ACCOUNTANCY EUROPE.

EU BUSINESS RESTRUCTURING & INSOLVENCY

The accountancy profession's views on the EU Directive

position paper

VIEWS.

GOOD GOVERNANCE & SUSTAINABILITY

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HIGHLIGHTS

The proposed EU Business Insolvency Directive aims to ensure that entrepreneurs in financial difficulties 1) can seek support at an early stage 2) benefit from a flexible and efficient restructuring framework, and 3) if all else fails, can get a second chance after insolvency.

Professional accountants can play a key role in advancing the Directive's objectives, especially in restructuring business and identifying early warning mechanisms for insolvency.

This paper presents the accountancy profession's positions on the most contentious matters in this Directive to contribute to its smooth adoption.

We provide three key principles for the current negotiations:

1. ensure that entrepreneurs have access to appropriate and timely advice
2. reduce bureaucracy in insolvency proceedings
3. consider the long term economic benefits that the Directive will bring to the market

INTRODUCTION

In November 2016, the European Commission (the Commission) issued for the first time a set of European rules on business insolvency. The proposed EU Directive[1] aims at ensuring that entrepreneurs and businesses in financial difficulties 1) can seek support at an early stage 2) benefit from a flexible and efficient restructuring framework, and 3) if no other option, have a second chance after insolvency.

Accountancy Europe issued a publication *Business Insolvency. A contribution from the Accountancy profession*[2] in January 2017, which provides an overview of accountants' and auditors' contribution to insolvency proceedings in Europe. In the same document, we put forward recommendations on how to improve restructuring and insolvency frameworks in Europe to contribute further to the debate on restructuring viable businesses and facilitating insolvency regimes in Europe. Below you may find the key messages of the Accountancy Europe position[3].

THE ACCOUNTANCY PROFESSION SUPPORTS:

- measures aimed at further specialisation of insolvency practitioners. The profession can assist the entrepreneur at all stages:
    - preventing financial distress
    - assisting the proceedings
    - achieving a new start after the insolvency has been completed

  There should be open and fair access to the market guaranteed to all holders of the right expertise.
- reducing the cost and length of insolvency proceedings. Communicating from the beginning the expected cost and time of the proceedings can work as an incentive to reduce the length. EU Member States should decide at national level on a maximum duration for insolvency proceedings or establish a relevant mechanism to be able to terminate insolvency proceedings within an acceptable period of time.
- early access to help. Member States need to raise awareness on availability of expert advice and to encourage entrepreneurs to seek help at an early stage and subsequently.
- directors being incentivised to take early and appropriate action when there is a warning of financial distress.
- cross-border proceedings: simplification of cross-border proceedings and introduction of further measures at EU level eventually leading to a harmonised environment. International networks of professional accountants and multi-disciplinary practices can also contribute to smoother and more effective cross-border cooperation.

In this follow-up paper, we provide our views on specific articles of the proposed Directive currently discussed with the EU institutions and stakeholders. Additionally, we cover sections on the appointment and training of insolvency practitioners considering the profession's role in insolvency proceedings. The purpose is to bring additional views into the ongoing debate which will hopefully contribute to the smooth adoption of the Directive.

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[1] Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures http://ec.europa.eu/information_society/newsroom/image/document/2016-48/proposal_40046.pdf

[2] Accountancy Europe (2017), EU Business Insolvency. A contribution from the Accountancy profession https://www.accountancyeurope.eu/publications/eu-business-insolvency-contribution-accountancy-profession/

[3] On the basis of the submitted reply to the Commission's consultation and the published Accountancy Europe briefing paper *EU Business Insolvency. A contribution from the Accountancy profession*

ACCOUNTANCY EUROPE POSITION

PRACTITIONERS' INVOLVEMENT (ARTICLE 5):

In the Commission's proposal, involving a practitioner in business restructuring is not mandatory. We understand the reasons behind the proposal as the cost could turn into a burden deterring an entrepreneur from seeking help, especially if already in debt.

Services provided by a practitioner involve a certain cost, which may vary depending on the complexity of the business. However, we believe that the cost should be regarded in combination with other factors considering particularly the long-term impact of not involving a practitioner.

Restructuring procedures are often very complex. An entrepreneur in financial distress, especially an SME, cannot easily cope with the overall procedures without the help offered by an expert. An impartial third party can contribute to smoother operations such as preparing documents to be submitted to the court and advise in turnaround aspects or cash flows during the period of 'stay of enforcement actions'.

Regional and national initiatives can provide further assistance to an entrepreneur going through restructuring or even insolvency proceedings. These initiatives can facilitate access to a practitioner's advice and possibly reduce costs. Similar examples already exist in Belgium and Spain.

It is standard practice for businesses to use an accountant acting as the closest advisor to a business. A professional accountant can help entrepreneurs identify risks and indicate the first steps to safeguarding the business. Accountants should have the right expertise to identify the signs of distress at an early stage.

Having the appropriate level of expertise should apply for any practitioner involved in restructuring. A practitioner needs to have the right knowledge to provide appropriate advice and successfully restructure a company. Poor advice or misguidance will amount to much higher costs for the debtor compared to the cost of involving a practitioner, and will result in loss for the creditors.

Hiring a practitioner is an investment worth-considering, as their advice may save the business from insolvency or provide an entrepreneur with a second chance. Losing the business altogether will accumulate much higher costs for the debtor and other affected parties.

STAY OF INDIVIDUAL ENFORCEMENT ACTIONS (ARTICLES 6, 7):

The Commission's proposal allows debtors to benefit from the 'stay' of individual enforcement actions for a maximum period of four months. A justified extension may be possible for a maximum period of 12 months.

How to preserve the balance between the creditors' and the debtor's rights is one of the key points currently discussed by the EU institutions. Some stakeholders have pointed out that the 'stay' may affect the position of secured creditors and potentially cause unintended consequences to the cost of future lending. Concerns have been raised on the duration of the 'stay' when considering the latest banking law matters on Non-Performing Loans[4].

The Directive aims to promote early warning and restructuring tools to rescue viable businesses. Protection of creditors' interest and rights, although important, should not be the major point. Granting a 'stay' for a certain period should be perceived as a long-term gain for the key stakeholders, including the creditors. Ultimately, the aim is to get the business fully operational after implementing a restructuring plan. If the debtor enters a formal insolvency procedure, the creditors may not be paid back at all.

To ensure consistency and avoid misuse of the provision, a general rule of four months can be a good basis. If specific cases require more time and the right evidence is provided, flexibility should be shown. The duration of the 'stay' can differ on a case-by-case basis and each case should be considered separately taking into account

[4] Article 178 CRR: a bank has to consider a repayment claim as in default if the debtor is past due more than 90 days

the complexity of the debtor's business. For instance, specialised courts could be well placed to decide on the duration of the 'stay'.

It is important to avoid unnecessary delays due to bureaucracy. The courts' specialisation should ensure that the debtor is not delayed by long administrative procedures. Procedures to obtain the 'stay' should be as short as possible.

As for the creditors, suppliers are expected to continue offering their services to the entrepreneur during the 'stay' period. This provision may cause an effect of 'chain insolvencies', particularly when referring to the small-scale industry. The Commission's text includes some provisions for Member States to stipulate specific rules for small suppliers[5]. However, this is not sufficient. Suppliers should be offered incentives to continue offering their services. In the case of new debt, suppliers should have priority among the other creditors.

Some Member States are in favour of including under Article 6 a requirement for valuation of the business at the moment of entering restructuring. This valuation would in most cases be public and involve the court. Their reasons for such a valuation requirement would be to:

1. consider whether there are sufficient funds to repay the debts
2. reassure that there is no fraud committed on behalf of the entrepreneur
3. check any possible conditions imposed by the law

Requiring such a valuation could be problematic as it may increase the length of the procedures. The objective of restructuring is business recovery. Introducing a valuation procedure as proposed would not achieve this goal. Investigating fraud should not be the objective of this exercise either.

In addition, involving the court could notify the market on the debtor's financial difficulties and would add to creating a stigma for their business. At this stage, it would be sufficient for a professional with the right expertise to attribute value to the business's assets. Consequently, they can better assess whether the business has the means to continue operating.

DUTIES OF DIRECTORS (ARTICLE 18):

The Commission is setting out the Directors' obligations to follow in the likelihood of insolvency. The Directors are expected to:

1. take immediate steps to minimise the loss for creditors, workers, shareholders, and other stakeholders
2. have due regard to the interests of creditors and other stakeholders
3. take reasonable steps to avoid insolvency
4. avoid deliberate or grossly negligent conduct that threatens the viability of the business

Spotting early signs of insolvency and taking appropriate immediate action can save a business from insolvency. We see value in incentivising the Directors to look for advice, and to act accordingly at the first signs of financial distress.

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[5] Preamble, paragraph 25: "National law may also stipulate specific rules supporting class formation where non-diversified or otherwise especially vulnerable creditors, such as workers or small suppliers, would benefit from such class formation." Also, Article 6.9: "Member States shall ensure that, where an individual creditor or a single class of creditors is or would be unfairly prejudiced by a stay of individual enforcement actions, the judicial or administrative authority may decide not to grant the stay of individual enforcement actions or may lift a stay of individual enforcement actions already granted in respect of that creditor or class of creditors, at the request of the creditors concerned."

The legislative text should elaborate further on the list of the Directors' obligations and what would be the consequences of not meeting those obligations. Where a Director acts on time using the right tools and this still leads to bankruptcy, a remission policy should be applied. Examples from Member States should be taken into account to enrich Article 18 in this regard, such as the ones we provide below:

- In Belgium, auditors can call for an extraordinary shareholders' meeting to dismiss the Directors. Also, the Directors are obliged to call a shareholders' meeting upon request from shareholders holding more than 20% of shares[6].
- In Italy, any shareholder may file a complaint to the Board of statutory auditors, which the Board of Directors has to consider in its report to the shareholders' meeting. Where the Board of Directors does not take appropriate actions based on the warning given by the Board of statutory auditors, the latter has the right to call for a shareholders meeting to inform them about the situation. The Board of Auditors also has the right to file a petition to the court in case of no action taken[7].

DISCHARGE PERIOD (ARTICLE 20):

The Commission proposes a maximum duration of three years for the discharge period. We consider this proposal an optimal solution, keeping in mind that in several cases duration depends on the leverage of business and its cash flow generation. The proposed discharge period is appropriate for over-indebted entrepreneurs to fulfil their obligations towards creditors in insolvency, considering that they have the means to pay their debts back. Reducing the discharge period to less than three years may offer an opportunity for dishonest entrepreneurs to take advantage of the system by setting up yet another business before fully fulfilling the responsibilities towards their previous creditors.

To give more information how alternative models work, in certain Member States, the debt is discharged after one year. Nonetheless, insolvency proceedings continue and an entrepreneur still has an economic responsibility towards the creditors over a certain period.

In the UK, the discharge of the debtor is 'divorced' from the debtor's assets. The debtor receives a discharge after one year, but continues to pay excess income – over and above what the debtor needs to pay for living expenses – for a period of three years after bankruptcy. Such payments are set if the debtor can afford it. For up to three years, the debtor's home remains in the estate of the creditors, whilst other assets are held in trust for creditors for any period until they are sold. Meanwhile, the debtor can rehabilitate back into society, for example, becoming director of a limited company or obtaining credit.

Possible pitfalls may occur, however, when it comes to debtor's ability to pay. The debtor has an obligation to pay excess income to the estate – over and above what the debtor needs – for three years after bankruptcy. If the debtor loses their job or ceases to have income, the responsibility to contribute also ceases. Should this happen after discharge of one year and before three years expire, the entrepreneur is no longer obliged to restart contributions even having a new job or starting a new business.

Applying the principle of such a model could allow a quicker rehabilitation of an entrepreneur into the community. Possible miss outs such as the one set out above should be foreseen in national legislation.

A maximum discharge period of three years should be agreed under the proposed Directive. If a Member State wants to reduce this, it should make sure creditors' rights are safeguarded.

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[6] The shareholders can ask to include the dismissal of the Directors in the agenda, but should Directors hold the majority of the shares this is not an option

[7] Such conditions apply to joint-stock companies

TITLE IV: "MEASURES TO INCREASE THE EFFICIENCY OF RESTRUCTURING, INSOLVENCY AND SECOND CHANCE"

Under Title IV, the Commission is proposing three articles on the role of insolvency practitioners:

- Article 25: measures on specialisation of insolvency practitioners
- Article 26: measures on the appointment procedure of insolvency practitioners
- Article 27: measures on supervision and remuneration of practitioners

The Commission's proposed text under Article 25, 26, and 27 remains high level and generic leaving room for interpretation by the Member States.

There are five aspects to consider:

1. Specialisation is key to restructuring and insolvency proceedings as they are often complex and require specific knowledge. The legislative text should clarify or at least give indications on what possible expertise and experience a practitioner should possess.
2. Fair and open access to the market by holders of the right expertise should be emphasised in the text.
3. During restructuring, a practitioner is expected to reach an amicable agreement between the debtor and the creditors to ensure continuity of the business. Member States should allow for enough flexibility to the practitioner to identify the best solutions. The proposal shall stress further the need for Member States to appoint practitioners acting in preventive restructuring proceedings without involving a judicial body. To do so, two conditions should apply: firstly, practitioners should be appointed only if they have the right expertise; secondly, the court should keep a supervisory role to ensure that the creditors' rights are protected.
4. The reference to independence and impartiality should be further emphasised. For example, the text could include additional provisions for a practitioner to declare a possible conflict of interest, ensuring an EU coordinated approach.
5. Insolvency is a complicated process involving various stakeholders, legislation and expertise. The text does not make any reference to the need for cooperation amongst diverse professions involved in the restructuring or insolvency phases. Practitioners working on a case should be able to exchange information and consult each other, even if from different backgrounds.

CONCLUSIONS

To draw some key conclusions, we need to consider the purposes of the proposed Directive. What is it aiming for and what can we do to ensure that it will bring the desired changes to the EU economy?

The proposed Business Insolvency Directive is an EU initiative aiming at increasing opportunities for early restructuring, facilitating insolvency regimes across Europe, and providing second chances to honest entrepreneurs who went through insolvency. The accountancy profession can play a key role in all mentioned stages, especially when it comes to restructuring business and early warning mechanisms. Our first publication of January 2017 *EU Business Insolvency. A contribution from the Accountancy profession* provides more information on that.

In this paper, we have expressed views on some of the most contentious articles of the Directive. We would like to highlight three overarching principles which we consider as key to the current negotiations on the Directive:

1. It is crucial to ensure that the entrepreneur has access to appropriate and timely advice
2. We need to reduce bureaucracy in insolvency proceedings
3. It is important to consider the long term economic benefits that the Directive will bring to the market

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