Brussels, 12.3.2014
SWD(2014) 62 final

# COMMISSION STAFF WORKING DOCUMENT

# EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT

*Accompanying the document*

**Commission Recommendation**

**on a new approach to business failure and insolvency**

{C(2014) 1500 final}
{SWD(2014) 61 final}

## 1. PROBLEM DEFINITION

At a time where the European Union (EU) is facing the biggest economic crisis in its history leading to record numbers of bankruptcies in most Member States, improving the efficiency of insolvency laws in the EU, in particular by re-enforcing a rescue and recovery culture, has become a key factor in supporting economic recovery.

This proposal aims at improving conditions and incentives for preventive restructuring of firms and giving a second chance to honest entrepreneurs who once failed. It links in with the EU's current priorities to promote economic recovery and sustainable growth, a higher investment rate and the preservation of employment, as set out in the Europe 2020 strategy.

An effective insolvency law should be able to liquidate speedily and efficiently unviable firms and restructure viable ones in order to enable such firms to continue operating and to maximise the value received by creditors, shareholders, employees, tax authorities and other parties concerned.

However, many Member States insolvency laws are still inflexible and costly or offer only limited restructuring options. In some Member States firms can only restructure out-of-court or only within formal insolvency proceedings; in others early restructuring procedures are formal, expensive and lack certain effectiveness features. A third group of Member States has a wider range of restructuring possibilities, but they are mainly court-driven and expensive; in a fourth group, hybrid procedures exist but their design could be improved.

Last but not least, in some Member States, discharge periods – the length of time that must elapse before a bankrupt entrepreneur is discharged of his/her debts and may start a new enterprise – are too long. This stigmatises failure and discourages entrepreneurship.

The European Parliament supports the harmonisation of certain aspects of insolvency law. Calls for a coordinated EU bankruptcy law have also been made by the Organisation of Economic Cooperation and Development (OECD).

## 2. ANALYSIS OF SUBSIDIARITY

Since 2009, an average of 200,000 firms went bankrupt each year in the EU. There is a significant cross-border dimension to these bankruptcies, as about one-quarter involved creditors and debtors in more than one EU Member State. Moreover, firms further upstream or downstream in the supply chain in one Member State may face financial difficulties because of the insolvency of a firm in another Member State, even if they have no direct dealings with that firm. Therefore virtually any business in the EU may be affected. For these reasons, an efficient and coherent preventive restructuring procedure should exist in all Member States.

Differences in national insolvency laws may hamper the effective administration of insolvency proceedings in the internal market. Stakeholders consider that the harmonisation of European insolvency regimes would substantially reduce barriers to cross-border investment and contribute to the smooth functioning of the internal market. In particular, such harmonisation could address the following cross-border problems:

- Additional costs for creditors if debtors are in Member States with no or inefficient preventive procedures

- Additional cost for creditors if firms relocate to other Member States to benefit from more debtor-friendly procedures.
- Additional cost of restructuring for cross-border groups of companies due to differences between Member States rules
- Financial detriment due to the discrepancies between discharge periods for entrepreneurs in the Member States
- Additional cost for creditors if debtors choose to relocate to jurisdictions offering shorter discharge periods

## 3. OBJECTIVES OF EU INITIATIVE

The general objectives are to:

1) contribute to the smooth functioning of the internal market by ensuring that, wherever in the EU a firm gets into financial difficulties, insolvency law enables efficient liquidation of unviable firms and restructuring of viable ones

2) enhance the prospects for survival of firms in financial difficulties

3) minimise the potential distortions to location and investment decisions caused by differences in national insolvency laws.

The table below shows the specific and operational objectives, and how they relate to each other.

| Specific objectives | Operational objectives |
|---|---|
| Increase the number of viable firms being successfully rescued<br><br>Reduce the cost of rescue in Member States with inefficient rescue procedures<br><br>Reduce the costs of cross-border restructuring of groups of companies | Ensure that all Member States have an effective restructuring procedure in place, which:<br>• Provides for an early possibility to restructure<br>• Improve chances of negotiations by allowing the debtor a "breathing space" from enforcement actions<br>• Facilitate the continuation of debtor's business<br>• disallow minority creditors to jeopardise restructuring effort<br>• increase chances of success of the restructuring plan by allowing new financing<br>• allow for limited court involvement |
| Reduce costs for creditors resulting from relocation of the corporate debtors | Reduce incentives for relocations benefiting the debtor at the expense of creditors |
| Reduce costs for creditors resulting from relocation of entrepreneurs which are debtors | Lower the discharge periods |

## 4. POLICY OPTIONS

Four policy options were identified:

– **Option 1: maintaining the status quo (baseline scenario)**

The revision of the Insolvency regulation which is currently in the legislative process would extend the scope of the Regulation to preventive proceedings, thereby ensuring that the effects of these proceedings are recognised across the EU. However, Member States will neither be obliged to notify their pre-insolvency proceedings, nor to introduce such procedures in their national law.

– **Option 2: a recommendation to the Member States on minimum standards for preventive restructuring frameworks and discharge periods for entrepreneurs (second chance)**

This measure would recommend to the Member States to put in place a preventive restructuring framework which contains certain minimum standards for effective corporate rescue, as well as minimum standards on discharge periods.

– **Option 3: a directive establishing minimum standards on preventive procedures and discharge periods for entrepreneurs (second chance)**

This option would oblige Member States to put in place the minimum standards referred to in Option 2.

– **Option 4: establishing a fully harmonised procedure**

This measure would fully harmonise all aspects of Member States' preventive procedures as well as the rules relating to the insolvency of entrepreneurs.

Options 1 and 4 were discarded at an early stage. Option 1 would not be adequate to address the problems identified. While option 4 would indeed provide a level playing field and address the problems, full harmonisation was judged to be a disproportionate response to the problems identified.

A set of sub-options for options 2 and 3 is presented in the table below. These sub-options were established on the basis of:

- international best practices, such as the World Bank Principles for Effective Insolvency and Creditor Rights Systems, UNCITRAL Legislative Guide on Insolvency Law, International Monetary Fund (IMF) Orderly and Effective Insolvency Procedures, European Bank for Reconstruction and Development Core Principles for an Insolvency Law Regime;
- the recommendations of the "Study on a new approach to business failure and insolvency – Comparative legal analysis of the Member States' relevant provisions and practices" commissioned to INSOL Europe;
- lessons drawn from the analysis of reforms of the restructuring laws in the Member States,
- conclusions drawn from the discussions in the Commission Group of private experts on insolvency and the meeting with Member States;
- the results of the public consultation;
- legal and economic literature.

| Operational objective | Sub-options on building blocks of the proposed framework | |
|---|---|---|
| **EFFECTIVE RESTRUCTURING FRAMEWORK** | | |
| **Early restructuring possibilities** | **Sub-option 1**<br>The procedure must be available when | **Sub-option 2**<br>The procedure must be available when |

| | | | |
|---|---|---|---|
| | the debtor is in financial difficulties, irrespective of whether there is any risk, actual or potential, of insolvency | the debtor is in financial difficulties and there is a risk, actual or potential, of insolvency | |
| **Moratorium** | **Sub-option 1**<br>A moratorium granted automatically and against all creditors. | **Sub-option 2**<br>A moratorium granted on request by the debtor | **Sub-option 3**<br>Sub-option 2 + a moratorium of limited (short) duration |
| **Debtor in possession** | **Sub-option 1**<br>Debtor remains in possession, no supervisor or mediator appointed by the court | **Sub-option 2**<br>Debtor remains in possession, but Member States may enable courts to appoint a mediator and /or a supervisor | |
| **Plan approval by a majority of creditors** | **Sub- option 1**<br>A minority of creditors can be bound by the plan if a majority in the same class of creditors agrees; Member States may choose to exclude secured creditors from majority voting (i.e. their rights cannot be affected) | **Sub-option 2**<br>A minority of creditors can be bound by the plan by a majority in the same class; all classes of creditors are bound, including secured creditors | **Sub-option 3**<br>Sub-option 2 + Member States may provide that no voting process needs to take place |
| **New financing** | **Sub-option 1**<br>Granting super-priority status to new finance, to be paid before any unsecured debt. | **Sub-option 2**<br>Exempting new financing contained in the restructuring plan from avoidance actions. Member States may also provide for super-priority status to new financing. | |
| **Reducing the formalities relating to court proceedings** | **Sub-option 1**:<br>A flexible framework, which allows for a more limited involvement of courts | **Sub-option 2:**<br>Sub-option 1 plus requiring courts to rule in principle in written procedure | |
| **DISCHARGE PERIODS FOR ENTREPRENEURS** | | | |
| **Lower the discharge periods** | **Sub-option 1**<br>Discharge of debts for entrepreneurs within 1 year, with limited exceptions. | **Sub-option 2**<br>Discharge of debts for entrepreneurs within 3 years, with limited exceptions. | **Sub-option 3**<br>Sub-option 2 + removing bad data from credit rating databases a short period of time after discharge. |

## 5. ASSESSMENT OF IMPACTS

The overall impacts of **option 2** in relation to the specific and general objectives are summarised in the table below:

| Specific objective | To what extent the objective is fulfilled |
|---|---|
| Increase the number of viable firms being rescued | If followed in the Member States, the recommendation could improve the restructuring activity in particular in BG, DK, SK, SI, HR, CY, EE, IE, LT, LU, NL, PL, RO where currently the restructuring is not effective (e.g. too late, formal, inefficient, lack of enabling framework) and to a lesser degree in Member States which have restructuring options but formalised and expensive (BE, FR, DE, FI, SE and LV). Small and medium viable firms in financial distress with not overly complex debt structure would benefit in particular. For example, if in **Hungary** restructuring |

<table>
<tr><td></td><td>rate increased from the current 1% to 20% (UK rate is 22%) as a result of implementing the proposed procedure, there would be (hypothetically) 4300 additional going concerns. Even if only 10% of these were successful, 430 firms could be successfully restructured.</td></tr>
<tr><td>Reduce the cost of rescue in Member States with inefficient rescue procedures</td><td>For the group of countries which have only formal restructuring procedures (BE, DE, FR, FI, SE, LV) the total savings for firms if they switched to the hybrid alternatives could be (with all due caveats) estimated to be around €135-223m. To this, additional and significant savings such as possible dividends should be added.<br><br>There could also be savings in costs in BG, DK, SK, SI, HR, CY, EE, IE, LT, LU, NL, PL, RO where liquidation is currently the most common outcome of insolvency, because part of formal and court-based liquidation proceedings are expected to be replaced by the proposed restructuring proceedings which are largely out-of-court.</td></tr>
<tr><td>Reduce the costs of cross-border reorganisation of groups of companies</td><td>Groups of companies (representing 0.2% of all companies, but 30% in terms of jobs and 41% of gross added value) could save costs from designing a restructuring plan which could work for all its subsidiaries, instead of designing one plan for each subsidiary, in accordance with local rules.</td></tr>
<tr><td>Reduce costs for creditors resulting from relocation of firms</td><td>The option could ensure a more even playing field for small and bigger companies, avoid additional cost for creditors after the shift in jurisdiction, and lower the pricing of loans by creditors.</td></tr>
<tr><td>General objective</td><td></td></tr>
<tr><td>1) Enable restructuring of viable firms, so as to maximise the total value to employees, creditors, owners, and other stakeholders<br><br>2) enhance the prospects for survival of illiquid but solvent firms<br><br>3) minimise the potential distortions to location and investment decisions</td><td>By increasing the number of viable companies being rescued and reducing the cost of rescue, the preferred option could contribute to the maximisation of asset value and better recovery rates for cross-border and domestic creditors. For example, in FR, the median recovery rates for liquidated firms are less than one third of those for “rehabilitated” firms (31% vs. 96%).<br><br>The quality of restructuring framework is considered one of the critical factors for resolving the problem of non-performing loans (NPLs). Improved recovery rates for creditors could contribute significantly to the reduction of NPLs, in particular in Member States with particularly high NPL values and below average recovery rates (HU, LV, RO, GR, BG, LT). The examples of possible reductions are in table below:<br><br>
<table>
<tr><th></th><th>Reduction of loss to all creditors (<u>bn</u> euro)</th><th>Reduction of loss to cross-border creditors (<u>million</u> euro)</th></tr>
<tr><td>Hungary</td><td>1.24</td><td>5.58</td></tr>
<tr><td>Bulgaria</td><td>1.41</td><td>6.35</td></tr>
<tr><td>Lithuania</td><td>0.22</td><td>1.00</td></tr>
</table>
<br>Saving companies saves jobs (the total number of insolvency related job reductions in 2009 is estimated at 1.7 million).<br>Shareholders would fare significantly better if bankruptcy is avoided. Around the announcement of a workout, firm value appreciates by up to 11% while the announcement of a bankruptcy filing is associated with a loss in shareholder value of up to 56%.<br>Improved recovery rates of creditors could be expected to result in decreased cost of capital thus benefitting entrepreneurs and investors.<br>The option could contribute to a reduction in the potential distortions to the location of investment decisions which result from the difficulties in assessing the risk of investing. According to the OECD 2014 Economic Review, EU directives or guidelines for efficient bankruptcy practices are needed to address this problem.</td></tr>
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**Option 3**, a minimum harmonisation directive comprising the same combination of sub-

options as option 2, would be a more effective tool, since all Member States put in place a preventive restructuring framework which contains **all** the elements necessary to make such a framework effective.

Nevertheless, since a considerable number of Member States are at this moment in time in the process of reforming their insolvency laws, a proposal for an EU legislative instrument would not be effective in the short term since the proposal may take time to be negotiated.

**Stakeholders' views:** A majority of respondents to the public consultation support the harmonisation of discharge periods (75% of respondents) and restructuring plans (70%). Some Member States also supported a harmonisation of certain aspects of restructuring plans (NL, LT, EE – minimum harmonisation only) or the reduction of discharge periods (ES, EE, LT, NL, EL). The European business associations (BusinessEurope, Euro Chambers, UEAPME, European Small Business Alliance) also largely support an initiative aimed at strengthening the rescue and recovery culture in Europe.

In a meeting with Member States' representativeson 12 December 2013, a majority preferred a recommendation (UK, FR, SE, PL, EE, AT, DE), while one Member States rejected any type of EU action (FI). Most Member States could not yet indicate a clear position (NL, SK, HU, ES, LU, BE, RO, SI, LT, LV, IT, DE, IE). Some preferred a harmonisation measure (EL, PT, CY).

## 6. COMPARISON OF OPTIONS/PREFERRED OPTION

Option 2 is the preferred option, as it better delivers the immediate objectives than any of the alternatives considered. The table below relates the preferred sub-options to the operational objectives.

| Operational objective | The preferred option |
|---|---|
| Early restructuring possibilities | The procedure must be available when the debtor is in financial difficulties and there is a risk, actual or potential, of insolvency |
| Improve chances of negotiations | A moratorium is granted on request by the debtor, of limited (short) duration |
| Facilitating the continuation of operations | Debtor remains in possession, but courts may appoint on a case-by-case basis a mediator or a supervisor |
| Disallow a minority of creditors to jeopardise the restructuring effort | A minority of creditors can be bound by the plan by a majority in the same class; all classes of creditors are bound, including secured creditors + Member States may provide that no voting process needs to formally take place |
| Encourage new financing | Exempt new financing contained in the restructuring plan from avoidance actions. Member States may also provide for super-priority status to new financing. |
| Reduce the involvement of courts | A flexible framework, which allows court involvement to be limited to granting a moratorium and confirming the plan + requiring courts to rule in principle in written procedure |
| Lower discharge periods | Lower discharge period to maximum 3 years + remov negative data from credit rating databases a short period of time after discharge |

The potential impacts of option 2 against the baseline are presented in the table below:

| **Objectives / impacts** | **Option 1 (Status quo)** | **Option 2 – potential impacts** |
|---|---|---|
| Increase in number of viable firms rescued | 0 | Potentially significant (in particular BG, DK, SK, SI, HR, CY, EE, IE, LT, LU, NL, PL, RO) |
| Reduce the cost of rescue in Member States with inefficient rescue procedures | 0 | Minimal order of magnitude of savings: €135-223 m (in particular BE, DE, FR, FI, SE, LV), plus other not quantified savings |

| | | |
|---|---|---|
| Reduce the cost of cross-border restructuring of groups of companies | 0 | Positive |
| Reduce costs for creditors resulting from forum shopping | 0 | Savings for creditors (e.g. travel, legal representation) |
| Reduce costs for creditors resulting from relocation of entrepreneurs which are debtors | 0 | Positive |
| General objective: Reduce the financial losses suffered by creditors and other stakeholders | 0 | Improved recovery rates, facilitated resolution of NPLs, saved jobs, less distortion to investment decisions |
| Entrepreneurship | 0 | Positive (due to expected decrease in cost of capital) |
| Court workloads | 0 | Significant savings |
| Financial institutions | 0 | Mainly positive but also potentially a slightly negative impact (less control on the loans) |
| Legal systems | 0 | Potentially significant for Groups 1 and 2 Member States |
| Fundamental rights | 0 | Neutral |
| Implementation costs | 0 | Limited |

## 7. MONITORING AND EVALUATION

The recommendation will invite Member States to implement the minimum standards within 12 months from its adoption.

18 months after its adoption, the Commission will conduct an evaluation of the extent to which the Recommendation is being implemented in the Member States and of the effectiveness of the actions taken.

On the basis of the evaluation, the Commission will decide on the appropriate follow-up.