A second chance for entrepreneurs

PREVENTION OF BANKRUPTCY, SIMPLIFICATION OF BANKRUPTCY PROCEDURES AND SUPPORT FOR A FRESH START

Final Report of the Expert Group

European Commission
Enterprise and Industry

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Promotion of entrepreneurship and SMEs
Entrepreneurship

REPORT OF THE EXPERT GROUP

A SECOND CHANCE FOR ENTREPRENEURS: PREVENTION OF BANKRUPTCY, SIMPLIFICATION OF BANKRUPTCY PROCEDURES AND SUPPORT FOR A FRESH START

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This project was conducted with national experts nominated by the national authorities of the EU Member States, Candidate/Accession Countries and EFTA/EEA countries under the Competitiveness and Innovation Programme.

Although the work has been carried out under the guidance of the Commission officials, the views expressed in this document do not necessarily represent the opinion of the European Commission.

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Information on other Projects

Information on other projects jointly carried out by the European Commission and by the national administrations that are addressing the issue of improving the business environment can be found at:
http://ec.europa.eu/enterprise/policies/sme/business-environment/index_en.htm

1. Introduction

Business entry and business exit are natural processes that are inherent to European economic life. In fact, 50% of enterprises do not survive the first five years of their life and of all business closures, bankruptcies account in average for 15%.

Even though today's failure can hold the germ of tomorrow's success, business closure is not yet seen as an opportunity for a more reinvigorated entrepreneurship and business activity. Despite their setback, failed entrepreneurs still prefer an entrepreneurial career to a salaried job after market exit. They learn from their mistakes and those that re-start have lower rates of failure and experience faster growth than newly established companies[1].

Yet, even though only 4-6% of bankruptcies are fraudulent, public opinion makes a strong link between business failure and fraud. Many honest bankrupts feel discouraged to re-start due to the stigma and difficulties or discrimination faced after a bankruptcy. In addition, bankruptcy has an important secondary effect on entrepreneurship: many would-be entrepreneurs do not start a company because of their fear of the consequences of business failure[2].

The latest data indicate that in **the euro zone bankruptcies grew by 5% in 2010 after having grown by 46% in 2009**[3]**.** The deterioration in 2009 came on top of a severe increase in 2008, that saw bankruptcies grow in Spain (+187%), Ireland (+113%), Portugal and Denmark (+67%), Italy (+45%) and the UK (+31%). In terms of total numbers, corporate insolvencies grew 22% in 2009 to 185,111 for Western Europe (EU15 + Norway and Switzerland). This made it the worst year in more than a decade for countries such as Sweden (since 1996), the United Kingdom (since 1993), the United States and Norway (since 1992) and was an all-time negative record for countries such as France, Spain, the Netherlands, Belgium, Switzerland, Austria, Finland, Ireland and Portugal.

The total number of insolvency related job losses in Europe in 2009 is estimated at 1.7 million (1.2 million in 2008)[4]

A second chance policy that enables formerly bankrupt entrepreneurs restart may represent one of the most promising and under exploited policy options for company creation and job growth.

Research shows that businesses set up by re-starters grow faster than businesses set up by first timers in terms of turnover and jobs created[5]. But acting on second chance would bring an even larger impact on entrepreneurship: many would-be entrepreneurs do not

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[1] E. Stam, D. B. Audretsch and J. Meijaard, "Renascent Entrepreneurship", ERIM, 2006.

[2] The European Commission's Flash Eurobarometer 192 "Entrepreneurship Survey of the EU (25 Member States), United States Iceland and Norway" (2007) and Flash Eurobarometer 283 "Entrepreneurship in the EU and beyond" (2009). The possibility of going bankrupt the greatest fear of setting a business amongst European citizens ahead of the "uncertainty of income", "job insecurity" or "need too much energy or time"

[3] Euler Hermes, Communiqué de presse 4/06/2009 "Accélération historique du nombre des défaillances d'entreprises dans le monde en 2009 : +35%"

[4] Source: "Insolvencies In Europe 2009/10" Creditreform Economic Research Unit

[5] E. Stam, D. B. Audretsch and J. Meijaard, "Renascent Entrepreneurship", ERIM, 2006.

start a company because of their fear of the consequences of business failure[6] and thousands of companies are not created and tens of thousands of jobs are not created every year in Europe. Fear of bankruptcy and its consequences acts as an effective deterrent to entrepreneurship. An effective second chance policy is fundamental to send a message that entrepreneurship may not end up as a "life sentence" in case things go wrong.

This report collects the conclusions and recommendations of a group of experts from 33 European countries on what are the key issues that public authorities should address to reduce the burden of bankruptcy on entrepreneurship. It is not about how to save companies at any cost regardless of their situation and perspectives but recognition that public policies and programmes during the time leading to, during and beyond bankruptcy/insolvency can create a business environment that helps entrepreneurs save viable businesses and create more companies.

2. Latest Commission activities[7]

The 2007 Communication from the Commission, "Overcoming the stigma of business failure – for a second chance policy; implementing the Lisbon Partnership for Growth and Jobs"[8], recognized that EU countries should facilitate "*a second chance for entrepreneurs who are at risk or have failed*" and invited Member States to act in order to reduce stigmatization of business failure.

Building on this, the Communication "A Small Business Act for Europe" (SBA)[9], adopted in 2008, devoted the second of its 10 principles to the issue. Principle II "*Ensure that honest entrepreneurs who have faced bankruptcy quickly get a second chance*" calls on the Commission to promote a second chance policy by facilitating exchanges of best practice between Member States and asks the Member States to:

- promote a positive attitude in society towards giving entrepreneurs a fresh start,
- enable the completion of all legal procedures to wind up a business, in the case of non-fraudulent bankruptcy, within a year,
- ensure that re-starters are treated on an equal footing with new start-ups.

3. The 2008-2010 project on Bankruptcy and Second chance

In order to fulfil its SBA commitments, the European Commission asked Member States, EEA countries and candidate countries to nominate a representative to participate in a two year project on "Bankruptcy and Second Chance". All EU Member States plus Croatia, Iceland, Montenegro, Norway, Serbia and Turkey nominated an expert. The experts met four times in 2009 and 2010 to share information and good practices and discuss the key issues surrounding bankruptcy and second chance.

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[6] Flash Eurobarometer 192 "Entrepreneurship Survey of the EU (25 Member States), United States Iceland and Norway" (2007) and Flash Eurobarometer 283 "Entrepreneurship in the EU and beyond" (2009). The possibility of going bankrupt the greatest fear of setting a business amongst European citizens ahead of "uncertainty of income", "job insecurity" or "need too much energy or time"

[7] Information on all Commission projects on bankruptcy and second chance can be found in http://ec.europa.eu/sme2chance

[8] COM(2007) 584 final

[9] COM(2008) 394 final

The main goal of the project was to find ways to minimise the "lost entrepreneurship potential" associated with bankruptcy and second chance with the ultimate goal of identifying policies that could get more companies and more jobs in the market.

The efforts of the group were supported by an independent study on "Business Dynamics" which analysed separately the impact of current practices on entrepreneurship in each of the areas of bankruptcy and second chance[10]

This final report collects the main conclusions and key policy recommendations of the group of experts.

Bankruptcy and 2nd chance. Conclusions

The focus of this paper is on the entrepreneur and how the processes in and around bankruptcy and insolvency support or impede entrepreneurship with a particular focus on *second chance*: supporting the return of honest failed entrepreneurs to the market.

Bankruptcy legislation has to balance two conflicting interests. On the one hand, the creditor's interests must be protected. On the other any system must keep viable businesses alive and, more importantly, create an environment that aids an entrepreneur to take risks and start a new business. This is valuable for the entrepreneur and for society at large.

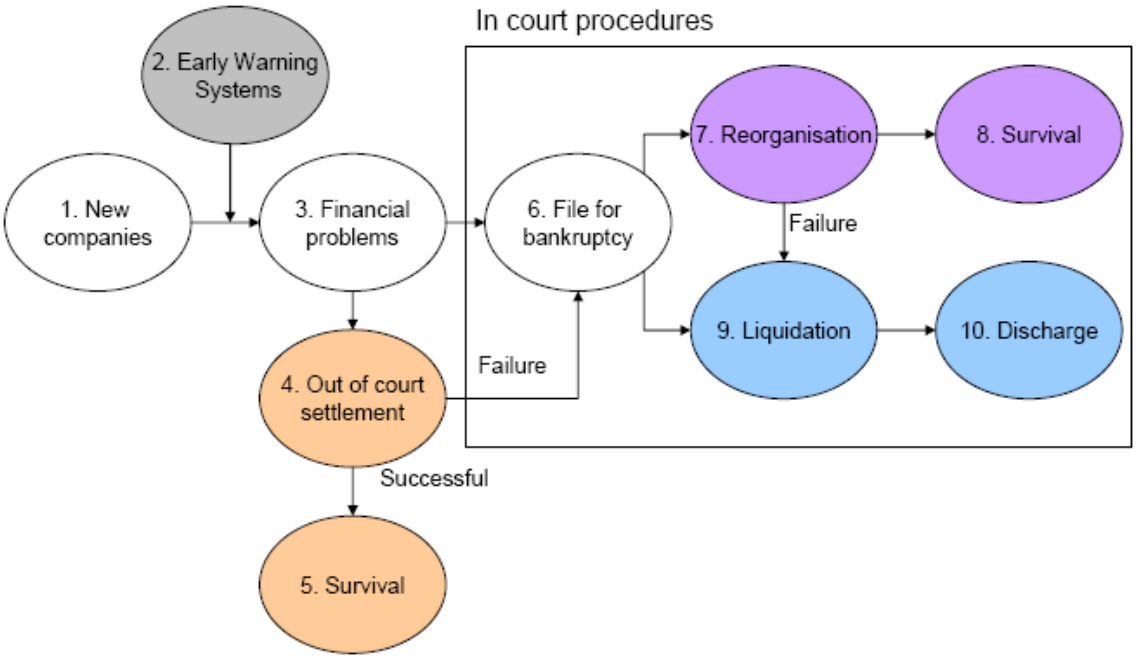
Keeping the pool of entrepreneurs in the system is essential. Entrepreneurs have specific skills and attitudes that are not transferrable and in Europe they represent a lesser percentage of the population than in the US. Many policies have focused on the necessity to "produce" more entrepreneurs and not so much on the necessity to preserve the stock of entrepreneurs.

In terms of the scope of this report we have taken a wide perspective. There are different approaches when defining what is understood by bankruptcy and insolvency procedures and practices, but we have taken a view similar to that of the OECD[11], which is presented in the scheme below:

[10] The study on "Business Dynamics" covered the areas of start-up and licensing procedures, transfers of business, bankruptcy and second chance. Available in: http://ec.europa.eu/enterprise/policies/sme/business-environment/failure-new-beginning/index_en.htm

[11] CFE/SME(2006)3 "Working party on small and medium sized enterprises and entrepreneurship – entrepreneurship policy indicators for bankruptcy legislation in OECD member and non-member economies". OECD 2006

Figure 1. Overview of Bankruptcy Process



This paper presents separate conclusions for each of the four, consecutive sub-areas that compose the bankruptcy process taken in its widest possible sense: from the time the company starts experiencing considerable financial problems until the company is eventually re-organised or liquidated and the subsequent effects of bankruptcy on the entrepreneur.

These chapters are:

1. **Prevention,** (early warning systems, support mechanisms)
2. **Out-of-court settlements,**
3. **In-court procedures,**
4. **Treatment of the entrepreneur post-bankruptcy and conditions for a second chance** (liquidation, discharge and its consequences)

The last chapter, "**Recommendations",** lists specific actions that public authorities should undertake so that bankruptcy and second chance are more conducive to entrepreneurship.

1. Prevention

In terms of maximising asset value and preserving jobs, a financially distressed enterprise is usually more valuable as a going concern than if it is liquidated. It is therefore often in the interest of all parties to have effective procedures to help financially distressed companies. In addition, countries with efficient early warning systems most commonly feature efficient bankruptcy and insolvency systems.

Effective prevention measures are based on the principle that, the earlier the recognition and intervention, the better the results. Yet entrepreneurs are unlikely to request assistance at an early stage.

Entrepreneurs are intrinsically characterised by self assurance and self reliance which makes them regard financial difficulties as something that can always be overcome without external involvement. In many cases, this will lead them not to seek help until it becomes unavoidable which in many cases may mean that it is already too late. Two additional factors reinforce this: the risk that they will lose control of their business if they seek a financial arrangement with the creditors and more importantly, the psychological trauma of admitting defeat will both weigh against corrective measures being taken by the entrepreneur. Thus, there are strong "incentives" not to act in time. Failure to take positive action when insolvency is a possibility is far too common and will exacerbate a difficult situation.

In this context, government intervention is crucial and active assistance should be offered to entrepreneurs in financial difficulties. Initiatives, programmes and support groups at this stage can all play a valuable role but it is accessibility and awareness of the tools and resources available to the entrepreneur entering the 'twilight zone' that are vital. This assistance should be based on making the maximum use of the available structures and support programmes, and therefore:

- Diagnostic tools should be guaranteed by public institutions since many enterprises will not be able to afford such services on a commercial basis.

- More information from public organisations on support measures should be made available to raise awareness by entrepreneurs

In terms of prevention, taxation can be a useful tool. Governments could take extraordinary actions, such as tax deferrals, graded multiple payments or the reduction of guarantees required to postpone payments, during periods of general economic duress. Tax agreements for companies on a one to one basis can also be an option or a development of the above point, such as, for example, renegotiating outstanding taxes over a longer time frame for repayment. An important caveat is that these measures must be structured and implemented in a way that do not create market distortions or undercut general competition.

Finally, strict vigilance against payment delays by public bodies, especially during periods of financial duress, is a key supporting tool to prevent companies falling into insolvency.

2. Out-of-court settlements

Entrepreneurs may experience financial problems during the life of their enterprise. Yet they are often not able to afford a long restructuring process involving external advisors and considerable financial costs. This is particularly applicable to the smallest SMEs.

Inexpensive and simple procedures for restructuring are therefore important. Out-of-court settlements or re-organisations offer speedier and more inexpensive solutions for companies suffering severe financial distress and will, in the vast majority of cases, save

more company value than the judicial alternative. The main goal of the out-of-court procedures must be the survival of the company as a going concern.

As with prevention, greater efforts must be made to communicate the existence and benefits of out of court settlements amongst entrepreneurs. This is especially relevant as it is problematic to overcome the initial reluctance from entrepreneurs to participate because of the stigma associated with a failure. In as much as it is difficult, from a policy point of view, to create incentives for the entrepreneur to seek financial restructuring as early as possible, it should be possible to avoid disincentives to act, by, for example, ensuring that the entrepreneur will be able to keep control of the business in restructuring cases. Allowing a business to reach a compromise with its creditors, whilst providing the freedom to trade through difficulties, can lead to a better result for all stakeholders than a court-based process.

Also, any measures to reduce the negative image of a failed entrepreneur (or an entrepreneur in distress) will increase the willingness of entrepreneurs in a (financial) crisis to accept help and take the necessary actions. In this respect out-of-court procedures must minimise publicising the entrepreneur's problems. They will not only be a barrier to more entrepreneurs opting for this solution but may also impede the company's turnaround if it erodes goodwill and reputation.

For out-of-court procedures to work, creditors must feel that there are guarantees to the process. Since an informal agreement may leave some creditors out and hence risk the integrity of the agreement, an efficient out-of-court settlement must legally preserve the agreement for all creditors. In this respect it is important that the greatest number of creditors and not just the largest ones are included in any refinancing process in order to reduce stigma.

To support this process it is important that there is the right infrastructure of insolvency and turnaround professionals to support such procedures, such as a licensed insolvency practitioner to supervise the process and pay creditors or, as in France and Italy, where private agreements are homologated by the court which supervises the fairness of the agreement. This provides integrity and credibility to the process.

In order to facilitate more out-of-court procedures, it is important to recognize that:

- Success depends on a timely start of such proceedings by the entrepreneurs so they must have access to information about out-of-court settlements.

- There is no "one size fits all" solution and a range of attractive formal "non bankruptcy" alternatives and informal work out plans should be available to satisfy the largest number of cases possible.

- Out-of-court procedures will be greatly supported if they include a system that facilitates re-financing of troubled companies as an alternative to the judiciary system. This is relevant as in the world of re-financing "size matters" and many SMEs do not participate as they have no negotiating leverage in the process

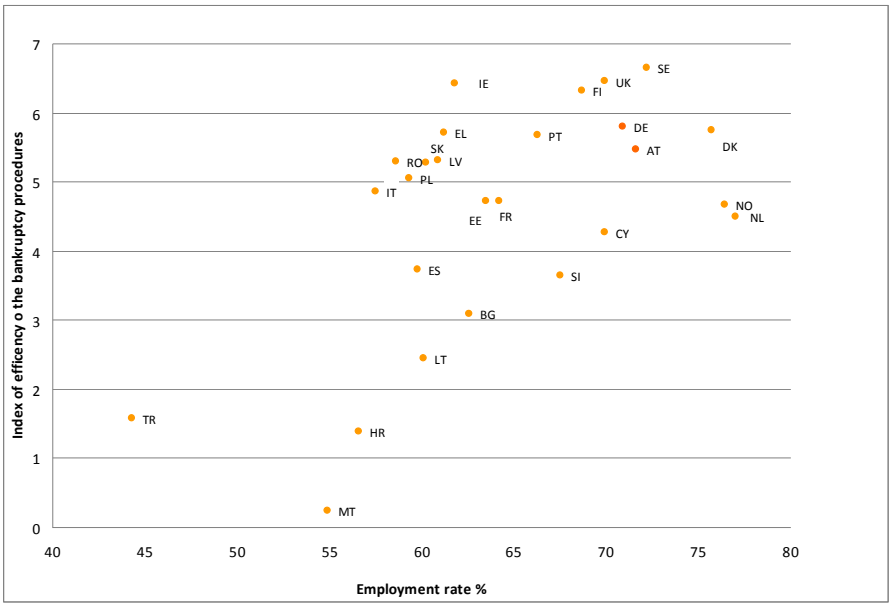
Finally, to support the process, a company that has signed a refinancing agreement should be allowed to participate in public tenders and public funds on equal conditions to any other company**.**

3. In-court procedures

If it is not possible to re-organise a firm out-of-court, the firm can be re-organised through formal court procedures. This will often involve drafting a re-organisation plan and allowing the discharge of part of the debt; a solution that will normally be preferable to both debtors and creditors if the firm is viable after the re-organisation.

If a firm is not viable it is equally important to have effective procedures for shutting it down. In this respect data collected by the World Bank[12] strongly suggests that there is a strong and direct link between length of procedures and loss of available company value. Importantly, the study on Business Dynamics indicates that the level of efficiency of the bankruptcy law is positively correlated to employment rate as it can be seen in the graph below.

Efficiency of bankruptcy procedures versus employment rate in European countries



Source: Business Dynamics: Start-ups, Business Transfers and Bankruptcy", European Commission, 2011

In-court procedures provide predictability and safeguards, so an infrastructure of courts and properly trained judiciary is indispensable. Specialised courts or specialised practitioners or specialised support to courts is fundamental. Good laws poorly applied do not make a good system.

A smooth credit system requires predictable, transparent, effective and affordable systems for both secured and unsecured creditors to protect their rights. This system has to provide a good balance between the rights of creditors and the rights of debtors and provide protection not only for creditors but also for debtors to make reorganisation proceedings more effective.

[12] www.doingbusiness.org

If a case is launched by creditors and not by the debtor, an administrator should be appointed and an analysis of the case should be launched immediately prior to the opening of court procedures to minimise the risk of value loss.

Courts add time and cost and court-managed procedures may not benefit anyone. Yet, once started, normal bankruptcy proceedings should be fast, cost-efficient and be able to save a reasonable amount of the value of the assets. If the process takes too long, the only certain results are that asset values will be eroded and any potential restart will be delayed. Despite this, deadlines may not be the best solution to increase speeds as the process needs to be as flexible as possible for practical reasons. Simplified procedures for micro-enterprises for bankruptcy and reorganisation proceedings should be considered by national legislators.

Simple and predictable in-court procedures will not only result in speedier processes but will also increase the chances of cases being resolved via out-of-court procedures as in court procedures will not be used as a delay manoeuvre by any of the parties.

Finally, in-court procedures should be a less-preferred option. In Ireland the introduction of a Pre-Action Protocol is being considered. Under this protocol prior to creditors bringing a petition for bankruptcy, creditors and debtors would be obliged to consider attempting to reach a Debt Settlement Arrangement or to negotiate a voluntary debt management plan.

4. Treatment of the entrepreneur post-bankruptcy and conditions for a 2nd chance

More and more countries have started viewing bankruptcy as a learning experience for the entrepreneur. However, if no clear distinction is made between honest but unlucky and dishonest or fraudulent bankrupts, honest bankrupts can be stigmatised through association with the dishonest, especially in terms of social acceptance of the failed entrepreneur. Thus, lack of discharge and/or lengthy and burdensome debt repayments will make it difficult to finance a new startup.

It is therefore important to have liquidation and discharge procedures that allow the entrepreneur a fresh start. This impacts directly those entrepreneurs who have a business for which they are personally liable. But it will also affect the creation of new limited companies as many banks and credit institutions demand personal guarantees from the entrepreneur if the company is seeking to secure a loan. A study commissioned by the Insolvency Service in the UK[13] shows that discharge periods have a very pronounced effect on levels of entrepreneurship.

The concept of a fair and quick second chance is not adequately recognised by national legislations. Most of the time business failure is not due to the incompetence of the entrepreneurs but to external circumstances, yet legislation and support programmes do not discern among an entrepreneurial failure and a personal failure. A system must be put in place that does not exacerbate pressure by creditors to declare an entrepreneur as dishonest.

[13] Bankruptcy Law and Entrepreneurship, J. Armour and D. Cumming, *University of Cambridge Centre for Business Research Working Paper No. 300*, 2005

This separation and strengthening of initiatives to help the re-starters should be promoted. Amongst them increased networking among entrepreneurs / re-entrepreneurs is important to foster a solid and realistic second chance.

The systematic recognition of honest vs. dishonest entrepreneurs is essential to reduce the stigma from bankruptcy. There has to be more effective measures against fraudulent bankruptcies in order to separate the non-culpable from the dishonest. In the UK, dishonest entrepreneurs are identified by the behaviour prior to or during the bankruptcy process (reckless expenditure of credit, paying family members, "evaporation" of assets, etc.) and are then liable for prosecution (civil procedures can deliver protection for the public from rogue traders in addition to any criminal punishment). This not only keeps a level playing field in the economy but acts as a deterrent for others who might act in a similar way. Importantly, effective mechanisms to identify wrong-doers give creditors some safeguards and help those who come cleanly through bankruptcy gain a better chance of a fresh start.

A modern system for discharge is paramount to reduce the stigma of bankruptcy. In this system discharge should be as automatic and as reasonably limited in time as possible. In principle one to three years could be a good target to aim for. Contribution beyond the period of discharge is not reasonable and all debts should be discharged after this time.

Moral hazard has to be addressed and there has to be a good balance between comfort for the debtor and what is acceptable for society in general and specifically for the creditors. If the latter is disregarded there is potential for a spectacular backfire where giving a second chance would result in a higher risk willingness of entrepreneurs (gambling) and in turn would only result in higher interest rates charged on loans or other actions being taken by the creditors to ensure against the higher risk of default. A good balance between the debtor's interests and those of the creditor is crucial for all actions being taken in order to reduce the level of stigma associated with failure.

Access to finance is paramount for a second chance. Suitable financing solutions for re-entrepreneurs need to be put in place. Re-starting entrepreneurs need capital, cash flow and credit, with few, if any, restrictions on future trade, without being encumbered with long repayment periods of debts captured by a bankruptcy proceeding.

Distinction between honest and dishonest entrepreneurs should translate into non-discrimination of those entrepreneurs which are non-fraudulent bankrupts in becoming beneficiaries of any supportive programs available on the market for starting up a new business whilst simultaneously avoiding any preferential treatment of "reborn" entrepreneurs, as this may lead to unfair competition and moral hazard.

RECOMMENDATIONS OF THE GROUP OF EXPERTS

1st Recommendation

Considering the available programmes and policies, and the results that can be achieved, Member States should prioritise their interventions to support SMEs in the following order:

1st Prevention;
2nd Post bankruptcy and second chance;
3rd Out-of-court settlements;
4th In-court procedures.

2nd Recommendation

Discharge is key for second chance: a 3 year discharge and debt settlement period should be a reasonable upper limit for an honest entrepreneur and as automatic as possible. It is fundamental to send a message that entrepreneurship may not end up as a "life sentence" in case things go wrong. Otherwise it acts as an effective deterrent to entrepreneurship.

3rd Recommendation

Decisive actions must be taken for a greater differentiation of honest and dishonest bankruptcies. It is best to assume in principle that all are honest and then identify those that are dishonest and prosecute/penalise them.

Insolvency regimes should differentiate between debtors who have acted honestly in their conduct or business giving rise to the indebtedness, and those who have acted dishonestly in that regard and contain provision that wilful non-compliance with legal obligations by a debtor be subject to civil sanction and, where appropriate, criminal liability.

4th Recommendation

Reorganisation can be extremely costly for micro and small companies to the extent that some of them may not be able to afford it and have only bankruptcy as a viable option. Solutions must be implemented by the legislator so that the costs of reorganisation for SMEs are lowered. Capped fees can provide a solution. Alternative procedures must be put in place so that adequate solutions are available for all types of SMEs. Procedures must be proportionate to the size of the business.

5th Recommendation

Out-of-court procedures must be available for all types of debtors regardless of the amount that can be repaid by the debtor.

6th Recommendation

Insolvency proceedings should be adjudicated upon by specialist judges. Specialised training should be available to judges and court officers adjudicating in or administering such proceedings.

7th Recommendation

The European Commission is requested to continue exchanges of information and good practices among Member States on a regular basis.

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