# BUSINESS INSOLVENCY

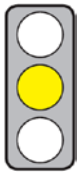
cep**PolicyBrief** No. 2013-37 of 16 September 2013



## KEY ISSUES

**Objective of the Communication:** A partial harmonisation of the insolvency rules in the Member States is intended to facilitate the reorganisation rather than liquidation of businesses and provide entrepreneurs with a "second chance".

**Parties affected:** All businesses.



**Pro:** (1) Maintaining and restructuring insolvent companies may increase the overall prosperity of an economy.

(2) Shorter discharge times enable failed entrepreneurs to restart businesses more quickly.

**Contra:** (1) In practice, the distinction between an "honest" and a "dishonest" bankruptcy is of little use without further clarification.

(2) Shorter discharge times increase the risk of loss for creditors.

## CONTENT

### Title

**Communication COM(2012) 742** of 12 December 2012: A new European **approach to business** failure and **insolvency**

### Brief Summary

Note: Page and footnote numbers without any additional indication refer to Proposal COM(2012) 742.

- **Background**
  - According to the Commission, the EU is currently facing a "severe" economic crisis. Between 2009 and 2011, an average of 200,000 firms went bankrupt per year involving the loss of 1.7 million jobs each year. About 50% of new businesses fail within the first five years. (p. 2)
  - The Commission regards promoting growth and securing jobs as a "high political priority". "Justice for growth" therefore also forms part of the approach. A more "efficient" justice system, in this sense, contributes to the creation of "sustainable" economic growth by
    - providing legal certainty,
    - minimising the risks for businesses and thus
    - stimulating cross-border business activity and investment. (p. 2 et seq.)
  - This will specifically help Member States that are receiving financial aid and undergoing an "economic recovery programme" (p. 3).
- **Objectives**
  - The "rescue and recovery culture" across the Member States is to be "developed" (p. 3).
  - Speedy and more "efficient" insolvency procedures will facilitate
    - the systematic discharge of debtors and
    - faster settlement of creditors' claims, particularly those of small and medium-sized enterprises (SMEs) (p. 3, 8).
  - In concrete terms, the Commission wants to (p. 3, 5)
    - partially harmonise the insolvency rules of the Member States,
    - restructure, rather than liquidate, insolvent businesses and
    - give failed "honest" entrepreneurs a "second chance" to go into business.
- **Member States: Partial harmonisation of insolvency law**
  - By way of a partial harmonisation of the insolvency law of the Member States, the Commission wants to (p. 3 et seq.)
    - remove "obstacles, competitive advantages and/or disadvantages",
    - increase the confidence of businesses, entrepreneurs and private citizens in the internal market,
    - reduce the number of business liquidations and
    - restrict the loss of jobs.
  - The Commission is considering the harmonisation of the criteria for opening insolvency proceedings. Differences exist in this respect to the extent that in some countries actual insolvency is required, whereas in others, imminent insolvency suffices. There are also differences in the solvency or liquidity tests used to determine the financial condition of the business. This can result in businesses in similar situations being treated differently and thus lead to differing efforts being made at restructuring to avoid insolvency proceedings. (p. 6)

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- The Commission is considering the harmonisation of the conditions under which creditors can initiate insolvency proceedings. Diverging national provisions may constitute an obstacle especially in cross-border insolvencies. (p. 7)
- The Commission is considering harmonisation of the deadlines for filing insolvency proceedings. The deadline should be set such that
  - debtors have sufficient time to solve their liquidity problems,
  - delays in the insolvency proceedings are avoided and
  - creditors do not have to wait too long for settlement of their claims. (p. 6)
- The Commission is considering harmonisation of the ability of creditors to propose concrete reorganisation measures in the form of a restructuring plan, and their ability to influence its preparation and adoption (p. 7).
- The Commission is considering harmonisation of the national rules on the restructuring of insolvent businesses. It specifically refers to the majorities required for adopting a restructuring plan and the powers of the courts when reviewing the plan. (p. 7 et seq.)
- The Commission is considering the harmonisation of the rules under which creditors can lodge their claims. This relates in particular to (p. 7)
  - the time limits which have to be met in this regard,
  - the consequences of failure to comply with time limits,
  - verification of the legitimacy of claims and
  - availability of information relevant to the creditor.

- **Businesses: Restructuring not liquidation**
  - **Priority for business restructuring**
    - The Commission wants an "efficient system" to push through the restructuring and reorganisation of insolvent businesses thus enabling them to make a fresh start (p. 2).
    - This will safeguard jobs - for suppliers as well - and create incentives for retaining value in viable companies (p. 3). This will, in particular, secure the continued existence of SMEs (p. 2).
  - **Cost reduction and "alternative procedures" for business restructuring**
    - According to the Commission, restructuring of SMEs is "extremely costly". It is therefore considering "capped fees". (p. 8)
    - It also proposes "alternative procedures" "proportionate" to the size of the business; out-of-court settlements are seen as a particularly appropriate method. The time taken for these is "relatively short" and the success rate is "above 50%". (p. 8)

- **Entrepreneurs: Second chance for "honest" failure**
  - **"Honest" versus "dishonest" failure**
    - The Commission sees the insolvency of an "honest" entrepreneur as an "honest" failure. This "honest" failure must be distinguished from "fraudulent" failure. (p. 5, footnotes 11 and 13)
    - An "honest" failure may be presumed where there is no "obvious fault" on the part of the owner or manager and the insolvency has not been caused "irresponsibly" or with "fraudulent" intent (p. 5).
    - The Commission believes that "honest" entrepreneurs learn from their mistakes and the new companies they establish will experience faster growth. "Honest" entrepreneurs should therefore be given better chances to establish restarts and discharge debts. (p. 5)
  - **"Honest" failure as a requirement for a second chance**
    - There should be separate liquidation proceedings for "honest" and "dishonest" insolvencies. "'Fast-track' liquidation proceedings" should be introduced for "honest" bankrupts. (p. 6)
    - The discharge period for "honest" entrepreneurs should be harmonised and limited to a maximum of three years (p. 5).
      - The time to discharge is the time from when a company is bankrupt to when it can restart its business (p. 4).
      - The period should apply "as automatic as possible" (p. 6).
    - Any supportive programmes for starting up a new business should be available only to "honest" bankrupts, but they should not be treated differently from non-bankrupt businesses (p. 5).
    - The Commission is considering imposing fines and criminal liability on entrepreneurs who fail "dishonestly" (p. 5).

## Statement on Subsidiarity by the Commission

Differences between national insolvency laws reduce the confidence of economic operators in the "systems of other Member States" and thereby in the functioning of the internal market. This inhibits the availability of credit thus preventing investment activity which has a negative impact on the production of goods and consequently on economic growth. The Commission also hopes that the partial harmonisation of national insolvency rules will "improve the functioning of the internal market". (p. 3)

## Policy Context

To coincide with the Communication on business insolvency, the Commission has submitted a Regulation to amend the EC Insolvency Regulation (EuInsR) [Proposal COM(2012) 744; see cep**PolicyBrief**]. The EuInsR relates to cross-border insolvency proceedings by companies and private individuals. The concept of a second chance for failed "honest" entrepreneurs is already contained in the Communication on Implementing the Lisbon Partnership for Growth and Jobs [COM(2007) 584]. It is also contained in the "Small Business Act" [COM(2008) 394; see cep**PolicyBrief**] as the second of ten principles for improving the conditions for SMEs. In the "Entrepreneurship 2020 Action Plan" [COM(2012) 795; see cep**PolicyBrief**] the Commission looks at the concept as one of six key areas for promoting start-ups. Confidence in the European judicial area and efficient insolvency proceedings should serve economic growth in the EU [Action Plan Implementing the Stockholm Programme [COM(2010) 171]; see cep**PolicyBrief**] and are thus directly connected to the growth strategy "Europe 2020" [COM(2010) 2020; see cep**PolicyBrief**]. The Commission recently proposed a special framework for bank recovery [Proposal for a Directive COM(2012) 280; see cep**PolicyBriefs**].

## Options for Influencing the Political Process

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|---|---|
| Directorates General: | DG Justice (leading) |
| Committees of the European Parliament: | Legal Affairs (leading), Rapporteur N. N. |
| Federal Ministries: | Justice (leading) |
| Committees of the German Bundestag: | Legal Affairs (leading); Economy & Technology; EU Affairs |
| Consultation procedure: | Any citizen may express an opinion. The procedure ends on 11 October 2013; http://ec.europa.eu/yourvoice/ipm/forms/dispatch?form=InsolvencyTwo |

# ASSESSMENT

## Economic Impact Assessment

Businesses carry out important functions within an economy. They are responsible for ensuring an optimum combination of scarce production factors, consequently ensuring their efficient use, thus creating jobs and capital investment opportunities. Innovations in businesses give rise to new products and/or processes and establish them in the marketplace. The technical progress thus initiated is an important requirement for economic growth, specifically in the industrialised economies.

**Insolvency rules which focus on maintaining and restructuring insolvent businesses can** increase the number of businesses and thus **contribute to greater prosperity in the economy.** In principle, they should therefore be regarded as positive. At the same time, the failure and accompanying insolvency of businesses is one characteristic of a functioning free market economy. It ensures that only those goods are offered in the marketplace for which there is a corresponding demand. Barriers preventing failed businesses from leaving the marketplace in turn represent barriers preventing new companies from entering the marketplace.

The harmonisation of the insolvency laws of the Member States is only appropriate for cross-border business insolvencies. That will allow insolvent businesses to restructure, or where necessary wind up, parts of the business located in different Member States according to standardised procedures. A reduction in transaction costs will be the result. Such insolvency cases are, however, already governed by European conflict-of-law rules. In principle, this allows the national insolvency rules applicable in the debtor's "centre of main interest" to apply to the entire insolvency proceedings (Art. 3 (1) EuInsR; see cep**PolicyBrief**). There is therefore no need for an ex-ante harmonisation of national insolvency rules.

Further, there is no reason to believe that partially harmonised insolvency rules will reduce the number of business insolvencies and thereby the loss of jobs. In an economic situation characterised by unemployment, the Member States already have sufficient incentive to pursue these objectives with their own insolvency rules. Partial harmonisation is more likely to undermine these objectives because it does not take account of national preferences. That would also be an unjustified shift away from the principle of subsidiarity.

The idea of giving failed "honest" entrepreneurs a second chance and encouraging them to restart businesses may generate economic growth and jobs. As innovators, entrepreneurs are an important factor in the dynamic development of the economy. In addition, even where the likelihood of a market-exit is high, start-ups are essential for employment development and efficient use of capital. In this regard it makes sense to use the know-how acquired by failed businesses and enable them to restart. In addition, a revaluation of entrepreneurship itself may help to put the social stigma attached to bankruptcy into perspective.

**The distinction between "honest" and "dishonest" failure is** basically appropriate but **of little use without further clarification.** The Communication does not make it clear what the honesty of a failed entrepreneur refers to and how it is to be proved in the individual case. The Commission also fails to clarify who is responsible for assessing honesty. A fundamentally precise definition is required in order to prevent free-rider behaviour by "dishonest" bankrupts because if "dishonest" bankrupts were to get a second chance in the same way as "honest" bankrupts, any distinction would be pointless.

**A reduction in the discharge period is two-edged: it enables failed entrepreneurs to restart more quickly** and does not deter potential start-ups in the early stages; **however, there is an increased risk for creditors** that, as a result of insolvency, they will lose some of their claims irrevocably. Consequently, greater restrictions

on the availability of credit or a corresponding risk premium are needed. This, however, runs counter to the Commission's desire for a positive effect on employment.

## Legal Assessment

### Legislative competence

**Under the European treaties, the power to develop judicial cooperation in civil matters explicitly requires, a - in this case very doubtful - "cross-border implication"** (Art. 81 (1) TFEU). This express limitation is already incompatible with any indiscriminate harmonisation of national insolvency laws.
Harmonisation of insolvency laws under the internal market competence (Art. 114 (1) TFEU), on the other hand, is not immediately ruled out; standard rules could be an appropriate way of facilitating cross-border investment. The Commission's subjective intention of supporting the internal market is, however, insufficient in this regard. The measure must also, in fact, improve the conditions for the establishment and functioning of the internal market (settled case law, e.g. ECJ, Case C-376/98, Germany / Parliament and Council, para. 84). This will be hard to prove, however. Investment decisions by businesses are hardly likely to be dependent on the varying arrangement of insolvency laws in the Member States.

### Subsidiarity

**Application to insolvency cases without cross-border implication is** in any case **in breach of the principle of subsidiarity,** always assuming there is any sound basis for legislative competence at all (Art. 5 (3) TEU in conjunction with Art. 4 (2) a and j TFEU; cf. also Art. 69 TFEU). Purely national insolvencies can be handled according to national preferences and national law without any problem.

### Impact on German law

The primary purpose of German insolvency law, even after its reform by the Act to further facilitate the restructuring of companies (ESUG), is still the satisfaction of creditors and not the restructuring or reorganisation of companies [cf. § 1, sentence 1 Insolvency Statute (InsO)]. The option of discharging "honest" debtors from their residual debts also applies (§§ 1, sentence 2, 286 et seqq. InsO).
Previously, discharge from residual debts, in the case of "good conduct" by the debtor, took effect six years after the start of the insolvency proceedings (cf. §§ 287 (2), 300 (1) InsO). This will change on 1 July 2014 as a result of the latest reform by way of the Act to shorten the discharge procedure and strengthen the rights of creditors (promulgated in the Federal Law Gazette 2013 I No. 38 of 18 July 2013, p. 2379). In future, discharge from residual debts will take effect after five years if the debtor is at least in a position to pay the cost of proceedings and after three years where, in addition, the creditors have been at least 35% satisfied (§ 300 (1) No. 2 and No. 3 InsO, new version). In other cases, the term for discharge will still be six years.
Discharge from residual debts must be refused, inter alia, where the debtor has already been discharged from its residual debts during the ten years prior to the application to institute insolvency proceedings (§ 290 (1) No. 3 InsO). In these cases, the application to open proceedings actually will be inadmissible according to the aforementioned reform as from 1 July 2014 (§ 287a (2) No. 1 InsO, new version). This could collide with the Commission's objectives of giving entrepreneurs a chance to restart as soon as possible, and in any case within three years, and of ensuring equal treatment for entrepreneurs, with or without previous insolvency, as regards support programmes.

## Conclusion

Insolvency rules which focus on maintaining and restructuring insolvent businesses can contribute to greater prosperity in the economy. The distinction between "honest" and "dishonest" failure is of little use without further clarification. A reduction in the discharge period is two-edged: it enables failed entrepreneurs to restart more quickly but increases the risks for creditors.