INSOL International

Restructuring Options for MSMEs and Proposals for Reform

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ISBN: 978-1-907764-23-3

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President's Introduction

On behalf of INSOL International, I am pleased to introduce this Special Report on MSME insolvency, titled "Restructuring Options for MSMEs and Proposals for Reform", a project that emanates from the Small Practice Group.

One need only read the World Bank's "Report on the Treatment of MSME Insolvency" (https://openknowledge.worldbank.org/handle/10986/26709) to understand how important this topic is in the context of global insolvency. While emerging market and developing economies have a larger number of informal MSMEs, the number of MSMEs in developed countries is also very high. Statistics quoted in the World Bank report referred to above, show that in the United States 99 percent of all enterprises are MSMEs and employ over 50 percent of private sector employees. Similarly, in the United Kingdom 99.9 percent of enterprises are MSMEs and employ over 60 percent of all private sector employees. With statistics such as these, it should be clear why MSME insolvency is high on the agenda for both the World Bank and UNCITRAL, the joint international standard-setting bodies for insolvency.

This Small Practice project is INSOL International's first foray into MSME insolvency and restructuring, although it is unlikely to be the last. In most economies, the formal restructuring or turnaround procedures can be too cumbersome or expensive to generally be effective in the MSME environment. In addition, many MSMEs are of the unincorporated informal variety and the formal restructuring mechanisms may not apply in such cases. In many jurisdictions this means that the consumer bankruptcy laws, which are either ill-suited to a restructuring or contain no tools with which to conduct a rescue, are applied. By comparing a number of different jurisdictions' approach to restructuring and turnarounds in the MSME sector, the results of this project show that the manner in which MSME insolvency is dealt with in practice, is indeed problematic.

A number of INSOL members have generously given their time and expertise in contributing to this project. INSOL International would like to thank all the authors who have contributed to this publication. We trust that you will find this report both informative and useful.

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Bowmans

April 2018

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AUSTRALIA

1. Is there a legal definition of MSMEs?

A number of government departments both at Federal and State level have definitions for micro, small and medium enterprises although the definitions established by the Australian Bureau of Statistics (ABS) and the Australian Taxation Office (ATO) appear to be the most quoted definitions.

The ABS defines a micro enterprise as a business with less than 5 staff members. A small enterprise is defined as a business with less than 20 staff members. A medium enterprise is defined as a business with less than 200 staff members.

The Australian Taxation Office defines a business as micro if it has a turnover of less than A$2,000,000. A small business has a turnover of between A$2,000,000 and A $10,000,000. These definitions are generally used to determine whether a business is entitled to tax concessions or not. No definition exists for a medium enterprise.

Whilst there is no statute that combines the above definitions it is not unusual to see it done in business commentary as stated below.

- Micro Enterprise – generally a business with less than 5 employees with a turnover of less than A$2,000,000.
- Small Enterprise – generally a business with between 6 and 20 employees with a turnover of between A$2,000,000 and A$10.000.000.
- Medium Enterprise – generally a business with over A$10,000,000 turnover and between 20 and 200 employees.

It is possible that a business will meet more than one definition.

The Corporations Act only distinguishes between small and large proprietary companies. A company is defined as a small proprietary company if it meets at least two of the following criteria.

- A consolidated turnover of less than A$25,000,000.
- Consolidated gross assets at year end of less than A$12,500,000.
- Less than 50 employees.

2. Is there currently a formal restructuring process? If so what are the main characteristics?

Generally Australian businesses in financial difficulty are restructured through Voluntary Administration (VA) and a Deed of Company Arrangement (DoCA) Pursuant to Part 5.3A of the Corporations Act.

Although a voluntary administrator may be appointed by a Secured Creditor or the Court the appointment will generally be made by directors.

The role of the voluntary administrator is to investigate the affairs of the company and report to creditors on its financial position and if any statutory breaches have been committed by the directors in trading the business to date. If a restructuring plan is proposed through a DoCA the voluntary administrator must advise creditors whether he or she believes accepting the proposal is in the interest of the body of creditors. If the restructuring proposal is accepted by a majority of creditors it is binding on all creditors other than secured creditors that do not vote for it. If a restructuring plan is rejected or one is not put forward the company generally proceeds to liquidation.

During the period of voluntary administration the control of the company rests with the voluntary administrator. The voluntary administrator accepts personal liability for all services rendered to, goods purchased by or property leased or hired to the company during the period of voluntary administration. This imposition of personal liability may see companies that may have an opportunity to be restructured be shut down by the voluntary administrator.

Restructurings may also be undertaken through a scheme of arrangement which is a court supervised restructuring although generally schemes of arrangement are used to restructure solvent entities, often as part of a merger.

At the present time there is no legislation that applies specifically to MSME's nor is there any government incentives to restructure rather than close a business.

3. Are there any barriers (legal and / or financial) which make the restructuring process prohibitive for use by MSMEs?

Prior to entering into voluntary administration, the directors of the company must determine that the company is insolvent or is about to become insolvent. It is therefore not possible to utilise Voluntary Administration as a restructuring tool while the company heads towards insolvency but has not yet reached it or it is absolutely imminent.

A voluntary administration consists of an appointment of the administrator, a holding of an initial creditors meeting, a period of investigation and trade on for generally for four weeks in which the administrator is in control, the writing of a report to creditors, the holding of a second creditors meeting to determine the company's future and the preparation of a DoCA if a proposal is accepted by creditors. This process is extremely labour-intensive and the cost is quite often prohibitive for MSME's.

4. Are other insolvency processes utilised as an alternative to a formal restructuring procedure?

In Australia pre-pack liquidations are used as an alternate process to restructure businesses in the MSME economy. It is generally done by a sale or transfer of the business to the directors or an entity related to the directors of the original company. The shell of the company is then left to placed in liquidation at a later date.

Whilst this may be done in a transparent fashion after the appointment of an insolvency practitioner it is usually done beforehand with the assistance of a pre-insolvency advisor. There is no requirement for pre-insolvency advisers to be a member of any professional body and they are not regulated in any way.

5. Are there any barriers or restrictions on the use of the proceedings identified in question 4? Are they open to abuse?

At the present time there is no barrier or limitation on the transfer of assets of a business prior to it entering into a formal insolvency procedure. In Australia pheonixing of business can be divided into either a good phoenix or an illegal phoenix. A good phoenix is where all assets are transferred at market value and the creditors of the transferring entity are not any worse off as a result of the transaction. An illegal phoenix is where the assets are transferred for no value or undervalue and creditors are left in a worse position as a result of the transaction.

Whilst at present there are no laws that specifically combat illegal phoenix activity the Australian Government has recently released for consultation a reform package to combat phoenix activity. The reforms include:

- introduction of a Director Identification Number;
- a government hotline for reporting phoenix activity;
- penalties for promoters of phoenix schemes;
- stronger powers for the Australian Taxation Office to obtain a security deposit from suspected phoenix operators;
- additional taxes of corporations to be able to be collected direct from directors where the Australian Taxation Office issues a Director Penalty Notice;
- banning the backdating of director registrations and allowing directors to notify the ASIC of their resignation;
- establishing a rotational system for the appointment of liquidators to entities associated with phoenix operators;
- the creation of a prohibition on the transfer of property from Company A to Company B if the main purpose of the transfer is to prevent, hinder or delay the process of that property becoming available for division among the creditors of Company A; and
- restricting related party creditors from voting on any resolution to replace an external administrator.

6. Are there any implications for restructuring through an informal process?

As stated above Australia has had historically very strict insolvency laws (see below Re Safe Harbour Reforms) in which directors can be held personally liable for debts incurred when trading a company whilst it is insolvent.

This has led to a perception that larger entities are appointing voluntary administrators too early in order for directors avoid personal liability rather than consider restructuring the company. Similarly, with respect to smaller entities particularly MSME's go in for voluntary administrators rather than attempt to trade through an insolvency and run the risk of being found liable for insolvent trading as a result of action commenced by a liquidator.

7. Are there any current proposals for reform of restructuring processes with respect to MSMEs?

7.1 Safe harbour provision

Australia has recently amended the Corporations Act to introduce Section 588GA Safe Harbour - taking a course of action likely to lead to a better outcome for the company. Under safe harbour directors will not be liable for debts incurred whilst insolvent if after suspecting insolvency, the director starts taking a course of action reasonably likely to lead to a better outcome for the company rather than entering into liquidation or voluntary administration.

In order to qualify for safe harbour a director will have had to have taken steps to prevent misconduct within the company that could adversely affect the company's ability to pay all its debts, taken steps to keep appropriate financial records, obtain appropriate advice, informed himself or herself of the company's financial position and develop or implement a plan for restructuring the company to improve its financial position.

However there are limitations on when safe harbour can be relied upon. A director will not be able to rely on the safe harbour exceptions where the company has not maintained proper books and records, has failed to pay employee entitlements when they fell due or failed to file documents required by taxation laws, except where such failure was either insubstantial or did not occur more than once in the preceding 12 months.

Unfortunately it is likely that inadvertently many MSME's will fall foul of the exceptions as they do not have the accounting and finance structure of larger organisations and as a company heads towards insolvency the directors of an MSME are more likely to concentrate on the operations of the business rather than compliance with its statutory obligations.

7.2 *Ipso facto clauses*

In addition to the safe harbour provisions the government has passed S451E of the Corporations Act which places a stay on enforcing rights merely because the company is in administration. The new law will introduce an automatic stay on the enforceability of certain *ipso facto* clauses that allow contracts to be terminated or varied merely because the company has entered into a scheme of arrangement or administration.

Whilst it will ensure that services of supply are continued throughout a voluntary administration process it is unlikely to lead to a better outcome for MSME's as finance contracts are generally specifically excluded. This means that when directors appoint voluntary administrators for the purpose of restructuring an MSME if a secured creditor is in existence they will still have the ability to appoint a receiver or receiver and manager for the purpose of protecting their interests over and above that of the company or its unsecured creditors.

8. What reforms would be useful if they were to be implemented?

There are 2 reforms that that should be considered to enable more efficient restructuring of MSME's.

8.1 Streamlining voluntary administration

The first reform would be a streamlined voluntary administration process for companies with less than 20 employees and creditors of less than $1 million. The company should be able to appoint an administrator who can put a proposal to creditors as soon as practicable for them to vote on. The administrator would not have to conduct an investigation into the affairs of the company but would have to advise as to why they recommend the acceptance of the proposal. This reform would greatly lower the cost of an administration by removing the first meeting of creditors and reducing the period of time which the administrator must control the business operations of the company. There would have to be a safeguard in that an entity or a director associated with an entity that has utilised the abbreviated voluntary administration procedure would be precluded from doing so more than once in any five-year period.

8.2 Extension of the *ipso facto* prohibition

The second reform would be an extension of the *ipso facto* prohibition to finance agreements during a period of voluntary administration. This would enable voluntary administrators a period in which to review the company's affairs and to consider restructuring plans including refinancing without the spectre of an appointment of another insolvency practitioner over the top. There would of course have to be protection in respect of any assets secured pursuant to a financing agreement and such a prohibition would have to be limited in the case of voluntary administrations that are undertaken for an extended period of time through the approval of either the courts or creditors.

CZECH REPUBLIC

1. Is there a legal definition of MSMEs?

Neither the insolvency law nor any other branch of law provides a general definition of micro, small or medium enterprise (MSME).

The definition of MSME is contained in the European Commission regulation No. 800 / 2008 (General block exemption Regulation)[1] to which the Czech Act No. 47 / 2002 Coll. refers to and states that it supports small and medium-sized enterprises.

Pursuant to the relevant legal provisions, the category of MSMEs is made up of enterprises that employ fewer than 250 persons and which have an annual turnover not exceeding EUR 50 million, and / or an annual balance sheet total not exceeding EUR 43 million. Within the MSME category, a small enterprise is defined as an enterprise which employs fewer than 50 persons and whose annual turnover and / or annual balance sheet total does not exceed EUR 10 million. A micro-enterprise is described as an enterprise which employs fewer than 10 persons and the annual turnover and / or annual balance sheet total does not exceed EUR 2 million.

The abovementioned definitions are however, limited in their application for the purpose of state aid. In other words, the definitions are not generally accepted as uniform definitions in other areas of law in the Czech Republic.[2]

Moreover, it might be argued that for the sake of the Czech Republic, the definitions set out above are rather broad as they derive from the EU Regulations. Companies having more than 50 employees or turnover exceeding approx. EUR 5 million will be considered to fall outside the scope of the general notion of a medium-sized enterprise.

2. Is there currently a formal restructuring process? If so what are the main characteristics?

2.1 Legislated restructuring framework

Act no. 182 / 2006 Coll., Insolvency Act (Insolvency Act) sets out three insolvency resolution methods.

(i) Liquidation (*konkurs*)

(ii) Discharge of debts (*oddlužení*)[3]

(iii) Reorganisation (*reorganizace*)

Rules on reorganisation provide a framework for a formal restructuring process in the Czech Republic.

Pursuant to the Insolvency Act, the objective of reorganisation is to satisfy the creditors' claims while preserving the debtor's business activity in accordance with an approved reorganisation plan. There is no mandatory form of reorganisation. In principle, reorganisation involves an "agreement or composition with creditors"

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1 European Commission Regulation No. 800/2008 declaring certain categories of aid compatible with the common market in application of Articles 87 and 88 of the Treaty (General block exemption Regulation).

2 Act No. 89/2012 Coll., Civil Code (Civil Code) refers to small and medium entrepreneurs. Yet, there is no settled case-law on this matter, and opinions of academics differs.

3 In theory, discharge of debts is also available for entrepreneurs as individuals. Yet, it is not available for business entities. Since discharge of debts does not anticipate any restructuring apart from the possibility to a cut-off of claims, this paper leaves the topic of discharge of debts aside. It suffices to mention that discharge of debts anticipates (i) repayment of debts over a 5-year period (repayment plan), (ii) sale of assets of the debtor, or (iii) combination of both methods.

reflecting whatever was agreed to in the reorganisation plan (entry of a strategic investor, disposal of assets, waiver of debt, debt-for-equity swap etc.).

2.2 Restructuring legislation applicable to MSMEs

The current Insolvency Act does not provide for a simplified reorganisation procedure with respect to MSMEs or any other insolvency process or any other special approvals that may be applicable to MSMEs.[4]

In this connection, one cannot disregard the thresholds entrenched in the Czech legislation which apply to reorganisation. Unless the debtor formally agrees otherwise with the creditors, reorganisation may only be used if the debtor has reached a turnover of at least CZK 50 million (approx. EUR 2 million) in the last year or has at least 50 employees. In other words, the general requirement is that the debtor meets the stated size test. Initially, the Insolvency Act anticipated higher thresholds (turnover of at least CZK 100 million, or at least 100 employees). However, as of 1 January 2014, the legislation has been modified in order to render the size test better achievable for smaller companies. Yet, it appears that only a very limited number of debtors pass the size test annually.

If a debtor does not qualify for reorganisation on the ground of the abovementioned criteria, the only possibility for such a debtor is to gain support from a majority of secured and unsecured creditors counted per the value of their claims within a specific period of time. In practice, it seems that the only way for such debtors to achieve reorganisation is to seek so-called pre-packaged reorganisation.

In a pre-packaged reorganisation, the debtor and the creditors first approve the reorganisation plan and only then the debtor files for reorganisation. In principle, the debtor files with the court a reorganisation plan pre-approved by creditors. This process can be quite difficult because to obtain the support of the creditors is usually not easy.

2.3 Controlling the debtor during the period of restructuring

During the period of reorganisation, the management of the debtor (the governing body) remains in charge of control over the debtor and runs its business. Nevertheless, during the respective phases of the reorganisation, distinct limitations apply (i.e. the management might need to obtain the consent of the creditors' committee).

Also, the court might impose restrictions on, or completely remove, the powers of the management. To the extent that the management does not control the debtor, the powers are generally transferred to the insolvency trustee.

In any case, the insolvency trustee as well as the creditors' committee supervises the debtor throughout the reorganisation process.

2.4 Treatment of creditors' claims

Unless the debtor proposes a pre-packed reorganisation plan, the decision making process has essentially two main phases. First, the court decides whether it approves reorganisation. Second, the reorganisation plan is subject to the approval by creditor groups with a possibility of the so-called cram-down. This is the point where the classes of creditors step in.

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[4] The Insolvency Act contemplates a simplified procedure in the case of liquidation.

Creditors will be divided into different classes whereas creditors with similar legal status and similar economic interests will be the same class of creditors. Special groups are created comprising of each secured creditor, stakeholders (partners, members, shareholders) of the debtor and creditors unaffected by the reorganisation plan. If the reorganisation plan is not approved, liquidation is declared.

2.5 Decision to liquidate or re-organise

Generally, the Insolvency Act leaves the decision whether to reorganise or liquidate the debtor company to its creditors who vote at creditors' meeting. If the decision is not adopted, the court decides whether to approve the reorganisation or declare liquidation. No preference is upheld by the statute. The court will consider *inter alia* the recommendation of the insolvency trustee contained in the report prepared for this purpose.

2.6 Government incentives

Past experience shows that debtors in insolvency commonly face cash-flow problems. The Insolvency Act anticipates the provision of the so-called credit financing (*úvěrové financování*) whereby the creditor might obtain a preferential claim or even a security interest over the debtor's assets. Such financing is available both in liquidation and reorganisation. Still, in reorganisation, a creditor providing new capital might under certain circumstances share the security of incumbent secured creditors.

More importantly, after the publication of the motion for reorganisation in the insolvency register, creditors cannot set off their claims *vis-à-vis* the debtor. This rule seeks to protect vulnerable cash-flow management of the debtor and might be seen as an advantage of reorganisation in comparison to liquidation where less stringent rules apply to set-off of claims.

In order to motivate secured creditors to support reorganisation, the Insolvency Act provides that the secured creditor may obtain an interest on the secured claim accrued after the issuance of the reorganisation order (*rozhodnutí o povolení reorganizace*). In liquidation, such interest is not generally subject to satisfaction.[5]

From a legal perspective, a number of differences exist between reorganisation and liquidation. Overall, none of the abovementioned aspects seems to play a key role in the decision-making process on the part of creditors. Usually creditors take into account the probability of satisfaction of their claims particularly with respect to safeguarding the going-concern value, which might be also achieved in liquidation (see below).

3. Are there any barriers (legal and / or financial) which make the restructuring process prohibitive for use by MSMEs?

3.1 Preconditions required before entering into a restructuring

There are no formal requirements that the debtor must necessarily fulfil prior to entering into formal insolvency proceedings.

In this context, it may be mentioned that one of the requirements of reorganisation is to establish that the debtor's intentions are honest. Prior criminal convictions or other known dishonest conducts prevent the debtor from undertaking a reorganisation.

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[5] The Insolvency Act anticipates one exception consisting of liquidation which takes form of a sale of an undertaking of the debtor (see more details in s. 290 of the Insolvency Act).

Also, in certain businesses such as securities traders and companies that are already being wound up, cannot be subject to reorganisation under any circumstances.

3.2 Limitations of MSMEs using restructuring procedures

The size test described above seems to be the most prohibitive restriction to enter reorganisation. By definition, the size requirement might be over-inclusive as well as under-inclusive. In the latter case, it appears to be very difficult to strike an agreement with the majority of secured as well as unsecured creditors as transaction costs might be too high.

3.3 Cost of a formal restructuring

Monthly remuneration paid to the insolvency trustee in reorganisation might discourage entrepreneurs from undertaking a reorganisation. This payment depends on the turnover of the debtor, but the minimum payment is CZK 33,000 (approx. EUR 1,300). For small businesses such a monthly payment might be too burdensome.

The updated regulation on the remuneration of insolvency trustees anticipates that with the consent of the insolvency trustee and approval of creditors, such remuneration may be reduced. Yet, since the debtor cannot choose the insolvency trustee unless the reorganisation is pre-packed, the debtor can never be sure that it will be able to agree on reduced costs with the insolvency trustee.

Moreover, reorganisation is a rather complex procedure which in practice requires assistance of lawyers as well as other insolvency professionals. Costs of such services would inevitably inhibit the restructuring process.

4. Are other insolvency processes utilised as an alternative to a formal restructuring procedure?

4.1 Liquidation as an alternative

Under the Czech law it is possible to arrange an asset-by-asset transfer or a sale of an undertaking prior to liquidation.

Asset-by-asset transfer is a transfer by which individual assets and liabilities are identified and acquired by the purchaser. This structure allows the largest degree of flexibility as to which specific assets and liabilities are acquired. However, it is also the most complex as each of those specific assets and liabilities has to be transferred in accordance with specific legal requirements. In addition, an asset-by-asset transfer requires third party cooperation as Czech law requires, for example, the consent of the counterparty with the transfer of agreements and liabilities and so on.

In the case of a sale of an undertaking, the business could be transferred as a whole, which allows the purchaser to acquire, in one step and based on one contract (for purchase of a business or its part), an organised set of assets and liabilities that together form a business or any part thereof that is an independent organisational unit. All concluded contracts are “automatically” transferred together with the organised set of assets and liabilities.

Compared to an asset-by-asset transfer, the business transfer is considerably more straightforward and gives slightly less flexibility to exclude unwanted liabilities which relate to the business (or its part). Therefore, such form of sale might be difficult to undertake if the debtor is over-indebted.

Both of the aforementioned forms of the transfer could be, under Czech insolvency law, considered by the insolvency trustee and insolvency court as an ineffective juridical act if the purchase price paid for such a business is substantially lower than the usual (fair market) price and if the debtor has performed such a transfer when it was insolvent (if such transfer was performed for the benefit of a person who forms a group with the debtor, then it is assumed that the debtor was insolvent when such a transfer was made).

If the transfer is declared to be ineffective, the buyer is obliged to return the obtained assets (or a cash equivalent) to the debtor's estate.

Liquidation as an alternative to reorganisation also anticipates the sale of an undertaking. In liquidation, incumbent liabilities (debts) are not transferred as part of an undertaking whereas the going concern is safeguarded. Therefore, liquidation might serve the same purpose as reorganisation with respect to the protection of the value of the going concern. In practice, in several large insolvency cases, such option has been availed of.

The Czech Insolvency Act does not recognise a pre-pack liquidation. Theoretically, the management of the debtor might try to prepare a plan for the liquidation in advance (with an agreement with its secured creditors for example) but after the liquidation is declared the management is replaced by a trustee and it is difficult to predict the trustee's next steps (in liquidation it is not possible to choose a trustee in advance), so the outcome of such an effort will be uncertain.

As an alternative to a formal restructuring procedure, it is also possible to consider a so-called 'moratorium', which provides protection from creditors that can last no longer than 3 months. The main purpose of a moratorium is to give the debtor an opportunity to satisfy its creditors without a need for an insolvency proceedings as no decision on liquidation can be issued during the moratorium.

5. If so, are there any barriers or restrictions on the use of the procedures identified in question 4? Are they open to abuse?

5.1 Are there laws that prevent the 'phoenixing' of businesses?

There are no specific laws preventing the 'phoenixing' of the debtor's business. However, in such a case, there may be relevant civil liability of the governing body, especially when a member of the governing body breaches due managerial care during such 'phoenixing' of business. This means that he or she does not act with necessary (i) loyalty, (ii) required knowledge, or (iii) diligence. Such a member of the governing body would be then obliged to compensate any and for all damages incurred by the debtor.

Specifically, if the debtor would continue to fulfil the current on-going deals but would not enter into any new deals and a new, similar company would be established in parallel to the debtor, there might be a possible conflict of interests by the governing body which may amount to a breach of loyalty.

Such liability however, is hardly enforced during an insolvency proceeding and it seems not to be a very common in practice.

If the whole transaction is at first sight conducted with the intention to damage the creditors of the debtor, the members of the governing body could also be taken into account and be subjected to criminal liability. However, such intention is usually difficult to prove, and these crimes are also uncommon in practice.

5.2 Applicable laws to deal with the transfer of employee entitlements

Under Czech law, when a business is transferred, such transfer might trigger the automatic transfer of rights and obligations arising from employment relationships of affected employees, subject to several conditions (information obligation, specific time limits to meet etc.).

However, in the light of up-to-date case law, the automatic transfer should not occur in the case of mutual termination of employment by agreement between the debtor and the affected employees, which should be primarily the case under the 'phoenix' alternative.

The parties are free to conclude a mutual agreement and the employees may commence new employments from the outset even if the new employer is an affiliated company.

6. Are there any implications for restructuring through an informal process?

6.1 Directors' liabilities

A director of the debtor is in general terms obliged to submit an insolvency petition without undue delay after he or she became, or should have become while acting with due diligence and prudence, aware of the legal entity's insolvency.

If a director fails to comply with the obligation to submit the insolvency petition, such a director is liable to the debtor's creditors for the loss or damage caused by such breach of obligation, provided that such loss or damage is equal to the difference between the ascertained amount of the claim and the amount the creditor actually received in payment of his claim in insolvency proceedings.

If the "late" submission of the insolvency petition had an (adverse) effect on the extent of satisfaction of the creditors' claims in the insolvency proceedings, the director(s) could be potentially held liable for such "late" submission of the insolvency petition.

Further as stated before, in the country under corporate laws members of the governing body of the debtor also have a duty to act with due care and duty of loyalty, and if such duty is breached they may be obliged to compensate any and or all damages caused by or resulting from such a breach.

If a member of the governing body fails to compensate the company for the damage incurred, that person will become liable by way of suretyship to the company's creditors for the company's debts to the extent that a governing body failed to compensate the damage, provided that the creditor is unable to recover the performance from the company.

Since restructuring of a company within insolvency proceedings is public, it is not uncommon that business partners of such a company become more cautious and might even start to request pre-payments for their deliveries which might have a negative impact on the cash flow of the company undergoing a restructuring.

6.2 Adviser's liabilities

Under Czech law the adviser is not liable for the debts of a company during the period it is being restructured. The adviser however, could be generally held liable for giving wrong advice during such a period if the advice provided directly led to a loss or damage incurred by the company. Such liability is not very common in practice because the potential wrongfulness of advice is difficult to prove.

7. Are there any current proposals for reform of restructuring processes specifically aimed at MSMEs?

7.1 Proposed legislation

Currently there is no proposed legislation to deal with the restructuring of MSMEs.

There is however a group called 'Association of small and medium-sized enterprises CZ' and its main purpose is to promote and defend the interests of MSMEs (which also includes improving the legislative process).

8. What reforms would be useful if they were to be implemented?

There is no need for a new legislation specifically aimed at MSMEs since such a step could cause an unnecessary fragmentation of the law which could lead to a number of uncertainties.

However, a form of amendment with respect to the voidance of antecedent transactions should be considered in the case of restructuring scenarios as envisaged partly under the European Commission proposal for a directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012 / 30 / EU.

The current legislative framework lacks provisions that would provide more certainty to third parties in cases where the debtor seeks to restructure its business and to overcome insolvency regardless of whether such an endeavour is viable or not.

In general, mediation is not as entrenched in the jurisdiction as, for example, in the USA, and entrepreneurs (not only MSMEs) are rather distrustful towards non-judicial assistance.

ENGLAND AND WALES

1. Is there a legal definition of MSMEs?

At the time of writing the UK remains within the EU and as such the definition of medium, small, and micro businesses follow the definitions laid down by the European Commission and can be summarised as follows:-

Company category	Employees	Turnover	Balance sheet total
Medium-sized	< 250	≤ €50 million	≤ €43 million
Small	< 50	≤ €10 million	≤ €10 million
Micro	< 10	≤ €2 million	≤ €2 million

The latest Parliamentary Business Statistics paper dated 28th December 2017 (no 06152) provides the following useful summary of business numbers:-

- In 2017, there were 5.7 million businesses in the UK;
- Over 99% of businesses are Small or Medium Sized businesses – employing 0-249 people;
- 5.5 million (96%) businesses were micro-businesses – employing 0-9 people. Microbusinesses accounted for 33% of employment and 22% of turnover;
- In London, there were 1,519 businesses per 10,000 resident adults. In the North East there were 657 per 10,000 resident adults;
- The service industries accounted for 74% of businesses, 79% of employment and 71% of turnover;
- The manufacturing sector accounted for 5% of businesses, 10% of employment and 15% of turnover;
- There were 414,000 business births and 328,000 business deaths in 2015;
- 21% of SMEs are female-led and in 2017 28% of FTSE100 board members were female.

2. Is there currently a formal restructuring process? If so what are the main characteristics?

The current legislation used in the restructuring of insolvent businesses is the Insolvency Act 1986, Enterprise Act 2002 and related rules. The legislation has stood the test of time by the regular updating of the rules.

The procedures available to Insolvency Practitioners to help in the restructuring process include Administration, Liquidation and Company Voluntary Arrangements (CVAs).

2.1 Administration and Company Voluntary Arrangements

Administration and CVAs are used most often to preserve the company or at worst the business of the company. This is achieved in a CVA by putting forward a full and final settlement proposal to creditors which may take a period of years to achieve; once accepted by creditors and shareholders there is affectively a standstill on creditors taking any enforcement action against the company.

Administration can be used as a precursor to CVA to provide a shield against action by creditors to recover their debt. It can also be used to put forward proposals to creditors to deal with the realisation of the assets of the company for maximum value. This may involve the controversial use of a 'prepack' deal to sell the business of the company to a new company set up to carry on the old company's business activities.

2.2 Liquidations

Liquidation brings the life of the company to an end, and can be used in restructuring groups when companies are no longer required. Besides voluntary liquidations where the directors and shareholders consent to liquidation, there is the process of compulsory liquidation where the court orders the company to be placed into liquidation. In very rare cases this procedure allows for the appointment of Special Managers who can manage the business on behalf of the liquidator (who is usually the Official Receiver).

The legislation is available for companies of all sizes and there is no specific legislation for varying size of entity. However, some of the less costly and time consuming procedures are more appropriate for MSMEs. Liquidation is usually the cheapest procedure and therefor often most appropriate for micro and small companies. It is often the medium sized and small companies (where the business is worth saving) which benefit most from Administration or a CVA.

2.3 Insolvency office-holder

The person in control of the company whilst in an insolvency procedure depends on the type of procedure entered. In a CVA the directors remain in control of the company and the insolvency practitioner is known as the Supervisor and their job is to make sure that the company and its directors comply with the terms of the agreement entered into. In all other cases, the insolvency practitioner takes control and their title comes from the type of procedure (an administrator is appointed in an administration and a liquidator in a liquidation). The insolvency practitioner will often work with the assistance of the cooperative director to maximise realisations for creditors. The directors have a statutory duty to cooperate with the insolvency practitioner.

2.4 Order of payments

The order of payment of the costs of an insolvency procedure and the payment of creditors is set out in the Insolvency Act 1986 and rules.

Secured creditors, also known as fixed charge creditors, rely on their security to get paid from the sale of the relevant asset. Preferential creditors come next in the payment order and they are usually employees for unpaid wages or outstanding holiday pay. Third in line for payment are creditors who hold a floating charge over the assets of the company. A floating charge is an equitable charge over the assets of a going concern company. The charge remains dormant and the company free to dispose of the assets (for example trading stock) until the company ceases to be a going concern or the lender intervenes to enforce the charge.

After the floating charge creditors come the bulk of creditors, the 'unsecured non-preferential creditors' who are often trade creditors, unpaid taxes, and other government debts, unsecured lenders, and those where the value of the secured asset was insufficient to pay the debt in full when it was sold.

It is often this last class of creditor who receives little or no payment and as a result has little incentive to participate in any restructuring proceedings. However, there is one shadowy area in that if it wasn't for the costs of the proceedings, creditors would receive a return and as such it is important for these creditors to participate acting as a guard dog to keep costs in check.

2.5 Disincentives for trading while insolvent

There are no real incentives to restructure early, but there are real disincentives to continuing to trade when the company is insolvent (for example, claims for wrongful trading against directors by the administrator or liquidator which can create personal liability for directors under section 214 of the Insolvency Act 1986) and director disqualification can occur as a result of a whole number of Insolvency Act and Companies Act offences (for example, preferring certain creditors for payment, failure to maintain proper books and records, non-payment of crown debts, as well as wrongful trading).

One barrier to early restructuring is personal guarantees given by the owner of the MSME, who may face personal liability if there is a shortfall to the lender. It is not unknown for owners to keep trading the enterprise to avoid bringing on this painful reality.

2.6 Post-commencement finance

In the UK there is no legislation which deals with post-commencement finance. As such the insolvency practitioner is often reluctant to trade the MSME on post appointment and that is what makes the prepack sale option so attractive. Any finance for trading is often provided by existing lenders and repaid from asset realisations; it is a brave insolvency practitioner who continues to trade when their own personal liability and professional standing is at risk.

3. Are there any barriers (legal and / or financial) which make the restructuring process prohibitive for use by MSMEs?

The use of the insolvency procedures available under the Insolvency Act 1986 and rules generally require the company to be insolvent or close to being insolvent. Without the cooperation of directors and shareholders to pass the appropriate resolutions, it is difficult to make constructive progress. Each type of procedure has its own particular method of appointing an insolvency practitioner and the Insolvency Act and rules set out the relevant procedures; in voluntary liquidation it is usually the nominee of the directors who is appointed by creditors and shareholders; in a compulsory liquidation it can be either the Official Receiver (a government official) or an Insolvency Practitioner, and the appointment can be made by the court, creditors or the Secretary of State.

In Administration, the appointment can again be made by the court, the creditors, the directors and the shareholders; whilst in a CVA the arrangement is approved by creditors and shareholders.

From practical experience, a complex restructuring solution may not be understood by the director of a MSME and the professional costs can put owners off using any of the procedures as they can swallow up any return to creditors.

4. Are other insolvency processes utilised as an alternative to a formal restructuring procedure?

MSMEs are often 'restructured' using a 'pre-pack' administration or liquidation. The acquiring company may or may not be owned by the existing owners; the controversy usually arises when the sale is a ‘connected pre-pack’ (in other words a sale back to the owners of the failed company).

4.1 Pre-pack sales

The transaction usually occurs immediately after the appointment of the insolvency practitioner, but the practical arrangements have been put in place prior to the formal appointment. Asset sales may take place to connected parties both pre- and post-appointment; the insolvency practitioner will be expected to ensure that best value is obtained by having an agent’s advice on the sale and reporting the same to creditors as is required by both the Insolvency Act, the Insolvency Rules and regulations issued by the profession. Statements of Insolvency Practice (SIP) numbers 13 and 16 deal with the sale of assets to connected parties and pre-packaged sales, details of which can be obtained from any of the Regulated Professional Bodies (RPB) that authorise insolvency practitioners.

The purpose of the SIPs is to provide guidance to insolvency practitioners in how best to inform stakeholders in the failed company of what steps the insolvency practitioner took to get best value for the assets and who they sold them to.

The controversy surrounding pre-pack sales in the UK led to the creation of the ‘pre-pack pool’, an independent organisation that reviews connected party pre-packs. The pool operates on a voluntary basis and is funded from fees charged on the cases submitted to the pool for consideration. However, it is considered best practice by the RPBs for insolvency practitioners to submit connected party pre-packs to the pool for consideration. The turnaround is usually within 24 hours, so there is minimum delay in the process, a traffic light system of approval is operated which is designed to give creditors some level of confidence in the sale.

SIPs require the insolvency practitioner to explain why a case isn’t referred to the pool and to notify creditors within 7 days of the sale and where appropriate (in the case of getting the Administrators proposals approved) seek to obtain creditor approval at the very earliest practical opportunity. The aim of the pool is to achieve transparency in the arrangement at a time when creditors are at their most sceptical and the costs of the pool review are paid by the purchasers.

From practical experience, the prepack sale has become the procedure of choice when trying to save the business of an MSME. Even though it is a controversial procedure, a sale back to the existing owners often provides best value for creditors in terms of asset realisations.

5. If so, are there any barriers or restrictions on the use of the procedures identified in question 4? Are they open to abuse?

Prepack sales to connected parties and phoenixing in its widest form maybe controversial with creditors, but it is generally considered to be the best way of maximising value from a failed business. As such, rules and regulations don’t prevent the procedures but aim to provide safeguards for creditors to ensure that it is the best deal available. There are restrictions on the re-use of the same or similar company and these are set out in the Insolvency Act 1986 (Section 216). Contravention of this section may lead to personal liability if the new company doesn’t pay the debts. The director is generally safeguarded from this section if the assets have been acquired in a sale arranged by the officeholder, or approval to use the name has been obtained from the Court.

The employees’ position in any insolvency procedure will depend on the type of procedure and any transfer of the business. Specialist advice needs to be taken in dealing with employees, but in general terms if the business ceases to trade the employees' claims, subject to certain limits, will be paid by the Governments National Insurance Fund. Any additional claim will be a claim in the insolvency procedure itself.

If the business is being rescued there could very well be a transfer of undertakings and as such the employee rights will transfer to any new owners.

6. Are there any implications for restructuring through an informal process?

There is no 'safe harbour' in UK insolvency legislation and a director of an insolvent company can be subject to personal liability if the officeholder can show the directors' decisions showed further losses from the point when the directors knew or should have known of the company's insolvency. This is generally known as wrongful trading (see section 214 of the Insolvency Act 1986). To avoid any claim, the director needs to demonstrate that he took 'every step' to minimise losses to creditors (in other words, he did not let things get any worse than they already were).

Wrongful trading claims always depend on the particular circumstances of the case and it is important that directors of 'troubled' companies get the best advice on the way forward. It is vital that they record their decisions and actions to enable them to demonstrate what steps they took to stem the losses.

The amount of any claim is usually the increase in creditors from the point when the directors knew or should have known that insolvent liquidation was inevitable. Experienced insolvency practitioners all know things never turn out as planned, so it is vital to keep a full record of events and decisions and to support the decisions notes of how the decisions were reached.

In addition, in all formal insolvency procedures with the exception of Company Voluntary Arrangements and Members Voluntary Liquidations, the officeholder must submit a report on the conduct of the directors of the failed company to the Insolvency Service. It is for the Insolvency Service to decide whether or not to take further action and disqualify the director from acting for a period of time in the future and there is also the possibility that the Court may order a compensation payment to creditors.

Those advising directors of failing companies must also proceed with caution as they can be considered as shadow or *de facto* directors and be subject to the same Insolvency Service enquiries and actions.

7. Are there any current proposals for reform of restructuring processes specifically aimed at MSMEs?

At present the restructuring of MSMEs is usually carried out by way of either a CVA or Administration, whilst a pre-pack or phoenix sale may also involve the liquidation of the old company.

However, in May 2016 the UK Government launched a consultation entitled 'A Review of the Corporate Insolvency Framework'. The consultation is now closed and the Government of the day is considering responses.

The proposals had four areas of consideration:

- The creation of a three-month moratorium (with extension);

- Helping businesses continue through restructuring by protecting contracts for essential supplies being broken by suppliers holding the rescued company to ransom;

- Developing flexible restructuring plans binding both secured and unsecured creditors;

- Looking at options for rescue finance.

It is proposed that these additional tools would be used within both CVAs and Administration and as such the insolvency practitioner will remain the focus of attention. Interested parties are currently waiting for the outcome of the consultation before lobbying for their own agenda.

8. What reforms would be useful if they were implemented?

There is no need to introduce a whole new suite of legislation for MSMEs; what is needed is a simpler, quicker and more easily understood slimmed-down version of what is already in place. Both directors and creditors need to trust any system used and that can only come from an understanding of how it works and being able to participate in the decision-making process. The more complicated and unfamiliar the legislation is, the less likely it is to be understood, used and trusted by stakeholders. Creditors in particular need to be able to trust the officeholder in charge, so they know that they are getting the very best out of a bad situation.

Of the proposals referred to under question 7., the most important is the prevention of essential suppliers holding companies to ransom and preventing a rescue that would benefit all creditors.

The best turnaround and rescue of any business comes from all parties' interests being satisfied, or at least knowing they have been listened to. Compromise by all sides is key, mediation may help if it brings participation, but more important is legislation which prevents one selfish creditor's agenda ruining the chances of rescuing a business for the benefit of all concerned.

GERMANY

1. Is there a legal definition of MSMEs?

Small and medium-sized companies, in their entirety widely known as the "*German Mittelstand*". Further, a vast number of micro enterprises constitute the backbone of German economy, and in total small and medium-sized enterprises account for almost 99% of all German businesses. Consequently, the support and promotion of MSMEs is of major importance to nearly every German economic policy. This being said, the German jurisdiction does not, however, provide with a uniform legal definition of micro, small or medium enterprises. Instead, every area of law shows a different approach towards different business size.

German commercial law at initial level provides with a distinction between enterprises that are considered as merchants and enterprises that are too small to be considered as such. A merchant is an entity that carries on a commercial business.[1] A commercial business is then defined as any commercial enterprise, unless, due to its nature or size, the enterprise does not require a commercially organized business operation. Whether an enterprise does not require a commercially organized business operation is determined according to its overall appearance and is not tied to certain fixed parameters. Common indications are however the amount and volume of the enterprises' orders or the complexity of its organization. As a consequence, non-merchants are not bound by most of the Commercial Code's provisions, for example, complying with certain accounting obligations or the duty to keep an inventory.

Merchants under the Commercial Code on the other hand are required to comply with specific requirements especially regarding accounting, financial reporting or inventory, which then differ according to the business size. According to the Commercial Code an extensive exemption is granted for merchants who act as a sole proprietor and whose annual revenue does not exceed EUR 600,000.00 and annual profit does not exceed EUR 60,000.00 within two years in a row.[2] Apart from this classification, the Commercial Code hold different accounting and financial reporting requirements for enterprises that are structured as corporations, depending on their respective business size.[3]

Classification when at least two of the following features are met	Average number of employees	balance sum	annual revenue
micro corporations	≤10	700,000 €	350,000 €
small corporations	≤50	12,000,000 €	6,000,000 €
medium corporations	≤250	40,000,000 €	20,000,000 €
large corporations	all other corporations including all publicly held corporations		

Another classification of business size is applied within German taxation law. Enterprises with an annual revenue of less than 17,500 € within the last business year and an expected revenue for the current business year of less than 50,000 € are exempt from paying VAT.[4] The goal of this provision is a tax relief for very small business entities as well as support for growing start-ups. Furthermore, enterprises where the annual revenue does not exceed EUR 600,000.00 or the annual profit does not exceed EUR 60,000.00 are exempt from the obligation to keep certain tax records.[5] This provision roughly correlates with the exemption for sole proprietors

[1] Section 1 of the German Commercial Code (Handelsgesetzbuch - HGB).
[2] Section 241a and section 242 of the German Commercial Code.
[3] Section 267 and 267a of the Commercial Code.
[4] Section 19 of the German VAT Code (Umsatzsteuergesetz – UStG).
[5] Section 140 and 141 of the German Fiscal Code (*Abgabenordnung – AO*).

stated in the Commercial Code.[6] However, especially the methods to determine the enterprises' revenue and profit do not correspond completely.

Nearly all present German legislation on MSMEs has in some way have been influenced by previous guidelines, directives or regulations by the European Union. Apart from these harmonization efforts within the European jurisdiction, the European Commission has put forward its own definition for MSMEs as early as in 2003. The following indications as stated in the EU recommendation 2003/361 are still valid today and set an important framework especially for European and German national support and subsidy programs for MSMEs.

Company category	Average number of employees	Annual balance sheet total	**or**	Annual turnover
micro	≤10	2,000,000 €		2,000,000 €
small	≤50	10,000,000 €		10,000,000 €
medium-sized	≤250	43,000,000 €		50,000,000 €

German insolvency law on the other hand does not adopt any of the definitions presented above, but sets forth its own modifications according to the size of the business.

2. Is there currently a formal restructuring process? If so what are the main characteristics?

2.1 Formal restructuring processes under the German Insolvency Code

The German Insolvency Code (*Insolvenzordnung-InsO*) states only one type of formal insolvency proceeding that constitutes a legal framework for formal liquidation as well as for formal restructuring proceedings. All formal proceedings follow the same exclusive objective, namely the best possible satisfaction of all creditors. Consequently, there is no general prioritization of liquidation over restructuring or the other way around. Practically however, restructuring is given priority over liquidation, if it promises a higher level of creditor satisfaction.

2.2 General liquidation and restructuring framework

Every formal insolvency proceeding is initiated through a respective application to the locally competent insolvency court, either by the enterprise itself or its creditors. According to the Insolvency Code, all enterprises that are structured as a corporate identity are obliged to file for insolvency if they reach a certain level of illiquidity or over-indebtedness.[7] When receiving an insolvency application from an ongoing company, the insolvency court will at first implement a preliminary insolvency administrator, who is to validate the state of indebtedness as well as to secure the enterprise's assets. The insolvency court will then open the formal insolvency proceeding and will appoint an insolvency administrator, who is granted full legal representation and administration rights concerning the enterprise's assets.[8] On this basis, the insolvency administrator will subsequently execute the liquidation or restructuring of the insolvent enterprise.

While the supervision of the insolvency administrator is conducted by the insolvency court, the creditors are granted their own participation rights in order to influence the course of the insolvency proceeding. The preliminary creditor committee has the right to put forward a specific insolvency administrator that may only be denied by the

[6] Section 267 and 267a.
[7] Section 15a.
[8] Section 80 of the Insolvency Code.

insolvency court on well-reasoned grounds.[9] Further, extensive co-determination rights follow alongside the respective liquidation or restructuring measures.

Overall, the Insolvency distinguishes between insolvency claims of secured and unsecured creditors. Concerning the satisfaction of unsecured creditors, the Insolvency Code sets out a certain ranking.[10] Shareholders with open loan assets or creditors who previously declared the subordination of their claims will only be satisfied secondarily. Meanwhile, no priority is granted to wage claims of the enterprise's employees that originate from before the opening of the formal insolvency proceeding. Employees may however be granted advance financing worth of maximally three months pay by the German Federal Labor Office. The Federal Labor Office will then take recourse against the insolvent enterprise in the rank of a regular creditor.

Claims that are constituted after the opening of the formal insolvency proceeding generally originate from the continuation of business under the management of the insolvency administrator and therefore are not considered to be insolvency claims. On the contrary, any such claims have to be paid in full directly from the insolvency estate (administrative claims). This also applies to wage claims of employees that were still employed at the time the proceeding was formally opened due to a continuation of business. The Insolvency Code does not alter the termination periods for employment contracts constituted by German labor law. If the insolvency estate is not sufficient enough to cover all post-opening claims due to a miscalculated continuation of business, the insolvency administrator may be held personally liable.[11]

2.3 Formal restructuring processes

Formal restructuring of insolvent enterprises under the Insolvency Code may either be reached through a transferring reorganization or by way of a reorganization of the legal entity itself. The majority of restructuring proceedings in Germany are however accomplished through transferring reorganizations, meaning the transfer of the enterprise's business or certain business units to another legal entity. The new legal entity may be a mere hive - off vehicle (*Auffanggesellschaft*) that was solely created for this purpose or may belong directly to a competing enterprise that is willing to take over the insolvent business unit. While the profit realized through the sale of business is utilized to satisfy the enterprises' creditors, its former legal entity is still liable for all former debts and therefore becomes subject to liquidation. Any transfer of major parts of the debtor's business requires the consent of the creditors committee or, if a committee has not been appointed, the majority of creditors.[12] Unalterable is the mandatory transfer of undertakings. In case of a transfer of business, all former employees that were still employed at the time of transfer automatically become employees of the acquiring entity and may not be fired for the period of one year.[13]

Restructuring through reorganization of the original legal entity on the other hand implies the continuation of the enterprise's business within its original legal framework. The continuation of business requires the consent of the majority of creditors.[14] The reason for this requirement lies within the high level of uncertainty that is inherent to every restructuring process. While the full recovery of the indebted enterprise without selling off its business to another legal entity promises the highest rate of creditor satisfaction, failure to do so also poses the biggest threat. In order to support the continuation of business, the Insolvency Code includes certain

[9] Section 56a of the Insolvency Code.
[10] Section 39.
[11] Section 60 of the Insolvency Code.
[12] Section 160 of the Insolvency Code.
[13] Section 613a of the German Civil Code (*Bürgerliches Gesetzbuch – BGB*).
[14] Section 157 of the Insolvency Code.

modifications to German contract and foreclosure law. For example, the cancellation of rental agreements is hardened and may not be based on the failure to pay rent regarding the period before the opening of the formal insolvency proceeding.[15] The realization of securities lies within the hands of the insolvency administrator so that necessary manufacturing equipment may temporarily be preserved for purposes of the business.[16] That means that creditors who were granted a lien may not demand the return of actual operating material but solely gain a right of separated satisfaction out of the sale of the pledged objects. Furthermore, shareholders who are willing to submit (further) shareholder loans are granted a privileged status, as they will then rank as regular insolvency creditors and not as secondary creditors.[17]

The described legal framework alone however hardly allows for a successful reorganization of the original legal entity. On the contrary, in the state of formal insolvency proceeding under the Insolvency Code, practically no reorganization will be possible without further cooperation of the enterprise’s major creditors. This is based on the fact that in this state, most of the entrepreneurial measures that may be executed without the creditors consent, such as reducing fixed cost, laying off employees or raising additional (shareholder) capital, were already unsuccessfully implemented prior to the formal insolvency proceeding. Consequently, a reorganization of the original legal entity may only be feasible in the prospect of the major creditors agreeing on a substantial debt reduction as well as a privileged status of new capital providers. The framework for such a joint creditor agreement is stipulated within the so-called insolvency plan procedure.[18]

2.4 Insolvency plan procedures pursuant to section 217 of the Insolvency Code

According to this section, certain provisions of the Code are not binding, but may be altered by a so-called insolvency plan. In the following provisions the Insolvency Code then puts forward a complex procedural framework enabling the creditors together with the insolvency court, the insolvency administrator and the insolvent enterprise to implement a set of alternative regulations. While the main characteristic of an insolvency plan under section 217 of the Insolvency Code is the cooperation of all parties concerned, the procedure also includes a variety of rules to overcome possible discrepancy. The objection of individual creditors against a certain insolvency plan may not fall into account, if the plan does not impair their standing compared to that under the regular legal framework and if the plan provides them with a reasonable economical share of the assets that are to be distributed on the basis of the insolvency plan (“cram-down- rule”).[19] Following the 2012 reforms introduced to the he Insolvency Code, this cram-down-rule now also applies to the companies’ shareholders. Section 247 of the Insolvency Code includes a similar provision concerning the insolvent enterprise’s consent.

Alterations are possible concerning the satisfaction of creditors and of such creditors that are entitled to separate satisfaction, the disposition of the assets involved in insolvency proceedings and their distribution to the parties concerned, as well as the debtor’s liability subsequent to termination of the insolvency proceedings. Generally, that means that it is also possible to deviate from the legal framework concerning the liquidation or transferring reorganization of an insolvent enterprise. Practically however, insolvency plans are mainly used in order to achieve the enterprise’s reorganization within its original legal setting. Only by the means of said alterations, creditors may be willing to agree on substantial debt reductions or provide additional loans. In this respect especially section 264 of the Insolvency Code plays a major

[15] Section 112 of the Insolvency Code.
[16] Section 166 and 172 of the Insolvency Code.
[17] Section section 39 of the German Insolvency Code.
[18] Section 217 of the German Insolvency Code.
[19] Section 245 of the Insolvency Code.

role, as under this provision, in contradiction to the general principles, it is possible to grant providers of fresh outside capital privileged satisfaction over all other creditors. Furthermore, a debt-equity-swap is made possible without the consent of the former shareholders.[20]

2.5 Self - administration proceedings pursuant to section 270 of the Insolvency Code

Section 270 and 270a of the Insolvency Code provide the possibility to, in addition to the application for the opening of an insolvency proceeding, apply for self-administration (*Eigenverwaltung*). This mode of insolvency process is comparable to Chapter 11 of the US Bankruptcy Code, leaving the debtor in possession. That means that instead of an insolvency administrator with excessive administration rights, the insolvency court appoints a so-called insolvency trustee (*Sachwalter*) with only limited rights, such as the right to challenge transactions. Apart from the supervision through the insolvency trustee, the debtor then executes the insolvency proceeding himself. A successful self-administration therefore requires thorough preparation prior to the filing for insolvency. In practice, the indebted enterprise is well advised to gain the support of its main creditors, prepare restructuring measures and hire respective restructuring consulting before initiating a self-administration. Only then the successful implementation of an insolvency plan will become practically possible.

While the self-administration is designed to fully replace an insolvency proceeding with a court-appointed insolvency administrator, section 270b provides a simplified procedure for enterprises that suffer from pending over-indebtedness or illiquidity but not actual illiquidity and want to file for an early insolvency proceeding with the intend to already work out an insolvency plan (*umbrella proceeding-Schutzschirmverfahren*).

2.6 Modifications applicable to MSMEs

German Insolvency law only knows one uniform insolvency procedure for both individuals as well as companies, namely the insolvency proceeding under the German Insolvency Code. Regardless of its size, structure, or organization any enterprise that is considered to be insolvent according to a certain definition qualifies for an insolvency proceeding under the Insolvency Code. Nonetheless certain modifications are included in according to the enterprises size.

At an initial level, section 304 of the Insolvency Code differentiates between insolvent individuals, that may still be qualified as consumers and are considered to conduct regular businesses. Consumers are all individuals who do not execute more than an insignificant part time business and do not have more than 20 creditors. The insolvency proceeding for consumers is mainly focused on a settlement of debts prior to the opening of an insolvency proceeding. Nonetheless, if a settlement fails, the regular rules also apply to insolvent consumers. As of late, this also includes the regulations on insolvency plans, but not the regulations on self-administration.

Individuals that are considered to conduct regular businesses as well as all other enterprises, the Insolvency Code contains certain benchmarks according to business size leading to certain simplifications for smaller enterprises. Pursuant to section 22a of the Insolvency Code a preliminary creditors committee can be formed only when the insolvent enterprise does not meet at least two of the features stated in the table below.

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[20] Section 225a of the Insolvency Code.

Preliminary creditors committee only formed when two of the following features are met:	Average annual number of employees	Annual balance sheet total after deducting the enterprise's assets	Annual turnover
	≤50	6,000,000 €	12,000,000 €

The preliminary creditors committee plays a major role during the time of preliminary insolvency proceedings, namely the period of time between the application for an insolvency proceeding and opening of the formal insolvency proceeding. It is the preliminary creditors committee's right to put forward a specific insolvency administrator that may then only be denied by the insolvency court on well-reasoned grounds.[21] Consequently, the creditors of smaller enterprises regularly do not have the possibility to name a certain insolvency administrator. The preliminary creditors committee has the right to submit a written statement concerning the enterprise's eligibility for a proceeding under self-administration.[22] The preliminary creditors committee may at any time end the self-administration of the distressed enterprise under this provision.[23] These possibilities also are not granted to the creditors of smaller enterprises. Furthermore, the fulfilment of the features states above has an impact on the volume of information that has to be submitted in order to draft an admissible application for insolvency under section 13 of the Insolvency Code.

Lastly, the Insolvency Code provides with certain formal simplifications if the debtor's financial situation may be considered to be clear and the debts considerably low. In detail, Section 5 allows for the entire proceeding before the insolvency court to be executed in writing and section 29 of the Insolvency Code declares the exemption from the duty to hold a formal debtor meeting. Whether an enterprise meets these requirements is determined according to the overall appearance and is not tied to certain fixed parameters.

3. Are there any barriers (legal and / or financial) which make the restructuring process prohibitive for use by MSMEs?

There are no provisions within the German Insolvency Code that would prohibit MSMEs from undergoing a formal restructuring process. In fact it is the expressed desire of the German legislator, to enable more MSMEs to undergo restructuring. Especially the reform of the regulations concerning the implementation of formal insolvency plans in 2012 was designed to make the formal restructuring process more accessible for MSMEs. Nonetheless the number especially of micro and small enterprises that enter the formal procedure to conduct an insolvency plan is still significantly low. One of the reasons is that Germany has no culture of a so-called second chance. If you as a company director of a micro, small or medium enterprise lead the company into an insolvency proceeding you are kind of brand marked. Therefore, most of the micro, small and medium enterprises try to avoid filing for insolvency until there is no other chance to do so, which means there is no liquidity anymore. When these companies are entering into the proceeding, it is mostly impossible to think of a restructuring process for them. The use of a restructuring process needs good preparation by hiring professionals and that makes such a process expensive. Micro, small and medium sized enterprises often do not have the necessary resources to cope with high restructuring costs.

[21] Section 56a of the Insolvency Code.
[22] Section 270 of the Insolvency Code.
[23] Section 270b.

4. Are other insolvency processes utilized as an alternative to a formal restructuring procedure?

Alternatives to a formal restructuring process in the form of fully self-standing other processes are not provided for by statute. The Insolvency Code does, however, provide just the above mentioned slightly modified proceedings (Insolvency Plan, Self-Administration and Protective Screen Proceedings "*Schutzschirmverfahren*").

5. If so are there any barriers or restrictions on their use and implementation? Are they open to abuse?

As already stated, the German Insolvency Code provides a legal framework for formal insolvency plans. Consequently, it may be considered useful to work out an insolvency plan prior to filing for formal insolvency, so that the actual phase of the formal insolvency proceeding is shortened. Particularly in cases where an enterprise seeks to additionally apply for self-administration[24] or an early self-administration,[25] a previously prepared plan may even be considered necessary in order to successfully undergo restructuring. Nonetheless, German insolvency law does not yet provide any judicial framework that governs out-of-court restructurings. For this reason a pre-packed plan is only useful, if actual formal insolvency proceedings are opened later on.

6. Are there any implications for restructuring through an informal process?

Any efforts of restructuring distressed enterprises within the scope of the German jurisdiction are always performed in the light of the regulations of the German Insolvency Code. All enterprises that are structured as a corporate identity are obliged to file for insolvency if they are in a state of illiquidity, pending illiquidity or over-indebtedness.[26] Failure to do so results in the liability of the company's directors and may even constitute a criminal offense.

7. Are there any current proposals for reform of restructuring processes specifically aimed at MSMEs?

Due to the variety of jurisdictional differences in Europe, the European Commission has issued a directive conturing a framework for preventive restructuring methods (COM (2016)723) which is widely approved by insolvency practitioners. The directive's objective is to make restructuring more effective so that it may offer significant chances for MSMEs as they will be saved from costs and risks of "insolvency tourism". In general, however, it contradicts the "Further Facilitation of Restructuring Businesses Act" (*Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen, ESUG*) which enables both creditors and debtors to be more efficient and reliable and use German insolvency law to further their legitimate interests. Throughout the legislation process for ESUG, the parties expressly waived to create pre-insolvency proceedings and instead focus on in-court remediation measures.

Whether the directive forces the German legislature to create national pre-insolvency restructuring proceedings, seems questionable. The EU member states are only bound by the targets of the directive and thus have a significant margin of discretion in order to take account of the specific national characteristics. When the ESUG came into force in 2012, Germany already had a number of effective restructuring instruments that largely corresponded with the directive's target allowing profitable companies in financial distress to continue operation of their businesses.

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[24] Section 270.
[25] Section 270b of the Insolvency Code.
[26] Section 15a of the Insolvency Code.

8. What reforms would be useful if they were to be implemented?

The current German legal insolvency framework seems well-established for operational restructurings with regard to MSMEs.

However, from a legal comparative standpoint, Germany does not have a coherent corporate insolvency law. The broad possible range of insolvent assets is, in principle, subject to a uniform procedure. A single procedure for all types of debtors appears to be inefficient in that it establishes the same rules and, above all, the requirements for the insolvency of large as well as small businesses. In the past two decades, the financial structure and corporate governance of large companies have been significantly detached from the reality of small businesses. The special situation in small enterprises, in particular their limited resources of liquidity and know-how, is still largely ignored in the current legislative efforts, for example in the preparatory proceedings for a protective screening process.

The principle of the single procedure will not only have to be questioned with regard to the rehabilitation opportunities of MSMEs, it is also questionable the variety of insolvent assets and legal persons. The implementation of a corporate insolvency statute, taking into account the structural features of MSMEs, would be the necessary basis for any further reform regarding facilitation of proceedings for insolvent MSMEs.

INDIA

1. Is there a legal definition of MSMEs?

In India, keeping in view the huge contribution by the MSME sector to the economy, a specific law for the protection of MSMEs has been enacted, namely, "The Micro, Small and Medium Enterprises Development Act, 2006". The Act[1] defines an enterprise as an industrial undertaking or a business concern or any other establishment, by whatever name called, engaged in the manufacture or production of goods, in any manner, pertaining to any industry specified in the First Schedule to the Industries (Development and Regulation) Act.[2] or engaged in providing or rendering of any service or services;

Further Section 7 of the Act defines and sub-classifies the enterprise as follows:

(1) (a) in the case of enterprises engaged in the manufacture or production of goods pertaining to any industry specified in the First Schedule to the Industries (Development and Regulation) Act, 1951:

(i) a micro enterprise, is where the investment in plant and machinery does not exceed twenty-five lakh rupees;

(ii) a small enterprise, is where the investment in plant and machinery is more than twenty-five lakh rupees but does not exceed five crore rupees; or

(iii) a medium enterprise, is where the investment in plant and machinery is more than five crore rupees but does not exceed ten crore rupees;

(b) in the case of the enterprises engaged in providing or rendering of services, as-

(i) a micro enterprise, is where the investment in equipment does not exceed ten lakh rupees;

(ii) a small enterprise, is where the investment in equipment is more than ten lakh rupees but does not exceed two crore rupees; or

(iii) a medium enterprise, is where the investment in equipment is more than two crore rupees but does not exceed five crore rupees.

Although in the year 2015, a legislative Bill, namely, Micro Small Medium Enterprises Development (Amendment) Bill, 2015 was proposed for increasing the level of investment for classification in each category the same has not been passed by the Parliament yet.

Other than in the Micro, Small and Medium Enterprises Development Act, 2006, the term MSMEs has not been defined under any other law.

2. Is there currently a formal restructuring process? If so what are the main characteristics?

In India, there were multiple laws dealing with insolvency and restructuring procedures relating to both corporate entities and individuals. Recently however, the Indian legislators have enacted a new law codifying the entire procedure dealing with insolvency and restructuring of both corporate and unincorporated entities and individuals called the IBC[3]. At the time of writing, the provisions relating to

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[1] Section 2(e) of the Micro, Small and Medium Enterprises Development Act, 2006.
[2] (1951 (55 of 1951)).
[3] Insolvency & Bankruptcy Code, 2016.

unincorporated entities and individuals are yet to be notified and are expected to come in to force shortly.

2.1 Insolvency resolution process

Under the IBC, initiating the process for corporate entity is based on the occurrence of default in payment of dues to a creditor either financial or operational with a minimum threshold limit of Rupees 1.00 lakh for corporate entity and Rupees 1.00 thousand for an unincorporated entities and individuals.

The IBC provides for different forums for initiation of insolvency and bankruptcy procedures for corporate and unincorporated entities and individuals. For corporate entities the jurisdiction to deal with a procedure is conferred on the National Company Law Tribunal (NCLT) presently established at 10 places in India. The jurisdiction of each NCLT has been limited on territorial basis and linked to the registered office of the corporate debtor. Similarly, for unincorporated entities and individuals, the jurisdiction to deal with the insolvency and bankruptcy process has been conferred on the Debts Recovery Tribunal (DRT) having territorial jurisdiction over the place where the individual debtor or unincorporated entity debtor actually and voluntarily resides or carries on business or personally works for gains. Presently there are 21 places in India in which DRTs are functional and in some places, such as Delhi, Mumbai, Kolkata and Chennai there are 3 DRTs each and at Ahmedabad and Chandigarh there are 2 DRTs each.

2.2 The role of insolvency professionals

In terms of the IBC, the responsibility to carry out and oversee the entire resolution process is conferred on a duly registered Insolvency Professional registered with the Insolvency & Bankruptcy Board of India (IBBI), a regulator constituted under the IBC.

The IBC has not been specifically developed for MSMEs however they have also not been excluded out of its purview, either.

2.3 Framework for revival and rehabilitation of MSMEs

In addition to the IBC, there is another out of court formal restructuring option specifically developed for MSMEs by the Reserve Bank of India. In 2015, the Reserve Bank of India introduced a Framework for Revival & Rehabilitation of MSMEs which is required to be followed by banks while dealing with financially stressed MSMEs.

Under the said framework, every bank is required to constitute a committee at each district or at division level or regional office level, depending upon the number of MSME units financed in the region. These committees will be standing committees and will resolve the reported stress of MSME accounts of the branches falling under their jurisdiction.

The committee can be approached by lenders as well as the stressed enterprise for consideration under the framework.

2.3.1 Corrective Action Plan (CAP)

On receipt of information relating to the liabilities of the enterprise and issuance of notice to all concerned including statutory creditors as disclosed by the enterprise, within 30 days of convening its first meeting for a specific enterprise, the committee shall take a decision on the option to be adopted under the Corrective Action Plan

(CAP) as stated below and notify the enterprise about such a decision, within five working days from the date of such decision.

If the CAP decided by the committee envisages restructuring of the debt of the enterprise, the committee shall conduct the detailed Techno-Economic Viability (TEV) study and finalise the terms of such a restructuring in accordance with the extant prudential norms for restructuring.

Where an application has been admitted by the committee in respect of an MSME, the enterprise shall continue to perform contracts essential to its survival but the committee may impose such restrictions, as it may deem fit, for future revival of the enterprise.

The CAP by the committee may explore various options to resolve the stress in the account. The committee shall not endeavour to encourage a particular resolution option and may decide the CAP as per the specific requirements and position of each case. While Techno-Economic viability of each account is to be decided by the concerned lender / s before considering restructuring as CAPs, for accounts with aggregate exposure of Rs.10 crore and above, the committee should conduct a detailed Techno-Economic Viability study before finalising the CAP.

During the period of operation of CAP, the enterprise shall be allowed to avail both secured and unsecured credit for its business operations as envisaged under the terms of CAP.

The options under CAP by the committee may include the following slutions

2.3.1.1 *Rectification*

Obtaining a commitment, specifying actions and timelines, from the borrower to regularise the account so that the account comes out of Special Mention Account status or does not slip into the Non-Performing Asset category and the commitment should be supported with identifiable cash flows within the required time period and without involving any loss or sacrifice on the part of the existing lenders. The rectification process should primarily be borrower driven. However, the committee may also consider providing need based additional finance to the borrower, if considered necessary, as part of the rectification process. It should however be ensured that this need based additional finance is intended only for meeting, in exceptional cases, unavoidable increased working capital requirement. In all cases of additional finance for working capital, any diversion of funds will render the account as NPA. Further, such additional finance should ordinarily be an *ad-hoc* facility to be repaid or regularised within a maximum period of six months. Additional finance for any other purpose, as also any roll-over of existing facilities, or funding not in compliance with the above conditions, will tantamount to restructuring. Further, repeated rectification with funding, within the space of one year, will be treated as a restructuring and no additional finance should be sanctioned under CAP, in cases where the account has been reported as fraud by any lender.

2.3.1.2 *Restructuring*

Consider the possibility of restructuring the account, if it is *prima facie* viable and the borrower is not a wilful defaulter, i.e., there is no diversion of funds, fraud or malfeasance, etc. Commitment from promoters for extending their personal guarantee along with their net worth statement supported by copies of legal titles to assets may be obtained along with a declaration that they would not undertake any transaction that would alienate assets without the permission of the committee. Any deviation from the commitment by the borrowers affecting the security or recoverability of the loan may be treated as a valid factor for initiating recovery process. The lenders in the committee may sign an Inter-Creditor Agreement and also require the borrower to sign the Debtor-Creditor Agreement which would provide the legal basis for any restructuring process. Further, a stand-still clause may be stipulated in the Debtor-Creditor Agreement to enable a smooth process of restructuring. The stand-still clause does not mean that the borrower is precluded from making payments to the lenders. The Inter-Creditor Agreement may also stipulate that both secured and unsecured creditors need to agree to the final resolution.

2.3.1.3 *Recovery*

Once the first two options are seen as not feasible, due recovery process may be resorted to. The committee may decide the best recovery process to be followed, among the various legal and other recovery options available, with a view to optimizing the efforts and results.

Under the framework, the decisions agreed upon by a majority of the creditors (75% by value and 50% by number) in the committee would be considered as the basis for proceeding with the restructuring of the account, and will be binding on all lenders under the terms of the Inter-Creditor Agreement. If the committee decides to proceed with recovery, the minimum criteria for a binding decision, if any, under any relevant laws or Acts shall be applicable.

Detailed timelines are given for carrying out various activities under the framework. If the committee is not able to decide on CAP and the restructuring package due to non-availability of information on statutory dues of the borrower, the committee may take additional time not exceeding 30 days for deciding CAP and preparing the restructuring package. However, they should not wait beyond this period and proceed with CAP.

If the committee decides that the enterprise requires financial resources to restructure or revive, it may draw up a plan for provision of such finance. Any additional finance should be matched by contributions by the promoters in appropriate proportion, and this should not be less than the proportion at the time of the original sanction of loans. Additional funding provided under restructuring / rectification as part of the CAP will have priority in repayment over repayment of existing debts. Therefore, instalments of the additional funding which fall due for repayment will have priority over the repayment obligations of the existing debt.

If the existing promoters are not in a position to bring in additional funds the committee may allow the enterprise to raise secured or unsecured loans. The committee may, with the consent of all creditors, provide such loans a higher priority than any existing debt.

The committee is required to periodically review the account for achievement / non-achievement of milestones and consider initiating suitable measures including recovery measures as deemed appropriate.

If the committee decides on options of either 'Rectification' or 'Restructuring', but the account fails to perform as per the agreed terms under these options, the Committee shall initiate recovery.

The resort to framework for restructuring can be made by all stressed enterprises except where such enterprise is classified as wilful defaulter or involve cases of frauds and malfeasance. In case of a wilful default the committee has the power to review the reasons for classification of the borrower as a wilful defaulter and satisfy itself that the borrower is in a position to rectify the wilful default. The decision to restructure such cases is subject to the approval of the Board of the concerned bank within the committee that has classified the borrower as a wilful defaulter.

3. Are there any barriers (legal and / or financial) which make the restructuring process prohibitive for use by MSMEs?

There are no such legal or financial barriers that make a restructuring process prohibitive for use by MSME's except fulfilment of certain minimum eligibility criteria as stated above for both IBC and RBI's Framework.

As stated above, the restructuring process under the IBC as well as the RBI's Framework is simple, time bound and does not involve any complicated procedures.

3.1 Cost of a formal restructuring

The cost involved in resorting to the IBC is not at all prohibitive. However, the admission costs can be burdensome in some cases due to the involvement of professionals as the statute does not prescribe or put any restriction as regard fee to be charged by the professionals. Under the IBC, the entire cost involved in the resolution process is required to be taken out first under the resolution plan and therefore at the end the cost does not appear prohibitive.

4. Are other insolvency processes utilised as an alternative to a formal restructuring procedure?

Presently in India such practices are not in use. In the future, however, one can reasonably expect such informal practices to develop. However, practice of settlement of dues by the sale of mortgaged properties to a third party by way of tripartite agreements between bank, borrower and third-party purchaser is common. Settlement of dues of banks by assignment of debt to a borrower identified third party is also very common. In addition, there are other alternatives available to banks such as Corporate Debt Restructuring, Strategic Debt Restructuring (SDR) and the scheme for sustainable structuring of stressed assets (S4A) propounded by the individual Reserve Bank of India (RBI) which enable banks to recover their bad loans by converting the advances into equity and taking control of distressed companies.

4.1 Transfer of business to related parties prior to a liquidation

Related party business transfer can be resorted to subject to lender approval. If such a transaction takes place within the twilight zone i.e. two years from the date of liquidation, the same can be reopened for examination by the court / tribunal dealing with liquidation. In view of tis limitation, it is not considered to be a preferred option.

5. Are there any barriers or restrictions on the use of the proceedings identified in question 4? Are they open to abuse?

There are no such barriers or restrictions on their use and implementation. There is no such statute / legislation in India that refers to the transfer of a business to related parties prior to liquidation as an alternative to a formal restructuring.

5.1 'Phoenixing' the business of an insolvent company

A related party business transfer can be resorted to subject to lender approval, however, if such transaction takes place within the twilight zone i.e. two years from the date of liquidation, the same can be reopened for examination by the court / tribunal dealing with the liquidation. In view of the aforesaid it is not considered to be a preferred option. There are provisions both under the IBC and the Companies Act, which provides the power to look into any preferential and fraudulent transactions during the twilight period.

The Reserve Bank of India has also issued guidelines on how to identify a wilful defaulter. If a Company and / or its promoters / directors despite financial withdrawal deliberately to avoid making payment, the banks are required to identify and intimate the name of such a wilful defaulter to the Reserve Bank of India. The Reserve Bank will add the names in the list of wilful defaulters so that such a person are not able to obtain loans or credit from any bank or financial institution.

5.2 Transferring of employee entitlements

Although there aren't any laws that particularly prohibit transfer of employee entitlements, phoenixing if done with an intention to defraud creditors would definitely attract consequences. For example, it is essential that anyone who is appointed as Director of a company obtain a DIN (Director Identification Number. DINs are proposed mechanisms to curb mal-practices including phoenixing for the wrong purposes.

There aren't many reported instances of phoenixing in India.

6. Are there any implications for restructuring through an informal process?

There are no such implications for restructuring in India.

6.1 Liability of directors during a restructuring

A director is not, by way of holding the position of a director, liable for the debts of the company during the process of restructuring as there is no such specific legislation that makes a director liable during the informal restructuring process. Thus, as a general rule, a director is not held personally liable on behalf of the company except when the director has indulged in fraud, misfeasance and malfeasance and the corporate veil is lifted.

6.2 Liability of the adviser during a restructuring

There is no liability unless such an advisor is held party to any fraud, misfeasance and malfeasance.

7. Are there any current proposals for reform of restructuring processes with respect to MSMEs?

There are no current proposals for reform of restructuring processes with respect to MSME's.

8. What reforms would be useful if they were to be implemented?

There is a strong need to have a specific enactment for revival of MSMEs.

There should preferably be a new legislation specifically designed for the MSME sector for revival, rather than modifying the existing legislations,

8.1 Non-judicial assistance such as mediation

Mediation although not specifically prescribed is already in vogue and is being encouraged by the Supreme Court and various High Courts. Several mediation centres attached to the Supreme Court and various High Courts have already been established.

MEXICO

1. Is there a legal definition of MSMEs?

Since 2002 México has had a law[1] that defines when an enterprise is micro, small or medium.

In terms of Article 3 of the above Mexican law, large enterprises are distinguished from MSMEs by employing the number-of-employees criterion,[2] although this concept is not included in the insolvency law itself.

2. Is there currently a formal restructuring process? If so what are the main characteristics?

México's formal restructuring process, the *Ley de Concursos Mercantiles*, has been in place since May 2000[3] and was one of the first pieces of legislation in the world to include the UNCITRAL Model Law on Cross-Border Insolvency.

The main characteristics of the *Ley de Concursos Mercantiles* are as follows:

a) It is a Federal Law that applies across the whole of the Mexican territory;

b) Only merchants are able to file (whether a corporation or a natural person);

c) There is no difference between the restructuring of a large corporation and the restructuring of MSMEs;

d) The restructuring process under the *Ley de Concursos Mercatiles* has three stages, namely:

   i) *Visita:* IFECOM (*Instituto Federal de Especialistas de Concursos Mercantiles)* appoints a professional to help the court review whether or not the enterprise is eligible to initiate the insolvency procedure;

   ii) *Conciliación:* this is the actual reorganisation part of the procedure that can take between 180 and 365 days; and

   iii) *Quiebra:* this part of the procedure deals with the liquidation of the entity when no agreement on a reorganisation plan can be reached;

e) During the reorganisation procedure the debtor remains in possession, subject to supervision y the *Conciliador* who is a professional appointed by the IFECOM. The creditors can also appoint a *Interventor* to supervise the *Conciliador.* Where the entity is placed in liquidation, a trustee is appointed to oversee the process;

f) The law establishes different classes of creditors, namely: priority creditors, secured creditors, tax and labour creditors, unsecured creditors and subordinated creditors;

g) The main spirit of the law is that the company should continue trading, thereby encouraging restructuring over liquidation, but must at the same time consider the legitimate rights of the stakeholders to collect fairly;

h) In cases where a reorganisation plan cannot be agreed, there is no discharge of debt or a "fresh start";

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[1] *Ley para el Desarrollo de la Competitividad de la Micro, Pequeña y Mediana Empresa.*

[2] Micro: 0-10 employees. Small: 11-50 employees in Industry and Services and 11-30 employees in Commerce. Medium: 51-250 employees in Industry, 31-100 employees in Commerce and 51-100 employees in Services.

[3] This law has been modified twice, once in December 2007 and once January 2014.

i) The insolvency of enterprise groups is regulated in México;

j) México has a chapter in the law dealing with cross-border insolvency and is based on the UNCITRAL Model Law on Cross-Border Insolvency;

k) There is also a chapter in the law dealing with the obligations of directors and officers of the entity, as well as the penalties that may be imposed when their acts affect the company;

l) Although the law provides for a super priority for new money injected into the entity during a restructuring, this is negated by the fact that creditors do not lend in these circumstances due to the restrictions set by México's financial laws.

3. Are there any barriers (legal and / or financial) which make the restructuring process prohibitive for use by MSMEs?

Yes, there are various factors that play a role here:

a) When filing under the law, substantial information as to be presented to the court. Most MSMEs will not have this information available and will be unable to file as a result;[4]

b) In most cases,[5] the judge will order the *Visita* part of the restructuring process where a professional will conduct an audit of the entity in order to analyse whether it qualifies for the procedure. The *Visita* part of the process has a cost attached to it for the debtor and many MSMEs cannot afford it.[6] This is also a time-consuming process that the debtor has to go through before the actual restructuring process can commence;

c) Once in the restructuring process, an insolvency professional[7] is appointed and the debtor has to cover those fees. This makes it an expensive procedure beyond the means of most SMEs;

d) México does not have specialised bankruptcy courts that can protect the interests of the debtor, so if the debtor does not have access to legal advice it would be difficult for the entity to follow what is quite a complicated process.

4. Are other insolvency processes utilised as an alternative to a formal restructuring procedure?

The only formal insolvency process in México is the *Ley de Concursos Mercantiles*. However, there is a Civil Law that contains a restructuring process for natural persons although this is never used as it does not provide any benefit to the debtor due to the fact that there is no automatic stay and there is no debtor in possession – in fact, there is no reorganisation at all, it is a liquidation process.

In México there is no possibility of reorganising a municipality (County) or a non-merchant natural person.

Although the *Ley de Concursos Mercantiles* allows for the use of a "pre-pack", the only difference with the regular procedure is that the *Visita* part of the process is

[4] Art. 20 *Ley de Concursos Mercantiles.* The type of information required by the law varies from complete financial statements for the preceding three years, a complete list of all creditors and debtors, a complete list of all the assets, a partners' agreement for initiating the insolvency procedure, etc.
[5] Unless a prepack is filed.
[6] It costs approximately USD 6,000.
[7] *Conciliador.*

omitted and the court starts the reorganisation process immediately. The rest of the process remains basically the same.

5. Are there any barriers or restrictions on the use of the proceedings identified in question 4? Are they open to abuse?

Because there are no other procedures available, there are no barriers or restrictions.

6. Are there any implications for restructuring through an informal process?

In the majority of cases, companies in México use out of court restructuring in order to address their financial difficulties. In most cases this results in the business continuing during the negotiation phase, including ongoing trading and continued employment.

If the out of court restructuring fails or is ineffective and the company initiates a formal restructuring process, all the acts of the directors and officers can be reviewed. However, such directors and officers will not be liable for their actions during the negotiation of an informal creditor workout; they will only be liable if such acts were fraudulent, or caused or contributed to the insolvency of the company.

7. Are there any current proposals for reform of restructuring processes specifically aimed at MSMEs?

Currently there are no proposals for reform.

8. What reforms would be useful if they were implemented?

It is submitted that it would be extremely complex to have new legislation specifically designed for MSMEs.

If the existing legislation was modified to make it easier for MSMEs to use, this might be a workable solution. Some changes that could be made are as follows:

a) Introduce an automatic stay when filing, and exclude the *Visita* part of the process;

b) Reduce to the absolute minimum the documents that need to be filed when commencing the process;

c) Reduce the cost of the insolvency professional where MSMEs are involved (or perhaps the court should pay the professional fees);

d) Make the process simpler by reducing court involvement;

e) Eliminate the current restrictions on bank lending to companies in formal restructuring;

f) Although provision has been made for the introduction of specialised courts, these have not yet started functioning. These courts should be introduced to make it easier for MSMEs to file for restructuring;

g) Provide options to the debtor regarding tax and labour problems.

h) In México, most MSMEs need the collateral of their shareholders in order to get financing. When a MSME company is facing insolvency, the procedures allows the company to enter reorganization, but not the shareholders. As a result, the creditors target the shareholders. In other jurisdictions, if the shareholder is also a debtor along with the MSME company, the law allows the insolvency procedure to include both the company and the shareholders - this should also be the case in México.

PEOPLE'S REPUBLIC OF CHINA

1. Is there a legal definition of MSMEs?

1.1 Does any legislation define what a micro, small or medium enterprise is?

On 1 January 2003, China promulgated the "Law of the PRC on the Promotion of Small and Medium-sized Enterprises (SMEs)", which was revised on 1 September 2017 (hereinafter referred to as “SME Promotion Law”). Its legislative purpose is to improve SMEs’ business operating environment, promote SMEs’ healthy development, increase China’s urban and rural employment rates and to enhance SMEs’ important role in China’s national economy and social development.

The SME Promotion Law defines “small and medium-sized enterprises” as enterprises that are legally formed within the territory of the People's Republic of China and that have relatively small staffing and business operation scales, including medium-sized enterprises, small-sized enterprises and micro-enterprises. It is to be noted that although this legislation is called the SME Promotion Law, not only medium and small enterprises are covered thereunder; under the 2017 revision, micro-enterprises have been included in the new definition. In addition, the SME Promotion Law entitles a specific department of the State Council to develop the standard for classifying medium-sized, small-sized and micro-enterprises on the basis of the number of employees, business income, total assets and other indicators of an enterprise and in light of the industrial characteristics, and to be submitted to the State Council for approval.

In June 2011, the Ministry of Industry and Information Technology, the National Bureau of Statistics, the National Development and Reform Commission, and the Ministry of Finance jointly issued the specific division standards for medium, small, and micro-enterprises based on business practitioners, operating income, total assets and other indicators, combined with industry characteristics.

1.2 Is there any conflict between any of those definitions?

Because this is the only legislative definition in China so far, there’s currently no conflict.

2. Is there currently a formal restructuring process? If so what are the main characteristics?

In June 2007, a new "Enterprise Bankruptcy Law of the PRC" came into effect, a chapter of which specifically regulates the restructuring process of enterprises. For enterprises that may already have, or may already have exhibited, bankruptcy causes while still containing some maintenance value and some hope of regeneration, a mandatory restructuring and debts clean-up can be processed according to this Enterprise Bankruptcy Law. This is achieved through the coordination of different parties’ interests in order to enable such enterprises to rid themselves of their financial difficulties, to restore business capacity, to avoid bankruptcy and to eventually re-emerge as viable entities.

The principles of China's restructuring system are consistent with mainstream contemporary restructuring systems in the world, and have been widely applied in the rescue of troubled enterprises since its implementation in 2007.

2.1 Is there a legislated restructuring framework?

In China, enterprise restructuring has two forms, bankruptcy restructuring (restructuring with court supervision) and out-of-court corporate restructuring. Chapter 8 of the Enterprise Bankruptcy Law specifically provides for the former.

Meanwhile, creditors, debtors and investors can self-initiate out-of-court corporate restructuring under the general civil and commercial laws other than the bankruptcy laws. These laws mainly refer to the General Provisions of the Civil Law, Contract Law, Company Law, and their relevant judicial interpretations. Sometimes special commercial laws, such as laws dealing with foreign investment, are also included based on the special characteristics of the entity being restructured. The above-mentioned restructuring legal procedures are generally applied to all enterprises, regardless of the size of the entity.

2.2 Is the restructuring legislation specifically developed to apply to MSME insolvency or is the existing legislation modified to apply to MSMEs?

In China there is currently no specific restructuring legislation for MSMEs, nor is the existing legislation modified to apply to MSMEs. Consequently, the same restructuring laws that apply to ordinary enterprises (referred to above) also apply to the restructuring of MSMEs. Nevertheless, both bankruptcy law scholars and practitioners have noticed that the ordinary restructuring legislation is inefficient when applied to MSMEs and may therefore impair the effect of a restructuring in such cases. This issue has recently become a key research topic in China.

It is noteworthy that, within the framework of the existing insolvency law, some courts in China have introduced their own guidance on simplifying insolvency proceedings by shortening unnecessary trial cycles and inventing new working methods regarding creditors' rights claims and creditors' meetings, etc., all of which aim to make the restructuring laws more suitable for MSMEs.

2.3 Who controls the entity during the period of restructuring?

During MSME's out-of-court restructuring, generally the debtors control the enterprise, who often will consult with the creditors and investors to conduct the enterprise restructuring.

When MSMEs enter a formal in-court restructuring process (bankruptcy restructuring), there are two forms of operations:

- the court designates a coordinator to take over the enterprise, including the debtor's assets and business operations, during which time the coordinator fully controls the enterprises, leads the restructuring and who is also responsible for developing the restructuring plans; or

- the debtor self-manages its assets and business operations (under the coordinator's supervision) and also develops the restructuring plan, during which time (theoretically, at least) the enterprise is still controlled by the debtor. However, the coordinator actually has the fundamental controlling authority over the enterprise via its supervision powers. All restructuring work is conducted under the supervision of the court.

2.4 How are different classes of creditors treated?

In general terms, during the enterprise restructuring those creditors' with legal priority, such as secured claims, labour claims, tax claims, construction payment claims (under certain conditions) and consumer claims for house purchases, are compensated first under the restructuring plan. Consequently, there is almost zero possibility of these creditors decreasing the amount of their claims through negotiation.

For creditors' without priorities in out-of-court restructurings, there is the possibility of decreasing the amount of their claims through negotiation; in fact, in the case of bankruptcy restructurings (in-court restructuring), the creditors will often agree to decrease the amount of their claims.

In many bankruptcy restructuring proceedings, creditors with smaller claims are often given preferential payment, sometimes even amounting to full repayment, with the purpose of passing the restructuring plan by the majority of (large) creditors sooner.

2.5 Are there government incentives for restructuring?

Government encourages enterprise restructuring, which is good for maintaining the total economic revenue and tax revenue, as well as improving employment rates. The existing bankruptcy restructuring system provides various support for restructuring, for example:

- exercise of the secured creditor's rights in respect of the debtor's specific collateral is suspended upon entering the restructuring procedure; and

- if a voting group whose interests are not impaired by a restructuring plan do not pass the plan, the debtor or the coordinator is entitled to petition the court to pass the restructuring plan in spite of their opposition to such plan.

These and other incentives provide convenience for enterprise restructuring.

Regarding the super-priority granted for fresh funds or new money, the out-of-court restructuring procedure lacks sufficient special legislation to protect the lenders of new money by categorizing them as general creditors when the restructuring fails. On the other hand, in bankruptcy restructurings, mechanisms such as co-claims are easily utilised to ensure that lenders have super-priority in compensation orders in the event of restructuring failures, the purpose of which is to encourage investment and financing to the debtor.

3. Are there any barriers (legal and / or financial) that make the restructuring process prohibitive for use by MSMEs?

In China, whoever initiates the bankruptcy procedure does not need to bear the expense as such expenses are covered as a priority out of the bankruptcy assets. Therefore, technically speaking, there's no economic burden on the MSME petitioner to initiate a bankruptcy procedure. However, in practice, sometimes the liquidation process cannot proceed due to insufficient bankruptcy assets to cover the bankruptcy procedural expenses at the time the bankruptcy administrator applies to the court for bankruptcy procedural termination. To avoid this risk, some cities in China have established certain funds to provide assistance in covering the bankruptcy procedural expenses for these cases.

Speaking from a legislative perspective, the bankruptcy assets being insufficient to cover the expenses of the bankruptcy proceedings is not a barrier for MSMEs to initiate the restructuring process. This is because even if the bankruptcy proceeding is terminated later under article 43 of PRC Bankruptcy Law (due to insufficient funds to cover the expense of the proceedings), such proceedings should still be allowed to be initiated. This is because the reasons for the lack of funds are generally complicated. For example, the actual controller of the company may have illegally transferred or hidden the company's assets and at this time starting a bankruptcy proceeding is the key procedure to use to determine this. This is also why some cities in China have provided certain funds to cover the expense of the proceedings.

3.1 Are there any preconditions required before entering into a restructuring?

There are no special preconditions required before MSMEs may enter into out-of-court restructurings. If it is necessary to restructure the enterprise through a bankruptcy restructuring procedure, then the general preconditions have to be satisfied under the bankruptcy laws (i.e., that the debtor is unable to repay its debts as they fall due). Specifically, there are three preconditions:

- the debtor is insolvent;
- a clear lack of solvency; or
- a significant loss of solvency.

Applicants who can directly petition the court for bankruptcy include the debtor or the creditor. When the court accepts the creditors' application for bankruptcy of the debtor (and before the court announces the debtor's bankruptcy), the debtor or investors with contributions over 10% of the registered capital, can also apply to the court for restructuring.

3.2 Does a complex restructuring process discourage timely use by MSMEs?

A complex restructuring process is not conducive to the efficiency of MSME restructurings. For example, many MSMEs have clear and simple assets and liabilities and the application of ordinary bankruptcy restructuring proceedings will not only be time-consuming but also inefficient in restructuring, which may even lower the chances of a successful restructuring.

3.3 Is the cost of a formal restructuring prohibitive to either micro, small or medium enterprises?

There are no legislative restrictions on the cost of MSME restructurings. However, in practice the cost of restructuring needs to be matched with the asset scales under restructuring and the efficiency of the restructuring itself. Not to do so violates the principle of economic efficiency. It is therefore generally uncommon to see the expenses in enterprise restructurings exceeding the available assets. In addition, overly complicated restructuring processes may result in a waste of resources and unnecessary expenses, which may ultimately hurt the restructuring success rate.

4. Are other insolvency processes utilised as an alternative to a formal restructuring procedure?

Although alternative measures are rarely seen in China, since there is no such legal framework in the present legal system, they do exist and are generally regulated through relevant civil laws and regulations such as contract law, company law, etc. Unless the restructuring party or the debtor manage to satisfy all the creditors' compensation requirements, disputes may occur even with the required consents of creditors.

Generally, when the company and the investor (if any) have raised a restructuring plan regarding how to arrange the debts and which has been agreed upon among all the creditors in a written agreement, and when the restructuring plan has been carried out, such an out-of-court restructuring procedure is regarding as having been successful. It is a basic requirement for an out-of-court restructuring that all creditors should receive more or less the same in terms of the debt repayment. Out-of-court restructurings are more successful when the company's financial status is still quite healthy and less successful when investors are only brought in only after the company is already in financial distress. Out-of-court restructurings in cases where the company is already in financial distress are rare – in such cases a bankruptcy procedure normally has to be initiated to achieve a restructuring of the company.

Moreover, if defectively processed, informal out-of-court procedures (such as pre-packs) are easily ruled by the court as invalid or revocable via the co-ordinator's petition.

4.1 Are businesses transferred to related parties prior to liquidation as an alternative to a formal restructuring?

If the relevant enterprise is not bankrupt and its restructuring is conducted out-of-court, this is deemed to be an "Enterprise Separation" in China and is plausible in practical terms under the Company Law. The company's debts after separation are borne jointly and severally by the successor entities after separation.

However, if the relevant enterprise is unable to pay off its debts in a timely manner and needs to go through insolvency proceedings, a restructuring measure whereby businesses are transferred to related parties prior to liquidation as an alternative to a formal restructuring, is likely to be ruled by court as invalid or revocable. For example, when some of the debtor's assets were transferred to a related company without fair consideration, thereby impairing the creditor's interests, such a transfer may be void or revoked by the court. In practice, an asset transfer without the creditor's consent raises doubts as to whether fair consideration was given under the transaction.

4.2 If so, is this regulated in any way or form?

If the enterprise is involved in bankruptcy, there is no legislation dealing with the above-mentioned businesses transfer to related parties.

4.3 Is it the preferred method of MSME restructure?

Whether this is the preferred method of MSME restructure should be evaluated case by case. However, considering the above-mentioned risks and the difficulty to satisfy the creditors' interests, this approach is rarely used in the current Chinese bankruptcy restructuring practices.

5. Are there any barriers or restrictions on the use of the proceedings identified in question 4? Are they open to abuse?

5.1 Are there laws that prevent the 'phoenixing' of businesses in the jurisdiction?

There is no special legislative provision preventing such acts. However, in the General Provisions of Civil Law, the Company Law, Labour Contract Law, Tort Law and other civil and commercial laws of the PRC, relevant provisions to prevent certain related acts can be found, such as the principle of good faith in the General Provisions of Civil Law, and the competition prohibition provision in the Labour Contract Law, and so on.

5.2 Are there any laws to deal with the transferring of employee entitlements in this situation?

There are no legislative provisions specifically preventing or allowing the transfer of employees together with an enterprise in this situation. However, as mentioned above, provisions preventing certain related acts can be found in Chinese law. For example, articles 23-25 of the Labour Contract Law of the PRC provides for a "competition prohibition" mechanism, under which certain employees of the previous company are prohibited from being hired by the new company if any business secret or other intellectual property of the former may be misappropriated as a result.

6. Are there any implications for restructuring through an informal process?

If illegal acts occurred during restructuring through an informal process, various consequences may result. But in general, as long as the operator is in good faith, the probability of adverse legal consequences is extremely low.

6.1 Can the director be held liable for the debts of a company during the period of restructure?

In the event of normal performance of their powers and duties, the directors of the company will not be held responsible for the debts of the company during the restructuring.

6.2 Can the adviser be held liable for the debts of a company during the period of restructure?

In the event of normal performance of their powers and duties, restructuring advisers are not responsible for the debts of the company during the restructuring.

7. Are there any current proposals for reform of restructuring processes with respect to MSMEs?

7.1 Is there any current proposed legislation to deal with restructuring of MSMEs?

Experts from both academia and practice have suggested reform proposals in order to simplify the restructuring processes in relation to MSMEs. For example, at the 2010 China Bankruptcy Law Forum, a Justice of the Supreme People's Court of the PRC openly proposed that, in practice, small and medium-sized enterprises will encounter obstacles (such as unduly long procedure cycles, high bankruptcy costs and enterprise staff placement difficulties) if they are forced to use the ordinary bankruptcy restructuring processes. This in turn will result in great inconveniences to the court and other related parties. As a result, it was suggested that a convenient and cost-saving simplified bankruptcy procedure should be established to meet the current needs of MSMEs. This should be done by looking at advanced domestic and foreign legislation aimed at China's current national conditions.

7.2 Are any interest groups proposing any changes to the legislation in respect of MSMEs?

Although experts from academia and practice have raised proposals regarding special procedures for MSMEs, there are currently no formal proposals in play. However, at the 2014 National People's Congress, a representative of the People's Congress of Zhejiang Province put forward the following motion: "On the emphasis on medium, small and micro enterprises to solve their bankruptcy difficulties". The motion stated that the ordinary bankruptcy procedures in the PRC are not suitable for medium, small and micro enterprises.

8. What reforms would be useful if they were to be implemented?

8.1 Should existing legislation be modified to apply to MSMEs or new legislation specifically be designed for MSMEs?

It is submitted that general bankruptcy proceedings as currently provided for in the Bankruptcy Law of the PRC is relatively complex, resulting in MSME insolvency suffering unnecessarily long cycles and also impairing the efficiency of the bankruptcy liquidation or restructuring. Special legislative action should therefore be taken to simplify procedures and to improve the efficiency of bankruptcy and restructuring of MSMEs. It is feasible to either add a special chapter in the existing Bankruptcy Law, or to promulgate a specific new law regulating MSME bankruptcy proceedings.

SOUTH AFRICA

1. Is there a legal definition of MSMEs?

1.1 Does any legislation define what is a micro, small or medium enterprise?

Regulation 127(2)(b) to the South African Companies Act 71 of 2008 (Companies Act) defines large, medium and small companies. The aforesaid regulation defines a large company as one with a public interest score (PI score) of 500 or more points, a medium company has a PI score of at least 100 points but not less than 500 points, and a company with a PI score of less than 100 points is considered a small company.

In order to calculate a PI score, the company must give due consideration to:

- the number of employees of the company;
- the liabilities of the company;
- the turnover of the company; and
- the shareholders of the company.

Regulation 127 is, however, only relevant to the requisite level of experience a business rescue practitioner (BRP) to be appointed must have, and the fees which such a practitioner may charge in the course of a company's business rescue proceedings.

There is, in addition, also several other legal entities that can be classified as MSMEs. This will often include, *inter alia,* close corporations, partnerships, and sole proprietors.

1.2 Is there any conflict between any of those definitions?

There is no conflict between any of the definitions.

2. Is there currently a formal restructuring process? If so, what are the main characteristics?

2.1 Is there a legislated restructuring framework?

Section 155 of the Companies Act sets out the procedure and requirements for a compromise to be proposed to creditors of a company (whether not the company is in financial distress).

Furthermore, chapter 6 of the Companies Act applies to all South African companies and allows for a formal rescue and restructuring process through the appointment of a supervisor, namely the Business Rescue Practitioner (BRP). Section 66(1A) of the Close Corporations Act 69 of 1984, read with item 6 of Schedule 3 of the Companies Act, provides that Chapter 6 of the Companies Act also apply to close corporations. A reference to a company herein therefore includes close corporations.

If a company is financially distressed as defined in section 128(1)(f) of the Companies Act (i.e. the company will either be unable to pay its debts as and when they fall due for payment or become insolvent on its balance sheet within the immediately ensuing 6 months) and there appears to be a reasonable prospect of rescuing the company as contemplated in section 128(1)(h) read with section 128(1)(b) (i.e. it continues as a going concern, or creditors receive a higher dividend that they would have in liquidation proceedings), then –

- the company's board of directors may adopt a resolution in terms of section 129(1) of the Companies Act to enter into business rescue proceedings voluntarily; or

- an affected person (employee, its representatives or trade union, shareholder or creditor) can, in terms of section 131 of the Companies Act, bring an application to Court to place the Company under business rescue by court order.

The Companies Act does not apply to partnerships or sole proprietors. However, such debtors may apply for debt relief under the National Credit Act 34 of 2005, or for an administration order under the Magistrates' Court Act 32 of 1944, in order to pay off the debts in instalments or otherwise. Some drawbacks would be that administration applications can only be made if the debtor' debts do not exceed ZAR50,000, whereas debt review has no monetary cap but applies only to credit agreement debt. Neither the administration nor the debt review process prohibits other debt relief measures such as a voluntary distribution based on a composition between a debtor and his / her creditors, or sequestration of the estate of a debtor in terms of the Insolvency Act 24 of 1936.

2.2 Is the restructuring legislation specifically developed to apply to MSME insolvency or is the existing legislation modified to apply to MSMEs?

The legislation and timelines of the business rescue process remain the same, regardless of the size of the company.

However, the remuneration which BRPs may expect during the course of business rescue proceedings are subject to the tariff set out in Regulation 128 to the Companies Act and is based on the size of a company placed under supervision.

2.3 Who controls the company during the period of restructuring?

A BRP is responsible for supervising and managing the company whilst it is under business rescue and, as such, the board of directors and individual members of the board are obligated to continue to perform their duties and functions, subject to the authority, in each instance, of the BRP.

2.4 How are the different classes of creditors treated?

Section 135 of the Companies Act sets out the order in which the claims of creditors rank during business rescue. In terms of this section, post-commencement financiers are preferred. Section 135(3)(a)(ii) of the Companies Act states that the claims of post-commencement financiers (whether secured or unsecured) will rank ahead of the claims of all "unsecured" creditors, but after the business rescue practitioner's claim for remuneration and expenses and employees' remuneration during the business rescue process.

Save for post commencement financiers, there are no other statutory preferred creditors (such as the South African Revenue Service) which must be paid before other concurrent (unsecured) creditors in terms of a business rescue plan. That is, all pre-commencement unsecured creditors rank equally in business rescue proceedings. This usually results in unsecured creditors receiving a dividend in business rescue proceedings, whereas they would a negligible dividend, or none at all, in liquidation proceedings.

In addition, section 134(3) of the Companies Act sets out how secured creditors must be treated in a business rescue:

- Unless the proceeds of the assets that form the subject matter of the secured creditors' security are sufficient to discharge the company's indebtedness to that creditor in full, the company must obtain the consent of that secured creditor before disposing of the asset in question; and

- The company must promptly pay the proceeds from the disposal of the assets in question to the creditor up to the amount of the company's indebtedness to the creditor or provide security for the amount of those proceeds to the reasonable satisfaction of that creditor.

2.5 Are there government incentives for restructuring?

Through Chapter 6 of the Companies Act 2008, government has clearly indicated a preference for restructuring over liquidation and this is stated quite clearly in a number of provisions in the Act.

The business rescue provisions in Chapter 6 of the Companies Act 2008 provide for the provision of post-commencement financing and also provides for a super-priority in favour of those who provide fresh funds for a restructuring.

There are no other government incentives that encourage use of the corporate rescue provisions.

3. Are there any barriers (legal and / or financial) which make the restructuring process prohibitive for use by MSMEs?

3.1 Are there any preconditions required before entering into restructuring?

As mentioned above, in terms of section 129 of the Companies Act, the precondition for a company entering into the business rescue process is that it is "financially distressed" and that "there appears to be a reasonable prospect of rescuing the Company".

3.2 Does a complex restructuring process discourage timely use by MSMEs and is the cost of formal restructuring prohibitive to MSMEs?

The remuneration of the BRP and ancillary costs (e.g. legal and accounting fees) can be a financial burden for smaller companies in financial distress and may prove to be prohibitive in some cases.

4. Are other insolvency processes utilised as an alternative to a formal restructuring procedure?

4.1 Are businesses transferred to related parties prior to liquidation as an alternative to a formal restructuring?

Section 112 of the Companies Act, read with section 115, provides that a Company may dispose of the whole or greater part of its business, only if such a disposition has been approved by a special resolution (75% majority) of the Company's shareholders, or if such a disposition is pursuant to an approved business rescue plan as contemplated in Chapter 6 of the Companies Act.

A viable business can therefore be transferred to related parties prior to liquidation as an alternative to a formal. However, there must be a proper valuation of the business before it is transferred in order to ensure that the company receives value for the transfer. Should a company's business be transferred for no / inadequate value, then a liquidator may apply to Court to have that transfer declared void (more fully dealt with below).

As an alternative, section 155 of the Companies Act sets out the procedure and requirements for a compromise to be proposed to creditors of a company (whether not the company is in financial distress). The board of a company may deliver a proposal regarding an arrangement or compromise of its financial obligations to all of the company’s creditors. A proposal is adopted by the creditors of a company if it is supported by a majority in number, representing at least 75% in value of the creditors present and voting at a meeting called to consider the proposal. If a proposal regarding an arrangement or compromise of a company’s financial obligations to all of the company’s creditors is duly adopted, the company may apply to the court for an order approving the proposal. Once sanctioned by court order, the compromise or restructuring will be final and binding on all of the creditors or members of the relevant class of creditors. Section155 does not, however, apply to companies in business rescue and while a compromise in terms of this section is being negotiated, any creditor could apply either for the business rescue or the liquidation of the company.

Also, a business may also be transferred to related parties as a "pre-pack" in business rescue proceedings. In this regard, prior to entering into business rescue, the Company will have to conduct a proper valuation of the business and commence negotiations with major creditors in order to secure a pre-agreed 75% statutory vote (50% of which must be unrelated to the Company).

4.2 If so, is this regulated in any way?

The business of an insolvent company, together with the company's employees (in terms of section 197 of the Labour Relations Act 66 of 1995 (LRA)), may only be transferred to another entity (whether related or unrelated) if value is received. That is, where a company's business is transferred without it having received value, such a transfer would constitute an impeachable disposition in terms of the Insolvency Act 24 of 1936 (Insolvency Act), read with section 340 of the Companies Act 61 of 1973 (the 1973 Companies Act) and item 9 of Schedule 5 of the Companies Act and which can then be set aside by court order.

4.3 Is it the preferred method of restructure?

Informal restructurings (whether by transferring the business of the company, or reaching a compromise in terms of section 155 of the Companies Act) in South Africa hold several advantages, which may result in it being the preferred restructuring tool. That is, informal restructurings are usually conducted in a confidential manner and as such distressed companies are not affected by adverse publicity, their reputations remain intact, market value is preserved and missed opportunity costs are reduced. Informal restructurings are consequently also less disruptive to relationships with employees, customers and suppliers, whether current or prospective. Informal restructuring also holds other significant advantages such as the flexibility to agree on "tailor-made" solutions, and continued control by management. Because these advantages can make informal restructurings more attractive than business rescue, it attracts companies that are more inclined to commence informal restructurings earlier on, which then in turn increases the prospects of a successful rescue.

5. Are there any barriers or restrictions on the use of the procedures identified in question 4? Are they open to abuse?

5.1 Are there laws that prevent the "phoenixing" of businesses in the jurisdiction?

As mentioned above, section 340(1) of the 1973 Companies Act, read with item 9 of the Schedule 5 of the Companies Act, states that '*[e]very disposition by a company of its property which, if made by an individual, could, for any reason, be set aside in the event of his insolvency, may, if made by a company, be set aside in the event of the company being wound up and unable to pay all its debts, and the provisions of the law relating to insolvency shall mutatis mutandis be applied to any such disposition*'. Also, in terms of the LRA, a company's business (assets) may not be transferred without its employees being transferred with it.

It is also worth mentioning that, in terms of section 162(7)(b) of the Companies Act, a court may make an order placing a director under probation if, within any period of 10 years, the director was a director or managing member of two or more companies that were unable to fully pay all of their debts to creditors, except in terms of a business rescue plan in terms of Chapter 6 of the Companies Act or a statutory compromise in terms of section 155 of the Companies Act. A court order for a director's probation may also include an order for the director to pay compensation to any person adversely affected by that director's conduct.

6. Are there any implications for restructuring through an informal process?

6.1 Can a director be held liable for the debt of a company during the period of restructure?

Section 22(1) of the Companies Act states that a company must not carry on its business recklessly, with gross negligence, with intent to defraud any person, or for any fraudulent purpose. In this regard, section 77(3)(b) continues to state that any director of a company is liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of the director:

- having acquiesced to the carrying on of the company's business despite knowing that it was being conducted in a manner prohibited by section 22(1) of the Companies Act; or

- being party to an act or omission by the company despite knowing that the act or omission was calculated to defraud a company creditor, employee or shareholder, or had another fraudulent purpose.

On what constitutes recklessness, the Supreme Court of Appeal in the case of *Heneways Freight Services (Pty) Ltd v Grogor* 2007 (2) SA 561 (SCA) referred with approval to *Ex parte De Villiers NO: In re Carbon Developments (Pty) Ltd* 1993 (1) SA 493 (A) which in turn quoted with approval from the case of *Ex parte Strydom No: In re Central Plumbing Works (Natal) (Pty) Ltd* 1988 (1) SA 616 (D): *"…the true test of a company's solvency is not whether the company's liabilities exceed its assets but whether it is able to pay its debts.*" Therefore, directors can be held liable for the for any loss, damages or costs sustained by the company as a direct or indirect consequence of the directors allowing the company to incur credit under circumstances where the company is unable to pay its debts as and when they fall due.

However, this conclusion was qualified by the South African Supreme Court of Appeal in the case of *Fourie NO v Newton* [2010] JOL 26517 (SCA) which stated that "*The essential question is whether the board would be acting recklessly in seeking to* *exploit the other sources of funding. The answer to that question would in the first place depend on the amount of funding required, for how long it would be required, and the likelihood of it being obtained – whether timeously or at all; and in the second place, on how realistic the possibility is that the company's fortunes will be turned around. The second consideration will materially depend on whether there is a credible business plan or strategy that is being or could be implemented to rescue the company. A business that may appear on analysis of past performance to be a hopeless case, may legitimately be perceived as a golden opportunity for a turnaround strategy.*"

6.2 Can the advisor be held liable for the debts of a company during the period of restructure?

Section 140(3) of the Companies act provides that during a company's business rescue proceedings, the practitioner has the same responsibilities, duties and liabilities of a director of the company as set out in sections 75 and 77. Therefore, the advisor can also be held liable for any loss, damages or costs sustained by the company in terms of section 77(3).

In addition, in terms of section 424 of the 1973 Companies Act, read with section 218 and item 9 of Schedule 5 of the 2008 Companies Act, a court can declare any person who knowingly allowed company to conduct its business recklessly or with intent defraud that company's creditors, personally liable for all or any of the debts or other liabilities of the company as the Court may direct once that company is placed in liquidation.

7. Are there any current proposals for reform of the restructuring processes with respect to MSMEs?

7.1 Is there any current proposed legislation to deal with restructuring of MSMEs?

There are no current proposals dealing with the restructuring of MSMEs.

7.2 Are any interest groups proposing any changes to the legislation in respect of MSMEs?

There are no interest groups currently proposing any changes to MSME legislation.

8. What reforms would be useful if they were to be implemented?

8.1 Should existing legislation be modified to apply to MSMEs or new legislation specifically be designed for MSMEs?

The costs of business rescue can be prohibitive for companies and close corporations that are MSMEs and both administration and debt review proceedings are geared towards individuals as opposed to businesses. In sum, existing legislation does not currently cater for MSMEs and there is certainly room for improvement in this regard.

8.2 Should further non-judicial assistance such as mediation be provided to MSMEs?

Within the current business rescue framework, it is often the case that formal dispute resolution mechanisms need to be introduced where ongoing and protracted disputes, which might hamper the success of the business rescue process, be resolved in a speedy fashion. Protracted litigation delaying the ultimate discharge of the company from its business rescue process is a frustrating prospect, therefore non-judicial assistance such as mediation should be provided to MSMEs.

THE BAHAMAS

1. **Is there a legal definition of MSMEs?**

There is no legislation in The Bahamas which defines a micro, small or medium enterprise.

2. **Is there currently a formal restructuring process? If so what are the main characteristics?**

The only type of insolvency process presently available under Bahamian law is liquidation, which generally results in the dissolution of the company. There is no specific statutory procedure for the restructuring of the obligations of an insolvent company in The Bahamas which also covers – expenses whether they are micro, small or medium in size.

3. **Are there any barriers (legal and / or financial) which make the restructuring process prohibitive for use by MSMEs?**

Since there are no formal or informal restructuring process in place there is no relevant answer to provide.

4. **Are other insolvency processes utilised as an alternative to a formal restructuring procedure?**

Because there is no formal legislative regime for restructurings, informal or consensual restructurings are generally explored when a company finds itself in financial difficulty. Often, banks and other lenders may provide support. The level of such support will usually depend on the nature of the security provided and the level of risk as assessed by the banks or other lenders. A consensual workout may involve a restructuring of the loan, forbearance by the lender or the injection of new money or security. Where the debtor is an operating company, the opportunity to achieve a restructuring may be more limited because of the statutory offence of insolvent trading for which a director may be personally liable.

In the case of the winding up of an insolvent Bahamian company it is not possible to arrange a pre-packed regime for the winding up that is binding upon the court and the creditors. However, a solution might be possible by a scheme of arrangement proposed by the directors under the International Business Companies Act or a liquidator in the course of a winding up.

5. **If so are there any barriers or restrictions on their use and implementation? Are they open to abuse?**

There are no laws in The Bahamas that expressly prevent the ‘phoenixing’ of a company’s business. However, a phoenixing transaction shall be invalid if it is made in favour of a creditor at a time when the company is unable to pay its debts, with a view to giving such creditor a preference over the other creditors, and the company is placed into liquidation within six months of the transaction.

Additionally, a phoenixing transaction may be set aside if it is made at an undervalue with the intent to defraud the company’s creditors. In this context “undervalue”, means that the business of the company was transferred to the recipient company without consideration or for a consideration that is significantly less than the value of the business being transferred.

The Employment Act makes provision for the automatic transfer of employee relationships in circumstances where there is a change in the ownership of a business in which persons may be employed. In the case of a phoenixing transaction, if an employee of a company continues to be employed without interruption, the company which is the new owner of the business immediately after the transaction shall be deemed to be the new employer of the employee, and the employment of the employee shall be deemed to be continuous, notwithstanding the change in the ownership of the business.

6. Are there any implications for restructuring through an informal process?

As indicated above, in The Bahamas there is a statutory offence of insolvent trading for which a director may be personally liable. The application is made by the liquidator of the company and the court may make an order requiring a director to contribute to the assets of the company if it is satisfied that, prior to the commencement of the winding up of the company, that director knew or ought to have concluded that there was no reasonable prospect that the company would avoid being wound up by reason of insolvency.

In order to avoid liability, the director must satisfy the court that after he first knew, or ought to have concluded, that there was no reasonable prospect that the company would avoid being would up by reason of insolvency, he took every step reasonably open to him to minimise loss to the company's creditors.

7. Are there any current proposals for reform of restructuring processes in your jurisdiction particularly in relation to MSMEs?

Currently, there is no proposed legislation to deal with restructuring generally or the restructuring of MSMEs.

8. What reforms would you like to see implemented in your jurisdiction?

Legislative changes that expressly provide for corporate restructurings would be good as a key insolvency reform. Such changes should include particular provisions to address issues specific to MSMEs as they do play a major role in the Bahamian economy.

UNITED STATES OF AMERICA

1. Is there a legal definition of MSMEs?

In the United States, some special rules apply to small businesses that file for bankruptcy protection. 11 U.S.C. § 101 defines a "small business case" as "a case filed under chapter 11 of this title in which the debtor is a small business debtor."[1] A small business debtor is further defined as:[2]

> (A) a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under this title and excluding a person whose primary activity is the business of owning or operating real property or activities incidental thereto) that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition or the date of the order for relief in an amount not more than $2,566,0501 (excluding debts owed to 1 or more affiliates or insiders) for a case in which the United States trustee has not appointed under section 1102(a)(1) a committee of unsecured creditors or where the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor; and
>
> (B) does not include any member of a group of affiliated debtors that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than $2,566,0501 (excluding debt owed to 1 or more affiliates or insiders).

The dollar amount that qualifies a debtor to be a small business debtor ("SBD") is adjusted periodically by the Judicial Conference of the United States. There are no other classifications such as micro or medium enterprises. However, the Bankruptcy Code of the United States does carve out some specific rules for "single asset real estate" debtors. Although single asset real estate rules and case law will not be addressed in the current issue, the definition is "real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto."[3]

2. Is there currently a formal restructuring process? If so, what are the main characteristics?

2.1 Modified Application of Chapter 11

Restructuring of SBDs is governed by Chapter 11 of Title 11 of the United States Code. Chapter 11 is the general business restructuring chapter of the United States Bankruptcy Code. Although it is applicable across the board to mostly all restructurings, parts of it have been modified to apply specifically to SBDs. The SBD in Chapter 11 is subject to a number of special provisions designed to expedite the process.

2.1.1 Absence of a Creditors Committee

Perhaps the most noteworthy difference is that no committee of unsecured creditors is created in a Chapter 11 reorganization of a SBD, a usually crucial component of

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[1] 11 U.S.C. § 101(51C).
[2] 11 U.S.C. § 101(51D).
[3] 11 U.S.C. § 101(51B).

the Chapter 11 process for non-SBDs. The absence of a creditors' committee is somewhat balanced by enhanced reporting obligations and greater scrutiny by the U.S. Trustee assigned to the case.[4] The SBD is controlled either by the debtor-in-possession or an appointed trustee. The U.S. Trustee, however, has a responsibility to interview the SBD before the first meeting of creditors and to monitor the SBD during the case.[5]

Different classes of creditors of the SBD are treated no differently than those of non-SBDs. That is to say, their treatment is determined by the provisions of the plan of reorganization. Normally, a plan will provide for the full payment of administrative claims and group holders of unsecured claims into classes that may vote on the confirmation of the plan if they are satisfied with their treatment in the plan. In terms of confirmation of the plan, whereas a non-SBD has an exclusive period of 120 days to file a plan, which is extendable to 18 months from the petition date, the SBD has an exclusivity period of 180 days, but it may only be extended to 300 days, regardless of who authors the plan.[6]

3. Are there any barriers (legal and / or financial) that make the restructuring process prohibitive for use by MSMEs?

The sole qualifying conditions of restructuring of a SBD under the Bankruptcy Code are set forth above. Principally, the debtor must not have total debt in excess of $2,566,0501. While there are no greater financial hurdles to overcome specifically because an entity is a SBD, reorganization under Chapter 11 can very often become a costly process that a SBD may be more vulnerable to than a larger company with more resources. Thus, a SBD may sometimes be better suited for a liquidation as opposed to a restructuring. Nevertheless, provisions applicable to SBDs aim to move the restructuring along rapidly and keep costs down. The absence of an unsecured creditors' committee itself relieves an immediate financial pressure on the estate because unsecured creditors' committee professionals, such as counsel, can generate administrative fees. However, having a creditors' committee with counsel can streamline the restructuring process by having a collective voice / representative of unsecured creditors. As with most considerations of reorganization under Chapter 11, the moving-forward strategy is very fact specific and decisions should be made on a debtor-by-debtor basis.

4. Are other insolvency processes utilised as an alternative to a formal restructuring procedure?

4.1 Pre-packaged bankruptcies

Pre-pack liquidations, usually referred to as "pre-packaged bankruptcies" in this jurisdiction, are not prohibited in the United States. In order to have a pre-packaged bankruptcy, the debtor usually creates a plan of reorganization, solicits and receives the required affirmative votes for the plan, and then files the plan concurrently with the petition for relief. Some SBDs may find this easier and less costly than a traditional Chapter 11 reorganization, especially if they maintain close relationships with their creditors such that open negotiations can take place prior to filing the bankruptcy petition and invoking the protection of the automatic stay provided by the Bankruptcy Court. In so doing, a SBD may greatly decrease administrative costs, costly appearances before the court and emerge from bankruptcy in a much quicker fashion than if plan confirmation had to be solicited and acquired during the pendency of the case. All statutory necessities otherwise required by the Bankruptcy Code would continue to be applicable to a pre-packaged bankruptcy.

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[4] *See* 11 U.S.C. § 1116; *see also* 1 Bankruptcy Law Fundamentals § 12:24 (2017).

[5] *See* 28 U.S.C. § 586(a)(3)(H) and (7).

[6] 11 U.S.C. § 1121(e).

5. If so, are there any barriers or restrictions on the use of the procedures identified in question 4? Are they open to abuse?

The pre-packaged bankruptcies described above are still subject to the provisions of Chapter 11 of the Bankruptcy Code. Although a plan and disclosure statement may be agreed to prior to filing the bankruptcy petition, they must still receive acceptance by the statutory majority required for each class. As stated above, plans of reorganization group creditors into different classes. Any "impaired" class, i.e., a class that receives less than a 100% distribution of its claim, is entitled to vote on the plan (the precise votes a potential SBD would look to secure prior to filing its petition). Proponents of the plan must secure the support of at least two-thirds in amount and more than one-half in number of at least one impaired class, as well as confirming the plan complies with all other requirements for confirmation. Additionally, solicitation of prepetition votes for the plan must also conform with applicable non-bankruptcy law.[7] While this may not be a concern for many SBDs, larger companies, especially publically traded ones, may have additional considerations because of applicable non-bankruptcy law, such as federal or state securities regulations.

5.1 Alternate non-bankruptcy procedures

Of course, there are also various other non-bankruptcy procedures that an entity may wish to look into, such as an assignment for the benefit of creditors, where all of a debtor's assets are assembled and liquidated in an orderly fashion for the benefit of creditors of the debtor's estate.

- An assignment for the benefit of creditors is governed by state statutes as opposed to federal bankruptcy statutes and can either be court-supervised or conducted outside of any judicial process.

- Workouts and agreements negotiated directly between a debtor and creditor or their respective counsels can be much less costly and do not require the approval of a bankruptcy judge.

- A creditor may also wish to pursue foreclosure proceedings under the Uniform Commercial Code, which provides a state law remedy for a secured creditor to repossess its property.

- A debtor may also enter into receivership, where a responsible party is appointed to take control of the debtor's business and assets and operate or liquidate them as the receiver sees fit.

6. Are there any implications for restructuring through an informal process?

Out of court restructurings, also known as workouts or compositions, where there is a negotiated contractual settlement between a debtor and its creditors, are subject to all the applicable federal laws and those of whichever state(s) has jurisdiction over the parties and / or proceedings. This includes all prohibitions against fraudulent transfers. A creditor could still criticize a transaction under theories of actual intent or constructive intent fraud. While actual intent to defraud is difficult to prove, constructive intent can be established by showing a debtor was insolvent at the time of a given transaction or was rendered insolvent by said transaction, and the debtor received less than adequate consideration in the transaction.

Fraudulent transfers are usually governed by state statutes, so one would be wise to consult the specific jurisdiction's statutes to determine any nuances. For instance,

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[7] 11 U.S.C. § 1126(b).

New Jersey has a four year statute of limitations on fraudulent transfers whereas New York's statute of limitations is six years. Furthermore, in workouts, it may not be possible to use some extraordinary remedies, such as lifting the veil of incorporation or subordinating the claims of insiders.

Formal restructuring processes also have the advantage of sometimes being able to dispose of assets or take other actions that will affect the debtor's estate, up to and including liquidation, without the consent of the debtor itself. For instance, a court-appointed trustee of a debtor's estate would not be required to seek the consent of a corporation's shareholders in selling assets of the corporation, whereas outside of formal proceedings a debtor / officer of a corporation may be required to first obtain consent of the corporation's shareholders.

A limitation of an informal process is that a recalcitrant creditor cannot typically be forced accept a restructuring even if it is supported by the majority of creditors; it is for this reason that formal processes are often instituted to bind the recalcitrant creditor to a court ordered restructuring plan.

Although there are many considerations that should be pondered in deciding whether to initiate formal or informal restructuring procedures, one that should be noted is recognition by a foreign jurisdiction. A small business debtor's insolvency may be less likely to have international ramifications, but to the extent foreign creditors exist that may wish to take action in courts of extra-terrestrial jurisdiction, those courts will be more likely to acknowledge and give comity to formal proceedings here in the United States as opposed to an out of court workout.

7. Are there any current proposals for reform of restructuring processes specifically aimed at MSMEs?

In 2015, the American Bankruptcy Institute ("ABI") formed a commission to review the provisions for small business debtors under the Bankruptcy Code. The commission noted that small and middle-market enterprises are increasingly using insolvency alternatives such as those discussed above – alternatives that the commission largely views as subpar to formal proceedings.

7.1 ABI commission recommendations

- The commission recommended that the small business debtor provisions of the Bankruptcy Code be deleted entirely; instead, the Bankruptcy Code should contain provisions for "small or medium-sized enterprises" ("SME") that would be defined as business debtors with
  - no publically traded securities in its capital structure or in the capital structure of any jointly administered debtors, and
  - less than $10,000,000.00 USD in consolidated assets or liabilities.

Furthermore, the commission suggested that any debtor that falls into the above definition should automatically receive SME treatment and, in cases where a debtor's assets and liabilities were between $10,000,000.00 and $50,000,000.00, the debtor should be allowed to apply for SME treatment with the approval of the court.

Under the commission's suggestion, a creditor's committee would not be appointed unless requested by an unsecured creditor or the U.S. Trustee. Also, the court *sua sponte*, the U.S. Trustee, the debtor-in-possession, or a party in interest could request the appointment of an estate neutral that would have the authority to investigate and advise the SME debtor in possession on operation and financial matters and assist the debtor in developing and negotiating its Chapter 11 plan.

Additionally, instead of the timelines discussed above for filing a plan and disclosure statement, a SME would be required to file a schedule for filing and soliciting acceptances of its plan within 60 days of the petition date.

The commission suggested that the Bankruptcy Code should contain an equity retention plan for existing owners that allows the prepetition equity owners of an SME debtor to retain no more than 15% of the reorganized debtor's economic interests and grants general unsecured creditors at least 85% of the economic ownership interest in the reorganzied debtor.

8. What reforms would be useful if they were to be implemented?

The ABI's recommendations should be implemented. While the ABI's recommendations may not be perfect, there is a need to make the United States Chapter 11 process more inviting for small and medium sized business enterprises. The ABI's changes appear geared to making the Chapter 11 process more efficient and less expensive for small and medium sized business enterprises.

The United States Bankruptcy Code presents an excellent framework for small and medium sized businesses to reorganize (or liquidate), however, too few small and medium business enterprises are taking advantage of Chapter 11 because of the perceived (and real) concerns of cost and complexities of the process.

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