MSMEs IN DISTRESS: REGULATORY COSTS AND EFFICIENCY CONSIDERATIONS IN THE IMPLEMENTATION OF PREVENTIVE RESTRUCTURING MECHANISMS: AN ANGLO-GERMAN-ITALIAN PERSPECTIVE

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Abstract: Micro-, small- and medium-sized enterprises (MSMEs) are the backbone of modern economies. MSMEs struggle to make the most of existing insolvency and restructuring tools, because their owners and directors often lack the knowledge, expertise and funding to navigate the legal tools available to companies in financial distress. This article analyses recommendations stemming from reputable international organisations, as well as the academic debate in the area, to identify whether there is general consensus in favour of an efficient and MSME-friendly insolvency framework being implemented at the national level. The purpose of this research is to assess whether the states considered in this study (Italy, Germany and the United Kingdom) should introduce MSME-specific rules, or alternatively amend existing rules, to comply with these recommendations.

Keywords: *insolvency law; restructuring; Part 26A restructuring plans; Stabilization and Restructuring Framework for Businesses; Insolvency Code of Germany; Italian Insolvency Code; insolvency plan; director's liability; minor enterprises; modular approach; MSMEs*

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I. Introduction

Micro-, small- and medium-sized enterprises (MSMEs) are the backbone of modern economies and account for a substantial portion of employment, economic power and social integration in many countries. The COVID-19 pandemic, the changing patterns of consumer demand and the development of new technologies have increased insolvency risks for these enterprises, particularly as MSMEs are vastly over-represented in sectors that were hard-hit by the pandemic, such as hospitality and trade. High numbers of MSME insolvencies and collective redundancies resulting from widespread distress in this employment-intense sector threaten both macroeconomics and social stability.

Some countries, most notably the US,[1] Ireland[2] and Australia,[3] have introduced simplified insolvency regimes for MSMEs, while many other countries apply the same procedures equally to large corporations and MSMEs. This may prove to be an unfortunate policy choice, as traditional insolvency procedures can be overly expensive, procedurally complex, long and ultimately ineffective for MSMEs. As a result, opportunities to rescue distressed yet viable businesses may be lost in the absence of tailored procedures or procedures which are flexible enough for MSME insolvencies.

This article analyses recommendations stemming from reputable international organisations, as well as the academic debate in the area, to identify whether there is general consensus in favour of an efficient and MSME-friendly insolvency framework being implemented at the national level. The purpose of this research is to assess whether the states considered in this study should introduce MSME-specific rules, or alternatively amend existing rules, to comply with these recommendations.

The approach adopted in this article may be loosely characterised as the functional comparative approach,[4] which focuses not on the rules themselves but on their effect. Thus, this article focuses not on the law as it appears in the books but on how it applies in practice. As a result, this article does not provide general

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1 Small Business Reorganization Act of 2019. For a comment, see (among others) W Norton III and J Bailey, "The Pros and Cons of the Small Business Reorganization Act of 2019" (2020) 36 *Emory Bankruptcy Developments Journal* 384; A Walters, "The Small Business Reorganization Act: America's New Tool for SME Restructuring for the COVID and Post-COVID Era" (2020) 41:10 *Company Lawyer* 324.

2 Companies (Rescue Process for Small and Micro Companies) Act 2021. For a comment, see (among others) A McPartland and N McGrath, "The Small Company Administrative Rescue Process: Some Thoughts" (2022) 29:1 *Commercial Law Practitioner* 3; GB Hutchinson, "The Small Companies Rescue Act—False Hope for Failing Companies?" (2021) 28:7 *Commercial Law Practitioner* 122. For a recent account of the South African experience see Michelle Kelly-Louw, "South African Micro-, Small- and Medium-sized Enterprises (MSMEs): Challenges in Accessing Microcredit and the Need for Microcredit Legislation" (2023) 10:2 *Journal of International and Comparative Law* 167.

3 Corporations Amendment (Corporate Insolvency Reforms) Act 2020 (Cth) (Act).

4 On functional method see Ralf Michaels, "The Functional Method of Comparative Law" in M Reimann and R Zimmermann (eds), *The Oxford Handbook of Comparative Law* (Oxford UK: Oxford University Press, 2nd ed., 2019), 345–389.

recommendations. It provides tailored, country-specific suggestions designed to align domestic frameworks with international best practices and goals.

This comparative study demonstrates that alignment with such goals does not necessarily require adoption of uniform mechanisms for the resolution of financial distress, especially when it comes to MSMEs. The Italian legislator has adapted the main procedures by creating more MSME-friendly versions. In Germany, there is no special procedure for MSMEs, but the insolvency procedure is well equipped to assist MSMEs to regain a competitive position in insolvency. Finally, with reference to the UK, despite the absence of specific procedures for MSMEs and the presence of some financial barriers to rescuing distressed debtors, the framework provides for a sufficiently modular and flexible range of options to small debtors in financial distress.

This article is structured as follows. Sections II and III explore the international and scholarly debate on the treatment of MSMEs in distress, in order to identify the core pillars underpinning the treatment of distressed MSMEs. The "general consensus" is tested in Sections IV–VI of this study, where an assessment is made regarding if and to what extent national laws in Italy, Germany and the United Kingdom (UK) comply with the international recommendations in the area. Section VII concludes by summarising the main findings of this article.

II. International Proposals

A. *The World Bank's Perspective*

One of the first documents to significantly challenge the *status quo* on the treatment of MSMEs in insolvency was the *Report on the Treatment of MSME Insolvency*, published by the World Bank in 2017.[5] The report reviewed how legislation around the world deals with MSME insolvencies and considered whether international standards should be updated to address the needs of these enterprises in a more tailored way. The World Bank report highlighted the need for expeditious and cost-effective liquidation procedures, alternative resolution mechanisms and investment in financial education for company directors. The World Bank published another report, which supplemented the discussion of MSME insolvency by considering proposals for the rescue and rehabilitation of these enterprises.[6]

Taken together, these two reports suggest that an optimal MSME insolvency regime, applicable to the broadest range of countries and contexts, should include

5 The World Bank, "Report on the Treatment of MSME Insolvency" (2017), available at https://documents1.worldbank.org/curated/en/973331494264489956/pdf/114823-REVISED-PUBLIC-MSME-Insolvency-report-low-res-final.pdf (visited 1 May 2023).

6 The World Bank, "Saving Entrepreneurs, Saving Enterprises: Proposals on the Treatment of MSME Insolvency" (2018), available at https://documents1.worldbank.org/curated/en/989581537265261393/pdf/Saving-Entrepreneurs-Saving-Enterprises-Proposals-on-the-Treatment-of-MSME-Insolvency.pdf (visited 1 May 2023).

the following two main components: (i) a liquidation-and-discharge regime for natural person entrepreneurs; and (ii) a simplified, creditor-controlled restructuring regime applicable to both natural and legal persons. An MSME insolvency regime based on these two components should address some of the challenges of MSME insolvencies, namely: (i) the exceedingly complex nature of insolvency systems, which deter MSMEs from resorting to them; (ii) the strategic behaviour of secured and unsecured creditors, which may result in rescue opportunities being lost; (iii) debtors' tendency to protract the process by not considering formal rescue or insolvency procedure until their companies are hopelessly insolvent; (iv) the lack of adequate financial means to conduct any serious rescue attempts and (v) the link with personal assets, and the risk that commercial insolvencies may result in personal bankruptcies.

B. UNICITRAL's Perspective

Problems faced by MSMEs (including their treatment when insolvent or in financial distress) were also considered in more depth by the United Nations Commission on International Trade Law (UNCITRAL). In 2013, Working Group I began developing a series of rules designed to streamline regulation and registration procedures for these entities. This work resulted in the *UNCITRAL Legislative Guide on Key Principles of a Business Registry* (2019)[7] and the *UNCITRAL Legislative Recommendations on Limited Liability Enterprises* (2021).[8] Still within UNCITRAL, Working Group V has been focusing on the needs of micro and small enterprises, with a view to creating a simplified insolvency regime suitable for such enterprises. Its work resulted in the *UNCITRAL Legislative Recommendations on Insolvency of Micro- and Small Enterprises* (2021).[9] Because MSMEs need fast, simple, accessible and affordable procedures (known as "simplified insolvency regimes"), as well as guidance and assistance on how to use them, the UNCITRAL Insolvency Recommendations build on the World Bank's recommendations by: (i) suggesting that guidance and assistance should be provided before the commencement of, and throughout, insolvency proceedings; (ii) implementing an effective sanctions regime to prevent abuse or improper use of simplified insolvency regimes, together with appropriate penalties for misconduct and (iii) reducing the stigma associated with insolvency through the promotion of the debtor's fresh start as an autonomous goal of MSME procedures. The UNCITRAL Insolvency Recommendations include detailed advice on how these regimes should be structured. However, among the

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7 https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/lg_business_registry-e.pdf (visited 1 May 2023).

8 https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/uncitral_legislative_recommendations_on_limited_liability_enterprises.pdf (visited 1 May 2023).

9 https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/part_5_en.pdf (visited 1 May 2023).

countries considered in this study, only Italy has so far implemented a simplified and comprehensive insolvency regime specifically for MSMEs.

C. The European Union's Perspective

The European Union (EU) has promoted a series of initiatives to support entrepreneurialism[10] but it is yet to develop any specific initiatives in respect of MSME insolvencies. With the exception of the EU Preventive Restructuring Directive[11] and a related study examining the impact of this directive on MSMEs,[12] the only EU initiative specifically intended for MSME insolvencies is the proposal for harmonising certain aspects of insolvency law, dated 7 December 2022, which recommended a directive, a draft of which was appended to the proposal.[13] One of the key elements of the proposed Insolvency Directive is the introduction of a title dedicated to micro enterprise[14] insolvencies. The proposal aims to ensure that even micro enterprises with no assets and money are wound up in an orderly manner, through swift and cost-effective proceedings.

The EU proposal for harmonising certain aspects of insolvency law suggests that insolvency practitioners should not be appointed to supervise micro enterprise proceedings as, typically, the involvement of an insolvency practitioner is assumed to be the main cost factor in such proceedings. Moreover, the business models at the heart of these companies are usually not so complex as to require an insolvency practitioner. Similarly, the proposed directive states that, as a rule, the honest debtor should remain in possession of the business' assets and affairs throughout the proceedings. Another cost-mitigating factor is the option for the court to proceed with asset realisation using an electronic auction system, which each member state would set up as part of their simplified proceedings for micro enterprises. Generally speaking, all communications between the parties would take place electronically using either simplified forms or no forms. Finally, art.56 states that it is not simply the debtors of entrepreneurs that should have effective access to full debt discharge as a consequence of the closure of simplified winding-up proceedings. Rather, the

10 For an outline: https://ec.europa.eu/growth/smes_en (visited 1 May 2023).

11 Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132OJ L 172/18.

12 S Madaus, "The Impact on SMEs of the Proposal of Preventive Restructuring, Second Chance and Improvement Measures" (2017), available at https://www.europarl.europa.eu/RegData/etudes/IDAN/2017/583151/IPOL_IDA(2017)583151_EN.pdf (visited 1 May 2023).

13 European Commission, "Proposal for a Directive of the European Parliament and of the Council Harmonising Certain Aspects of Insolvency Law" (2022) COM/2022/702, available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52022PC0702 (visited 1 May 2023).

14 Micro enterprises are enterprises with less than 10 employees whose annual turnover and/or annual balance sheet does not exceed €2 million: EU Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises, art 2(3).

founders, owners and members of the unlimited liability micro enterprise should also have access to this, as they are personally liable for the debts of the debtor.

These reforms constitute one element of a bundle that also covers other aspects of insolvency, including interim finance, pre-packaged procedures and the harmonisation of transaction avoidance laws. While not all of these proposals reflect the recommendations of the World Bank and UNCITRAL, there is broad alignment among these institutions as to the mechanisms that must be implemented to support MSMEs in financial distress.

D. OECD's Perspective

A similar approach has also been adopted by the Organisation for Economic Co-operation and Development (OECD). Since 2019, the Working Party on SMEs and Entrepreneurship has been looking into the adoption of strategies[15] that would ultimately help countries develop coherent, effective and efficient MSME and entrepreneurship policies. Through an iterative process undertaken in 2021–2022, the Working Party arrived at a set of guiding principles for SME and entrepreneurship policies (*OECD Recommendation on SME and Entrepreneurial Policy*).[16] While these recommendations touch on issues such as governance and financing of MSMEs, they do not contain any specific provision on the treatment of distressed or insolvent enterprises.

E. IMF's Perspective

Finally, the International Monetary Fund (IMF) addressed the topic of MSME insolvencies in a staff discussion note published on 2 April 2021.[17] On that occasion, the group of experts advocated a three-pronged approach for addressing difficulties faced by MSMEs post-pandemic: (i) continuing equity injections and liquidity support;[18] (ii) further developing quasi-equity injections for instance through "profit participation loans" and (iii) developing a tailored insolvency and debt-restructuring framework. According to the IMF, such framework should include "dedicated out-of-court restructuring mechanisms, hybrid restructuring, as well as strengthened reorganisation and liquidation procedures, including simplified reorganisation procedures for smaller firms".[19]

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15 https://www.oecd.org/cfe/smes/strategy.htm (visited 1 May 2023).

16 https://www.oecd.org/cfe/smes/oecdrecommendationonsmeandentrepreneurshippolicy/ (visited 1 May 2023).

17 FJ Diéz *et al*., "Insolvency Prospects Among Small and Medium Enterprises in Advanced Economies: Assessment and Policy Options" (2 April 2021) SDN/2021/002, available at https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2021/03/25/Insolvency-Prospects-Among-Small-and-Medium-Sized-Enterprises-in-Advanced-Economies-50138 (visited 1 May 2023).

18 On this issue, see (among others) M Gray, "A Tsunami of Undesirable Debt: The Case for an Equity Solution" (2021) 18:2 *International Corporate Rescue* 134.

19 FJ Diéz *et al*., "Insolvency Prospects Among Small and Medium Enterprises in Advanced Economies" (n. 17), 9.

F. Summary

This analysis illustrates that international organisations encourage states to prioritise the following initiatives when dealing with MSMEs in distress:

(1) Simplification of rescue and liquidation procedures.
(2) Introduction of mechanisms to promote creditor cooperation.
(3) Promotion of timely filing and good record-keeping by debtors.
(4) Introduction of provisions for interim rescue financing.
(5) Widening the scope of discharge of debtors to ensure that they can benefit from a "fresh start" and to reduce the stigma associated with insolvency.[20]

The next section considers to what extent scholars and researchers agree with the above conclusions.

III. Academic Debate

The regulatory debate has been complemented, and at times prompted, by the academic literature in the field. Designing an efficient insolvency system has traditionally been the cornerstone of the economics literature on insolvency law.[21] However, the focus has typically been on large corporations.

One of the most influential studies specifically aimed at MSMEs was published in 2018 by a team of leading insolvency scholars.[22] Their book proposes a modular approach for dealing with MSMEs in distress. This approach would: (i) allow national policymakers to choose from a range of available options, including the extent to which appropriate institutions may be involved and (ii) provide an essential "core" process in each insolvency and restructuring case while allowing relevant stakeholders to invoke additional tools ("modules") if and when the benefits of wielding those tools in the particular case outweigh the costs. This article and other papers in the field[23] have made some key findings that must be considered in reforming domestic insolvency and restructuring tools. Besides the need to

20 On the stigma of insolvency and on how it affects decisions taken by directors, see (among others) E Ghio and D Thomson, "Why are Directors Afraid of Help?" (2023) *Chicago-Kent Law Review* (forthcoming).

21 For an outline, see (among others) J Armour, "The Law and Economics of Corporate Insolvency: A Review" (2001) ESRC Centre for Business Research, University of Cambridge Working Paper No. 197, available at https://www.cbr.cam.ac.uk/wp-content/uploads/2020/08/wp197.pdf (visited 1 May 2023).

22 RJ Mokal *et al*., *Micro, Small and Medium Enterprise Insolvency: A Modular Approach* (Oxford UK: Oxford University Press, 2018).

23 See, among others: S Paterson, "Debt Restructuring and Notions of Fairness" (2017) 80:4 *Modern Law Review* 600 (examining how principles of fairness can be applied to small- and medium-sized enterprise restructurings); J McCarthy, "Challenges in Finding the 'Right' Approach to SME Rescue: The Example of Reforms to the Irish Examinership Process" (2019) 32:2 *Insolvency Intelligence* 43; W Paterson, "Insolvency Reform Trends in Developing Countries" (2019) 16:5 *International Corporate*

simplify and render existing mechanisms more efficient, scholars have drawn attention to the following: (i) the specific funding needs of MSMEs; (ii) the importance of addressing the stigma associated with both insolvency and restructuring procedures and (iii) the causal link between commercial MSME insolvency and personal bankruptcy (occurring because many MSMEs are unincorporated and do not benefit from separate or limited liability).

A recent academic paper identified the following as the four pillars of an effective MSME insolvency and restructuring regime: (i) promotion of out-of-court restructuring for viable MSMEs facing financial trouble; (ii) if attempts at such informal restructuring fails, implementation of simplified insolvency processes based on tendering systems; (iii) introduction of effective discharge of debt mechanisms for honest but unfortunate sole traders or shareholders/managers behind MSMEs and (iv) adoption of policies and educational programmes designed to reduce the stigma associated with insolvency proceedings.[24]

The next sections discuss to what extent the Italian, German and UK systems comply with the recommendations detailed above, especially in light of the German and English reluctance to implement simplified mechanisms for MSMEs in distress.

IV. MSMEs in Distress in Italy

Since 2012, the Italian legislation provides specific insolvency procedures for small-sized enterprises and special measures to promptly detect and deal with MSMEs in distress. The following sections outline the Italian legislative framework, starting with the measures in the old Italian Bankruptcy Law of 1942 before analysing the provisions in the new Code of Business Crisis and Insolvency (the Italian Insolvency Code), which implements the relevant European regulations and directives. As mentioned below, most of the Code entered into force in 2022.

A. *The Italian Insolvency Definition of MSMEs*

The Bankruptcy Law 1942 exempted from its scope all enterprises considered too small to fail. The precise legislative requirements for exemption have been amended more than once. In Italian law, the definition of "small enterprise" differs depending on the legislative text where the specific rule appears. There is a general definition in art 2083 of the Civil Code, while laws dealing with other specific subjects adopt their own definition. For the purposes of our insolvency analysis, the

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Rescue 293; M Barton *et al*., "Financial Liquidity and Business Restructuring in the Wake of COVID-19" (2020) 180 *New Law Journal* 11.

24 A Gurrea-Martínez, "Implementing an Insolvency Framework for Micro and Small Firms" (2021) 30 *International Insolvency Review* S46, S52–S59, available at https://ssrn.com/abstract=3715654 or http://dx.doi.org/10.2139/ssrn.3715654 (visited 1 May 2023).

relevant definition was originally found in art.1(2) of the Bankruptcy Law 1942, which stated that the exemption covered enterprises that:

(a) had invested capital[25] not exceeding €300,000 in the firm in the past three financial years before filing the insolvency petition or from the commencement of the business, if shorter;
(b) had an average gross annual revenue,[26] calculated on any basis, not exceeding €200,000 in the past three financial years before filing the insolvency petition or from the commencement of the business, if shorter;
(c) had debts, including not yet payable claims, not exceeding €500,000.

To be eligible for bankruptcy proceedings, it was sufficient for the business to exceed just one of the thresholds. The Italian Insolvency Code adopts the same definition in art.2(1)(d), defining small entrepreneurs as "minor enterprises".

B. Early Approach

Until the beginning of 2012, insolvent MSMEs were not eligible for insolvency procedures and their creditors could only rely on civil law remedies. In that year, the legislators introduced the Over-indebtedness Law 3/2012 regarding the composition of over-indebtedness crises. The law defined "over-indebtedness" as a situation in which there is a persistent imbalance between obligations and assets that can be easily liquidated, as well as an inability to regularly fulfil the obligations. While the law was primarily aimed at over-indebted consumers, it also applied to MSMEs, thereby filling the gap in legislation.

The Over-indebtedness Law 3/2012 offered two distinct solutions to the entities not subject to the Bankruptcy Law 1942: a debt restructuring agreement[27] or a debtor's assets liquidation.[28]

The first solution, a debt restructuring agreement, which was modelled on a remedy already available to larger enterprises under art.182-*bis* of the Bankruptcy Law 1942, envisaged a proposal presented by the debtor for a compromise or arrangement. The plan had to be feasible and allow the debtor to fulfil all the obligations identified in it. Any creditors who were not part of the plan had to be paid in full. If the debtor did not have enough assets to fulfil their obligations under the plan, they needed to obtain guarantees from third parties. After a summary scrutiny of the proposal by the competent court, the plan had to be approved by creditors representing at least 60 per cent of the debtor's debt. If all the legal requirements were met, the court would sanction the plan. The second solution, a debtor's assets liquidation, was a simplified liquidation procedure. Unlike the proposal for an

25 Invested capital includes both fixed assets and working capital.
26 Gross annual revenue is the actual turnover of the business.
27 Law no. 3/2012, arts.10–12.
28 Law no. 3/2012, arts.14*ter*-14*quaterdecies*.

Insolvency Directive, there was no requirement to involve independent monitors,[29] and the debtor did not remain in possession of their assets.

C. The MSMEs Toolbox for the Early Detection of Distress

The framework drastically changed with the entrance into force of the Italian Insolvency Code, which occurred between March 2019 and July 2022. One of the principal results of the recent reforms is the enactment of the Italian Insolvency Code, which promotes the early detection of business distress through preventive measures and alert mechanisms. The Code is also mindful of the additional peculiarities of MSMEs, including the coincidence of ownership and governance of the company and the need for cost-effective measures.

One of the crucial aspects of a possible toolbox for early detection of distress is found in art.2086 of the Italian Civil Code, as amended by the legislative decree 14/2019. The law compels entrepreneurs, irrespective of their size, to establish "an organisational, administrative, and accounting structure adequate for the nature and size of the business, including in view of timely detection of a company crisis and the loss of its status as a going concern, and to act without delay in such cases, implementing the appropriate legal tools to overcome the crisis and recover the status of a going concern".

The Italian Chamber of Commerce provides a general practical test to verify the debt sustainability of an enterprise, the seriousness of a crisis situation and the business's chances of survival.[30] Directors are obliged to put in place adequate measures to detect whether a company is experiencing a crisis or is not viable (ie, that the company is not a "going concern"). They will be liable for manifestly irrational management decisions and failure to take measures to deal with an evident crisis.[31]

Article 3 of the Italian Insolvency Code provides some guidance on assessing the appropriateness of the structure. The toolbox aims to: (i) detect any asset, economic or financial imbalance, correlated to the specific characteristics of the debtor; (ii) verify the sustainability of the debts and the prospects of business continuity for a period of at least 12 months and (iii) gather the information necessary to use the detailed checklist, in order to determine whether the proposed reorganisation plan is feasible.

The Italian law contains specific rules for small-sized corporations in order to assure another form of control and/or auditing. In particular, art.2477 of the Civil Code provides that articles of association (of a limited liability company or a cooperative) may provide for the appointment of a supervisory body or an auditor. The appointment of a supervisory body or auditor is mandatory if the company:

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29 The preliminary assessment was made by the Organismo di Composizione della Crisi (Corporate Crisis Settlement Body), with a professional liquidator only appointed at a later stage.

30 https://composizionenegoziata.camcom.it/ocriWeb/#/home#sezioneSimulazione (visited 1 May 2023).

31 Court of Rome, 8 April and 15 September 2020.

(i) is required to prepare consolidated financial statements; (ii) controls a company that is required to carry out statutory audit or (iii) has exceeded at least one of the following limits for two consecutive financial years: total balance sheet assets of €4 million; revenue from sales and services of €4 million or an average of 20 employees during the year. This internal mechanism is complemented by an external mechanism carried out by qualified public bodies (such as tax and social security ones).

Article 3(4) of the Italian Insolvency Code also identifies a list of predictive signals of distress. The list includes: (i) wages and salaries that went unpaid for a period of at least 30 days, amounting to more than half of the sum paid on wages and salaries on a monthly basis; (ii) commercial debt that went unpaid for 90 or more days and exceeding in value the amount of not-yet-due claims; (iii) financial debt that has gone unpaid or exceeded the authorised limit for more than 60 days, provided that it represents a total of at least 5 per cent of the company's debt and (iv) other special conditions.

D. Tools in the Italian Insolvency Code

The Italian Insolvency Code offers some tools available only to MSMEs. The first instrument which came into effect in November 2021 enables viable businesses and incentivises debtors to reach a compromise or arrangement with their creditors. The process can only be initiated by the debtor, by submitting an electronic request to the competent Chamber of Commerce. The Chamber will investigate the seriousness of the crisis, verify if the business can be rescued and appoint an expert. These experts play a crucial role in encouraging the uptake rate of such procedures among MSMEs. At this stage, courts do not intervene, negotiations are confidential and parties are free to amend their existing contracts. However, debtors may apply to the competent court for interim protective measures. The compromise or arrangement procedure is a debtor-in-possession procedure. The expert must be competent in restructuring, independent and hold specific professional accreditations (eg, as a lawyer, chartered accountant or labour consultant). Their main role is to facilitate the restructuring negotiations with third parties. The application process is conducted online, where a test is available to verify the sustainability of the debt, the seriousness of the crisis and the rescue chances of the business. To further promote the use of this procedure, the legislator introduced certain tax benefits for using it. Negotiations are deemed successful if the debtor applies to use any of the insolvency tools found in the Code. Otherwise, the debtor can apply for a simplified form of judicial composition with creditors in order to liquidate the business. Once a proposal for a composition envisaging either the transfer of assets or the restructuring of the debtor's business is prepared, it must be submitted to a court, which would sanction it provided that creditors had been invited to comment on it, the distribution rules are respected and the return to creditors is more generous than in a liquidation procedure. This proposal does not need to be approved by creditors as it is subject to scrutiny by an independent expert.

Article 25-*quater* of the Italian Insolvency Code outlines the options available to distressed MSMEs when negotiating a composition with creditors. Where an agreement with creditors has been reached, the MSME may: (i) reach an agreement only with consenting parties suitable for ensuring business continuity, (ii) opt for a moratorium convention or (iii) reach an agreement with key creditors, subject to the scrutiny of an independent expert. Otherwise, the debtor may: (i) propose a minor composition with creditors, (ii) petition for a controlled liquidation, (iii) offer a simplified judicial composition with creditors or (iv) opt for a debt-restructuring agreement (the latter available only to farmers). Some of these options are available to debtors even if they did not commence a negotiated composition.

According to the moratorium convention (art.62 of the Italian Insolvency Code), an entrepreneur and their creditors can agree to postpone the payment of debt, waive obligations or suspend the use of individual executory actions and/or any other measure that does not involve a waiver of their claims. As an exception to the general rule, these measures are effective against non-member creditors who belong to the same category.

A stay on executory actions should be negotiated in good faith and must gather the support of creditors representing at least 75 per cent of claims in value in each class. A stay cannot be imposed on dissenting creditors if they are worse off than in the relevant alternative. Finally, a stay can only be approved if an expert certifies that the company's books are "in order" and that the convention is, at least in principle, capable of overcoming the crisis.

Article 64-*bis* of the Italian Insolvency Code introduces the possibility of undertaking a restructuring plan, subject to sanctioning from a court. This is a debtor-in-possession procedure, meaning that the debtor retains the management of their business during the procedure—even if it is conducted in the interest of all creditors and under the supervision of a judicial commissioner. Restructuring plans are a very flexible tool, as they allow creditors to be divided into different classes based on their legal position and respective economic interests. Plans need to be approved by the absolute majority of creditors in each class (both in terms of number and value). Alternatively, the plan needs to be approved by two-thirds of the voting members, provided that creditors representing the value of at least half of the claims of the same class took part in the vote. The plan must be approved by a competent court and employees' claims must be settled within 30 days of such judicial approval.

Finally, art.74 of the Italian Insolvency Code deals with minor composition with creditors, which would ensure viability of the business or ensure a higher return to creditors if the debtor's owners contribute fresh resources to the procedure. The minor composition proposal: (i) must indicate how the business plans to overcome the crisis; (ii) may envisage partial repayment of debts and the division of creditors into classes and (iii) must be submitted to the crisis settlement body. The proposal must be judicially scrutinised to ensure that the proposal complies with the legal requirements. Creditors are provided with the necessary information and cast their vote on the proposal. Such a composition is sanctioned if it is approved

by a simple majority of creditors, meets the legal requirements and is feasible. The plan is executed by the debtor under the supervision of the crisis settlement body.

E. Assessment of the Revised Italian Framework

Since 2005, the law has provided for out-of-court restructuring mechanisms and for over 10 years has provided hybrid restructuring mechanisms, compliant with 2021 IMF Staff Discussion Note "Insolvency Prospects Among Small-and-Medium-Sized Enterprises in Advanced Economies: Assessment and Policy Options" as well as simplified reorganisation and liquidation procedures.[32] For over 10 years, the Italian framework has featured specific provisions for MSMEs in distress. While the tools introduced in 2021 (negotiated composition with creditors and various alternatives to be pursued to solve the business crisis) were already compliant with the suggestions of the World Bank reports (see Section II of this article), further positive changes have been introduced by the Code. It can be said that the Code implemented a modular approach for tackling MSMEs in distress. The tools introduced by the Italian Insolvency Code encourage debtors to deal proactively with the causes of financial hardship, in line with the UNCITRAL insolvency recommendations.

Despite all of these achievements, more can be done to promote the financial education of directors and also to promote the adoption of policies and educational programmes designed to reduce the stigma associated with insolvency proceedings.

V. MSMEs in Distress in Germany

In Germany, there is no insolvency procedure specifically designed for MSMEs. Until 2021, Germany had only one integrated insolvency procedure. The insolvency procedure regulated by the Insolvency Code (InsO) may provide for (piecemeal) liquidation of the debtor's assets, an asset deal for (part of) the debtor's business, or for an insolvency plan. The insolvency procedure can be conducted in external administration or as a debtor-in-possession procedure. Since the enactment of the Stabilization and Restructuring Framework for Businesses (StaRUG) restructuring procedure in 2021, an additional debtor-in-possession restructuring procedure is available to debtors as an alternative option to the established insolvency procedure. The eligibility criterion of imminent insolvency applies to both the restructuring procedure and to a (voluntary) insolvency application.

A. The Insolvency Framework

The German insolvency procedure starts with the so-called opening procedure, upon the insolvency filing by the debtor or a creditor. Insolvency proceedings will

32 See n. 17.

be opened if the debtor is unable to pay debts due[33] or is over-indebted[34] (these being mandatory insolvency grounds). The insolvency court would refuse to open insolvency proceedings if the debtor's assets are insufficient to cover the costs of the procedure.[35] Where a debtor requests the opening of insolvency proceedings, that is, in case of a voluntary filing, imminent insolvency is also an acceptable ground to open the procedure.[36]

If the debtor's business meets certain criteria (concerning minimum balance, turnover and/or employees), a (preliminary) mandatory creditor committee is established to oversee the procedure.[37] During the opening procedure, a qualified insolvency administrator is appointed as examiner to evaluate whether the debtor is in fact insolvent. During the opening procedure, the debtor remains in control of their day-to-day business, unless the examiner appointed by the court asks the court to be appointed as a so-called strong preliminary insolvency administrator, thus assuming control of the insolvent estate. In practice, the examiner will often be appointed as a "weak insolvency administrator", if there is a prospect that the debtor's going-concern business can be rescued. In such cases, the court may require that the debtor obtains the administrator's approval before entering into specific transactions.

The debtor benefits from the support and advice of the (preliminary) insolvency administrator, especially in case of MSME insolvencies. The (preliminary) insolvency administrator is typically a skilled legal expert with profound practical business experience of distressed situations and holds an official mandate to act independently in the best interests of all creditors. This provides a solid foundation to instil confidence in (previously disappointed) business partners in a distressed situation. While larger corporate debtors may be able to engage restructuring lawyers and turnaround experts to support the debtor's recovery strategy, MSMEs often lack sufficient funds for the support of a specialised restructuring team. The owner and manager of a distressed MSME are typically busy with its day-to-day operations. In such case, they may not be able to meet the additional challenges of reorganising and transforming the business, as well as renegotiating its financial obligations.

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33 InsO, s.17. A debtor is considered to be unable to pay debts due if the debtor cannot cover at least 90 per cent of its liabilities due and falling due within three weeks with its liquid assets including liquid assets (or assets to be liquidated) within three weeks.

34 InsO, s.19. A debtor is over-indebted if: (i) the value of its assets exceeds the nominal amount of its liabilities and (ii) the debtor is likely to become unable to pay its debts in the upcoming 12 months (temporarily reduced to four months until 31 December 2023).

35 InsO, s.26(1). For the recent Chinese legislative experiment drawing upon the European approach, see Dan WEI and Zhe MA, "Towards a Chinese Approach of Personal Bankruptcy Discharge: From Shenzhen Experience to National Legislation" (2023) 10:2 *Journal of International and Comparative Law* 329.

36 InsO, s.18. A debtor is imminent insolvent if the debtor is likely to become unable to pay its debts within the upcoming 24 months.

37 InsO, s.22a.

A major challenge that distressed debtors, in particular MSME debtors with limited financial reserves, face is the need to fund going-concern operations. German law provides a special liquidity boost for insolvent debtors in the form of insolvency money (*Insolvenzgeld*): for up to three months, the Employment Agency will cover the salaries of the debtor's employees. While the Employment Agency can claim reimbursement, the claim is subject to modification by an insolvency plan. A further liquidity benefit during the insolvency procedure is that liabilities occurring after the opening of the insolvency procedure rank ahead of ordinary insolvency claims. This allows debtors to continue trading in insolvency. Such preferential treatment can also be sanctioned by the court during the opening procedure, that is, after filing and before opening. Debtors are also protected from enforcement actions by any individual creditors during the insolvency procedure and, potentially, from the moment they file for insolvency. This way, the debtor benefits from some breathing space to consolidate its business strategy.

Once the insolvency procedure is opened, the administrator/debtor has the right to uphold profitable executory contracts (ie, contracts not fully performed by one side from which ongoing obligations arise) and reject loss-generating ones. This is a very valuable restructuring tool for companies in distress and a key difference to the restructuring procedure which offers no such tool. On the one hand, executory contracts or leases may be too costly or simply obsolete in light of the debtor's (post-reorganisation) business strategy. In particular, if the debtor goes through a substantial business reorganisation, they may want to reject unprofitable contracts. On the other hand, the debtor may depend on certain essential contracts. While there is no general explicit ban on *ipso facto* clauses[38] in insolvency, provisions which limit the insolvency administrator's right to choose performance of executory contracts are often declared invalid by the courts (with certain exceptions, eg, if the contract can be terminated because of a statutory termination right).[39]

In the end, an MSME has two main options for a fresh start without an unbearable debt burden: (i) an insolvency plan or (ii) an asset deal. An insolvency plan can modify debt and equity claims and rights in collateral (including collateral provided by connected companies), in order to give the business a fresh start. The insolvency plan requires the qualified approval of creditors (and shareholders) voting in classes. A cross-class cram-down, whereby dissenting classes are bound by the vote of other classes, is possible. An asset deal similarly allows the business to survive even if contracts, licences and official permits are not transferred as part of the asset deal. If such contracts are of no significant value or can easily be

38 *Ipso facto* clauses are clauses that determine the automatic termination of a contract upon the commencement of an insolvency procedure.

39 The limitation on such clauses has been developed by courts drawing assistance from InsO, ss.119, 103 et seq. See in particular the German Federal Court of Justice, decision of 15 November 2012—IX ZR 169/11. For exceptions to this rule, see especially German Federal Court of Justice, decision of 07 April 2016—VII ZR 56/15 and German Federal Court of Justice, decision of 27 October 2022—IX ZR 213/21.

renegotiated or concluded anew, an asset deal which is procedurally less complicated may be the preferred option for MSME businesses.

B. The Restructuring Framework

The restructuring framework provides debtors with an opportunity to restructure their liabilities outside a formal insolvency procedure. The restructuring procedure follows a very flexible modular approach which allows the debtor to request a stay on enforcement—applicable to all or only selected creditors—or a (cross-class) cram-down of certain creditors, shareholders and secured parties to be bound to a restructuring plan proposed by the debtor. The debtor may also request both of these tools.

The debtor also has the privilege of being the only party entitled to request a stay or a vote on the restructuring plan, to voluntarily enter a restructuring procedure and to propose a restructuring plan. During the restructuring procedure, the debtor benefits from an explicit prohibition on the enforceability of *ipso facto* clauses which bars the termination and detrimental modification of ongoing contracts.[40]

A key benefit of the restructuring procedure may be that it does not carry with it the stigma of insolvency, because the procedure is generally not available to over-indebted debtors and debtors already unable to pay their debts. In fact, the procedure is regularly terminated if the debtor becomes unable to pay its debts or over-indebted, unless it is in the best interest of creditors to continue the procedure.[41]

A hurdle especially for small debtors may be that, absent the appointment of an insolvency administrator and given the limited role of the restructuring expert, debtors may be reluctant or unable to (voluntarily) commit financial resources on legal and technical advice—advice that is often necessary in a restructuring scenario. Moreover, while the restructuring procedure was introduced as a tool to unburden debtors of debt accumulated during the COVID-19 pandemic, it lacks mechanisms to terminate executory contracts or to modify claims arising from such contracts. This limitation is a burden for debtors whose businesses require a substantive operative reorganisation and who are bound by long-term executory contracts with significant financial obligations steadily occurring.[42]

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40 For the prohibition of *ipso facto* clauses in the restructuring procedure, see StaRUG, s. 44 and for the more extensive protection (which also covers delays occurring prior to the application for a stay), see StaRUG, s.55.

41 StaRUG, s.33, para.2, no. 1.

42 S Madaus and D Ehmke "German Restructuring Procedure" (2022) Herstructuring en Recovery Online W-004, 4.8, available at https://www.online-hero.nl/art/4351/special-issue-preventive-restructuring-4-germany-still-waiting-for-the-revolution-in-restructuring-to-come (visited 1 May 2023). On the treatment of executory contracts in insolvency and restructuring, also see D Ehmke and A Wolf, "Executory Contracts in Insolvency: The German Perspective" in J Chuah and E Vaccari (eds), *Executory Contracts in Insolvency Law: A Global Guide* (Cheltenham UK: Edward Elgar Publishing, 2nd ed., 2023), 328.

C. Directors' Liability and Personal Discharge

MSMEs typically have a concentrated ownership structure. The directors controlling the business are often its shareholders or owners. In theory, controlling business owners can shield themselves against liability through the incorporation of a limited liability company. In practice, this shield has many weaknesses. If an MSME director asks for a loan, the lender will often require a personal guarantee, security or other pledge on the shareholder's personal estate, especially if the director is already in a precarious financial situation.

Besides the (voluntary) assumption of personal liability, directors who delay insolvency face civil liability. Once their company is insolvent, the directors are obliged to file for insolvency without undue delay. Should they continue trading outside formal insolvency, they are liable for any payment made after the debtor has become insolvent because these payments will be considered unlawful, with only limited exceptions.[43] Founding directors of MSMEs who are heavily involved in the business, often without professional accounting support and ongoing legal advice, are typically over-optimistic about the potential of the business also in distress situations and may keep on trading beyond the point of insolvency. Such misplaced optimism would find them filing for personal bankruptcy when their business is beyond redemption. Additionally, they may face prosecution for delayed insolvency filings.[44]

As part of the implementation of the EU Preventive Restructuring Directive, debtors can now obtain a full discharge of their debts within three years from the beginning of the bankruptcy procedure. While the shortening of the personal discharge period to three years was an important step in the right direction, one might have wished for more courage to shorten it further, at least for debtors who make diligent efforts to repay their creditors. Unfortunately, debtors who have benefited from a personal discharge are unable to apply for a similar remedy for the following 11 years.[45] Given that success in entrepreneurism is often preceded by several failures, this seems unduly harsh.

While it would be an important reform to further shorten and relax the personal discharge period, and especially the waiting period, a similarly pressing reform would be to make the rules on wrongful trading more flexible. For instance, if debtor sanctions were capped at the actual quantum of damages evidenced by the insolvency administrator, this would reduce their potential liabilities compared to the current approach, while at the same time adequately sanctioning the directors' misbehaviour when their companies are in distress.[46]

43 InsO, s.15b.
44 InsO, s.15a.
45 InsO, s.287a, para.2.
46 W Prusko and D Ehmke, "Restructuring Lessons from the Covid Pandemic: Bail-Out vs. Market Approach" (2023) 24 *European Business Organization Law Review* 207, 219.

D. Assessment of the German Framework

While there exists no special procedure for MSMEs under German insolvency law, the existing framework coped well with the challenges of distressed MSMEs.

In small businesses there is a close link between ownership and management, with managers committing substantial resources to the day-to-day business. The practice of involving a skilled insolvency expert, even in the limited capacity of custodian in a debtor-in-possession procedure, is often vital for MSME businesses to succeed in a turnaround and restructuring situation. This is not because the owner-manager cannot run the business on their own in calm waters but because the distress situation will often overwhelm owner-managers with little support from outside experts and internal account management.

The German insolvency and restructuring procedures supply important tools for MSMEs to overcome distress, in particular in the insolvency procedure through the support and intervention of an independent expert. As a result, the EU recommendation to not involve an insolvency practitioner (or at least an independent professional) in many MSME insolvencies is ill-suited to the reality of German enterprises. This is because insolvent but capable entrepreneurs already retain the day-to-day management of their enterprises in most cases, even if they operate under the supervision of an independent administrator.

The most obvious shortcoming of the current insolvency and restructuring framework is the rather harsh and inflexible approach to director's duties. These parties, often the owners or principal shareholders of MSMEs, face significant civil sanctions for delayed insolvency filings. Additionally, the German system is also characterised by rigid provisions for personal discharge, especially regarding reapplications. A more flexible regime would encourage entrepreneurial activity, have a positive signalling effect to combat the stigma of insolvency and encourage debtors to proactively seek timely support while making use of the tools that the German restructuring and insolvency regime can offer.

VI. MSMEs in Distress in the UK

Aside from company law reforms introduced by the Small Business, Enterprise and Employment Act 2015, including accelerated strike-off provisions for companies that are no longer operating in the market, and the temporary exemption to the unenforceability of termination clauses against small companies, which was introduced by the Corporate Insolvency and Governance Act 2020 or "CIGA 2020", the UK has been reluctant to promote insolvency and restructuring reforms targeted to MSMEs only. A partial exception is (as stated) CIGA 2020, which introduced a new restructuring tool into the English corporate framework, known as a Part 26A restructuring plan.

This section of the article assesses if and to what extent this newly introduced tool, together with the existing insolvency provisions for rescuing distressed

debtors, can address the peculiarities of MSMEs and, in doing so, remove the need for dedicated procedures solely applicable to enterprises of this size.

A. Regulatory Framework

Part 26A restructuring plans are arguably the most prominent innovation within the English insolvency and restructuring toolkit since the enactment of the Insolvency Act in 1986 or, more recently, since the changes to the administration procedure introduced by the Enterprise Act 2002. Part 26A restructuring plans are the result of a reform process aimed at approximating the English insolvency framework to the reorganisation procedure in Chapter 11 of the US Bankruptcy Code. Following two consultations in 2016[47] and 2018,[48] the need to reform the English restructuring framework was made more pressing by the enactment of the EU Preventive Restructuring Directive. The implementation of this directive led to the introduction of rescue-friendly mechanisms in countries such as the Netherlands and Germany, thus threatening the role of London as a restructuring hub for the European area.[49]

A Part 26A restructuring plan is an "arrangement" or "compromise" between the company and its creditors and/or shareholders.[50] While it may be proposed by anyone, it is usually the company and some of its key creditors acting in unison that set the restructuring plan in motion. This restructuring procedure is set out in the Companies Act 2016. Part 26 of the Companies Act deals with schemes of arrangement, while Part 26A deals with restructuring plans. There is some overlap between Parts 26 and 26A: many of the rules set out in Part 26 apply also to Part 26A.

There are, however, some significant differences between the two procedures. While Part 26 schemes are frequently used in merger-and-acquisition procedures, Part 26A restructuring plans can only be used to restructure debt and/or businesses. Part 26A restructuring plans are only available to companies that have encountered, or are likely to encounter, financial difficulties that are affecting, or will or may affect, their ability to carry on trading as a "going concern".[51] This led the English courts to conclude that, despite being regulated under Companies Act 2006, Part 26A restructuring plans are "proper" collective insolvency procedures.[52]

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47 The Insolvency Service, "A Review of the Corporate Insolvency Framework. A Consultation on Options for Reform" (May 2016), available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/525523/A_Review_of_the_Corporate_Insolvency_Framework.pdf (visited 1 May 2023).

48 Department for Business, Energy & Industrial Strategy, "Insolvency and Corporate Governance" (20 March 2018), available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/691857/Condoc_-_Insolvency_and_Corporate_Governance_FINAL_.pdf (visited 1 May 2023).

49 E Vaccari, "WHOA, Brexit! Which Future for London as Europe's (Largest) Insolvency Forum?" (2022) 37:2 *Journal of International Banking Law and Regulation* 46.

50 Companies Act 2006, s.901A(3).

51 *Ibid*., s.901A(2).

52 *Re Gategroup Guarantee Ltd* [2021] EWHC 304 (Ch), at [110].

Another critical difference between Part 26A restructuring plans and other restructuring tools (such as Part 26 schemes and company voluntary arrangements or "CVAs") is that it is possible to bind dissenting (classes of) creditors to an approved Part 26A plan. This characteristic is known as "cross-class cram-down" and is only possible if the following two conditions are simultaneously met:

(a) the court is satisfied that, if the compromise or arrangement were to be sanctioned, none of the members of the dissenting class would be any worse off than in the event of the relevant alternative. Relevant alternative is defined as whatever the court considers would be most likely to occur in relation to the company if the compromise or arrangement were not sanctioned; and
(b) the restructuring plan has been agreed by a number representing 75 per cent in value of a class of creditors or of members who would receive a payment or have a genuine economic interest in the company, in the event of the relevant alternative.[53]

Where these two conditions are met, a court must also consider whether it should exercise its discretion to sanction the restructuring plan. In all circumstances, courts retain full discretion not to sanction a Part 26A restructuring plan where it would be inappropriate to do so—for example, if sanctioning the plan would not be just and equitable.[54]

To date, the main issue with Part 26A restructuring plans has been the costs involved. "R3, Insolvency & Restructuring", a trade association of UK's insolvency and restructuring professionals, is understood to be working on a simplified plan for MSMEs. However, professionals are generally of the view that, until these procedures become less expensive and more commonly used, CVAs will continue to suit better the needs of MSMEs than other restructuring mechanisms. This is unless the UK tax authority, HM Revenue and Customs (HMRC), states from the outset that they are not willing to support CVAs.

On 1 December 2020, HMRC regained their status as a preferential creditor in insolvency proceedings. In CVAs, preferential creditors cannot be forced to accept a compromise or arrangement if they are not paid in full, unless they consent to a variation of their rights. This is where the provisions on cross-class cram-down in Part 26A restructuring plans gain prominence, and where the case of *Re Houst Limited* becomes particularly relevant.

B. *Re Houst Limited*

The *Re Houst Limited* case provides valuable guidance on the extent to which the English insolvency and corporate statutory provisions, particularly those dealing

53 Companies Act 2006, s.901G.

54 *Re Virgin Active Holdings Ltd* [2021] EWHC 1246 (Ch), [104]. For the criteria that must be met when exercising this discretion, see *Re Noble Group Ltd* [2018] EWHC 3092 (Ch).

with Part 26A restructuring plans, meet international and academic recommendations for the treatment of MSMEs in distress.

The facts of the case are as follows. A company ran an online short-term holiday let business. As a result of the impact of COVID-19 pandemic, it became cash-flow insolvent, with current liabilities of approximately £5.2 million. In the face of threatened winding-up petitions by its principal creditors, Houst Ltd planned to adopt a Part 26A plan with a view to returning the company to solvency by way of capital injection. The company directors considered that the only alternative to what it proposed was a pre-pack administration that would place all the stakeholders in a worse position.

The company applied for an order convening meetings of its creditors and shareholders. The application was granted, the court approving the convening of separate meetings.[55] All classes of creditors voted in favour of the plan, except secondary preferential creditors, the only creditor in that class being the HMRC. The HMRC, who were owed approximately £1.7 million, opposed the plan because it would have meant relinquishing their preferential creditor status to allow dividends to be paid to unsecured creditors.[56] HMRC were not prepared to do this, despite acknowledging that they were likely to receive a smaller dividend in the event of the debtor's administration or liquidation than if the restructuring plan was agreed to.

The Part 26A restructuring plan was approved on the following basis:

- the unwillingness of the UK government to include even a modified version of the US absolute priority rule in Part 26A restructuring plans "must be taken to have been deliberate".[57]
- the statutory provisions (including those on cross-class cram-down) were complied with.[58]
- the better treatment afforded to critical creditors[59] (both higher-ranking such as secured lenders, and lower-ranking such as unsecured creditors) was justified on the basis that the company's ability to generate additional funds to pay an

55 *Re Houst Ltd* [2022] EWHC 1765 (Ch).

56 The HMRC's relinquishment of its status of a preferential creditor would have been in breach of the absolute priority rule, which applies in US bankruptcy proceedings but not in the UK. The absolute priority rule dictates that lower-ranking creditors cannot receive any distribution in insolvency until higher-ranking creditors are paid in full. In holding that the absolute priority rule is not part of UK law, Zacaroli J said that "given that consideration was given by the UK government to including a modified form of the absolute priority rule in Part 26A (see also *Virgin Active Holdings Ltd [2021] EWHC 1246,* [289]), its exclusion must be taken to have been deliberate" *Re Houst Ltd* [2022] EWHC 1941, [30].

57 *Re Houst Ltd* [2022] EWHC 1941 (Ch), [30]. See the text of n 59.

On this, see also S Paterson, "Judicial Discretion in Part 26A Restructuring Plan Procedures" (24 January 2022), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4016519 (visited 1 May 2023).

58 *Re Houst Ltd* [2022] EWHC 1941 (Ch), [32].

59 Critical suppliers and employees would be paid the debt they were owed because of the impact that non-payment would likely have on the company's ability to continue trading successfully.

enhanced dividend to HMRC and to other unsecured creditors depended on its continued trading. Without paying critical creditors, the company would be unable to trade.[60]

- HMRC, the only disadvantaged creditor, is a sophisticated creditor able to look after their own interests. HMRC had full notice of the plan and, although they voted against it, they neither attended the hearing to oppose the plan nor presented any arguments against sanctioning (approving) the plan. In any case, they were better-off than in the relevant alternative.[61]

This judgment is significant for a number of reasons: for the first time, a medium-sized company made use of such a procedure to turn around their business and reach a composition with creditors, thereby avoiding the need to enter into an alternative formal insolvency procedure; for the first time, a secondary preferential creditor, specifically HMRC, was crammed-down, despite their objection to the restructuring plan; for the first time, junior creditors received a dividend pay-out; while the court carefully scrutinised the distribution of post-restructuring value under the plan, it did not require the same evidential burden of proof as with larger corporations; the court found that, in these circumstances, there is no reason to exercise their discretion not to sanction the proposed plan, as the plan remained just and equitable under the law.

The restructuring plan in *Houst case* achieved what would not have been possible via a CVA. As a result, this plan could provide an impetus for other smaller businesses to attempt to cram-down dissent on debtors' restructuring proposals emanating from HMRC or other secured creditors. Overall, it can be said that this decision supports the English courts' willingness not to hinder Part 26A restructuring plan cases submitted by MSMEs, thereby echoing the UK government's intentions when it introduced Part 26A restructuring plans following the approval of CIGA 2020.[62]

C. Assessment of English Rules on the Treatment of MSMEs in Distress

Despite the absence of a dedicated set of rules for MSMEs in distress, the analysis of *Houst* and the applicable legislation suggests that English law offers a flexible and modular approach to corporate restructuring.[63] This article mentioned two relevant alternatives to Part 26A restructuring plans: CVAs and Part 26 schemes of

60 *Re Houst Ltd* [2022] EWHC 1941 (Ch), [35].

61 *Ibid*., [42].

62 *Explanatory Notes to the Corporate Insolvency and Governance Bill*, Bill 128-EN, 58/1, [9]–[16], available at https://publications.parliament.uk/pa/bills/cbill/58-01/0128/en/20128en.pdf (visited 1 May 2023).

63 See E Vaccari, "A Modular Approach to Restructuring and Insolvency Law: Executory Contracts and Onerous Property in England and Italy" (2022) 31:5 *Norton Journal of Bankruptcy Law and Practice (West)* 534.

arrangement. Furthermore, under English law, companies can also resort to more structured procedures such as (pre-packaged[64] or light touch) administrations and short interim stays from individual executory actions known as Part A1 moratoria.[65]

It is arguable that simplification has been achieved through a series of initiatives. First, as evidenced elsewhere,[66] courts have developed a consistent approach for interpreting the provisions on Part 26A restructuring plans (and alternative remedies). As a result, practitioners are able to rely on established and predictable case law when acting on behalf of parties in such cases. Additionally, the restructuring plan in *Houst* was not overly lengthy or detailed. While the application documents were comprehensive, the plan itself covered only 12 of the 126 pages of documents submitted in the docket.

As mentioned above, it would be inappropriate to look at the provisions of Part 26A restructuring plans in isolation. MSMEs and their owners may resort to a variety of remedies under the law. One of these remedies is a discharge, that is, the forgiveness of bankruptcy restrictions and pre-filing debts that operate to the advantage of the bankrupt party.

With reference to discharge, the UK has a largely debtor-friendly regime. Under section 279(1) of the Insolvency Act 1986, bankrupt debtors are, in most cases, automatically discharged from bankruptcy 12 months after the making of the bankruptcy order, even if no payments have yet been made to creditors. Once discharged, the bankrupt is no longer bound by statutory restrictions. The exception is where a trustee obtains a Bankruptcy Restrictions Order against a bankrupt who abused the system or whose conduct had been “dishonest, reckless or otherwise culpable”. Alternatively, debtors can also apply to obtain debt relief orders in situations where they owe less than £30,000, where they do not have much spare income, and where they do not own their home. In this case, the debtor is subject to certain restrictions for a period up to 12 months. While discharge provisions do not in themselves remove the stigma attached to insolvency, the relatively generous rules regarding concession of this benefit ensure that debtors have the best possible chance of starting afresh after a bankruptcy event.

However, there are downsides. It is well known that filing costs and legal fees have been, and still are, one of the main barriers preventing cash-stripped debtors

64 That is, “Part A1 Moratorium” of the Insolvency Act 1986. Pre-packaged administrations have recently been reformed by the Administration (Restrictions on Disposal etc to Connected Persons) Regulations 2021. These reforms are broadly aligned with the more recent Insolvency Directive. This directive advocates for the establishment of an independent monitor and for more scrutiny in case of sales to connected parties. However, the differences between the proposed European system and the already enacted English system remain quite marked.

65 For an assessment of the effectiveness of the measures introduced by CIGA 2021, see The Insolvency Service, “Corporate Insolvency and Governance Act 2020 – Final Evaluation Report” (November 2022), available at https://www.gov.uk/government/publications/corporate-insolvency-and-governance-act-2020-evaluation-reports/corporate-insolvency-and-governance-act-2020-final-evaluation-report-november-2022 (visited 1 May 2023).

66 E Vaccari and E Ghio, *English Corporate Insolvency Law: A Primer* (Cheltenham UK: Edward Elgar Publishing, 2023), chapter 9.

from using restructuring procedures. Unfortunately, there is no hard evidence regarding the cost of these procedures, as practitioners' fees are not disclosed in filing documents. Additionally, no special legal measures have been introduced to promote more timely filings or to ensure that management are more accountable in the way they operate their companies.[67]

With reference to rescue financing, in certain insolvency procedures (namely, administration), an insolvency practitioner can dispose of, or take action relating to, property subject to a floating charge[68] or other security[69] as if it were not subject to such charge. Similar powers are granted to administrators dealing with hire-purchase agreements.[70] Finally, administrators have general power to borrow funds and prioritise repayment of debts owed under contracts entered into by the administrator.[71] There were consultations in 2009[72] and 2016[73] regarding the potential introduction of US-style rescue finance mechanisms, which would have permitted debtors the power to grant new lenders security over assets already subject to fixed charges.[74]

Ultimately, the government was persuaded not to implement this statutory change for a variety of reasons. Some of their reasons, such as the non-comparability of the US and UK frameworks and markets, are not quite persuasive. Other reasons, such as the claim that the price of credit would be adversely affected, are unsubstantiated. Moreover, the "widespread assertion that viable businesses [do] not struggle to secure rescue financing"[75] contradicts the findings of Sections II and III of this article. While it is true that administrative costs have preferential status in the distribution process, these funds may not be enough to financially support viable cash-stripped businesses during restructuring procedures.

Overall, it seems that, while the UK has a somewhat developed insolvency framework for dealing with MSMEs in distress, there are areas where more needs to be done to align the legislation to international and academic recommendations. The UK system is modular in nature, generally straightforward to use, predictable in the implementation of its rules, and provides generous and effective mechanisms for discharging debts. Its cram-down provisions ensure that, if a creditor chooses not to cooperate with the distressed debtor, courts can issue remedies to promote

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67 For an outline of the current rules that directors need to follow to comply with the statutory duties prescribed by English law, see (among others) A Keay, P Walton and J Curl, *Corporate Governance and Insolvency: Accountability and Transparency* (Cheltenham UK: Edward Elgar Publishing 2022); SHC Lo, "Corporate Governance in the Context of Insolvent Companies" (2023) 10:1 *JICL* 113. See also the guidance provided in *BTI 2014 LLC v Sequana BTI* [2022] UKSC 25.

68 Insolvency Act 1986, Sch.B1, para.70(1).

69 *Ibid*., para.71(1).

70 *Ibid*., para.72.

71 *Ibid*., para.99.

72 Department for Business, Innovation and Skills, "Encouraging Company Rescue – A Consultation" (September 2009).

73 The Insolvency Service, *A Review* (n. 46).

74 11 US Code, § 364(c).

75 Department for Business, Energy and Industrial Strategy, "Insolvency and Corporate Governance. Government Response" (26 August 2018), para.5.181.

the collective interest of the other parties in the procedure. However, further attention is needed to ensure that: rescue (and liquidation) procedures are cost effective; existing rules promote timely filing and good record-keeping by debtors, through a comprehensive reform of directors' duties and disqualification procedures; rescue is not detrimentally hindered by lack of available financial resources, especially in Pt.26A restructuring plans or during interim moratoria. Whether this is done through the creation of simplified insolvency procedures or through tailored changes to existing laws is a policy choice. Any comment on the desirability of either solution is beyond the scope of this article.

VII. Concluding Remarks

The COVID-19 pandemic has accelerated an ongoing trend towards the enactment of simplified insolvency and restructuring measures for MSMEs. This is because MSMEs have been particularly badly affected by trade restrictions and because traditional insolvency frameworks have not succeeded in providing an effective lifeline to MSMEs in distress.

Of the three countries considered in this article, Italy is the only one to have introduced dedicated procedures for MSMEs into its legal framework. However, this is not to say that MSME restructuring has not gained a prominent position in the policy agendas of either Germany or the UK.

Overall, this article demonstrates that alignment with international goals does not necessarily require the adoption of uniform, specialised mechanisms for the resolution of financial distress, especially when it comes to MSMEs. Italy, Germany and the UK have adopted different approaches for dealing with MSMEs in financial distress. As our analyses show, these approaches are not without their flaws. Crucially however, each system remains supportive of MSMEs that find themselves in financial distress.

Accordingly, the national insolvency frameworks of the countries considered in this study do not have to be fully aligned with recommendations stemming either from relevant international institutions or from the academic debate in the area. For MSMEs, the need for harmonisation is less pressing than it is for larger corporations typically with an international group structure, interlinked financing arrangements and substantial cross-border business relations. There is, however, a need for tailored reforms that address the statutory flaws in each of the systems considered in this article. These statutory reforms should take place in a context where all involved stakeholders (particularly professionals and the judiciary) work towards the same goal of educating small entrepreneurs, reducing red tape challenges and promoting the rescue of distressed yet viable businesses. More empirical research is needed to assess whether the involved stakeholders in the jurisdictions considered in this study do effectively pursue these goals.