

Controlling distressed SME debtors' behaviour: wrongful trading or duty to file?

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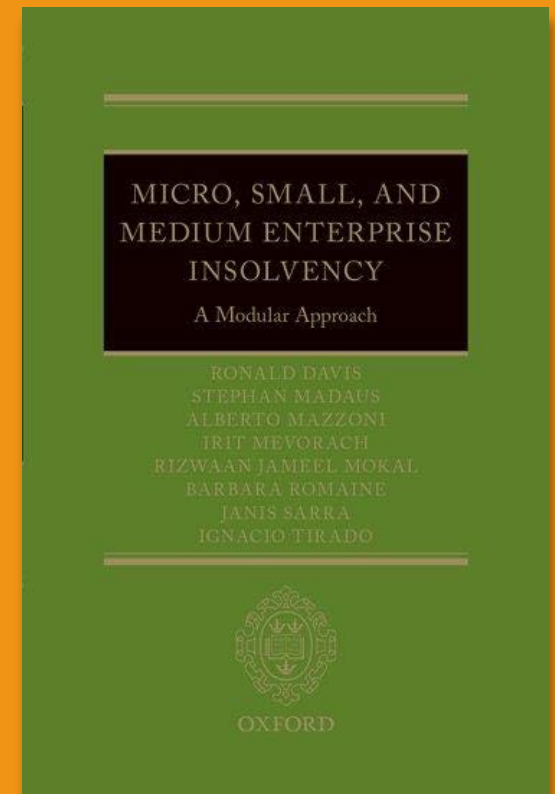
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Introduction and Background

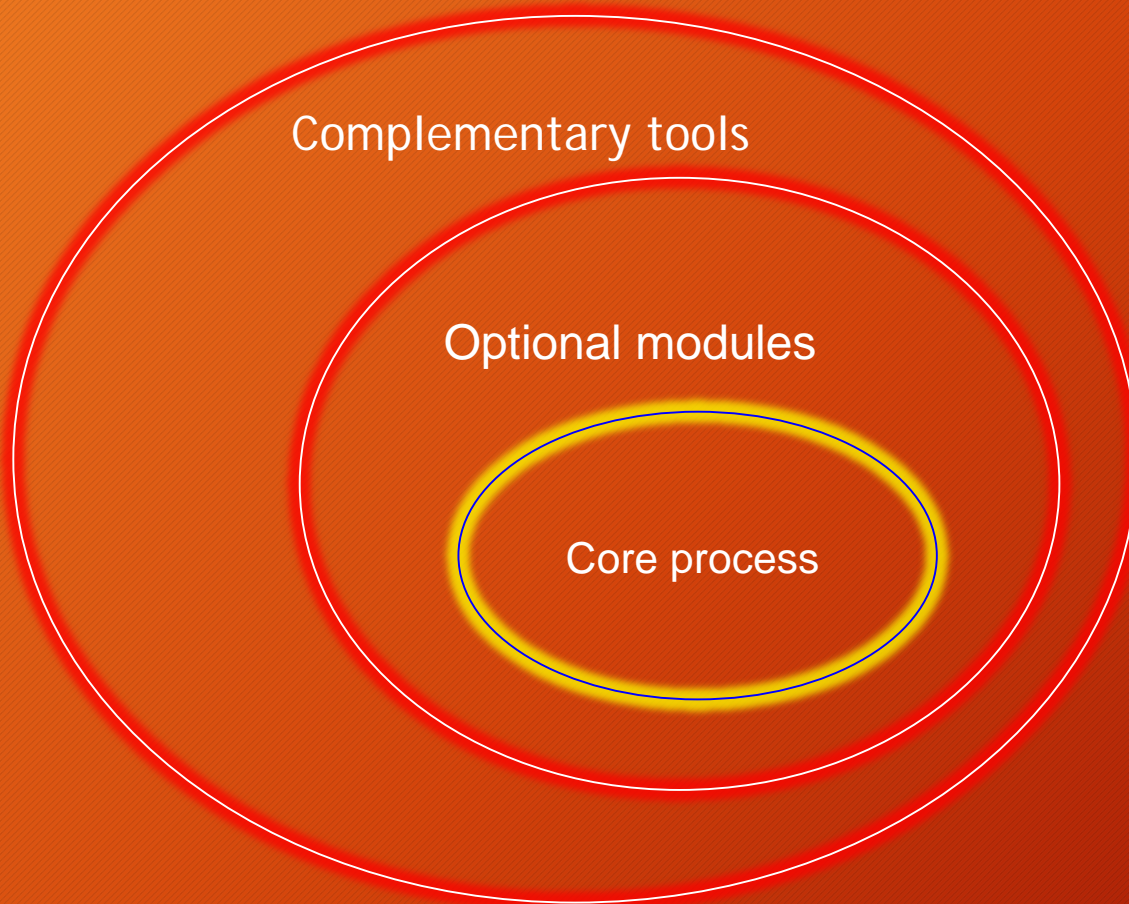
- MSMEs - the backbone of the economy
- MSMEs in distress- require cost-effective procedures; which reduce stigma; and provide a fresh start
- But most insolvency regimes are designed for large entities; and do not address the peculiar MSME features and needs:
 - Often few assets, undermined separate legal personality
 - Informality
 - Low technical level
 - Social problems/household insolvency
 - Creditor passivity (...)

A modular approach for MSMEs in distress

- In the book *'Micro, Small, And Medium Enterprise Insolvency, A Modular Approach'* (Ronald Davis, Janis Sarra, Stephan Madaus, Riz Mokal, Barbara Romaine, Alberto Mazzoni, Irit Mevorach and Ignacio Tirado) we propose:
- To 'think small first' and design an approach 'from the ground up' (unpacking elements of existing procedures and standards, leaving two core solutions)
- To implement in legal systems a bespoke **Modular Approach** for MSMEs in distress:
 - Modular for parties
 - Modular for countries



Core and optional modules, supported by complementary tools



Core process, two possible exits

- Debtor proposes
- Discharge
- No mandatory IP or court involvement

Optional modules

- Mediation
- Creditor action moratorium
- Creditor competing plan proposal
- Debtor action moratorium
- IP involvement
- Doomed failure

Complementary tools

Complementary tools and incentives

- Supporting the MSME insolvency procedures
- Incentivising access and proper use of the regime
- Preventing abuse
- Overcoming information barriers
- Interim and post-commencement financing
- Addressing the position of guarantors, creditors, employees
- Etc.

Complementary tools: the debtor's role and obligations at times of distress (approaching insolvency)

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

- In many countries, insolvency systems are infrequently used
- MSMEs tend to be passive and reluctant to address their distress:
 - Late realisation due to insufficient sophistication and poor info
 - Fear to lose control vis a vis lenders and suppliers
 - Family business, only source of income
 - Heads in the sand/bargaining for resurrection
- A need for a balanced regime; with 'positive' and 'negative' incentives: a "stick and carrot" approach:
 - Debtor in control when feasible
 - Reasonable probability of discharge

Designing the “stick”



Duty to file or Wrongful Trading
for MSMEs in distress?

Wrongful trading?

Pros	Cons
<ul style="list-style-type: none">• Flexible, nuanced• Imposes duties before actual insolvency – promoting rescues and early action• Education tool; informs MSMEs of their broader obligations at times of distress	<ul style="list-style-type: none">• Complicated concept, period of duty defined vaguely• May require seeking expensive professional advice• Based on court discretion – may be difficult to implement

Duty to file?

Pros	Cons
<ul style="list-style-type: none">• Provides clear instructions to MSMEs; simple to navigate• Easy to implement by IPs and courts• Stricter corporate governance incentive	<ul style="list-style-type: none">• Based on arbitrary timeframes• May not incentivise rescues; duty is too narrow and too rigid• May result in premature filings

MSME-focused, core approach akin to wrongful trading

Duty to avoid or minimise the effect of insolvency -

- Requires early action- refers to the 'twilight zone' period of distress
- Realigns duties with creditors' interests
- Imposes simple duties - accurate accounts; proper use of resources; due consideration to the 'modules'
- Focuses on civil liability limited to harm caused; includes sanctions for non-incorporated debtors; available not only in formal processes [*in addition to sanctioning fraud and criminal behaviour]
- Supported by institutions inc. through training programmes

Optional, tailored duty to file and hybrid regimes

Lesser discretion for less developed systems -

- Stricter duty to file (when insolvent; within a short period of time)
- Duty suspended if the debtor seeks alternative solutions
- Option to include duties to take steps to minimise harm when in imminent insolvency
- Focuses on civil liability limited to harm caused; includes sanctions for non-incorporated debtors; available not only in formal processes [*in addition to sanctioning fraud and criminal behaviour]
- Supported by institutions inc. through training programmes

Conclusions

- There is a need for special regulation of MSME insolvency
- The process needs to be flexible and efficient
- Reform to implement the system needs to tackle several laws and all stakeholders involved
- There is a need to include mechanisms to foster its widespread use
- Incentives are important, but the special characteristics of MSMEs require stronger rules
- A bespoke, well-designed system of liability on the verge of insolvency is a key element of the system