Insolvency proceedings: avoid the domino effect on SMEs in the supply chain

The European Small Business Alliance recommendations to the European Commission.

Key ESBA recommendations for ensuring more transparency and fairness for unsecured creditors

- **More equal treatment of claims by creditors**
- **Fairer distribution of Insolvency Practitioners' (IP) costs**
- **Maximising asset value**

ESBA welcomes the Commission's efforts towards establishing a common framework for insolvency proceedings within the European Union. Whilst recognising fair procedures for micro and small businesses in particular. The discussion regarding the problems and obstacles in Insolvency procedures go hand in hand with the discussion on 'second chances for honest entrepreneurs' and the stigmatisation of business failure in the EU in general, which has long resulted in a risk-averse business climate in Europe.

ESBA's proposition deals with the correlation between second chances for entrepreneurs and insolvency procedures. Many insolvencies are the result of the bankruptcy of a large client, having a negative effect down the supply chain. By attempting to reduce this knock on effect, fewer small entrepreneur will need to deal with bankruptcies and second chance procedures, as many of the smallest ones, starting entrepreneurs in particular, will be unable to cushion and surve the blow.

Existing legislation

On 2 March 2016 the European Commission published an Inception Impact Assessment entitled Insolvency II. It underlines the effect of current insolvency legislation on the Single Market as well as having fragmented substantive insolvency regimes. The Juncker Commission places the new proposals in the framework of a number of key policy initiatives: the Capital Markets Action Plan, the Single Market Strategy and the Banking Union Communication. So far, at the European level, legislation regarding insolvency has been primarily focused on the cross-border aspects of it. However, the new initiative aims to look at establishing an EU framework for the actual procedure of insolvency, through to the potential bankruptcy or recovery of a business.

Policy recommendations

In an ideal world, we ought to promote equal treatment of claims when it comes to debt repayment, putting small businesses as the most vulnerable creditors, at a similar level as preferential creditors. However, ESBA recognises that the current system simply would not allow for his. Yet. ESBA does however advocate a system whereby banks pay a proportionate share of the receivership fees so as to ensure that priority creditors also have an interest in finishing the proceedings as quickly and cost-effectively as possible, and to ensure that costs are equally split among all creditors, and not excessively burdening the small guy, especially since the bank often appoints the receiver. With the greater pressure banks can exert on receivers, such a provision would allow costs to be kept down

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and the process to be sped up. This, however, should not impact the priority given to employees' payment in full in insolvency procedures.

Furthermore, ESBA is advocating that when it comes to the sale of assets, the price of these should remain at market value, or alternatively, the difference between the selling price of the assets and their market value should be reimbursed into the receiver's fund, should they be sold below market value either by a bank holding the asset or by the receiver, in order to make sure that small businesses, as creditors impacted in the process, have a fair chance to recover as much of their debt as possible.

What these suggestions would achieve is a balance between speed and value in the recovery of assets. They would also provide for a balance between smaller and bigger creditors, and preferential and unsecured ones.

Our proposals

1. Equal treatment of claims

The possibility of the domino effect needs to be dealt with by ensuring that a fairer system for the treatment of claims is put in place. Stage payments should be encouraged, meaning that as the receivership recovers funds they should be repaid to creditors. Member States have substantial differences in the priority they give to claims in insolvency proceedings. For the small business community, it is important that the order of claims be as fair as possible.

In the EU, there are generally two models of debt repayment when it comes to government debt repayment in insolvency proceedings – one giving tax authorities priority over unsecured creditors, and the other which does not do that. The proposed changes would ensure there is a greater chance that all creditors receive a fairer piece of the pie, and within a reasonable time limit. Bad practice example have been reported across the two types of systems, where companies wait for a long time after the preferential creditors have been paid only to recover a small part of their money . Instead of a fairer system that gives confidence enabling banks to loan to creditors, in practice the current systems create uncertainty for the smaller businesses that would have outstanding debts with the insolvent company, leaving them trapped within the proceedings.

2. Bank participation in the Insolvency Practitioners' (IP) fees

However, as harmonisation of order of payment is not the preferred option for stakeholders at EU level, and the models that are in practice in the Member States do not currently allow equal treatment of secured and unsecured debt, we propose a less invasive option on how to minimize the impact of insolvency on smaller unsecured creditors. ESBA proposes looking into the option of having banks and other preferential creditors participate in the payment of the receivership fees. Just because a particular creditor is preferential should not absolve them from paying their proportion of fees and costs of the insolvency proceedings. In this way, without the need to change the priority of the creditors, the new legislation would be able to ensure that there is an incentive for all involved parties in keeping the insolvency proceedings timely, quick, and cost effective.

Here, the issue lies in the fact that once the preferential creditors have received what they are being owed by the insolvent company, they exit the winding down procedure, which, now lacking the major creditors' pressure, has been reported to last years and result in minimum recuperation of

debt by the remaining unsecured creditors. In the case where these are small or micro companies, they can neither afford for the process to keep on going for too long, nor pressure the IP to speed it up. An inclusion of secured creditors in the IP fees payments and the recovery of debt by **ALL** creditors **ONLY** at the end of the winding down would guarantee a swifter and fairer closing of the insolvency proceedings.

3. Fair price of sold assets

ESBA strongly supports the introduction of a provision regarding the selling off of assets during the insolvency procedure. Assets of insolvent entities should be sold at a price that is not below their market value, so as to allow creditors to recuperate a fair share of their asset value. ESBA is advocating that when it comes to the sale of assets, the price of these should remain at market value and these should be reimbursed into the receiver's fund, either by the preferential creditors or by the insolvency professional.

This is normally at the discretion, and legal obligation, of the insolvency practitioner, and ESBA agrees that in order to ensure that insolvency proceedings go smoothly there need to be appropriate provisions on how the IPs are appointed and appropriate standards for the insolvency practitioners to ensure an equal level of professionalism amongst them in any Member State. This added confidence in the outcome of the winding down proceedings would give confidence for the businesses' recovery, which could make banks more inclined to provide bridge loans to cover the time gap between their major client's insolvency and any debt recovery.

Conclusion

ESBA believes that common European rules on the three points outlined above will be beneficial not only for the SMEs impacted by other companies' insolvencies, but would also provide for the stability of insolvency frameworks throughout the EU, while simultaneously reducing the reliance on the second chance provisions envisioned. It would make it less likely for companies to go forum shopping in case of insolvency (looking for their preferred insolvency regime across the EU, for companies that operate in more than one EU Member State).

It should be noted that most bankruptcies come with collateral damage. In the UK alone, a recent study found that 27% of bankruptcies were the result of another company going bankrupt. In this context, the proposals above aim to introduce more stability for the small businesses that are impacted by the insolvency proceedings of their larger clients.

ESBA looks for a more comprehensive and fair European insolvency regime, reducing the aversion against taking risk, whilst taking away the stigma that often follows bankruptcy.

ESBA welcomes all input from the SME Envoy network on this topic and is looking forward to cooperating for the creation of a fair insolvency regime, which bridges the gap between the insolvency proceedings and second chance for entrepreneurs.

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