future business for the bank preserved.

Irrespective of the existence of such codes of conduct, keeping the “day zero level” of financing may be a difficult task. Often debtors will have no assets to provide as collateral for fresh financing, which is why the optimization of a jurisdiction´s system of secured transactions over movable assets is key. Although all tangible assets may already be “attached”, the debtor should be able to resort to its immaterial assets to offer creditors: security over inventory, receivables, non-intermediated non-certificated securities, etc., might constitute an additional resource to keep the business running during this interim period of negotiation.[183]

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[182] See the discussion on creditors’ involvement in the MSME insolvency process, Part VI.B.

[183] Although this issue is generally an access to finance problem, not specific of distressed financing, it might be useful to point here to the risk that, given the weak bargaining power of the debtor, the financial institutions may demand excessive additional collateral in exchange for continued support (or simply in exchange for a moratorium or a rescheduling of the debt). Over-collateralization is a banking practice that causes substantial damage in many jurisdictions, overprotecting the banking sector at the expense of the non-financial economy.

Beyond additional security and soft law rules, legislation can still provide tools to foster the financing of viable, troubled but not yet insolvent, businesses. The following are important examples:

- The regulatory framework of banks may increase the likelihood of MSME business rescue by designing balanced provisioning rules. Experience shows that when rules are too strict and provisioning comes at a very early stage, banks lose interest in the rescue of their debtors. Perhaps more importantly, the framework ought to be lenient on the treatment of out-of-court agreements, and, in the case an agreement is reached and implementation has successfully started, the system should provide for the possibility of positive reclassification of the loans. This option would constitute a relevant incentive to facilitate agreements and the financing that often comes with it.
- The provision of new financing to distressed businesses should be conferred high priority in subsequent formal insolvency proceedings, in case the restructuring fails.
- Out-of-court agreements, and the additional financing that would come with it, ought to be protected from claw-back actions in case a subsequent insolvency proceeding ensues.

Naturally, both the high priority and the protection from claw-back actions in failed out-of-court rescue attempts should be subject to a number of requirements: the agreement ought to be approved by a large percentage of creditors, or it should have certain characteristics that make it objectively positive (*i.e.,* not damaging to non-participating creditors), or be subject to some sort of control by a judge or assessed by an independent expert. These measures would be put in place to avoid, among other problems, banking malpractice, which, although rare, is not to be ruled out. The strong bargaining position of the financial creditors may, in extreme cases, lead them to impose agreements that benefit their position at the expense of the rest of creditors.

Often, the other important creditor of MSMEs will be the tax authority. Legislation regulating public creditors may also pose a very serious hurdle to business restructuring and, consequently, to the provision of new financing:

- It is not uncommon that public creditors are, by law, not allowed to reach restructuring agreements with debtors outside formal insolvency proceedings. Tax authorities should be allowed to reschedule the pay-

ments of the debtor, at least and in any case whenever the debtor has prospects of recovery and is only experiencing liquidity problems. The law should reduce the guarantees generally required to postpone payments. If needed, they should also be allowed to accept write-downs of the debt. The alternative places tax creditors in a position legally of hold-out creditors, which may cause the provision of new finance by other creditors to disappear, since creditors will not want to provide fresh money that will go directly to the pockets of the public treasury.

- In some jurisdictions, the restructuring services of tax authorities are understaffed and unaccustomed to engaging in negotiations to reach out-of-court agreements. The improvement of this organizational element would be a key measure to facilitate business rescue of MSMEs.
- Agreements reached out of court should be at least treated as tax neutral. Taxing these operations often poses severe hurdles to business recovery and the provision of new finance for the debtor.

Stage II: During the stage of formal insolvency proceedings, and until a restructuring plan (or a liquidation of the business as a going concern) has been agreed upon, the main concern will be to succeed in keeping the business alive and operating. For this aim, suppliers and trade creditors are essential. The entrance in formal proceedings brings about an unavoidable reputational damage and an increase in the perception of risk by third parties. Absolute priority of all post-commencement claims, an adequate system of effects on executory contracts, or the presence and good management of an insolvency representative will not always be sufficient to convince suppliers and operational creditors to continue to provide commercial credit. Additional measures might be needed.

A possibility would be the creation of a public fund to support trade creditors whose claims arise after the commencement of insolvency proceedings. The fund would not be providing direct financing, but rather, guarantee the provision of credit by private sector stakeholders: either directly to trade suppliers or to financial institutions that are willing to finance the operation of the business. Clearly, this type of support would only follow a careful assessment of the viability of the project. It could be directly conducted by the fund, or, more likely, the fund could avail itself of

the expert and independent opinion of the insolvency representative appointed to manage, or monitor the management of, the debtor during the insolvency procedure.[184] In certain areas of the economy (often in the rural economy), this type of support is offered by public or private cooperatives or by reciprocal guarantee schemes (*i.e.,* all the members of a certain community jointly guarantee the new debts incurred by one of their members).

Stage III: This stage would commence with the approval of a plan and would last during its full implementation. During this period, the debtor´s situation with regard to its creditors will be mainly ruled by the content of the plan. New financing ought to be more simple, since the business will have normally been restructured, often downsized, and always, at least in theory, improved. Pre-existing debts will have been restructured, and hence the financial burden will be lighter. New financing debts (by trade creditors, or new financial facilities) will be payable as they fall due, and the insolvency law should include a rule that protects the preferential treatment of financing debts arisen during the implementation stage in case of failure of the plan. In order to underpin the success of the approved plan, tax regulation could offer tax incentives that would be added to the restructuring of debt as regulated in the plan. A restructuring that should, to the extent possible, include a reduction or a full write off of sanctions and default interest. This type of special treatment ought to be limited in time, so as not to cause damage to other businesses competing with the previously insolvent debtor.

The former considerations for stage III refer to the implementation stage of a plan; but the need for new financing and the enabling framework must also exist following the liquidation of the assets in case of sole entrepreneurs. Access to finance is paramount for a second chance. Suitable financing solutions for re-entrepreneurs need to be put in place. Re-starting entrepreneurs need capital, cash flow and credit, with few, if any, restrictions on future trade, without being encumbered with long repayment periods of debts captured by a bankruptcy proceeding. Distinction between honest and dishonest entrepreneurs should translate into non-discrimination of those entrepreneurs that are non-

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[184] This solution could also be helpful during the out of court stage. This fund, however, is not intended to substitute banks outside insolvency proceedings, and ought to be regarded –and used- as an exceptional solution. Making it generally available to out of court negotiations might create moral hazard problems and end up being negative for the system.

fraudulent bankrupts in becoming beneficiaries of any supportive programs available on the market for starting up a new business while simultaneously avoiding any preferential treatment of "re-born" entrepreneurs, as it may lead to unfair competition and moral hazard.

Many jurisdictions impose obligations on financial institutions as principal lenders to act prudentially in lending decisions regarding MSMEs. However, for all three stages, the banking law should not pose a hurdle to the restructuring of viable but troubled MSMEs. Lending to distressed business should be a possibility. It is not uncommon that banking law rules on corporate governance include limits to the bank and personal sanctions to directors of financial institutions that lend to debtors that are unlikely to repay the loan. These rules, objectively reasonable, seek to avoid excessive risk taking and fraud. They are not aimed at prohibiting and sanctioning the financing of viable but troubled businesses. If, however, they are phrased in a very general manner, directors of banks and other financial creditors may be hindered from financing the rescue of viable MSMEs to avoid the risk of their own personal liability.

Similarly, consideration ought to be given to limiting securitization and scope of permissible hedging through credit default swaps and other derivatives, still allowing financial institutions to manage risk but requiring them to retain some risk, thus preserving oversight and early intervention in credit relationship, and creating incentives to lend but controlling speculative market.

C. Connected persons' guarantors

The treatment of connected-person guarantors of MSME debtors raises particular issues that the Modular Approach addresses:

- Efficacy across the population of MSME debtors: Guarantees are taken in large part precisely to hedge against the principal debtor's insolvency. Tampering with a category of guarantees in bankruptcy proceedings would tend to impair their value to the lender significantly, and thus restrict the extent to which that category of guarantees would help would-be borrowers to access credit in the first place.
- Family destitution: However, micro and small enterprises, and perhaps smaller medium ones also, raise particular issues where the guarantor is the entrepreneur him or herself or another natural person con-

nected with him/her.[185] Allowing guarantees to be called in without restriction might result in "family bankruptcy", leaving an entire family destitute.

- Accordingly, the *ex ante* costs of restricting the utility of connected-person guarantors of MSME debtors have to be carefully balanced against the *ex post* costs of allowing their entirely unrestricted enforcement.
- Guarantors benefit from creditor action moratorium: It may, in some cases, be a powerful incentive to timely commencement by the debtor, and would create a space for a rational decision to be made collectively about the entirety of the debtor's obligations and affairs.
- Creditors holding guarantees must be classified separately for plan voting purposes. This class is subject to the cram-down process, as previously described.
- Treatment of guarantees depends on an approved plan: Where a plan is approved that restructures and/or discharges the underlying liability, that does not in and of itself constitute *pro tanto* discharge of the guarantor's liability.[186] The plan must explicitly provide for the guarantor's discharge.
- Fairness-based unenforceability? Should a court be able to render a connected natural person guarantee unenforceable on the presumption or establishment of undue influence, unconscionability, etc.? If so, should this decision be taken only in the principal debtor's bankruptcy proceedings, rather than whenever such a tainted guarantee is sought to be unenforced?[187]

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[185] Note - for further discussion: If the invocation of the guarantee means that the individual will likely become bankrupt should the two processes be merged, should we consider reduction of the guarantee in such circumstances as a *de facto* discharge but without necessarily declaring the debtor bankrupt (*i.e.* avoiding their bankruptcy)?

[186] This approach broadly reflects the US position: *In re: Larry Ralph Gentry*, No. 14-1441 (10th Cir. Dec. 8, 2015).

[187] This issue is a contract law issue and requires further discussion as to whether there should be any special treatment, or not, in MSME insolvency.

D. THE ROLE OF EMPLOYEES

1. Employees in insolvencies

Employees are often the objects of specific regulation with respect to their claims during insolvency proceedings. A study of the treatment of employee claims in countries that are members of the Organization for Economic Cooperation and Development ("OECD") found most countries provide some form of preference for such claims within their insolvency regimes and many also have guarantee programs that satisfy some part of the claims, with the guarantor pursuing the preference rights of the employees within the insolvency proceeding.[188] This section of the report will discuss the policy reasons for such special treatment of these claims and how this policy can be pursued within a MSME insolvency regime.

Two general justifications for the separate treatment of employees as creditors in insolvency proceedings have been offered. The first deals with the "weakness" of employees relative to other creditors, the second concerns their ability to effectively participate in the insolvency process. With respect to employees' weakness, commentators have pointed to the lack of evidence that a risk premium for the extension of credit is part of their compensation and to the problems of cognitive and volitional deficiencies in bargaining such a premium or other form of insolvency protection.[189] As a result, they conclude that this lack of a risk premium for employees allows secured creditors to shift some of the insolvency risk to the employees, allows employers to obtain cheaper credit and may result in inefficient allocation of resources to firms with a high risk of insolvency.[190] The same informational and volitional problems that lead to the lack of an employee risk premium disadvantage them in comparison with other stakeholders during corporate restructurings.[191] Employees do not bargain for the kind of control mechanisms that would allow them to constrain man-

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[188] Paul M. Secunda, "An Analysis of the Treatment of Employee Pension and Wage Claims in Insolvency and Under Guarantee Schemes in OECD Countries: Comparative Law Lessons for the United States and Detroit", (2014) 41 *Fordham Law Journal* 867, at 875. ["Secunda"]

[189] Kevin Davis and Jacob Ziegel, "New Priority Scheme for Unpaid Wage Earners and Suppliers of Goods and Services" paper prepared for Corporate Law Policy Directorate of Industry Canada (April 30, 1998) at 13. [Davis & Ziegel]

[190] *Ibid*, at 14.

[191] Robert Howse and Michael Trebilcock, "Protecting the Employment Bargain", (1993) 43 *U.T.L.J.* 751.

agement from making post contractual changes to the risks, even if they were to be able to establish a risk premium at the point of entering into the employment contract.[192] Finally, it has been pointed out that employees are poor risk bearers relative to other creditors, due to their lack of relevant financial information and inability to diversify the insolvency risk from their employment.[193]

The second issue is that individual employees are ill equipped to effectively participate in insolvency proceedings. They lack both the requisite knowledge and access to legal expertise. Individually the amount of their claims and likely recovery would not pay the expense entailed in effective participation. The expense may be recoverable if a mechanism to pursue such claims collectively were available.

2. Employees in MSME insolvencies

In Canada, employees' average weekly compensation declines with the size of the enterprise.[194]

Max # of employees	19	49	99	299	499	< 500
Avg. weekly earnings 2014	$751.88	$800.70	$829.60	$914.85	$993.87	$1055.98

According to Industry Canada, only 51% of small and medium sized enterprises survived more than 5 years.[195] Thus, it would seem that employees in such businesses are subject to all of the conditions previously discussed regarding the policy justifications for specific treatment in countries' insolvency regimes. The issue is how best to ensure that the policies adopted in individual countries for the protection of employee claims are effectively applied to MSME insolvencies. These employees are likely to be lower wage employees and unlikely to have a surplus available to fund legal representation. The most efficient way for their claims to be

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[192] *Ibid*, at 755-56.

[193] Davis & Ziegel *supra*, note 189 at 15.

[194] Statistics Canada, "Earnings, average weekly, by enterprise size" http://www.statcan.gc.ca/tables-tableaux/sum-som/l01/cst01/labr76a-eng.htm accessed January 31, 2016.

[195] Industry Canada, "Key Small Business Statistics", July 2012 https://www.ic.gc.ca/eic/site/061.nsf/vwapj/KSBS-PSRPE_July-Juillet2012_eng.pdf/$FILE/KSBS-PSRPE_July-Juillet2012_eng.pdf accessed on January 31, 2016.

pursued would be through a process that allows them to be processed collectively, rather than individually. OECD countries use a preference, a guarantee, or a hybrid of both to protect some portion of employees' unpaid wage claims when an employer is insolvent, with most using some form of the hybrid system.[196] The hybrid system has the advantage of providing earlier payment of wages, while allowing for the efficient collectivization of wage claims in the insolvency proceeding through the subrogation process, allowing the guarantor to pursue one claim using the employees' preference.

3. Policy implementation in the MSME Modular Approach

The policy approaches to MSME insolvencies in this paper are grounded in the assertion that such insolvencies are generally low asset enterprises where the implementation of ordinary insolvency regimes would likely result in the destruction of either the residual value or the going-concern value due to the cost and complexity of such regimes. This report's suggestions envision a simplified Modular Approach to either liquidation or rescue. The problem is how to incorporate existing employee protections into the revised process. For example, under the usual insolvency process where the insolvency professional is a key participant, one policy option that has been implemented is that the insolvency practitioner in the MSME insolvency be required to: calculate the employees' claims; advise the employees' of their rights under the applicable country's insolvency and/or wage guarantee regime; advise the relevant guarantee organization of the claim where that type of protection is offered.[197] The insolvency practitioner would be compensated for the work required to fulfill these obligations.

This procedure would be consistent with Convention 173 of the International Labour Organization: Protection of Workers' Claims (Employer Insolvency) 1992 which provides that countries that ratify the convention should provide protection for employee claims through a preference, a guarantee scheme or both. It would also be consistent with the EU Directive on the protection of employees in event of the insolvency of their employer requiring that protection be provided through a form of guarantee.[198]

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[196] Secunda, *supra* note 188 at 2.

[197] *Wage Earner Protection Program Act,* S.C. 2005, c. 47, ss. 1, 22, 23 (Canada).

[198] EU Directive (2008/94/EC),

However, some parts of the Modular Approach to MSME insolvency in this report envisage minimal involvement of insolvency professionals in the process. For the liquidation/discharge module, the debtor employer will have the most cost-efficient access to the information necessary to identify the amount and type of employee claims, as well as the information required to notify employees of their claims and rights under existing insolvency preference and guarantee legislation. The requirement to include such calculations and notifications to both employees and guarantee institutions should be part of any standard form MSME bankruptcy discharge application. The collectivization of employee claims in the guarantee institution and their pursuit by it in the bankruptcy would provide a more efficient means of dealing with these claims than their pursuit by individual employees. A discharge conditional on the relevant institution's satisfaction that the debtor employer's calculation and notification obligations have been complied with would provide the incentive for compliance, while a denial/revocation of discharge for failure to comply would provide the negative incentive.

For the rescue module, it would seem the similar calculation and notification obligations would apply and be incorporated into the forms needed to initiate a MSME rescue module. Pursuit of employee participation rights, for example, voting on a plan, could be exercised by the guarantee institution or the employees themselves, and their interests in the future revenue streams generated by the continued operation of the business as a result of the compromise of their current claims would be part of the assessment of any plan's "fairness and equity" with respect to the distributions of its burdens and benefits.

Including such obligations in the MSME Modular Approach would overcome the informational and expertise deficits facing employees in the event that the employer enters an insolvency proceeding. Having the employer assume some of the responsibility for assembling the needed information to substantiate the claims and notify the employees of their rights would further the public policy goals of the particular country's provisions protecting employees in the event of an employer insolvency, without dictating what those provisions should contain. At the same time, it would increase the fairness of the process by providing assistance to the

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http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:283:0036:0042:EN:PDF, accessed 31 January 2016.

most vulnerable and disadvantaged creditors and provide a mechanism to comply with international obligations such as those in the EU Directive and ILO Convention.

If the business closes without any formal insolvency proceeding, as many MSME enterprises do, then hopefully the country's labour standards regime will provide some effective relief for those employees, but that eventuality is beyond the scope of this report.