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COMMISSION STAFF WORKING DOCUMENT

IMPACT ASSESSMENT

Accompanying the document

Commission Recommendation

on a New Approach to Business Failure and Insolvency

{C(2014) 1500 final}
{SWD(2014) 62 final}

1. BACKGROUND AND POLICY CONTEXT

At a time when the European Union (EU) is facing the biggest economic crisis in its history leading to record numbers of bankruptcies in most Member States, improving the efficiency of insolvency laws in the EU has become an important factor in supporting the economic recovery. In recent years, an average of 200,000 firms went bankrupt each year in the EU, resulting in direct job losses totalling **5.1 million** over three years. A large proportion of SMEs are unable to pay down their short-term debts as they fall due (e.g. 24% in the UK, 2012). About one-quarter of these bankruptcies involved creditors and debtors in more than one EU Member State. Moreover, firms further upstream or downstream in the supply chain in one Member State may face financial difficulties because of the insolvency of a firm in another Member State, even if they have no direct dealings with that firm. These chain effects are particularly damaging for Small and Medium Enterprises (SMEs).

Many European restructuring frameworks are still inflexible, costly, and value destructive[1]. Insolvency systems in some Member States often channel viable businesses towards liquidation. An effective insolvency law should be able to liquidate speedily and efficiently unviable firms and restructure viable ones in order to enable such firms to continue operating and to maximise the value received by creditors, shareholders, employees, tax authorities, and other parties concerned.

This proposal aims at improving conditions and incentives for effective preventive restructuring of firms (i.e. to change the composition, conditions and/or structure of assets and liabilities of debtors in financial difficulty with the objective of avoiding insolvency) and on giving a second chance to honest entrepreneurs who once failed. It links in with the EU's current political priorities to promote economic recovery and sustainable growth, a higher investment rate and the preservation of employment, as set out in the Europe 2020 strategy for jobs and growth.

In November 2011, the European Parliament adopted a Resolution[2] on insolvency proceedings. It included recommendations for harmonising specific aspects of national insolvency law and company law. A study[3] commissioned by the EP had shown that disparities between national insolvency laws can create obstacles, competitive advantages and/or disadvantages and difficulties for companies with cross-border activities or ownership within the EU. The study found that harmonising insolvency processes would increase the efficiency restructuring process and increase returns to creditors The study concluded that 'there are certain areas of insolvency law where harmonisation is worthwhile and achievable'[4].

In December 2012, the Commission presented a proposal for a reform of Regulation No 1346/2000 on insolvency proceedings[5] (EIR proposal) which is currently in the legislative process. The Regulation only deals with the laws and jurisdictional rules applicable to cross-border insolvencies, and does not affect the content of national insolvency procedures. As set out in more detail in section 2.4 below, the reform notably aims at strengthening the rescue culture in Europe by broadening the scope of the

[1] Sergei A Davydenko and Julian R Franks, *Do Bankruptcy Codes Matter? A Study of Defaults in France, Germany and the UK* (2008) LXIII The Journal of Finance 565, 603 – 604.

[2] European Parliament Resolution of 15 November 2011 with recommendations to the Commission on insolvency proceedings in the context of EU company law, P7_TA (2011) 0484.

[3] INSOL Europe, *Harmonisation of Insolvency Law at EU level, 2010,* PE 419.633.

[4] These are: the conditions under which insolvency proceedings may be opened, aspects related to avoidance actions and filing of claims, rules on the establishment, effects and content of restructuring plans, and the qualifications and work of liquidators.

[5] COM(2012) 744 final.

Regulation to include pre-insolvency and debtor-in possession proceedings as well as certain personal insolvency proceedings which are currently outside the scope of the instrument.

The Commission Communication of December 2012[6] highlights certain areas where differences between domestic insolvency laws may hamper the establishment of an efficient internal market. Those differences affect the principle of free movement, in particular free movement of capital, competitiveness, and overall economic stability.

Under an economic recovery programme, the Commission has identified the key role of judicial reforms, including reforms of national insolvency laws, as a means to promote economic recovery. A number of Member States received country-specific recommendations relating to conditions for rescuing and restructuring of firms in difficulties as part of the European Semester in 2013[7]. On 9 January 2013 the Commission adopted the Entrepreneurship 2020 Action Plan[8] where the Member States are invited, among others, to reduce when possible, the discharge time and debt settlement for an honest entrepreneur after bankruptcy to a maximum of three years by 2013 and to offer support services to businesses for early restructuring, advice to prevent bankruptcies and support for SMEs to restructure and re-launch.

An approximation of the Member States' bankruptcy systems has also been recommended, with a view to removing the barriers to the flow of capital in the European Union, by the Organisation for Economic Cooperation and Development in its 2014 Economic Review for the European Union[9], by a High Level Expert Group on SME and Infrastructure Financing[10] as well as by the Association for Financial Markets in Europe[11].

2. PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

2.1. Impact assessment study and expertise

The IA has benefited from the following reports and studies carried out by the Commission:

- *Study on a new approach to business failure and insolvency – Comparative legal analysis of the Member States' relevant provisions and practices* (INSOL Europe, Annex 1 to this report)
- *Fostering a rescue culture in the EU: preventive corporate restructuring procedures and second chance for entrepreneurs* (DG ECFIN, Annex 2 to this report)
- *A second chance for entrepreneurs, Final Report of an Expert Group*, DG ENTR

A list of further studies and evaluations used in this report is found in Annex 3.

[6] COM(2012) 742 final.
[7] Available at http://ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/.
[8] COM(2012) 795 final.
[9] Forthcoming. The OECD found that differences in bankruptcy laws create additional costs for foreign investors to assess the risk properly and called the EU to address this problem by means of directives or common guidelines, see pp. 25-26 of the Review.
[10] "Finance for Growth – Report of the High Level Expert Group on SME and Infrastructure Financing", 11 December 2013, pp. 13-16, available at http://europa.eu/efc/working_groups/hleg_2013_en.htm.
[11] "Unlocking funding for European investment and growth – An industry survey of obstacles in the European funding markets and potential solutions", Association for financial markets in Europe, 2013, www.afme.eu/unlocking-funding-for-European-investment-and-growth.

2.2. Consultation of the IAB

The IA was presented to the Impact Assessment Board on 17 December 2013. The Board recommended that the report should better explain the extent to which the problems identified are cross-border; better justify the initiative on subsidiarity grounds; better explain how the minimum standards have been identified; better assess the impacts on domestic justice systems and on the protection national legal frameworks provide to creditors; better reflect the position of stakeholders; and propose clear and operational monitoring and evaluation arrangements.

This report has answered all these comments. The problem definition presents more clearly the barriers which the divergence of national rules on preventive restructuring frameworks and second chance pose to free movement, in particular free movement of capital, and the smooth functioning of the internal market. The subsidiarity analysis has been strengthened by new insights brought by the OECD and A High Level Group on SME and Infrastructure Financing. The impacts section makes a better assessment of the impacts on the protection of creditors' rights and the preferred option for the short term better reflects the concern for domestic justice systems which are currently undergoing urgent reforms in this area. The stakeholders positions, in particular Member States, are now better reflected throughout the report. Finally, more specific monitoring and evaluation arrangements have been foreseen.

On 7 February 2014, the Board gave a positive opinion. However, some improvements were suggested, such as reinforcing the explanation of why the proposed minimum standards are considered to provide an optimal regime, likely costs, views of stakeholders other than Member States and evaluation arrangements. These have now been addressed in this revised Report.

2.3. Stakeholder consultation

Stakeholders have been consulted as follows:

- Public consultation on a new European approach to business failure and insolvency (5 July – 11 October)[12].

More than 200 replies were received, among these 7 Member States (CZ, EE, FI, EL, LT, NL, ES). Around 70% of participants consider there is a need to eliminate all or some of the divergences of national rules regulating restructuring plans. About three quarters of respondents support the European objective to limit the discharge and debt period to a maximum of 3 years in order to facilitate a second chance for entrepreneurs.

- A technical meeting with experts on insolvency from the Member States governments took place on 12 December 2013. Bilateral meetings also took place at technical level with a number of Member States.
- Several meetings with business stakeholders: BusinessEurope, EuroChambers, UEAPME, Association of Family Businesses.
- Two one-day dedicated meetings of the Commission Expert Group on Insolvency[13].

[12] See *Executive Summary of the outcome of the Public Consultation* in Annex 4 to this Report.
[13] This Commission Expert Group comprises of insolvency experts from several Member States and was initially established to assist the Commission with the revision of the Insolvency Regulation.

2.4. Scope of the current initiative

The current initiative focuses on an area of insolvency law where the divergence and absence of preventive restructuring frameworks poses the biggest and most urgent risks the smooth functioning of the internal market. Several Member States are currently reforming their insolvency laws with a view to improving the legal framework enabling the early restructuring of companies in financial difficulty. There is a risk that a lack of coordination of these reforms as well as a lack of action on the part of those Member States which do not have effective frameworks in place or plans to reform their laws will be a missed opportunity for removing barriers to the internal market which flow from the divergence of insolvency laws.

The 2012 Communication and the 2013 Public Consultation also raised a number of other possible problems, such as the divergence of insolvency tests applied in the Member States, the powers and qualifications of liquidators, directors' duties and liabilities and professional disqualifications, divergent rules on the priority of claims and on avoidance actions in insolvency proceedings. The Commission will conduct further comparative law and economics research in addition to that already undertaken and give all these problems an appropriate follow up, accompanied, when necessary, by a dedicated Impact Assessment.

2.5. Relationship with other instruments

The **European Insolvency Regulation** (EIR) proposal and the current initiative are complementary. The EIR and its reform deal with the problems of jurisdiction, applicable law, recognition and enforcement of insolvency decisions, as well as coordination of cross-border insolvency proceedings. It "works with" the insolvency procedures that exist in the Member States and ensures that their results are recognised throughout the EU. The revision of the Regulation will extend the scope of the Regulation to preventive/pre-insolvency procedures and certain personal insolvency procedures which are currently not covered by the Insolvency Regulation.

However, the EIR proposal will not oblige Member States to introduce specific types of procedures or to ensure that their procedures are effective in promoting rescue and second chance.

The current initiative would therefore be complementary to the Insolvency Regulation by requiring Member States to ensure that their national insolvency procedures comply with certain minimum standards. Below are two examples which illustrate the complementarity of these two instruments

- **Example 1: companies in financial difficulties** which do not have effective early restructuring possibilities in their home country have an incentive to relocate to Member States which have more effective systems. The revision of the Regulation would ensure that such restructuring plans agreed early (before the company becomes insolvent) would be recognised and enforced in another Member State (including the Member States from where the company relocated). The revision would not however solve the primary problem, which is the fact that ailing companies in many Member States do not have efficient early restructuring procedures in place at home and need thus to relocate to benefit from those. Furthermore, it does not provide any solution for ailing companies not having direct foreign creditors but which are nevertheless in the supply chain of a company which does.

- **Example 2:** In respect of **groups of companies**, the revision of the Regulation would improve the coordination of cross-border proceedings. It would not however ensure that subsidiaries located in different Member States of the same group of companies have the possibility to

restructure in an efficient manner and according to a coherent restructuring plan. Each subsidiary would need to be restructured according to the law of the Member State where it is located, which would entail costs in terms of more experts being needed and the impossibility of having a coherent restructuring approach. Groups of companies are not necessarily big multinational corporations – SMEs can also be groups of companies, for example where an SME acquires one of its suppliers in another Member State.

The proposed **European Account Preservation Order** (EAPO) is meant to help creditors recover their claims across borders before any insolvency procedure is open, i.e. before the debtor is in a state of financial difficulties and risks becoming insolvent. Once an insolvency procedure – including a preventive restructuring procedure – is open, the EAPO procedure is closed.

2.6. Impact Assessment Steering Group (IASG)

The IASG was convened 2 times. The first meeting took place on 23 September 2013 and the second meeting on 25 November 2013. The DGs invited were the following: Secretariat General, Legal Service, DG MARKT, DG TRADE, DG COMP, DG ENTR, DG SANCO, DG ECFIN, DG MOVE, DG EMPL, DG HOME, DG BUDG.

3. PROBLEM DEFINITION

3.1. Introduction

The differences between Member States' laws in respect of (1) preventive restructuring possibilities and (2) second chance for entrepreneurs create barriers for the smooth functioning of the internal market. The ensuing problems include the losses for cross-border creditors, difficulties for groups of companies to restructure, high risks for foreign investors and disincentives for companies to establish themselves in certain Member States, and losses of creditors if debtors relocate to other Member States. SMEs, including micro-enterprises, are likely to suffer disproportionately the effects of these barriers.

25% of all insolvencies have a cross-border character. However, the financial difficulties or insolvency of one company have repercussions upstream and downstream its supply chain, so that even domestic insolvencies can have a cross-border impact[14].

3.2. Discrepancies between the rules on corporate rescue

3.2.1. The availability of a range of restructuring procedures and their advantages

Procedures available to enable firms to address their financial difficulties through restructuring fall into three main categories: fully out of court, fully in court, or a range of hybrid procedures which combine the benefits of judicial control and out-of-court easiness and low cost. While almost all Member States have fully in-court restructuring proceedings[15], the possibilities for less formal, hybrid restructuring procedures are limited in several of them. The absence or limited availability of out-of-court procedures is a particular issue for smaller companies, who are less well able to afford the (mostly fixed) costs of legal proceedings than larger firms. This incomplete legal framework pushes solvent firms which however experience financial difficulties, actual or foreseen, into insolvency proceedings. This leads in

[14] 27% of insolvencies in the UK are triggered by the insolvency of another company, the European Small Business Alliance response to the public consultation, 2013.

[15] BG seems to be an exception.

turn to the closure of potentially viable firms, creating financial losses for firm's creditors, firm owners, employees, investors and public authorities across the EU.

Debtors should be able to address their financial difficulties at different moments in time and by different means which respond to their particular needs and those of their creditors. Chart 1 illustrates the **existence of different options that may be used at different moments in time**, depending on the situation, or alternatively, and which imply an increasing degree of judicial intervention and formality in general. As a general observation, **the later a business initiates restructuring proceedings, the higher the costs of restructuring and the lower the management powers and the success rate**. Therefore the existence of an option to intervene early increases the chances of survival of an ailing company and minimises the costs of the restructuring.

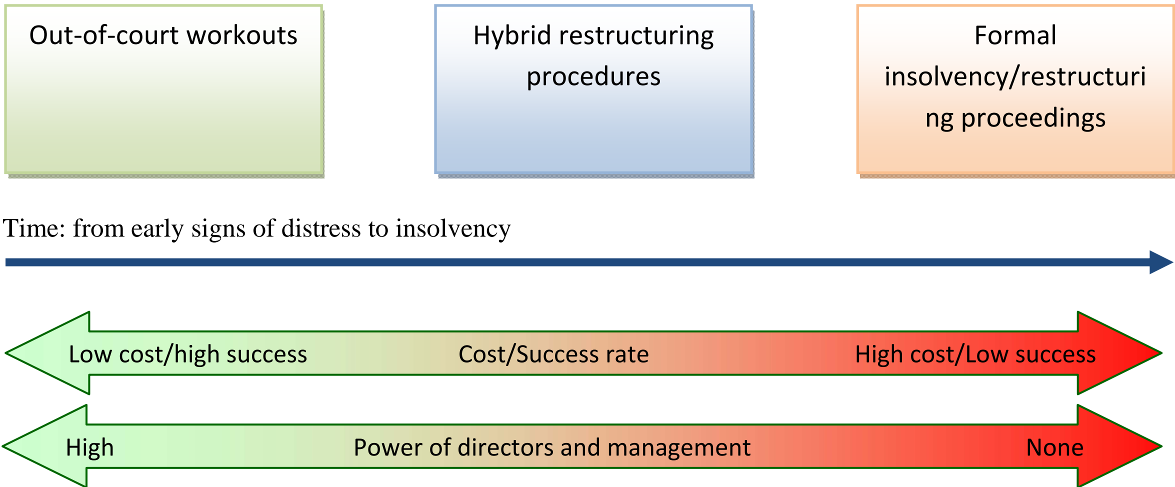

Chart 1. Restructuring possibilities in time

- **Out-of-court workouts:** Any debtor facing financial difficulties always has the option of negotiating with his creditors the terms and conditions of their contracts. Such amendments may result, for example, in the rescheduling of payments, a reduction in interest rates, a total or partial write-off of the debt or new loan facilities. These are purely contractual transactions based on the individual consent of all affected creditors. This means that there is no possibility in purely out-of-court agreements of imposing a restructuring plan on dissenting creditors who do not sign up to the agreement. For this reason, out-of-court restructuring usually involves de debtor and a very small number of creditors (often one or two).
- **Formal insolvency/restructuring proceedings:** these are collective proceedings (involving all creditors) subject to the control or supervision of a court and/or an insolvency administrator, which means that the debtor can lose the control of his assets or is greatly restricted in his actions. This procedure implies an automatic moratorium (stay of enforcement actions) and can result in either restructuring (where this is possible) or liquidation. The restructuring plan is binding on all creditors, whether they are in favour of it or not.
- **Preventive (hybrid) restructuring procedures:** these combine the advantages of informal agreements (e.g. ease of negotiation, debtor remains in possession) and formal insolvency proceedings (e.g. stay on enforcement actions, binding effects of a restructuring plan on a minority of creditors). The economic function of these hybrid procedures is to reduce the risk that a minority creditors could stop the restructuring process, without the need to incur the costs associated with formal insolvency proceedings. Binding the minority of creditors is a

necessary condition for the success of restructuring and avoiding the company being forced into a formal insolvency process. In order to balance this sort of "expropriation of the individual consent" outside formal insolvency proceedings, legal systems lay down certain safeguards (e.g. approval by a majority of creditors and confirmation by the court).

The overview of advantages, disadvantages and situations in which these various procedures can optimally be used as well as their availability in Member States is presented in **Annex 6**.

According to the World Bank**, the highest recovery rates for creditors are recorded in economies where restructuring is the most common insolvency proceeding**[16]**.** For instance, 45 percent of OECD economies use reorganization as the most common insolvency proceeding to save viable firms and have an average recovery rate of 83 cents on the dollar, as opposed to 57 cents on the dollar with liquidation[17].

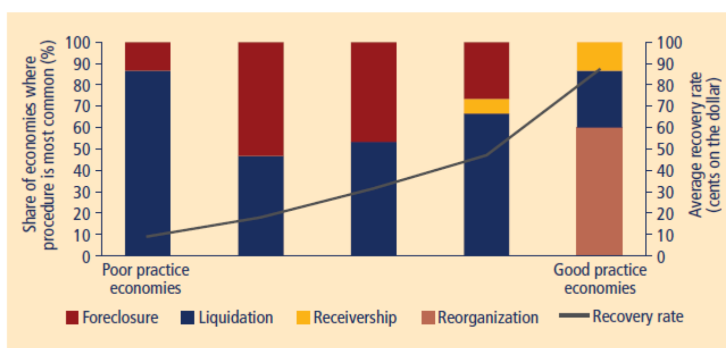

Chart 2: higher recovery rates are more likely in economies where restructuring is the most common insolvency proceeding,

Source: World Bank

Hybrid preventive procedures would not always be appropriate. For example, if the debtor only needs to negotiate with one creditor, an out-of-court bilateral workout is the solution; on the other hand, if the debtor is not a viable business which can be successfully turned around, it is better to liquidate it as soon as possible. If the degree of viability of the debtor is in doubt, using a preventive procedure is the best course of action since it allows an in-depth analysis of the financial situation of the debtor and, should the prospects of a restructuring prove slim, the debtor could always commence insolvency proceedings[18].

Formal insolvency procedures (while warranted in certain situations) imply that the parties lose control over negotiations, incur significantly higher costs and delays which result in value destruction for both creditors and the debtor, and cause a big disruption of the debtor's business.

Company Voluntary Arrangements (CVA) in the UK as an example of an optimal hybrid procedure [19]

[16]http://www.doingbusiness.org/reports/globalreports/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB14-Chapters/DB14-Resolving-insolvency.pdf

[17]Doing business, smart lessons, 2013

[18] Jose M. Garrido, "Out-of-Court Debt Restructuring", The World Bank, Washington, 2012 (hereinafter "World Bank Study on Out-of-Court Debt Restructuring"), p. 8.

[19]For an overview of the restructuring procedures available in UK (including their advantages and disadvantages) seehttp://www.taylorwessing.com/uploads/tx_siruplawyermanagement/Insolvency_Procedures_in_the_UK_01.pdf

A CVA is essentially a voting mechanism which allows a restructuring proposal to be brokered by the company with the assistance of a licensed insolvency practitioner and implemented if it is approved by the requisite majority of creditors (but proposal may not compromise rights of secured creditors unless consent given). CVAs take two forms. The first is a "stand-alone" CVA which does not provide for a moratorium (stay) on creditors' claims in the period before the creditor vote. The second is a "CVA with moratorium" which provides for a pre-vote moratorium of up to 28 days. However, the CVA with moratorium is only available to small companies which satisfy defined eligibility criteria.
Although the management remains in control, the insolvency practitioner supervises the process. The court involvement is normally very limited.
The underlying rationale of the CVA is that it offers creditors a better return than they would realise if some other form of insolvency procedure were to be commenced in relation to the company[20].

3.2.2. Features of an efficient restructuring procedure: lessons learnt from the reforms of restructuring laws in Member States

A restructuring procedure must contain certain features in order to be effective. The table below presents the main features of such procedures which have been identified on the basis of:

- international best practices, such as the World Bank Principles for Effective Insolvency and Creditor Rights Systems, UNCITRAL Legislative Guide on Insolvency Law, International Monetary Fund (IMF) Orderly and Effective Insolvency Procedures, European Bank for Reconstruction and Development Core Principles for an Insolvency Law Regime;
- the recommendations of the Study on a new approach to business failure and insolvency – Comparative legal analysis of the Member States' relevant provisions and practices[21];
- lessons drawn from the comparative study of Member States systems[22] and from the analysis of reforms of the restructuring laws in the Member States[23],
- conclusions drawn from the discussions in the Commission Expert Group on Insolvency and a meeting with the Member States;
- the responses received during public consultation;
- dedicated evaluations[24] and literature.

These elements were also discussed with the Member States in the meeting of 12 December 2013.

Elements of procedure	**Effectiveness features**
Early possibility of restructuring *Needed to ensure that restructuring avoids the insolvency of the debtor*	• Debtor must be in financial difficulty but not yet insolvent • The restructuring plan should avoid the insolvability of the debtor • legal systems should not have in place barriers to early negotiations, provided that they are carried out in good faith
Moratorium (stay of enforcement actions)	• Moratorium needs to protect against individual enforcement actions, but it is not needed against pending legal procedures

[20] Preliminary Report to the Insolvency Service into Outcomes in Company Voluntary Arrangements, p.19
[21] See Annex 1.
[22] INSOL Europe Study, Recommendations.
[23] See Annex 7.
[24] Such as Evaluation of Member State Procedures for Financial Reconstruction of Enterprises in Financial Distress, 2010, CSES, http://ec.europa.eu/enterprise/dg/files/evaluation/final_to_dge_to_gr_en.pdf.

Needed to allow time for negotiations with creditors and address the hold-out problem[25]	• During the stay, debtor should not be required to file for insolvency and request from creditors should be suspended • Stay must be of limited duration (to incentivise quick agreement and prevent abuse of creditors' rights) • Stay should be granted on request by the debtor, rather than automatically • should be balanced by the need to adequately protect secured creditors' interests (e.g., by allowing them to request a relief from the stay under certain specified conditions).
Debtor in possession *Needed to facilitate the continuation of the operations by the debtor*	• provides an incentive for debtors to use the procedure early • ensures minimum disruption to the operations of the debtor and allows him to carry on his day-to-day operations
Support by a majority of creditors binds the dissenting minority *Needed to avoid jeopardising the restructuring effort and the unanimity problem*	• Dissenting creditors may be outvoted by a majority of creditors • All types of creditors should potentially be bound by the plan • Secured and unsecured creditors must vote in separate classes • Dissenting creditors must not be affected more than they would be in formal insolvency proceedings • Creditors should be treated in the same way as similarly situated creditors
Possibility of new financing *Needed to increase the success of restructuring plans*	• facilitate the provision of new financing which is vital for rescuing the business • No civil or criminal liability for good faith lenders • Exemptions from avoidance actions • Priority over pre-existing debt
Limited court involvement *Needed to ensure the legality of acts having legal effects on third parties and reduce costs*	• Ensure effectiveness of hybrid procedures by giving binding effects to acts which have effects on dissenting creditors and third parties • ensures that the stay and the plan are not hurting the legitimate rights of creditors • ensures a degree of confidentiality of the negotiations[26]

While the empirical data is scarce, there is evidence that the reforms already undertaken by Member States which have introduced several of the above-mentioned features have brought positive results, in terms of:

- Lower incidence of liquidations (e.g. in the UK the number of corporate liquidations is 30% lower during this recession than during the economic crisis of the 1990s thanks to the improved legal framework)
- Increased restructuring as a share of total insolvency related procedures. For example, in Italy the number of formal reorganisations increased from 1% to 10% as an effect of 2005 reform, and positive impact on the Reorganizations/Liquidations ratio, both in terms of new and closed proceedings (22% and 42% respectively) was identified. In Belgium the 1997 reform encouraged small firms to reorganise instead of liquidate, and a liquidation rate of partnerships in bankruptcy

[25] A stay of individual enforcement actions is necessary to solve the "holdout" problem, i.e. "the fact that one or more creditors uses enforcement actions against the debtor which could lead to the end of negotiations and the start of a race among creditors and end with the opening of a fully formal insolvency proceeding frequently aimed at liquidation, without consideration for the fact that the debtor could have been rescued with an adequate workout agreement", World Bank Study on Out-of-Court Debt Restructuring, p. 48.

[26] This feature diminishes the risk of a rush by creditors to enforce their claims and possibly trigger the insolvency of the debtor. It also allows the debtor to better negotiate with certain creditors a restructuring plan.

fell by an annual average of 8.4 %. Additional significant increase in reorganisations was identified as a result of the 2009 reform.

- Increased recovery rates (Italy)
- Positive assessments of the IMF and World Bank (e.g. Italy, Spain).

See Annexes 2 and 7 for a more detailed account.

All potential elements of the procedure were considered. However, some of these were not retained as appropriate for common minimum standards (e.g. on a preliminary analysis carried in the context of DG ECFIN's analysis, the initiator of the procedure - whether the debtor, the creditors or a public authority - did not seem to influence the effectiveness of the insolvency system). Others had objectives which were considered to be sufficiently addressed by the minimum standards retained (e.g. the INSOL Study recommends that preventive insolvency procedures are confidential in order to diminish the immediate loss of value for the debtor's business which usually accompanies a public opening of such procedures; however, it is considered that the limited court involvement as well as the fact that a moratorium is granted optionally, on request by the debtor, would help the debtor mitigate the negative impact of too much publicity of his financial difficulties in the phase preceding his insolvency).

3.2.3. Insufficient restructuring options in Member States and their cross-border implications

An effective legal framework avoids leaving excessive space to formal insolvency proceedings and makes the maximum room for out-of-court and hybrid possibilities. An effective legal framework also enables debtors to restructure at an early stage, before they become insolvent. Finally, an effective legal framework for restructuring contains certain elements which contribute to successful negotiations, adoption and implementation of restructuring plans.

While a wide range of (efficient) resolution tools is essential for an efficient restructuring regime[27], the discrepancies between national rules are reflected in a categorisation of national systems as follows: some Member States have a limited range of the procedures in that firms can only restructure late and within formal insolvency proceedings (Group 1), or can restructure somewhat earlier but procedures lack certain effectiveness features (Group 2); finally, some Member States have a wider range of restructuring possibilities, including early procedures aimed at avoiding insolvency, but they are mainly court-driven and potentially expensive (Group 3), and in some Member States where hybrid procedures exist their design could be improved (Group 4). Annex 5 contains an overview of the elements of restructuring procedures and discharge periods in the Member States.

Group 1: Late restructuring possible when debtor is already insolvent AND within formal insolvency procedures

In Member States where restructuring is only possible once the debtor is insolvent (*BG, HU, DK, CZ, SK, SI*[28]*, HR, LT),* the rescue rate is rather low. The effectiveness of insolvency proceedings in restructuring debtors in financial distress is very limited given that the debtor's assets are most often insufficient to keep the business as a going concern. In addition, the procedure is expensive.

[27] The World Bank Study on Out-of-Court Debt Restructuring, p.5.

[28] A new law entered into force on 7 December 2013. The law introduces a preventive procedure which can be used before the debtor becomes insolvent.

For example, in Hungary less than 1% of companies that use insolvency continue to operate as a going concern[29] and nearly all bankruptcies end in liquidation[30]. Out of **22,644 companies bankrupt** in Hungary in 2012 (exceptionally high number compared with other Member States), 226 firms were going concerns. In the **Czech Republic** in 2011 there were 2,229 declared bankruptcies and these included 17 reorganisations (0.8%)[31]. The low effectiveness of the Czech law is attributed to the fact that restructuring commences too late[32]. **Only 0.4% of all in-court insolvencies in pre-reform Germany** (1999-2004) resulted in restructurings according to data from *Creditreform Datenbanken*. Many of resulting liquidations can be premature.

Hypothetically, if in **Hungary** restructuring occurred at least in 20% of close-to-insolvency situations as is in the UK[33],[34], there would likely be additional 4300 going concerns. Even if only 10% of these restructurings were successful, **430 firms could be successfully restructured**, benefiting their creditors and other stakeholders. The number of firms restructured in the Czech Republic in 2011 under the same scenario would be **42.**

Insolvency of an airline in a rescue-unfriendly and rescue-friendly jurisdiction
Hungarian airline Malev went into bankruptcy and ceased flying on February 3, 2012. It proved unable to restructure with implications for Malev stakeholders and taxpayers. The debt was $270m. None of passengers' claims were reimbursed. The company was declared bankrupt, about 2000 employees were laid off, and this triggered further redundancies at Budapest Airport Ltd and at the company's suppliers. Shortly after the closure of Malév, Budapest Airport Ltd (BA) announced it was making 250 workers redundant[35]. Passengers did not receive any reimbursement[36]. If the Hungarian law were a more rescue friendly those losses could have been avoided.
In November 2011, American Airlines and its US based subsidiaries filed voluntary petitions for Chapter 11 reorganization. The process enabled the airlines to continue conducting normal business operations while they restructure their debt, costs and other obligations.[37] **In September 2013,** US Bankruptcy Court confirmed the airlines' proposal to exit restructuring proceedings. As part of the plan, American agreed to merge with US Airways, a move that received the backing of creditors as well as its three main labour groups. The ruling was

[29] Importance of Effective NPL Resolution –Legal and Regulatory Issues, Mahesh Uttamchandani, WB https://www.wbginvestmentclimate.org/advisory-services/regulatory-simplification/debt-resolution-and-business-exit/upload/Importance-of-Effective-NPL-Resolution-Legal-and-Regulatory-Issues.pdf
[30] http://business-finance-restructuring.weil.com/cross-border-update/dead-or-alive-liquidation-or-restructuring-under-the-hungarian-insolvency-law/
[31] Data from the Czech Ministry of Justice, see also http://www.wseas.org/multimedia/journals/economics/2013/105707-103.pdf
[32] Czech Insolvency Law After Four Years, Smrcka, Schonfeld, 2013, http://www.wseas.org/multimedia/journals/economics/2013/105707-103.pdf
[33] The share of restructuring procedures in all insolvency procedures in the UK was 22% in 2012 (without counting schemes of arrangements for which there are no statistics). Receivership Appointments: (1222), Administrations (2532), CVA (839), Liquidations (16156). Source: The UK Insolvency Service http://www.insolvencydirect.bis.gov.uk/otherinformation/statistics/201308/table3.pdf
[34] These include restructuring procedures mentioned above and company liquidations (compulsory and voluntary). Source: The UK Insolvency Service http://www.insolvencydirect.bis.gov.uk/otherinformation/statistics/201311/table1.pdf
[35] Out-of-Court Restructuring versus Formal Bankruptcy in a Non-Interventionist Bankruptcy Setting http://www.eurofound.europa.eu/eiro/2012/08/articles/hu1208021i.htm
[36] The Hungarian office of the ECC-Net
[37] http://www.aa.com/i18n/amrcorp/newsroom/fp_restructuring.jsp

supposed to cap a two-year process after American sought court protection to reorganize its business. (For an outline of US Chapter 11 please see Annex 10).

Absence of an early restructuring possibility - German law before 2012
At the time of Rodenstock's contemplated restructuring (before 2012), there was **no German equivalent of a scheme** which would allow it to put in place an effective pre-insolvency restructuring. Rodenstock **was solvent, though financially distressed** and facing liquidation. The company sought the injection of fresh liquidity, but lenders would only be prepared to do so if the company could properly secure their claims and/or grant them priority over existing creditors. This required an amendment of the terms of the senior facilities agreement and the inter creditor deed, in order to enable €40 million of new money to be raised, ranking on a super senior basis. There were many creditors and it was expected that the **consent of all creditors to these proposals would not be achieved**. The first option was an **out of court pre-insolvency restructuring**, which would require the consent of all creditors, and would therefore be subject to hold up problems by the minority creditors, but might also raise difficulties for the directors, since they are under an **obligation to file for a request for the opening of insolvency** proceedings within three weeks of the commencement of illiquidity or over-indebtedness. The second option was a restructuring within a **formal court-supervised insolvency** proceeding, with all of the stigma of insolvency and other difficulties that this brings with it in practice. Rodenstock regarded the English scheme as a more flexible option for carrying out its restructuring.
While this company managed to find a solution (relocation to the UK), a smaller company could most likely not have afforded it and would have gone into liquidation.

***Group 2**: Early restructuring options are in place but do not contain certain effectiveness elements*
Some Member States have early restructuring options, but these are not effective because they are missing a number of the essential effectiveness features. For example in LU it is not possible to bind all types of creditors by majority decision, in EE and PL the new financing is discouraged. In effect, in those countries reorganization procedures are rare, are embarked upon too late[38],[39],[40],[41], and therefore insolvency is the most common outcome. Other Member States in this group are *CY, IE, NL, RO.*

What is the indicative financial impact on cross-border creditors in the absence of effective early restructuring (situation of Group 1 and 2)? Example of Hungary

In Hungary there is 4bn volume of corporate non-performing loans. Given the current recovery rate of 39%[42], €2.44 bn worth of value of those loans is currently being destroyed. If the Hungarian law were more rescue friendly, its recovery rate could most likely be at the level of the OECD average of 70%[43]. Consequently, the destroyed value would amount to €1.20bn. Thus the foregone benefits of not being rescue friendly are €1.24 bn –

[38] The Restructuring Review 2013
[39] Why reorganization of firms fails. Evidence from Estonia, Lukason, Urbanik, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2335982
[40] The need for improvement of the restructuring proceedings in Estonia was acknowledged by the EBRD, http://www.ebrd.com/downloads/sector/legal/estonia.pdf
[41] Polish Ministry of Economy, The policy of second chance, 2012 http://www.mg.gov.pl/files/upload/17483/Nowa_szansa_miedzyresortowe_spoleczne_wersja3_ost_.doc
[42] Recovery rates are provided by the World Bank, see the methodology of their calculation at http://www.doingbusiness.org/Methodology/resolving-insolvency#recoveryRate
[43] According to the WB, the highest recovery rates are recorded in economies where reorganization is the most common insolvency proceeding.

equivalent to fully 1% of Hungary's GDP. Given that cross-border bad debts amount to 0.45% of total bad debts[44], cross-border creditors can be estimated to forego €5.58 million.

Similar simulations were performed for Bulgaria and Lithuania (see below)

	Aggregate value of corporate NPL (bn euro)	**Current recovery rate (%) in insolvency[45]**	**Value destroyed currently (bn euro)**	**Value destroyed if the recovery rate were the OECD average of 70%**	**Difference (bn euro)**	**Loss to cross-border creditors (million euro)**
Hungary	4	39	2.44	1.20	1.24	5.58
Bulgaria	3.75	32	2.53	1.12	1.41	6.35
Lithuania	1	48	0.52	0.3	0.22	1.00

Group 3: *Early restructuring options are in place but are formal and complex, and therefore potentially expensive*

While these procedures can be advisable in certain situations (e.g. complex restructurings, such as those of large companies) they may nevertheless be disproportionately complex or costly in other situations, in particular for SMEs, involving the court unnecessarily and generating unnecessary costs (such as court fees, obligation to appoint practitioner, use of court for voting, professional fees, long procedures). This can be a disincentive for smaller companies if they wish to use the procedure for restructuring, for example in *FR, DE, SE and LV*. For example, the reform in DE has led to a small improvement, but is by no means significant (in 2012-2013, only 0.2% of insolvency proceedings take place under the newly introduced preventive shield procedure).

Formal preventive procedures are efficient in some Member States, such as FI[46] and, to a certain extent BE. The need for hybrid procedures in these Member States may therefore seem less pressing than in others. However, even such Member States would benefit from the introduction of a hybrid procedure as an alternative solution for enterprises in difficulty, especially SMEs.

Disadvantages and disincentive of formal procedures

(1) **Cost**. Formal proceedings can be a very costly exercise due to:

(a) The obligations placed on having a mediator or a supervisor (sometimes by courts as well) during the process.

(b) The significant responsibilities of the supervisor once appointed. Carrying out these responsibilities requires a considerable amount of expensive time.

(c) Therefore, the cost of formal proceedings can often be:

(i) Prohibitive to smaller companies.

(ii) In excess of the benefits achieved by the restructuring.

(2) **Time**. Although a company can be placed into a formal procedure quite rapidly, there is a considerable amount of time taken by the fact that mediators need to launch negotiations or supervisors/courts need to go over

[44] IA on Account Preservation Order, p.83

[45] The recovery rate calculates how many cents on the dollar claimants (creditors, tax authorities, and employees) recover from an insolvent firm

[46] FI has an efficient formal restructuring procedure in place, with high recovery rates for creditors, despite the fact that courts are involved all along the procedure, including for voting on a restructuring plan. This can be explained by the fact that the FI framework on restructuring presents most of the elements of an efficient procedure, such as low conditions for entering the procedure, a stay of individual enforcement actions, majority voting binding all types of creditors and provisions for new financing. Furthermore, the court proceedings are short and make use of modern technology, which contribute to keeping the costs of restructuring proportionate.

all the operations of the debtor, creditors (sometimes all creditors) need to be notified and allowed to raise objections, plans need to be voted sometimes in a court hearing etc.
(3) **Financing**. It can be difficult to finance a long restructuring process in terms of:

(a) Financing short-term working capital.

(b) Financing trade supplies.
(4) Interference with the continuation of operations by the debtor.
(5) Publicity of the procedure

According to the World Bank study (2004) the likelihood of achieving the goals of an efficient bankruptcy system is inversely related to "court power".

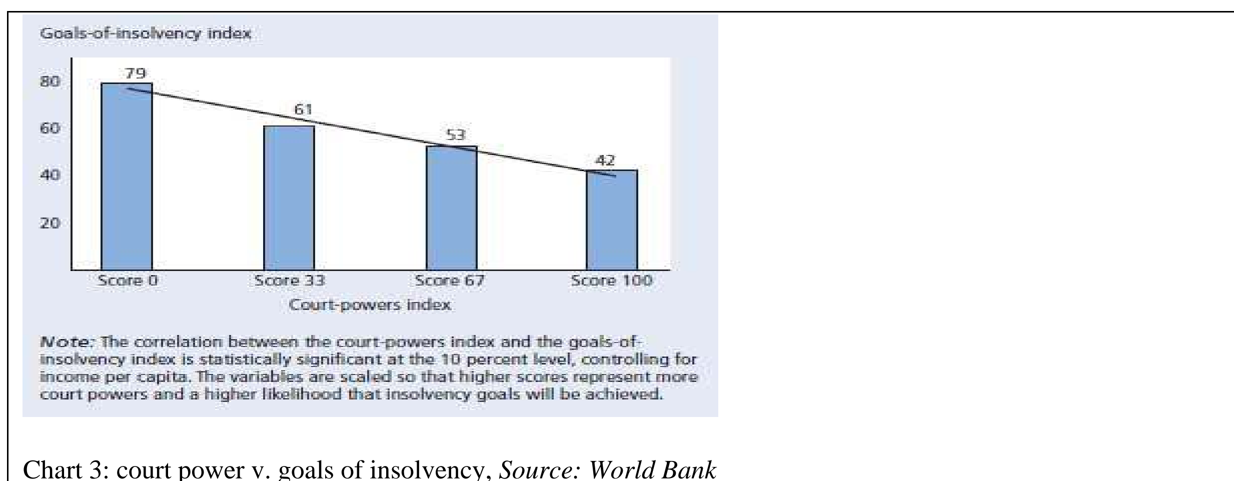

Chart 3: court power v. goals of insolvency, *Source: World Bank*

The box below presents the disadvantages of the formal procedure on the example of the UK administration procedure.

What is the foregone cost of too formalised procedures? An example from the UK

1) Hypothetically, if the UK restructuring framework did not include the less formal tools such as the CVA, firms would need to use formal procedures such as Administration in order to restructure. Assuming that 27% of firms use the CVA procedure successfully, that all firms using it are small[47] and that 839 firms were using it in 2012[48] it allows for the conclusion that if they used instead the Administration procedure (assuming that they could afford it), this would create for them **additional cost of between £0-62.2 million[49]**.

2) The average return for unsecured creditors in the administration procedure is 4%[50]. Average return for unsecured creditors in rescue cases under CVA is 37% [51]. The CVA rescue rate is 27%, so the number of firms rescued in 2012 would be 226[52]. Assuming the average unsecured debt of £506,781, if those firms were dealt

[47]Preliminary Report to the Insolvency Service into Outcomes in Company Voluntary Arrangements, prof.A.Walters, dr S.Frisby, Outcomes from the sample of CVAs commencing in 2006 http://www.insolvencydirect.bis.gov.uk/insolvencyprofessionandlegislation/research/corpdocs/CVA-Report.pdf
[48] Data provided by The Insolvency Service, UK
[49] (27%*839*£300000) – (27%*839 * £25000)= £62.2 m
[50] Companies House data, based on 500 records
[51] This concerns rescue cases. In wind down cases the average recovery is 17%
[52] The CVA seems to be also used as informal wind-down device with the average return of 17% in wind down

with in the administration procedure the return would be 20,000 (compared with 187 500 under CVA). Consequently, the **foregone value would amount to 167,500 per case, or £37.8 m in total**.

In conclusion, the (hypothetical) financial cost of not having an alternative to the formal restructuring procedure in the UK would be in the region of **£37.8 – 62.2 m**. In reality this cost would be significantly higher if the cases of restructuring via another UK's less formal procedure (Schemes of Arrangements) were included[53]. An additional benefit of CVAs is the fact that dividends of over 30% are being returned in 14% of the CVA cases.

Scaling up the quantifiable part of the cost to the group of countries which have only formal restructuring procedures (BE, DE, FR, FI, SE, LV) the total cost of not having a hybrid alternative could be (with all due caveats) estimated to be in the order of magnitude of **€135-223 m**[54].

Below are the indicative costs of a formal rescue procedure (administration) compared to the less formal procedure (company voluntary arrangement, or CVA) in the UK:[55]

	per Administration (formal procedure) (£ 000's)	**per CVA (less formal procedure) (£ 000's)**
Small company	5 – 300	5 - 25
Medium company	45 – 500	10 - 200
Large company	2000 - 4000	500 - 1500

The procedures are briefly compared in Annex 8.

Group 4: *Hybrid restructuring options are in place, but they could be made more effective*

Hybrid procedures could take different forms. First, they may not require a formal opening of the restructuring procedure through a court decision. Second, the conditions for entering the procedure are low, for example there is no need to prove the debtor's financial difficulties, provide professional expertise from a third party or ensure that a high percentage of creditors are in favour of restructuring. Third, insolvency professionals such as administrators or supervisors are not appointed in all circumstances. Finally, creditors' meetings and voting take place out-of-court.

UK, EL, PT, ES and AT have in place early rescue procedures which combine the advantages of out-of-court and formal procedures. These procedures could potentially be more successful and cheaper than formal and complex ones. They also address the holdout problem by providing the stay on enforcement and allow a majority of creditors to bind a dissenting minority of creditors.

However, for different reasons, they are not always effective. In AT, the threshold conditions for accessing the preventive procedure are too strict, there is no possibility for a moratorium and the majority rules are ineffective. In IT and PT, the conditions for accessing the hybrid procedure are too strict. In EL and ES the majority rules are ineffective, e.g. because they do not bind secured creditors.

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cases. This benefit was not included.

[53] According to anecdotal evidence, the schemes of arrangement are becoming increasingly popular, see for example an article at http://www.thelawyer.com/the-rise-and-rise-of-schemes-of-arrangement/124768.article

[54] 14.7% (the share of UK in EU GDP) was scaled up to 44% (the share of Member States from Group 3 in EU GDP)
(44%). Data on GDP shares is for 2012 and comes from the IMF.

[55] Impact Assessment on encouraging company rescue - consultation, UK (Informal figures sourced from the insolvency profession), http://www.detini.gov.uk/encouraging_company_rescue_-_impact_assessment.pdf

3.2.4. Economic effects of insufficient or ineffective restructuring options

The insufficient restructuring options in Member States create the following problems:

- **Obstacles to free movement of capital**: differences in national insolvency regimes create an additional cost for foreign investors to assess the risk properly according to the OECD[56]. Insufficient insolvency laws affect negatively SME and infrastructure financing[57]. According to the Association for Financial Markets in Europe (AFME), the differences in insolvency laws (including in restructuring frameworks) increase the cost of funding in certain countries or may even effectively prohibit investment altogether[58]. The lack of effective restructuring framework in some Member States is considered to discourage high yield bond investment[59].
- **Loss of asset value and production potential for the overall economy**: The rescue of a company allows preserving the value of its technical know-how and business goodwill whereas liquidation is limited to the value of the company's physical assets[60]. For example, announcement of a bankruptcy filing is associated with a loss in shareholder value of up to 56%. Around the announcement of a restructuring or workout, firm value appreciates by up to 11%.[61] The graph below shows the superiority of returns from a hybrid procedure (UK's CVA) over liquidation returns[62]. Where such rescue procedures do not exist or are inefficient, those assets are lost.

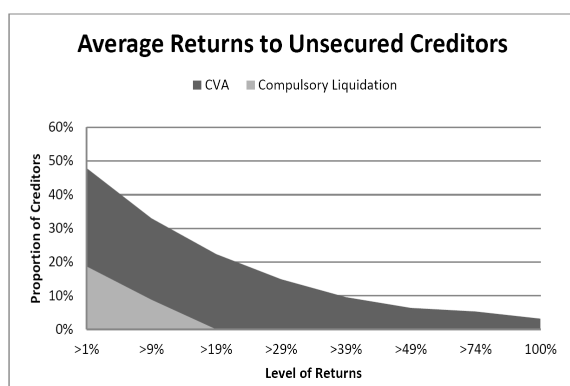

Chart 4: average returns to unsecured creditors

Source: The law and economics of orderly and effective insolvency, Keith Crawford, doctoral thesis, 2012

- **Poorer recovery rates for creditors**, i.e. the percentage of their debt that creditors get back: In France, the median recovery rates for liquidated firms are less than 1/3 of those for “rehabilitated” firms (31% vs. 96%); the same is true also for the UK, even though the difference between the

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[56] OECD, 2014 Economic Review for the European Union, p. 50.

[57] The Report of the High Level Expert Group on SME and Infrastructure Financing has identified the harmonisation of bankruptcy law as a desirable measure to be pursued at EU level from a "finance for growth" perspective, 11 December 2013, p. 16.

[58] Unlocking Funding for European Investment and Growth, AFME, 2013, www.**afme**.eu/unlocking-funding-for-European-investment-and-growth, p. 100.

[59] ibidem, p. 8.

[60] A Second Chance for Entrepreneurs, Prevention of Bankruptcy, Simplification of Bankruptcy Procedures and Support for a Fresh Start', Final Report of the Expert Group (January 2011), DG Enterprise and Industry, p. 7, available at http://ec.europa.eu/enterprise/policies/sme/businessenvironment/files/second_chance_final_report_en.pdf , ; see also IMF, Orderly and Effective Insolvency Procedures (1999) available at http://www.imf.org/external/pubs/ft/orderly/#genobj

[61] Out-of-court restructuring versus formal Bankruptcy in a Non-Interventionist Bankruptcy setting, Jostarndt, Sautner, 2009, p.664

[62] The law and economics of orderly and effective insolvency, Keith Crawford, doctoral thesis, 2012 http://etheses.nottingham.ac.uk/3372/1/Keith_Crawford_Doctoral_Thesis_Submitted_Final_Draft.pdf

median recovery rates seems smaller[63]. SME creditors are particularly affected by poor recovery rates[64].

- **Loss of jobs.** Saving companies saves jobs (including cross-border). This is an important benefit given that the total number of insolvency related job reductions in 2009 is estimated at 1.7 million[65].
- **Higher costs:** the costs of preventive hybrid procedures are on average lower than that of traditional insolvency proceedings. Where such preventive procedures do not exist or are expensive, firms prefer to go into insolvency[66]. Reducing the costs of the procedure has been identified as the first priority for improving the procedures for SMEs in the public consultation. Lower costs of procedures lead to better recovery rates for creditors.
- **Delays and length of insolvency proceedings:** lead to loss of an unreasonable portion of the outstanding claims[67].
- **Less entrepreneurship and economic dynamism**: fear of bankruptcy and its consequences acts as a deterrent to entrepreneurship[68]; efficient pre-insolvency and hybrid insolvency proceedings ease entrepreneurs' fears and encourage entrepreneurial activity[69].
- **The problem of non-performing loans**, especially in Central and Eastern Europe is more difficult to resolve without effective restructuring tools. [70],[71],[72]
- **Bigger losses of manufacturing firms**. According to the data from the OECD, in the Member States where pre-insolvency proceedings are not available the **rate of loss of manufacturing companies** is higher than in countries where those proceedings are available (1.8 versus 2.6%)[73]
- **Loss of tax revenue.** Liquidated firms stop paying taxes.
- **Loss of output:** More effective insolvency procedures help to attenuate the loss of output due to corporate deleveraging as firms seek to improve their debt-to-asset ratios[74].
- **Macroeconomic structure / development imbalances:** relocation of companies might lead to the exodus of dynamic and innovative companies - because this is what a company that looks for innovative ways of restructuring also is - to the Member States with more favourable insolvency regulation, leading to a "bleeding of enterprises" of already distressed regions.

The problems being addressed concern firms of small (although not micro), medium or large size which undergo financial distress. For example, 24% of SMEs in the UK are currently unable to pay down their short-term debts as they fall due.[75]

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[63] Forum Shopping and the Global Benefits of Soliciting Insolvency, p. 9 citing IMF, "2 – General Objectives and Features of Insolvency Procedures", p.8.

[64] See results of public consultation, Annex 4.

[65] The Expert Group, "A Second Chance for Entrepreneurs, Prevention of Bankruptcy, Simplification of Bankruptcy Procedures and Support for a Fresh Start." , Final Report for Directorate General Enterprise and Industry (2011) (available at http://ec.europa.eu/enterprise/policies/sme/businessenvironment/files/second_chance_final_report_en.pdf)

[66] See result of public consultation, Annex 4.

[67] See results of public consultation, Annex 4.

[68] A Second Chance for Entrepreneurs, Prevention of Bankruptcy, Simplification of Bankruptcy Procedures and Support for a Fresh Start. Flash Eurobarometer 354, 2012, on Entrepreneurship in the EU and beyond identified the possibility of going bankrupt as the greatest fear of people considering stating up a business (43% in 2012).

[69] DG ECFIN analysis, see annex 2

[70] European Banking Coordination Vienna Initiative, 2012, http://www.imf.org/external/region/eur/pdf/2012/030112.pdf

[71] Dealing with private debt distress in the wake of the financial crisis, IMF, http://www.imf.org/external/pubs/ft/wp/2013/wp1344.pdf

[72] DG ECFIN analysis, see Annex 2.

[73] IA on Regulation on Insolvency Proceedings, p.18

[74] DG ECFIN analysis, see Annex 2.

[75] SME Distress Monitor, http://www.bakertilly.co.uk/SiteCollectionDocuments/RR/Baker%20Tilly%20SME%20Distress%20Monitor%20-%20National.pdf .

3.2.4.1. Additional cost for creditors if firms relocate to other Member States to benefit from more debtor friendly procedures

By nature, it is **difficult to quantify the occurrence of relocation** and its effects on the internal market, since there are many reasons why companies may choose to relocate. Some high profile examples have been noted in the impact assessment on the revision of the insolvency regulation already. In a recent series of cases the three German companies *Deutsche Nickel*, *Schefenacker* and *Hans Brochier* took steps in order to achieve the applicability of English law on schemes of arrangement. Another high-profile case involves Hellas Telecommunications, which led to a reported loss of €1.3 billion for its unsecured creditors[76]. However, as these examples only cover large companies, they may not be representative of the total amount of relocations, nor of the average economic impact. It seems likely that many more relocations happen 'behind the scenes' and involving smaller enterprises.[77]

The fact that the debtor opts for another jurisdiction could be related to the court efficiency or certain features of the jurisdiction's preventive procedure (e.g. the possibility to bind dissenting creditors to a restructuring plan[78] which helps save a business from bankruptcy and liquidation).

.***Deutsche Nickel* and *Schefenacker*** (both unreported)[79] illustrate successful attempts to shift the centre of main interests (COMI). In both cases, the migration of COMI (by way of a transfer of assets and liabilities) from Germany to the UK was vital to the survival of the group. Without the benefit of an English law CVA, allowing a debt for equity swap and release of guarantees, the groups were likely to have collapsed[80].

Relocation of debtors may create the following problems:

- **Only bigger firms can afford** to relocate to another jurisdiction or apply for a preventive procedure in another jurisdiction, which puts the smaller ones at a competitive disadvantage (legal cost of advice in both jurisdictions, cost of using the procedure, travel and relocation expenses).
- **Additional costs for creditors** after the relocation (e.g. costs of legal aid to get properly informed on the effects of relocation, costs of representation, travel costs to the foreign place of jurisdiction)[81]. Especially when the debt is relatively low, the costs related to a shift in centre of main interests may be a barrier for creditors to properly manage their interests in recovering the debt. In the aforementioned Rodenstock case, the dissenting creditors had to hire legal representation in the UK to plead their case for a scheme they did not support. Such costs would not have been necessary if adequate preventive procedures existed in Germany.
- **Creditors are unable to price the loan appropriately** due to the lack of predictability of the bankruptcy forum. Relocation might lead to the application of a different insolvency regime than originally expected by the creditor. This would adversely affect those creditors even though the restructuring itself could be beneficial to the company as a whole – see the

[76] See for more examples: B. Laufer, An economic analysis of the German bankruptcy code in the context of the European reform movement, Paris 2012, p. 33, available at http://www.professionsfinancieres.com/docs/2013090822_153_vn_m_economic_analysis_of_german_bankruptcy_code.pdf .

[77] See, for instance, http://www.thisismoney.co.uk/money/markets/article-2052296/Bankruptcy-tourism-crackdown-shuts-61-companies.html#ixzz24QOWR1P9. Legal practitioners confirm that COMI-shifts are usually a serious option for restructuring – in particular in non-UK jurisdictions.

[78] See GHK/Milieu report, p. 16. See also L. Webb and M. Butter, 'Insolvency Proceedings: Shopping for the best forum' (2009) (available at: practicallaw.com).

[79] See also the example of the firm Rodenstock on p.11.

[80] Webb L and Butter M (see footnote 81)

[81] See, for example, the Vivacom case as described in: 'Scheme of Arrangement – jurisdiction and class composition in recent cases involving overseas companies', *ILA Bulletin,* no. 477.

aforementioned Rodenstock case, in which dissenting creditors located in Germany were eventually overruled by the UK judge.[82]

The above-mentioned problems can be addressed only to some extent through contractual terms and conditions.[83] Ultimately, this situation could lead to extra costs for debtors as well, as creditors are likely to compensate the legal uncertainty due to the current situation by raising their interest rates on loans, mortgages and other forms of credit or on reducing the amount they lend.

3.2.4.2. Additional cost of restructuring for cross-border groups of companies due to differences between Member States rules

No restructuring plan involving the continuation of the business of groups of companies has ever been accepted in three or more jurisdictions[84]. Even when a group of companies is represented by a mother company and one subsidiary in another Member State (for example an SME which has acquired one of its foreign suppliers), a common restructuring plan may be hard to be adopted. There are various reasons for this:

- in some Member States it is not possible to restructure a company in difficulty before it becomes insolvent (Group 1 Member States);
- rules on proper insolvency proceedings are formal and therefore often imply different rules on court involvement than preventive procedures
- in some Member States early restructuring procedures are formal while in other they are less formalised: this creates extra costs for cross-border groups of companies undertaking restructuring as they face different rules in each Member States where they have subsidiaries[85];
- the national rules on restructuring may contain such very serious limitations that coordinated plans are unachievable. For instance, in some Member States restructuring is not possible because of insufficient rules on stay or majorities needed for the adoption of a restructuring plan.

The insolvency of a large company has significant effects on the European economy because large companies, although only representing 0.2% of European companies, provide 30% of jobs in the EU and produce 41% of gross added value. According to the April 2011 report of the Reflection Group on the Future of EU Company Law, the international group of companies has become *the* prevailing form of European large-sized enterprises, in which business activity is typically organised and conducted through a multinational network of subsidiaries. About 20% of large enterprises (ca. 8,500) have foreign subsidiaries or joint ventures[86]. There are more than one million SMEs in Europe which have subsidiaries or joint ventures abroad[87].

Where the rules for the content and adoption of an early restructuring plan are complex and cumbersome and the conditions vary from Member States to Member States, the restructuring of the whole group of companies in financial distress is hardly an option for the management board. Although ad hoc solutions have been found in practice (mainly through the relocation

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[82] See P. Kuipers and M. Roelofs, ' Judicial comity and Chauvinism: The Need to Go Forum Shopping in Insolvency Matters, *International Corporate Rescue* 2004, p. 323.

[83] Wolf-Georg Ringe, *Forum Shopping under the EU Insolvency Regulation*, EBOR 9 (2008), p. 602.

[84] Robert van Galen, Stephan Madaus, *Corporate Rescue,* 2013, p. 52.

[85] See NL response to the public consultation.

[86] 2007 Eurobarometer survey

[87] Internationalisation of European SMEs, EIM, report for DG Enterprise and Industry.

of the firm to a Member States with an efficient preventive regimes, such as the UK), where the legal uncertainty and costs for all parties involved is an obstacle to the functioning of the Single Market.

In **the insolvency of the PIN Group, a mail delivery service provider**[88] the Luxemburg holding company moved its COMI to Germany where the vast majority of its subsidiaries were located, in order to enable a proper restructuring process for all members of the group in the same jurisdiction. Despite the vicinity of the insolvency petition the court held that the COMI shift was not abusive as it merely tried to coordinate the insolvency proceedings over the whole holding group. Therefore, it was regarded as being in the interest of the creditors as it tried to maximize the debtor's net assets. The restructuring of the group was successfully carried out[89].

In the **La Seda** case, the plastic bottle maker La Seda de Barcelona, S.A. filed for rescue proceedings in June 2013 with the Commercial Court of Barcelona. The petition was filed for the parent company in Spain and the companies of the Group which are based in Italy, Greece, Benelux, Germany, UK, France and Poland. A refinancing proposal was negotiated that was backed by the main shareholder and by the lenders under specific conditions, which included a capital increase of the Company and a debt-for-equity swap. However the refinancing plan was not approved by the necessary majority of shareholders which under Spanish law was able to block the plan. Consequently, the rescue of La Seda failed and the company had to be liquidated.

3.3. Financial detriment due to the discrepancies between discharge periods for honest entrepreneurs in the Member States

3.3.1. Introduction

In a few Member States (ES[90], HU, BG), there are no provisions for entrepreneurs to have their debts discharged within a reasonably short period of time after their bankruptcy and have a fresh start. In the Member States which provide in their rules for a repayment plan over some years, the duration for discharge varies from 1 year (UK) to 10 years (CZ) or more (in EL in practice not less than 20 years). In some Member States the discharge is at the judge's discretion or it is more than 3 years (AT, BE, EE, EL, IT, LV, LT, LU, MT, HR, PL, PT, RO), while in others it is 3 years conditional on the payment of a certain percentage of the debt (CY, FR, DE and SK).

In several Member States, a bankruptcy procedure for natural persons was only very recently introduced (EE, ES, FR, EL, IT, LV, LT, PL and SI), or has been recently reformed to reduce the discharge period (e.g. DE, IE) following the Competitiveness Council Conclusions.

From the point of view of the economy, long discharge periods are counterproductive as they stigmatise failure, discourage entrepreneurship, with negative effects for employment rates, growth and innovation, while shorter discharge periods in principle have a positive impact on

[88] Local District Court Cologne, Resolution of February 19, 2008 (73 IE 1/08), [2008] Zeitschrift für Wirtschaftsrecht 423

[89] Schlaefer, G., 'The International Insolvency Institute: International Insolvency Studies' (2010) Forum Shopping under the Regime of the European Insolvency Regulation (available at: http://www.iiiglobal.org/images/pdfs/georg_schlaefer.pdf) 24

[90] ES has recently reformed their insolvency laws and allows for a very limited discharge.

the level of entrepreneurship, including the self-employment rates.[91] In fact there is evidence which shows that re-starters have a greater chance of success than first starters[92].

While long discharge periods seem to be justified when applied to dishonest entrepreneurs, evidence shows that only a small proportion of bankrupts are actually fraudulent (4-6%). Long discharge periods which do not distinguish between honest and dishonest entrepreneurs contribute to maintaining this stigma culture.

A problem associated with the period of discharge concerns negative information about the insolvency of the debtor in public or private credit registers. Only one Member State (FR) keeps a Public credit rating system (via Banque de France), in the rest it is private (ASNEF, EQUIFAX, DUNS & BRADSTREET, etc). Negative credit scores are kept for a period that usually ranges from 1 to 5 years for bankrupt persons. Keeping such negative data after the moment of discharge greatly undermines the entrepreneurs' capability of obtaining credit for their second venture and contributes to maintaining the stigma against failed entrepreneurs. After the discharge period, retaining such data may be an unnecessary interference with the entrepreneur's private life or be unjustifiable from a data protection point of view. [93]

3.3.2. Additional cost for creditors if debtors choose to relocate to jurisdictions offering shorter discharge periods

Great discrepancies between the discharge regimes in the Member States create incentives for relocation. Debtors who want to free themselves of long-standing re-payment obligations at home gain from re-locating to another Member State with less stigmatising regimes[94]. At the same time, creditors at home would greatly lose if debtors would relocate too soon, if creditors would be taken by surprise or if they would incur legal and administrative expenses trying to enforce their claim in another Member State.
As said, the scale of relocations is very hard to estimate. Part of the difficulty is that re-locating to another Member State is an expression of the freedom of movement. Potentially however, many debtors would have incentives to re-locate simply for the purposes of getting a quicker discharge.

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[91] See "A Second Chance for Entrepreneurs, Prevention of Bankruptcy, Simplification of Bankruptcy Procedures and Support for a Fresh Start." , Final Report of the Expert Group for Directorate General Enterprise and Industry (2011), p 10; with reference to Bankruptcy Law and Entrepreneurship, J. Armour and D. Cumming, University of Cambridge Centre for Business Research Working Paper No. 300, 2005.

[92] Ibidem, p 3. with reference to E. Stam, D. B. Audretsch and J. Meijaard, "Renascent Entrepreneurship", ERIM, 2006.

[93] In this context, the European Court of Human Rights has considered that the registry of a person in a bankruptcy register is an interference with his private life and should in any case be legitimate and proportionate (ECHR 23 March 2006, Case of *Campagnano v. Italy*, (Application no. 77955/01)

[94] Burkhart Hess et al., *External Evaluation of Regulation No. 1346/2000/EC on Insolvency Proceedings*, 2012, p. 81.

Case example Sparkasse Velbert v. Benk

Mr. Benk was a German notary who had run into financial difficulties, notably owing €3 Million to his bank, the Sparkasse Velbert. Enforcement proceedings by the Sparkasse against Mr. Benk's real estate and pension fund in Germany were pending. In June 2009, Mr. Benk was suspended from his practice as a German notary because of his unsound financial situation and filed for bankruptcy in the UK later that month. Mr Benk alleged COMI in the UK claiming that he had lived in Birmingham since late 2008 and exercised a professional activity as a sports photographer. The discharge order was granted on 17 June 2010 following which Mr. Benk moved back to Germany.

On appeal by the Sparkasse, the High Court carried out an in-depth examination of the circumstances of the case. It discovered that Mr. Benk had relocated with the help of a German relocation agency which had assisted him with renting a furnished room in Birmingham as well as purchasing and registering a car in the UK. Moreover, Mr. Benk's business as a sports photographer was loss-making from day one as his only client was an old friend from Germany and he had not even owned a camera in the first months in his new "job". The court concluded from the evidence that Mr Benk's COMI was in Germany at the time of the presentation of the bankruptcy petition because he had neither his habitual residence nor his professional domicile in England, as his presence in England was only temporary and the photography business was merely window-dressing, with no potential for any significant degree of permanence. Consequently, the discharge order was annulled and the Sparkasse could continue enforcing its claim against Mr. Benk.

However, the appeal cost the Sparkasse about €50000 in lawyers' fees because on appeal, it is the creditor who has to prove that a COMI shift was not genuine. The high costs of appealing a court decision in the UK deter many creditors from challenging a debt discharge for their debtor because they are not sure to be able to recover the legal costs from the insolvent debtor.

UK and France appear to be popular insolvency venues for individuals due to their short discharge period. Under the former German insolvency regime (before 2012), a discharge could be obtained after 6 years. During that period the income of an insolvent person above a certain threshold was used in order to satisfy the claims of the creditors. In comparison the UK and the French models appear to be more debtor-friendly. The end of the insolvency proceedings directly leads to a discharge in France. Furthermore the discharge periods in the UK (1 year from the beginning of insolvency proceedings) and France (on average about 18 months) are considerably shorter than in Germany. This of course is a great incentive for insolvent entrepreneurs to migrate to the UK and France.

3.4. Baseline scenario

In the absence of any EU action, the discrepancies between the Member States' insolvency legislations are likely to continue to create high costs for cross-border creditors, incentives for forum-shopping, and obstacles to the re-organisation of cross-border groups of companies. Several Member States are currently reforming their insolvency laws with a view to improving the legal framework enabling the early restructuring of companies in financial difficulty. There is a risk that a lack of coordination of these reforms as well as a lack of action on the part of those Member States which do not have effective frameworks in place or plans to reform their laws will be a missed opportunity for removing barriers to the internal market which flow from the divergence of insolvency laws.

The revision of the Insolvency regulation would have certain benefits in terms of increasing legal certainty as to the jurisdiction applicable not only to formal insolvency proceedings, but also to certain preventive (pre-insolvency) proceedings. Member States will be able to notify those pre-insolvency proceedings which they wish to be bound by the principles of the Regulation. There will be however no obligations on the Member States to notify any such pre-insolvency proceedings, nor to put in place

such procedures (where they do not exist).

In the absence of any EU action in the area of preventive restructuring proceedings and second chance, it is likely that reforms in the Member States will be incomplete and incremental. For example, SI has introduced a preventive procedure into their insolvency framework in December 2013. It excludes from its scope of application small companies. ES has introduced a preventive restructuring procedure in 2009 – it has since reformed it twice in order to improve its practical application.

4. EU RIGHT TO ACT

Depending on the preferred option chosen, the legal basis could be either Article 114 TFEU (Directive of the European Parliament and of the Council) or Article 292 TFEU (Commission Recommendation).

The rationale for EU action is the improvement of the smooth functioning of the internal market. The discrepancies between the Member States' insolvency legislations create barriers to the free movement of capital, goods and services in the internal market. These discrepancies are likely to continue to create high costs for cross-border creditors, incentives for the relocation of the debtors and obstacles to the restructuring of cross-border groups of companies. Creditors located in one Member State suffer losses (e.g. sub-optimal recovery of debts) due to the insufficient procedures in another Member State. While only about 25% of bankruptcies have a direct cross-border element, in practice the vast majority of businesses are in the value chain of at least one company which has cross-border activities. Therefore virtually any business in the EU may be affected.

It is estimated that about 5 million European companies have customers, creditors or business partnerships in other Member States. About 50,000 companies (1% of 5 million) per year will be debtors and at least **twice as many (100,000) will be creditors in cross-border insolvencies alone**.

In recent years the **number of insolvencies has increased** as a result of the economic crisis and further increase in insolvencies in 2013 and 2014 are expected[95] (Chart 5). The number of **non-performing loans (NPLs) has also surged in all Member States** (Chart 6). While cross-border bad debts amount to only 0.45% of total bad debts (2009), in absolute terms this percentage amounts to 56 billion euros[96]. This figure concerns the times of economic crisis where cross-border lending was drastically reduced compared to the pre-crisis times when the volume of cross-border lending (and therefore of NPLs) is much higher[97]. If the trend continues, there will be increased financial losses for creditors and other stakeholders. Furthermore, liquidating companies or selling companies as a going concern may not be realistic as the main solution for companies in difficulty because the market for distressed assets and companies could be saturated[98].

[95] Euler Hermes Economic Insight, June 2013.
[96] IA on Account Preservation Order, p.83
[97] See more on the trends in cross-border lending in article "Cross-border Bank Credit and Global Financial Stability, Quarterly Bulletin 2013 Q2, Bank of England, http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2013/qb130204.pdf
[98] World Bank Study, p. 52.

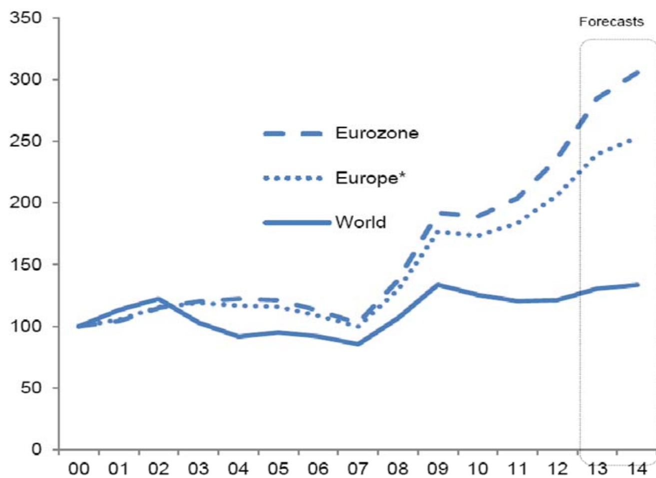


Chart 5 Insolvencies in Europe; *Source: Euler Hermes, 2013*

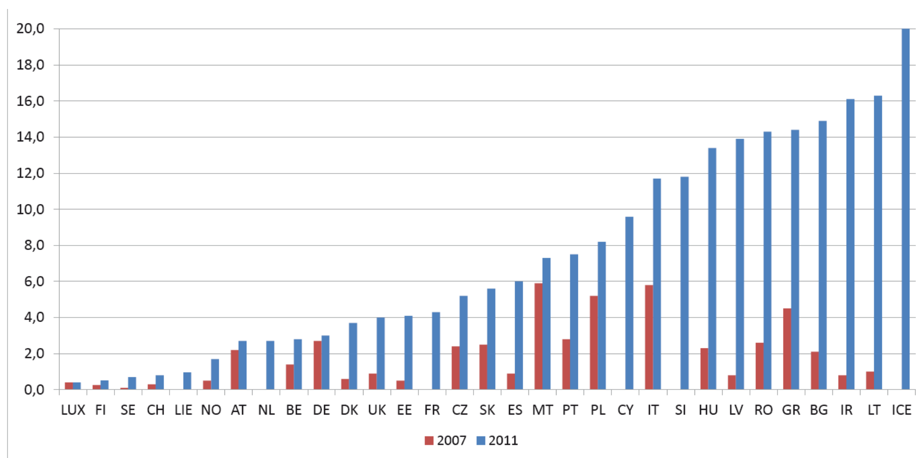


Chart 6 Non-performing loans to total loans, %;

Source: IMF Dealing with Private Debt Distress in the wake of the European Financial Crisis, 2013

The need for EU action in this area is already acknowledged by action undertaken under the European Semester, which makes recommendations to several Member States to reform their insolvency laws. However, they lay out general principles and do not specify technical details that will reduce in a coordinated way the differences between national procedures that give rise to distortions in investment and location decisions; they also address a small number of Member States. They therefore cannot achieve a consistent solution to an EU-wide problem. According to the OECD 2014 Economic Review, differences in bankruptcy laws create additional costs for foreign investors to assess the risk properly and the EU is called for to address this problem by means of directives or common guidelines[99].

Recent and on-going reforms in a number of Member States improve the effectiveness of national insolvency regimes. However, they are not coordinated and therefore will only partially address the distortions identified above.

[99] See pp. 25-26 of the OECD 2014 Economic Review for the European Union. See also the 2014 Economic Survey of the Euro Area, which recommends harmonised bankruptcy rules and procedures to further increase the consistency of the assessment of banks' assets in the banking union.

Minimum standards for a preventive procedure would enhance the mutual trust between the Member States. The current negotiations under the revision of the Insolvency Regulation show that important consideration in the examination of the Commission's proposal are the different notions of what a preventive procedure is and the lack of trust when it comes to recognition and enforcement of restructuring plans agreed in the pre-insolvency stage.

For these reasons, EU action is justified in order to contribute to the establishment of an efficient preventive restructuring framework in all Member States.

5. POLICY OBJECTIVES

General objectives:

1) to contribute to the smooth functioning of the internal market by ensuring that, wherever in the EU a firm is located when it gets into financial difficulties, the applicable insolvency law enables the efficient liquidation of unviable firms and restructuring of viable ones, so as to maximise the total value to creditors, owners, employees and other stakeholders

2) enhance the prospects for survival of firms in financial difficulty

3) minimise the potential distortions to location and investment decisions caused by differences in national insolvency laws.

Specific objectives	Operational objectives
Increase the number of viable firms being successfully restructured and rescued Reduce the cost of restructuring in Member States with inefficient restructuring procedures Reduce the costs of cross-border restructuring of groups of companies	Ensure that all Member States have an effective restructuring possibilities in place, which: • Provide for an early possibility to restructure • Improve chances of negotiations by allowing the debtor a "breathing space" from enforcement actions (stay) • Facilitate the continuation of debtor's business • Disallow dissenting minority creditors to jeopardise restructuring effort • Increase chances of success of the restructuring plan by allowing new financing • Allow for limited court involvement
Reduce costs for creditors resulting from relocation of the corporate debtors	Reduce incentives for relocations benefiting the debtor at the expense of creditors
Reduce costs for creditors resulting from relocation of entrepreneurs which are debtors and foster entrepreneurship	Align the discharge periods

These objectives are consistent with the two following objectives of an effective corporate insolvency law as defined by the IMF: to allocate risks among market participants in a predictable,

equitable and transparent manner and to maximize value for the benefit of all interested parties and the economy in general[100].

6. POLICY OPTIONS

High-level options:

- **Option 1: maintaining the status quo (baseline scenario)**
- **Option 2: a recommendation addressed to the Member States on minimum standards for a preventive restructuring procedure for enterprises, including micro-enterprises, and discharge periods for entrepreneurs (second chance)**

This measure would recommend to the Member States to put in place a preventive restructuring framework which contains certain minimum standards for effective corporate rescue, as well as minimum standards on discharge periods.

- **Option 3: a directive setting up minimum standards in the two areas mentioned above**

This option would imply that Member States insolvency laws make provisions for a hybrid preventive restructuring procedure which fulfils certain minimum standards. In respect of second chance, the directive would translate into binding legislation the Competitiveness Council Conclusions in respect of reducing discharge periods. These features would be equivalent to the minimum standards in Option 2.

- **Option 4: setting up a fully harmonised procedure**

This measure would fully harmonise the Member States preventive procedures, regulating in detail the elements of the procedure, including for example the majorities required, the insolvency test and the rules on avoidance actions. As for discharge periods, such a solution would imply harmonising the rules on the insolvency of the entrepreneur, providing for a uniform discharge period across the EU and setting out all the exceptions from the uniform discharge period (e.g. defining the concept of "honest" entrepreneur).

Sub-options for Options 2 and 3:

<table>
<tr><th>Operational objective</th><th colspan="6">Sub-options on building blocks of the proposed framework</th></tr>
<tr><th colspan="7">EFFECTIVE RESTRUCTURING FRAMEWORK</th></tr>
<tr><td>Early restructuring possibilities</td><td colspan="3">Sub-option 1
The procedure must be available when the debtor is in financial difficulties, irrespective of whether there is any risk, actual or potential, of insolvency</td><td colspan="3">Sub-option 2
The procedure must be available when the debtor is in financial difficulties and there is a risk, actual or potential, of insolvency</td></tr>
<tr><td>Moratorium</td><td colspan="2">Sub-option 1
A moratorium granted automatically and against all creditors.</td><td colspan="2">Sub-option 2
A moratorium granted on request by the debtor</td><td colspan="2">Sub-option 3
Sub-option 2 + a moratorium of limited (short) duration</td></tr>
<tr><td>Debtor in possession</td><td colspan="3">Sub-option 1
Debtor remains in possession, no</td><td colspan="3">Sub-option 2
Debtor remains in possession, but</td></tr>
</table>

[100] See the IMF Orderly and Effective Insolvency Procedures (IMF, 1999), the World Bank Principles and Guidelines for Effective Insolvency and Creditor Rights Systems (World Bank, 2001) and UNCITRAL Legislative Guide on Insolvency Law (UNCITRAL, 2004). See also http://www.imf.org/external/pubs/ft/wp/2013/wp1344.pdf , p.12

	supervisor or mediator appointed by the court	Member States may enable courts to appoint a mediator and /or a supervisor	
Plan approval by a majority of creditors	**Sub- option 1** A minority of creditors can be bound by the plan if a majority in the same class of creditors agrees; Member States may choose to exclude secured creditors from majority voting (i.e. their rights cannot be affected)	**Sub-option 2** A minority of creditors can be bound by the plan by a majority in the same class; all classes of creditors are bound, including secured creditors	**Sub-option 3** Sub-option 2 + Member States may provide that no voting process needs to take place
New financing	**Sub-option 1** Granting super-priority status to new finance, to be paid before any unsecured debt.	**Sub-option 2** Exempting new financing contained in the restructuring plan from avoidance actions. Member States may also provide for super-priority status to new financing.	
Reducing the formalities relating to court proceedings	**Sub-option 1**: A flexible framework, which allows for a more limited involvement of courts	**Sub-option 2:** Sub-option 1 plus requiring courts to rule in principle in written procedure	
DISCHARGE PERIODS FOR ENTREPRENEURS			
Lower the discharge periods	**Sub-option 1** Discharge of debts for entrepreneurs within 1 year, with limited exceptions.	**Sub-option 2** Discharge of debts for entrepreneurs within 3 years, with limited exceptions.	**Sub-option 3** Sub-option 2 + removing bad data from credit rating databases a short period of time after discharge.

7. ANALYSIS OF IMPACTS OF POLICY OPTIONS

7.1. Option 1: maintaining the status quo

See the assessment in the problem definition.

7.2. Option 2: A Commission Recommendation on minimum standards for a preventive restructuring framework and discharge periods for entrepreneurs

Several Member States are currently reforming their insolvency systems, with a view to improving the preventive restructuring framework (e.g. NL, PL, EE) in order to cope with the surge in corporate liquidations and personal bankruptcy of entrepreneurs following the economic crisis. A Commission Recommendation addressed to the Member States and setting out minimum standards for an effective preventive restructuring framework and for lowering discharge periods would provide immediate **support and a framework in which various reform efforts undertaken at national level are implemented in a coherent and coordinated manner across the EU**. It would also encourage those Member States which do not have any preventive restructuring framework in place or have inefficient frameworks to reform their laws in order to increase the rescue and recovery possibilities for companies, in particular SMEs, and entrepreneurs.

A recommendation, while addressing the immediate need for guidance, comes inevitably with the risk of low up-take by the Member States and of a considerable proportion of the discrepancies currently

affecting the smooth working of the internal market still remaining in place. Thus, a review of its implementation by the Member States and of the need for further action would need to be carried out two years after its adoption.

7.2.1. Early restructuring possibility

A framework that supports early restructuring contributes to reducing firm exit rates[101].

Description	**Sub-option 1** **A framework encouraging restructuring must be available when the debtor is in financial difficulties, irrespective of whether there is any risk, actual or potential, of insolvency**	**Sub-option 2** **A framework encouraging restructuring must be available when the debtor is in financial difficulties and there is a real risk, actual or potential, of insolvency.**
Impact on effectiveness	The earlier the possibility of restructuring and the lower the thresholds for entering into the procedure, the better for the prospects of success and continuation of business of the debtor. However, Sub-option 1 carries the risk of some debtors using the procedure in order to get rid of some debts even when they are not in a real danger of becoming insolvent.	A link with the actual or potential risk of insolvency would reduce the scope of the procedure and exclude situations where the debtor simply wants to restructure their debts. On the other hand, such a limitation would remove the risk of abuse under Sub-option 1.
Impact on costs	Such a possibility exists in the UK where scheme of arrangements already provide for very early possibility or restructuring. However, the risk of abuse is eliminated in the scheme by a heavy involvement of courts and court supervision. For this reason the scheme is very expensive and affordable only to big companies.	Where this sub-option is combined with a limited role for courts, the procedures could be more affordable to smaller companies.
Impact on legal systems	This sub-option would require a change in the laws of all Member States which have early preventive procedures with the exception of UK and CY. Member States which do not have in place early restructuring procedures would need to put such procedures in place (Group 1 and Group 2 Member States).	This sub-option would enlarge the restructuring possibilities for debtors in those Member States where there are early restructuring procedures in place but they are available only if the debtor is actually insolvent (Group 1 Member States) or his insolvency is imminent and the concept of "imminence" is defined very strictly (e.g. illiquidity) (DE, AT, IE, IT, PT). In order to make the procedure effective, Member States will need to provide that for as long as the debtor is engaged in the procedure, he will not be under an obligation to launch insolvency proceedings, not will he incur civil or criminal liability for not doing so.
Impact on fundamental rights	Creating early restructuring possibilities would have a positive impact in terms of the freedom to conduct a business and right to engage in work	Creating early restructuring possibilities would have a positive impact in terms of the freedom to conduct a business and

[101] DG ECFIN analysis, see Annex 2.

	since it would improve the chances of survival of firms in difficulty. However, this sub-option may have a negative impact on the right to property, since a lowering of the rights of a minority of dissenting creditors may not be proportionate if there is no risk of insolvency of the debtor.	right to engage in work. The risk of insolvency also justified a restructuring plan which may affect the rights of a minority of dissenting creditors.

Conclusion: Sub-option 2 seems to be preferable since it ensures an early possibility of restructuring, without creating a risk of abuse or high costs.

Most Member States support the idea of early restructuring. Several have also agreed that a risk of insolvency must also be present as a condition for early restructuring (DE, FR, IE, SK, PL, SE, FI).

Strengthening the rescue culture in the EU and giving viable businesses an opportunity to recover early is widely supported by stakeholders, for example UEAPME, BusinessEurope, EuroChambers and the European Small Business Alliance. 69% of the respondents to the public consultation are in favour of eliminating all or some of the divergences of national rules regulating restructuring plans, while 22% are not in favour of such action.

7.2.2. Moratorium

Introducing a moratorium on enforcement of individual claims is an element of restructuring procedures that contributes to higher rates of self-employment, and to attenuating the negative effects on output of corporate deleveraging as firms seek to reduce their debt-to-asset ratios[102]. The performance of on-going contracts shall not be affected.

Description *Improve chances of negotiations by allowing the debtor a breathing space*	**Sub-option 1:** **An automatic and general moratorium implies that all creditors' enforcement actions and formal insolvency proceedings are automatically suspended with a court order.**	**Sub-option 2:** **A moratorium on request by the debtor. Creditors participating in negotiations will also be stayed. Moratorium only affects individual enforcement actions and suspends formal insolvency proceedings.**	**Sub-option 3:** **Sub-option 2 + moratorium of a short, limited duration.**
Impact on the effectiveness of the procedure	A general and automatic stay would not be effective because it can have a negative impact on the success of the negotiations between the debtor and its creditors: once a court order granting an automatic stay is issued, the financial difficulties of the debtor become public knowledge and creditors may start cancelling contracts or not renewing	The stay should be on request by the debtor, so that debtors who are able to continue to pay their debts as they fall due and do not need a stay can negotiate in confidentiality with those creditors which they need to involve. If there is no time limit, then negotiations may drag on, adding to the costs of the procedure (and reducing the	A limited, short period of the stay provides an incentive for finalising the negotiations between the debtor and his creditors. The limited duration of the stay is not a hindrance to using the procedure: because of its limited duration, the debtor would have started negotiating early with creditors and use the stay only towards the end of

[102] DG ECFIN analysis, see Annex 2.

	contracts and the business could fast plummet[103]. Costs may be relatively higher than the other sub-options because of the larger number of creditors involved.	prospects of a successful restructuring.	the negotiations, when his financial difficulties may also be more acute. The short stay period will reduce the length of the procedure as compared to Member States where restructuring procedures in place last for too long, to the detriment of creditors. At the same time, where the complexity of the case requires it and where progress in negotiations has been made, the courts should be allowed to renew the initial stay period.
Impact on the availability and cost of credit	This solution may have a negative impact on the cost and volume of lending in some Member States where preventive procedures do not currently allow for moratoria, since creditors may need to take more risks when lending in those countries.	As compared to sub-option 1, this sub-option would pose a lower risk for lenders since the debtor may in certain circumstances decide not to use a moratorium (for example when publicity about its restructuring negotiations would quickly depreciate the value of the company). The creditors in these cases would not be affected by the stay.	A short moratorium is likely to mitigate any possible damaging impact that a stay under Sub-option 1 may have on the availability and cost of credit, since it is unlikely to seriously affect the rights of creditors.
Impact on judicial authorities	The possibility for the debtor to request a stay will not greatly increase the workload of courts. On the contrary, since the objective of this procedure is that companies avoid insolvency - which universally implies heavy court involvement - courts would be able to reduce their workload by dealing with much simpler requests.	The burden on judicial authorities would be even lighter than in Sub-option 1 since debtors may decide not to request a moratorium in certain circumstances.	Same as Sub-option 2

[103] Conclusions of the Expert Group meeting of 18 November 2013.

Impact on legal systems of Member States	Some Member States would need to implement a moratorium (AT and CY).	Member States which have an automatic stay in place would need to provide for a stay on request (EE, FR, DE, IE, LV, PT, LU, MT, NL, PL, ES and SE).	If Member States chose to implement the minimum standards by amending one of their existing procedures, a minimum standard for the moratorium of a short duration would accommodate those Member States where moratoria are short (CZ, DE, EL, HU, IE, SE, HR, PT, IT, UK). Those Member States where currently moratoria are longer (BE, DK, EE, FI, FR, LV, LT, LU, MT, NL, PL, RO, SK, SI) may need to reduce that period, or increase the judicial control in order to remove the risk of abuse of the stay periods. .
Impact on the right to property and the right to an effective remedy and to a fair trial	The right to an effective remedy and to a fair trial may be affected by the moratorium, which suspends a creditor's right to enforce his individual claim against the debtor for a certain period of time. The shorter the period, the less impact on creditors' rights. Nevertheless, in order to ensure that the debtor does not abuse the moratorium in order to, intentionally or non-intentionally, diminish the value of the debtors' estate, appropriate safeguards need to be put in place, such as allowing a court to reject the application for a stay or to lift the stay subsequently in certain circumstances, such as if there is an indication of abuse/fraud on the part of the debtor (e.g. he misrepresented the actual conditions which justify a moratorium).. The need for safeguards decreases as the duration of the moratorium gets shorter.		

Conclusion: Sub-option 3 is preferable since it balances the interests of all parties and does not have detrimental effects on the availability and cost of credit or on the exercise of fundamental rights.
Most Member States seem to support in general the idea of a stay-on-request (moratorium) being part of an effective procedure (IE, BE, FR, LU, PL, DE, SK, ES, AT, CY, LV, IT, PT) although the opinions diverge on the exact conditions, such as length and scope of the stay. Some considered that a targeted stay (only against certain problematic creditors) would pose the risk of treating creditors unequally (IE, BE, FR, DE, PT, UK, AT), although several systems recognise the possibility to stay a particular creditor's enforcement action when such action is an abuse of right.

7.2.3. Debtor in possession

Allowing the debtor to remain in possession is an element of restructuring procedures that contributes to higher rates of self-employment, and to attenuating the negative effects on output of corporate deleveraging as firms seek to reduce their debt-to-asset ratios[104].

Description *Facilitating the*	**Sub-option 1** **Debtor remains in control of the day-to-**	**Sub-option 2** **Debtor remains in control of the day-to-**

[104] DG ECFIN analysis, see Annex 2.

continuation of business	**day operation of the business, no supervisor or mediator needs to be appointed by the court**	**day operation of the business; however courts may appoint, on request by the debtor, the creditors or any interested party (e.g. a regulator) a mediator and / or a supervisor.**
Impact on efficiency of the procedure	Allowing the debtor to remain in possession means that there is no disruption of the day-to-day operations of the business. Such a measure is necessary first to provide management with an incentive to use the procedure as early as possible, and second to ensure a smooth transition to the restructured business with minimum disruption.	A **mediator's** role is to assist the parties in reaching a compromise on a restructuring plan. A mediator may be appointed ex officio or on request by the debtor or creditors where the parties cannot manage the negotiations by themselves. The role of **supervisors** is to keep an eye on the actions of the debtor and creditors and ensure they are fair to the body of creditors and comply with the law. He does not take over the day-to-day operation of the business of the debtor. A supervisor may be appointed on a case-by-case basis, e.g. where there is a risk of abuse of the stay of enforcement of actions, or of certain high-risk transactions being undertaken by the debtor. The possibility to appoint a supervisor must however be exceptional.
Impact on costs	The absence of a court appointed supervisor or mediator from the beginning of the negotiations means first a reduction of costs for the debtor and creditors since they would be able to choose a mediator without having to apply to a court for this purpose. In most cases, the role of mediating an agreement between the debtor and the creditors does not necessarily require knowledge of the insolvency framework, meaning that a mediator could also be a lawyer or a consultant for instance. Creditors may also nominate one or more representatives from among themselves to negotiate with the debtor on their behalf. Supervisors appointed by the court would need to be specially trained, are insolvency practitioners proper and therefore their fees are usually high. Removing the obligation to have a supervisor in all cases would greatly reduce the costs of the procedure, which could be particularly beneficial for SMEs.	This sub-option could be more costly for certain debtors, but the costs are outweighed by the benefits of having a mediator helping with negotiations or a supervisor advising on the legality of certain actions of the debtor and creditors. Still, the reduction in costs is significant compared to those preventive national procedures where a supervisor is always appointed, as the fees of insolvency practitioners are the biggest cost element of insolvency procedures across the EU. The reduction of costs of restructuring is crucial for allowing SMEs to benefit from restructuring procedures.
Impact on legal systems	Some Member States already provide for the possibility that a mediator/supervisor need not a priori be appointed by a court (PT, BE, EL, IT, ES). Many other Member States would need	Several Member States would need to remove the blanket obligation of appointing a mediator/supervisor and provide for a case-by-case assessment of this need.

	however to remove the obligation to appoint a mediator or a supervisor in every case.	
Impact on the judiciary	The burden on the judicial systems would be greatly reduced, since courts would not be required to formally open preventive procedure with the sole purpose of appointing a mediator/supervisor.	This sub-option would still significantly reduce the burden on the judiciary, even though in some cases courts would need to appoint a mediator or supervisor.
Impact on fundamental rights	The principle of debtor in possession would have positive impacts in terms of the freedom to conduct a business and right to engage in work, since it contributed to higher rates of self-employment. However Sub-option 1 may have an impact on the right to property of creditors if there is no possibility of appointing a supervisor who would have the role of safeguarding the interests of the body of creditors.	The principle of debtor in possession would have positive impacts in terms of the freedom to conduct a business and right to engage in work, since it contributed to higher rates of self-employment. Compared to Sub-option 1, Sub-option 2 would also eliminate the risk of negative impacts on creditors' rights.

Conclusion: Sub-option 2 is preferable since it allows for a reduction of the costs of procedures, which could be significant for smaller companies, while at the same time it provides a safety net for debtors in need of assistance and for courts suspecting abuse of the procedure.
This element of the procedure did not seem to be contentious, although several Member States stressed that minimum standards should not impede a light supervision regime over transactions which could be prejudicial to the body of creditors (NL, SK, DE, SE, FI) during the procedure (e.g. some transactions would need to be approved by a supervisor). This possibility is not however hampered by the principle that appointment of a mediator or a supervisor needs to be made on a case-by-case basis.

7.2.4. Plan approval by a majority of creditors

Majority decision arrangements are an element of restructuring procedures that support the return of levels of non-performing loans in the economy to more "normal" levels in the aftermath of an economic downturn, thereby helping economic recovery[105].

Description *Disallow a dissenting minority of creditors to jeopardise the restructuring effort*	**Sub-option 1** **A minority of creditors can be bound by the plan if a majority in the same class agrees; but Member States may choose to exclude secured creditors from the majority voting**	**Sub- option 2** **A minority of creditors can be bound to a restructuring plan which reduces their rights adopted by a majority of creditors in the same class; all classes of creditors can be bound, including secured creditors. However, secured creditors must not be outvoted by unsecured creditors (eg they must vote in separate classes). Decisions are made in formal voting.**	**Sub-option 3** **Sub-option 2 + Member States may provide that there is no need for a formal voting process as long as debtors are able to prove that the restructuring plan is supported by the required majority of affected creditors. The minority creditors would nevertheless need to be notified and allowed to raise objections before the court.**
Impact on	This sub-option is less	Without a majority rule	Removing the obligation of

[105] DG ECFIN analysis, see Annex 2.

efficiency of the procedure	effective since financial restructuring involving secured creditors may be crucial for solving the financial difficulties of the debtor. Without the possibility to bind dissenting creditors having a security right to a plan approved by a majority of these creditors, the successfulness of the plan would be in doubt.	binding secured creditors, restructuring would not be efficient. This is because most cases apt for this type of restructuring are probably financial restructurings of companies whose business is otherwise sound; or, in some Member States most financial claims enjoy some form of collateral, even if it is worth less than the claim.	voting on a plan would reduce the time needed to adopt the plan and the costs incurred by the debtor with organising the voting process, especially in those Member States where exercising the right to vote implies that creditors must travel to the court hearing the case.
Impacts on availability of credit	This sub-option does not affect on the face of it the availability of credit. However, if the legal framework does not enable the adoption of a restructuring plan and the alternative is the closing of the business and the liquidation of its assets, financial institutions may have more to lose, for example if the assets of the debtors are devalued as a result of its financial difficulties .	This sub-option may have negative impacts on the availability and cost of finance. To avoid this unwanted effect, the legal framework must ensure that secured (as well as unsecured) creditors would not lose more as a result of the implementation of the restructuring plan than if the restructuring did not take place and the debtor went into liquidation or the business was sold as a going concern.	Same as Sub-option 2.
Impacts on legal systems of Member States	Member States will not need to change their laws in this respect but the procedure would have little efficiency.	Those Member States where preventive procedures do not contain such a feature will need to amend those existing procedures (AT, EE, EL, LV, LU, NL, PL, PT, ES, SE).	Some Member States already have such possibility in place (e.g. ES), while others may wish to create such a possibility in order to speed up the adoption of restructuring plans.
Impacts on fundamental rights - right to property	A minority of creditors may need to accept a reduction in the amount of their claim without their consent. This is more clearly the case in Sub-option 2 and 3 (where both secured and unsecured creditors could be affected) than in Sub-option 1. However, such a measure is proportionate in view of the fact that creditors would not lose more as a result of the restructuring than if the restructuring did not take place (i.e. the debtor was liquidated or sold as a going concern). They should also be able to contest the plan if they disagree with it before the competent court.		

Conclusion: Sub-option 3 seems preferable since it would allow secured creditors to also be bound by the plan, reduce the costs and time with organising a formal voting procedure and at the same time ensure the proper safeguards for the protection of the right to property. Under all sub-options, Member States will be able to set up the majorities they consider appropriate (simple majority, qualified majority etc.). They can also make provisions for cram-down (i.e. plan would be confirmed by court if a majority of classes agree with the plan while a minority of classes opposes it) if their laws provide for several classes of creditors.

The principle of adopting a restructuring plan which can in principle bind a minority of creditors was supported by many (RO, UK, ES, EL, AT, FR, IE, LU, SK, DE). Some (UK, IE, HU) proposed to include 'a formal voting process' as a safeguard for minority creditors. Other Member States (NL, SK, SI) expressed the view that the majority required in preventive procedures should be higher than in formal insolvency procedures. Sub-option 3 leaves Member States the freedom to both keep the requirement of a formal voting process and decide which majority is required for plan adoption.

7.2.5. New financing

Allowing new financing is an element of restructuring procedures that helps to raise self-employment rates[106].

Description *Increase chances of success of the restructuring plan*	**Sub-option 1** **Granting super-priority status to new finance, to be paid before any unsecured debt**	**Sub-option 2** **Exempting new financing contained in a restructuring plan confirmed by a court from avoidance actions, except where fraud has been subsequently established. Member States may also provide for super-priority status to new financing. Member States may extend the protection to all new debts which were agreed after the court was first seised.**
Impact on efficiency of the procedure	Granting super-priority status to new financing alone would not solve the problem unless the order of priority is changed so that new lenders are paid before secured creditors. This solution however is unlikely to be beneficial for the availability of credit and for legal certainty. In addition, secure creditors may not agree to it if they would lose their collaterals. On the other hand, if priority is given only over unsecured debts, the lender will have little certitude that he will be able to recover his money in the event of liquidation of the debtor (many unsecured debts remain unpaid, after the expenses of the liquidation and the secured creditors have been satisfied).	As a minimum, lenders must have the confidence that new financing is exempted from avoidance actions and automatic retroactivity of debt incurred during suspect periods, and that they would not incur civil or criminal liability. If they have this basic certainty, they can negotiate how to price or collateralize fresh money in the context of the restructuring plan. Member States may also provide a super-priority rule if they think this is necessary. To encourage lenders to support ailing companies by extending new financing, restructuring plans providing for such new financing should be confirmed by a court .
Impact on legal systems	In some Member States, changes to the rules on priority of claims would need to be made.	In some Member States, changes to the rule on avoidance actions, suspect periods and the civil and criminal liability of lenders to companies in distress would need to be made.
Impact on fundamental rights – right to property	If the super-priority rule changes the order of priority which secured creditors expect, this solution may lead to a limitation in the exercise of the right to property of dissenting creditors. Nevertheless, this measure would be	Exemption from avoidance actions may also impair the rights of secured creditors, for example when a new financing is collateralised with an asset already encumbered. However, the risk is much less, because of the principle that all creditors

[106] DG ECFIN analysis, Annex 2.

	proportionate if the alternative is the liquidation of the debtor and if as a result of this liquidation the secured creditors would not receive more than in the planned restructuring.	with a similar situation should be treated similarly in the restructuring plan. Again, this measure would be proportionate if the alternative is the liquidation of the debtor and if as a result of this liquidation the secured creditors would not receive more than in restructuring.

Conclusion: Sub-option 2 is preferable since it provides the necessary incentives and support for restructuring plans to be successful, without unduly affecting the rights of existing creditors.
The principle of supporting new financing being part of the restructuring plan and offering legal certainty for the lender was supported by many Member States (CY, DE, NL, UK, EL, FI, ES, RO). Some Member States (UK, NL) requested an exception to be made for transactions which prove to be fraudulent after the judge has confirmed the plan. This is now reflected in Sub-option 2.
53% of the respondents to the public consultation consider that the divergence between the conditions under which a detrimental act can be avoided created problems in practice, while 25% consider that it did not. According to UEAPME, a unitary system on EU level for cases of avoidance would be very helpful.

7.2.6. Reducing the formalities relating to court proceedings

Reducing the formalities relating to court proceedings lowers the costs of insolvency, which is associated with higher rates of self-employment[107].

Description *Lower the costs of the procedure by reducing the involvement of courts*	**Sub-option 1:** **A flexible framework, which allows for a more limited involvement of courts, for example where third parties may be affected such as when a moratorium is requested or a plan needs to be confirmed by a court in order to bind dissenting creditors**	**Sub-option 2:** **Sub-option 1 + requiring courts to rule in principle in written procedure**
Impact on the efficiency of the procedure	Court need only be involved where certain procedural acts are intended to have legal effects on parties or where judicial control is needed in order to avoid abuses. In a simplified preventive procedure, the court needs only be involved at 2 moments: when a moratorium is sought against enforcement actions of certain creditors and when a plan agreed upon by the debtor and a majority of creditors needs to be approved in order to bind a minority of creditors or to provide security to new lenders. Removing the involvement of courts in other procedural steps, such as formally opening a court procedure, the obligation to appoint a mediator or supervisor in each case at the beginning of the process, convening creditors' committees and taking a vote among the creditors present in a court	This sub-option is even more efficient than Sub-option 1, in that it enables courts to make a decision in principle in written procedure. For this purpose, the application for stay and the application for confirmation of the plan (including the content of the plan) must be sufficiently detailed and contain all those elements on the basis of which the court could take a decision. Creditors or other interested parties (e.g. regulators) would be able to raise objections also in writing. Exceptionally, courts may organise oral hearings where the written evidence presented to them is not sufficient in order to make a decision.

[107] DG ECFIN analysis, Annex 2.

	hearing (e.g. UK – scheme of arrangements) etc. would make these procedures less cumbersome, less costly and speedier than they are currently in some Member States.	
Impact on costs/length of procedure	Evidence from the Member States shows that reducing the courts' involvement in the procedure results in significant cost savings for the debtor and creditors. Thus, a comparison between the CVA and the administration procedure in the UK has shown that costs with hybrid procedures are cheaper than costs with formal court proceedings. The time between the moment the court is seised and the issue of its decision is also significantly reduced.	Sub-option 2 will reduce costs and time even further by removing the need for organising oral hearings in most cases. The use of written procedures would reduce the costs, which would be especially beneficial for SMEs for which the costs of restructuring are prohibitive and which may submit less complex restructuring plans.
Impact on judicial authorities	This sub-option would reduce the workload per case of courts, first by comparison to other preventive procedures which are highly formalised in the Member States (Group 3), and second by comparison to full insolvency procedures where these are the only alternative or where the existing preventive procedures are not effective in rescuing ailing debtors (Groups 1 and 2). This reduction in the workload per case of the courts is an imperative given the overwhelming number of insolvencies which currently burden the judiciary. As more of these insolvencies will be channelled towards the preventive procedures, courts would become less burdened and more able to focus on the most difficult cases.	Same as Sub-option 1, with the addition that courts may experience a slightly lower workload if the need to convene an oral hearing is left to the discretion of the court.
Impact on legal systems	Member States would need to make possible that courts are not seised when negotiations start, but at a later stage when the prospects of a restructuring plan are also more tangible (BE, FI, IE, NL).	Some Member States would need to provide for the possibility of decisions being taken in written procedure (e.g. UK, NL). However, many current reforms already confirm the trend of modernising and simplifying the judicial proceedings in order to lower the burden on courts.
Impact on fundamental rights - right to an effective remedy and to a fair trial	A simplified procedure would not affect the right to a fair trial. It would simply reduce the court involvement and allow for certain elements of the procedure to take place out-of-court, while at the same time retaining the rights of interested parties likely to be affected by those procedural elements to raise objections at the moment the court is seised with the application for moratorium or the application for confirmation of the	In addition to Sub-option 1, the principle of written procedure does not unduly affect the right to a fair trial of interested parties, since they would be able to submit objections in writing and also orally, should the court deem necessary to invite them for an oral hearing.

	plan.	

Conclusion: Sub-option 2 is the preferred option since it balances both the need to reduce costs in order to make the procedure more affordable, and at the same time to safeguard the procedural right of the parties. With one exception (FI), Member States did not oppose in principle the idea of hybrid procedures.

The establishment of flexible out-of-court procedures as a measure to increase the efficiency of the insolvency systems for SMEs was identified as a priority by 40% of the respondents to the public consultation. This option is also supported by the European business organisations, such as BusinessEurope, EuroChambers and UEAPME (in the form of conciliation procedure).

7.2.7. Lowering and aligning discharge periods

Reducing the stigma culture and encouraging restarters rests first on a distinction between honest and dishonest entrepreneurs and a reduction of the discharge period for the honest bankrupts, whether they have the means to pay their creditors under a payment plan or not. While the concept of honesty should in principle cover fraudulent conduct, Member States may also extent it to bad faith either before or after the opening of bankruptcy procedures.

Description *Reduce costs for creditors and foster entrepreneurship*	**Sub-option 1** **Discharge of debts for entrepreneurs within one year, with limited exceptions e.g. in case of dishonest entrepreneurs.**	**Sub-option 2** **Discharge of debts for entrepreneurs within three years, with limited exceptions e.g. in case of dishonest entrepreneurs.**	**Sub-option 3** **Sub-option 2 + automatically removing bad data relating to the data subject's bankruptcy from credit rating databases a short period of time after discharge**
Impact on entrepreneurship	A short discharge period would have positive effects on the level of entrepreneurship, as the possibilities for a second and more successful start increase. Exceptions allow Member States to filter out dishonest or fraudulent entrepreneurs.	A medium length discharge period would have positive effects on the level of entrepreneurship, albeit less than Sub-option 1. Exceptions allow Member States to filter out dishonest or bad faith entrepreneurs, and thus reduce the stigma associated with bankruptcy.	Sub-option 2 + Removing negative information on entrepreneurs will decrease the stigma associated with bankruptcy and have positive effects on the number of second starters and the speed with which they return to activity.
Impact on bankruptcy tourism	Incentives for relocation for the purposes of taking advantage of more favourable discharge periods would be eliminated.	Incentives for relocation for the purposes of taking advantage of more favourable discharge periods would be greatly reduced.	Same as Sub-option 2.
Impact on availability and costs of credit	A short discharge period may have negative impact on availability and costs of credit, as the creditors may fear that they are likely to have more claims unpaid due to the discharge.	Compared to sub-option 1, the negative effects on availability and costs of credit are limited, as in practice creditors will write off their outstanding claims after a few years have passed.	Sub-option 3 will have a positive impact on the availability of credit for second starters. Second starters are more likely to succeed; therefore the costs of credit are likely to decrease. Since only honest entrepreneurs would be the subject of such measures,

			creditors' decision to invest in second starters would not be riskier than in the case of first starters. On the contrary – evidence shows that second starters have a higher chance of succeeding in their new venture.
Impact on legal systems	Almost all Member States (except UK) would have to change their laws to adjust to the new discharge period.	Many Member States (except e.g. FI, SE) would have to provide for shorter discharge periods, while some Member States may only have to reconsider the conditions under which discharge is granted (e.g. FR, DE, SK, CY). Compared to sub-option 1, the legal system of Member States is less affected.	Member States would have to implement in their laws the principle that negative information relating to a previous bankruptcy should be automatically erased from private or public credit rating databases a short period of time after discharge.
Impact on fundamental rights	The change may be detrimental in the short term to the creditors' right of property in some Member States. Debtors, on the other hand, would benefit from less interference with their private life, as creditors can enforce claims for a shorter period of time.	Compared to sub option 1, the change would strike a better balance between the creditors' right of property, due to the shorter discharge period, and the interference with the debtor's private life following a reduced discharge period.	Sub-option 2 + Debtors would profit from better protection of their personal data and less interference with their private and professional life.

Conclusion: Sub-option 3 is preferable, as it provides for a fair balance between the rights of the creditor and the rights of the debtor, while having a positive effect on the levels of entrepreneurship. A discharge at the latest after 3 years, with limited exceptions, was supported by most Member States (NL, EL, DE, UK, FI, IE, SK, ES, CY), although a Member State (DE) mentioned the exceptions should be a bit broader (i.e. allow payment thresholds). PL, AT thought the discharge period was too short compared to their national practices.
This option is also supported by businesses and business organisations, such as UEAPME, BusinessEurope and the European Small Business Alliance. Furthermore, 73% of the respondents to the public consultation support this option, while 23% do not.

7.3. Option 3: a directive setting up minimum standards on a preventive restructuring procedure and discharge periods for entrepreneurs

A directive would ensure that all Member States put in place a preventive restructuring framework which contains **all** the elements necessary to make such a framework effective. However, since a considerable number of Member States are at this moment in time in the process of reforming their insolvency laws in the areas of preventive procedures and second chance, a proposal for an EU legislative instrument would not be effective in the short term since a legislative proposal may take time to negotiate.

7.4. Option 4: a fully harmonised procedure

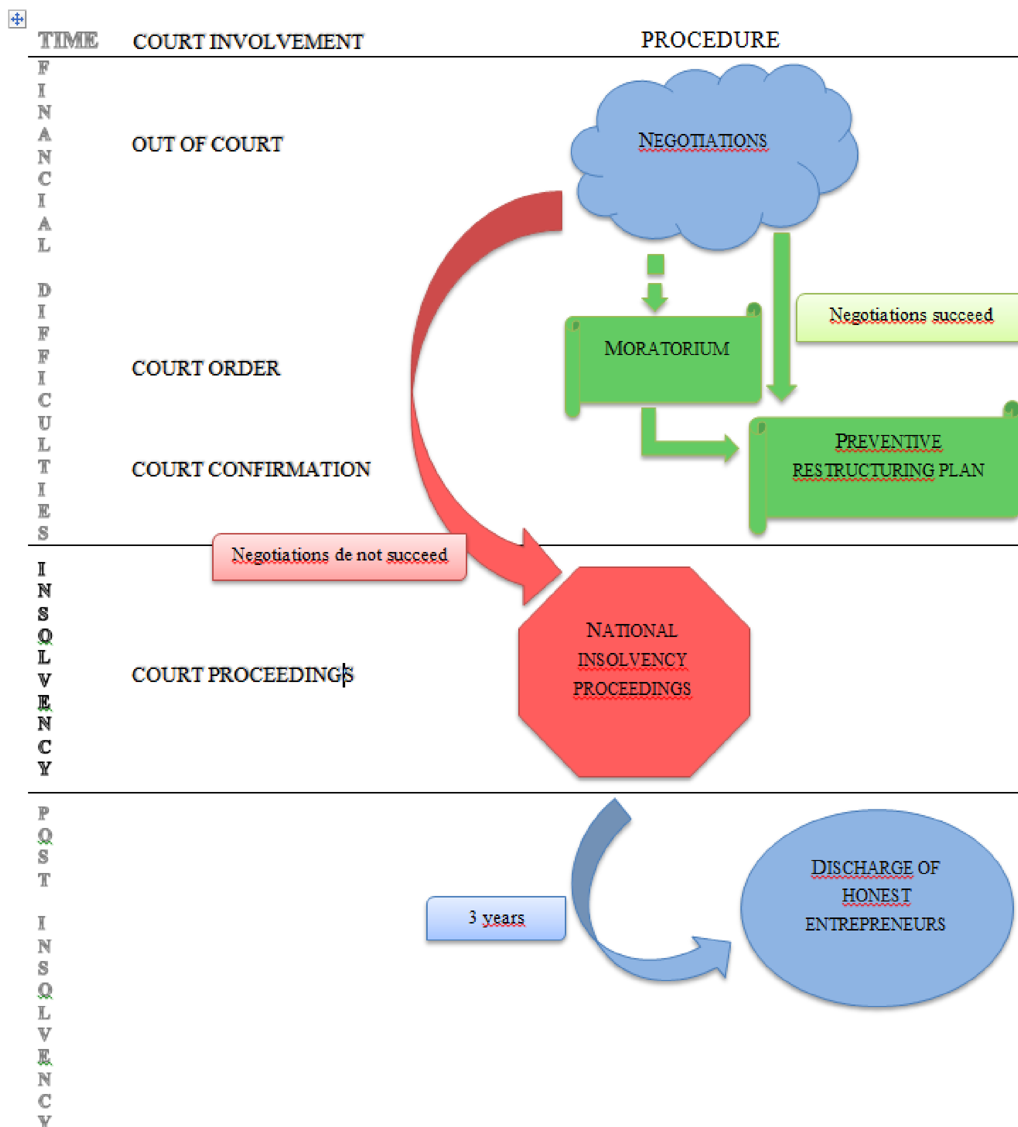
Although this option would seem to be more effective in terms of levelling the playing field for creditors and debtors in the EU, it would not be proportionate since the objective of enabling firms in all Member States to have access to a preventive procedure which fulfils certain minimum standards would not require such level of detailed regulation, nor would such a solution be required to ensure that honest entrepreneurs have a second chance. Finally, given the level of intrusiveness, such a solution is unlikely to meet with the approval of Member States. For these reasons, this option was discarded at an early stage.

8. PREFERRED OPTION

The preferred option if Option 2 Recommendation with the following combination of sub-options:

Operational objective	The preferred option
Early restructuring possibilities	The procedure must be available when the debtor is in financial difficulties and there is a risk, actual or potential, of insolvency
Improve chances of negotiations by allowing the debtor a breathing space (moratorium)	A moratorium granted on request by the debtor, of limited (short) duration
Facilitating the continuation of the operations by the debtor	Debtor remains in possession, but courts may appoint on a case-by-case basis a mediator and /or a supervisor
Disallow a dissenting minority of creditors to jeopardise the restructuring effort	A minority of creditors can be bound by the plan by a majority in the same class; all classes of creditors are bound, including secured creditors + Member States may provide that no voting process needs to formally take place
Increase chances of success of the restructuring plan by allowing new financing	Exempting new financing contained in the restructuring plan from avoidance actions. Member States may also provide for super-priority status to new financing.
Lower the costs of the procedure by reducing the involvement of courts	A flexible framework, which allows for a limited involvement of courts, for example for granting a moratorium and for confirming the plan + requiring courts to rule in principle in written procedure
Lowering discharge periods	Lowering discharge period to maximum 3 years + removing bad data from credit rating databases a short period of time after discharge

The flowchart below offers an illustration of how this framework could work in practice:



9. ANALYSIS OF OVERALL IMPACT OF OPTION 2

The absence of detailed, systematic statistics specific to the number and types of restructurings and insolvencies makes it difficult to make precise, robust estimates of the scale of the positive impacts that Option 2 is expected to generate. There is, nevertheless, substantial evidence that the approach to restructuring that is set out in the preferred option, of giving preference to restructuring over liquidation, and of avoiding placing unnecessary hurdles in the way of failed entrepreneurs who wish to have a "second start", can give rise to significant economic benefits (as already cited in the problem section).

Specific objective	To what extent the objective is fulfilled
Increase the number of viable firms being rescued	If followed in the Member States, the recommendation could improve the restructuring activity in particular in BG, DK, SK, SI, HR, CY, EE, IE, LT, LU, NL, PL, RO where currently the restructuring is not effective (e.g. too late, formal, inefficient, lack of enabling framework) and to a lesser degree in Member States which currently have restructuring options but formalised and expensive (BE, FR,

<table>
<tr><td></td><td>DE, FI, SE and LV). Small and medium viable firms in financial distress with not overly complex situation (e.g. debt structure) would benefit in particular. As said, 24% of SMEs in the UK are currently unable to pay down their short-term debts as they fall due. For example, if in Hungary restructuring rate increased from the current 1% to 20% (UK rate is 22%) as a result of implementing the proposed procedure, there would be (hypothetically) 4300 additional going concerns. Even if only 10% of these were successful, 430 firms could be successfully restructured, benefiting their creditors and other stakeholders. The number of additional firms restructured in the Czech Republic under the same scenario would be 42.</td></tr>
<tr><td>Reduce the cost of rescue in Member States with inefficient rescue procedures</td><td>For the group of countries which have only formal restructuring procedures (BE, DE, FR, FI, SE, LV) the total savings for firms if they switched to the hybrid alternatives could potentially be (with all due caveats) estimated to be in the order of magnitude of €135-223 m[108]. To this, additional and significant savings such as possible dividends should be added (the problem section presents the illustrative calculation).

There could also be savings in costs in BG, DK, SK, SI, HR, CY, EE, IE, LT, LU, NL, PL, RO where liquidation is currently the most common outcome of insolvency, because part of formal and court-based liquidation proceedings are expected to be replaced by the proposed restructuring proceedings which are largely out-of-court.</td></tr>
<tr><td>Reduce the costs of cross-border reorganisation of groups of companies</td><td>Groups of companies (representing 0.2% of all companies, but 30% in terms of jobs and 41% of gross added value) could save costs from designing a restructuring plan which could work for all its subsidiaries, instead of designing one plan for each subsidiary, in accordance with local rules. A legal framework enabling a European rescue plan is needed[109].</td></tr>
<tr><td>Reduce costs for creditors resulting from relocation of firms</td><td>The option could ensure a more even playing field for small and bigger companies, avoid additional cost for creditors after the shift in jurisdiction, and lower the pricing of loans by creditors.</td></tr>
<tr><td>General objective</td><td></td></tr>
<tr><td>1) Enable restructuring of viable firms, so as to maximise the total value to employees, creditors, owners, and other stakeholders

2) enhance the prospects for survival of illiquid but solvent firms

3) minimise the potential distortions to location and investment decisions</td><td>By increasing the number of viable companies being rescued and reducing the cost of rescue, the preferred option could contribute to the maximisation of asset value and better recovery rates for cross-border and domestic creditors. For example, in FR, the median recovery rates for liquidated firms are less than one third of those for “rehabilitated” firms (31% vs. 96%).

The quality of restructuring framework is considered one of the critical factors for resolving the problem of NPLs[110]. Improved recovery rates for creditors could contribute significantly to the reduction of NPLs, in particular in Member States with particularly high NPL values and below average recovery rates (HU, LV, RO, GR, BG, LT). The examples of possible reductions are in table below[111]:

<table>
<tr><th></th><th>Reduction of loss to all creditors (<u>bn</u> euro)</th><th>Reduction of loss to cross-border creditors (<u>million</u> euro)</th></tr>
<tr><td>Hungary</td><td>1.24</td><td>5.58</td></tr>
<tr><td>Bulgaria</td><td>1.41</td><td>6.35</td></tr>
<tr><td>Lithuania</td><td>0.22</td><td>1.00</td></tr>
</table></td></tr>
</table>

108 The scaling up was done on the basis of shares in EU GDP of the UK (14.7%) and the group of concerned Member States (44%). Data on GDP shares is for 2012 and comes from Eurostat.

109 See for example http://www.nautadutilh.com/PageFiles/7558/Lecture-on-groups-of-companies-Brussels-10-February-2012.pdf.

	Saving companies **saves jobs** (the total number of insolvency related job reductions in 2009 is estimated at 1.7 million). **Shareholders** would fare significantly better if bankruptcy is avoided. Around the announcement of a workout, firm value appreciates by up to 11% while the announcement of a bankruptcy filing is associated with a loss in shareholder value of up to 56%.[112] Improved recovery rates of creditors could be expected to result in decreased cost of capital thus benefitting **entrepreneurs and investors**. The option could contribute to a reduction in the potential distortions to the location of **investment decisions which result from the difficulties in assessing the risk of investing**. According to the OECD 2014 Economic Review, EU directives or guidelines for efficient bankruptcy practices are needed to address this problem.

Other impacts	The nature, scale and distribution of the impact
Impact on death rates and entrepreneurship	Highly accessible systems seem to provide a backstop for firm destruction, which might be particularly relevant in times of economic distress as it could ease the adjustment of investment and employment flows. Furthermore, a more efficient preventive framework fosters entrepreneurship[113]. More rescue friendly procedures could potentially result in decreased risk premium and cost of capital[114] and encourage entrepreneurial activity in Group 1 and 2 Member States and to a lesser degree in Group 3. The demand for venture capital finance is expected to increase potentially fostering innovation. Shorter discharge periods would lower entry barriers and risks for entrepreneurs to launch new businesses. Countries with efficient out-of-court settlement procedures tend to have both a lower rate of insolvencies and a higher survival rate of firms than other countries[115]. By limiting considerably court intervention, this option would improve on both aspects, in particular in the above mentioned Member States.
Impact on SMEs	SMEs are at the core of this initiative: as debtors, they are most likely to succumb to temporary financial difficulties, as their smaller size may mean that they have fewer financial reserves on which they can draw in case of financial difficulties – often triggered by the financial difficulties of a bigger company in their network, most affected by the cost of restructuring and the reticence of lenders to extend new finance to companies in financial distress. Therefore, a preventive restructuring framework which is more accessible, cheaper, and faster would afford SMES more chances to restructure successfully. As creditors, an efficient restructuring procedure would enable SMEs to recover more than in the case of the insolvency of the debtor, since creditors' recovery rates are in general higher where the insolvency framework allows for early and efficient

[110]European Banking Coordination "Vienna" Initiative, http://www.imf.org/external/region/eur/pdf/2012/030112.pdf

[111] Assuming the scenario of recovery rates being increased up to the average OECD level of 70% as a result of more rescue friendly environment. Of course, there might also be other possible obstacles to the NPL resolution (e.g. tax, bank and corporate regulation, etc.)

[112] Out-of-court restructuring versus formal Bankruptcy in a Non-Interventionist Bankruptcy setting, Jostarndt, Sautner, 2009, p.664

[113] DG ECFIN, see Annex 2.

[114] Rodano 2011, Davydenko & Franks 2008

[115] DG ECFIN, see Annex 2. See also the Business Dynamics Study…

	restructuring of viable firms and quick resolution of the non-viable ones.
Impact on corporate deleveraging and financial stability	Efficient preventive procedures lead to a speedier normalisation of the increase in NPLs as a reaction to macroeconomic shocks. Furthermore, there is a significant negative relationship between corporate deleveraging and GDP growth (1 percentage point reduction in the ratio of debt to financial assets leads to about 0.4 percentage points less GDP growth)[116].
Impact on courts' workload	By reducing the necessity of involving courts in many restructuring proceedings, this option would contribute to alleviating the workload for courts. Where the proposed procedure is used, the courts' involvement would only be limited and they would have the possibility of concentrating on the cases that are best suited for formal insolvency procedures. That fact alone constitutes an immediate advantage for any legal system where the workload for courts is excessive. Modernising court procedures by increasing the use of distance means of communication and written procedure would have a similar impact.
Impact on financial institutions and other secured creditors	This option could potentially have a mix of positive and slightly negative impacts on financial institutions. The positive impacts result from the expected increase in recovery rates, from the accelerated rate of reduction in the share of non-performing loans, and from overall higher output levels in the economy. The financial institutions which responded to the Public Consultation were favourable to the harmonization of discharge periods, restructuring procedures and efficiency measures for SMEs (Annex 4). See also the Report of the High Level Expert Group on SME, long-term and infrastructure financing and the OECD 2014 Report on the European Union (forthcoming). However, the moratorium could potentially have a negative impact on enforcement action of secured creditors. Moreover, the provision on majority decision on the restructuring plan binding all types of creditors may lead financial institutions to think that they have less control over their loans held against borrowers in distress or insolvent. This would be of particular importance for security held subject to negative pledge clauses. These clauses give lenders a degree of certainty, at the time they agree the initial loans to a company, about the extent to which they might eventually rely on that security for repayment of the loan amount. These negative impact is expected to be limited, given the short duration of the moratorium, and the fact that the court should not approve a restructuring plan if dissenting creditors would lose more than what they could reasonable expect to lose in the case of the insolvency of the debtor.
Impact on unsecured creditors, including consumers	Unsecured creditors are likely to be able to recover more of their debts. While the magnitude effect is not possible to quantify, even a small increase in unsecured credit (its current value in the UK is £80bn[117]) extended by SMEs would amount to many millions EUR saved. Consumers would benefit from the fact that debtors would be able to continue operating rather than shutting down. Their rights as creditors are furthermore safeguarded by the possibility to contest the plan if they do not agree with it. The court would not approve a plan which unduly affects the rights of dissenting creditors.
Impact on innovation	Excessive liquidations cause the firm to shy away from innovation. In contrast, by

[116] DG ECFIN, see Annex 2.
[117] http://www.oft.gov.uk/shared_oft/reports/Insolvency/oft1245

	promoting continuation upon failure, a debtor-friendly framework induces greater innovation[118]. The option would have potentially positive impact on innovation in particular.
Social impact, jobs	Positive impact on employment as savings firms saves jobs (in particular in BG, DK, SK, SI, HR, CY, EE, IE, LT, LU, NL, PL, RO). The measures on discharge period have an impact on preserving a decent livelihood for debtors (who can otherwise slide into the black economy), and good use of human capital.
Impact on Member States legal systems (what laws would need to be changed and how)	Group 1 Member States would need to implement a preventive procedure in their laws. Group 2 would need to make their existing procedures more efficient, including by putting in place a flexible framework which also allows for procedures with a reduced involvement of courts. Group 3 would mainly need to a flexible framework which also allows for procedures with a reduced involvement of courts.
Impact on fundamental rights	The right to conduct a business and engage in gainful employment will be enhanced, since companies will be able to continue operating, and entrepreneurs would be able to have a second chance. Although certain elements of the procedure may affect the right to property and the right to an effective remedy and to a fair trial, safeguards will be foreseen in each case in order to ensure that these are proportionate in view of attaining the objectives.
Impact on competition	Firms benefiting from the moratorium on creditors and reduction in debt can gain temporary competitive advantage over the firms which are paying their debts. However, this is likely to be offset by lower concentration ratios, due to fewer firms leaving the industry though insolvency, and therefore greater competition.
Impact on environment	There are no foreseeable impacts on the environment.
Risks to effectiveness	**Quality of civil justice**. The empirical results show that the efficacy of reforms depends on the quality of the civil justice that is the judges' productivity in each court (e.g. in Italy) [119]. While the preferred sub-options will lead to a reduction of the courts' workload, a simplification and modernisation of procedures, more may need to be done in terms of training of judges and reduction of time limits (e.g. length of stay). **Early warning tools**: a complete system of early warning (such as online self-tests, training for managers, call centres, information sessions, assistance by public/private agencies[120]) would need to be put in place in order to improve the practical functioning of the legal framework. **Adequate implementation**. In particular, a failure to ensure the high quality of the judges and insolvency administrators who facilitate insolvency proceedings would be a risk to adequate implementation. Insolvency law may not provide clear benchmarks to incentivise debtors and creditors to reach a restructuring agreement early on. Lack of regulatory framework requiring financial institutions to write down the value of distressed debt, tax disincentives for using not fully formal restructuring procedures.

[118] Bankruptcy codes and innovation, CEPR, May 2007, http://www.cepr.org/pubs/dps/DP6307.asp

[119] http://www.rivisteweb.it/doi/10.1434/36778

[120] See Busyness Dynamics Study, available at http://ec.europa.eu/enterprise/policies/sme/business-environment/files/business_dynamics_final_report_en.pdf.

	A full list of elements of legal system to be assessed to verify the existence of obstacles to preventive restructurings was compiled by the World Bank (see Annex 9). An analysis of those elements will reveal the areas that need improvement and refinement in the legal system to create the proper incentives for effective restructuring procedures.
Implementation costs	Member States where preventive procedures are introduced for the first time would need to provide training for their courts and for insolvency practitioners. These training costs are in the region of €950-1300 per judge in those countries where a preventive procedure is used for the first time. Exchange of best practices: this will be done in the context of the European Judicial Network, at no extra cost. Cost of reporting obligations: many Member States already have statistical data, and only need to make it available to the Commission once a year. For the rest of the Member States, the costs of gathering such data are not expected to be significant. They concern the filing of certain procedures with courts competent which are clearly identified. Records of applications for opening different procedures and for closing them are already likely to be kept in all these courts.
Stakeholders' views	Respondents to the public consultation support in their majority the harmonisation of discharge periods (3/4 of respondents) and restructuring plans (70%). Among the Member States which responded in the consultation, some could harmonisation of certain aspects of restructuring plans (NL, LT, EE – minimum harmonisation only) or the reduction of discharge periods (ES, EE, LT, NL, EL). In the meeting with the Member States which took place on 12 December 2013, many Member States preferred a recommendation (UK, FR, SE, PL, EE, AT, DE), while one Member State rejected any type of EU action (FI). Most Member States could not indicate a clear position yet, this depending on the concrete proposal submitted by the Commission (NL, SK, HU, ES, LU, BE, RO, SI, LT, LV, IT, DE, IE). A last group of Member States clearly preferred a harmonisation measure in this field (EL, PT, CY).

10. Summary comparison of Option 2 against the status quo

Objectives / impacts	Option 1 (Status quo)	Option 2 – potential impacts
Increase in number of viable firms rescued	0	Potentially significant (in particular BG, DK, SK, SI, HR, CY, EE, IE, LT, LU, NL, PL, RO)
Reduce the cost of rescue in Member States with inefficient rescue procedures	0	Minimal order of magnitude of savings: €135-223 m (in particular BE, DE, FR, FI, SE, LV), plus other not quantified savings
Reduce the cost of cross-border restructuring of groups of companies	0	Positive
Reduce costs for creditors resulting from forum shopping	0	Savings for creditors (e.g. travel, legal representation)
Reduce costs for creditors resulting from relocation of entrepreneurs	0	Positive

which are debtors		
General objective: Reduce the financial losses suffered by creditors and other stakeholders	0	Improved recovery rates, facilitated resolution of NPLs, saved jobs, less distortion to investment decisions
Entrepreneurship	0	Positive (due to expected decrease in cost of capital)
Court workloads	0	Significant savings
Financial institutions	0	Mainly positive but also potentially a slightly negative impact (less control on the loans)
Legal systems	0	Potentially significant for Groups 1 and 2 Member States
Fundamental rights	0	Neutral
Implementation costs	0	Limited

11. MONITORING AND EVALUATION

The recommendation will invite Member States to implement the minimum standards contained therein within 12 months from its adoption. However, a recommendation, while addressing the immediate need for guidance, comes inevitably with the risk of low up-take by the Member States and of a considerable proportion of the discrepancies currently affecting the smooth working of the internal market still remaining in place.

Thus, 18 months after its adoption, the Commission will conduct an evaluation of the extent to which the Recommendation is being implemented in the Member States. The Commission will also assess, most likely on the basis of an external study, the effectiveness of the actions that Member States will be taking in terms of achieving the objectives set out in section 5 above.

The implementation of the Recommendation in the Member States would be followed in the context of the European Judicial Network, which will also provide for the first time a forum for the exchange of best practices on insolvency frameworks at EU level.

In the Recommendation, the Commission will request Member States that they provide annual statistical data on the numbers of preventive restructuring procedures opened by enterprises in difficulty, the number of liquidations and sales as a going concern, the length of procedures, the size of the debtors involved in such proceedings (medium, large or micro-enterprises) and the outcome of the procedures opened.

On the basis of the evaluation including statistical data, the Commission will decide on the appropriate follow-up.