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ECONOMISTS' OUTLOOK

The New World Bank Insolvency Principles: Informal Workouts and MSE Insolvency Processes as Key Pillars of Economic and Financial Stability

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Synopsis

On 22 April 2021, the World Bank released the revised edition of its Principles for Effective Insolvency and Creditor/Debtor Regimes ('Principles').

The Principles are one of two components of the internationally-recognised standards for insolvency systems. They cover a broad range of themes, and are a result of close collaboration with INSOL International, UNCITRAL the International Association of Insolvency Regulators and a task force of experts drawn from both the public and private sectors around the world. The 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.

In the latter regard, the Principles cover matters as diverse as the nature and scope of formal liquidation and reorganisation processes, voidable transactions, the administration and disposition of assets, claims resolution, the role of courts and judicial training, the insolvency of domestic and international enterprise groups and effective cross-border insolvency protocols. Two of the particular areas of concentration in the Principles are the promotion of informal (or 'out of court') workouts and flexible and efficient rescue and restructuring laws for micro and small enterprises ('MSEs').

These areas have indeed become a stronger focus point for developed and developing nations alike in the last few years, and the onset of COVID-19 has highlighted the deficiency in many of the existing processes that exist globally.

The particular dilemma at present is that most insolvency systems across the world are geared towards *formal* restructuring (and liquidation) outcomes, and the formal processes that have been adopted are designed primarily for larger companies. The result is that they are very often complex and costly, and there are also limited means for entities to access additional working capital. This leaves many distressed but viable MSEs with little option but to proceed to a potentially value-destructive liquidation. On a macro level, this creates an adverse impact on broader economic and financial stability, employment and the preservation of socially important enterprises. There also comes to be a certain stigma about business 'failure', which becomes synonymous, in these systems, with liquidation and acts as a deterrent to responsible risk-taking, innovation and the generation of an entrepreneurial culture.

On the World Bank's estimate, small businesses represent over 95 per cent of enterprises and account for more than 60 per cent of employment worldwide. The magnitude of these adverse impacts is therefore particularly profound.

While, before COVID-19, there had been important progress in a number of jurisdictions to create more flexible insolvency processes, including for MSEs, the pandemic has served as an important trigger which has catalysed the introduction of enduring reforms globally as a key pillar of recovery from the current economic and financial downturn.

What do the Principles say on informal workouts and MSE reorganisations?

A key underpinning of the Principles is that an optimal rescue environment is created by a system that supports both formal and informal workouts.

Notes

1 Scott Atkins is President of INSOL International.

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Informal workouts are beneficial in saving costs and maximising efficiency, avoiding the necessity for court applications and administrative expenses encountered in formal insolvency processes. However, because they rely on a collectivist approach, informal workouts have in the past been hampered by creditor 'hold out' problems, and a certain mistrust in deferring the right to immediate enforcement in the absence of complete information about a debtor's financial prospects and an underlying framework for cooperation.

The Principles therefore advocate for the creation of an optimal enabling environment which 'encourages participants to restore an enterprise to financial viability' in circumstances where there is a genuine prospect of a return to long-term self-sustaining trade. This includes, importantly, the ability of all creditors to access timely and accurate financial information about a distressed debtor (thereby overcoming the potential for information imbalances and removing one of the key reasons for creditor hold outs) and providing favourable or neutral tax treatment for restructurings, for example in exempting loan haircuts and other concessions from counting as assessable tax income.

These are important steps, particularly in creditor-friendly insolvency systems where there is currently little incentive for creditors to work together in a collective manner to support a workout even where that may be in the long-term interests of a broad range of corporate stakeholders.

The Principles also identify a role for central banks and finance ministries to adopt formal guidelines for out of court workouts. Indeed, this would help to set a baseline expectation that banks and other lenders should consider and work towards an informal restructuring where possible, and that in turn would act as a foundation stone in building a better rescue culture and normalising a collectivist approach over time.

However, the Principles identify that informal workouts are best sustained when they operate alongside *formal* restructuring alternatives. First, if creditors know they can resort to formal processes to protect their rights if informal negotiations break down, that can itself assist in overcoming the 'hold out' problem, and this preservation of creditor rights in turn incentivises continued lending in both a pre-insolvency context and during the negotiation of a restructure. Secondly, some informal workouts will ultimately need to be implemented as part of a tailored formal insolvency process, for example pre-pack administrations and pre-scheme restructuring plans.

In relation to laws that provide for more flexible restructuring alternatives for MSEs, the Principles outline the core problem that MSEs 'are frequently deterred from resorting to complex and expensive insolvency proceedings to tackle financial distress' because they 'often lack the resources to cover the costs and fees of an ordinary insolvency proceeding'.

Among the key recommendations in the Principles are that effective insolvency systems for MSEs should, in addition to encouraging the early use of out of court restructuring options (which should also be pursued for larger enterprises), lower the barriers for MSEs to access simplified *formal* restructuring processes where the business is viable. In that regard, the Principles suggest that states ought to 'design and implement a streamlined regime that reduces the complexity and costs of ordinary insolvency processes, providing for expeditious and flexible mechanisms to rehabilitate and/or reorganise viable insolvent or financially distressed MSEs'.

That streamlined regime should, according to the Principles, be a debtor in possession ('DIP') model, where the existing management of the MSE remains in control of the business and works to implement a restructure. The preferred approach under the Principles is that 'removing the debtor or its management from administration of the business should be exceptional and based on limited grounds well-defined by law'.

A DIP model certainly has the advantage of enhancing efficiency, access to information and leveraging the expertise and relationships built with key stakeholders by management, and this model is a feature of the reorganisation processes in the United States and Singapore. However, in creditor-friendly jurisdictions, such as the United Kingdom and Australia, there has been a traditional aversion to a DIP model in an insolvency context, and this can be seen as stemming from an underlying cultural norm that insolvency is automatically a 'failing' and management has necessarily contributed to that failing, so that if management were to remain in control of the business, that would of itself perpetuate the potential for stakeholder abuse. That underpinning has led to a degree of stigmatisation of business failure in both countries, and this has deterred the development of an entrepreneurial culture that is a key feature of the United States and Singapore insolvency, and indeed broader economic, systems.

To that end, the 'compromise' approach of the Principles is beneficial, in recognising the role for an independent professional to be appointed to exercise an oversight role for the debtor's management as a restructure is negotiated for a MSE, with the aim of 'ensuring that the process is not subject to abuse and the insolvency estate is protected'.

While the Principles emphasise the need for streamlined rescue processes to be 'straightforward, speedy and cost-effective', with a focus on 'fewer and less complex procedural formalities and shorter deadlines than those required in ordinary insolvency proceedings', there is no specific elaboration on how a restructuring plan ought to be negotiated and submitted to a vote by creditors, nor on specific commencement and termination criteria.

The Principles contemplate, as part of a more flexible MSE restructuring process, 'safeguards for protecting the rights of creditors, debtors and all parties involved', and those safeguards ought to prevent 'the improper use and abuse of streamlined MSE rescue processes'. The Principles do not detail the means for achieving this but one possibility would be to require the independent advisor appointed to oversee the DIP process to form the view, at commencement and throughout the duration of the MSE rescue process, that the MSE is viable and that a restructuring would likely achieve a better result than immediate liquidation or another formal insolvency process. This prevents abuse of the process, and also ensures that where a MSE is not viable in the long-term, there can be an efficient recycling of capital into other more profitable ventures in the economy.

An important issue, however, in reconciling the rights of creditors with the goal of maximising the prospect of a successful restructure for MSEs is to consider a cram-down mechanism so that a restructuring plan can be held to be binding on dissenting secured creditors if it would be likely to achieve a rescue of the company or business as a going concern and creditors are provided with adequate protection.

Further, the Principles emphasise again the importance of adequate working capital in any successful restructure. It is therefore recommended that a best practice insolvency process includes mechanisms to promote access to credit. The means for doing so are not included in the Principles, but there is a potential role in this context for a statutory DIP finance regime, including super-priority for new lending. These financing models exist in the United States and Singapore, and permit existing loans to be primed if senior lenders receive adequate protection and new finance is likely to contribute to the success of a reorganisation.

Recent global developments

Prior to the outbreak of COVID-19, Singapore had already established itself as one of the leading insolvency and restructuring hubs in the world due to its law modernisation process which led to the enactment of significant reforms in 2017 and 2018 that were based on the United States Chapter 11 process, including an automatic moratorium with worldwide effect, a pre-pack scheme, DIP finance and restrictions on the enforcement of ipso facto clauses. Yet there was no specific process for MSE restructuring before COVID-19 in Singapore.

In contrast, a streamlined rescue process was introduced for small businesses under new Subchapter V of Chapter 11 of the United States Bankruptcy Code with effect from 22 February 2020 – just before the outbreak of the pandemic (with eligibility expanded later in 2020 to help mitigate the economic impact of COVID-19) – which provided for shorter timeframes (with debtors required to file a reorganisation plan within 90 days), less administrative expenses and elimination of the absolute priority rule so that equity owners can retain their interests over the objection of a class of unsecured creditors without paying creditors in full.

In Myanmar, the new Insolvency Law 2020 took effect on 25 March 2020 and provided for a dedicated small business rescue process, operating under a DIP model overseen by a rehabilitation advisor, along with a simplified small business liquidation process. The implementation of that process has, unfortunately, been upheld by the recent coup and ongoing military rule in Myanmar.

The pandemic then provided the spark for other nations to implement new restructuring laws that otherwise could have been the subject of years of additional consultations and other delays.

In the United Kingdom, a new Part A1 moratorium (as well as a separate new formal process in the form of a restructuring plan with a cross-class cram down intended for larger entities) took effect on 26 June 2020 and is designed to provide an incentive for eligible entities to pursue an informal restructuring, or otherwise lay the foundation for a pre-pack or other formal insolvency process, while benefiting from an initial 20 business day moratorium (capable of extension) on the enforcement of claims by secured creditors, unsecured creditors and landlords. This requires the appointment of an expert monitor who must form the view that it is likely a moratorium will result in the rescue of the company or its business as a going concern. This is an important 'gate control' measure that ensures the moratorium is restricted to viable entities, a safeguard of the kind referred to above in designing MSE restructuring processes in accordance with the Principles.

That said, the Part A1 moratorium is itself not a dedicated process exclusively for MSEs, and a standalone process which also provides for a unique restructuring plan unlike the new formal process intended for larger entities, could become a focus point for future reform as global momentum in this space continues.

In Australia, with effect from 1 January 2021, a new small business restructuring (SBR) process was introduced for small businesses with outstanding debts of less than AUD $1 million. There is also now a streamlined liquidation process for those entities. The SBR process provides for directors to appoint a small business restructuring practitioner while they remain in office and work to develop a restructuring plan to submit to creditors over a 20 business day period. Unlike in the United Kingdom, there is no express requirement for the SBR process to be limited to *viable* small businesses. Rather, a practitioner has the discretion (but not an obligation) to terminate a SBE if it is unlikely to produce a better return for creditors than immediate liquidation or a period of voluntary administration. Whether a clearer commencement process is required is an issue that will be keenly debated as the use of the new process develops in the next few years.

In Singapore, with effect from 29 January 2021, there is now a six month trial period for a new simplified insolvency program. This consists of both a simplified debt restructuring program and a simplified winding up program for eligible MSEs. The simplified debt restructuring program is a DIP process monitored by a restructuring advisor and dispenses with many of the usual reorganisation processes such as convening creditors' meetings and the need to make multiple court applications.

Future priority areas

The development of a recognised framework for informal workouts, building on INSOL International's Statement of Principles for a Global Approach to Multi-Creditor Workouts and supported by central banks and other regulatory bodies in states domestically, which incorporates information sharing and incentives such as tax relief, should be a priority focus area for governments globally to create the enabling environment required to create viable alternatives to costly formal restructuring options for distressed entities likely to be able to trade out of their immediate difficulties.

Dedicated MSE rescue processes that are simple, quick and cheap, will also enable a greater number of viable entities to restructure instead of being forced to an early liquidation due to prohibitive costs and delays.

In tandem, judicial training and capacity building ought to be prioritised, particularly in countries where insolvency processes are still a new concept, including in Hong Kong where there is still no formal restructuring option for any enterprise, let alone MSEs.

It is important to continue the dialogue on the value of these processes while the appetite for law reform remains strong due to the continued impact of COVID-19, and feeding off the impetus from measures introduced by a number of jurisdictions both prior to and during the pandemic.

The key point is that greater flexibility and efficiency in restructuring processes, both formal and informal, and particularly for MSEs, is critical to enable viable entities to continue to trade and to, in turn, drive investment domestically and globally and provide a foundation for future economic and financial stability and long-term growth. This should be an important feature in the post-pandemic recovery plans of any government, and in that sense insolvency and restructuring needs to be viewed not simply as what the law does when everything goes wrong, but rather as a necessary system for building businesses and the economy back up again and creating innovation, value and growth domestically and globally.

At the same time, there is also a need to continue streamlining insolvency processes through a common cross-border recognition and cooperation framework provided for under the UNCITRAL Model Law on Cross-Border Insolvency and supporting international court-to-court communication protocols. This is another matter identified in the Principles and is especially important in an era where business, notwithstanding the pandemic, is conducted on a global basis outside domestic borders.

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