



A Modular Approach to Micro, Small, and Medium Enterprise Insolvency

Access paper at <https://ssrn.com/abstract=2904858>
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MSMEs – Crucial role and definitional challenges

MSMEs constitute the bulk and beating heart of virtually all of the world's economies

- Primary drivers of economic growth
- Employ more than 1/3 of world's labour force

No globally accepted definition of MSME



The vast majority of businesses entering insolvency proceedings are MSME

Yet most insolvency regimes designed for larger enterprises

MSME:

- Lack types of physical assets acceptable to financial lenders as collateral
- Tend to be relatively undiversified - higher default risk on loss of significant counterparty or from late payments
- Most creditors are disinterested in insolvency process as there is little or no value available for distribution



Cost-effective and timely insolvency proceedings can:

- Encourage inefficient firms to exit
- Encourage greater entrepreneurial activity and new firm creation
- Reduce uncertainty and improve transparency
- Result in greater returns to creditors

One size does not fit all

- Need to distinguish viable businesses from non-viable businesses
- Need to address the issue of cross-over of commercial and personal insolvency
- Need to recognize different cultural, social and economic norms

Why a MSME insolvency regime is needed

Insolvency regimes characteristically assume:

- extensive estate of significant value
- engaged stakeholders, particularly creditors
- cost-justified involvement of insolvency professionals, lawyers, and courts

MSMEs characteristically have:

- any physical assets already encumbered by security interests
 - secured creditors able and willing to use individualistic enforcement methods
- little or no value
 - for distribution to unsecured creditors, who are thus rationally disengaged
 - to support insolvency and legal professionals

Traditional response

Ad hoc changes to 'standard' insolvency regimes in relation to MSMEs:

- removal of some requirements, such as formal proof of claims or avoidance actions
- shortened statutory timelines
- dispensing with certain types of stakeholder engagement, such as through creditor committee

Remaining and resulting problems:

- Arbitrary boundaries between MSME/'standard' regimes
- Rigid preconditions for availability
- Clumsy and of limited functionality, since not designed to address peculiar MSME features and needs

The Modular Approach

Systematic, bottom-up rethinking of the treatment of MSME insolvency

- Familiar **core objectives**
 - preserving and maximizing value
 - fair distribution of that value
 - accountability for wrongdoing
 - enabling discharge of over-indebted natural persons

Foundational assumptions

Enacting state should define the MSME regime respecting constitutional requirements and in full view of the policy choices involved and their respective costs and benefits.

Subject to those policy choice:

- ▶ parties to particular insolvency case are best placed to select the tools appropriate to that case
- ▶ the law should
 - ▶ 'unpack' tools traditionally bundled for workouts, liquidations, and reorganisation
 - ▶ provide these tools in a maximally flexible way
 - ▶ similarly unpack and flexibly distribute process functions
 - ▶ create the correct incentives for their deployment
 - ▶ control moral hazard for entrepreneur and creditors alike

Three categories of function in each insolvency

1. Management function

- ▶ ordinary commercial decisions
- ▶ commercially informed choices about which of the available legal tools to deploy
- ▶ negotiations with creditors and other stakeholders to obtain a desirable conclusion to the insolvency process

Choices: Entrepreneur in possession or insolvency practitioner

2. Administrative function

- ▶ Deadline compliance, notification, and disclosures

Choices: Insolvency practitioner, government agency, court official, or judge

3. Judicial function

- ▶ findings of fact reasonable, law correctly applied, and parties treated fairly

Choices: Insolvency practitioner or government agency acting quasi-judicially, or judge

Who is allowed or required to perform these various functions is a critical policy decision for the state

Core

- **Entrepreneur commences** – capitalise on private information; preserve idiosyncratic investments
- **No requirement to declare or demonstrate insolvency** – incentive to use regime; reduce stigma; better ways to control abuse
- **Entrepreneur remains in possession of business** – incentive to use regime; private information and relationships; lowers costs by combining management and residual risk bearing
- **Entrepreneur proposes 'plan'** to restructure or sell piecemeal or as a going concern; 'plan' may be tailored or off-the-peg (i.e. standardised); would cater to the particular needs of the MSME
- **Plan accepted** if sufficient support **or insufficient opposition**
- **Automatic liquidation of business** if no proposed plan is accepted, unless relevant authority considers that another plan may be approved
- **Discharge of entrepreneur** – Most MSs are sole proprietorships or partnerships with entrepreneur(s) bearing personal liability; discharge essential barring fraud or non-cooperation
- **No necessary involvement of court or professionals** so long as administrative authority ensures proper notification to stakeholders and no one objects

Modules – 1

- **Creditor commencement** – safeguards against entrepreneur incompetence and/or perverse incentives
- **Creditor action moratorium** – provides entrepreneur with incentive to use insolvency regime in countries where individualistic enforcement mechanisms are effective; costs include adverse signal, impaired relationships, and possible entrepreneur abuse
- **Debtor action moratorium** – on disposal of assets and incurring of liabilities; may incentivise creditor engagement; costs include business disruption and/or costs of external approval
- **Creditor plan proposal** – for example, a proposal to liquidate rather than restructure; if two plans, each put to vote with the one obtaining greater support prevailing
- **Mediation** – Resources permitting, entrepreneur and/or stipulated creditor majority may mediate claim proofs, plan formulation, guarantee treatment, etc; no adverse consequences from failure of mediation

Modules – 2

- **Binding of dissentient minorities** - a plan respecting intraclass equality, if approved by requisite majority, may be made effective against dissentients
- **Class cramdown** – subject to standard conditions, such as acceptance by majority of at least one affected class, respect for interclass priorities, and return not less than in liquidation
- **Insolvency practitioner involvement**
 - available if sufficient value in estate, and if entrepreneur or stipulated creditor majority opt for it
 - may overturn entrepreneur in possession default, or only oversee implementation of approved plan, etc.
 - benefits include specialist independent oversight and management
 - direct costs are often very high
- **Court involvement**
 - courts should be treated as the precious and scarce resource that they are
 - costs include involvement of legal professionals

Process overview

- **Oversight role** – core administrative function; backdrop would likely be a government entity: 1. public interest 2. no-asset cases 3. otherwise insufficient value in estate; set-up and operational costs, but likely outweighed by benefits over the medium to long term
- **Minimisation of commencement and participation costs** – standardised processes and forms; no necessary court or IP involvement; insolvency tools ('modules') deployed only when considered cost-effective; see *further below*.
- **Notices** – effective Individual and public notification is a *sine qua non* of Modular Approach; responsibility of administrative function holder
- **Timelines and non-compliance costs** – Administrative function holder enforces strict, brief timelines. **Scream or die**: non-exercise of right results in its waiver. **Deemed approval**: not to vote upon due notification is to be deemed to have voted in favour
- **Regulatory incentives for institutional lenders** – careful consideration to be given to adjusting classification and provisioning rules to incentivise responsible lending and value-maximising participation in insolvency process
- **Supportive framework** – including tax, credit histories, and treatment of guarantees



MSME Insolvency

Entrepreneur's role and obligations



The entrepreneur has a central role in the modular approach, however:

- Non-viable MSMEs may misuse the flexible modular approach and delay an inevitable liquidation; they may also withhold information and exploit the discharge
- Viable MSMEs may avoid taking actions, impeding rescues



Problem may arise:

➤ At times approaching insolvency

- Need to ensure that entrepreneur takes early action
- (and) that they act in the interest of the creditors/stakeholders as a whole

➤ Throughout the insolvency process

- Need to ensure that entrepreneur does not abuse/misuse the regime
- That they provide all relevant information

Obligations at times approaching insolvency

Wrongful trading

or

Duty to file

- Follows the insolvency standard
- Flexible
- Promotes rescues
- Education tool

- Clearer
- Easier to implement (less discretion required)



Options

- 'Wrongful trading' tailored for MSMEs- a **simplified** regime
 - Discharging the obligation by giving due consideration to the 'modules'
 - Support from institutions
 - A focus on civil sanctions; including for non-incorporated debtors
- 'Duty to file' lesser discretion for less sophisticated systems



Addressing abuse/misuse of the insolvency process

- Monitoring the entrepreneur's choices
 - Creditors (by stipulated value) may require: debtor action moratorium; IP supervision; court intervention [= the **Modular Approach itself addresses the risk of abuse**]
- Obligation to cooperate and provide information, enhanced by:
 - Tailored accounting duties
 - Pre-defined information models
 - Involvement of third parties
- Sanctions for misconduct, including
 - non-discharge of entrepreneur's personal liabilities
 - adverse entries in the credit history register

Conclusions

