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WORLD BANK GROUP INSOLVENCY AND CREDITOR/DEBTOR REGIMES TASK FORCE

WORKING GROUP ON THE TREATMENT OF MSME INSOLVENCY

Report on the Treatment of MSME Insolvency

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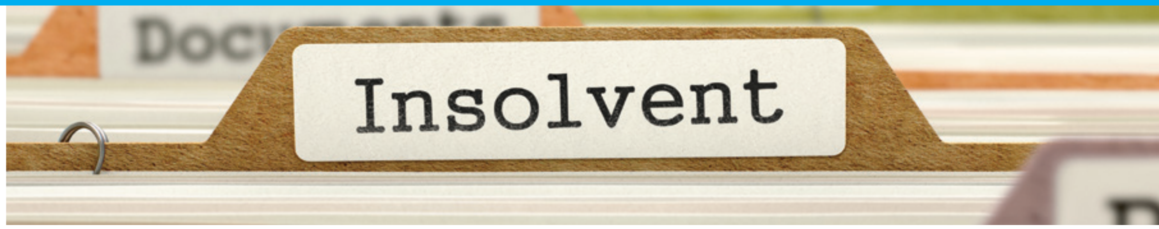

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Foreword

The *Report on the Treatment of MSME Insolvency* arises out of a panel presentation that took place during the 2015 meeting of the World Bank Group's Insolvency and Creditor/Debtor Regimes Task Force (the ICR Task Force) and subsequent discussion among Task Force members in 2016. Following the discussion in 2015, the ICR Task Force resolved to prepare a report on the challenges, needs, and responses to MSME insolvency. As always, in light of the ICR Task Force mandate, the objective of this work is to inform the World Bank Group's role as joint standard setter (together with the United Nations Commission on International Trade Law) in the area of insolvency and creditor/debtor rights. An earlier version of this report was distributed to the 2016 ICR Task Force members, who positively welcomed the discussion around this topic. During the 2016 meeting, the ICR Task Force was asked to consider the challenges faced by countries attempting to reform their insolvency systems in the context of MSME needs. The guidance from the Task Force is included in Chapter V of this paper.

This report is the result of the ICR Task Force's resolution. It has been developed under the leadership of Andres Federico Martinez, with support from Nicholas Avis and Oleksandra Svyryba, and includes contributions from other World Bank and International Finance Corporation Staff and Consultants Farid Anvari, Yiannis Bazinas, Simon Bell, Fernando Dancausa, Matthew Gamser, Antonia Menezes, Nina Mocheva, Will Paterson, and Ghada Teima. Comments were also provided by external peer reviewer: Catherine Bridge Zoller (Principal Counsel, European Bank for Reconstruction and Development).

Our appreciation is further extended to the team of seven leading academics, and a member of the Canadian judiciary, who co-authored the paper *The Modular Approach to MSME Insolvency:* Dr. Ronald Davis (University of British Columbia, Canada), Dr. Stephan Madaus (Martin-Luther-University Halle-Wittenberg, Germany), Dr. Alberto Mazzoni (President of Unidroit, Italy), Dr. Irit Mevorach (University of Nottingham, United Kingdom), Dr. Riz Mokal (South Square Chambers; University College London; University of Florence), Justice Barbara Romaine (Alberta Court of Queen's Bench, Canada), Dr. Janis Sarra (University of British Columbia, Canada), and Dr. Ignacio Tirado (Universidad Autonoma De Madrid, Spain). *The Modular Approach to MSME Insolvency* influenced the structure of this report and formed the foundation of much of the material found in Chapters II and III. Additionally, section B of Chapter IV was co-authored by Janis Sarra, Mahesh Uttamchandani, and Andres Federico Martinez.

Finally, we are grateful to those who provided valuable input relating to their jurisdictions, including: Robert Hertzberg (Partner, Pepper Hamilton LLP, and Past President, INSOL International) – United States, Kazuhiro Yanagida (Partner, Yanagida & Partners) – Japan, Justice June Young Chung (President Judge, Seoul High Court) – South Korea, and Annerose Tashiro (Partner and Head of International Business Recovery / Cross-Border Restructuring and Insolvencies, Schultze & Braun GmbH Rechtsanwaltsgesellschaft) – Germany.

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May 4, 2017

Mahesh Uttamchandani
Chair, ICR Task Force

Executive Summary

Micro, small, and medium enterprises (MSMEs) are among the largest commercial users of insolvency systems. MSMEs are a significant part of the global economy – and just as there are large numbers of MSMEs, there are large numbers of MSME insolvencies. However, there are very few specialized legal regimes for MSME insolvency; most jurisdictions treat MSME insolvencies the same as for other corporate entities, or conversely, natural persons, despite MSMEs' unique attributes.

This Report:

- Considers the specific challenges of insolvent MSMEs (including the difficulties of defining MSMEs and distinguishing them from large corporate entities);
- Reviews and analyzes how legislation in different jurisdictions deals with the challenges of MSME insolvency; and
- Considers if existing international standards are sufficient to address MSME insolvency.

This Report establishes that some of the key challenges for MSME insolvency are:

- Complex insolvency systems – these deter MSMEs from resorting to formal procedures to tackle financial distress. Many countries use complex systems that unsophisticated MSMEs struggle to understand this complexity; thus discourages timely use of insolvency by MSMEs;
- Creditor behavior – where creditors have few incentives to deal with MSME debtors through legal processes, those that are unsecured generally have limited participation in the process and those that are secured typically focus on enforcement of security at the first sign of financial distress and thus efficiencies may be lost;
- Lack of information about MSME debtors – MSME debtors may lack good records and reliable financial information. This makes it harder to assess the viability of the MSME debtor and erodes creditor trust in the MSME debtor and the effectiveness of insolvency processes;
- Post-insolvency financing – many insolvency systems do not permit or incentivize financing after formal insolvency proceedings are filed even though such financing will be vital to MSME survival. MSMEs are specifically vulnerable to this risk;
- Insufficient assets to fund a formal insolvency procedure – MSMEs often lack the resources to cover the costs and fees for a formal insolvency procedure;
- Personal debts – MSMEs are often financed with a mixture of corporate debt and personal debt taken on by the entrepreneur (including potentially personal guarantees being granted); the failure of the MSME may thus have severe consequences for the entrepreneur and their family including social stigma; and
- Natural persons – MSMEs might be informal entities that have not been incorporated, such as sole proprietorships. In many jurisdictions, they are therefore subject to the same insolvency regime as natural persons, which might not have the necessary commercial controls in place to protect the financially distressed business of the MSME.

This Report comes to the following main conclusions in relation to MSME insolvency:

- Any definition of MSME insolvency should not be overly prescriptive because of the varying definitions of “MSME” around the world;
- As a starting point, consideration should be given to addressing the particular issues that arise in the cases of MSME insolvency through specific MSME provisions in the existing insolvency frameworks; the ICR Task Force members did not endorse, at this stage, establishing separate regimes for MSME insolvency, but they acknowledged that further investigation into this topic is needed;
- Since the majority of MSMEs facing insolvency are more likely to liquidate and not go into reorganization/restructuring (by virtue of their size), frameworks should not only focus on reorganization/restructuring, but also on expeditious liquidation mechanisms;
- Due to the lack of sophistication on the part of MSMEs, jurisdictions should consider providing out-of-court assistance to MSMEs such as mediation, debt counselling, financial education, or the appointment of a trustee (though it is noted that funding such assistance must be considered);
- Further exploration is needed between the intersection of personal insolvency frameworks and MSME insolvency; and
- Further exploration is needed to determine if it is advisable to revise some of the World Bank ICR Principles to provide specific guidance for dealing with MSMEs.

Acronyms and Abbreviations

CPA	Certified Public Accountant
ICR	Insolvency and Creditor/Debtor Regimes
IFC	International Finance Corporation
IMF	International Monetary Fund
MSME	Micro-, Small-, and Medium-Sized Enterprises
NPL	Nonperforming Loan
OECD	Organisation for Economic Co-operation and Development
OHADA	Organization for the Harmonization of Business Law in Africa
SBR	Small Business Rehabilitation
SME	Small- and Medium-Sized Enterprises
UNCITRAL	United Nations Commission on International Trade Law
WB-ICR Principles	World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes

CHAPTER 1

Overview

Micro, small, and medium enterprises (MSMEs) form the foundation of the global economy. Although the diversity and sheer number of MSMEs make it difficult to properly quantify them and measure their impact, they represent the majority of businesses and are key drivers of employment, economic growth, and entrepreneurship in virtually all economies.

Just as MSMEs are present in large numbers, so too do they fail in large numbers. In many economies, they are among the largest commercial users of the insolvency system. Yet many jurisdictions treat them the same, for insolvency purposes, as other corporate entities, or consumers, without regard to their unique attributes. Given that many MSMEs, particularly micro enterprises, are informally organized, commercial legal systems (including for insolvency) tailored to their needs play a critical role in encouraging such informal MSMEs to formalize – a critical step in improving the economic and financial inclusion of the entrepreneurs and employees of informal MSMEs. The report explores the specific challenges of insolvent MSMEs, looks at how legislation in different jurisdictions responds to these challenges, and begins the examination of whether current international standards are sufficient to address the unique challenges, needs, and nature of MSMEs.

MSMEs vary in size and nature, and the term "MSME" encompasses a wide-ranging spectrum of businesses. Most MSMEs fall into the "micro" category, which usually includes sole proprietorships and single-employee businesses. Alternatively, firms at the other end – labeled as "medium" enterprises – may be starkly different from their micro counterparts and have hundreds of employees. This demonstrates that although MSMEs are often categorized under one label, there are vast differences among those companies labeled as such.

Studying MSMEs is difficult because there is no consistent or universally accepted definition of the term. Countries and international organizations apply different measurements and tools when determining whether an enterprise should be labeled as micro, small, medium, or large. Although this complicates the study of MSMEs, it has not hindered the development of a vast body of scholarship.

Regardless of how different countries define MSMEs, it is generally accepted that many of them face common challenges. Informality is one. Many entrepreneurs, for a variety of reasons, forgo formal registration of their enterprise and operate without limited liability. This practice is seen around the world, but it is particularly common in developing economies. However, for many entrepreneurs and shareholders, the difference between an informal and formal corporate structure is limited – in many cases, MSME lenders require personal guarantees to secure loans, meaning the main advantage of a limited liability corporate structure is significantly reduced.

Other challenges that commonly afflict MSMEs are their constrained access to credit and acute difficulty weathering macroeconomic and financial shocks. Furthermore, they may lack the sophistication or knowledge to properly address complex processes with limited resources.

The combination of challenges that MSMEs face makes it more difficult for MSMEs to manage the complexities normally required for insolvency procedures. Perhaps unsurprisingly, MSMEs are one of the business structures that most often undergo insolvency proceedings.

Having an efficient, expeditious insolvency system in place that rescues MSMEs or swiftly reallocates their productive assets to more efficient activities is paramount. Insolvency laws should be designed to allow debtors and creditors to meet and interact to resolve a situation of financial distress, as is deemed most appropriate. There remains a question of whether broad parameters for corporate insolvency systems, as reflected in the international standards, can effectively respond to the needs of MSMEs.

The insolvency process itself can be difficult for MSMEs. Of particular concern is the complexity and length of typical insolvency processes, especially in developing economies where the institutional support is lacking. When an MSME enters financial distress, the solvency of the parties that are personally liable (by operation of personal guarantees or an unlimited liability business structure) for the debts needs to be addressed. Another issue is that many smaller MSMEs may lack funds to cover the expenses of an insolvency process or fail to generate an expectation for unsecured creditors to receive any returns. Therefore, while insolvency laws require that creditors prove their claims, monitor the company either individually or via a creditors' committee, vote on restructuring proposals, etc., there are very limited incentives for creditors to actively participate in the process. Finally, MSMEs usually have more acute issues in obtaining financing during restructuring, whenever the company is viable.

Countries have adopted different approaches toward the issue of MSME insolvency. Many countries treat MSME insolvency with the same general procedures applicable to large corporations or conversely natural persons. Some other countries have tried to address the needs of MSME insolvency by tailoring their insolvency laws. They have done this by shortening timelines for MSMEs, or eliminating certain formalities from the "standard" insolvency law. Other countries have implemented tailored procedures that are specific to MSMEs, or provided some degree of procedural unification for personal guarantors and companies undergoing connected insolvencies. What these country experiences show is that there are typically two ways in which MSME insolvency is being addressed – either first, by making slight modifications or allowing exemptions from certain requirements to the existing provisions in the insolvency legislation, or second, by drafting entirely new provisions that target MSMEs, such as the cases of Japan and Korea.

The Report presents this material in detail with the aim of triggering a discussion and providing inputs to the next stage of the research, which is likely to revolve around whether a specific legislative treatment for MSME insolvency is appropriate or not. The preliminary evidence collected so far suggests that changes to insolvency standards might be a possible remedy to adequately address the specific challenges of MSME insolvency. However, the Report's scope is limited to describing the present situation and does not address solutions to the problems raised.

CHAPTER 2

Understanding MSMEs

LACK OF A CONSISTENT DEFINITION

The term "micro, small, and medium enterprises" (MSME) has different definitions depending on the context and location in which it is used.

The number-of-employees criterion is the most common method of distinguishing MSMEs from large enterprises. This criterion is often combined with other criteria such as sales or loan size.[1] A study by the World Bank found that the definition used by the financial regulators in 50 of 68 countries used the number-of-employees criterion, and 29 of them combined the number-of-employees criterion with the other two criteria. The sales criterion was used in a total of 41 of the 68 countries, and in 15 of the 68 countries loan size was used.[2]

Within each criterion, the exact standard that is used to define what constitutes a MSME varies greatly from country to country and region to region.[3] Regarding the number-of-employees criterion, a study of 122 economies, as seen in Table 1, found that the range of employees that represented the upper thresholds of a medium enterprise varied between 19 employees in American Samoa to 3,000 employees in China (though 249 is a more common upper threshold). The lower threshold that dictates the minimum criteria to count as a micro-enterprise also varies, but to a lesser extent: 83 of 110 jurisdictions set the threshold at one employee, and 27 include companies with fewer than one employee (indicating that sole proprietors are included). Moreover, within some economies' number-of-employees criterion are sector-specific thresholds, as demonstrated by the aforementioned threshold from China, which only applies to MSMEs in the transportation and construction sectors.

To further complicate the matter, in some countries there are different official definitions of what constitutes a MSME based on the ministry, department, or context in which the term is used. For example, a definition of *MSME* assigned by corporate law or regulations may often be different from the definition assigned by other legislation – including the insolvency law or regulations – within the same country.

What all this demonstrates is that the definition of *MSME* is not standardized. Depending on the country, industry, and entity using the term, *MSME* may take on a new meaning. This makes comparisons between jurisdictions difficult. It also means that countries need to be careful in how they define and regulate MSMEs in their legislation. As this research highlights, merely because they are small does not mean that they are less complex.

There is no official definition of *MSME* adopted in this report, but rather we defer to each country's definition – which, as stated, normally contemplates the number of employees alone or along with sales volume and/or loan size. Where necessary and appropriate, a definition may be provided, often in the context of how the term was treated as part of a relevant study. Overall, the report is structured such that its content relies on the respective country's definition, which typically is adapted to its specific circumstances.

ECONOMIC IMPORTANCE OF MSMES

Despite the absence of a uniform definition for MSMEs, there is no doubt that they play a crucial role in the economies of both developed and developing countries. Measuring the impact of

Table 1: Select Sample of How MSMEs Are Measured (Based on Number of Employees)[4]

Economy	Micro	Small	Medium
37 Economies*	1-9	10-49	50-249
7 Economies**	1-9	10-49	50-99
American Samoa	1-4	5-9	10-19
Bahrain, Jordan, Uruguay	1-4	5-19	20-99
China		<300 Industry <600 Construction <100 Wholesale <100 Retail <500 Transportation <400 Post <400 in Hotels & Restaurants	<2,000 Industry <3,000 Construction <200 Wholesale <500 Retail <3,000 Transportation <1,000 Post <800 in Hotels & Restaurants
United States	1-9	10-99	100-499

* Brazil, Bosnia and Herzegovina, Dominican Republic, European Union Member States, Iceland, Moldova, Macedonia FYR, Montenegro, Puerto Rico, Serbia, and Tunisia.
** Bangladesh, El Salvador, Islamic Rep. of Iran, Lebanon, Switzerland, Uganda, and the West Bank and Gaza.

MSMEs, however, can be difficult because many MSMEs (particularly micro-enterprises) form part of the informal economy, meaning they are not formally registered in their respective economies.[5] Kushnir et al state that the difficulty in counting the informal MSMEs is significant because MSMEs often outnumber formal MSMEs, particularly in developing countries. In India, for example, there are roughly 17 informal MSMEs for every formal MSME.[6] High-income countries tend to have more formal MSMEs, whereas informal MSMEs are more common in low-income countries.[7]

Nevertheless, even when accounting for the difficulties in measuring MSMEs, it is clear that they play an outsize role in many economies. In 2010, the total global number of formal and informal MSMEs was estimated to be 420 million to 510 million, and in the developing world there were an estimated 365 million to 445 million formal and informal MSMEs.[8] A 2016 International Finance Corporation (IFC) study of 132 countries found that on average there were 31 MSMEs per 1,000 people, and between 2000 and 2009 the number of MSMEs per 1,000 people grew at 6 percent per annum.[9] The growth rate for MSMEs was lower in high-income countries as compared to low-income countries.[10]

One of the most notable benefits of MSMEs is their contribution to employment.[11] An estimated 60 percent of private sector employment, or one-third of the world's labor force, is attributable to MSMEs (Box 2.1). The value generated by MSMEs is also significant: they represent 52 percent of private sector value added ("value added" is the value of an economy's output less intermediate consumption, or GDP less taxes but including subsidies).[12]

The importance of MSMEs was introduced as a key topic in the G20 agenda in 2010 and most recently reaffirmed at the G20 Antalya Summit in 2015, where leaders placed a "special focus"

BOX 2.1: The Impact of MSMEs on Employment[13]

Formal MSMEs employ more than one-third of the world's labour force.[i] In Canada, for example, small businesses employ 7.7 million employees, comprising 69.7 percent of the total private sector labour force and account for 78 percent of all private jobs created in Canada.[ii] In the European Union, 9.4 million jobs were created in the MSME sector in 27 European Union countries between 2002 and 2008.[iii] From a regional perspective, East Asia and the Pacific have the highest ratio of MSME employment to total employment, driven largely by China, where formal MSMEs account for 80 percent of total employment.[iv] The OECD countries report that MSMEs with fewer than 250 employees account for two-thirds of the formal work force.[v]

on promoting programs that contribute to MSME growth and employment.[14] The importance of them was again reinforced in the subsequent G20 meetings in 2016 and 2017.

MSMEs in Developed Economies

A 2014 report from the Bank for International Settlements found that "[i]n the non-government sectors of advanced economies, [MSMEs] account for over 95 percent of the total number of enterprises, 60 percent of total employment and over 50 percent of value added."[15] On average, 51 percent of the GDP in high-income countries is produced by formal MSMEs.[16] In the United States, 99 percent of all enterprises are MSMEs, and they employ over 50 percent of private sector employees and generate 55 percent of net new private sector jobs.[17] Similarly, in the United Kingdom 99.9 percent of enterprises are MSMEs, and they employ over 60 percent of all private sector employees.[18]

MSMEs in Developing Economies

The influence of MSMEs remains significant in low-income countries, although their impact is harder to measure because of higher levels of informal MSMEs. An estimated 16 percent of GDP in low-income countries is produced by formal MSMEs[19], and the informal MSME sector contributes about 40 percent of GPD.[20] In specific countries, the impact of MSMEs on GDP is evident – in Morocco, for example, "93 percent of industrial firms are [MSMEs], accounting for 38 percent of the production, 33 percent of investment and 30 percent of exports," and in South Africa an "estimated 91 percent of the formal business entities [...] that are [MSMEs] contribute 52-57 percent to GDP."[21] In Ghana, MSMEs contribute about 70 percent to the country's GDP.[22] Overall, an estimated 33 percent of employment in developing countries comes from formal MSMEs.[23]

THE CHALLENGES CONFRONTING MSMES

MSMEs often face specific challenges that make them fundamentally different from large enterprises. By definition, MSMEs are smaller, and they often have less capital, a lower market share in their respective markets, a smaller workforce, and fewer resources overall as compared to large enterprises. These factors result in MSMEs operating differently from larger businesses, and accordingly the challenges and obstacles they face are unique. The specific challenges confronting MSMEs also have consequences in the insolvency field, as highlighted more in depth in the next chapter.

MSMEs fail in significant numbers. A 1999 study that analyzed bankruptcies in the United States found that 80 percent of U.S. firms that filed for bankruptcy had assets under USD 1 million, and 88 percent had fewer than 20 employees.[24] Understandably, part of the explanation of why MSMEs fail in such large numbers is simply because they constitute the largest proportion of private sector businesses.[25] However, their small size and scope of operations contribute to their high failure rates. As Davis et al suggest, MSMEs often have undiversified suppliers and customers, making the loss of a significant counterparty or a late payment more unsettling. In addition, MSMEs frequently lack the resources to afford assistance from legal and financial experts.

Given that MSMEs are typically unable to access finance at levels similar to larger enterprises, MSMEs often have difficulty weathering macroeconomic and financial shocks, as observed in Denmark, Italy, Spain, and Ireland when MSME insolvencies exceeded 25 percent from 2007 to 2009 during the global financial crisis.[26] Accessing credit is necessary for many businesses to fund growth or to sustain operations during periods of cash flow misalignment. Underserved or unserved financing needs may push an enterprise into insolvency. The IFC estimates that half to two-thirds of formal MSMEs lack proper access to finance.[27] The total unmet credit need for formal and informal MSMEs around the world is estimated to be USD 3.1 trillion to USD 3.8 trillion. In emerging markets, the total unmet need for credit is USD 2.1 trillion to USD 2.5 trillion.[28]

What is striking about the credit gap affecting MSMEs is how it affects discrete groups within the MSMEs category. When focusing on formal enterprises (on which there are more data available than informal enterprises), the credit gap is most acute in emerging economies. Fifty-two percent to 64 percent of emerging market microenterprises have unmet financing needs representing USD 400 billion to USD 500 billion. Among SMEs, 55 percent to 68 percent of have unmet financing needs, representing USD 900 billion to USD 1.1 trillion. In comparison, the credit gap in developed countries is USD 100 billion to USD 200 billion, and USD 600 billion to USD 700 billion for microenterprises and SMEs, respectively.[29] Among Organisation for Economic Co-operation and Development countries (OECD), the stock of outstanding loans to MSMEs increased in 16 of 27 countries from 2013 to 2014, but it remains below 2007 pre-crisis levels in seven countries (when adjusted for inflation, the number rises to 12).[30] The OECD suggests that among its members, the financial crisis continues to have a long-lasting impact on the provision of financing to MSMEs, making it difficult for MSMEs to secure credit in some economies.[31]

For many MSMEs, the cost of credit is prohibitive because they are often subject to high collateral thresholds. For those that can secure debt, lenders frequently charge higher interest rates and fees as compared to larger enterprises.[32] Labor growth is also related to the ability to access finance. MSMEs that have access to financing have employment growth 1 to 3 percentage points higher than enterprises with no access to finance.[33] Moreover, increased access to finance has been correlated with higher numbers of MSMEs in an economy, thereby compounding the benefits of increased access to finance.[34]

Furthermore, many entrepreneurs must take a high level of personal financial risk to start a MSME, the most common of which is personally guaranteeing business loans. MSME owners are often required to give personal guarantees to secure loans, and in the event of bankruptcy, this means that individuals may be liable regardless of whether the business was a corporate entity. This could result in a lifetime of debt depending on the circumstances and governing legislation, thereby deterring entrepreneurs from re-entering the market.

Entrepreneurs are further afflicted by the difficult task of securing start-up capital. As previously discussed, access to credit is already difficult for MSMEs with existing business operations – understandably, getting start-up loans is even more difficult. This is a greater constraint in emerging economies where angel finance, seed capital, and even venture capital tend to be considerably underdeveloped. As the above suggests, MSMEs face a number of challenges in their normal operations that many larger enterprises do not. When entering the zone of financial distress, new challenges appear, as described in the following chapter.

CHAPTER 3

MSMEs in Relation to Insolvency Law

HAVING AN EFFICIENT INSOLVENCY SYSTEM IS CRITICAL – ESPECIALLY FOR MSMES

As mentioned in Chapter II, MSMEs play a large role in the global economy. They also fail in large numbers. Since MSMEs are large users of insolvency systems, it is necessary to ask whether existing insolvency frameworks address the needs of MSMEs.

Effective insolvency regimes, if properly implemented, may mitigate many of the challenges facing MSMEs, as outlined in the previous chapter. Consider access to credit – this is one of the greatest challenges plaguing MSMEs, and it can be mitigated by efficient insolvency systems. By replacing out-of-date insolvency legislation with a more effective regime, lender confidence is increased because the improved insolvency process provides lenders with more certainty and predictability in regard to the recovery of defaulted loans.[35] This increases the amount of credit available in an economy and in turn reduces the credit gap.

In addition, the issue of MSME insolvency is of importance to the World Bank Group agenda of financial inclusion, which is considered as a key enabler to reduce poverty and boost prosperity. Financial inclusion focuses on providing individuals and businesses access to useful and affordable financial products and services that meet their needs.[36] Clearly, as described throughout this report, if creditors have greater assurance of debt recovery through insolvency regimes, they will be more likely to provide financing through more innovative and better-suited financial products. It should be noted that for the purposes of this report, the focus is on how formal insolvency procedures can help address MSME financial distress. However, informal procedures, such as workout frameworks that take place without any court involvement, or hybrid procedures with limited court/institutional involvement, are also key in helping preserve viable businesses and encouraging creditor-debtor dialogue and restructuring. Moreover, as workout regimes typically involve informal and private negotiations, they provide greater flexibility, confidentiality, and less onerous administrative requirements, which is particularly useful when dealing with MSMEs. Further information on informal workouts and the different models they take can be found in other World Bank Group publications.[37]

As seen in Box 3.1, effective insolvency regimes form part of a well-functioning economy. The better these insolvency regimes can address the challenges and unique characteristics of their users, the better the outcome for the economy. In regard to MSMEs, an insolvency law is of particular importance to promote risk-taking and entrepreneurship, and reduce the stigma of bankruptcy, which can have widespread, and sometimes tragic, social consequences.[38]

BOX 3.1: "The Importance of Insolvency Law"[39]

Insolvency regimes that are responsive to the needs of MSMEs are particularly important. Insolvency law is broadly recognized as an essential tool in a well-functioning economic framework.[i] A balance of mechanisms that allow for timely and effective liquidation, but also for a "fresh start" for entrepreneurs and rehabilitation of viable businesses tends to enhance creditor recoveries and confidence. In turn, they can stimulate greater volumes of lending,[ii] at longer maturity periods,[iii] at lower cost[iv] and lower levels of collateral.[v] Such mechanisms can also offer an effective framework for the creation of new business activity.[vi] Credible restructuring schemes can ensure that businesses with viable going-forward business plans can survive, in turn preserving jobs, supply contracts, customer goodwill, and economic stability more generally.[vii] From a macro financial perspective, effective insolvency laws enable financial institutions to resolve problem assets more efficaciously, thereby freeing up provisioning resources, strengthening investors' perception of financial sector stability, *pro tanto* improving banks' ability to lend, and thus particularly benefitting small and medium enterprises in many economies where such businesses are particularly dependent on bank funding.[viii] The World Bank has observed that effective insolvency systems enhance predictability and thus lender confidence in loan recovery on default, which encourages more lending and leads to financial inclusion for more businesses.

Of significance for MSMEs globally are both the formal legal rules and informal societal rules and practice norms that affect entrepreneurs, including the design of bankruptcy laws, the structure of capital markets, and the perception of stigma related to personal responsibility.[ix] Cost-effective insolvency proceedings can encourage inefficient firms to exit, encourage greater entrepreneurial activity and new firm creation, and can result in greater returns to creditors.[x] Timely resolution of financial distress can reduce uncertainty for entrepreneurs, creditors and management, and improve asset value and transparency.[xi] A well-functioning MSME insolvency regime can heighten the salience of the downside risk of a venture, in turn increasing the number and variety of people pursuing entrepreneurial activities.[xii] It can benefit lenders because of the certainty in recovery rules, in turn increasing confidence in lending.

The efforts of organizations such as UNCITRAL and the World Bank have contributed significantly to creating model insolvency legislation, best practice guidance, and to helping governments implement reforms.[xiii] The effectiveness of insolvency laws nevertheless varies among countries around the world.[xiv] According to a survey on debt enforcement in 88 countries, referenced by a World Bank Research Paper, bankruptcy procedures are time-consuming, costly and inefficient in being able to preserve the business as a going concern; in only 36 percent of countries is the business preserved as a going concern; and an average of 48 percent of the business's value is lost in debt enforcement.[xv] The World Bank Group *Doing Business* report for 2014 found that among 38 selected indicators/measures of the regulatory and institutional environment, the secured creditor recovery rate in distress scenarios was the single most valuable measure.[xvi]

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

Better legislation can reduce the cost of credit. This is important for MSMEs because a lower cost of credit makes financing more accessible and affordable. In Brazil, reforms to its insolvency legislation caused an average reduction in the cost of credit ranging from 7.8 percent to 16.8 percent from the level prior to the reforms being enacted. A study involving SMEs in France, Germany, and the United Kingdom found that banks priced their loans based on their expected rights in the event of a default. Conversely, "creditor unfriendly" insolvency regimes resulted in higher costs.[40]

When companies undergo reorganization and business rescue, job preservation is promoted with efficient insolvency laws. In the United Kingdom, revised reorganization laws resulted in new owners retaining all of an enterprise's employees in 65 percent of receivership and administration cases where the business was sold as a going concern.[41] Job preservation for MSME employees is particularly important because MSMEs are the largest source of employment in many economies.

Effective insolvency regimes can also be used to spur entrepreneurship and reduce the personal risk that individuals who create enterprises are forced to shoulder. If a business defaults on a loan that the entrepreneur personally guaranteed, then that guarantor is liable to repay the business's debts. This may result in the guarantor being held liable for the business's debts long after bankruptcy. Debtor-friendly personal bankruptcy laws provide a safety net for entrepreneurs. By granting debtors some concessions, individuals are less likely to be deterred from pursuing entrepreneurial ventures because of the risk of guaranteed loans, and experienced entrepreneurs who undergo bankruptcy can quickly recover from their mistakes and re-enter the marketplace. Although entrepreneurship is hard to measure, economies with effective insolvency laws are known to have higher levels of venture capital funding (venture capital is often used to fund entrepreneurship, so higher levels of venture capital funding suggest higher levels of entrepreneurship).[42]

Finally, as referenced in Box 3.1 above, an insolvency regime for MSMEs might be needed on a temporary basis, to specifically and urgently address MSME financial distress arising in a crisis, similar to what several European countries experienced in the wake of the global financial crisis.[43] In such situations, MSME weaknesses can further erode banks' asset quality and profitability, with increasing levels of NPLs economy-wide. The faster the banks' balance sheets can be strengthened, the easier it will be to free up credit for new loans.[44] Although the analysis of MSME financial distress in a crisis context is not within the scope of this report, it should be noted that the International Monetary Fund (IMF) has examined different tools that European countries implemented to quickly and effectively deal with debt recovery following a crisis.[45] For instance, the analysis mentions Latvia, Moldova, Portugal, and Ukraine as introducing fast-track court approval procedures to support the rescue of viable businesses at an early stage, and other countries implementing out-of-court restructuring frameworks, such as Portugal, which adopted guidelines to facilitate debt recovery through mediation, with a specific focus on MSMEs.[46]

SPECIFIC CHALLENGES OF MSMES ENTERING INSOLVENCY

Apart from the challenges outlined in the previous chapter regarding MSME operations in normal circumstances, there are several challenges that arise specifically when MSMEs face acute financial distress. These challenges include a lack of incentives to access the insolvency procedure, creditor passivity, limited information, overlaps with the personal insolvency regime, and difficulty accessing new finance. Another challenge, more closely related to the end of a MSME's existence, is how to deal with insolvency cases where the MSME's assets are insufficient to cover the cost of the proceedings (the so-called "no-asset cases" or "insolvent insolvencies"). It is also worth mentioning that the absence of reporting requirements and frequent informality of MSMEs may exacerbate the difficulties of identifying financial distress at an early stage. These challenges are not exhaustive and they are not always present, but they are the most common and often the most concerning.

The challenges discussed below may afflict large enterprises as well as MSMEs. However, they arise more frequently in MSME insolvency proceedings than in large enterprise insolvency proceedings.

Incentives to Access the Procedure

Prior to entering an insolvency proceeding, many MSMEs are disadvantaged because they lack the sophistication to identify and react to financial distress.[47] This may result in MSMEs waiting too long before initiating the insolvency process. This problem is particularly acute for MSMEs given the limited incentives they have for starting a complex and burdensome proceeding, often without an effective business rescue framework, as is the case in many of the insolvency processes around the world. Also, the social barriers[48] and reputational stigma associated with the insolvency system may discourage MSME representatives from resorting to formal insolvency proceedings. Davis et al have summarized this challenge as follows:

BOX 3.2: "The Debtor's Position, Role and Obligations in MSME Insolvencies"[49]

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

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

The problems, however, do not only lie with the lack of use of the insolvency system. If and when the lack of rescue culture, the social stigma, and poor market perception are overcome, problems may nonetheless arise concerning the manner in which debtors utilize the MSME insolvency regime.

In many countries, insolvency laws are designed with the complexity and sophistication of large companies in mind. For a MSME, the complexity of insolvency proceedings often is a disincentive to seek timely remedies to financial distress. Some features in insolvency systems that may play a disincentive role are: (1) the automatic separation of management from the ordinary administration of the business upon filing for insolvency (including rehabilitation); (2) the copious documentation required to start the process that often includes a legal requirement to file audited balance sheets for several periods; and (3) the uncertainty in the costs generated by the many participants involved in the process.

Regardless of whether a MSME is a corporate or not, directors tend to delay filing for a formal insolvency process. Several corporate insolvency systems contemplate "sticks" when directors fail to access the insolvency procedures in a timely way – when entering the so-called "twilight zone" period – that often include a duty to file for insolvency or a regime based on wrongful trading. The World Bank Principles addressed this issue in their latest revision (2015) in Principle B2:

> "Laws governing directors' obligations in the period approaching insolvency should promote responsible corporate behavior while fostering reasonable risk taking and encouraging business reorganization. The law should provide appropriate remedies for breach of directors' obligations, which may be enforced after insolvency proceedings have commenced[50]."[51]

As described by David et al in Box 3.3 below, a pre-insolvency regime that focuses on facilitating the rescue of viable businesses is particularly critical for MSMEs, and can help address debtor moral hazard.

BOX 3.3: "MSME Obligations at Times Approaching Insolvency"[52]

When insolvency is imminent, debtors should have greater regard to the interests of creditors and should attempt to address the distress situation. Yet, at that time, small entity debtors may be very reluctant to access the insolvency system, concerned about stigma, about losing their business, which is likely their only source of income, and being overly optimistic about the business' prospects. Debtors may also be prone to adopt more high-risk strategies, attempting to avoid at all costs losing their business or the business' assets. They may be inclined to collaborate with related persons or powerful creditors, hide or dispose of assets. The problem is particularly acute where debtors use the corporate form for their MSMEs. Incorporated MSME managers, who are likely to also be the business owners, may consider that they are safe from the outcomes of insolvency as they are protected by limited liability. Small debtors are also likely to be less concerned about returning to the managerial labour market and thus more prone to act self-servingly. Unincorporated MSMEs may take excessive risks if they consider that they will be released from liabilities through an insolvency discharge.

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

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

Incentivizing MSMEs to file for insolvency procedures is challenging – and incentivizing them to do so in a timely fashion is even more challenging. This is especially the case when MSMEs operate as unincorporated entities and when they are family businesses. It is legitimate to pose the question of whether a tailored MSME insolvency regime could generate more incentives – and how to achieve the objective of MSMEs tackling distress in a timely way.

Creditor Passivity

MSME insolvency systems require that debtors and creditors put an early effort into resolving the business's issues in a timely manner, and pre-insolvency regimes (that are used to pre-emptively dealing with financial distress before businesses are insolvent) are becoming increasingly important. Regarding financial creditors and MSMEs, this is most likely to involve only one or two institutions. However, creditor passivity can hamper this process, as early and proactive actions result in the best outcomes.

Creditor passivity often arises when creditors weigh the amount they estimate they will receive from participating in the insolvency process against the amount of time and money this effort requires. If the costs outweigh the return, then creditors make the rational decision to not get involved.

In many large enterprise insolvency cases, the value of the debt to which creditors have a claim is high. The potential for recovering this claim is increased because large enterprises often tend to have large estates with many assets. In these cases, the expected return for participating creditors outweighs the costs of participating, so creditors are more active in the insolvency process. In the case of many MSME insolvencies – particularly those where the debtor is toward the "micro" end of the spectrum and has few assets – the return that creditors can expect to receive is simply not high enough to justify the costs of participating. In these cases, creditors choose to remain passive.

BOX 3.4: "Creditor Passivity and Reckless Behaviour"[53]

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

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

In the context where the approval of restructuring plans requires the majority of stakeholders to vote positively, creditor passivity makes it more complicated to save the business, even when the business is viable.

Limited Information during Insolvency

Ineffective gathering and dissemination of information to relevant parties can strain the insolvency system. As seen in Box 3.5, the insolvency system works best

BOX 3.5: "Addressing Information Gaps"[54]

One of the main obstacles to the proper implementation of a MSME system, and a major contributing cause of debtor misbehaviour is the absence of adequate information in the MSME insolvency process. An effective MSME insolvency system would work substantially better if the debtor provides the necessary information and is willing and available to collaborate throughout the entire procedure. In some cases, and in some jurisdictions, however, particularly in the less developed economies, the very existence of the information cannot be taken for granted.

when debtors provide creditors and other relevant parties with the information they require. Many debtor MSMEs, however, may have difficulty collecting and disseminating the required information because of inefficient or non-existent recordkeeping systems, whether caused by a lack of resources or simply not seeing a need for them.

The informal nature of many MSMEs, particularly in developing countries, further complicates recordkeeping. The legal obligations imposed on informal enterprises are often less stringent than those applied to formal enterprises (particularly large and publicly traded ones). Large corporations often maintain sophisticated records that are available to shareholders, creditors, and the public. MSMEs – even those that are formally registered but not publicly traded – have fewer reporting requirements, thus lowering the obligation to engage in comprehensive recordkeeping.

The issues arising when records are not kept up or kept at all are most problematic in relation to financial information, as discussed in Box 3.6. Out-of-date or non-existent record books make it hard to judge whether a MSME is approaching insolvency,

BOX 3.6: "Financial Information in MSME Insolvency"[55]

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

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

essentially preventing the MSME from proactively addressing the impending situation. Insolvency laws are usually very detailed about the documents required from debtors, which enable them to file for a voluntary insolvency process. Balance sheet information is needed, for example, to prepare the list of creditors and calculate assets and liabilities, which are required by most insolvency regimes. Many MSMEs, especially those on the "micro" end of the spectrum, struggle to provide such basic information because of inadequate recordkeeping.

Accessing Financing during the Insolvency Proceeding

Accessing finance is vital for MSMEs, even more so when they face financial distress. Many insolvency systems do not make it easy for MSMEs to access post-filing or post-commencement financing, even though survival of the enterprise may depend on it with the alternative being liquidation. For example, out-of-date legislation does not allow a super-priority to be granted to those creditors that provide a MSME with additional finance. The importance and challenges of accessing financing for distressed MSMEs has been described in Davis et al (Box 3.7).

BOX 3.7: "Financing MSME Proceedings"[56]

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

It should be stressed, however, that there does not appear to be a single effective strategy for financing of MSMEs in distress, given the size and range of such businesses. The universal features to consider when designing the framework must be efficiency and affordability. Implementation should be left to national variations, based on different socio-economic contexts and variety of legal traditions.

Most traditional insolvency systems do not consider the possibility of super-priority for fresh funds, or provisions that encourage access to finance for companies undergoing rehabilitation.

Consideration should be given as to whether, in the specific case of MSMEs, provisions of this nature could be introduced and how.

Overlaps between Business Insolvency and Personal Insolvency Regimes in the Case of MSMEs

A particular issue that arises for MSME insolvency is the overlap and conflicts between regimes for insolvency of businesses and regimes for insolvency of natural persons.

Whereas one of the main purposes of a business insolvency regime is to ensure the orderly resolution of debt and distribution of value to creditors whenever the business is unviable (frequently involving the dissolution of the debtor company), the purpose of a personal insolvency regime is to couple, and also balance the distribution of value to creditors with a basis for the debtor to continue their economic life (since, once the insolvency process for a natural person is concluded, the debtor will usually still be in existence). The nature of many MSMEs, particularly microbusinesses, is such that a clear distinction between the business and the persons operating it does not always exist and it is not clear which insolvency regime (business or personal) is better suited to apply to MSMEs. A MSME may be incorporated as a corporate entity or unincorporated; from a legal standpoint, this has several consequences for the limitation of liability and applicability of a personal or corporate insolvency law regime to the business, depending on each country's legislation.

Overview of issue

In contrast to the insolvency of large corporate entities, where the owners, directors, employees, and debt providers are largely separate and distinct classes with distinct interests, in the case of MSMEs, these roles may significantly overlap. As discussed in Chapter I, MSME entrepreneurs may not comply with corporate registration requirements or even establish companies and (as discussed in more length below) may provide personal guarantees to creditors of the MSME.

In the case of a large corporate entity: (1) the entity will frequently receive debt funding from external lenders (many of whom will not have any equity interest in the entity); (2) there will be at least some equity providers who have no other interest in the company; (3) the company will be controlled by directors who are supported by equity holders (but will themselves be employees with usually low levels of equity themselves); and (4) the entity will employ other employees who have no relationship (such as debt or equity) with the entity other than their contracts of employment. The application of the insolvency regimes to such large corporate entities will usually not impact the personal assets or status of the directors or employees of the entity (except to the extent they hold equity, which is lost because equity holders are typically the lowest ranking creditors of the entity). Creditors are looking to the assets of the company only so that the corporate veil is fully maintained in legal proceedings (except where there has been fraud or other breach of duty by employees of the entity).

A MSME, however, will, even if it is a company, frequently feature the directors of the entity providing not just equity but also debt funding to the company. There will often be poor or non-existent records of transactions and relationships between entrepreneurs and the company. There may be no clearly established ownership of key commercial assets (such as tools or other essential equipment) between the controllers and the company (since the controllers may, as founders of the business, have simply purchased commercial assets themselves with their own money) and the entrepreneur and their family may engage in work and activity for the MSME that is not documented or remunerated following typical commercial practices. The entrepreneur may use personal monies to fund or support the business without necessarily documenting such expenditures as a loan to the business or in any other way. The money that an entrepreneur invests in a MSME may itself be borrowed from a creditor who expects to look to the natural person as the relevant debtor, not the MSME. The personal assets of the entrepreneur may also be of equal or greater value than that of the MSME; this would encourage lenders to seek recourse personally to the entrepreneur, not the MSME. This is especially true in economies where the commercial practices still have a strong personal component (e.g., where credit information systems are underdeveloped).

In such circumstances, even where there is, as a matter of law, a corporate veil in place because the MSME business was established as a separate legal entity, as a matter of fact there will be little distinction between the affairs of the MSME and the personal affairs of the entrepreneur. These issues are most prevalent in the case of micro and small businesses in developing economies.

It can, therefore, be argued that at least some MSMEs operate, and are lent to by creditors, in such a way that the assets and/or legal status of the entrepreneur can hardly be meaningfully distinguished from the MSME.

Practical effects of the issue

Where relevant legal regimes permit, creditors have developed a particular commercial and risk-management solution to deal with the nature of many MSMEs when there is a high degree of involvement with an entrepreneur's personal affairs and/or the personal assets are of greater value than the business assets. In such circumstances, creditors seek to bring the personal assets of the entrepreneur within the scope of MSME insolvency through personal guarantees and security over personal assets. A personal guarantee typically extends liability for the debts of the MSME to the entrepreneur; the effect of this is that personal effects as well as business assets owned personally by the entrepreneur may be affected by the insolvency of the MSME (so that even if the MSME is a legal entity, the corporate veil is effectively pierced). Also, where a personal insolvency regime exists, it may be triggered in parallel to the business insolvency regime applying to the MSME. When an entrepreneur owns a home, lenders typically take security over it, since an entrepreneur's residential property may often be of greater value than the business assets of the MSME or other personal assets. Arguably, from a creditor perspective, the problem can be solved where there are personal assets to lend against so that creditors do not need to consider the relationship between the entrepreneur and their MSME nor the potential impact of personal insolvency law. An added complexity is that many countries do not have a personal insolvency system in place, which jeopardizes the chances of the personal debtor to obtain a "discharge." Providing the entrepreneur with the opportunity for a fresh start is essential, as recognized by the World Bank in earlier publications[57] and more recently recognized by the European Commission in its recommendation on a new approach to business failure and insolvency. The European Commission also proposed a new Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency, and discharge procedures.[58]

The creditor solution of seeking personal guarantees and/or security over personal assets effectively amounts to extending the reach of business insolvency regimes to personal assets. This may raise a series of policy questions that relate to the intersection with personal insolvency regimes. A particular concern is that personal insolvency regimes typically carve-out certain assets from the reach of creditors, considering those assets practically inappropriate for the discharge of debts. Another issue that may require further analysis is the applicability of a personal insolvency regime (or not) to an unincorporated MSME and the process to separate business assets from personal assets to respond to commercial debts. For all intents and purposes, lenders' use of personal guarantees and taking of security over personal assets result in there being no corporate veil for affected entrepreneurs; this has significant implications in the many jurisdictions that have no personal insolvency regime and thus subject debtors to lifelong debt repayments. The absence of any personal insolvency laws coupled with creditor policies may run contrary to longstanding policy aims of enabling business failure and debt write-off to encourage entrepreneurship.

Considering the significant proportion of businesses that are MSMEs in developing economies, it is clear that practical consequences of the overlaps between business and personal insolvency issues is significant and consideration may be given to treat these issues specifically in the World Bank ICR Principles.

Insufficient Assets to Fund the Insolvency Proceedings

Related to the challenges above, many MSMEs that meet the criteria for commencement of insolvency proceedings are never formally declared bankrupt and liquidated. Often, this is because MSMEs tend to wait too long to file an insolvency petition, to the point that when the petition is filed, the remaining funds are insufficient to cover even the administrative costs and fees, let alone provide any meaningful recovery to creditors. While this may not be a MSME-specific issue, in reality, MSMEs are more likely to face such a scenario. As explained above, the reasons for that are multiple: (1) lack of sophistication to navigate the complex insolvency system if the country does not have a simplified MSME regime (Box 3.2); (2) greater perception of stigma related to personal responsibility in the case of failure[59]; and (3) lack of sufficient internal control mechanisms, as prescribed by general corporate law for large corporations.

As a result of lateness, many MSME insolvency filings are classified as no-asset cases and insolvency laws differ in their approach to their administration. Despite the prevalence of no-asset cases in judicial practice across a number of jurisdictions, especially in developing countries, few insolvency laws provide a mechanism for their administration.[60] While creditors (especially unsecured) would prefer to open proceedings and pursue the recovery of hidden or transferred assets in order to maximize their chances of meaningful recovery, this can entail significant costs (e.g., the remuneration of insolvency practitioners and experts, court fees, etc.) that exceed the potential benefits. In many instances, only a close examination of these cases can uncover the debtor's full financial situation, possibly enable the avoidance of transactions or allow creditors to hold the debtor liable for malfeasance, and request compensation.

The approach of an insolvency regime to no-asset insolvencies may have a considerable effect on debtor and creditor incentives and influence the conduct of the debtor on the verge of insolvency. While a MSME might be in a no-asset situation because of normal business practice, or lack of sophistication and perception of stigma, as explained above, it could also result from improper business conduct. For instance, debtors may take unreasonable risk as they approach insolvency, gambling for their recovery in an attempt to avoid an insolvency filing and continue the operation of their business. The absence of assets may also be the result of fraud, with debtors taking money out of a business for personal use, concealing or transferring assets to related parties, and engaging in similar practices that might contribute directly to the failure of the business. Thus, no-asset cases not only present issues relating to the preservation of economic value and creditor recovery, but also relate to the integrity of the insolvency system and its role in setting the right incentives for debtors by promoting responsible risk taking and encouraging fair commercial conduct.[61]

There are currently at least two approaches to dealing with no-asset insolvency cases:

- Some insolvency laws provide that when, at the time of filing, it appears prima facie that the debtor's assets are not sufficient to cover the costs, the court should deny the petition, or order termination of the proceedings, if the absence of sufficient assets is determined post opening[62]; and
- Some insolvency systems not only provide for opening the proceedings in such circumstances, but also provide a specific mechanism to cover the necessary funds either by requiring the petitioning creditor(s) to provide them individually or by creating a specially designated fund, financed by individual creditor contributions and/or the public budget.

Greece and Poland are among the countries that have opted for not opening insolvency proceedings if the debtor's assets are not sufficient to cover the costs.[63] Thus, debtors are not declared bankrupt, and remain in the Business Registry (sometimes called "zombie companies").

Bulgaria, Serbia, and Romania, where no-asset cases present a significant percentage of all insolvency filings, have chosen other approaches. The Bulgarian Code of Commerce (Art. 629b) provides that, when the debtor's assets do not cover the expenses of proceedings, the court may determine the amount required to cover the administrative expenses, set a time limit for creditors to advance this amount, and open insolvency proceedings. When the amount is not advanced within the specified time limit, the debtor is declared insolvent and proceedings are immediately terminated.[64]

In Serbia (Art. 13, Serbian Bankruptcy Law), bankruptcy proceedings are terminated immediately when it is established that the value of the debtor's assets is lower than the expenses of the bankruptcy proceeding or that the debtor's assets are of negligible value. However, any petitioner, the debtor or a creditor, may request the continuation of proceedings if it deposits the necessary assets to cover the expenses of proceedings, as prescribed by the bankruptcy court.

The establishment of a fund to cover expenses in no asset insolvencies can be found in several jurisdictions. For example, in Armenia, under the Law on Bankruptcy (enacted in 2006, as amended in 2016), the absence of sufficient assets to cover the costs of proceedings is not grounds for rejection of the insolvency petition or the termination of insolvency proceedings. Proceedings are opened, and court fees and remuneration of the insolvency administrator are covered by the country's public budget.

The way an insolvency system deals with no-asset cases is an important policy decision that is usually affected by many factors such as the country's legal tradition, the public perception toward debt and fraudulent debtors, and so on. The prima facie rejection of such cases may result in reduced creditor recovery and "zombie companies" that are not properly liquidated. Additionally, the rejection of no asset cases creates the potential for owners/directors to avoid liability for malfeasance, since their business is never subject to court bankruptcy proceedings.

Considering MSMEs are most likely to face a no-asset insolvency situation, it may be worthwhile exploring whether the insolvency system could envisage a mechanism for opening and administering such proceedings, specifically in the context of MSME insolvency.

CHAPTER 4

Responses to MSME Insolvency Issues

IS IT NECESSARY FOR THE INSOLVENCY SYSTEM TO TREAT MSMES DIFFERENTLY?

If an insolvency regime is compliant with international standards and effectively addresses many of the challenges facing large corporations, the issue then becomes whether such an existing insolvency regime can also provide MSMEs with these benefits. As Davis et al write in Box 4.1, the common practice of using the same or similar insolvency procedure for MSMEs and large enterprises may produce suboptimal results. Instead, they suggest that MSMEs may be better served by a separate insolvency system that is specifically designed for MSMEs.

As stated in the overview, the purpose of the paper is simply to trigger a discussion on these matters. Although Davis et al present a compelling argument for creating a new insolvency regime specific to MSMEs, further investigation is needed. The following section examines how existing standards treat MSMEs, and whether changes to these principles can better address the challenges MSMEs face. The chapter concludes with case studies on how countries approach MSMEs in their existing legislation.

HOW EXISTING STANDARDS DEAL WITH MSME INSOLVENCY

The World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes, together with the United Nations Commission on International Trade Law (UNCITRAL) Legislative Guide on Insolvency, are the internationally recognized benchmarks for Insolvency and Creditor/Debtor Regimes (ICR), both in respect to in-court and out-of-court processes. They form the basis for the analysis conducted by the World Bank Group in the ICR Report on the Observance of Standards and Codes (ROSC). In this section, we consider the application of principles for in-court processes to MSME insolvency. Under the ICR Initiative, the World Bank Group carries out its mandate as a global standard setter for ICR systems, together with the UNCITRAL, as designated by the Financial Stability Board.

One of the main questions that persists in the treatment of MSMEs in insolvency is whether there are sufficient tools in the international domain to help guide countries in their domestic law reform processes. As noted above, the two primary international instruments – jointly designated as the international standard by the Financial Stability Board – are the World Bank Principles and the UNCITRAL Legislative Guide on Insolvency Law. UNCITRAL does mention small businesses in the Legislative Guide. The Legislative Guide aims to provide a comprehensive statement of the key objectives and principles that should be reflected in a State's insolvency laws. While it provides a valuable reference tool for national legislative authorities by reviewing the adequacy of their laws and regulations or enacting new ones, and discusses the obstacles facing small creditors in terms of barriers to participation, there are few policy suggestions specifically for MSMEs. Part one of the four-part Legislative Guide discusses the key objectives of an insolvency law, the types of mechanisms available and the institutional framework required to support an effective insolvency regime. It does not specifically address the particular challenges facing MSMEs that have been highlighted in this Task Force paper, aside from briefly noting that the

BOX 4.1: "One Size or Strategy for MSME Insolvency Will Not Fit All"[65]

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

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

As noted [in the previous chapter], the owners of small businesses usually need to secure business loans with their personal assets or personal guarantees, creating a convergence and blurring of distinctions between personal and business liability in practice, a factor not accounted for in most insolvency law regimes globally. Researchers have observed that while the personal guarantee of a firm's owner might encourage a level of financial discipline, in countries without a personal bankruptcy framework, a single business failure can doom an owner to a lifetime of outstanding debt;[i] effectively preventing such individuals from re-entering the market as experienced.[ii] Evidence suggests that exactly the opposite approach better serves standard public policy objectives. One study that compared self-employment in 15 countries in Europe and North America from 1990-2005 found that the more forgiving the personal bankruptcy laws, measured particularly in reference to the time a bankrupt individual has to wait to be discharged from pre-bankruptcy debts, combined with ready access to limited liability protections, the more entrepreneurial activity was enhanced.[iii]

The failure to recognize this convergence of personal and business debt means that debtors may have access to effective liquidation or rehabilitation schemes only if they fit within very specific criteria. For example, in Canada, there is a highly streamlined mechanism for MSME businesses under Division II consumer proposal provisions of the *BIA*, which are accessible to self-employed individuals and sole proprietors whose debts are less than 250,000 CAD (USD 185,435), excluding a mortgage or hypothec on the individual's principal residence, if 50 percent or more of their debts are business-related.[iv] But these mechanisms are not available where the individual has incorporated the business.

Nor are insolvency regimes only relevant to one end of the MSME lifecycle. Access to credit is particularly important for MSMEs. The global MSME lending volume is estimated to be 10 trillion USD, of which 70 percent is in high-income OECD countries.[v] On average, small and medium enterprise loans constitute 13 percent of gross domestic product ("GDP") in developed countries and 3 percent in developing countries.[vi] In a survey of 130,000 firms in 135 countries, the World Bank Group found that there is unmet demand for bank loans and lines of credit in developing regions, particularly Africa.[vii] The survey found that while almost 60 percent of businesses require a loan at some point, just over a third of businesses have a loan or line of credit. The survey results revealed that well-designed insolvency laws are a factor in accessing credit, directly related to creditor confidence in the ability to recover.[viii] In turn, access to credit can assist with fostering entrepreneurship and the creation of new business activity.

costs and fees associated with accessing insolvency proceedings may be of particular importance to small- and medium-size businesses.

Part two of the Legislative Guide deals with core features of an effective insolvency law, including standardized commencement criteria, stays, post-commencement finance, participation of creditors, expedited reorganization proceedings, simplified claims procedures, conversion of reorganization to liquidation, and clear rules for discharge of the debtor and closure of insolvency proceedings. While these elements are directly relevant to MSMEs, they assume that debtor companies have the financial and human resources to undertake the processes envisioned, which is not the reality for the vast majority of insolvent MSMEs. The Legislative Guide does make reference to cost burdens that deter creditors and discourage commencement of proceedings, "of particular importance in the case of insolvency of small and medium-size businesses." It also notes the issue of overlap of consumer and small business debt as follows:

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

Part three of the Legislative Guide addresses the treatment of enterprise groups in insolvency, both nationally and internationally; it is not directly applicable to the overwhelming majority of MSMEs and there is no specific reference to smaller debtor companies in this section. Part four of the Legislative Guide focuses on the obligations that might be imposed on the directors and officers responsible for making decisions when an enterprise faces insolvency or becomes insolvent. This section refers to family members and senior employees of small family-owned companies being considered de facto directors, some criteria for that assessment, and potential resultant liability. The UNCITRAL Model Law on Cross-Border Insolvency (1997) and its Guide to Enactment make no specific reference to MSMEs.

Part I C of the World Bank Principles contains the legal framework for insolvency and deals with different stages of the process, including the due process, commencement criteria, governance of insolvency processes, administration, claims and claims resolution procedures, and reorganization proceedings. While some of the Principles are more relevant to MSMEs than others, there is little or no specific reference to MSMEs.

Both documents reflect how insolvency systems have been designed in many States. Such systems have been designed with larger enterprises in mind, assuming "an extensive insolvency estate of significant worth, and the presence of creditors and other stakeholders with sufficient value at stake that they participate in and oversee the process."[66]

In April 2014, after an extensive and thorough preliminary analysis, UNCITRAL's Insolvency Working Group V declared that "the mechanisms provided by the Legislative Guide were not sufficient to address all of the needs of MSMEs; thorough treatment of the issues would require both a consideration of matters not yet addressed in the Legislative Guide as well as the tailoring of solutions already in the Legislative Guide to specifically address MSMEs."[67] The Group observed, for example, that "the application of elements of the insolvency law, such as creditor committees, the central role of the courts and extensive involvement of insolvency professionals, might not be appropriate for MSME regimes."[68]

The World Bank, while it has dedicated considerable resources to the financing and education of MSMEs, also does not have a specific approach to MSME insolvency that addresses the problems identified above. Its extensive studies acknowledge that MSMEs are collectively the largest employers in many low-income countries, facing barriers to access to capital and financial services. The World Bank has developed a wide range of available instruments to help meet the challenge of MSME finance, including data analysis, financing, risk-sharing, technical assistance, a financial inclusion support framework, and working globally with standard-setting bodies to develop guidelines, standards, and good practices. However, to date, there has not been the development of similar instruments and policies expressly aimed at MSME insolvency. The World Bank Insolvency and Creditor/Debtor Regimes Task Force, Report of the Working Group on the Treatment of the Insolvency of Natural Persons very briefly mentions small business in the context of overlap of consumer and business credit in small businesses. Hence, the current Task Force offers the potential to make a significant contribution to the development of instruments and approaches to MSME insolvency that address the core problems with the current framework.

RESPONSES TO MSME INSOLVENCY ISSUES

Jurisdictions around the world have taken steps to accommodate MSMEs through what they perceive to be more appropriate insolvency legislation. A few jurisdictions, such as Japan and Korea, have enacted new legislations that create tailor-made MSME insolvency procedures. In these jurisdictions, the insolvency framework that applies to MSMEs is different from the "general" insolvency framework. Other jurisdictions, such as Argentina and the 17 countries that are part of the Organization for the Harmonization of Business Laws in Africa (OHADA) eliminate certain requirements when dealing with MSMEs as compared to larger enterprises or focus on making insolvency proceedings faster for MSMEs, such as India and the United States. These latter models of insolvency frameworks generally represent tweaking, and not significant changing, of the "general" framework. The countries included in this report were selected as a sample only. There are several other regimes (including, but not limited to Iceland, Portugal, etc.) whose MSME-specific provisions deserve to be studied more in depth as well.

An important distinction must be drawn between "small cases" and "MSME-specific" procedures. Many jurisdictions adopt legislation that applies to "small cases," and the eligibility criteria for these proceedings often coincide with the requirements to be considered a MSME. The general idea that if an enterprise meets a certain threshold – such as the number-of-employees or revenue criterion – it is assumed to be a MSME and therefore subject to a special proceeding that may reduce formalities, shorten deadlines, reduce certain fees, etc. However, a criterion based on the number of creditors is also frequently used to separate small and standard cases. In such examples, enterprises that may not commonly be seen as MSMEs may fall under the "small case" criteria. If considered by itself, this number-of-creditors criterion means that a company – no matter its size by other measurements – is subject to a "small case proceeding" simply because it has a number of creditors below a certain threshold. As seen in the country examples below, some countries have adopted this path – in those cases, we conclude that although MSMEs might not be the exclusive beneficiaries of "small case" proceedings, such proceedings are the one generally applicable to MSMEs.

The following case studies show how select countries structure their MSME insolvency procedures. The insolvency frameworks are organized based on one of two categories: frameworks that eliminate elements of a "general" insolvency procedure, and frameworks that are tailored to MSMEs. Although the case studies are divided into categories, they are not mutually exclusive, so the category each jurisdiction is assigned is based on its dominant traits. Given the recent nature of several of the country examples included below, consideration should be given to further explore the success stories and impacts of each regime, in future publications.

Insolvency Regimes that Eliminate Certain Elements of the Proceeding or Shorten Timelines

Some jurisdictions opt to modify certain parts of the "general" insolvency proceeding for MSMEs. For example, in Argentina, there are no longer creditor committees and some fees have been either eliminated or reduced. Similarly, in OHADA countries, certain document filings are not required, and documents that are difficult to produce or to fully complete do not need to be filed provided the debtor files an acceptable explanation.

Some insolvency systems make few exceptions for "small cases" except for changes in the length of the insolvency proceedings. In India, the insolvency regime that was approved in 2016 provides for a "fast-track" for MSMEs – that is, enterprises that meet certain criteria may have shorter deadlines and reduced timeframes in which to conduct an insolvency proceeding. In the United States, some deadlines are reduced while other deadlines, such as the length of a reorganization plan, are eliminated. The framework adopted by OHADA would also fit into this category as it imposes shorter timeframes than do regular proceedings.

ARGENTINA

Eligibility to be considered "small case": Under the *Ley de Concursos* 24522 (Bankruptcy and Liquidation Law) are Arts. 288 – 89 that address small reorganizations and liquidations. To qualify for special treatment under the above Articles, the debtor must have one of the following characteristics: (1) liabilities do not exceed a sum that is equivalent to 300 minimum wage payment (approximately USD 154,652 at the August 2016 exchange rate); (2) there are no more than 20 unsecured creditors; or (3) there are no more than 20 employees. If one of the requirements is met, then the legislation contemplates a series of consequences. The "small case" procedure is triggered ex-officio, regardless of whether the debtor or the creditor files.

What are the main differences between the process for "small cases" and the general insolvency process?

The law contemplates four differences for "small cases," in contrast to large cases:

- The formalities for the debtor to open the process are lighter. One of the main simplifications refers to the filing requirements. While the general insolvency procedure requires the debtor filing for reorganization to attach a certified opinion of a certified public accountant (CPA) on both the list of creditors and the list of assets, the opinion from the certified public accountant is merely optional for "small cases," according to Art. 289 LCQ.
- The establishment of a creditors' committee is not mandatory, in contrast to the general insolvency process.
- The special proceedings specified in Art. 48 do not apply. Art. 48 opens up the opportunity for creditors to compete with the debtor in offering alternative restructuring proposals. In other words, according to Art. 48, when creditors do not ratify a reorganization plan proposed by the debtor, instead of leading to bankruptcy directly, it opens a process during which any creditor or interested party may file an offer to purchase the equity capital of the company.
- Finally, the insolvency practitioner's functions do not end with the ratification of the agreement, unless creditors determine so. The rationale is that typically a creditors' committee controls the reorganization agreement; this is optional in "small cases."

The application of the "small procedure" does not have any consequences in terms of shortening deadlines, unlike some other jurisdictions below.

GERMANY

Eligibility to be considered "small case": The German Insolvency Code (Insolvenzordnung) submits "small insolvencies" to the same process as envisaged for consumer insolvencies. Specifically, Part Nine of the Code applies to consumers (*consumer* is defined as a natural person who pursues or has pursued no self-employed business activity) and also to other debtors who have pursued self-employed activity provided that their assets are comprehensible and no claims exist against them from employment contracts (Art. 304). The assets of a debtor are considered comprehensible if the debtor has 20 or fewer creditors at the time the request is made to open insolvency proceedings.

The number of employees and revenues from the company do not determine its eligibility as a "small case."

What are the main differences between the process for "small cases" and the general insolvency process?

In general, the Insolvency Code envisages a simplified, pre-packaged restructuring procedure for the reorganization of the debtor's business in the cases described above. Art. 304 includes three steps:

- **Step 1. Attempt of extra-judicial settlement:** Consumers and small debtors (as defined above) are required to attempt an out-of-court settlement before filing for the commencement of formal proceedings. One of the reasons for this obligation is that the courts cannot be burdened with too many insolvency proceedings. Therefore, the debtor must submit, together with the filing request, a certificate issued by a suitable person or authority (or "agency") that, within the last six months before the filing, an unsuccessful attempt has been made to settle out of court with the creditors on the basis of an enclosed plan. Art. 305 specifies that the primary reasons for the plans failure must be explained. The federal states can determine which preconditions an agency or person has to meet to be regarded as "suitable" according to the law. Suitable agencies are, for example, the debtor advisory agencies of the welfare organizations. Suitable persons are typically the lawyers.
- **Step 2. The judicial settlement plan-proceedings:** If the extra-judicial attempt to reach a settlement with the creditors fails, the debtor can file a request to open insolvency proceedings. Besides the certificate of the suitable agency or person, the debtor must submit a settlement plan and records of its assets and its income, its creditors and its debts. Since the law envisages a pre-packaged procedure, the debtor must submit (upon petition) this plan for the settlement of its debts (Art. 305[4]). The settlement plan has to contain all provisions that are suitable for an appropriate settlement of the debts. It can be identical to the plan on which the debtor´s extra-judicial settlement attempts were based. The courts accept even a so-called "zero-plan." These are settlement plans of debtors with no income and no assets and that provide no payments to the creditors. The effect of the acceptance of the "zero-plans" by the court is that debtors either in the settlement plan-proceedings or at the latest after the six years of the discharge proceedings can be freed of their debts even if they cannot pay anything to their creditors. Upon submission of the petition, the court will suspend proceedings for a maximum period of three months (Art. 306) and communicate the plan (along with the inventory) to the creditors designated by the debtor, in addition to a request to submit their objections or comments within a month (Art. 307[1]). If no objections have been voiced against the plan, then it shall be deemed approved and binding upon the parties in the same manner as a civil settlement under the civil code (Art. 308). As a result, the approval process for the plan is expedited. If, on the other hand, objections have been voiced by creditors, the court may nevertheless set them aside if the plan has been approved by more than half of the total creditors holding more than half of total claims (Art. 309[1]). If, however, a dissenting creditor: (1) does not participate in the plan on equal

terms; (2) is likely to be placed at an economic disadvantage in comparison to the outcome of opening formal insolvency proceedings; or (3) manages to cast serious doubts on the existence or the exact amount of a claim in a manner that affects whether the participation of a creditor in the plan should continue, then the court will not confirm the plan and ordinary reorganization proceedings will be reopened ex-officio (Art. 311). Where the majority of the creditors object to the plan, the settlement plan-proceedings end and insolvency proceedings are opened.

- **Step 3. Insolvency and discharge proceedings:** After the failure of judicial settlement plan-proceedings and if the bankruptcy estate covers the costs of the proceedings, the insolvency proceedings are opened. The court appoints a trustee who liquidates the estate of the debtor and distributes the proceeds among the creditors. After that, over the next five to six years, the debtor has to transfer all his attachable wage claims to a trustee to be appointed by the court. The trustee distributes the collected money among the creditors once a year. Wage assignments or wage pledges of the debtor remain valid for a period of two years after the opening of the insolvency proceedings. Only after this period can the trustee seize the attachable part of the wages. After six years, the court decides on the discharge of debts. The discharge shall be for the benefit of honest debtors only.[69]

GREECE

Eligibility to be considered "small case": The Greek Insolvency Code makes provisions for "small insolvencies." Under Art. 162 of the Code, debtors whose inventory (estate) is less than EUR 100,000 (approximately USD 107,255) can undergo the simplified insolvency procedure.

Number of employees and number of creditors do not determine eligibility as a "small case."

What are the main differences between the process for "small cases" and the general insolvency process?

The benefits of the simplified insolvency procedure are that it provides for an expedited process for the verification of creditors' claims and for resolving contested claims. In particular, if a creditor presents any challenges to the procedure for the verification of claims or objects to the final list of creditors, the supervising judge and not the court as a whole (as is the case in general proceedings) makes the decision by summary motion. The creditor can then object to the court, which issues a final decision provided that the claim does not exceed EUR 80,000 (approximately USD 85,000) (Art. 163). The simplified procedure therefore has only a limited scope and does not extend to any aspects of the procedure other than the verification of claims.

In light of the rising number of nonperforming loans (NPLs) affecting SMEs in Greece, the simplified procedure was deemed inadequate. Law 4307/14 introduced a new, voluntary, out-of-court restructuring framework for SMEs as described below.

Eligibility to use the restructuring framework of the law: The law aims to facilitate an adjustment of debts for small enterprises and professionals. Small enterprises are identified as businesses that, for the year ending on December 31, 2013, had a turnover of less than EUR 2.5 million (approximately USD 2.7 million), whereas professionals are defined as legal or natural persons who are registered on a special registry in order to conduct their businesses and for the year ending on December 31, 2013, and had a turnover of less than EUR 2.5 million (approximately USD 2.7 million). As a result, the law covers not only commercial enterprises but also persons pursuing non-commercial business activities such as mechanics, doctors, pharmacists, etc. Furthermore, the persons described above need to fulfill the following requirements in order to be able to utilize the framework provided by the law: (1) they must not be subject to any procedure under law 3869/2010 on the restructuring of debts of natural persons; (2) they must be active in business and not subject to any formal insolvency procedure under the Greek Insolvency Code; and (3) the persons in charge of the business or the professionals themselves must not have been convicted of tax evasion, trafficking, racketeering, or any form of fraud against the State.

What are the main differences between the framework envisaged by the law and the general insolvency process?

Under Art. 61, debtors may request a write-down of their financial obligations from their lenders (defined as banks and other credit institutions) according to the framework. A debtor's write-down can amount to no more than EUR 500,000 (approximately USD 536,225) per debtor but (1) at the same time must include at least 50 percent of the credit institutions' total claims; or (2) following the write-down, the outstanding debts do not constitute more than 75 percent of the debtor's net financial position. The credit institutions are free to accept or reject such a proposed write-down or offer it under different terms.

INDIA

Eligibility to be considered "small case": The Indian Insolvency and Bankruptcy Code of 2016 (IBC) contains a "fast track corporate insolvency resolution process" (Arts. 55 – 58), which applies to: (1) debtors with assets and income below a level prescribed by the Central Government; (2) debtors with a certain number of creditors and a certain amount of debt prescribed by the Central Government; and (3) any other type of debtors prescribed by the Central Government (Art. 55). The procedure may be initiated either by the debtor or its creditors upon submission of proof of the debtor's insolvency and its eligibility to undergo a fast-track resolution process (to be determined by the implementing regulations).

Number of employees does not determine eligibility as a "small case."

What are the main differences between the process for "small cases" and the general insolvency process?

The fast-track procedure envisages completion within 90 days as opposed to the ordinary open-ended process. However, the insolvency professional petitions the court to extend the 90-day deadline by an additional 45 days if instructed to do so by a decision of the creditors' committee approved by a 75 percent majority. An extension may be requested only once and may only be granted by the Adjudicating Authority if it determines that the complexity of the case warrants it (Art. 56).

Regarding the rest of the process, the general provisions of the Insolvency Resolution Procedure apply "as the context may require" (Art. 58).

OHADA

The Organization for the Harmonization of Business Laws in Africa, which comprises 17 mostly West African states, recently adopted a uniform insolvency law that is directly applicable in all its member state jurisdictions. Among other reforms, the law provides for new simplified regulation of MSMEs, developed in recognition of the fact that most businesses in the OHADA region are small scale and that the longer it takes to address their financial distress, the less likely the possibility of recovering any assets. The focus of the reforms is to simplify and reduce the cost of procedures, with an understanding that while it is more difficult to reorganize smaller businesses in the same way as larger ones, there still needs to be an attempt to rescue them.

Eligibility to be considered "small case": The OHADA states ultimately agreed that in the context of their member state economies, a "small business" would constitute a proprietorship, partnership, or other legal entity having less than or equal to 20 employees and a turnover not exceeding CFA franc 50 million (approximately USD 80,000) in the 12 months prior to proceedings.[70] Moreover, a small business MSME has the option to select the simplified proceedings, but is not obliged to do so.[71]

The simplified proceedings apply to three of the four procedures set out in the law, namely *règlement préventif* (preventive settlement); *redressement judiciaire* (reorganization), and *liquidation des biens* (liquidation). They are simplified insofar as many of the formalities related to the filings or hearings are no longer necessary, which facilitates faster processes.

What are the main differences between the process for "small cases" and the general insolvency process?

Règlement préventif (preventive settlement)

The provisions for règlement préventif, or preventive settlement, are simplified by derogations from the "main" or overall règlement préventif proceeding. They provide that any small business as defined above may open proceedings before it is insolvent. The filing requirements are also simplified. For instance, the procedure can be opened even when no plan or arrangement has been provided, and although documents demonstrating the financial situation of the small business need to be filed, they do not need to be audited or include comprehensive financial statements or cash-flow statements as required for the regular proceeding.[72] In the event that any other documents required cannot be provided or are incomplete, the request must indicate the reason for their absence or incompleteness. As stated above, the debtor may request regular proceedings instead of the simplified procedure. The decision of the competent court to apply the simplified procedure is not subject to appeal. The simplified procedure not only imposes shorter timeframes compared to the general procedure, it also stipulates that the administrator must file the debtor-creditor agreement within two months after the opening of proceedings instead of the regular three (with a possible extension of 15 days instead of one month). The restructuring plan must be prepared by the debtor with the assistance of the administrator and can have simpler content than the plan under the general proceeding. This may include the settlement of liabilities, particularly the terms and conditions for the discharge of liabilities, write-offs, time extensions, the persons required to perform the arrangement, and, if applicable, the guarantees provided to ensure the plan's implementation. The court may order that the administrator remains in place to monitor the implementation of the plan.

Redressement judiciaire (reorganization)

As with preventive settlement, the form of simplified reorganization proceedings is derogation from the general reorganization process.[73] As with the general proceeding, the filing must be made by a debtor within 30 days of insolvency (using the cash-flow test), but with fewer documents required, and must be accompanied by a sworn statement attesting that the case meets the conditions of a simplified reorganization. The reorganization plan must be filed within 45 days of the declaration of insolvency.[74] Unlike the more detailed reorganization plan in the general reorganization process, in the simplified proceeding the plan may be limited to payment terms, debt relief, and the possible guarantees that the entrepreneur must make to ensure its execution. The financial statements and economic records do not have to be submitted with the simplified reorganization plan.[75] The court can decide to convert a general reorganization to a simplified reorganization within 30 days of opening the proceedings following representations from the administrator.[76] At the request of the debtor or administrator, the court can decide not to follow the simplified reorganization process.

Liquidation des biens (liquidation)

The conditions for opening the simplified liquidation are the same as for reorganization. However, in addition to meeting the definition of small business, there is an additional condition that the debtor does not own any immovable property. A sworn statement that the debtor meets the relevant conditions for a simplified liquidation proceeding must also be submitted. After the opening of a liquidation proceeding, the liquidator may prepare and file a report with the competent court within 30 days of appointment. On the basis of the report, the court may apply a simplified liquidation procedure after having heard or summoned the debtor. The court has the right to refuse to apply the simplified liquidation proceedings, even if the relevant conditions are met. Unlike with the general liquidation proceeding, the court may determine that the sale of the debtor's property should be a private sale agreement.[77] The trustee must take action on the agreement within 90 days. Any remaining property is sold at public auction.[78]

UNITED STATES

Eligibility to be considered "small case": In 2005, the United States introduced a simplified, expedited reorganization process for "small business debtors" in Chapter 11 of the U.S. Bankruptcy Code. Small business debtors are classified as such based on a two-part test: (1) the debtor is engaged in non–real estate activity with total fixed debts of USD 2,566,050 or less; and (2) the U.S. Trustee has not appointed a committee of unsecured creditors, or the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor.

What are the main differences between the process for "small cases" and the general insolvency process?

The main aspects of this process are simplified voting requirements, shorter deadlines, and more stringent oversight and reporting obligations. More specifically, a small business debtor must attach its most recent balance sheet, statement of operations, cash-flow statement, and federal tax return to the bankruptcy petition when it files for Chapter 11. The exclusivity period for the debtor is longer (180 days in comparison to 120 days for a regular debtor); however, the debtor is under a rather strict 300-day deadline to propose a plan, which has to be approved within 45 days of filing. Nevertheless, the debtor may file a reorganization plan without filing a separate disclosure statement if the court determines that adequate information is contained in the plan. An additional advantage is that the law sets no limit on the duration of the reorganization plan, which is favorable for small businesses that need additional time to restructure their mortgage or equipment loans. During the course of proceedings, a small business debtor is also under stricter monitoring by the U.S. Trustee, who must investigate the debtor's viability, inquire about its business plan, review and monitor the debtor's activities, and, as appropriate, seek dismissal of the case for cause, including a belief that the debtor is not viable or is otherwise unable to confirm a plan. Finally, during the case, the small business debtor must also file with the court periodic financial and other reports on its cash flow and profitability.

Insolvency Regimes that Eliminate Certain Elements of the Proceeding or Shorten Timelines						
	Argentina	**Germany**	**Greece**	**India**	**OHADA**	**United States**
Eligibility to be considered "small case"	To qualify for special treatment, the debtor must have one of the following characteristics: (1) liabilities do not exceed 300 minimum wages (approx. USD 154,652 at August 2016 exchange rate); (2) no more than 20 unsecured creditors; or (3) no more than 20 employees.	The assets of a debtor are considered comprehensible if the debtor has 20 or fewer creditors at the time the request is made to open insolvency proceedings. Number of employees and revenues from the company do not determine its eligibility as a "small case."	Under Art. 162 of the Code, debtors whose inventory (estate) is less than EUR 100,000 (approx. USD 107,255 at April 21, 2017, exchange rate) can undergo the simplified insolvency procedure. Number of employees and number of creditors do not determine its eligibility as a "small case."	Under Art. 55 - 58 of the new Indian Insolvency and Bankruptcy Code of 2016 (IBC): (1) a debtor with assets and income below a level prescribed by the Central Government; (2) a debtor with a certain number of creditors and a certain amount of debt as prescribed by the Central Government; and (3) any other type of debtors as prescribed by the Central Government. Number of employees does not determine eligibility as a "small case."	A "small business" constitutes a proprietorship, partnership, or other legal entity having 20 or fewer employees and a turnover not exceeding CFA francs 50 million (approx. USD 80,000) in the 12 months prior to proceedings.	A "small business" debtor is classified as such based on a two-part test: (1) the debtor is engaged in non–real estate activity with total fixed debts of USD 2,566,050 or less; and (2) the U.S. Trustee has not appointed a committee of unsecured creditors or the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor.

Jurisdictions with Comprehensive MSME Legislation

Some countries, like Japan and Korea, adopt comprehensive laws that are specifically designed to apply to MSMEs. The legislation in the following countries is considered comprehensive because it is specifically designed to apply to MSME insolvency. It does not merely eliminate an element of a "general" insolvency framework or reduce a timeline, but rather creates a framework for MSME insolvency that is significantly different from the framework applied to larger enterprises in the same jurisdiction.

JAPAN

Eligibility to be considered "small case": Even though the general civil rehabilitation procedure is primarily, albeit not exclusively, aimed at the restructuring of MSMEs, the Civil Rehabilitation Act of Japan (Act No. 225 of December 22, 1999) also contains special provisions on the rehabilitation of individuals with small-scale debts. These provisions apply to an individual debtor, who is likely to earn income continuously or regularly in the future and whose total claims amount to less than JPY 50 million (USD 455,000).[79] As a result, these provisions only apply to consumers and small individual proprietors.

Number of employees and number of creditors do not determine eligibility as a "small case."

What are the main differences between the process for "small cases" and the general insolvency process?

Some of the main differences can be summarized as follows: First, in small cases, creditors are not generally required to file their claims with the court, because the claims are regarded as filed when the schedule of the creditors is prepared by the debtor and submitted to the court. The debtor is required to prepare the schedule of the creditors and submit it to the court so that the case is regarded as a small case. Second, any avoidance claim would not be permitted in a small case. Third, under the general rehabilitation process, though the content of any modification of rights based on a rehabilitation plan shall apply equally to rehabilitation creditors, it would be possible to make certain differences among creditors if the legal requirement were satisfied. On the other hand, under a small case, such discrimination among creditors in the rehabilitation plan is not allowed.

Unlike in general civil rehabilitation proceedings, where the court appoints a supervisor to oversee the debtor's conduct of business, in small cases the court is allowed to appoint an "individual rehabilitation commissioner," who may be assigned with one or more of the following tasks: (1) investigating the status of the rehabilitation debtor's property and income; (2) assisting the court in the valuation of rehabilitation claim; and/or (3) making recommendations necessary for the rehabilitation debtor to prepare a proper proposed rehabilitation plan (Art. 223). As a result, the individual rehabilitation commissioner does not interfere significantly with the debtor and also does not impose such high costs on proceedings.

Another benefit of this special process relates to less stringent procedural requirements for proof and objection of claims (Art. 226) as well as a general exemption of the debtor from the duty to prepare balance sheets (Art. 228). In particular, when a debtor or creditor(s) file an objection to a claim, the court reviews the legitimacy or amount of the claim in summary, rather than plenary, proceedings. The court makes a binding decision only on the creditors' voting rights in the creditors' meeting, and there are no provisions for appeal.

In addition, the law specifies that a rehabilitation plan may only provide for an extension of the term of the debt if it meets the following requirements: (1) the payment plan specifies that the creditor receives a payment more than once in three months; and (2) the extension may not exceed three years from the date of the confirmation of the plan, and in special circumstances five years (Art. 229). The law also adopts a "negative approval standard" for the approval of the rehabilitation plan by the creditors. More specifically, a plan is accepted if the creditors that reject the plan in writing are owed half or less of the total allowed claims and number less than half of all the creditors (Art. 230). Following the creditors' approval, the court will confirm the plan if: (1) creditors receive at least as much as they would in liquidation; and (2) the minimum payment thresholds prescribed by the law are met. These minimum payment thresholds are (1) 20 percent of the face value of total claims if the total amount of such claims are JPY 30 million (USD 273,000) or less; and (2) 10 percent of the face value of total claims if the total amount of such claims is over JPY 30 million (USD 273,000) and JPY 50 million (USD 455,000) or less (Art. 231).

KOREA

Eligibility to be considered "small case": Korea recently introduced a specialized procedure for small businesses (Small Business Rehabilitation [SBR] Procedure). In order to request the opening of this specialized procedure, the debtor: (1) has to be a business income earner (not a wage income earner); (2) may be an individual or a legal entity; and (3) must have less than KRW 3 billion (USD 2.57 million) in total secured and unsecured debts. Only debtors may commence this simplified procedure.

What are the main differences between the process for "small cases" and the general insolvency process?

Upon the opening of the court proceedings, a trustee is not appointed and the debtor (or in the case of a legal entity, the debtor's managers) retains the management of the business. Furthermore, as with general proceedings, an examiner is appointed to assess the debtor's financial condition. In the SBR procedure, however, the examiner is usually an experienced deputy court clerk (in the case of an individual debtor) or an accounting firm (in the case of a legal entity debtor) and uses a simplified accounting method compared to general proceedings. In addition, there is no fee for a court clerk. The small business procedure also simplifies the requirements for the approval of a plan. Under ordinary business rehabilitation, a plan needs to be approved by at least three quarters of the amount of secured claims allowed and of the amount of unsecured claims. Under the SBR, the requirement of secured creditors is the same, but, as for unsecured creditors, approval is required by either two thirds of the amount of total claims or one half of the amount of total claims and one half of the number of total creditors. This way it is harder for one major creditor to block the approval of the reorganization plan.

CHAPTER 5

Conclusions of the World Bank ICR Task Force Meeting

September 19, 2016 – Washington, DC

MSMES FACE SPECIFIC CHALLENGES IN INSOLVENCY FRAMEWORKS

Task Force Members agreed with the challenges confronting MSMEs listed in the Report. Members noted that even if these challenges are also ones that larger enterprises face, they are often exacerbated and more acutely felt by MSMEs. The challenges discussed earlier in the report were:

- Complex insolvency systems. Many country insolvency frameworks are too complex for unsophisticated MSMEs to use and understand. The complexity and stigma of the procedure can act as a disincentive to access the system in a timely way. Further, these frameworks are likely to be costly and time intensive. At a period when the enterprise is facing financial difficulty, entrepreneurs may not have the funding or time required to complete an insolvency process designed with large corporations in mind. Also, MSMEs often have little liquidity at their disposal and are less sophisticated than larger corporations. A temporary and minor lack of liquidity could rapidly spiral into liquidation in a way it may not for a larger business and thus MSMEs are more affected by insolvency procedures that prevent re-entry into economic life. Insolvency procedures for MSMEs, which are rapid, simple to follow (e.g., with easy-to-use forms), and have minimal court involvement, may improve participation, increase debt recovery, and enable entrepreneurs to get back to their activities faster.
- Creditor passivity. Large creditors often do not have the financial incentive to spend time and resources dealing with MSMEs' relatively smaller debt cases considering they may not even recoup their costs for recovery. Participating actively in a complex restructuring process is often an expensive task, even for sophisticated creditors. Therefore, efficiencies may be lost if viable small businesses' assets are enforced by secured creditors at the first sign of financial distress and unsecured creditors remain passive.
- Limited information. Information transparency to creditors and other relevant parties aids the insolvency process to run smoothly. Information disclosure builds trust between parties and leads to a better understanding of the debtors' financial position, enabling creditors and insolvency administrators, as well as other relevant parties, to make an objective assessment of the viability of a debtor's business. However, many debtor MSMEs often lack good recordkeeping systems. They also frequently have little incentives to seek the help of financial professionals or do not see a need to keep records in the first place.
- Accessing financing during the proceeding. Many insolvency systems do not incentivize provision for MSME access to financing post filing in an insolvency procedure. However, financing, particularly fresh funds, are vital to MSME survival, especially when they face financial distress.
- **Insufficient assets to fund the insolvency proceeding.** MSMEs may not commence an insolvency procedure because they wait too long to file a petition and the remaining funds are insufficient to cover even administrative costs and fees. Two approaches are common in cases where no assets remain: not opening the case or establishing a common fund to pay for the insolvency process. A deeper analysis of the

impact of each in practice may be beneficial to better understand which works best in practice.

In addition to the above, the Task Force suggested two challenges that were not included in the draft Report circulated to the Task Force prior to the September 2016 meeting.

- **First, micro and small entrepreneurs face particular difficulties with a mix of personal and corporate debt when under financial stress.** In an insolvency situation, the failure of the enterprise could lead to severe consequences for the entrepreneur and their family associated with many personal insolvency regimes. For example, if a business defaults on a loan that the entrepreneur personally guaranteed, the guarantor is personally liable to repay the business debt. If that debt cannot be paid back or renegotiated, the entrepreneur may have to resort to personal bankruptcy. However, some countries do not have personal insolvency laws, and others with personal insolvency laws may have no discharge or a long waiting period before discharge, as well as heavy penalties for personal bankruptcy. This could result in the entrepreneur being unable or unwilling to re-enter the market productively and therefore lower growth overall. Adding to this problem, insolvency frameworks often lack the ability to register one-person business units. Such business units may be easier for entrepreneurs to formally register, enabling more entrepreneurs to have recourse to corporate insolvency law instead of relying on personal insolvency law, if such a framework exists in the country. The discussion during the 2016 Task Force led to the inclusion of Chapter III.B.v. of this report.
- **Second, the Task Force raised the issue of involving taxation authorities in the insolvency framework.** Members noted that in many countries taxation authorities did not actively contribute to the objectives of the insolvency framework of maximizing value and saving viable enterprises. Instead, many tax authorities participated purely to recover debts owed. For example, some tax authorities cannot provide debt forgiveness, which may stifle attempts to resolve insolvency and rehabilitate a viable enterprise. Certain countries also do not provide tax incentives for tax write-offs for bad or renegotiated debts, leaving less incentive for creditors to agree to restructurings. This is particularly important for MSMEs, because the amount of assets is often small compared to the restructuring costs; any additional incentive for creditors to restructure could have a positive impact.

Task Force Recommendations: The Definition of *MSME* and Existing Insolvency Framework

- **The Task Force recommended that the definition of *MSME* should not be overly prescriptive.** Members observed that the definition of *MSME* varies around the world. As noted in the Report, such a definition may include features such as the number of employees, sales, or loan size. Each jurisdiction may have legitimate local reasons for its particular definition of MSME, so the Task Force did not recommend making any one definition definitive in order to allow for flexibility.
- **The Task Force also suggested modification of the existing insolvency framework rather than a separate regime for MSMEs, as a preliminary position.** However, further investigation is needed to come to a final conclusion on this point. At the meeting, a number of MSME insolvency framework country examples were discussed. The Task Force noted that, for many countries, simple modifications to existing insolvency frameworks could be the most practical and efficient method of taking into account the distinctiveness of MSMEs at this stage. This contrasts with other approaches, which create an entirely separate regime for MSME insolvency. Such approaches may be appropriate for developed countries with more resources and a robust legal environment. However, they would not likely be effectively implemented in many developing countries, as they may lack the resources and infrastructure

necessary for implementation. It was agreed that further discussion on the impact that both types of approaches have had in practice is needed to come to a definitive conclusion in this regard.

Other Considerations – Liquidation and Assistance to the Debtor

The Task Force discussed a number of other considerations for policymakers in designing an insolvency framework that specifically considers MSMEs.

- **The Task Force noted that the majority of MSMEs facing insolvency are more likely to liquidate.** Only a small fraction is likely to be able to take advantage of a restructuring regime. Therefore, it was recommended that frameworks should not only focus on restructuring, but should also take into account that the majority of cases will end in liquidation.
- **The Task Force noted the importance of non-judicial assistance.** Since MSMEs often lack financial and legal sophistication and insolvency procedures frequently require production of financial and legal documents as well as navigation through complex legal processes, the Task Force suggested that jurisdictions might want to consider furnishing the MSME debtor with non-judicial assistance. Such assistance could take the form of mediation, debt counselling, financial education, or the appointment of a trustee. However, members noted that there was an outstanding question of who would fund such assistance.

Further Exploration Warranted

Given the Task Force's discussion on these challenges, Members agreed that further exploration into whether the World Bank ICR Principles should be amended to treat MSMEs was warranted. Therefore, the Members recommended that the Bank, along with its partners, should further study whether the Principles should provide specific guidance for dealing with MSMEs.

Endnotes

1. Oya Pinar Ardic, Nataliya Mylenko, and Valentina Saltane. 2011. "Small and Medium Enterprises: A Cross-Country Analysis with a New Data Set." Policy Research Working Paper 5538, World Bank Financial and Private Sector Development Consultative Group to Assist the Poor, Washington, DC. Accessed August 3, 2016. http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-5538.

2. Ibid.

3. See, for instance, the European Commission recommendation regarding the definition of MSMEs in the European Union: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32003H0361&from=EN.

5. Khrystyna Kushnir, Melina Laura Mirmulstein, and Rita Ramalho. 2010. *Micro, Small, and Medium Enterprises Around the World: How Many Are There, and What Affects the Count?* Washington, DC: World Bank. Accessed July 27, 2016.

6. Ibid.

7. Ibid, 4.

8. Peer Stein, Tony Goland, and Robert Schiff. 2010. *Two Trillion and Counting: Assessing the Credit Gap for Micro, Small, and Medium-size Enterprises in the Developing World.* Washington, DC: World Bank. Accessed July 25, 2016, at 1. http://www.ifc.org/wps/wcm/connect/3d5d09804a2d54f08c1a8f8969adcc27/Two+trillion+and+counting.pdf?MOD=AJPERES. "MSME" in this context is defined as an enterprise with fewer than 250 employees.

9. Kushnir et al, supra, note 4 at 3-4.

10. Ibid, 4.

11. Edinburgh Group. "Growing the Global Economy Through SMEs." Accessed August 5, 2016, 7. http://www.edinburgh-group.org/media/2776/edinburgh_group_research_-_growing_the_global_economy_through_smes.pdf.

12. Ibid.

14. G20, "G20 Leaders' communiqué Antalya summit, 15-16 November 2015." Accessed August 5, 2016. http://www.consilium.europa.eu/en/press/press-releases/2015/11/16-g20-summit-antalya-communique/ at 2.

15. Ryan Banerjee. 2014. "SMEs, Financial Constraints and Growth." BIS Working Papers No. 475, Bank for International Settlements. Accessed August 5, 2016.

16. European Investment Bank / Dalberg. 2011. *Report on Support to SMEs in Developing Countries Through Financial Intermediaries*. Accessed August 5, 2016. 8. www.eib.org/attachments/dalberg_sme-briefing-paper.pdf.

17. *MSME* in this study is defined as an enterprise with fewer than 500 employees. Shahin Firoozmand, Philip Haxel, Euijin Jung, and Kati Suominen. 2015. "State of SME Finance in the United States in 2015." Tradeup and Nextrade Group, as cited in Davis et al, supra, note 12 at 16.

18. UK Department for Business, Innovation, and Skills, Statistical Release: Business Population Estimates for the UK and Regions 2015 (14 October 2015), as cited in Davis et al, supra, note 12 at 16.

19. European Investment Bank / Dalberg, supra, note 15 at 8.

20. Edinburgh Group, supra, note 10 at 8.

21. Ibid.

22. Ibid.

23. Kushnir et al, supra, note 4 at 4.

24. E. Warren, J. L. Westbrook. 1999. "Financial Characteristics of Business in Bankruptcy." *American Bankruptcy Law Journal* 73: 499-589, as cited in Davis et al, supra, note 12 at 19.

25. Davis et al, ibid, 19.

26. Organisation for Economic Co-operation and Development (OECD). 2009. "The Impact of the Global Crisis on SME and Entrepreneurship Financing and Policy Responses," as cited in Davis et al, ibid, 20-21.

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28. Stein et al (2010), supra, note 7 at 1. "MSME" in this context is defined as an enterprise with fewer than 250 employees.

29. International Finance Corporation. 2013. "Access To Credit Among Micro, Small, And Medium Enterprises." Accessed July 27, 2016, 1. http://www.ifc.org/wps/wcm/connect/1f2c968041689903950bb79e78015671/AccessCreditMSME-Brochure-Final.pdf?MOD=AJPERES.

30. OECD. 2016. "Financing SMEs and Entrepreneurs 2016: An OECD Scoreboard." Paris: OECD Publishing, 36.

31. Ibid.

32. Stein et al, 2013, supra, note 25 at 11.

33. Meghana Ayyagari, Pedro Juarros, Maria Soledad Martinez Peria, and Sandeep Singh. 2016. *Access to Finance and Job Growth: Firm-Level Evidence across Developing Countries.* Washington, DC: World Bank. Accessed July 27, 2016, 4. http://documents.worldbank.org/curated/en/804781467990954208/pdf/WPS7604.pdf.

34. Kushnir et al, supra, note 4 at 1.

35. World Bank. 2014. *Debt Resolution and Business Exit.* Viewpoint 343, 5. https://www.wbginvestmentclimate.org/advisory-services/regulatory-simplification/debt-resolution-and-business-exit/upload/VIEWPOINT_343_Debt_Resolution.pdf.

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37. World Bank. 2016. *A Toolkit for Out-Of-Court Workouts*. Washington, DC: World Bank; and World Bank Group. 2012. *Out-Of-Court Debt Restructuring*. Washington, DC: World Bank.

38. Mahesh Uttamchandani and Antonia Menezes. 2010. "The Freedom to Fail: Why Small Business Insolvency Regimes Are Critical for Emerging Markets." *International Corporate Rescue* 7 (4): 262–68.

40. Ibid, 5.

41. Ibid.

42. Ibid.

43. Wolfgang Bergthaler, Kenneth Kang, Yan Liu, and Dermot Monaghan. 2015. *Tackling Small and Medium Sized Enterprise Problem Loans in Europe, European Department.* International Monetary Fund, Legal Department, and Monetary and Capital Markets Department, 6.

44. Ibid.

45. Yan Liu and Christoph B. Rosenberg. 2013. "Dealing with Private Debt Distress in the Wake of the European Financial Crisis: A Review of the Economics and Legal Toolbox." Working Paper. Washington, DC: International Monetary Fund.

46. Ibid, 11.

47. OECD. 2009. “The Impact of the Global Crisis on SME and Entrepreneurship Financing and Policy Responses,” as cited in Davis et al, supra, note 12 at 20–21.

48. Mahesh Uttamchandani and Antonia Menezes, 2010.

50. “This principle addresses only accountabilities of directors in the period when they know or ought reasonably to have known that the enterprise imminently or unavoidably faces insolvency. General principles for corporate governance and officer and director liability to their shareholders are dealt with under the OECD Principles for Corporate Governance.”

51. World Bank Principles, B2.

57. World Bank. 2013. *Report on the Treatment of the Insolvency of Natural Persons.* http://siteresources.worldbank.org/INTGILD/Resources/WBInsolvencyOfNaturalPersonsReport_01_11_13.pdf.

58. “European Commission Recommendation of 12.3.2014 on a new approach to business failure and insolvency” available at http://ec.europa.eu/justice/civil/files/c_2014_1500_en.pdf and Proposal for a Directive Of The European Parliament And Of The Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU” available at http://ec.europa.eu/information_society/newsroom/image/document/2016-48/proposal_40046.pdf.

59. Davis et al, supra, note 12 at 20–23.

60. For instance, in Germany, in 2014, around 10,000 petitions (representing 8 percent of total petitions) were dismissed for lack of assets. (Statis.de). In Poland, in 2009, almost 20 percent of the filings (51 out of 246 cases) in the District Court for Wrocław Fabryczna were “motion rejected” cases for lack of sufficient assets to cover the proceedings. In 2010, they were about 35 percent of the cases filed (76 out of 216). Sylwia Morawska. *The Morawska Report.* 2012. “Efficiency and Effectiveness of Insolvency Proceedings in Poland.” Report available only in Polish). See UNCITRAL Legislative Guide on Insolvency Law, paras 72-73.

61. See UNCITRAL Legislative Guide on Insolvency Law, para. 73

62. In these situations, the creditor can pursue individual enforcement actions and may resort to non- insolvency remedies to challenge certain debtor transactions.

63. Per Art. 6 of the Greek Insolvency Code, the court must dismiss an application for insolvency if it is proven that, although the general requirements of the law have been met, the debtor’s estate is insufficient to cover the expenses of proceedings. Thus, no-asset cases are prima facie assessed and rejected as such by the court. The 2010 Polish Bankruptcy and Recovery Law specifies, in Art. 13, that the court must dismiss a petition when the assets of the insolvent debtor do not cover the costs of the proceedings. Furthermore, the court must also dismiss a petition if the insolvency estate possesses sufficient assets, but they are encumbered to such an extent that the residual assets cannot cover the costs of proceedings. The 2015 amendments to the law also required the court to reject the petition if the assets could cover the administrative expenses but were not sufficient to “cover any of the debts owed to its creditors.”

64. Nevertheless, creditors are able to resume proceedings within a year if they prove that the estate has sufficient assets or they deposit the amount specified by the court. Thus, even though the termination of proceedings is the norm, the law allows interested parties to open proceedings in case they agree to cover the costs.

66. Davis et al.

67. United Nations Commission on International Trade Law. 2014. Report of the Working Group V (Insolvency Law) on the Work of Its Forty-Fifth Session. New York: United Nations. https://documents-dds-ny.un.org/doc/UNDOC/GEN/V14/028/64/PDF/V1402864.pdf?OpenElement.

68. Ibid.

69. According to Art. 290, therefore - on the request of a creditor - the discharge will be refused if the debtor:

- has been convicted of a bankruptcy crime,

- within the last three years before the opening of the proceedings made false statements to obtain a loan or grants from public funds or to avoid making payments to public funds,

- obtained discharge of debts within the last 10 years, or

- neglected his information and cooperation duties during the proceedings. The discharge has the effect that the debtor is freed from all debts except:

- from claims to maintenance that arose during the insolvency proceedings (see Art. 40),

- from obligations of the debtor incumbent on him under a tort by wanton act, insofar as the creditor has stated this legal reason when filing the corresponding claim with the administrator, and

- from fines and from interest-free loans granted to the debtor to pay the costs of the insolvency proceedings (see Art. 302).

70. Article 1–3.

71. Article 1–2.

72. Article 6–1.

73. Article 145–1.

74. Article 145–3.

75. Article 145–4.

76. Article 145–5.

77. Article 179–6.

78. Article 179–6.

79. The expression "earn income continuously or regularly in the future" is generally interpreted in practice as meaning that the individual debtor would likely earn income at least once every three months in approximately three to five years.

Box Citations

These citations apply to the quoted text in the Report's boxes. All citations come from the Davis et al paper.

Box 2.1

i. Shahin Firoozmand, Philip Haxel, Euijin Jung, and Kati Suominen. 2015. "State of SME Finance in the United States in 2015." Tradeup and Nextrade Group.

ii. Industry Canada. Key Small Business Statistics August 2013, at 8, figures are for 2012, and job creation figures represent the period from 2002-2012. https://www.ic.gc.ca/eic/site/061.nsf/vwapj/KSBS-PSRPE_August-Aout2013_eng.pdf/$FILE/KSBS-PSRPE_August-Aout2013_eng.pdf.

iii. Oya Pinar Ardic, Nataliya Mylenko, Valentina Saltane. 2011. "Small and Medium Enterprises: A Cross-Country Analysis with a New Data Set." Policy Research Working Paper 5538, World Bank Financial and Private Sector Development Consultative Group to Assist the Poor, Washington, DC, 6-8.

iv. Khrystyna Kushnir, Melina Laura Mirmulstein, and Rita Ramalho. 2007. Counting MSMEs Across the World. Washington, DC: World Bank, 7. http://www.ifc.org/msmecountryindicators. This database is current as of August 2010 and updates and expands on the January 2007 Micro, Small, and Medium Enterprises: A Collection of Published Data, 2. http://www.ifc.org/msmecountryindicators.

v. Ardic et al, supra note iii.

Box 3.1

i. The Financial Stability Board, which monitors the global financial system, recognizes "Insolvency and Creditor Rights" as one of 14 policy domains "designated as key for sound financial systems," in which internationally recognized "best practice

standards" are considered as "deserving of priority implementation depending on country circumstances." Financial Stability Board. Key Standards for Sound Financial System.s (http://www.fsb.org/what-we-do/about-the-compendium-of-standards/key_standards/. Accessed March 7, 2016).

ii. J.P. Fan, S. Titman, and G. Twite. 2012. "An International Comparison of Capital Structure and Debt Maturity Choices." *Journal of Financial and Quantitative Analysis* 47 (1): 23-56.

iii. Ibid.

iv. See J. Qian and P.E. Strahan. 2007. "How Laws and Institutions Shape Financial Contracts: The Case of Bank Loans." *Journal of Finance* 62 (6): 2803-34.

v. S.A. Davydenko and J.R. Franks. 2008. "Do Bankruptcy Codes Matter? A Study of Defaults in France, Germany, and the UK." *Journal of Finance* 63 (2): 565-608.

vi. See J. Armour and D. Cumming. 2008. "Bankruptcy Law and Entrepreneurship." American Law and Economics Review 10 (2): 303-50; S.H. Lee, Y. Yamakawa, M.W. Peng, and J.B. Barney. 2011. "How do Bankruptcy Laws Affect Entrepreneurship Development Around the World?" *Journal of Business Venturing* 25 (5): 505-20.

vii. See E.S. Hotchkiss, K. John, R.M. Mooradian and K. Thorburn. 2011. "Bankruptcy and the Resolution of Financial Distress." *Handbook of Empirical Corporate Finance: Empirical Corporate Finance* 2: 235.

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

ix. S. Lee, M.W. Peng, and J.B. Barney. 2007. "Bankruptcy Law and Entrepreneurship Development: A Real Options Perspective." *Academy of Management Review* 32 (1): 257–272 (Lee et al); M.W. Peng. 2003. "Institutional Transitions and Strategic Choices." *Academy of Management Review* 28 (2): 275-296.

x. Elena Cirmizi, Leora Klapper, and Mahesh Uttamchandani. 2010. "The Challenges of Bankruptcy Reform." Policy Research Working Paper 5448, World Bank, Development Research Group Finance and Private Sector Development Team, Washington, DC, 4.

xi. Ibid, 5.

xii. Lee et al, supra note ix.

xiii. United Nations Commission on International Trade Law (UNCITRAL). Legislative Guide on Insolvency Law. New York: United Nations Publication. No.E.05.V.10; World Bank. 2015. Principles on Effective Insolvency and Creditor/Debtor Regimes (revised May 2015).

xiv. See O. Couwenberg. 2001. "Survival Rates in Bankruptcy Systems: Overlooking the Evidence." European Journal of Law and Economics 12 (3):253-73; S. Claessens and L.F. Klapper. 2005. "Bankruptcy Around the World: Explanations of Its Relative Use." *American Law and Economics Review* 7 (1):253-83.

xv. Cirmizi et al, supra note x at 6.

xvi. Ibid, 4.

xvii. Ibid, 3.

xviii. Wolfgang Bergthaler, Kenneth Kang, Yan Liu, and Dermot Monaghan. 2015. Tacking Small and Medium Sized Enterprise Problem Loans in Europe. Washington, DC: International Monetary Fund, European Department, Legal Department, and Monetary and Capital Markets Department, 6.

xix. Ibid.

Box 3.3

i. Unlike medium-size businesses, some of which may feel attracted by the prospect of seeking competing forms of financing from a plurality of banks, virtually all micro and small businesses

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

Box 4.1

i. M. Uttamchandani and A. Menezes. 2010. "Freedom to Fail: Why Small Business Insolvency Regimes Are Critical for Emerging Markets." *International Corporate Rescue* 7 (4): 262-68.

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vi. Ibid.

vii. Ronald Davis, Stephan Madaus, Alberto Mazzoni, Irit Mevorach, Riz Mokal, Barbara Romaine, Janis Sarra, and Ignacio Tirado. 2016. "The Modular Approach to MSME Insolvency." Draft Working Paper. File on record with World Bank Group and authors.

viii. Ibid.

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