CONFERENCE ON EUROPEAN RESTRUCTURING AND INSOLVENCY LAW

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Re: **CERIL EXECUTIVE STATEMENT 2020-1 on COVID-19 and insolvency legislation**

Reporters: Professor Stephan Madaus and Professor Em. Bob Wessels on behalf of the Executive of CERIL[1]

COVID-19 urges legislators to adapt insolvency legislation

The Executive of CERIL (Conference of European Restructuring and Insolvency Law) is deeply concerned with the ability of existing insolvency legislation to provide adequate responses to the extremely difficult situation in which many companies find themselves as a result of the spread of the COVID-19 (corona) virus. It calls upon EU and European national legislators to take immediate action and adapt insolvency legislations where necessary in light of the current extraordinary economic situation and to prevent unnecessary bankruptcies of entrepreneurs.

I. Introduction

CERIL is an independent non-profit organisation of some 60 lawyers and other restructuring and insolvency practitioners, law professors and (insolvency) judges committed to the improvement of restructuring and insolvency laws and practices in Europe.

The Executive of CERIL urges the EU and European national legislators to act swiftly and to respond to two specific needs when adapting or amending their legislation:

1 The (temporary) loss of the business income.
2 The (temporary) impracticality of a cash flow forecast.

[1] The Executive of CERIL would like to express its sincere gratitude to Gert-Jan Boon LL.M MSc, researcher at the Department of Company Law at Leiden University and Associate Researcher of CERIL for the assistance in the preparation of this statement, the draft text of which was delivered by Stephan Madaus (Germany) and Bob Wessels (The Netherlands). It has been discussed and approved by the other members of CERIL's Executive, Giorgio Corno (Italy), Prof. Tuula Linna (Finland), Dr. Paul Omar (UK), Prof. Ignacio Tirado (Spain) and Prof. Reinout Vriesendorp (The Netherlands).

II. Background

The COVID-19 (corona) virus has reached pandemic status. It spreads all over the world and is expected to infect a majority of all people within the next month(s), according to health experts. This new development has not just caused consumers to restrict their usual spending. Even more, it has caused governments all over the world to restrict travel, free movement and social activity. The medical urgency justifies the current extraordinary measures. However, all of these governmental and societal responses directly affect the business operations of companies and public institutions. Companies and (educational) institutions are closing their doors; certain sectors (catering, travel industry, entertainment industry, day-care centres) are effectively forced to close their business operations for the foreseeable future; events are cancelled at the last minute and employees are asked to work from home *en masse* if they can. The devastating effects on businesses may even be prolonged by the approach of public health officials in an attempt to delay the impact of the COVID-19 pandemic as much as possible. This approach – at the same time – produces uncertainty about the moment in which businesses may expect to resume their activities. Even more, businesses are simply unable to calculate the period of time they need to bridge.

The existing uncertainty hits both financially reasonably healthy companies, which depend on a smooth inflow of liquidity, and companies with fundamentally solid business models. The exogenous shock affects entire industries,[2] especially non-food businesses, and businesses of all sizes, possibly all businesses eventually. The danger of a snowball effect is certainly not to be underestimated. Companies that experience a dramatic drop in turnover or exports due to a huge drop in demand will soon severely limit their own purchases of semi-finished products or services, to the detriment of the financial situation of these suppliers.

While larger companies face the special situation with the help of advisers and bargaining power *vis-à-vis* counterparties, politicians and tax administrations and still have credit absorption capacity to use public liquidity assistance, the situation looks much more pessimistic for the many hundreds of thousands of small businesses in Europe with little or no relevant financial reserves. Any government response must address the needs of all businesses affected by this crisis.

The Executive of CERIL recommends the following two steps to be taken immediately by European national legislators:

STEP 1: Suspend the duty to file for insolvency proceedings based on over-indebtedness

The current uncertainty regarding future developments affects the market prices of assets which directly affects the balance sheets of companies as well as their financial situation. In jurisdictions, where the balance sheet test is combined with a viability forecast, the same uncertainty renders such a forecast impracticable. The current duties to file in many EU Member States[3] would, thus, require prudent entrepreneurs and boards of companies to file for insolvency or,

[2] See the survey of the German Ifo Institute, available at: hiips://www.ifo.de/en/node/53751 .

[3] The duty exists, for instance, in Austria, Belgium, Czech Republic, France, Germany, Greece, Italy, Latvia, Poland and Spain in several variants; see Bob Wessels and Stephan Madaus, Instrument of the European Law Institute on Rescue of Business in Insolvency Law, 2017, p. 166, available at: hiips://ssrn.com/abstract=3032309 .

sometimes, for restructuring proceedings[4] in the personal interest of limiting the risk of any personal liability if the business situation further deteriorates in weeks to come.

The function of a duty to file is to select non-viable businesses and force them to initiate insolvency or restructuring proceedings early in the interest of their creditors and other stakeholders in general. The current uncertainty, however, hampers the selection as the test indicating a non-viable business is not conclusive in these market conditions. Many companies with a viable business model in 'normal markets' would be forced to file and possibly suffer a piecemeal liquidation under value in resulting insolvency proceedings where liquidation would proceed under the current, distressed market conditions.

In conclusion, we recommend that the duty to file based on over-indebtedness in the relevant jurisdictions to be temporarily suspended, for instance until a certain date or pending the decision of a government agency. This suspension should not depend on further substantial requirements, like for instance the need for state aid or the proof to be affected by the current crisis in the German response.[5] As a temporary measure based on the existence of an extraordinary situation that directly or indirectly affects all businesses, an immediate suspension for all is required. The emergency legislation in Switzerland[6] and Spain[7] is the recommended role model here. The suspension should also relieve from any liability for entrepreneurs based on the fact that over-indebtedness occurred and no motion for insolvency was filed. Further, it would include a suspension of the creditor's rights to file.

STEP 2: Respond to the illiquidity of businesses

The (partial) shutdown of a business for weeks or even months, the lack of supply or workforce based on lockdown measures or the inability of customers to use products or services directly reduces the cash flow coming into a business. Especially small businesses with limited cash reserves are quickly approaching a moment of illiquidity that qualifies as an inability to pay under applicable insolvency laws.

As in cases with over-indebtedness, businesses with a lack of liquidity would risk being liquidated, while they would probably remain viable in a more normal market situation. The legislative response to this overreach of 'good weather' insolvency laws should include a range of assisting tools for businesses.

Furthermore, for both steps, we recommend that the European Commission makes available an up to date overview of the ad-hoc measures adopted across Europe. With the European internal market, national legislators and

[4] See, in particular, Italy, where Art. 2086 para 2 of the Italian civil code, as amended by Art. 375 of the so-called Code of Crisis and Insolvency (legislative decree 12 January 2019, n. 14), in force from 16th March 2019, requires any entrepreneur who operates as a legal entity to adopt or implement without delay one of the instruments provided for in the crisis management system, and the recovery of business continuity.

[5] See the German draft law announced on March 16, 2020, available at: hiips://www.bmjv.de/SharedDocs/Pressemitteilungen/DE/2020/031620_Insolvenzantragspflicht.html .

[6] See the Swiss '*Verordnung über den Rechtsstillstand'* effective from March 19, 2020 until April 4, 2020, available at: hiips://www.bj.admin.ch/dam/data/bj/aktuell/news/2020/2020 -03-18/vo-d.pdf.

[7] See Art. 40-43 of the Royal Decree of the Spanish government 08/2020 of March 17, 2020, available at: hiips://www.boe.es/buscar/act.php?id=BOE -A-2020-3824.

entrepreneurs across Europe should be better informed of the local measures adopted during this crisis.

The areas to be considered by legislators:

Below, we highlight four specific areas where legislators should consider introducing further measures responding to the COVID-19 crisis: interim financing, suspending the duty to file based on the inability to pay, 'Hibernation' (winter sleep) for (small) businesses, and supporting the livelihood of entrepreneurs and their employees. This is followed by some remarks for consultants and legal professionals, and a conclusion.

a. Interim financing

Especially for key industries (automotive, airlines, railways, etc.), but also for mid-size businesses, state aid in the form of interim crisis financing should be available. The ECB already announced to purchase bonds of EU businesses and Member States in support of a failing capital market.[8] Many Member States have initiated their own programmes focussing on credit supply for such businesses. For key industries, governments may also consider taking equity positions for liquidity support, which would in effect nationalise these industries.

For many smaller businesses, however, liquidity offered in the form of credit may not be useful. Considering the already existing level of debt for most businesses and their expected rate of return on capital even in normal markets, prudent entrepreneurs would and should decline to raise their debt level. Credit programmes are not useful here, which means that they are not useful for the vast majority of businesses in the EU.

b. Suspending the duty to file based on the inability to pay

For businesses facing an inability to pay, the loss of function of a duty to file should be reflected in the law. As with the duty based on over-indebtedness, in the relevant jurisdictions, the duty to file based on an inability to pay should be suspended during the times of emergency with no further requirements. Again, emergency legislation in Switzerland[9] and Spain[10] is the recommended role model. And again, such a suspension should relieve the entrepreneur/directors of the business from any connected liability.

c. *'Hibernation'* for (small) businesses

Lifting the duty to file does not solve the problem of entrepreneurs in a situation where they are lack sufficient cash revenues and are facing their inability to pay. A business, which is not viable due to lockdown measures and COVID-19 markets responses, must be offered a chance to temporarily shut down and 'hibernate' (or: enter into winter sleep) until uncertainty is overcome and the market situation returns to normal.

[8] See hiips://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318_1~3949d6f266.en.html .
[9] See the Swiss '*Verordnung über den Rechtsstillstand'* effective from March 19, 2020 until April 4, 2020, available at: hiips://www.bj.admin.ch/dam/data/bj/aktuell/news/2020/2020 -03-18/vo-d.pdf.
[10] See Art. 40-43 of the Royal Decree of the Spanish government 08/2020 of March 17, 2020, available at: hiips://www.boe.es/buscar/act.php?id=BOE -A-2020-3824.

There are different ways to achieve such a '*hibernation*':

a) General moratorium
The least complex legislative response would temporarily suspend the enforcement of claims (together with the duties to file). The Swiss response includes such a moratorium.[11] It would only limit coercive measures of creditors, not, however, suspend due dates for claims or rights to accelerate or terminate contracts based on default.

b) Deferral of payment (and enforcement)
The effects of a moratorium fall short of what businesses need these days. A 'hibernation' would need to produce a state of law in which the entrepreneur closes the business for the duration of the emergency and all legal duties rest for that period. This would include the due date of claims, including tax claims. Non-payment within this period would not constitute a default that would enable contracting parties to invoke termination or acceleration rights.

Such a deferral can be implemented statutorily which would provide an immediate effect on all existing claims in a jurisdiction. Alternatively, it could also depend on a motion of the debtor filed with a court or a competent authority.

An example for the latter response can be found in the Italian legislation issued as a reply to the current emergency situation.[12] Other jurisdictions may recall relevant wartime legislation. For instance, 106 years ago the legislator of the Netherlands enacted the so-called Payment Delay Act ('*Betalingsuitstelwet*'[13]). The act intended to protect against the economic consequences of the outbreak of the First World War by introducing a special judicial moratorium. Persons who found themselves in financial difficulties as a result of the extraordinary circumstances of wartimes could achieve a deferral of payment date in a situation in which they were either sued in court for payment of a monetary debt or faced the enforcement of claims or bankruptcy or any other loss of wealth.[14]

It should also be recalled that the Directive on Restructuring and Insolvency (Directive EU 2019/1023) contains provisions on a pre-insolvency moratorium available in a preventive restructuring framework that would not only suspend a duty to file and acts of enforcement, but also limits the ability of contracting parties to modify contracts based on default rights.[15] Hence, the immediate implementation of these parts of the preventive insolvency framework could also provide for the relief needed.

[11] See the Swiss '*Verordnung über den Rechtsstillstand*' effective from March 19, 2020 until April 4, 2020, available at: hiips://www.bj.admin.ch/dam/data/bj/aktuell/news/2020/2020 -03-18/vo-d.pdf.
[12] See the Italian Decreto-Legge 17 marzo 2020, n. 18, Misure di potenziamento del Servizio sanitario nazionale e di sostegno economico per famiglie, lavoratori e imprese connesse all'emergenza epidemiologica da COVID-19, artt. 83 and 91, available at: hiips://www.gazzettaufficiale.it/eli/id/2020/03/17/20G00034/sg
[13] The Netherlands Government Gazette 1914, 444.
[14] This suggestion has been made by professor Ben Schuijling, University of Nijmegen (The Netherlands). In The Netherlands too, after the flooding that hit the South-West Netherlands early February 1953, a general postponement was enacted by the government for the payment of debts of a specified group of debtors. See Royal Decree 12 March 1953, Meeting of the House of Representatives No. 2918.
[15] Articles 6 and 7 of the Directive on Restructuring and Insolvency.

The CERIL Executive would recommend to impose a statutory deferral as part of the emergency legislation and accelerate the implementation of the tools of the Directive in order to brace the restructuring frameworks in each Member State for the aftermath of the immediate COVID-19 crisis. Measures in times of exceptional circumstances should be effective without formalities, especially when courts and public authorities may not be fully available due to lockdown measures.

A compromise solution could provide for a deferral under available restructuring or even insolvency laws by allowing entrepreneurs (and creditors) to file for the protection of such regimes while at the same time staying any proceedings for the duration of emergency measures. Such an approach would require the entrepreneur to externalise the need for a deferral while it would not immediately bind scarce resources of the courts. With the termination of emergency measures, the motion could be withdrawn if the business is solid again. Otherwise, the fallout of the crisis could be met in subsequent proceedings.[16]

d. Supporting the livelihood of entrepreneurs and their employees

In cases where larger companies are supported by interim financing measures, the livelihood of directors and employees are financed as well. State aid[17] might even cover some of the labour costs when factories, offices and shops temporarily close.[18]

For small businesses that are not able to raise their debt level, the 'hibernation' of this business alone does not provide for the livelihood of the entrepreneurs and their employees. They are without income for weeks, possibly months. State aid initiatives must cover both the employees of such businesses and their directors or entrepreneurs. The latter should also be protected against any enforcement actions by business creditors based on guarantees or mortgages securing business debt. State aid to entrepreneurs and directors must, however, be earmarked to secure their livelihood and the survival of the 'hibernating' business structure (electricity, emergency personnel, servers, etc.). They shall not be allowed to pay any deferred business claims from such funds.

III. A special remark to advisors

The outbreak of the COVID-19 virus affects the economy, the society and daily life.

The CERIL Executive is aware that amongst the businesses significantly affected by the COVID-19 measures are advisers and law firms, especially those of small size, and their employees and consultants.

On the other hand, given the seriousness of this particular situation, many larger adviser and law firms have formed multidisciplinary teams or set up separate help desks, where businesses and institutions can turn to with legal questions about the impact of the COVID-19 (corona) virus on overall business operations.

[16] For more details, see hiips://stephanmadaus.de/2020/03/15/covid -19-der-gesetzgeber-muss-das-insolvenzrecht-anpassen.

[17] The EU state aid regime allows for some exceptions for state aid in cases to make good for natural disasters or exceptional occurrences, and to remedy serious disturbances in the economy of an EU Member State (Articles 107(2)(b) and (3)(b) TFEU).

[18] See e.g. the German compensation scheme for reduced working hours ('*Kurzarbeitergeld*') and similarly the Dutch '*Noodmaatregel Overbrugging voor Werkbehoud*' (NOW).

In order to promote the use of these helpful instruments, it is suggested that, for those who can afford it, advisers offer the deferral of (preferably mitigated or moderated) fees with special discounts and introduce or extend a pro bono services programme (for instance until 31 August 2020). There is nothing wrong with structurally showing that you are concerned with the fate of many affected by the current measures. So, a call is made to rise to the challenges all (future) clients are facing. After all, the business operations of the advisors and consultants themselves in the long run will benefit that vital companies remain and do not go under.

IV. Conclusion

Extraordinary times require extraordinary measures. Adapting the rules on insolvency law to the specific needs of businesses in the current crisis is a key measure for all Member States. Some already acted, all others should follow soon.

It must be stressed that legislative inaction is not justified and cannot be justified by pointing at the EU level. The EU Commission[19] already indicated that it does not intend to impose restrictions on EU state aid law for COVID-19 response measures. The same should apply to other restricting provision in EU laws, for instance to the deferral of VAT claims in the Directive on the common system of value added tax (2006/112/EC) or to loans for failing businesses under the banking regulations (CRD IV).

Further, Member States should be aware that courts may be available only partially due to lockdown measures for a significant period of time. Relief measures should not put further stress on these scarce resources. In addition, Member States should allow courts to arrange hearing remotely using equipment available to them for online group chats or telephone conference calls. Several national judicial systems have enacted measures of this nature.

All people in Europe face an exceptional situation, a global crisis with major impact on businesses and our society as a whole. European and national legislators are asked to make quick, but adequate decisions in the interest of both the physical and economic survival of their constituency. We are confident that our recommendations contribute to this cause.

Whether the aftermath of the crisis requires additional adaptions in the insolvency, discharge and restructuring frameworks, in particular to address the position of public emergency funding claims adequately, remains to be seen and will be covered by a separate CERIL Executive statement in due course.

On behalf of the Executive of CERIL,

Bob Wessels
Chair

[19] Communication from the Commission to the European Parliament, the European Council, The Council, The European Central Bank, The European Investment Bank and the Eurogroup, Coordinated Economic Response to the COVID-19 Outbreak, 13 March 2020, available at: hiips://ec.europa.eu/info/sites/info/files/communication - coordinated-economic-response-covid19-march-2020_en.pdf.