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COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL AND THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE

A new European approach to business failure and insolvency

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1. INTRODUCTION: JUSTICE FOR GROWTH

As Europe is facing a severe economic and social crisis, the European Union is taking action to promote economic recovery, boost investment and safeguard employment. It is a high political priority to take measures to create sustainable growth and prosperity[1].

The debt crisis has a direct effect on people, jobs and businesses. The economic crisis has led to an increase in the number of failing businesses. From 2009-2011, an average of 200 000 firms went bankrupt per year in the EU. About one-quarter of these bankruptcies have a cross-border element. About 50 % of all new businesses do not survive the first five years of their life. 1.7 million jobs are estimated to be lost due to insolvencies every year.

Growth has been put at the heart of the Commission's agenda on justice ('Justice for Growth'), in line with the growth strategy Europe 2020, the Annual Growth Survey and the recently adopted Single Market Act II.[2] Modernising the EU's insolvency rules to facilitate the survival of businesses and present a second chance for enterpreneurs has been identified as a key action to improve the functioning of the internal market. The 2009 Stockholm Programme for the European area of justice[3] highlighted the importance of insolvency rules in supporting economic activity.

The European response should be to create an efficient system to restore and reorganise business so that they can survive the financial crises, operate more efficiently and when necessary, make a fresh start. This applies not only to large multi-national companies, but to the 20 million small companies that are the backbone of Europe's economy. The effective handling of insolvency cases is an important issue for the European economy and sustainable growth.

The EU Regulation on insolvency proceedings[4] was adopted to deal with issues of cross-border insolvency through the proper recognition and coordination of national insolvency proceedings and in order to avoid incentives for the parties to transfer assets or judicial proceedings from one Member State to another, seeking to obtain a more favourable legal position (forum shopping). As its scope is cross-border, the Regulation however did not harmonise insolvency laws used for national insolvency cases. Thus, differences in national laws remain, and as a consequence, economic activities may be lost, creditors recover less than they otherwise would, and creditors from different Member States are not treated equally. The Commission is currently proposing the modernisation of the EU Regulation on insolvency proceedings but the changes proposed concern only cross-border cases.

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1 See President Barroso's letter to EP President in the framework of the State of Union address on 12 September 2012.

2 COM(2012) 573.

3 OJ C 115, 4.5.2010, p. 1.

4 Council Regulation (EC) no 1346/2000 on insolvency proceedings, OJ L 160, 30.6.2000, p. 1.

Modern insolvency law in the Member States should help sound companies to survive and encourage entrepreneurs to get a second chance. It should ensure that procedures are speedy and efficient, in the interest of both debtors and creditors, and should help safeguard jobs, help suppliers to keep their customers, and owners to retain value in viable companies.

To achieve the Europe 2020 objectives, we need to focus on the general objective of improving the efficiency of justice in the EU. Efficient justice systems can greatly contribute to reducing risks and legal uncertainties and encouraging cross-border business, trade and investment. In its experience with the Member States under an economic recovery programme, the Commission has identified the key role of judicial reforms. Reforms of national insolvency law are an important tool to promote economic recovery. The 2012 European Semester reflected the impact of justice systems on the economy by making recommendations to certain Member States relating to efficient insolvency proceedings. The challenge is to address adequately and swiftly the debtor's financial difficulties while protecting the creditor's legitimate interests and ensuring access to justice to all parties.

During the last twenty years, the single market has been developed as an area without barriers. If a company is in trouble financially, it should be just as easy to get help cross-border as domestically. The creation of a level playing field of national insolvency laws should lead to greater confidence in the systems of other Member States for companies, entrepreneurs and private individuals willing to operate in the internal market. Efficient insolvency rules also improve access to credit, which encourages investment. Creditors are more likely to lend when they are confident that they will be able to collect their loans. Greater compatibility of the rules on insolvency proceedings can therefore improve the functioning of the internal market. Although diversity is part of legitimate regulatory competition based on national political choices, it generally leads to the problem of forum shopping[5].

Giving entrepreneurs a second chance to restart viable businesses and safeguarding employment are key elements of the new European approach to business failure and insolvency. This approach aims to give a solid boost to European business in the internal market. The proposal to update the EU Regulation on insolvency proceedings in the cross-border context, adopted in parallell to this Communication, is already based on this new approach. It will also be supported by the forthcoming European Entrepreneurship Action Plan.

This Communication highlights those areas where differences between domestic insolvency laws have the greatest potential to hamper the establishment of an efficient insolvency legal framework in the internal market. It seeks to identify the issues, on which the new European approach to business failure and insolvency should focus so as to develop the rescue and recovery culture across the Member States.

2. SHAPING THE NEW APPROACH TO INSOLVENCY: THE NEED TO CREATE A MORE BUSINESS FRIENDLY ENVIRONMENT

A lot of research and analysis has already been carried out by both the European Parliament and the Commission relating to national insolvency laws.

[5] The problematic is described in more detail in the Impact Assessment, accompanying the Revision of Regulation (EC) No 1346/2000 on insolvency proceedings, COM(2012) 744.

In November 2011, **the European Parliament** adopted a Resolution on insolvency proceedings.[6] It called, first, for the revision of the Insolvency Regulation and the proposed revision responds to this call. The European Parliament also recommended harmonising specific aspects of national insolvency law and company law. A study[7] commissioned by it had shown that disparities between national insolvency laws can create obstacles, competitive advantages and/or disadvantages and difficulties for companies with cross-border activities or ownership within the EU. The study found that harmonising insolvency processes across the EU Member States would increase the efficiency of the insolvency and business reorganisation process. In turn, this would increase the return to creditors if a decision is taken to liquidate the assets or improve the prospects for reorganisation by encouraging more creditors to support plans for restructuring. Together this would increase confidence of the commercial and financial sectors in the efficiency of the EU's financial infrastructure.

Based on the study, the European Parliament concluded that 'there are certain areas of insolvency law where harmonisation is worthwhile and achievable'. However any further consideration of reforming insolvency law will have to take into account the impact on other important areas of law.

The Commission has recently studied business dynamics[8]. The study revealed no evidence of impact of the type of legal system (common law/civil law) on the level of entrepreneurship (firm birth rate, total entrepreneurial activity, firm survival rate). This means that efficient bankruptcy procedures are not determined by the type or focus of legal system, but by specific provisions like out-of-court settlements, fast-track procedures for SMEs, an early warning system and other provisions that significantly affect the efficiency of the system. The best performing countries have an efficient legal framework for bankruptcy and early warning systems. The study shows that almost all countries considered to have a very efficient bankruptcy legal system are also considered to have highly efficient early warning tools.

An important issue to support an effective second chance[9] is the 'time to discharge', which is the time from when a company is bankrupt (liquidation) and when it can restart its business. A discharge is often regarded as crucial for the opportunity to restart. Currently, the discharge time varies greatly from country to country. In some countries, honest business bankruptcies are automatically granted a discharge immediately after liquidation is finished. In some, bankrupted companies have to apply for a discharge; and in others, bankrupted companies cannot obtain discharge.

An additional reflection concerning the question of 'second chance' refers to the business re-start of a formerly bankrupt/failed entrepreneur. In many European countries, there is a policy commitment to address the issue of business failure and promote second chance. Member

[6] EP resolution of 15.11.2011 with recommendations to the Commission on insolvency proceedings in the context of EU company law.

[7] 'Harmonisation of insolvency law at EU level', European Parliament 2010, PE 419.633. This was followed by the study "harmonisation of insolvency law at EU level with respect to opening of proceedings, claims filing and verification and reorganisation plans" EP 2011, PE 432.766

[8] 'Business dynamics: start-ups, business transfers and bankruptcy, European Commission, DG Enterprise and Industry, January 2011. This report contains a study on the economic impact of legal and administrative procedures for bankruptcy and opportunities for a second chance after bankruptcy in 33 European countries (27 EU Member States plus Iceland, Norway, Croatia, Turkey, Serbia and Montenegro).

[9] See 'A second chance for entrepreneurs: prevention of bankruptcy, simplification of bankruptcy procedures and support for a fresh start', Report of the Expert Group, European Commission, DG Enterprise and Industry, January 2011.

States have put forward plans to reform their national insolvency legislation in order to support entrepreneurs looking for a second chance. Most national legislation does not seem to make it easy for re-starters. This leads to fewer re-starters, despite the fact that failed entrepreneurs have a strong inclination to go back into business.

The May 2011 Competitiveness Council called for specific measures to be taken. The Council 'invites Member States to promote a second chance for entrepreneurs by limiting, when possible, the discharge time and debt settlement for honest entrepreneurs after bankruptcy to a maximum of three years by 2013'[10].

3. AREAS IN NATIONAL INSOLVENCY LAW WHERE APPROXIMATION COULD BRING BENEFITS

On the basis of an analysis of the above findings, the Commission has identified a number of areas where differences in national insolvency laws can create legal uncertainty and an 'unfriendly' business environment. This creates a less favourable climate for cross-border investment.

3.1. Second chance for entrepreneurs in honest bankruptcies[11]

Principle II of the Commission's 'A Small Business Act for Europe'[12] is aimed at the promotion of a second chance for honest entrepreneurs[13]. The 'honest' failure is a case where the business failure was through no obvious fault of the owner or the manager, i.e. honest and above-board, contrary to cases where the bankruptcy was fraudulent or irresponsible. It calls for exchanges of best practice between Member States.

Lengthy and costly bankruptcy procedures are a major limitation to an effective second chance. In addition, honest bankrupt entrepreneurs are usually subject to the same limitations as fraudulent entrepreneurs. This not only means a risk that failed honest entrepreneurs face the social stigma attached to bankruptcy, but there are also legal and administrative impediments to re-starting a business. Difficulties in finding financing for a new venture are considered as the main problem for re-starters. But it should be kept in mind that those that attempt to re-start, learn from their mistakes and usually experience faster growth than newly established companies.

Action could be taken to differentiate more between honest and dishonest bankruptcies. Insolvency regimes could differentiate between debtors who have acted honestly in their conduct or business giving rise to the indebtedness, and those who have acted dishonestly, and could for example contain a provision that wilful or irresponsible non-compliance with legal obligations by a debtor be subject to civil penalties and, where appropriate, criminal liability. Any supportive programmes for starting up a new business should be available only to honest bankrupts without treating those businesses however differently from the non-bankrupt businesses.

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[10] Council of the European Union document 10975/11.

[11] There is a clear need to distinguish 'honest' failures from fraudulent ones and to clearly avoid encouraging the latter.

[12] COM(2008) 394 final. This had been preceded by a Communication on 'Overcoming the stigma of business failure — for a second chance policy', COM(2007) 584final.

[13] Principle II: 'Ensure that honest entrepreneurs who have faced bankruptcy quickly get a second chance'.

The following measures should be considered as the most significant to be taken in order to reinforce second chance:

- Separate liquidation proceedings for honest and dishonest entrepreneurs;
- Frame and apply 'fast-track' liquidation proceedings for honest bankruptcy.

3.2. Discharge periods that do not encourage a second chance

Discharge is also key for second chance: a three-year discharge and debt settlement period should be a reasonable upper limit for an honest entrepreneur and as automatic as possible. It is crucial that entrepreneurship does not end up as a 'life sentence' if things go wrong[14].

Member States agreed on the need to harmonise the 'time to discharge' to less than three years in the May 2011 Competitiveness Council conclusions, following the launch of the Review of the Small Business Act for Europe[15].

Shortening and aligning the 'time to discharge' would be an important step towards creating a friendlier and more innovative business environment, allowing European enterprises to operate on a level playing field. It could be a first step towards a wider approximation of national bankruptcy laws.

3.3. Varying chances for restructuring due to different rules on the opening of proceedings

There are significant differences between the criteria for opening insolvency proceedings. In certain Member States, insolvency proceedings may be opened only for debtors that are already affected by financial difficulties and are insolvent. In others, proceedings can be opened for solvent companies that anticipate insolvency in the imminent future. Further differences may be found in insolvency tests (like the liquidity test) adopted in the laws of Member States. Evidently, the differences between insolvency tests mean that companies in a similar financial condition may meet an insolvency test in one Member State but not in another. As a consequence, companies may have unequal chances to resort to informal out-of-court restructuring in order to resolve financial difficulties and avoid insolvency proceedings that involve partial or total divestment of a debtor and the appointment of a liquidator.

Another problem relates to the rules on mandatory filing of insolvency. There are significant differences between Member States regarding the deadlines a debtor must meet when the opening of insolvency proceedings is mandatory. In some Member States, the debtor has two weeks after becoming insolvent to file for bankruptcy, in some the debtor must file within two months from the date it becomes aware of the insolvency situation. In others, the debtor must file for bankruptcy at the latest 45 days following cessation of payments.

The length of the timeframe may impact a debtor's ability to solve financial difficulties. While overly tight deadlines may adversely affect this ability, long deadlines may delay the granting of relief under insolvency proceedings and undermine the efficiency of proceedings for all creditors.

[14] This was also a recommendation in the above-mentioned report of the expert group on second chance.

[15] COM(2011) 78 final.

3.4. Unfulfilled expectations of creditors for different categories of debtors

The laws of Member States differ in the possibilities granted to creditors to commence insolvency proceedings against debtors and in relation to the various categories of debtors. These differences may be difficult to reconcile with the legitimate expectations of creditors. Creditors expect to be able to impose insolvency proceedings on their debtors and, instead of resorting to individual enforcement action, may instigate collective insolvency proceedings.

Another area in which approximation may be needed is the capacity to commence proceedings against a debtor. All Member States have systems allowing a debtor (a natural person or a public or private legal entity) that carries on a business activity, a creditor and the state to apply to the courts to initiate insolvency proceedings against a debtor. However, some jurisdictions limit the ability of a creditor to start insolvency proceedings by adding special conditions. Any limitations on the creditor's ability to commence insolvency proceedings may lead to situations where a creditor is treated differently when it comes to opening main and secondary proceedings against the same debtor.

3.5. Uncertainty for creditors relating to procedures to file and verify claims

In order to reduce uncertainty and create equal treatment among creditors in the Member States, further approximation of the rules on filing and verifying claims should be considered, such as the procedures, time limits, penalties and consequences for failure to comply and the information to be provided to creditors.

The transparency and efficiency of the claims filing and verification process impact significantly on creditors' ability to obtain a satisfactory outcome of bankruptcy proceedings. The laws of Member States regulate this area differently. The differences found include the time limits for filing claims and asserting rights, availability and access to information about the process and the consequences of delayed filing of claims. Frequently, the time limit for filing claims is laid down in the bankruptcy decision. Failure to meet the time limit can also have different consequences in difference Member States. In some, a creditor who missed the time limit may lose its rights to advance and obtain a satisfactory outcome of its claim in bankruptcy proceedings, whereas in other Member States it does not.

Foreign creditors are more likely than domestic creditors to be impacted by the significant differences between the laws of Member States, given the potentially severe consequences of failure to observe the rules governing the process. These include losing their right to participate in distributions.

3.6. Promoting restructuring plans

The rules regulating restructuring plans (including contents and related procedural issues) have a crucial role in creating the conditions for successful restructuring in insolvency proceedings. Rigid and impracticable rules may hinder the chances of adopting a restructuring plan, leaving no alternative but to wind up a company. The legal framework for restructuring plans adopted in Member States differ significantly. The main differences concern identification of the parties that can act as promoters of the plan and also the adoption, modification and verification of plans.

While the laws of Member States generally accept that it is up to the debtor to propose a restructuring plan, the rules on whether creditors may propose the plan or influence its preparation vary. There are also major differences in the rules regarding the procedure for

adopting the plan, including whether creditors are divided into categories and required majorities. In certain Member States, they are not divided into categories. The laws of the Member States contain different rules on the required majorities for approving a plan. The laws of the Member States also differ on the standards applied by the courts when reviewing the plan. Under some laws, the courts have wide discretionary powers, under other laws, these powers are rather more limited.

4. SPECIAL NEEDS OF SMES TO PROMOTE SECOND CHANCE

The EU pays special attention to the situation faced by SMEs and to giving them a second chance. The Commission considers that support for SMEs to tackle economic difficulties should be granted for[16]:

- Prevention;
- Post-bankruptcy and second chance;
- Out-of-court settlements;
- In-court procedures.

Restructuring can be extremely costly for SMEs, so much so that often only bankruptcy is a viable option. Solutions should be found to lower restructuring costs for SMEs. Capped fees can be a solution. Alternative procedures should be put in place to make adequate solutions available for all types of SMEs. Procedures should be proportionate to the size of the business. Out-of-court procedures should be open to all types of debtors, regardless of the available funds. While the average time taken of out of court settlements is relatively short, the rate of success in achieving settlements is above 50% in most EU Member States. Even though out-of-court settlements and pre- insolvency proceedings are recently introduced mechanisms, they are increasingly used by SME's in the EU.

SMEs can also be affected by economic difficulties as creditors. Certain SME representatives consider that micro businesses as creditors lose an unreasonable proportion of their outstanding claim in insolvency proceedings due to lengthy proceedings and national priority rules. It is worth exploring what could be done to improve the status of SMEs as creditors.

5. STEPS TO BE TAKEN

The Commission, as a first step, proposes the modernisation of the EU Regulation on insolvency proceedings. In addition, it intends to adopt a European Entrepreneurship Action Plan which would include action to promote efficient bankruptcy procedures and offering second chance .

As a further step the Commission is reflecting on ways forward to tackle problems arising from the disparities between national insolvency laws. Individual action at national level cannot adequately address the challenges posed by the transnational aspects of the internal market. Action could usefully be taken to diminish uncertainty and to create a more business-friendly environment. The challenge is to address adequately and quickly the debtor's financial difficulties alongside the creditor's interests, while facilitating the rescue and restructuring of businesses.

16 'A second chance for entrepreneurs: prevention of bankruptcy, simplification of bankruptcy procedures and support for a fresh start', see above footnote 9.

The Commission will continue the approach started under the previous European Semester cycle, in the context of which some Member States have already reformed their domestic insolvency laws. Country-specific recommendations inviting the Member States to update their insolvency laws could therefore be issued where necessary.

Furthermore, the Commission intends to deepen its analysis of the impact arising from differences between national insolvency laws on the functioning of the internal market. To this end, it will enter into a dialogue with the European Parliament and the Council on the basis of this Communication. Moreover, the Commission will launch a public consultation so as to receive views from stakeholders on the issues identified in this Communication and any other concerns as well as on possible solutions and policy options.