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ARTICLE

Policy and Regulatory Advances in Informal Workout and MSE Processes

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Synopsis

In August 2021, the authors published an article in this journal[2] outlining the key features of the World Bank's revised edition of its *Principles for Effective Insolvency and Creditor/Debtor Regimes* (Revised ICR Principles), released in April 2021.

The Revised ICR Principles are intended to provide a policy framework that global governments can use to both support lending and credit transactions and structures (including an effective framework for the creation, registration and enforcement of security interests to provide an incentive for lenders to advance working capital as the lifeblood of any business), and create a best practice insolvency system. The Revised ICR Principles are informed by the World Bank's work with UNCITRAL, INSOL International, the International Association of Insolvency Regulators and the advice of an ad hoc committee of partner organisations including the Asian Development Bank ('ADB').

The original article concentrated on the recommendations in the Revised ICR Principles in relation to informal workouts and micro and small enterprise ('MSE') insolvencies, and outlined options for future law and policy reform in relation to those recommendations.

This new article is intended to serve as an update to the original article. We continue the focus on informal workouts and MSE insolvencies, providing a 'deeper dive' into the importance and contextual place of these matters as part of an efficient, best practice insolvency system. We also explore how informal workouts and MSE insolvencies have been treated under other international policy and regulatory standards – particularly in the work of the ADB, and in the Asian Principles of Business Restructuring ('Asian Principles') developed in partnership between the Asian Business Law Institute ('ABLI') and the International Insolvency Institute ('III') – and the advancements made since the Revised ICR Principles were originally released.

There is a strong appetite for insolvency law reform across the world at the present time, as governments and regulators are realising the important role that efficient restructuring and insolvency processes play in ensuring economic and financial stability. Informal rescue and MSE-specific insolvency laws have been focus points of this reform process. A growing number of jurisdictions are putting in place hybrid workout frameworks under which informal creditor negotiations are pursued prior to expedited court confirmation of an agreed restructuring plan, while there have also been new MSE insolvency developments in India, Spain and in the European Union ('EU') since the time of our original article, following the MSE systems introduced in the United States, Australia, Myanmar and Singapore prior to the release of the Revised ICR Principles.

This reflects a clear movement towards an approach where informal rescue and more flexible, simple MSE processes are considered to be essential features of an efficient, effective insolvency regime. This opens the door to the potential for greater cross-border harmonisation in relation to these issues as different jurisdictions continue to rapidly advance their insolvency law and policy agendas.

Informal workouts

Why is there a need for informal workouts in a best practice insolvency system?

The value of informal (or 'out of court') workouts in achieving some of the core features of what the World Bank identifies as an 'effective insolvency system' is a key feature of the Revised ICR Principles – in particular, in maximising the prospect of rescuing a distressed but viable business. As noted by the World Bank, that outcome 'preserves jobs, provides creditors with a greater return based on higher going concern values of the

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1 Scott Atkins is President of INSOL International.

2 Scott Atkins and Kai Luck, 'The New World Bank Insolvency Principles: Informal Workouts and MSE Insolvency Processes as Key Pillars of Economic and Financial Stability' (2021) 18(4) *International Corporate Rescue*.

enterprise, potentially produces a return for owners, and obtains for [the economy] the fruits of the rehabilitated enterprise'.[3]

In an additional publication released after the Revised ICR Principles in January 2022, *A Toolkit for Corporate Workouts* ('Workouts Toolkit'), the World Bank notes:

> 'A well-functioning insolvency system seeks to sort financially distressed viable businesses from financially distressed non-viable businesses ... In a poorly designed or poorly functioning insolvency system, viable but financially distressed businesses may have to enter liquidation and close, while non-viable and unproductive businesses may be more likely to stay afloat (these may be termed zombie firms).'[4]

These are points echoed in INSOL International's *Statement of Principles for a Global Approach to Multi-Creditor Workouts* ('INSOL Principles'), which have come to be regarded as a leading framework to guide creditor coordination and cooperation in support of an informal workout. In specifically identifying the benefit of *informal* workouts as distinct from *formal* reorganisation and restructuring frameworks, the INSOL Principles state:

> 'Although there is a growing international trend in the development of local insolvency laws to facilitate the rescue and rehabilitation of companies and businesses in financial difficulty (as opposed merely to closing them down through liquidation), it is a truism that, no matter how debtor-friendly and 'rescue'-orientated local insolvency regimes may be, there are often material advantages for both creditors and debtors in the expeditious implementation of informal or contract-based rescues or workouts (particularly in cases of debtors having cross-border businesses or complex capital structures), compared with the unpredictable costs and uncertainties of a formal insolvency.'[5]

This can have positive flow-on impacts for local and regional economies by spurring entrepreneurship, lessening the impact that deleveraging has on gross domestic product growth and improving financial stability by reducing protracted creditor disputes and coordination difficulties and thereby hastening the normalisation of non-performing loans.[6]

The role of informal workouts as part of a best-practice insolvency process has also been promoted by the ADB in its capacity building work over the last two decades. In its landmark publication released in 2000, *Good Practice Standards for Insolvency Law* ('Good Practice Standards'), the ADB sets out 16 principles intended to serve as a framework for the design of a best-practice insolvency regime for Asian countries. This was the first project of its kind in the world, pre-dating the first edition of the World Bank's ICR Principles in 2001 and Parts 1 and 2 of UNCITRAL's Legislative Guide on Insolvency Law in 2004. The Good Practice Standards make the important point that active creditor consultation, with shared access to information, is critical in building trust, confidence and the collaborative culture necessary to achieve a successful rescue outcome:

> 'A rescue process is largely the province of creditors working, hopefully, in concert with the debtor. Creditors are vital to the process. They need to be organised, available and involved. A rescue or reorganisation process should, in effect, create a market place of its own where the bargaining, dealing and negotiation of people of commerce can be given full and fair effect.'

The ADB released another publication, *Promoting Regional Cooperation in the Development of Insolvency Law Reforms* ('Regional Cooperation Principles'), in 2008.[7] The Regional Cooperation Principles took shape from a new ADB project that commenced in 2002, and they concentrate on cross-border insolvency, the intersection between secured transactions and insolvency law regimes and informal workouts. In the latter regard, the Regional Cooperation Principles include separate *Principles for Informal Workout Processes* ('Informal Workout Principles'), and are accompanied by a Model Agreement to Promote Restructuring ('Model Agreement'). Significantly, the Informal Workout Principles make express reference to the benefit of mediation in resolving creditor conflicts during an informal workout (discussed in further detail below). Both the Informal Workout Principles and the Model Agreement have gone on to be endorsed by the Asian Bankers Association in encouraging informal workouts in Asia.

Especially within the Asian region, there has been a concern that, while many Asian jurisdictions have effective *formal* restructuring tools, *informal* workout tools are still very under-developed. This is reflected in the *Guide on Conducting an Out Of Court Workout in Asia* ('OCW Guide'), released in March 2023 as part of

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3 Revised ICR Principles, 8.
4 Workouts Toolkit, 5.
5 INSOL Principles, 5.
6 ABLI and III, *Guide on Conducting an Out Of Court Workout in Asia* ('OCW Guide'), 19 (citing research and data analysis undertaken by the European Commission).
7 Both the Regional Cooperation Principles and the Good Practice Standards were the result of an ADB Regional Technical Assistance for Insolvency Law (RETA) project originally conceived by Clare Wee, with the support of the ADB Office of the General Counsel.

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the Asian Principles.[8] As is aptly identified in the OCW Guide:

> 'For a region which is estimated to require some USD 1.7 trillion in annual investment until 2030 to maintain growth momentum, Asia's need to create a robust insolvency infrastructure and to converge on best practice in workouts is more pressing than ever.'[9]

While the benefit and value of informal workouts is clear, the policy focus – and imperative – is now on how to create incentives to support the *use* of informal workouts in insolvency scenarios.

General informal workout guiding principles, such as the INSOL Principles, provide important structure and cohesion to creditor negotiations – detailing matters such as the negotiation and scope of a standstill period, the appointment of representative creditor coordination committees and the timely sharing of information. At the same time, as the INSOL Principles recognise, those guiding principles will be the most successful in facilitating informal workouts 'if an appropriate legal, regulatory and governmental policy framework supports them'.[10]

This is a point which also features in the Revised ICR Principles, with the World Bank noting that informal workouts ultimately need to be negotiated in 'the shadow of the law' – meaning that there must be an overarching *enabling environment* which encourages and incentivises informal workouts.[11]

Otherwise, we are confronted with the reality that informal workouts, without more, are purely voluntary, and are typically hampered by information imbalances, creditor mistrust and hold outs. As the OCW Guide states, this can be a particular problem in Asian jurisdictions, with a number of 'common hurdles' such as:

- a 'culture of secrecy and avoidance' by debtors, resulting in 'less than transparent reporting to creditors'. In turn, incomplete information about the debtor hampers creditor cooperation and negotiation, which inherently depend on equal and shared access to comprehensive financial information and records about the debtor; and
- hold outs that are driven by a lack of creditor experience and awareness of workouts (with creditor representatives often 'fearful of making any decisions that involve debt write-offs'), lack of training at creditor institutions as to the benefit of rescue and in some countries a banking culture that is unwilling to 'accept any reduction in return' and that is 'focused only on extension to temporal loan terms', often prompted by government policy that 'either penalises or discourages write-offs'.[12]

Incentives for informal workouts

So what kinds of incentives can be created to encourage resort to informal workouts in a distressed enterprise scenario?

Jurisdictions with a strong banking system and financial and prudential frameworks can incentivise informal workouts through guidelines and principles developed and supported by central banks, banking supervisory entities and banking associations. There are a number of examples of this approach.

In Singapore, the Association of Banks has issued a set of principles for facilitating informal workouts through its *Principles and Guidelines for the Restructuring of Corporate Debts*. The Hong Kong Monetary Authority and the Hong Kong Association of Banks have issued joint guidelines for informal workouts known as the *Hong Kong Approach to Corporate Difficulties*. In each case, these principles and guidelines are not mandatory per se, but member banks are expected to comply with them in proactively cooperating in the event of a debtor's financial distress, and seeking to come to an informal workout agreement.

Further, the Reserve Bank of India issued the Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions in 2019, which prescribe a system for the timely resolution of distressed assets *prior* to default. Once a debtor has defaulted, the Framework requires financiers to undertake a review of the debtor's accounts and seek to agree to a resolution plan within a 30 day period. The Framework, given its status as a prudential regulatory guideline, applies automatically to banks and some non-bank institutions.

Apart from guidelines and directions of this nature, there is also a role for master restructuring agreements in incentivising informal workouts. Master restructuring agreements set out certain general requirements that signatory financial institutions must comply with in relation to a distressed debtor, such as an

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8 The first phase of the Asian Principles of saw the III and ABLI publish a compendium of jurisdictional reports entitled *Corporate Restructuring and Insolvency in Asia* 2020, which paints a comprehensive picture of the insolvency regimes in 16 different jurisdictions across the Asia-Pacific region. The project has since moved on to the development of guidelines on distinct insolvency topics. In May 2022, the III and ABLI published the first of these guidelines, the *Guide on the Treatment of Insolvent Micro and Small Enterprises in Asia* ('MSE Guide'). The OCW Guide is the second of the guidelines.

9 OCW Guide, 19.

10 INSOL Principles, 5.

11 Revised ICR Principles, 7.

12 OCW Guide, 24-25.

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enforcement standstill and majority decisions for participating financiers. One example of the successful use of these agreements is Turkey. Since 2019, the Turkish Banking Association has prescribed two Framework Agreements on Financial Restructuring – one for large enterprises with indebtedness of TL 25 million or more, and one for smaller enterprises with debts of less than TL 25 million. All of the primary banks and financial institutions in Turkey are signatories to these agreements, and accordingly are required to participate in an informal workout under a prescribed contractual process.

Another way to encourage the use of informal workouts is to leverage alternative dispute resolution ('ADR') to actively guide creditors towards consensus outside the intensity and adversarial setting of a court process. The role of ADR in this context is identified by the World Bank in principle B4.1 of the Revised ICR Principles, which states that '[a]n informal workout process may work better if it enables creditors and debtors to use informal techniques, such as voluntary negotiation or mediation or informal dispute resolution'.

Already, mediation and other ADR processes are being actively used in *formal* restructuring matters across the world, particularly in the United States which has a strong familiarity with court-ordered mediation in reorganisation matters, backed by mandatory court referral powers. ADR may have an especially important role in resolving complex creditor disputes, such as those arising from mass tort claims, and in cryptocurrency filings. However, in an *informal* workout context, ADR is still an evolving tool.

France's credit mediation scheme – supported by the Banque de France – is one successful example, with a national credit mediator and a team of local credit mediators helping to negotiate among financiers in the event of a debtor's distress, and also seeking to ensure the continuation of finance for distressed but viable entities. In Japan, SME Revitalisation Support Councils function as a free of charge mediation service for distressed debtors and participating creditors, while the Regional Economy Vitalisation Corporation ('REVIC') of Japan has a mandate to help negotiate restructuring plans and to coordinate among creditors in relation to distressed mid-sized regional companies. The REVIC also has the ability to provide distressed debt funding to a debtor, and purchase non-performing loans.

Another incentive for informal workouts is to offer taxation concessions for haircuts on loans agreed to in a workout – so that the amount of the haircut does not count as assessable income. This has been adopted in a number of jurisdictions, such as Japan, Hong Kong and Thailand.

For jurisdictions that have an insolvent trading regime which imposes personal liability on directors for the debts incurred by a company while it is insolvent, another option is to provide a relaxation of those duties in an informal workout scenario. Australia has adopted this option – with the introduction of a 'safe harbour' under section 588GA of the *Corporations Act 2001* (Cth). The safe harbour protects directors from personal responsibility for a company's debts in circumstances where they develop and implement an informal restructuring plan acting on the advice of an appointed specialist restructuring expert, and the plan is likely to lead to a 'better outcome' than a formal insolvency alterative. Nevertheless, the safe harbour only acts as an incentive to pursue an informal workout on the *debtor* side of the equation. It does not of itself provide any greater impetus for *creditors* to cooperate, which will ultimately depend on other incentives of the kind outlined above.

The movement towards hybrid workout models

In addition to these incentives for purely informal workouts, there has also been a strong movement towards the introduction of 'hybrid' workout models in different jurisdictions. Under hybrid models, the primary negotiations among creditors in relation to a potential workout (or at least a sale of the debtor's business to achieve a positive business rescue outcome) are conducted out of court, before the arrangement agreed to among creditors is confirmed by the court.

In its analytical report released in May 2022, *Thematic Review on Out of Court Corporate Debt Workouts* ('Thematic Review'), the Financial Stability Board (FSB) notes that hybrid models are diverse. The court's role may be confined to confirmation of a pre-agreed plan, for example under a pre-pack reorganisation process (which the FSB calls a 'hybrid I model'), or it may be more extensive, as occurs under a scheme of arrangement (which the FSB calls a 'hybrid II model').[13]

The hybrid I model is closer to the side of an informal workout as it is typically understood as being primarily driven out of court. Sophisticated pre-pack or accelerated court conformation processes for pre-agreed restructuring plans exist in the United States, as well as Japan, Argentina, Brazil, Italy, Uruguay, China, Korea, Mexico, Singapore, Spain, Switzerland and the United Kingdom.[14]

Pre-packs are also expected to be introduced throughout the EU in coming years if, as anticipated, the European Commission's draft proposal for a directive of the European Parliament and of the

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13 Thematic Review, 3, 12.

14 Thematic Review, 12. See also the useful analysis provided by Associate Professor Aurelio Gurrea Martinez in 'The Rise of Pre-Packs as a Restructuring Tool: Theory, Evidence and Policy' (2023) 24 *European Business Organisation Law Review* 93-116.

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Council harmonising certain aspects of insolvency law (2022/0409 (COD) ('Draft Directive') is adopted by the European Parliament.

The pre-pack model under the Draft Directive is designed to facilitate the negotiation of the sale of the debtor's business (the 'preparation stage') before the opening of insolvency proceedings and the completion of the sale with accelerated court approval (the 'liquidation phase'). During this preparation phase, the debtor remains in possession, the sale process is subject to the supervision of a 'monitor' appointed by the court.

MSE processes

Why is there a need for tailored MSE laws in a best practice insolvency system?

In the Revised ICR Principles, simplified insolvency processes for MSEs – enabling viable enterprises to restructure as quickly as possible with minimal costs, and enabling unviable companies to quickly exit the market – is an important focus area. As the Revised ICR Principles aptly identify, addressing the needs of insolvent MSEs 'is vital for economic growth and entrepreneurship' as MSEs 'often struggle to navigate an ordinary insolvency process, and typically lack the resources to cover the costs and fees of the proceedings.'[15]

Globally, micro, small and medium-sized enterprises ('MSMEs') are estimated by the World Bank to account for around 90% of all businesses, and more than 50% of employment. According to research undertaken by ABLI and the III in their joint *Guide on the Treatment of Insolvent Micro and Small Enterprises in Asia* ('MSE Guide'), released as part of the Asian Principles in May 2002, those figures are even higher in Asia – accounting for 99.8% of all firms and 79.4% of employment in China and 97.2% of firms and 69.4% of the total workforce in Southeast Asia.[16] This crystallises the importance of ensuring efficient reorganisation and exit processes for such entities as an essential condition for economic and financial stability, innovation, future growth and continued jobs growth in a rapidly expanding global population. That is even more the case in light of continued adverse economic conditions and volatility across the world, projected to continue over the next 12 to 24 months. In these conditions, MSEs are hit the hardest, given their susceptibility to systemic demand and supply shocks, their level of debt overhang as fiscal support measures which applied during the pandemic have been wound back, and their limited capital reserves compared to larger entities.

Because the vast majority of MSMEs are in fact MSEs, the insolvency policy reform agenda tends now to refer to *MSE* insolvency processes, rather than *MSME* processes (omitting 'medium'-sized entities).

Policy and regulatory advances

Building on the Revised ICR Principles, the ABLI-III MSE Guide sets out five 'key principles' suggested for immediate adoption by Asian jurisdictions, and six 'aspirational principles' which should ideally be adopted over time to provide MSEs with a comprehensive legal and institutional environment to deal with financial distress. One of the key principles is that Asian jurisdictions should adopt simplified insolvency processes for MSEs, consisting of either a single-entry insolvency process, or a dual-gateway insolvency process which features both simplified reorganisation procedures and simplified liquidation procedures. Simplified insolvency processes should also incorporate a range of tools which contribute to the creation or preservation of value – such as enforcement moratoria, prohibiting the enforcement of *ipso facto* clauses, avoidance actions and super priority for new finance.

The authors' original article outlined advancements in MSE insolvency laws in the United States, Australia, Myanmar and Singapore prior to the publication of the Revised ICR Principles. Since that time, India has also introduced a new framework for the pre-packaged insolvency resolution of MSEs ('PPIRP'), intended to be completed within 120 days. The PPIRP is a debtor in possession model which is initiated when the debtor files an application with the adjudicating authority upon obtaining consent from at least 66% of its unrelated financial creditors and a special resolution passed by its shareholders. Upon approval, the adjudicating authority will declare an enforcement moratorium and appoint a restructuring professional, who works with the debtor to submit a restructuring plan to creditors. If approved by the requisite 66% of unrelated financial creditors, the plan can be sanctioned by the adjudicating authority and the PPIRP will then come to an end.

Additionally, in Spain, Act No 16/2022 of 5 September 2022 reformed the Recast Insolvency Act, introducing a new proceeding for micro-businesses (those with fewer than 10 employees, less than EUR 700,000 annual business and debts under EUR 350,000). This enables the debtor (or creditors if a company is already insolvent) to submit a notification to negotiate a plan of continuance. A plan is approved by a simple majority of creditors and has to be sanctioned by the court. If the continuance plan is not approved, the debtor is obliged to submit a request for a liquidation proceeding. The new micro-business proceeding cannot exceed

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15 Revised ICR Principles, iv.
16 MSE Guide, 11.

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four months – if it does, the company is automatically liquidated.

Reducing costs: the innovative model under the EU's Draft Directive

A simplified *winding up* (but not reorganisation) process principally for microenterprises is also contemplated in the EU's new Draft Directive. According to Preamble 35 of the Draft Directive:

> 'National insolvency rules are not always fit to treat insolvent microenterprises properly and in a proportionate manner. Taking into account the unique characteristics of microenterprises and their specific needs in financial distress, in particular the need for faster, simpler, and affordable procedures should be acknowledged, separate insolvency proceedings should be developed at national level in accordance with the provisions of this Directive. Although the provisions of this Directive concerning simplified winding up proceedings only apply to microenterprises, it should be possible for Member States to extend their application also to small and medium-sized enterprises that are not microenterprises.'

One of the key concerns about simplified processes that has arisen in practice since the introduction of MSE laws in the jurisdictions noted above is that the processes may still be cost-prohibitive for distressed entities, even after the reduced formalities and bypassing of 'one size fits all' court and administrative complexities inherent in general formal insolvency processes. In that context, the simplified winding up model in the Draft Directive offers some welcome alternative options.

First, the Draft Directive leaves the discretion to EU Member States to entrust oversight of the simplified winding up process to a court *or* a non-court administrative body to save costs for a distressed entity. Secondly, the Draft Directive contemplates that the laws of Member States should introduce rules for covering the costs of administering simplified winding up proceedings where assets and sources of revenue of the debtor are insufficient to cover those costs. And perhaps most significantly, the Draft Directive contemplates that the appointment of an insolvency practitioner will usually not be necessary, on the condition the debtor is required to 'provide accurate, reliable and complete information relating to its financial position and business affairs' to the competent authority during simplified winding up proceedings.[17]

In place of an appointed insolvency practitioner, the Draft Directive contemplates a novel approach, under which Member States should ensure the assets of the insolvency estate in simplified winding up proceedings can be realised through a 'public online judicial auction, if the competent authority considers this means of realisation of assets as appropriate.'[18]

This innovative, cost-saving alternative was in fact proposed by Associate Professor Aurelio Gurrea-Martinez in his research on the implementation of an insolvency framework for micro and small firms, published in August 2021.[19] As other jurisdictions also contemplate the introduction of MSE insolvency laws, this alternative would be a viable option to reduce costs and enhance the efficiency of reorganisation and exit options for distressed MSEs.

The role of early warning tools

Another way to support efficient insolvency outcomes for MSEs is to incorporate the use of early warning tools as part of the broader credit and distressed debt framework.

As the World Bank notes in its 2022 World Development Report, early warning tools help to detect a debtor's financial difficulties so they can be addressed proactively.[20] By catching the debtor's actual or impending financial distress at the earliest possible time, these tools help to maximise the prospect of a debtor being able to restructure its affairs, if viable, before its difficulties become insurmountable.

These policy objectives were endorsed by the European Parliament and the Council of the European Union in expressly including a requirement for EU Member States to adopt early warning tools in article 3 of the 2019 Directive on Restructuring and Insolvency ('EU Restructuring Directive').[21]

According to the EU Restructuring Directive, early warning tools help to 'incentivise debtors that start to experience financial difficulties to take early action'.[22] The earlier action is taken, 'the higher the probability of avoiding an impending insolvency or, in the case of a business the viability of which is permanently

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17 Draft Directive, Preamble 40.
18 *Idem*, Preamble 44.
19 Associate Professor Aurelio Gurrea-Martinez, 'Implementing an Insolvency Framework for Micro and Small Firms' (2021) 30(1) *International Insolvency Review* 46.
20 World Bank, *Finance for an Equitable Recovery: World Development Report 2022*, October 2022, 132.
21 Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency).
22 *Idem*, recital 22.

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impaired, the more orderly and efficient the liquidation process would be'.[23]

The EU Restructuring Directive also refers to the heightened importance of early warning tools for MSEs, 'taking into account the limited resources ... for hiring experts' if adverse financial circumstances are not picked up until it is too late to avoid costly formal restructuring processes.[24] Indeed, the long-term survival and viability of MSEs and their ability to navigate current and impending adverse financial circumstances ultimately depends on detecting signs of financial distress at the earliest possible time. Early detection means that critical working capital can be preserved and the opportunity for a company's board and management to proactively develop a workout plan and to consult and engage with creditors constructively is maximised. In contrast, if financial distress is only detected at a later stage, the prospect of informal creditor negotiations is diminished, and a formal insolvency appointment will become more likely. For MSEs, the significant costs and protracted timeframes involved in formal insolvency processes are often prohibitive and can, in practice, often spell the end of a successful restructuring attempt.

Early warning tools can take a variety of forms. Article 3 of the EU Restructuring Directive contemplates that early warning tools may include:

- alert mechanisms when the debtor has not made certain types of payments;
- advisory services provided by public or private organisations; and
- incentives under national law for third parties with relevant information about the debtor – such as accountants and tax and social security authorities – to flag a negative development to the debtor.

In France, *internal* early warning tools were implemented prior to the EU Restructuring Directive. Under the French Commercial Code, there are mechanisms (*procedures d'alerte*) for a company's auditors, employees' representatives or shareholders with 5% of the share capital to alert directors to any matter likely to 'compromise the continuity of the business'. Under Article L234-1, in the case of an alert issued by an auditor, if no reply is received within 15 days or if the reply received does not provide complete assurance of business continuity, the auditor is entitled to request that the board deliberates on the concerns identified, and to notify the Commercial Court of the request. This alert was strengthened by Ordinance 2021-1193, which transposed the EU Restructuring Directive into French law with effect from 1 October 2021. Under the Ordinance, an auditor is entitled to inform the Court without waiting for the 15 day period to expire if the auditor is of the view that the company needs to adopt emergency measures and its directors refuse to act or take insufficient steps to do so.

In terms of *external* early warning tools, Denmark is currently the leading proponent. 'Early Warning Denmark', an initiative of the Danish Business Authority, is a system which uses machine learning algorithms to analyse corporate data to detect MSEs that are at risk financially. Once identified, those entities are directly contacted and invited to participate in a free, confidential restructuring advisory program in which they are matched with the services of expert advisers. Since 2007, this initiative has assisted more than 7,500 MSEs to restructure their affairs. This network has since been extended across other jurisdictions under the Early Warning Europe initiative, including Greece, Italy, Poland and Spain.

Having in place both internal early warning tools, where auditors and advisers signal adverse financial circumstances to a company, and external tools, where corporate regulators and public authorities have responsibility for identifying signs of distress from data and documents filed on public registers and directly contacting boards of distressed entities, can play an important part in an optimal restructuring system. External tools are particularly important for MSEs, where lack of familiarity and awareness may inhibit self-perception of indicators of financial distress.

Further developments in AI will help to drive the advancement and integration of early warning tools within restructuring frameworks. This can draw on existing technology such as logistic regression, deep neural network classifiers ('DNN') and perceptron, each of which analyse a variety of data sets to predict outcomes (in this case insolvency, based on metrics such as cash flow, balance sheets, forecasts, increased debt levels, defaults and director resignations) through supervised learning, machine algorithms and, in the case of DNN, mimicking the human brain's ability to identify patterns and devise reasoned outcomes.

Concluding remarks

The World Bank's Revised ICR Principles set out an important framework to improve the efficiency of insolvency systems, enabling those systems to be integrated within a jurisdiction's broader credit and financial system to function as a core component of a resilient and stable economy. Across the world, there is now a clear movement towards policies and regulations that both support and incentivise informal workouts, and also provide for distinct insolvency systems for MSEs that save costs and protracted time delays.

Notes

23 *Ibid.*

24 *Idem*, recital 17.

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In relation to informal workouts, there is a trend towards hybrid models under which a distressed debtor and its creditors negotiate the terms of a restructuring plan out of court, before the plan is then confirmed by the court in an expedited process. This reflects the reality that a purely informal workout model, without more, is unlikely to overcome creditor hold out and coordination difficulties, especially in jurisdictions where there is limited experience with workouts and a lack of a collectivist creditor culture. While other workout incentives can be provided – such as central bank and banking association guidelines, the availability of ADR processes and favourable tax treatment, ultimately operating 'in the shadow' of a court process, whether by expedited approval or a more extensive role – presents the most optimal organisational and incentive framework to guide and achieve creditor cooperation in support of an informal workout.

The recent introduction of MSE insolvency systems in India and Spain, following those introduced previously in the United States, Myanmar, Australia and (on a temporary basis) Singapore, also reflect welcome advances in an area critical to ensure that entities which represent the substantial majority of global employment and economic activity are able to quickly and simply restructure their affairs, or exit the market where unviable – enhancing economic efficiency, innovation and long-term growth on a macro level also. The innovative online auction model under the EU's new Draft Directive – which could be passed into law as soon as early 2024 – provides a means to further reduce costs under MSE insolvency systems, and could be a model for other jurisdictions as well. Early warning tools also have an important role to play as a means for distressed MSEs to identify and navigate financial distress and maximise the prospect of a restructure where an entity is viable.

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International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialised enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

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