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Insolvency of micro, small and medium-sized enterprises

Note by the Secretariat

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I. Introduction

1. At its forty-sixth session (2013), the Commission requested Working Group V to conduct, at its Spring 2014 session, a preliminary examination of issues relevant to the insolvency of MSMEs, and in particular to consider whether the UNCITRAL Legislative Guide on Insolvency Law provided sufficient and adequate solutions for MSMEs. If it did not, the Working Group was requested to consider what further work and potential work product might be required to streamline and simplify insolvency procedures for MSMEs. Its conclusions on those MSME issues were to be included in its progress report to the Commission in 2014 in sufficient detail to enable the Commission to consider what, if any, future work might be required.[1]

2. At its forty-fifth session (April 2014), Working Group V considered the topic as requested and agreed that the issues facing MSMEs were not entirely novel and that solutions for them should be developed in light of the key insolvency principles and the guidance already provided by the Legislative Guide (see A/CN.9/WG.V/WP.121). The Working Group further agreed that it would not be necessary to wait for the results of the work being done by Working Group I in order to commence the study of insolvency regimes for MSMEs. As to the form that work might take, the Working Group agreed that, while such work might form an additional part to the Legislative Guide, no firm conclusion on that point could be reached in advance of undertaking a thorough analysis of the issues at stake.[2]

3. At its forty-seventh session (2014), the Commission gave Working Group V a mandate to undertake work on the insolvency of MSMEs as a next priority, following completion of the work on facilitating the cross-border insolvency of multinational enterprise groups and recognition and enforcement of insolvency-related judgments.[3]

4. At its forty-ninth session (May 2016), Working Group V noted the importance of MSME insolvency and the wide support that had been expressed in favour of work being undertaken on that topic. The Working Group agreed to recommend that the Commission should clarify, at its forty-ninth session (2016), the mandate given at its forty-seventh session to Working Group V as follows: "Working Group V is mandated to develop appropriate mechanisms and solutions, focusing on both natural and legal persons engaged in commercial activity, to resolve the insolvency of MSMEs. While the key insolvency principles and the guidance provided by the UNCITRAL Legislative Guide on Insolvency Law should be the starting point for discussions, the Working Group should aim to tailor the mechanisms already provided in the Legislative Guide to specifically address MSMEs and develop new and simplified mechanisms as required, taking into account the need for those mechanisms to be equitable, fast, flexible and cost efficient. The form the work might take should be decided at a later time based on the nature of the various solutions that were being developed."[4]

5. At its forty-ninth session (2016), the Commission noted that report of the Working Group and clarified the mandate of Working Group V with respect to the insolvency of MSMEs in accordance with the wording of the recommendation set forth in paragraph 4.[5]

6. In accordance with that mandate, and in view of the progress of the work on facilitating the cross-border insolvency of multinational enterprise groups and recognition and enforcement of insolvency-related judgments, the Working Group

[1] *Official Records of the General Assembly, Sixty-eighth Session, Supplement No. 17* (A/68/17), para. 326.

[2] Report of Working Group V on the work of its forty-fifth session, A/CN.9/803, para. 14.

[3] *Official Records of the General Assembly, Sixty-ninth Session, Supplement No. 17* (A/69/17), para. 156.

[4] Report of Working Group V on the work of its forty-ninth session, A/CN.9/870, para. 87.

[5] *Official Records of the General Assembly, Seventy-first Session, Supplement No. 17* (A/71/17), para. 246.

may wish to use some of the additional time allocated to its fifty-first session to hold a preliminary discussion on how the work on MSMEs might be developed.

II. Considerations specific to MSME insolvency

7. Recent work by the World Bank[6], the IMF[7] and others suggest that a properly implemented insolvency regime may help mitigate many of the challenges facing MSMEs, including access to credit, job preservation, facilitating entrepreneurship and reducing the personal risk of individuals who create enterprises. It might be noted, however, that the majority of MSMEs facing insolvency are likely to liquidate, with only a small fraction being able to take advantage of a restructuring regime. Insolvency frameworks for MSMEs thus should not focus solely on restructuring, but also aim to facilitate liquidation in the majority of cases.

A. Specific challenges for MSMEs entering insolvency

8. When MSMEs experience acute financial distress, they often face several challenges relating to access to insolvency procedures, creditor passivity, availability of appropriate and useful information during the insolvency process, difficulty accessing new finance and, potentially, the insufficiency of assets to cover the costs of the proceedings (the so called "no-asset cases" or "insolvent insolvencies").[8]

1. Access to insolvency procedures

9. Many MSMEs are disadvantaged because they lack the skills to identify and react to financial distress, often resulting in them waiting too long before initiating an insolvency process, which may, in any event, prove to be too complex, costly, lengthy and rigid, particularly for small family businesses and unincorporated MSMEs. Some of the features of insolvency regimes that act as a disincentive may include the automatic separation of management from the ordinary administration of the business upon applying for insolvency (including reorganization); the amount and complexity of documentation required to start the process, which often includes the legal requirement to file audited balance sheets; and the uncertainty of costs generated by the numerous participants involved in the process.

2. Availability of a "fresh start"

10. For unincorporated MSMEs, the treatment of individual defaulters (and in some cases their guarantors) in some insolvency regimes is very severe, leaving full personal liability for many years beyond liquidation of the business and, in some cases, limitations on freedom of movement and other such personal restrictions. The lack of a "fresh start" for insolvent owners who have demonstrated good faith in making payments can reduce the incentives to seek protection and restructuring within the courts. Some personal insolvency regimes also fail to clearly distinguish between bona fide and fraudulent default, resulting in stricter standards for a fresh start.

3. Creditor Passivity

11. Creditor passivity often arises when creditors weigh up the amount they estimate they will receive from the parties involved in the insolvency process

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[6] World Bank Group, "Report by the Working Group on the Treatment of MSME Insolvency" (2017 forthcoming). Paras. 9 to 24, 26 to 31 and 38 to 42 of this Working Paper are based upon the material provided by that report.

[7] "Tackling Small and Medium Sized Enterprise Problem Loans in Europe", Bergthaler, Kang, Liu and Monaghan, March 2015, SDN/15/04. Paras. 9 to 15 and 25 of this Working Paper draw upon the material contained in that report.

[8] See also para. 14 below under subheading 6, "Overlap between business insolvency and personal insolvency regimes."

against the amount of time and money this effort requires. If the costs outweigh the return, creditors are more likely to not become involved. In the case of many MSME insolvencies, particularly where the debtor is towards the "micro" end of the spectrum, the return creditors can expect to receive is insufficient to justify the costs of participating.

4. Limited information during insolvency

12. Insolvency systems work best when debtors provide creditors and other relevant parties with appropriate and pertinent information, particularly financial information. Many MSME debtors, however, may have difficulties collecting and distributing the relevant information because of inefficient or non-existent record keeping systems, whether due to a lack of resources, of formal obligations to maintain such records or of an understanding of any need for them. The lack of such information can make it hard to judge whether an MSME is approaching insolvency, and even if it is, to provide the information required to access insolvency procedures.

5. Accessibility of finance

13. Many insolvency systems do not make it easy for MSMEs to access post commencement financing. Even where legislation does contemplate the possibility for the parties or a court to grant, for example, a super-priority to the creditors who will provide additional finance, the lack of reliable MSME financial data makes it difficult to assess their viability and the feasibility of any restructuring plan. Moreover, MSMEs may lack the assets and resources to make obtaining post-commencement finance feasible, especially where high levels of collateral are a pre-requisite.

6. Overlap between business insolvency and personal insolvency regimes

14. The nature of many MSMEs, particularly microbusinesses, is such that a clear distinction between the business and the operating person does not always exist, making it unclear whether a business or a personal insolvency regime is the one most suited to a particular MSME's financial difficulties. Directors of MSMEs frequently provide not just equity but also debt funding, there will often be poor or non-existent records in respect of transactions and relationships between entrepreneurs and the company, there may be no clearly established ownership of key commercial assets (such as tools or other essential equipment), the entrepreneur and their family members' work for the MSME may not be documented or remunerated in accordance with typical commercial practices, the entrepreneur may use their own finances to fund or support the business without necessarily documenting that expenditure and, where funds are borrowed, the creditor may consider the natural person to be the relevant debtor, rather than the MSME. The personal assets of the entrepreneur may also be of equal or greater value than that of the MSME, which encourages lenders to seek recourse personally from the entrepreneur rather than from the MSME; a personal guarantee will typically extend liability for the debts of the MSME to the entrepreneur, affecting both personal effects (such as the family home) and business assets. The lack of personal insolvency systems that carve out personal assets and provide a discharge means that financial difficulty can have a significant impact upon entrepreneurs personally.

7. Insufficient assets to fund insolvency proceedings

15. Many MSMEs which meet the criteria for commencement of insolvency proceedings are never formally declared bankrupt and are eventually liquidated. As a result of late filing, many MSME insolvency filings are classified as "no asset cases" and insolvency laws differ in the approach to their administration, including denying the application or ordering termination of the proceedings or providing funding from individual creditor contributions and/or the public budget.[9]

[9] Greece and Poland are among the countries that have opted not to commence insolvency proceedings if the debtor's assets are insufficient to cover the costs.

B. Responses to MSME insolvency

16. MSME insolvency has been approached differently around the world. In some jurisdictions, such as Argentina and the 17 countries of the Organization for the Harmonization of Business Laws in Africa (OHADA), certain requirements of the general insolvency law are eliminated for MSME insolvency. In Japan and Korea, in contrast, the insolvency framework for MSMEs differs from the "general" insolvency framework.

1. Mechanisms modifying general insolvency regime

17. As discussed below, some jurisdictions opt to modify certain parts of the "general" insolvency procedures to accommodate some of the needs of MSMEs.

(a) Argentina

18. The law contemplates four differences for small cases that are available to qualified small businesses:[10] (a) there are fewer formalities for commencing the process; (b) establishment of a creditors' committee is not mandatory; (c) special provisions relating to the opportunity for creditors to compete with the debtor in proposing alternative restructuring proposals do not apply; and (d) the insolvency practitioner's functions do not end with the ratification of the agreement, unless creditors determine that it should do so.

(b) Germany

19. The German Insolvency Code (Insolvenzordnung) envisages a simplified pre-packaged procedure for the reorganization of qualifying debtors,[11] which includes three steps:

(i) Extra-judicial settlement of debts

20. Consumers and small debtors are required to attempt an out-of-court settlement before applying for the commencement of formal proceedings. With the application for those formal proceedings, the debtor must submit a certificate issued by a suitable person or authority[12] that, within the last six months before the application, an unsuccessful attempt has been made to settle out of court with creditors on the basis of a plan, together with an explanation for its failure.[13]

(ii) Judicial settlement plan proceedings

21. If the extra-judicial settlement fails, the debtor can request commencement of insolvency proceedings. A plan for settlement of its debts and records of the debtor's assets, income, creditors and debts together with a certificate from a suitable agency or person are to be submitted. The court can accept what is referred to as a "zero-plan", which is a plan for a debtor with no income and no assets and providing for no payments to the creditors. The effect of the acceptance of a "zero-plan" by the court is that the debtor can be freed from their debts, either in the settlement plan proceedings or following a discharge period. Upon submission of the application, the court suspends proceedings for a maximum of 3 months and communicates the plan to the creditors designated by the debtor. If creditors do not

[10] In order to qualify for special treatment, the debtor must have one of the following characteristics: (i) liabilities do not exceed 300 minimum wages (approximately US $154,650); (ii) no more than 20 unsecured creditors; or (iii) no more than 20 employees.

[11] Part Nine of the German Insolvency Code (Insolvenzordnung) submits "small insolvencies" to the same process as for consumers (defined as a natural person who does not and has not pursued self-employed business activity) and applies to other debtors who have pursued self-employed activity provided their assets are comprehensible (which means they have less than 20 creditors) and there are no claims from employment contracts against them (Art. 304).

[12] Suitable agencies might include debtor advisory agencies of welfare organizations; suitable persons are mainly lawyers.

[13] German Insolvency Code, Art. 305.

object to the plan, it will be deemed approved and binding upon the parties. If the majority of the creditors object to the plan, the settlement plan proceeding ends and the insolvency proceedings commence, if the insolvency estate covers the costs of the proceedings.

(iii) Insolvency and discharge proceedings

22. Once insolvency proceedings commence, the court appoints a trustee who liquidates the debtor's estate and distributes the proceeds among the creditors. A period of five to six years then starts, during which an attachable part of the debtor's wages is collected and distributed to creditors.

(c) Greece

23. A simplified insolvency procedure had been included in the Insolvency Code, which provided an accelerated process for the verification of creditors' claims and for resolving contested claims, but did not address other aspects of the insolvency process. Since it was found to be inadequate to address the rising number of non-performing loans affecting SMEs in the Greece, a new, voluntary, out-of-court restructuring framework for SMEs was introduced in 2014.[14]

24. The small enterprise or professional[15] needs to fulfil certain requirements to access the framework: (i) they must not be subject to any procedure under the law relating to the restructuring of debts of natural persons; (ii) they must be active in business and not subject to any formal insolvency procedure; and (iii) the person in charge of the business or the professional must not have been convicted of tax evasion, trafficking or racketeering or any form of fraud. The framework allows qualified persons to request lenders to write-down their financial obligations; a write-down cannot exceed EUR 500,000 and must include at least 50 per cent of the credit institution's total claim against the debtor or such an amount that, following the write-down, outstanding debts do not constitute more than 75 per cent of the debtor's net financial position. The credit institution can accept or reject the proposed write-down or offer it under different terms.

(d) Iceland

25. In 2010, the Icelandic Government, banks, and social partners entered into a voluntary debt restructuring scheme based on "joint rules on the financial restructuring of companies" specifically targeting SMEs with less than ISK 1 billion (approximately US $9 million) of liabilities and aimed at writing down debt to the value of the SME (that is, no equity value was created). Viability was determined to exist when the projected liquidation value was less than the going concern value. For SMEs below a certain debt-to-equity ratio threshold, liabilities were restructured based on the SMEs' capacity to pay. For SMEs with a high debt-to-equity ratio, the feature of "deferred loans" (that is, reduced interest rates for three years) was used. The scheme included an arbitration committee to resolve disputes among parties involved. The Government supported the scheme through various tax incentives and banks were subject to monthly targets to successfully restructure SMEs.

(e) India

26. The 2016 Insolvency and Bankruptcy Code includes a fast track corporate insolvency resolution process for qualified debtors,[16] which envisages shorter deadlines for the completion of proceedings. It may be initiated either by the debtor

[14] Law 4307/14.

[15] Small enterprises are identified as businesses that, for the year ending 31/12/2013, had a turnover of less than EUR 2.5 million. Professionals are defined as legal or natural persons, who are registered to conduct their businesses and for the year ending 31/12/2013, had a turnover of less than EUR 2.5 million.

[16] Debtors with assets and income below a level prescribed by the Central Government, debtors with a certain number of creditors and a certain amount of debt prescribed by the Central Government and any other type of debtors, as prescribed by the Central Government.

or its creditors upon submission of the documents that prove the debtor's insolvency as well as its eligibility (under the implementing regulations) to undergo a fast track resolution process. The process needs to be completed within 90 days from commencement, although the insolvency professional can request the deadline to be extended by the court for an additional 45 days if approved by 75 per cent of the creditors. Such an extension may only be requested once and shall only be granted if justified by the complexity of the case. The general provisions of the Insolvency Resolution Procedure apply to other aspects of the fast track process, "as the context may require".[17]

(f) United States of America

27. In 2005, the United States introduced special provisions for SMEs into Chapter 11 of the Bankruptcy Code. The main features of the United States simplified expedited reorganization process for small business debtors[18] are standardized forms, simplified voting requirements, shorter deadlines, no requirement for a creditor committee and more stringent oversight and reporting obligations. The application should include the debtor's most recently prepared balance sheet, statement of operations, cash flow statement and federal tax return. The debtor is under a strict deadline to propose a plan which has to be approved within 45 days of the application. The debtor is not required to file a disclosure statement with the reorganization plan, provided adequate information is included in the plan. The law sets no limit on the duration of the reorganization plan, which may be favourable for small businesses that need additional time to restructure their mortgage or equipment loans. During the course of the proceedings, the debtor's viability, business plan and activities are monitored and the proceedings may be dismissed if the debtor is not viable or otherwise able to confirm a plan. Periodic reporting on financial matters, cash flow and profitability is also required.

(g) OHADA

28. The focus of recent reforms in OHADA was upon establishing simplified, cheaper procedures to attempt the rescue of qualified small businesses.[19] The simplified proceedings apply the following procedures and the simplification relates to formalities concerning applications and hearings.

(i) Règlement Préventif (Preventive Settlement)

29. These procedures are in the form of simplifications of the main or overall *règlement préventif* proceeding. Any qualified small business can apply to commence simplified proceedings before they become insolvent and even if no plan or arrangement is provided; although documents relating to the debtor's financial situation do have to be submitted, those documents do not need to be audited and there is no requirement for comprehensive financial or cash-flow statements, unlike in the general proceedings. Shorter time frames are applicable and the required restructuring plan, to be prepared by the debtor with the assistance of an administrator, can be simpler than under the general proceeding. The procedure is commenced, monitored and closed by a judge.

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[17] 2016 Insolvency and Bankruptcy Code, art. 58.

[18] Small business debtors are classified in Chapter 11 of the United States Bankruptcy Code on the basis of a two part test: 1) the debtor is engaged in non-real estate activity with total fixed debts of US$2,566,050 or less; and 2) the United States trustee has not appointed a committee of unsecured creditors or the court determines that the committee of unsecured creditors is not sufficiently active.

[19] A "small business" would constitute a proprietorship, partnership or other legal entity having less than or equal to 20 employees and a turnover not exceeding 50 million francs CFA (approximately US$80,000) in the 12 months prior to proceedings.

(ii) *Redressement judiciaire* (reorganization)

30. As with the general proceeding, the application for a simplified reorganization proceeding must be made by an insolvent debtor within 30 days of insolvency (based upon the cash-flow test). Fewer documents are required to support the application and they must include a sworn statement indicating that the conditions for simplified reorganization are met. A reorganization plan must be filed, with the assistance of an administrator, within 45 days of the declaration of insolvency and, unlike the more detailed plan required in the general reorganization process, the plan can be limited to payment terms, debt relief and the possible guarantees that the entrepreneur must give to ensure its execution. Financial statements and records are not required. Conversion is available between general reorganization and the simplified proceeding.

(iii) *Liquidation des biens* (liquidation)

31. The conditions for commencing simplified liquidation are the same as for reorganization. However, as well as being a qualified small business, the debtor must not own any immovable property and must attest to meeting the relevant conditions for a simplified liquidation proceeding. After commencement, the liquidator can, within thirty days of appointment, prepare and file a report with the competent court, on the basis of which the court can apply the procedure, after having heard or summoned the debtor. The court can refuse to apply the procedure even where the conditions are met. Sale of the debtor's property can proceed by way of private agreement, as well as public auction.

(h) European Union

32. In 2014, the European Commission issued a non-binding Recommendation on a new approach to business failure and insolvency, which although not targeting MSMEs specifically, does include provisions for a discharge of individual debtors.[20] The Recommendation essentially addressed two main issues: first, the features of a restructuring mechanism with minimal court intervention (the mechanism); and second, the availability of a discharge for individual entrepreneurs within a short time frame. The mechanism was to be available to distressed entrepreneurs as early as possible, leave the debtor in control and be as informal as possible in order to reduce costs. Court involvement was not required, except where the rights of dissenting creditors were affected, either at the stage of imposing or lifting a stay of individual enforcement actions, or at the stage of validating a restructuring plan which affected such creditors or which provided for new finance directly or indirectly affecting the rights of certain creditors.

33. The mechanism was to include a stay of all creditor actions, limited to four months, but extendable up to twelve months. Creditors would be bound by a restructuring plan if it was approved by a majority of affected creditors in value (as determined under national law) according to separate classes (at a minimum, secured and unsecured creditors). Protective measures for dissenting creditors were to be included, that is, that no dissenting creditor could receive less under the plan than in liquidation. New finance was to be exempt from avoidance actions in any subsequent liquidation and providers of such finance were to be exempt from civil and criminal liability, where it existed.

34. Discharge would be available to all honest entrepreneurs after a maximum of three years from the commencement of liquidation proceedings or, where a repayment plan was approved, from the moment the plan took effect. Exemptions were included to, for example, safeguard the livelihood of the debtor and discourage dishonest entrepreneurs from taking advantage of a quick discharge.

35. In 2015, the Commission reviewed implementation of the Recommendation, concluding that, while it had provided a useful focus for Member States undertaking

[20] COM (2014) 1500 final.

reforms in the insolvency area, it had not had the desired impact on facilitating business rescue and giving a second chance to entrepreneurs due to only partial implementation in a significant number of Member States and the differences in implementation across those States.[21]

36. In November 2016, the Commission announced a proposal for a Directive to focus on three elements: (i) common principles on the use of early restructuring frameworks to help companies continue their activity and preserve jobs; (ii) rules to allow entrepreneurs to benefit from a second chance and be fully discharged of their debt after a maximum period of three years; and (iii) targeted measures for Member States to increase the efficiency of insolvency, restructuring and discharge procedures in order to reduce the excessive length and costs of procedures in many Member States, which results in legal uncertainty for creditors and investors and low recovery rates of unpaid debts.[22]

2. Comprehensive MSME insolvency regimes

37. Some countries, like Japan and the Republic of Korea, have adopted comprehensive laws that are specifically designed to apply to MSMEs and thus significantly different to the regimes applicable to larger enterprises.

(a) Japan

38. Although aimed at the restructuring of MSMEs, the Japanese legislation[23] also contains provisions on the rehabilitation of individuals with small scale debt.[24] The main differences from the general insolvency regime are that: (i) creditors are not generally required to file their claims with the court, as claims are regarded as filed when the schedule of the creditors prepared by the debtor is submitted to the court; (ii) avoidance claims are generally not permitted; and (iii) discrimination among creditors in a reorganization plan is not permitted. Both creditors and the debtor are able to initiate the procedure.

39. The court may appoint an "individual rehabilitation commissioner", who may be assigned one or more of the following tasks: (i) investigating the status of the debtor's property and income; (ii) assisting the court in the valuation of claims; or (iii) making recommendations necessary for the debtor to prepare and propose a proper plan. The commissioner is not significantly involved with the debtor and its business and the costs are thus reduced. The debtor is subject to the duty to act honestly and fairly, and requires court permission to undertake certain actions (for example, liquidate assets, acquire new loans, settle or pursue lawsuits, and hand over collateral).

40. There is no automatic stay, but temporary stays can be imposed by a court to enable negotiation. The consent of shareholders is not required to dispose of the business or reduce capital and post-petition financing has first priority in a class together with administrative expenses. Procedural requirements regarding proof of, and objection to, claims are less stringent than for the general regime and the debtor is exempted from the duty to prepare balance sheets. Where an objection is made to a claim by the debtor or creditors, the court reviews the legitimacy or amount of the claim in a summary, rather than a plenary, proceeding.

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[21] "Evaluation of the implementation of the Commission Recommendation of 12.3.2014 on a new approach to business failure and insolvency", 30 September 2015, Directorate-General Justice & Consumers of the European Commission.

[22] "Proposal for a Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU", 22 November 2016, COM(2016) 723 final, 2016.0359 (COD).

[23] Civil Rehabilitation Act of Japan (Act No. 225 of 22 December 1999).

[24] These provisions apply to an individual debtor who is likely to earn income continuously or regularly in the future and whose total claims amount to less than JPY 50 million (approximately US $455,000).

41. The plan may only provide for an extension of the term of the debt if the creditor is to receive a payment more than once in three months and the extension does not exceed three years from the date of confirmation of the plan. The law also adopts a "negative approval standard" for a plan: a plan is accepted if the creditors rejecting the plan are owed half or less of the total allowed claims and number less than half of all the creditors. Rights of secured creditors cannot be changed without their consent. Following approval, the court will confirm the plan if: (i) creditors receive at least as much as they would in liquidation; and (ii) the minimum payment thresholds prescribed by the law are met.

(b) Republic of Korea

42. The Republic of Korea has introduced a specialized procedure for small businesses,[25] the Small Business Rehabilitation Procedure, which can only be commenced by debtors. Upon the commencement of the court proceedings, the debtor retains the management of its business. An examiner is appointed, usually an experienced deputy court clerk or an accounting firm, who uses a simplified accounting method. No fee is required for the court clerk to perform his or her functions. The small business procedure also simplifies the requirements for the approval of a plan — for secured creditors, approval is required by 3/4 in amount (the same as for ordinary business reorganization), while for unsecured creditors, approval is required by either 2/3 in amount of total claims or 1/2 in amount of total claims and 1/2 in number of total creditors.

3. A modular approach to MSME insolvency

43. A "modular" approach to the design of insolvency regimes has been proposed for MSMEs, whether incorporated or unincorporated entities or sole traders or entrepreneurs. The purpose of the approach is to accommodate differences in the scope of insolvency regimes and to offer options for the allocation of various functions during the insolvency process — management (e.g. to the entrepreneur or an administrative agency), administrative (to a public body or a private sector official) and decision-making (to the court, an administrative agency or an insolvency professional). The following paragraphs provide a very brief summary of some of the elements of the proposal.[26]

44. The core objectives of the approach are the same as those for standard insolvency regimes, that is, preserving and maximizing the value in the insolvency estate, ensuring distribution 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. However, the approach differs in the way it pursues those objectives. The 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 is to make those tools available in a flexible manner and to create appropriate incentives for their use.

45. 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'

[25] In order to be able to request the opening of this specialized procedure, the debtor: (i) has to be a business income earner (not wage income earner); (ii) may be an individual or a legal entity; and (iii) must have less than 3,000,000,000 KRW (approximately US $2,570,000) in total secured and unsecured debts.

[26] See "The Modular Approach to Micro, Small and Medium Enterprise Insolvency", SSRN 26 January 2017 — The Bowen Island Group (Dr. Ronald Davis, University of British Columbia; Dr. Stephan Madaus, Martin-Luther-University Halle-Wittenberg; Dr. Alberto Mazzoni, Catholic University of Milan, Unidroit; Dr. Irit Mevorach, University of Nottingham; Dr. Riz Mokal, South Square Chambers; University College London; Justice Barbara Romaine, Court of Queen's Bench of Alberta; Dr. Janis Sarra, University of British Columbi; Dr. Ignacio Tirado, Universidad Autonoma De Madrid, European Banking Institute).

liabilities and to obtain discharge of any obligations that cannot be repaid. 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 failure to take action is interpreted as consent and the failure to exercise procedural rights within the process precludes a stakeholder from objecting to the part of the process to which those rights related.

46. The modular approach provides for processes to liquidate or rescue a small business, with stakeholders being able to adapt the process to their specific needs by employing various modules; the choice of which modules to include in the regime is left to lawmakers to consider in the light of the social, economic and political factors underpinning the local insolvency regime. Modules that can be used by the debtor include: (a) mediation, which requires the agreement of the various parties in dispute to ensure it is not being improperly invoked to delay the proceedings, and (b) a creditor action moratorium, which is available only upon request. It is treated as optional because it may not be required in all cases and it is thus not necessary to incur the associated costs in all cases. The moratorium could affect, for example, creditor claims enforcement, as well as ipso factor clauses and set-off rights.

47. Modules that may be employed by creditors (subject to specific thresholds) include: (a) mediation, to address disputes concerning, for example, admissibility or quantum of claims, plan formulation or treatment of guarantees; (b) a debtor action moratorium, which affects the debtor's rights to remain in possession and allows creditors to veto disposal of assets or the incurring of liabilities; (c) insolvency professional involvement, which allows creditors to seek to veto a debtor's decisions by appointing an insolvency professional to replace the debtor; and (d) "doomed to failure", which allows debtor-initiated rescue to be terminated where it can be demonstrated that the debtor's plan is doomed to failure and to be converted to liquidation.

III. Issues for consideration

48. As previously noted by Working Group V, solutions to the issues facing MSMEs in insolvency could be developed in light of the key principles and guidance already provided by the Legislative Guide.[27]

49. Working Group V may thus wish to approach the insolvency of MSMEs through the issues addressed in the Legislative Guide, taking the topics covered by each chapter as a starting point. If that approach is to be followed, document A/CN.9/WG.V/WP.121 provides a starting point for that task, as it has already identified the relevance to MSMEs of many of the key topics in the Legislative Guide, as well as outlining some of the modifications that might be required in addition to issues not currently covered by the Legislative Guide. That document might be amplified in greater detail to facilitate future discussion.

50. As part of its future discussion of those key issues to be addressed, Working Group V may wish to consider how the various elements could be combined in an insolvency regime for MSMEs and, in particular, the form that its final work product might take (e.g. a legislative guide).

[27] See footnote 2 above.