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A Class Apart: The Relevance of the EU Preventive Restructuring Directive for Small and Medium Enterprises

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Abstract
This article critically evaluates the significance of the recent EU Preventive Restructuring Directive for small- and medium-sized enterprises (SMEs). Considering the prevalence of SMEs across European economies, it stands to reason that the policy objectives of the Directive were grounded in facilitating the accessibility of restructuring and rescue procedures for such enterprises. However, there is a risk that the very distinct considerations involved in SME restructuring cases could be disregarded by the approach espoused within the Directive. The article proceeds to set out the procedural aspects of the Directive in respect of their putative suitability for the needs of SMEs. Class formation, confirmation of restructuring plans and creditor cram-downs are given particular attention since the Directive expressly includes safeguards for SMEs within these features of the Directive. The article assesses whether the preventive restructuring procedures envisaged by the Directive can truly offer a paradigm for SME restructuring. Even though the Directive accords flexibility to EU Member States as to transposition of these measures into national law, are there more specialised steps which ought to be taken when efficiently addressing the restructuring needs of SMEs?

Keywords SMEs; Restructuring; Insolvency; Rescue; Company law; Economics

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1 Introduction

The recently enacted European Directive on preventive restructuring could be presented by some quarters as a model framework for the rescue and rehabilitation of all types of financially distressed companies. The underlying aims of the Directive are directed towards facilitating the availability of necessary legal procedures for small- and medium-sized enterprises (SMEs). If the Directive fails in one of its core objectives, it casts serious doubt over the potential efficacy over such measures, particularly since SMEs comprise the overwhelming majority of active businesses across Europe. It is not a case of attempting to cater to a specialised or niche cohort of companies. The repercussions of the provisions for SMEs, as the preponderance of European firms, will help to reveal whether the envisaged preventive restructuring framework can be of practical use for all companies seeking to access the procedures. In effect, the Directive makes itself sound good in targeting its benefits towards SMEs. Yet, if SMEs are the bulk of the 'market' that can utilise such procedures, the determinant of the Directive's worth is through its suitability for such debtors. If the Directive is not of benefit to SMEs, then for whom can it purport to make a difference?

For the purposes of this article, SMEs are defined in accordance to the European Commission Recommendation.[1] SMEs are thereby regarded as including enterprises which employ less than 250 persons and which have an annual turnover not exceeding €50 million and/or an annual balance sheet total value not exceeding €43 million. Within this definition, a small enterprise is one which employs fewer than 50 persons with an annual turnover and/or annual balance sheet total of no more than €10 million. Micro-enterprises are defined to employ less than 10 persons each and have an annual turnover and/or balance sheet total of less than €2 million.

The article commences by describing the stated aims of the Directive in respect of SMEs and the main features within the provisions by which preventive restructuring is to be promoted among SMEs. The article turns to set out specific provisions within the Directive which directly refer to and are applicable to SMEs. Particular focus will be placed on the formation of classes for the voting upon and the adoption of restructuring plans, as well as safeguards afforded to SME debtors in the confirmation of a plan by a judicial or administrative authority. The integration of certain priority rules in confirmation will also be analysed so as to demonstrate how compromises towards ownership interests within SMEs may equally have a detrimental impact on the claims of fellow SMEs as trade creditors. The support of small-scale suppliers can be the vital lifeline for a debtor company and its prospects of a successful restructuring. In setting a context to these protections within the procedures, the article critically reflects on the purposes of preventive restructuring for SMEs. The causes of distress and failure among SMEs will be explained so as to highlight the paramount importance for SME owner-managers of discerning the symptoms of imminent financial difficulties.

The article then evaluates the likely effects of the Directive in proffering avenues of restructuring and rescue for SMEs. A superficial veneer of SME-friendly measures may count for little when the Directive seeks to be all things and tries to simultaneously string various parties along by satisfying all interests. It is the nature of such a legislative instrument to attempt to accomplish this and it may stand to reason in giving options to Member States. However, it ironically risks forgetting who the prime beneficiaries of restructuring should be, both as debtors and creditors. It raises the legitimate question as to whether SMEs should await something better which is committed to their restructuring concerns. For all of their prevalence, SMEs can be taken for granted and there are very distinct considerations involved in SME

[1] European Commission Recommendation 2003/61/EC of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises [2003] OJ L 124/36.

restructuring. If there is a game to crafting a balanced architecture of procedures, is the Directive honestly a level, or even fair, playing field? The article concludes by contemplating whether such legal mechanisms envisioned by the Directive are truly the most apt way of addressing SME cases of financial distress and non-performing loans.

2 The Policy Background

Following its progress through the legislative phases, the final act was signed in June 2019 for a Directive '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'.[2] The impetus for the original European Commission proposal for a Directive in November 2016 was the need to formulate harmonised standards which could grant Member States flexibility and ample discretion in implanting applicable provisions. The necessity for a more decisive approach was highlighted by the general disregard by EU Member States of the Commission's 2014 Recommendation on business failure and insolvency.[3] To a large extent, the Directive follows in the same vein as the earlier Recast Regulation[4] in striving to promote the effective use of company insolvency and rescue regimes within national law.

With the exception of a number of provisions, the Directive must be transposed into national law by Member States by 17 July 2021.[5] For Member States that encounter difficulties in its implementation, the transposition may be extended by one year.[6] The application and impact of the Directive shall be subject to a Commission review, no later than 17 July 2026 and for every five year period thereafter. On the basis of this assessment, the Commission may, if appropriate, submit a separate legislative proposal containing additional measures to further consolidate and harmonise the legal framework provided for under the Directive.[7]

Rather than surveying the entirety of the Directive, the focus of this article is on the provisions expressly applicable to SMEs. Other than the drive for harmonisation, a rationale for the Directive is broadly to reduce the obstacles confronting viable enterprises in effecting restructuring and to thereby alleviate the related legacy problem of non-performing loans (NPLs). To look out for the interests of SMEs across Europe could be seen as a no-brainer. As often referenced as they are, the figures can be astonishing. 99.8 per cent of active enterprises in the 28 Member States can be categorised as SMEs. SMEs accordingly provide employment

[2] 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 [2019] OJ L 172/18.

[3] Commission Recommendation of 12 March 2014 on a new approach to business failure and insolvency (2014/135/EU). On Member States' responses to the Recommendation, see European Commission (Directorate-General Justice and Consumers) (2015).

[4] Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings [2015] OJ L 141/19.

[5] Directive 2019/1023, Art. 34. On the provisions for the use of electronic means of communication between the parties to a restructuring, Art. 28 (a)–(c) must be transposed by 17 July 2024 and point (d) to be transposed by 17 July 2026.

[6] Directive 2019/1023, Art. 34(2). Member States should notify the Commission of the need to use this option of an extension by 17 January 2021.

[7] Directive 2019/1023, Art. 33.

for over 66 per cent of the workforce in the Member States.[8] The economic prospects and viability of SMEs can be regarded as being intrinsically connected to the future growth of the wider Eurozone economy. In devising suitable measures to bolster SME growth, policy initiatives across Europe have been increasingly predicated on supporting the 'think small first' principle of the adopted Small Business Act.[9] Some semblance of this approach may also be evinced in the latest Directive.

The contemporary challenges facing SMEs have been epitomised by the ongoing NPLs issue across European states which, nonetheless, has shown signs of improvement.[10] Debt overhang has been pervasive among SMEs in many EU states for the best part of a decade. There have been several methods utilised in addressing NPLs and in grasping the nettle to move away from creditors' forbearance in enforcing on their loans. According to the European Central Bank (ECB), 'cures', liquidations and debt write-offs have consisted of the bulk of the reduction in NPLs. At the same time, there have been burgeoning secondary loans markets in states such as Italy, Spain and Ireland which tend to revolve around the sale of portfolios or tranches of commercial loans to investors.[11] Such practices can seem to operate, if not in the shadow of, but, at least, within a parallel sphere to legal frameworks that enable timely winding-up of inefficient companies and the rehabilitation of viable, albeit financially distressed, firms. A significant gauge of the Directive's efficacy will be in its capacity to bridge this gap in facilitating SME access to suitable legal procedures.

3 The Stated Aims of the Directive in Benefiting SMEs

At its essence, the principal object of the procedures under the Directive is to enable debtors to restructure effectively at an early stage. In avoiding insolvency, appropriate restructuring reduces the probability of the liquidation of inherently viable companies.[12] Corporate restructuring procedures should therefore be available before companies enter formal insolvency under national law.[13] A debtor's financial difficulties should be such as to exhibit a 'likelihood of insolvency' and a restructuring plan must be feasible in precluding debtor insolvency and ensuring the viability of a business.[14] A synopsis of each of the provisions is beyond the ambit of this article.[15] The provisions expressly relating to SMEs do merit attention in illustrating the motivations underpinning the introduction of this legislation.

The conditions for SMEs are specifically identified in Recital 17 which establishes the grounds for a 'more coherent approach at Union level' in the interests of such companies. The greater chances of viable SMEs being liquidated, and the disproportionate costs to be incurred by SME companies in undergoing restructuring, necessitate specialised means of assistance.

[8] See European Commission (2018), and European Commission, Small Business Act Fact Sheet for EU-28, 2018, available at: https://ec.europa.eu/growth/smes/business-friendly-environment/performance-review_en#sba-fact-sheets.

[9] On the Small Business Act and the annual performance reviews of SMEs across EU Member States, see: https://ec.europa.eu/growth/smes/business-friendly-environment/small-business-act_en.

[10] See European Central Bank (2018) in which it is stated that the value of outstanding NPLs decreased by €94 billion in the first three quarters of 2018 alone.

[11] See European Central Bank (2018), para. 3.1.

[12] Directive 2019/1032, Recital 2.

[13] Directive 2019/1023, Recital 24.

[14] Directive 2019/1023, Recital 24 and Art. 4(1).

[15] For an assessment of the provisions of the Directive in terms of their likely effects in transposition into Irish law, see McCarthy (2019a).

Comprehensive checklists for restructuring plans, 'adapted to the needs and specificities of SMEs', are considered to be of meaningful benefit. Checklists are to include 'practical guidelines' on how restructuring plans are to be drafted with regard to national law.[16] The Directive endorses the availability of 'early warning tools' to identify imminent financial troubles and the urgent need to take preventive action are deemed. In putting in place these aids, the limited resources at the disposal of SMEs to hire expert advisors should be taken into account.[17] The barriers that SMEs must surmount in meeting the costs of everyday activities are also recognised in the Directive as being especially detrimental to SMEs' risk assessment of cross-border trading. It further vindicates the desirability of harmonised rules in respect of debtor insolvency and restructuring.[18]

Although the procedures can be applied for by debtors, the agreement of SME debtors will be required for applications by creditors or employees' representatives. Member States are free to decide whether the requirement for debtor agreement should be limited to only SMEs.[19] The veto is a notable concession to SME interests, considering that workers' rights generally have been shown particular precedence in many aspects of the Directive. The other prominent appeal for SME owner-managers is the debtor-in-possession format of the procedures with debtors remaining totally, or at least partially, in control of their assets and the day-to-day operation of their businesses.[20] The appointment of a practitioner may be decided on a case-by-case basis[21] but will be mandatory where: a stay on creditor enforcement is ordered by a judicial or administrative authority; a plan requires judicial or administrative confirmation by cross-class cram-down; and where practitioner appointment is requested by a debtor or by a majority of creditors (provided that the practitioner's costs are borne by creditors).[22]

Debtor-in-possession carries patent advantages for SMEs. With limited physical assets, SMEs can be more reliant on less 'tangible' resources such as commercial networks and trading relationships. Retaining the presence of existing management can be pivotal through familiarity with local suppliers and having the trust of local customers.[23] Indeed, the element of 'non-monetary' assistance that SME equity-holders can offer through 'experience, reputation or business contacts' is expressly acknowledged in the Directive.[24] An important feature in practice of SMEs (in particular, among micro-enterprises) is the number of family-owned businesses which can make the preservation of incumbent management in those scenarios all the more decisive to a successful restructuring.

There are evident drawbacks to singularly accommodating SMEs within any given framework of restructuring rules. For a start, the breadth of the definition given to SMEs in a European context covers a diversity of all kinds of firms. A micro-sized company of less than 10 employees can be sharply different in its ownership structure, resources and trading profile to a medium-sized company of roughly 200 employees.[25] The sheer numbers of SMEs could

[16] Directive 2019/1023, Art. 8(2).

[17] Directive 2019/1023, Recital 17.

[18] Directive 2019/1023, Recital 7. As but one initial example of the European Commission's emphasis on developing the exporting activities of SMEs, see European Commission (2010).

[19] Directive 2019/1023, Art. 4(8).

[20] Directive 2019/1023, Art. 5(1).

[21] Directive 2019/1023, Art. 5(2).

[22] Directive 2019/1023, Art. 5(3).

[23] See, for example, Mokal (2005). On the 'resource-based strength' of a company's management in contributing to its viability, see Cook, Pandit and Milman (2011).

[24] Directive 2019/1023, Recital 59.

[25] On this plurality which arises under the SME definition, see European Parliament Policy Department for Citizens' Rights and Constitutional Affairs (2017).

signify a consequent burden being placed on judicial systems to have to wade through a multitude of cases. Typical SME cases may involve minimal assets to be realised and distributed, or very few creditors. On the other hand, the macro-economic factors at stake here (and which will be elaborated upon in the final section) compel a level of scrutiny of individual cases for the sake of enhancing productive re-allocation of resources.[26] It may be all good and well to accept that SME cases must be part and parcel of such procedures but how should they be treated by the devil of the detail? The most contentious of such procedural aspects of restructuring can be in the class formation for the purposes of voting on a plan and its subsequent adoption or confirmation. It is also within these aspects that the Directive has inserted tailored safeguards for SMEs.

4 Class Formation and Adoption of Restructuring Plans

Voting on restructuring plans is to by means of divided classes of creditors 'which reflect sufficient commonality of interest based on verifiable criteria, in accordance with national law'.[27] Member States may ascertain the majorities required for adoption of restructuring plans, provided that it is no higher than 75 per cent of the amount of interests within each class, or, where applicable, the number within each class.[28] Notwithstanding the rather vague language of the provisions in distinguishing between possible classes, secured and unsecured claims are to be treated as separate classes as a minimum requirement. Member States have the option to determine whether to designate workers' claims as a separate class. By comparison, Member States have the rather nebulous obligation to 'put in place appropriate measures to ensure that class formation is done with a particular view to protecting vulnerable creditors such as small suppliers'.[29]

The circumstances of small-scale suppliers, or trade creditors, can arouse plenty of sympathy and, by the same token, some scepticism as to their ability to 'adjust' to their precariously lowly ranking as unsecured claims within the hierarchy of creditors' rights to repayment.[30] The ostensibly protective approach of the Directive towards SMEs is diminished by the fact that the Directive refrains from definitively categorising unsecured SME claims as a distinct class. Nonetheless, it is highly understandable in light of the arguments surrounding certain traders' capacity to adapt to their situation. For example, suppliers could rely on informational advantages concerning a market and possibly adjust the amounts of credit being extended to a debtor company which appears on the brink of application for preventive restructuring.[31] Ultimately, what such a provision illustrates most of all is the (perhaps glaringly obvious) point that there are two sides of the coin when reflecting on the Directive's impact on SMEs: SMEs as the debtors and SMEs as their (invariably unsecured) creditors.

From the vantage of SMEs as debtors, Member States have discretion in allowing such enterprises not to treat the various affected parties as separate classes.[32] The reasoning behind

[26] See European Law Institute (2017), at para. 758.

[27] Directive 2019/1023, Art. 9(4).

[28] Directive 2019/1023, Art. 9(6).

[29] Directive 2019/1023, Art. 9(4).

[30] The most well-known American work on this includes Bebchuk and Fried (1996), and LoPucki (1994). For an exploration of the issues relating to a preferential ranking for SME creditors, see Symes (2008). On the extent to which trade creditors could be construed to be 'voluntary' or 'adjusting', see Finch and Milman (2017), pp 81–84.

[31] On such trade credit practices, see further Petersen and Rajan (1997) and Armour (2006), p 215.

[32] Directive 2019/1023, Art. 9(4).

this is that SMEs are inclined to have relatively simple capital structures.[33] An SME undergoing restructuring—or entering into formal liquidation for that matter—will usually owe sums to a concentrated handful of creditors and a secured creditor as a principal creditor. It is stated that if an SME debtor opts for a single voting class and the proposed plan is rejected, the debtor should be permitted to submit another plan.[34] As with much of what the Directive is aiming to achieve in safeguarding SMEs, the idea appears a reasonable one and, yet, seems to forget the practical repercussions for other SMEs as creditors. By confining all unsecured claims within the one class (presumably also including the 'unsecured' claims of taxation authorities that are granted preferential status in many jurisdictions), it opens the possibility of the rights of those same SMEs that are creditors of the debtor SME being severely impaired within the adoption of a restructuring plan. A delicate balance needs to be struck in pursuing incentives for SMEs as debtors to engage in procedures to restructure and to rehabilitate as going concerns. Creditors' entitlements must be honoured as much as possible for these parties to be convinced of a restructuring plan and to be motivated to engage in a workable compromise. Such creditors will inevitably include other SMEs whose continuance of trade with a debtor could be instrumental to a company emerging on the other side of restructuring. The search for a balance becomes even more complicated when the implications of the types cross-class creditor cram-downs provided for under the Directive are considered.

5 Not So Absolute? The Costs of Priority

The Directive specifies three examples whereby restructuring plans can be made binding on parties following confirmation by a judicial or administrative authority. Firstly, where plans affect the claims or interests of dissenting parties. Secondly, where plans provide for new financing. Thirdly, where plans entail the loss of more than 25 per cent of a workforce.[35] A major source of academic debate in the initial reaction to the legislation has been the integration of rules on cross-class cram-down of dissenting interests under Article 11 of the Directive.[36] The original position set out in the proposed provisions was redolent of US Chapter 11 corporate bankruptcy rules through the application of an 'absolute priority rule'. This default approach towards cram-down is retained in providing that 'dissenting voting classes of affected creditors are treated at least as favourably as any other class of the same rank and more favourably than any other junior class'.[37] The absolute priority rule in this regard can be imposed by means of a 'best interest of creditors' test. This test is 'satisfied if no dissenting creditor would be worse off under a restructuring plan than such a creditor would be if the normal ranking of liquidation priorities under national law were applied, either in the event of liquidation, whether piecemeal or by sale as a going concern, or in the event of the next-best-alternative scenario if the restructuring plan were not confirmed'.[38]

In late 2018, the draft provisions were amended to include an alternative, what may be described as a form of 'relative priority rule.' In the final provisions, Member States can derogate from the requirement of absolute priority rule and can impose a cram-down whereby 'the claims of affected creditors in a dissenting voting class are satisfied in full by the same or

[33] Directive 2019/1023, Recital 45.

[34] Directive 2019/1023, Recital 45.

[35] Directive 2019/1023, Art. 10(1).

[36] For examples, see Mokal and Tirado (2019); de Weijs, Jonkers and Malakotipour (2019a); and de Weijs, Jonkers and Malakotipour (2019b).

[37] Directive 2019/1023, Art. 11(1)(c).

[38] Directive 2019/1032, Art. 2(1)(6).

equivalent means where a more junior class is to receive any payment or keep any interest under the restructuring plan'.[39] Aside from the somewhat clumsy juxtaposition in presenting Member States with a choice between two contrasting approaches, a great deal of the academic commentary has referred to the potential consequences for SMEs should a relative priority rule be favoured. From the positive side, Rizwaan Mokal and Ignacio Tirado support the introduction of relative priority on the basis that, *inter alia*, it may preclude creditor hold-outs and may protect the equity-holders of SME who are regularly the owners of the same companies. SME shareholders could therefore anticipate dividends (irrespective of how minimal the amounts may turn out to be), albeit at the expense of a dissenting class that would occupy a more senior ranking under the seemingly stricter absolute priority rule.[40] However, this argument on behalf of SME shareholders may not be of as much significance as might be imagined since the Directive provides that cross-class creditor cram-downs should only be optional for SME debtors.[41]

The recurring point that SMEs will constitute both debtors and creditors must be again reinforced here. If the vista of confirmation by cross-class cram-down is more likely then in the circumstances of larger, or non-SME, companies, the adverse results of a relative priority rule can be expected to be more stringently felt by dissenting unsecured trade creditors and it is the shareholders that benefit. Despite the flaws of the absolute priority rule in enforcing an apparently austere hierarchical structure to the treatment of claims,[42] trade creditors can fare marginally better in the event of a large corporate debtor being granted confirmation of a restructuring plan. The most persuasive critique to date of the inclusion of the relative approach and its probable effects for SMEs is proffered by Roelf de Weijs, Aart Jonkers and Maryam Malakotipour.[43] As incisively identified in their work, the Directive's espousal of the standards of relative priority cannot be asserted to closely match the recommendations in recent years for reform of the analogous Chapter 11 rules. The American Bankruptcy Institute (ABI)'s final report on Chapter 11 reform in 2014 proposed a set 'redemption option value' (calculated by reference to the sale value of the firm within three years of expiration of a company's petition for entry into reorganisation) to be distributed to unsecured claimants from encumbered claims and over a senior class of dissenting claimants.[44]

The redemption option value changes are arguably more along the lines of a carve-out and not as blunt a value-destroying measure as the Directive's putative version of a new relative priority could be. Indeed, the recommendations for redemption option value have been met with criticism in the US for being a 'costly and perhaps insurmountably complicated proposal'.[45] There is the inclusion of a 'death trap' within the ABI's proposal whereby a junior class must vote in favour of a plan so as to gain from a distribution over the immediately senior claimants. What is most likely to arouse objections is the accurate valuation of a company and its sale value for the measures to be implemented. Furthermore, the ABI recommended an 'equity retention plan' in the case of SMEs[46] that ownership and control of the full stock could

[39] Directive 2019/1032, Art. 11(2).

[40] Mokal and Tirado (2019).

[41] See Directive 2019/1032, Recital 58.

[42] For a review of the considerations favouring and opposing the use of the absolute priority rule in Chapter 11 proceedings, see McCormack (2008), pp 266-275. For an assessment of absolute priority's shortcomings and a submitted alternative model, see Casey (2011).

[43] De Weijs, Jonkers and Malakotipour (2019a).

[44] See American Bankruptcy Institute (2014).

[45] Loan Syndicating and Trading Association (2015).

[46] Defined in Part VII of the ABI Report as a business debtor with: (i) no publicly traded securities in its capital structure or in the capital structure of any affiliated debtors whose cases are jointly administered with the debtor's

be kept by the SME equity-holders as well as 15 per cent of the distributions from the business for up to four years after bankruptcy. This recommendation can, perhaps inevitably, be criticised with the typical line of argument that, by abandoning the tried and tested absolute priority, it would impair the pre-bankruptcy rights which other creditors have voluntarily bargained for with the debtor.[47] It remains to be seen to what extent such proposals will be enacted in the US in the coming years,[48] even if the ABI recommendations stand as a useful point of comparison with the Directive's measures.

Beyond a comparative appraisal of the outcomes for SME trade creditors within absolute and relative priority under the Directive, the losses for such creditors under an application of the relative priority rules could be exacerbated by the status to be accorded to fresh funds received by debtors over the course of the restructuring. Member States may entitle grantors of new financing[49] or interim financing[50] to priority of payment in any subsequent insolvency of a debtor company.[51] Such funding can be crucial to debtors in enabling the carrying on of trade and a successful restructuring. However, it does give risk to a heightened risk of opportunistic behaviour by debtors in taking advantage of the supplementary injection of funding and by certain interim creditors in taking advantage of their priority should the debtor hurtle towards insolvency.[52] Most pertinently for unsecured SME creditors, the use of 'rescue finance' can be controversial for its further demotion of already vulnerably-ranked claims.[53] When combined with the consequences of a relative priority rule in cram-downs, unsecured SME creditors may be forgiven for viewing these measures with trepidation.

6 Early Warnings and Uneasy Steps: Distress Symptoms, Self-Diagnosis and Accepting Preventive Treatment

In aiming to incentivise companies to take steps to address impending financial difficulties, the Directive promotes the necessity of Member States having 'clear, up to date, concise and user-friendly information' on the available procedures, in addition to the availability of one or more 'early warning tools'.[54] Under Article 3, such early warning tools are specified to include: 'alert mechanisms' for when a debtor has not made certain types of payments (for instance, taxation payments or social security contributions)[55]; advisory services for debtors as run by either public or private organisations[56]; and incentives under national law for third parties with relevant information about the debtors concerned (accountants, tax or social security

case; and (ii) less than $10 million in assets or liabilities on a consolidated basis with any debtor or non-debtor affiliates as of the petition date.

[47] See Loan Syndicating and Trading Association (2015), pp 71–74.

[48] See Lewis (2015).

[49] Directive 2019/1023, Art. 2(1)(7) defines new financing as 'any new financial assistance provided by an existing or a new creditor in order to implement a restructuring plan and that is included in the restructuring plan'.

[50] Directive 2019/1023, Art. 2(1)(8) defines interim financing as 'any new financial assistance, provided by an existing or a new creditor, that includes, as a minimum, financial assistance during the stay of individual enforcement actions, and that is reasonable and immediately necessary for the debtor's business to continue operating or to preserve or enhance the value of that business'.

[51] Directive 2019/1023, Art. 17(4).

[52] See de Weijs and Baltjes (2018).

[53] See Payne (2018), p 147.

[54] Directive 2019/1023, Recital 22.

[55] Directive 2019/1023, Art. 3(2)(a).

[56] Directive 2019/1023, Art. 3(2)(b).

authorities) 'to flag to the debtor a negative development'.[57] The details on preventive tools are to be publicly available online and in an easily accessible presentation for SME debtors.[58] As well as the debtors in question, the information should also be available to employees' representatives.[59]

Knowing that a company is facing difficulties is one matter but gaining an accurate indication of the level of distress that must be addressed is another. In many circumstances, the characteristics of financial and economic distress blend into each other.[60] Firms that are otherwise efficiently well-run can have hefty debts and liabilities that they struggle to pay.[61] 'Restructuring' itself is defined within the Directive as measures aimed at restructuring a debtor's business. It encompasses changing the composition, conditions or structure of assets and liabilities, or any part of a debtor company's capital structure. It extends to the sales of assets and parts of businesses as well as any 'necessary operational changes'.[62] The scope for sales of businesses and for modifications to companies' activities can thus serve to also focus the preventive procedures on any symptoms of 'economic' distress.

It is possible for distress—be it of a financial or economic variety—to be identified through profitability, liquidity or solvency ratios by reference to corporate accounts. The use of such ratio-driven calculations is an established accounting technique for the prediction of corporate failure.[63] However, even with different advisory supports, there are sharp limitations to the utility for SMEs of these kinds of predictive resources. Finding a reliable model or methodology for the assessment of risk in SMEs can be far more arduous than developing similar formulae to apply to larger firms. Again, the distinctions between micro-, small and medium enterprises can elude a straightforwardly uniform mathematical approach.[64] As David Milman cautions, models, ratios or diagnostic tools for the prediction of long-term solvency or corporate failure may be reasonably beneficial and accurate for larger companies. For SMEs, more prosaic measures are commonplace due to a lack of awareness of comparable predictive methods and a reluctance by SME owner-managers to use them to constructive effect.[65] The reality of running an SME is that there is a constant onus upon owner-managers themselves to take the appropriate anticipatory actions in getting to grips with the problems that are threatening to engulf the business.

The 'internal' factors of company failure can all bear some relation to poor management. Inadequate financial and information controls have been found to be predominantly the root causes of later distress.[66] Nonetheless, this cannot detract from the significance of 'external' shocks such as price fluctuations, obstacles in sourcing raw materials, intensified market competition, increased wage demands, credit constraints and the effects of over-regulation.[67] In previous empirical findings from a sample of UK SMEs, the primary problems experienced by businesses included general failures to meet budgets, sales shortfalls,

[57] Directive 2019/1023, Art. 3(2)(c).

[58] Directive 2019/1023, Art. 3(4).

[59] Directive 2019/1023, Art. 3(3). Under Art. 3(5), Member States may also provide support for employees' representatives for the assessment of a debtor's economic situation.

[60] McCormack (2008), p 10.

[61] See Baird (1998), p 581.

[62] Directive 2019/1023, Art. 2(1)(1).

[63] Especially among financial institutions through using Altman's Z-score model. See Altman (1968).

[64] On such challenges in cultivating prediction models for SME bankruptcies, see El Kalak and Hudson (2015).

[65] Milman (2013), p 37.

[66] See Finch and Milman (2017), pp 124–131.

[67] Finch and Milman (2017), pp 131–135.

poor margins, high overheads, bad debts, over-trading, excessive directorial remuneration, cash flow difficulties and excessive borrowing.[68]

Regardless of whether nascent signs of distress are 'internal' or 'external' in origin, an SME debtor—or, more to the point, its management—must want a restructuring for any procedures to be put to good use. In this regard, the reasons for any reluctance to resolve financial distress should be understood. The vacillation of those in control of SMEs can often be linked to the very background of the businesses and a prevailing enterprise culture. A hesitancy to admit to problems can be an issue in family-owned businesses which make up such a sizeable proportion of SMEs. Proper governance principles are also more likely to be followed in a relatively loose fashion by family-owned SMEs.[69] A seeming stigma in relation to financial difficulties can discourage management from acting soon enough to address what may be eminently solvable. Leaving it too late can also mean that there may be far less to be yielded once decisive action is taken to restructure or even to wind up a company's activities. In elevating the use of early warning tools, the Directive will have accomplished an important function in the interests of SMEs if it instils some cognisance of the necessity for prompt recognition of financial distress and acceptance of the advantages in undergoing restructuring.

7 A Paradigm for SME Restructuring?

As procedures that are supposed to be of a preventive hue, the Directive could be viewed as adhering to an 'informal' model of restructuring or rescue and which largely tries to minimise undue court supervision of proceedings. The expense associated with court-centred procedures tends to principally be the fatal barrier for SMEs to surmount in applying for necessary legal avenues of restructuring.[70] To a large extent, a relatively informal setting correlates with the general nature of debt restructuring involving SMEs. However, as Sarah Paterson observes, what 'makes us uncomfortable' about SME restructuring can be the sense that agreements have to be struck in the shadow of the law, thus generating questions as to equitable treatment of all stakeholders and procedural fairness.[71] Although Paterson acknowledges that the circumstances will vary according to a particular case, situations of SME restructuring lead to concerns especially over a lack of protection for the claims of vulnerable (SME) trade creditors. Other than banks as secured creditors, families as the effective owners of so many SMEs are also 'insiders' that have more information which they can exploit to reach a desired outcome.[72]

Even where court procedures are the mode of restructuring, it has been noted that many businesses are 'in an absolutely desperate condition' by the time an application or petition is filed and that too many smaller companies are essentially 'doomed from the start'.[73] Due to the costs associated with procedures and the 'resource poverty' of the archetypal small business, Donald Korobkin recognises that there is a 'somewhat ironic conclusion' in that 'small businesses urgently require the kind of timely intervention that they may be least likely to seek'.[74] For Korobkin, the most pragmatic response to these conditions is for a 'weeding out of the undeserving'. To describe it in perhaps less callous-sounding terms, this connotes that

[68] Day and Taylor (2001), pp 105-106. For a similar study of US firms, see Carter and van Auken (2006).

[69] See Milman (2013), p 36.

[70] On the costs obstacles confronting SME companies seeking to enter the Irish company rescue and restructuring process of examinership, see McCarthy (2019b).

[71] Paterson (2017).

[72] Paterson (2017), p 610.

[73] Korobkin (1994), p 424.

[74] Korobkin (1994), p 428.

the most substantive threshold of entry for an SME restructuring could be a court-sanctioned determination (by an independent expert) of a business' true economic viability and its prospects of trading on as a going concern. To maintain the cost-efficiency of procedures for smaller businesses, Korobkin proposes that a 'viability hearing' could occur in conjunction with a 'viability study'. The court would make specific findings as to the likelihood of a company's survival and would retain power to convert the case to liquidation. The preparation of the study or report into viability should preferably not be allowed to be the job of debtors themselves as some management of small businesses 'would be prone to present the evidence in an unduly favourable light'.[75]

The Directive does not establish precise thresholds or gateways by which debtors could enter into the preventive restructuring procedures. The 'likelihood of insolvency' is referred to but it is expressly stated that the term must be understood by reference to national law.[76] Member States may maintain or introduce a 'viability test' which is not detailed any further within the provisions other than that such a test should have the purpose of excluding debtors without prospects of viability and that it should be carried out without detriment to debtors' assets.[77] The absence of definitive screening in favour of giving more flexibility to Member States could be a profound weakness of the procedures. In its issued opinion on the draft proposal of the Directive, the ECB had recommended that a likelihood of insolvency needed elaboration within the Directive's text and that interpretation should not be left to individual Member States.[78]

The lack of a filtering mechanism as to business viability is accentuated even further when considering the full duration of the stay on creditor enforcement actions which is available under the procedures 'to support the negotiations of a restructuring plan'.[79] Although there is an initial length of no more than four months,[80] it can be extended by a judicial or administrative authority to 12 months. The examples of 'well-defined circumstances' for extending a stay are: where relevant progress is made in negotiations, where its continuation would not unfairly prejudice the rights or interests of affected parties, and where insolvency proceedings have not been opened in respect of a debtor.[81] Regardless of the specified circumstances for granting the extension, precluding creditors (such as SME traders) from acting on their entitlements for a year could be argued to be disproportionately long. Various grounds are set out for ordering a stay to be lifted, including where there is undue prejudice caused to creditors by a stay's continuation.[82] However, there remains a plausible risk of abuse of this protection period if debtor companies manoeuvre to stave off creditors for as long as possible. It might just give credence to Horst Eidenmüller's perspective on the Commission's

[75] Korobkin (1994), p 431.

[76] Directive 2019/1023, Art. 2(2).

[77] Directive 2019/1023, Art. 4(3).

[78] European Central Bank (2017).

[79] Directive 2019/1023, Art. 6(1).

[80] Directive 2019/1023, Art. 6(6).

[81] Directive 2019/1023, Art. 6(7)–(9). The total duration of a stay should not exceed four months if the centre of main interests of a debtor has been transferred from another Member State within three months of filing for request of the procedures.

[82] Directive 2019/1023, Art. 6(9). As well as where undue prejudice results, a stay may be lifted if it no longer fulfils the objective of supporting negotiations when it is clear that a requisite proportion of creditors will not consent to further negotiations. It may be lifted at the request of the debtor or of an appointed practitioner. A stay can also be lifted when it would bring about the insolvency of a creditor.

original proposal that there was a danger that the procedures could offer a refuge for dying firms and would attract such businesses 'as the light attracts mosquitos'.[83]

The end product of the Directive may have been to craft an awkward amalgamation of procedures, consisting of flimsy checks for viability at entry points, consensual compromises between parties, a lengthy moratorium, and cram-down rules which could turn out to be both harsh and confusing in their implementation by Member States. It could be queried as to whether the procedures have been overly intermingled and have neglected to choose between being either an insolvency or a reorganisation regime.[84] Irrespective of the contradictions within the 'character' of the Directive, it becomes increasingly evident that the innate considerations of SME cases infer that they must be handled differently. The paradox is that SMEs would comprise the vast majority of business debtors expected to utilise the procedures. The costs associated with restructuring could well be mitigated by the procedures envisaged under the Directive. However, it is the overall efficiency of the procedures which must also be maintained when dealing with substantial numbers of SME debtors. As the proposal progressed through the legislative stages, it was suggested that 'a full-scale solution of non-performing SME loans in Europe would not only require a viable (preventive) restructuring option, but also an effective liquidation process'.[85]

7.1 Alternative approaches?

Recent literature on SME restructuring and on a 'modular approach' towards the most appropriate legal framework has advanced the feasibility of such a coalescence.[86] Within this bespoke model, restructuring procedures could operate in tandem with an automatic passage to winding-up for SMEs that are unable to demonstrate the potential for successful restructuring. Dissenting creditors are allocated a 'scream or die' option whereby objections must be raised to approved restructuring plans within a specified timeframe, after which time the plans receive court confirmation. From the vantage of SME debtors, such a proposed system would be comparably cost-effective. The combination of automatic liquidation may be a necessary component given that debt resolutions cannot simply be effected in many SME instances due to limited assets, onerous liabilities and the consequent inability to achieve debt-for-equity swaps within a market.[87]

At the wider economic level, conversion to liquidation at an entry gate could be commensurate with Schumpeterian economics.[88] In the interests of promoting economic growth as a whole, patterns of productive re-allocation of resources would have to be preserved in clearing the space for new entrants into markets. The dynamics of young SME businesses are inclined to have an 'up-or-out' narrative by exhibiting low productivity before quickly exiting or instead demonstrating a rapid acceleration in growth with above-average productivity.[89] A disruption to these kinds of patterns—whether it be through creditor forbearance or the dearth of appropriate insolvency processes—can only compound the

[83] Eidenmüller (2017), p 288.

[84] See further Tollenaar (2017).

[85] European Parliament Policy Department for Citizens' Rights and Constitutional Affairs (2017), p 6.

[86] See Stanghellini et al. (eds.) (2018), Chapter VIII: 'Special Considerations for Micro, Small, and Medium Enterprises'; and Davies et al. (2018).

[87] See Paterson (2016), p 721.

[88] For the seminal work on the subject, see Schumpeter (1934), and (1942). For a review of modern perspectives on Schumpeterian theories of 'creative destruction', see Dal Pont Legrand and Hagemann (2017).

[89] Haltiwanger (2012), p 18.

protracted NPLs problem across Europe, hamper economic productivity and instigate the limping onwards of 'zombie' companies.[90]

Much of what is being advocated for here ultimately correlates to Jose Garrido's study prepared for the World Bank in 2012 which classified hybrid processes as connoting 'workout procedures in which there is a mixture of the features of contractual workouts and limited court intervention'.[91] Within a 'continuum' for the treatment of corporate distress, there is no dividing border between informal restructuring and formal insolvency. For example, a restructuring process can be converted to a fully formal reorganisation or liquidation, depending on the most suitable course of action. So long as viability could be retained as the overarching determining factor,[92] something close to Garrido's idea could well be possible under the provisions of the Directive. For the purposes of the Directive, the preventive restructuring 'may consist of one or more procedures, measures or provisions, some of which may take place out of court […]'.[93] Whether it enables a glimpse of a model approach to SME rescue is debatable. It would have to be realised in transposition into national law—but, at the very least, it attests to an inherent flexibility within the Directive.

9 Conclusion

The transposition of the provisions of the Directive into national law may gradually reveal the true scope of the preventive restructuring procedures in adapting to the considerations involved in SME cases. However, the most telling indication of this legislation's worth will be its efficacy in catering for the requirements of the market actors which should be most likely to apply to enter the procedures. The design of the Directive contains several incongruous elements. This prompts more than just an abstract discussion as to its nature as an insolvency or rescue process. The procedural practicalities in relation to class formation and plan adoption, the choice between absolute and relative priority rules, and the lengthy duration of a stay all possess their own deficiencies in facilitating a smooth restructuring. As described throughout this article, the deficiencies become more pronounced in respect of SMEs. It also remains paramount to be reminded that when SMEs might be spoken of in somewhat broad terms in restructuring contexts, it is really SMEs as both debtors and creditors that necessarily must be thought of.

Even though the interests of SMEs occupied a central place within the policy aims of the Directive, the argument persists that such enterprises continue to demand a specialised approach. Such an approach should be imbued with regard for not only the rights of the stakeholders at issue—debtors and creditors—but also the wider economic picture in guaranteeing that financial distress is no longer allowed to fester and expand the degree of legacy debt overhang. A determination of viability of underlying businesses should be at the heart of such a restructuring framework, along with a ready transfer to prompt and efficient winding-up for companies which cannot be salvaged as going concerns. When all is critically evaluated about this Directive, there is a dose of reality which cannot be evaded. The capacity of the envisioned procedures—and of any preventive restructuring process—to thrive will depend on the willingness of debtors and SME owner-managers to actually use the procedures. It is their responsibility to refer to early warning tools, to recognise when financial difficulties

[90] See Adalet McGowan and Andrews (2016); Bricongne et al. (2016); Andrews and Petroulakis (2019).

[91] Garrido (2014), p 47.

[92] On ensuring that viability tests should be at the forefront of SME debt resolution, see also Bergthaler et al. (2012).

[93] Directive 2019/1023, Art. 4(5).

cannot be allowed to continue, to come forward early with their cases for restructuring and, by the same logic, to accept when it must be all over.

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