

Finance to micro-businesses

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Overview

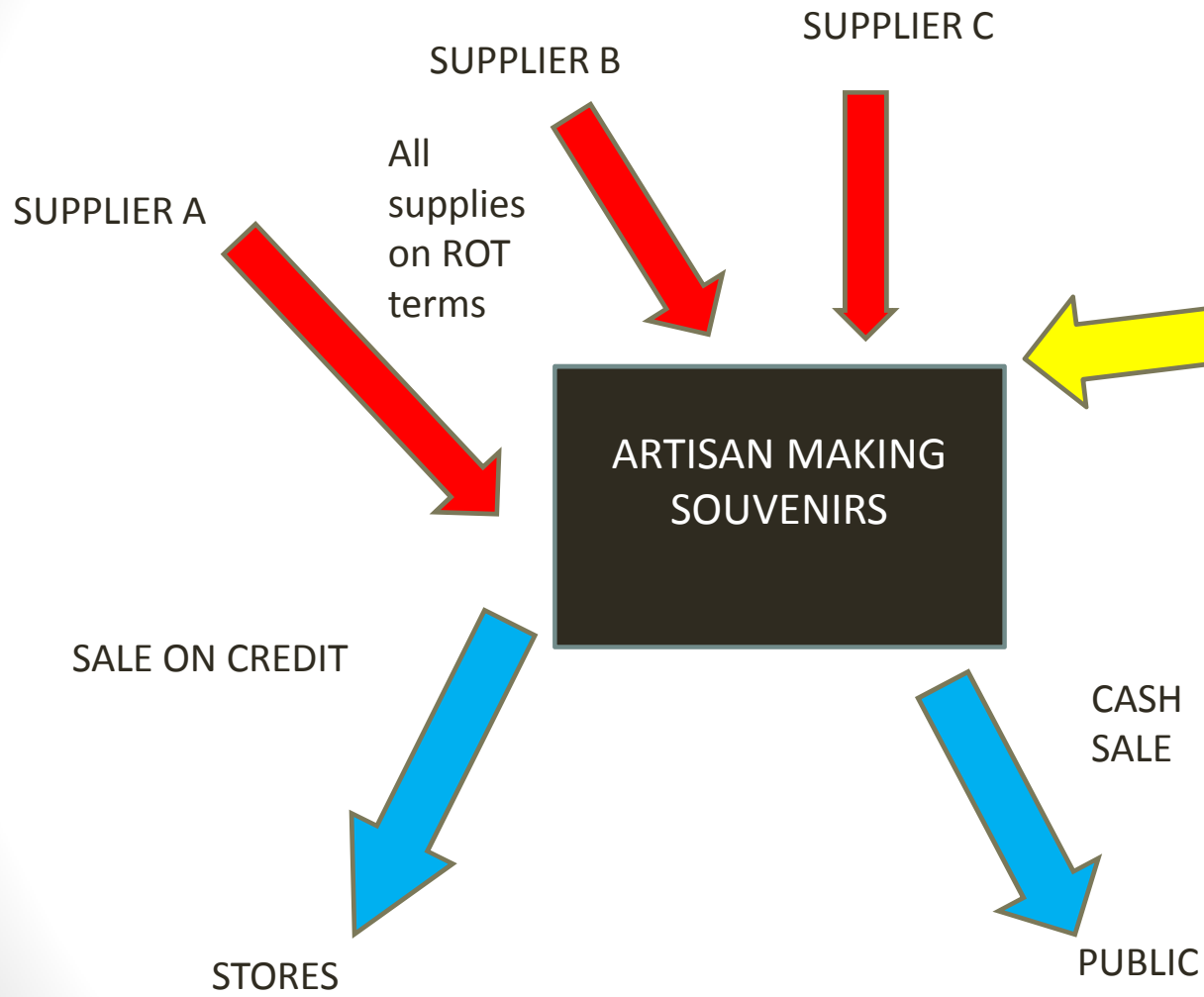
- What a micro-business is
- The importance of micro-businesses for developing economies and problems in the financing of micro-businesses: views from the World Bank and Latin America
- Case study analysis
- Aspects of Model Law which need attention/explanation
 - Notification
 - Enforcement
 - Interaction with guarantees
- Other areas of law which need study Guarantees
 - Contractual unfairness

What a micro-business is

- Why does it matter? Big difference in definitions. Smaller share more features with insolvency of individuals than with medium sized business
- Any or a combination of the following:
 - No of employees: the most commonly used; eg., WB 1-4; EU less 10
 - Turnover: eg. EU less 2 million
 - Volume of assets: EU less 2 million
 - Sectorial definition: banks use size of loan
- Lack of standard definition makes data difficult to compare
- Our analysis focuses on micro-business along the lines of WB
- What kind of legal persons are we talking about?
 - Limited Liability Companies. In some jurisdictions one person LLC
 - Other kinds organisations, such as partnerships
 - Sole entrepreneur
 - Self-employed professional providing services (eg lawyer, plumber)
 - In some jurisdictions, self employed professional would be equivalent to sole entrepreneur (at least for some purposes)
 - Difficulty arising when talking about sole trader: how do we draw the line between business finance and consumer finance (and the consequent need/availability of protection for the borrower)?



STANDARD EXAMPLE



Originating finance

Possible guarantors

- Government
- Family/friends
- Mutualised organisations

BANK

MAYBE ASSET FINANCIER



Sources of finance

- No or little chance of equity financing
- Bank loan
 - Guarantees from Government, family/friends or mutualised organisation
 - Collateral
- Guarantees of ongoing obligations: eg. lease
- Loan from Micro-finance organisation. Special considerations
- Credit card. Widespread use?
- Asset finance (leasing)
- ROT trade sales. Widespread use? Distinction between types of jurisdiction



Assets available for collateral

- Inventory
 - Raw materials
 - Manufactured goods
- Receivables (from stores)
 - Difficulties in using these
- Cash (ie bank account? Or currency?)
- Equipment
- IP?
- Licenses ?
- Non-business assets
 - any real estate or good owned privately by the entrepreneur?
 - If business incorporated this will need to be by way of guarantee and security interest over private assets

Issues arising from financing micro-businesses

- Individual trader
 - Overlap between business and personal assets.
 - Difficulties of identification and notification
- Amounts at stake very small
 - Lenders don't bother to do proper risk assessment
 - Complicated enforcement procedures too costly
 - "Evergreening" of uncollateralised loans: interest rates mean debt rises very quickly
 - "Rational" creditor passivity
- Inequality of bargaining power
 - Danger of unfair contractual terms
 - No legal advice, so need protection, but this has to be balanced against cost
- Financing of receivables

Aspects of the ML which need attention/explanation

- ML generally good for finance of micro-businesses as security can be taken over all assets and at low cost
- Some issues:
 - Security over bank accounts: does this work well for TP lender?
 - Notification
 - Enforcement
 - Guide to how ML works for micro-businesses

Security over a bank account for a third party lender

- Would have to specify that cash received paid into bank account
- TP lender would want priority to claims over the bank holding the account
 - Model Law: to get priority over bank have to have account in name of lender (art 47(2))
 - Control agreements (art 47(4) too complicated for this kind of lender (and would not give priority, see 47(3))
- How do you enable business to use cash it receives to pay bills?
 - Permission to withdraw over a certain amount? Or up to a certain amount? or completely until enforcement?
- Enforcement by collecting from bank account (art 82(1) after default)
 - Art 82 (2): lender can collect from bank account at any time if borrower agrees:
 - Restricts borrower's flexibility of running business BUT enables lender to monitor cash flow (if has to agree every time new advance)
 - What if the bank account is the only source of income for the sole trader and his family?
 - What counts as 'exempt property' for individual?
 - Minimum wage if employed
 - What if self-employed?

Notification requirements of the Model Law

- Registration
 - Art 15(2) Registry Provisions: SC to inform grantor re registration at address in notice or most recent address if know address has changed
- Enforcement
 - Art 77(2)(b) (obtaining possession): notice of default, notice of intention to possess
 - Art 78 (4) : notice of intention to dispose
 - Art 80(2)(a): notice of proposal to acquire.
 - Notice of default: likely to be required in finance agreement ?
- Must think of a system where details of how to notify not left up to the parties
 - System (registry?) captures details at inception: email/physical address/other means of notification?
 - Duty to update: made clear to debtor at outset, and consequences made clear
 - If don't update notice to last address deemed to be notified and enforcement consequences triggered (backstop for emergencies?)
 - Written template of how to achieve this
 - How do you notify changes to the system: needs to be straightforward
 - Important to make sure debtor can't disappear: creditors must be sure that notification effective
 - Notification part of the balancing of interests between ability of creditor to enforce effectively (and out of court) and protection of debtor

Enforcement

- Some personal assets should not be able to be touched: how does this work for bank accounts, ‘tools of trade’?
- Complexity and cost of ML procedures
 - Out of court procedures too complicated and costly, and assume more than two parties involved
 - ADR/ODR?
 - Need much simplified procedure with some protection for debtor built in
 - May need modified court procedures. Perhaps need to reconsider “procedural neutrality” of the ML
 - Move towards “small claims” court model?

Other areas of the law (I)

- Inequality of bargaining power
 - Danger of unfair contractual terms
 - No legal advice, so need protection, but this has to be balanced against cost
- Unfair contractual terms. A problem limited to consumers or equally valid for MSMEs due to disproportion in bargaining power?
 - Access: the problem of “fast cash” institutions (beyond consumer practice)
 - Overall high rate of interest
 - High rate of default interest. Is there a need for a cap? Some European examples (Germany, Spain, etc.)
- Challenging the definition of default: what constitutes sufficient grounds for early termination/acceleration.
 - Less relevant for MSMEs. Usually a problem with covenants in large loans
 - Should the judge have discretion?
 - Should termination be limited to material breach?

Other areas of the law (II)

- Individual entrepreneur
 - Difficulties of identification and notification
 - Overlap between business and personal assets
 - Does it make sense to have separate proceedings in case of individual entrepreneurs?
- Guarantees
 - The lack of relevance of the corporate form
 - Issues of protection of guarantor (who is likely to be individual(s) or mutualised organisation of micro-businesses)
 - The problems of household insolvency
 - The discharge of the recourse action
 - Coordination of proceedings
 - Special rules?
- Guarantees and their interaction with secured lending

Other areas of the law (III)

- Banks and MSMEs:
 - Amounts at stake very small
 - Lenders don't both to do proper risk assessment: risk of overcollateralization
 - Complicated enforcement procedures may cost too much
 - “Evergreening” of uncollateralised loans: interest rates mean debt rises very quickly
 - Low value of business compared to costs means that the bank is not interested in rescuing
 - Banking regulatory framework
 - Special provisioning rules?
 - Control at the origination of credit. Generation and transfer of information. Special relevance to tackle fraud in personal insolvency (ie, prevention of unjustified discharge)
 - Tackling lender passivity: Codes of conduct in recovery/enforcement before the debtor becomes insolvent

Other areas of the law (IV)

- Insolvency and MSMEs. Special problems:
 - Lack of information/correct information
 - Personal/family structure delays access to proceedings. Little value to rescue
 - Creditors' -rational- apathy
 - Liquidation over reorganization as a rule
 - Need for simplification of proceedings
- The need for rules that sanction fraud and breach of information duties
- Enforcement of wrongful trading/duty to file rules
- “Scream or die” Principle; “Deemed consent” Principle
- Templates, limited creditor involvement and other techniques to offer ad hoc solutions for MSME insolvency

Other Definitions:

- Colombian Law
 - Entity or individual person with no more than 10 active workers; with the valuable of minimum five hundred and one (501) month legal wages
- Peruvian Law
- Natural or a legal person, which will be dedicated to extraction, transformation, production, commercialization of goods no more than 10 workers and no more than 150 UIT (approximately Us 150,000) annual sales

Why micro-business are different?

- First Aspect:

Owners don't even use any kind of organizational structure, but only manage it while being a part of the economic unit at the same time. So, without clear delimitations between their personal equity and the enterprise's equity.

- Second Aspect:

It is usual that they only keep a very basic form of accounting based on the presentation of monthly forms for taxes on consumptions and taxes over income (these are not mandatory all they time because of the amount of the yearly income).

- Third Aspect:

Micro entrepreneurs have very little working capital. Therefore, these microenterprises depend on great extent, to the punctual compliance of their debtors in order to survive in the market.

Some solutions:



Legal forms specially design for micro-business

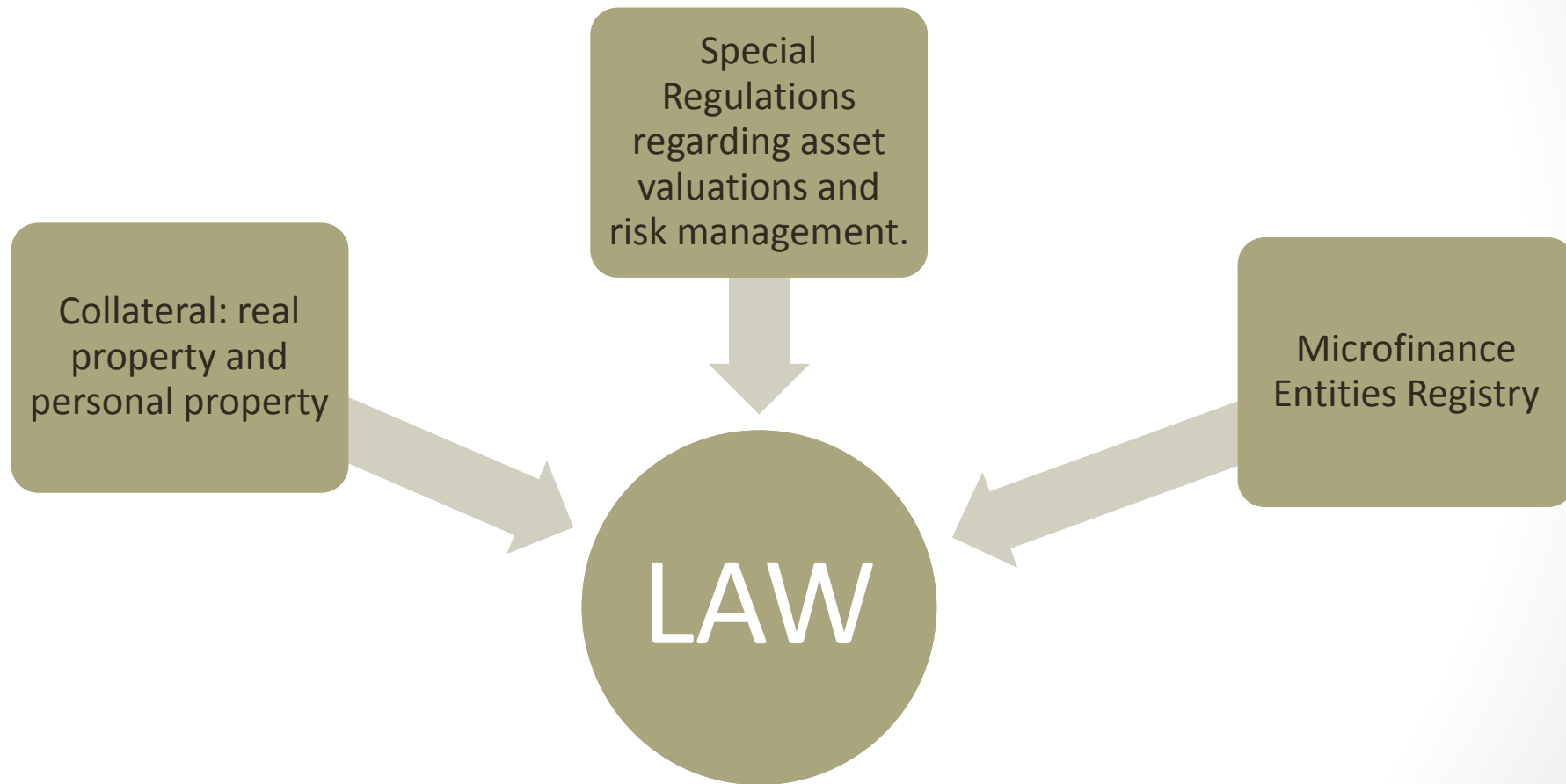


Capacity building in accounting

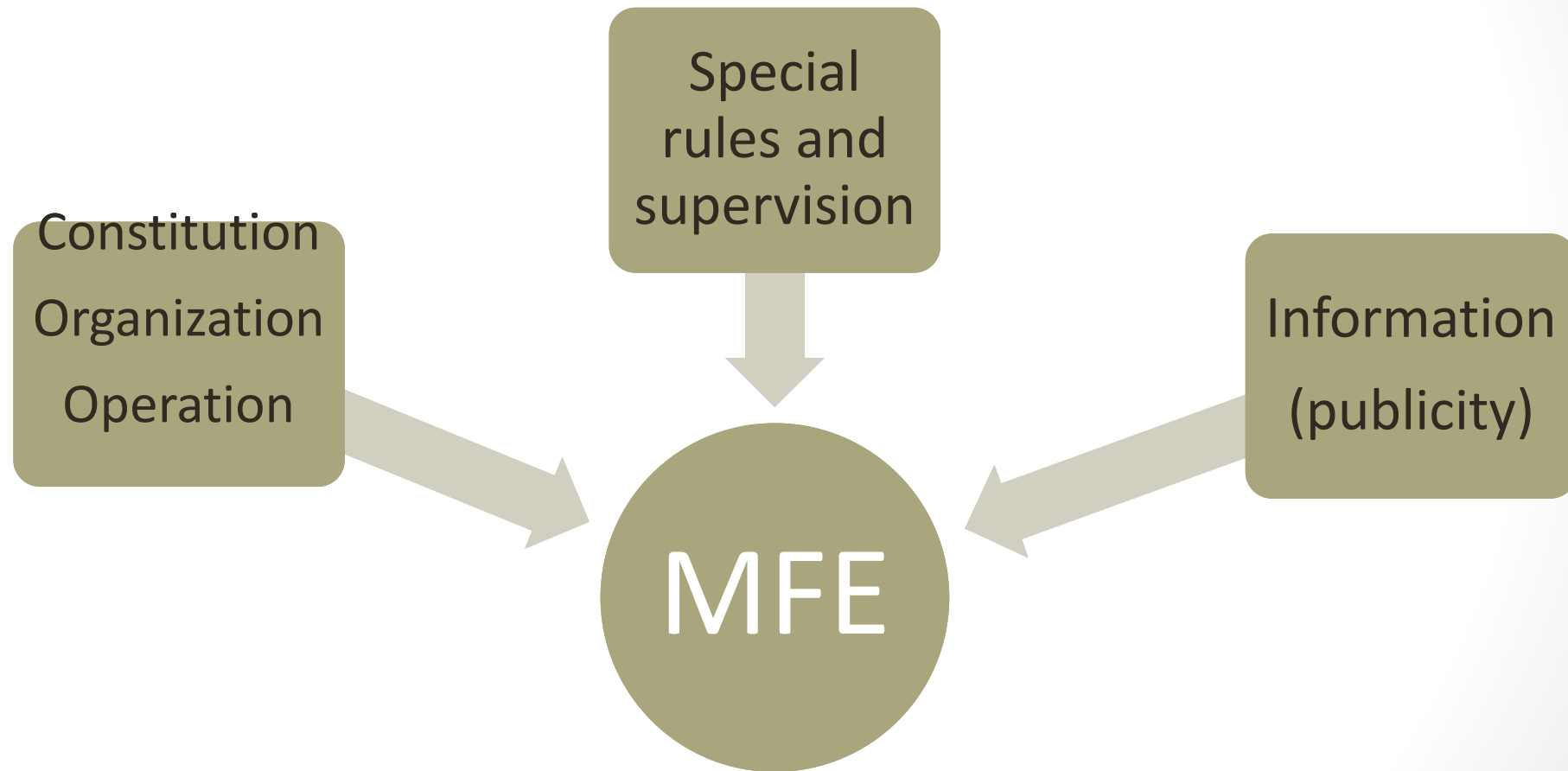


Factoring specially design for micro-business

Legal frame for Microfinance Entities



Legal frame for Microfinance Entities



The Impact of MFE-Law

They will be supervised: special regulations will be approved

They will have more information: access to credit (credit buro)

They will give more information to third parties

Importance

Capacity building for both micro-business and microfinance entities



New products in the market



Economic growth for the country