European Bank
for Reconstruction and Development

# EBRD Covid-19 Response

## Financial Restructuring and Insolvency

## Discussion Paper

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# Executive summary[1]

1. The Covid-19 crisis has had a major impact on economic activity around the globe. Unlike the 2008-9 financial crisis, which originated in excessive bank lending, countries are dealing with a global health pandemic that has caused a crisis in the economy and is expected to spread to banks and the financial markets. Economies in the regions covered by the European Bank for Reconstruction and Development (EBRD)[2] have experienced numerous political and economic crises before, but there is widespread agreement that the scale of the Covid-19 crisis and its global effects are unique. Many national governments and international organisations, including the EBRD, the European Union, the European Investment Bank, the International Monetary Fund (IMF) and the World Bank Group, have announced Covid-19 emergency financial assistance packages.

2. *This paper proposes a number of policy initiatives for the EBRD regions for discussion and analysis and does not constitute legal advice.* These include the following financial restructuring and insolvency policy initiatives to complement the emergency financial assistance being provided by national governments and the international community:

   2.1 *immediate initiatives* to support new financing and co-financing by international financial institutions and national banks through secured transaction reforms that recognise the validity of intercreditor and security agent structures and ring-fence Covid-19 and other new financing from insolvency avoidance provisions;

   2.2 *short-term initiatives* to help small and medium-sized enterprises (SMEs) through the particularly challenging period of financial and operational distress caused by Covid-19. These initiatives will include the provision of integrated legal, business and financial guidance tailored for smaller businesses, including generic advice on how to restructure operations and adapt to remote working and web-based trading; and

   2.3 *medium to long-term initiatives*: (i) to strengthen (pre)insolvency restructuring procedures for all stakeholders, including SMEs; (ii) to improve the efficiency of general insolvency (including liquidation) procedures and the enforcement and sale of secured assets; and (iii) to build stronger bank resolution regimes in countries where these are inadequate to meet the challenge of a future banking crisis.

3. Businesses require breathing space, free from creditor pressure, to deal with liquidity pressures. While this entails the risk of asset stripping and fraud by some businesses, a statutory standstill helps to contain the otherwise uncontrolled impact of Covid-19 on the economy. Some economies in the EBRD regions have suspended enforcement and insolvency procedures or have introduced moratoria on loan repayments. Other countries have relied on forbearance by banks. A lack of emergency legislation can perhaps be attributed to slow national enforcement and insolvency procedures or the relatively low use of such procedures. In many economies where the EBRD operates, debt recovery actions by creditors take years and there is often no market for the assets, further delaying the process.

4. New emergency liquidity is essential for the survival of many businesses hit by the Covid-19 crisis in the EBRD regions and will depend on a combination of support from local banks and international financial institutions. Any lending will be provided in a distressed context, but it will be challenging to ensure that new financing has the super priority status that is generally expected. This is because in some economies, the enforceability of subordination agreements between creditors is uncertain and security cannot be shared efficiently among creditors through a security agent structure. New financing transactions and, in particular, new security granted in favour of such transactions, may also be at risk from insolvency law avoidance provisions that are triggered when a company later enters into a liquidation procedure. Immediate reforms will be needed to ring-fence Covid-19 emergency financing

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[2] The EBRD is present in 38 economies across south-eastern Europe, central Europe and the Baltic states, eastern Europe and the Caucasus and Central Asia: https://www.ebrd.com/where-we-are.html.

and to encourage lending to distressed businesses.

5. The Covid-19 crisis presents a significant risk of the insolvent liquidation of many viable businesses and longstanding damage to the economy. While there have been improvements in national insolvency frameworks since the EBRD began its operations in 1991, insolvency regimes in many countries need strengthening, both in terms of business rescue and overall creditor recovery. This is fundamental to minimising and containing the future effects of the crisis on national economies. Any emergency standstill legislation therefore needs to be followed, in short order, by the more difficult task of insolvency law reform. The EBRD can assist national legislators to meet this reform challenge through its Legal Transition Programme, which has led a number of insolvency and restructuring projects in the EBRD regions, including projects aimed at transposing the new EU Directive 1023/2019 on preventive restructuring in EU member states.[3] Any insolvency reforms will need to strike a delicate balance between safeguarding debtor, creditor and other stakeholder rights in order to support businesses, while at the same time continuing to build a creditor-friendly investment and risk climate that encourages the supply of credit.

6. The crisis has also caused unprecedented levels of consumer debt and financial distress. National insolvency reform initiatives will need to go beyond businesses and encompass natural persons, who have lost their jobs and livelihoods because of the crisis. Some country authorities will need to put in place a statutory framework for consumers to reach an agreement with their creditors to pay all or part of their debts and, for consumers who cannot pay, a regime that allows a full discharge of debts within a reasonable timeframe. Special attention will be required to ensure that individual entrepreneurs, who are often subject to different and more complex rules, are able to restructure and obtain early discharge of their debts.

7. Any insolvency reform projects will need to concentrate the majority of efforts on the implementation and future monitoring of the use of insolvency procedures. Courts closely oversee insolvency proceedings in most economies in the EBRD regions. They have struggled, prior to the crisis, with a lack of judicial capacity, as well as a lack of resources to be able to embrace new technologies. There is, therefore, a risk that courts will be overwhelmed once any emergency standstill or lockdown measures are lifted. Any reform programme should thus focus on the court system and ensure that it can manage insolvency procedures effectively within a reasonable timeframe. A lack of attention to the court system could result in restructuring and insolvency processes that take years to complete and that result in zombie businesses and a drag on economic growth.

8. Countries should consider, as part of insolvency reform efforts, where it does not exist, the introduction of an accelerated insolvency procedure that reduces court involvement and alleviates the burden on the court system. As a minimum, accelerated or simplified procedures should be available for micro and smaller businesses, which have a more basic debt structure. A specialist group of judges with the right expertise, skills and training should manage insolvency cases. Large-scale investments should be made in digital infrastructure to introduce electronic court case management systems and thereby permit the efficient management of court proceedings. This will also add transparency to the insolvency process.

9. In the longer term, the banking sector may also need assistance to recover from the crisis. These may include the recapitalisation of banks. Many bank loan portfolios are affected by Covid-19. The general expectation is that there will be higher levels of distressed loans in the banking sector, including in countries that were already struggling with non-performing loans (NPLs) before the crisis. This demands a coordinated approach to NPL resolution across the EBRD regions, beyond the existing focus of the Vienna Initiative[4] on central, eastern and south-eastern Europe. Strengthening NPL resolution will require improving the efficiency of insolvency, execution and enforcement procedures. Bank resolution regimes in the EBRD regions may also need reforms to make these more robust. Some emerging economies are at risk from weak bank resolution regimes and limited government support to keep the financial system afloat.

[3] https://www.ebrd.com/what-we-do/sectors/legal-reform/overview.html.

[4] See the EBRD website https://npl.vienna-initiative.com/.

# 1. Emergency standstill and forbearance measures

## Background

1.1 Operating restrictions, lower customer demand and difficulty accessing working capital, especially in the tourism, hospitality and retail sectors, have affected many businesses around the world. Some businesses have been ordered to close by governments and others are unable to trade due to disruptions in supply chains. There is likely to be substantial litigation because of the crisis, some of which will turn on whether Covid-19 constitutes a force majeure event.[5] The Covid-19 crisis has created a significant liquidity need for many businesses and has restricted access to finance, as banks stop lending. Where possible, companies have drawn on working capital facilities in full as a precautionary measure. While some governments are offering fiscal stimulus plans in response to the crisis, advisors are already pointing to gaps in the market, in particular for the "squeezed middle" of mid-sized corporate firms not covered by such plans.[6]

1.2 International organisations, such as the World Trade Organization (WTO) and the Organisation for Economic Co-operation and Development (OECD), emphasise that the scale of the problem is unprecedented. According to the OECD, many economies will enter recession.[7] There is even discussion of a global depression. In terms of the economic outlook, the IMF has projected a sharp contraction of the global economy by 3 per cent in 2020, much worse than during the 2008–9 financial crisis.[8] Emerging markets have been dramatically impacted by record high capital outflows and there has been a severe shortage of foreign exchange liquidity. In this context, the EBRD approved on 13 March 2020 an initial €1 billion resilience fund for clients suffering temporary difficulties and confirmed on 23 April 2020 an increase in this emergency response to €4 billion under the broader framework of the 'Solidarity Package 2.0'.[9] The expanded envelope includes funding for policy initiatives to respond to the short-term and long-term consequences of the crisis. Other international organisations are providing similarly large-scale emergency responses. The World Bank Group is providing a $14 billion Covid-19 package, out of which its private-sector development arm, the International Finance Corporation, will dispense $8 billion of financing.

## Emergency statutory assistance

1.3 Many countries have introduced some form of emergency legislation to protect businesses and consumers. But national government responses to the crisis across the world and in the EBRD region have, so far, been uncoordinated. In response to this changing legislative landscape, a number of private-sector players and international organisations, such as the World Bank and the EU, have introduced Covid-19 emergency legislation guides or trackers to record the new measures introduced by national governments.[10] Annex 1 to this paper provides an overview of some of the emergency financial measures that have been introduced for businesses across the EBRD regions and beyond.

1.4 Emergency legislation for businesses has generally included some form of statutory 'standstill' on the exercise of execution and enforcement rights by creditors. A statutory standstill provides businesses with immediate breathing space to assess the impact of the crisis and to minimise that impact. It avoids the complications of businesses having to agree a private standstill with their creditors and buys time for more full-scale insolvency reforms, where these are needed. Countries may stipulate that emergency legislation has retrospective effect, such as in the United Kingdom.

1.5 There have been broadly two main legislative approaches by national governments to the Covid-19 crisis: (i) the *use of emergency standstill legislation* to suspend the execution, enforcement and insolvency procedures, which has been adopted in a number of emerging markets in the EBRD regions, such as Turkey; and (ii) a *combination of emergency standstill measures and temporary insolvency law amendments* to introduce a wider moratorium for businesses in the more mature markets of the United Kingdom and the United States of

5 China issued 4,811 force majeure certificates as of 3 March 2020.
6 See EY "Working together to transmit stimulus - action for today COVID-19", March 2020.
7 http://www.oecd.org/coronavirus/en/.
8 IMF World Economic Outlook, April 2020: https://www.imf.org/en/Publications/WEO/Issues/2020/04/14/weo-april-2020.
9 The total amount of EBRD financial support to be provided by the end of 2021 is estimated at €21 billion.
10 https://www.worldbank.org/en/topic/financialsector/brief/finance-and-covid-19-coronavirus; https://e-justice.europa.eu/content_impact_of_the_covid19_virus_on_the_justice_field-37147-en.do.

America.[11] Other economies in the EBRD regions have relied on banks to show forbearance towards their debtors, overseen by the banking regulator or banking association. This approach has been made easier by the fact that enforcement and insolvency proceedings are typically overseen by the courts and courts have stopped operating in many countries because of the lockdown. This has resulted in a de facto standstill. Another explanation for this approach is that enforcement and insolvency procedures in many countries are very slow and do not always result immediately in action that is detrimental to the debtor.

1.6 A statutory standstill is vital for any emergency financial support provided by government authorities and international financial institutions (IFIs) to SMEs. It helps fulfil the aim of the support by enabling businesses to deploy emergency funding for survival and not necessarily to honour existing creditors. Nevertheless, the scope of any standstill should be carefully defined and drafted clearly to ensure that there are no ambiguities concerning its interpretation. Any standstill directed at SMEs and entrepreneurs, for example, should cover a stay on execution of personal guarantees. Banks often request personal guarantees as part of a security package and these guarantees include the personal assets of entrepreneurs and management of the business.

1.7 Some national governments have restricted the benefit of the statutory standstill to eligible businesses. One approach, such as in Russia, has been to list certain sectors of business activity covered by the standstill.[12] Another approach, such as in the United Kingdom, has been to require the directors of a business to declare by means of a statutory declaration (a formal process that bears sanctions for false statements) that the business is affected by Covid-19. This has the benefit of potentially carving out businesses that do not need a standstill, for example, businesses with a strong and stable cash flow and, in relation to a statutory declaration, may reduce the risk of abuse of the standstill by strategic defaulters. At the same time, directors may need some emergency statutory support to continue trading despite liquidity concerns. A number of national governments in mature markets have sought to limit statutory directors' liabilities for: (i) failure to file for insolvency within the statutory prescribed timeframe (for example, Germany); or (ii) wrongful trading (for example, the United Kingdom) to reduce the risk of management putting a business into an insolvency procedure prematurely to avoid personal liability. An initial assessment of the risks for directors in the EBRD regions presents a mixed picture, with some countries being low risk and others higher risk, depending on the extent to which sanctions for directors are available and enforced in practice.

## Box 1. Scope of COVID-19 statutory standstill affected debts

**Scope of Covid-19 statutory standstill**

(1) *Pre-pandemic debts*, involving a temporary suspension of six to 12 months of execution rights and rights to initiate insolvency procedures, should be covered to allow businesses to re-establish the necessary cash flow to be able to honour their debt obligations and creditors to assess whether the business can remain viable. This may require a business to certify by means of a formal process, which bears sanctions for false statements, that the business is affected by Covid-19 in order for the business to benefit from the standstill.

(2) *Post-pandemic debts*, mainly those resulting from governmental emergency assistance, where applicable, should be expressly included to freeze the financial status quo for all businesses borrowing government-backed loans and suspend all contractual remedies, actions and liabilities arising from such loans, as well as all relevant insolvency, company and accounting laws and regulations applicable to such loans. Protection for post-pandemic debts could be extended to new lending or capital grants from banks and IFIs.

[11] In the United Kingdom, the government announced on 28 March 2020 the future introduction of key measures to protect companies, including new Covid-19 restrictions on creditor winding up petitions, a new interim administration moratorium and protection for directors from wrongful trading actions, in addition to new insolvency legislation to promote preventive restructuring, in line with EU Directive 1023/2019. The United States of America introduced temporary amendments to Chapter 11 under the Coronavirus Aid, Relief, and Economic Security Act signed on 27 March 2020.

[12] On 3 April 2020 the Russian government adopted a resolution, in which it introduced a moratorium on the filing of creditors' petitions for bankruptcy of companies in a specified list of sectors mostly affected by Covid-19, including air transportation, airport activities, road transportation, culture, leisure and entertainment and the hotel business.

# 2. Liquidity and financial restructuring

## New lending

2.1 It is very challenging in the existing environment for banks to identify which businesses to support. The vast majority of businesses require financial support to absorb the incurred losses, restructure and, in some cases, resume operations. Banks will need to make some longer-term assessments regarding the likelihood that a business will continue its operations for classification and recognition purposes.[13] SMEs are particularly vulnerable to the crisis because of their small operating margins and lack of reserves to withstand the downturn in business activity. Furthermore, banks often lack capacity to focus on smaller exposures and some SMEs do not have access to the necessary legal and business advisory support.

2.2 The EBRD and other IFIs are providing fresh liquidity in countries affected by the Covid-19 crisis to meet the short-term liquidity and working capital needs of existing clients and other emergency facilities. Any new lending by IFIs and national banks is in a distressed context and, therefore, requires careful financial and legal due diligence. The level of business distress may be particularly acute in countries where the state has not intervened with fiscal measures, such as loans or commercial paper programmes, to support businesses. Part of any due diligence will therefore be to assess the seniority of any new funding and the insolvency risk, namely the risk that any new financing and security granted in support of such financing may be avoided in a subsequent liquidation of the debtor or third party grantor. Some form of super priority is needed for new money, together with an agreement or a restriction on any funds being used to pay down existing lenders. This requires an intercreditor agreement to govern the relationship between senior and junior creditors, including shareholders, and deals with priority of payments and any existing security rights.

2.3 There are uncertainties relating to the validity of intercreditor agreements in a number of the economies where the EBRD invests, as these have not been tested before the courts or recognised by legislation. There are also unclearly drafted provisions in some countries' insolvency legislation, which could put any new financing and related security at risk of challenge and avoidance in a later insolvent liquidation. This requires immediate reforms aimed at supporting new money-lending procedures. Such reforms will reduce lender risk and encourage more lending to cash-strapped businesses. In the long term, these types of reforms will help lay the foundation for the further development of the lending sector.

## Financial restructuring

2.4 Many businesses need to restructure their debts throughout the lockdown or standstill period and financial restructurings are likely to continue for some time once this period comes to an end. More work needs to be done in the EBRD regions to strengthen national restructuring frameworks and to provide businesses and their creditors with the best opportunities to achieve a restructuring. This means striking the right balance, in the national context, between debtor and creditor rights and carefully considering the incentives for different parties to participate fully in any formal restructuring procedure.

2.5 There are numerous examples of obstacles to financial restructuring throughout the EBRD regions. Some of these obstacles relate to the position of secured creditors and the reluctance of legislators to affect secured rights within a formal restructuring procedure. This can mean that it is impossible, according to a country's legislation, to compromise secured creditor claims as part of a majority creditor-approved restructuring plan. It can also mean that secured creditors are able to enforce their security, despite the commencement of a restructuring procedure and the convention that there should be a standstill on creditor recovery actions, to give the debtor the time and opportunity to restructure. Since many businesses provide security over their assets, the exclusion of secured creditors from the formal restructuring process undermines the goal of achieving a financial restructuring. Where secured creditors are not included, the debtor must instead rely on the individual consent of each secured creditor and the absence of that consent may act as a veto to the restructuring.

2.6 Other obstacles to financial restructuring are the lack of recognition and protection of creditors' rights to participate and influence any formal restructuring procedure. There may

[13] For example, in the EU, the European Banking Authority has recommended that when interpreting IFRS 9, "institutions would be expected to distinguish between obligors for which the credit standing would not be significantly affected by the current situation in the long term, from those that would be unlikely to restore their credit worthiness."

be no rights to amend or propose an alternative restructuring plan to the debtor or to initiate a restructuring procedure. There may be limited rights to approve or raise objections to the insolvency office holder or to receive information from the office holder. The diluted nature of creditor rights in some countries' legislative systems undermines the participation of creditors.

2.7 Weaknesses in formal restructuring procedures are thought to have a knock-on effect on informal, out-of-court restructuring, since there is no credible threat or majority creditor led alternative to a fully consensual deal. The EBRD has supported the introduction of institutional frameworks in both Serbia and Ukraine to encourage the use of out-of-court restructuring. But our experience has taught us that these initiatives, while important, cannot be successful without broader insolvency reform.[14] Parties in many countries also prefer a court-administered process since it provides more legal certainty and protection from third parties. It therefore seems sensible, in response to the Covid-19 crisis, to concentrate efforts and funds on improving formal court-sanctioned restructuring tools and procedures, which can bind all creditors subject to majority creditor approval. This, in time, may encourage more informal, out-of-court restructuring. When designing any formal restructuring procedure, it will be important to ensure that creditors' rights are appropriately safeguarded. There should also be flexibility built into any procedure and the possibility to reach a consensus or pre-agreement among majority creditors prior to any court involvement, in other words a "pre-pack" restructuring. This has the additional benefit of reducing the administrative burden on the court and is likely to be more time-efficient and less value-destructive than a fully court-administered process.

2.8 As part of any reforms to support financial restructuring, particular attention should be paid to the role of the state as creditor. This will require countries to weigh the need to maximise and prioritise tax recoveries in insolvency, and the revenue to the state against the need to help businesses to restructure and the potential loss in revenue to the state for failure to do so. Tax is considered to be a major obstacle to both informal and formal restructuring in many economies across the EBRD regions, since the state typically benefits from priority treatment or protections, including veto rights or limitations on restructuring of state debts and can often be a reluctant decision-maker and participant in a financial restructuring.

2.9 In the European Union, there is now a new standard against which national states must reform their financial restructuring regimes. The EU Directive 1023/2019 on preventive restructuring, published in June 2019, sets a European minimum harmonisation standard for restructuring, inspired by Chapter 11 of the US Bankruptcy Code. The Directive identifies a number of measures and concepts in support of financial restructuring, which are intended to be grafted onto EU member states' national insolvency laws and frameworks[15] (see Box 2). The Directive can therefore provide a useful benchmark for non-EU countries seeking to identify areas for improvement in their legislation. At first glance, many of the elements contained in the Directive appear to be missing from legislative frameworks in non-EU countries in the EBRD regions. Even EU countries need to introduce significant reforms to their national laws to transpose the Directive in full.

2.10 The EBRD's Legal Transition Team is working in a number of EU countries on analysis and assistance related to transposition of the Directive. It has also launched a full assessment of the state of business reorganisation in the 38 economies covered by the EBRD, which will provide a comprehensive insight into the types of reforms that may be needed in different legislative systems. This experience and knowledge may assist other countries in the EBRD regions, including accession countries, to reform their laws related to financial restructuring.

[14] Known as the Consensual Financial Restructuring Law, the institutional OOCR framework adopted in Serbia in 2015 is led by the Serbian Chamber of Commerce and Industry and involves the appointment of a mediator to lead OOCR negotiations. The procedure in Ukraine introduced an administrative body known as the Secretariat to record OOCR cases under the framework and the eligibility of such cases for tax and other incentives under the Financial Restructuring Law.

[15] More advanced concepts in the Directive, such as cross-class cram down, may not be suitable for more emerging economies.

## Box 2. EU Directive: Key financial restructuring concepts

**EU Directive: Key financial restructuring concepts**

- *Linkage* between out-of-court and court-led financial restructuring, as part of an overall supportive financial restructuring framework.
- *Flexible, wide-ranging and time-limited moratorium* capable of review and termination by the court and covering secured, as well as unsecured, creditors.
- *Protection of essential contracts* necessary for the day to day operation of the business.
- *Invalidity of contractual ipso facto clauses* permitting termination of the contract as a result of entry into (pre)insolvency procedures.
- *Ability to determine classes of creditors on case by case basis* and not only according to a limited category of classes set out by statute.
- *Effective cram down* of a minority of dissenting creditors, including secured creditors.
- *Cross-class cram down* enabling one class of creditors, subject to certain conditions, to impose a restructuring plan on (other) dissenting classes of creditors.
- *Protection of new financing*, including a minimum protection from potential avoidance actions by liquidators in an insolvent liquidation procedure.
- *Directors' obligations* to consider the interests of different stakeholders, including creditors during a restructuring and to take steps to avoid insolvency.

## Going concern sales and accelerated insolvency procedures

2.11 In parallel with strengthening financial restructuring frameworks, countries would also be advised to test the fitness for purpose of their insolvency sales and liquidation procedure. An efficient process that enables the transfer of the business as a going concern, free from liabilities, to a new ownership structure is also important since there may be circumstances in which financial restructuring alone does not add value. Subject to appropriate safeguards and competition, the sales process could also be open to existing management, a feature that might be particularly useful for SMEs and entrepreneurs. The sales process could be an option within a financial restructuring procedure or a liquidation procedure.

2.12 Time is of the essence in insolvency proceedings, as lengthy proceedings destroy value. The lockdown period and any closure of the court system may, for some countries, result in the courts resembling the emergency rooms of hospitals. Large numbers of ongoing insolvency proceedings may, if left unaddressed, act as a drag on economic recovery and future growth. Insolvency reform should therefore address the need for faster insolvency procedures to help the insolvency process and recovery from the impact of the Covid-19 crisis. Countries should consider the introduction of accelerated insolvency procedures both for financial restructuring and for the liquidation of businesses. Such procedures may reduce the number and/or duration of steps in the proceedings and may also involve an out-of-court element. As a minimum, an accelerated procedure should be made available to micro and small companies that have a simpler debt structure.[16]

### Implementation support

2.13 Implementation planning and support is critical for any successful legal reform. Many economies in the EBRD regions do not have specialised courts or judicial lists for insolvency cases. This makes it difficult to ensure the quality and the predictability of judicial decision-making, which is so important for investors and businesses. All of the reform measures (to promote financial restructuring, sale of the business as a going concern or accelerated procedures) discussed above should be supported by administrative reforms where necessary and by outreach to and consultation with insolvency stakeholders. The risk of neglecting this aspect is that there is no 'ownership' of the insolvency reforms and that these are not implemented properly or, in the case of new procedures, remain on the statute books, unused in practice. In many countries, insolvency procedures are viewed as liquidation procedures and judges and other stakeholders may have limited experience of financial restructuring. It will be important to ensure buy-in of stakeholders and an understanding of the main concepts and rationale for different types of insolvency procedures.

2.14 As recognised by the EU Directive 1023/2019, judges and insolvency practitioners should have the necessary skills and expertise to increase the efficiency of insolvency procedures. While training can help strengthen these skills, it is difficult to administer and more costly where it needs to be delivered to all of the judiciary. Expertise is developed through practical experience, as well as training. A lack of specialisation of the judiciary in insolvency means that judges will encounter fewer insolvency cases and therefore have less experience and expertise. This issue may be aggravated where insolvency cases are concentrated in a country's major city or commercial centre and the number of cases managed by courts outside that centre are low. Depending on the national context, legislators could require insolvency cases to be managed in one or more courts by an identified list of judges responsible for insolvency cases. It would be essential as part of this process to ensure proper remuneration and the character and integrity of any specialist judges, since specialisation of courts has, in a number of countries in the past, raised issues of abuse and corruption.

2.15 The Covid-19 crisis has highlighted the importance of technology for business. Technology can also play an important and decisive role in future legal reforms in the area of insolvency and restructuring. A major issue affecting many national legislators is the paucity or disparate data on the use of insolvency proceedings and, consequently, the inability to monitor in full the outcome for the debtor business and the return to creditors. Electronic case management systems have been introduced in more advanced jurisdictions, such as the United States of

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16 http://documents.worldbank.org/curated/en/973331494264489956/pdf/114823-REVISED-PUBLIC-MSME-Insolvency-report-low-res-final.pdf.

America and the United Kingdom and are planned for others, such as Germany. An insolvency reform process that embraces technology, through electronic case management systems and data collection, may enable countries to monitor properly for the first time the use of insolvency procedures and will undoubtedly help to inform any future reforms that are needed. Electronic case management systems should improve not only time efficiency, but also the transparency of information flow to stakeholders and, therefore, oversight by stakeholders, including creditors, on the insolvency process.

# 3. SMEs and entrepreneurs

3.1. There is widespread recognition that SMEs are especially vulnerable to the financial crisis caused by Covid-19, due to their smaller operating margins and lack of reserves to survive the crisis without assistance. This vulnerability has been intensified by a lack of digital transformation, a problem which was highlighted even before the crisis.[17] This is a significant issue because social distancing measures implemented to tackle the Covid-19 pandemic have forced some businesses to operate exclusively online. The measures have also made other technical and practical tasks, such as the signing of documents, instantly more difficult.

3.2. Any policy response for SMEs needs to take into consideration the diversity of the SME population and the differences across regions and countries. There is no universal definition of an SME.[18] According to the OECD SME Policy Responses report, banks in many countries have increased credit lines or have introduced new loan programmes to facilitate access to operational funding for SMEs affected by Covid-19. Measures also include increased risk coverage by state-owned development banks for working capital loans channelled through commercial banks. SMEs are at the heart of the emergency Covid-19 response of many IFIs, including the EBRD.[19]

3.3. SMEs need clear policy support to survive the crisis. One aspect of this policy support is the reforms to financial restructuring and insolvency procedures outlined above. As the majority of businesses in the EBRD regions are SMEs, any financial restructuring and insolvency law reform should arguably firstly meet the demands of SMEs and then consider any additional tools needed by larger businesses, which are found in more developed markets and legal systems. Neverthless, when introducing any reforms, national legislators should always consider the burden that a procedure may place on an SME, particularly the financial burden of using a formal restructuring or insolvency procedure. In almost all cases this requires some professional advisory assistance and/or the appointment of an insolvency practitioner and is usually paid by the debtor business. Legislators should also consider SME incentives to use the procedure and whether there are any features that could act as an obstacle or delay to entry. This could, for instance, include requiring the SME to produce a long and complex list of documentation and financial reporting.

3.4. Greater information and accessibility of information is critical for SMEs in the present crisis. In addition to thinking about SMEs as end-users of insolvency systems, legislators and policy makers should act quickly to establish central digital information platforms for SMEs that can help SMEs respond to the crisis and in the longer term (see Box 3). These platforms may contain general advice to SMEs in relation to the crisis and offer other support in the form of practical, step-by-step guidelines on financial and operational restructuring and template documentation, such as a standstill agreement for SMEs and their creditors. This would address, in some part, the lack of professional support that many SMEs experience and would help SMEs analyse their business and contractual position and restructure their operations. In this respect there should be an emphasis on digitalisation and adapting to remote working and online business platforms where appropriate.

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[17] OECD study: *Strengthening SMEs and Entrepreneurship for Productivity and Inclusive Growth*, 24 July 2019.

[18] The term 'SME' is typically defined by national law, although in the EU some assistance and uniformity is provided by Directive 2013/34/EU of the European Parliament and of the Council and the Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises.

[19] https://www.ebrd.com/what-we-do/coronavirus-solidarity.

## Box 3. SME information portal

**SME information portal: Covid-19 and beyond**

- Information should be provided for SMEs in targeted countries on common legal issues arising as a result of the crisis, eligibility for any fiscal stimulus programmes and practical guidance and training related to management (and turnaround) of the business.
- Introduction of guidelines for businesses in financial distress can help guide SMEs, in a systematic way, through the financial and operational restructuring process.
- Advice to SMEs may include: (i) financial reporting to help businesses monitor the situation and impact on their business; and (ii) e-commerce and e-signatures to facilitate the continuation of business remotely and digitalisation.
- Common legal issues arising under SME contracts, such as the application of force majeure clauses and (in)formal dispute resolution solutions, could be included within the scope of advice.

## Individual entrepreneurs and consumers

3.4 There continue to be gaps in the insolvency framework in many economies in the EBRD regions for individual entrepreneurs and consumers, which leaves these groups particularly vulnerable to the crisis. The Covid-19 crisis is an opportunity to close these gaps and to bring some entrepreneurs into the formal sector. In some countries, discharge procedures may either not be available to entrepreneurs or entrepreneurs may be required to go through lengthy proceedings to obtain any debt discharge or may only obtain discharge of their debts after a long period of time. In some countries, entrepreneurs must first go through a business insolvency procedure for business assets and then through a consumer insolvency procedure for personal assets. The EU Directive 1023/2019 requires EU member states to ensure that entrepreneurs have access to at least one insolvency procedure, in which they are able to receive a full discharge for their debts, within a maximum period of three years. It also states that entrepreneurs must be able to access any national business support following such discharge. The EU Directive may, therefore, be a useful benchmark for reforms to support entrepreneurs outside the EU.

3.5 For consumers, the social impact of job losses will be harsher in countries where there is no regime for the discharge of debt of natural persons or where there is significant shame and social stigma attached to financial incapacity. The lack of a legislative safety net and 'second chance' culture in some countries may lead to depression, and potentially suicide, for consumers and entrepreneurs alike. This risk is apparent even in developed markets. In South Korea, a country with one of the highest suicide rates among OECD nations, statistics show that an overwhelming majority of people who consider ending their lives do so due to financial hardship, particularly debt.[20] Some commentators attribute this trend to the higher level of anxiety caused by the 1997 economic crash, during which many people lost their jobs.[21] Further due diligence and analysis is needed to identify the gaps in entrepreneur and consumer insolvency in the EBRD regions and any overlap between the two regimes.

[20] https://data.oecd.org/healthstat/suicide-rates.htm.

[21] https://bpr.berkeley.edu/2017/10/31/the-scourge-of-south-korea-stress-and-suicide-in-korean-society/.

# 4. NPLs

4.1 The immediate strategic focus of the EBRD should be on supporting new financing, in parallel with financial restructuring and insolvency law reform. Nevertheless, banking regulators are likely, at some point in the future, to act to tackle a rise in NPLs in the banking sector. In some countries, where a bank resolution regime does not exist or is inadequate, a government bailout may be needed should the financial position of banks seriously deteriorate.

4.2 The Covid-19 crisis will impair many banks' loan portfolios. Depending on how the relevant banking regulator defines an NPL, there may be a growth in NPLs, as the loan quality deteriorates. NPLs will also accumulate in banks' balance sheets because of an inactive NPL market. The moratoria introduced in a number of countries and uncertainty around state action has reportedly deterred NPL investors.

4.3 At a European level, the European Banking Authority (EBA) has sought to mitigate the impact of Covid-19 on the EU banking sector by postponing an EU-wide stress test exercise for banks to allow them to prioritise operational continuity. The EBA has also called for competent authorities to make full use, where appropriate, of flexibility embedded in existing regulation regarding adequate capital and liquidity buffers.[22] A further EBA statement has specified that public and private moratoria imposed as a result of Covid-19 extend the 90 days past due period and do not trigger an automatic reclassification of any loan under the definition of forbearance.[23] How banking regulators in the EBRD regions will react to the Covid-19 crisis is unclear, but some relaxation in rules related to the classification of loans is likely.

4.4 In addition to regulatory action, the Covid-19 crisis will ultimately require stronger 'legal' NPL resolution tools and procedures for banks to tackle their distressed loans. Slow court processes, low recovery rates and lack of transparency around sale of assets in insolvency and enforcement procedures have historically impeded NPL resolution in the EBRD regions. This is partly due to the high level of court involvement in many countries and the consequential build-up of court cases, together with the lack of digitalisation of insolvency and enforcement proceedings. National governments will need to improve the effectiveness of NPL resolution tools (including financial restructuring, insolvency and security enforcement and execution mechanisms) to operate efficiently at a minimum cost to creditors. Nevertheless, this should be balanced against the systemic impact of many businesses going into formal procedures at the same time. In this context, it is helpful to prepare an NPL resolution strategy covering all legal, regulatory, financial and accounting impediments to NPL resolution as preparation for an action plan to reduce NPLs in the banking sector.

4.5 As mentioned above, the crisis has underlined the vital importance of technology, and in particular, the importance of broadband connectivity and digitalisation in preserving economic and social functioning.Yet, digitalisation of many aspects of the legal infrastructure in countries within the EBRD regions, with a few notable exceptions, such as Estonia, is incomplete or inadequate to meet the challenges of a crisis like Covid-19 and the requirements for businesses to adapt to survive. The EBRD recently concluded a study on enforcement frameworks in countries with high NPLs (Albania, Croatia, Cyprus, Greece and Ukraine). This revealed that many courts do not have electronic court case management systems or well-functioning public auction platforms for the sale of collateral in enforcement proceedings.[24]

4.6 At EU level, the EU Directive 1023/2019 requires EU member states to allow parties to perform certain actions, such as filing claims and notifiying creditors by electronic means. Member states will need to make significant investments into online case management systems, but this investment is expected to produce numerous benefits. These include, not least, the ability of government authorities to monitor insolvency rates of return for creditors and to enable creditors to obtain information more easily on the conduct of the insolvency proceedings. National governments throughout the EBRD regions should promote, where possible, the introduction of digital legal infrastructure in relation to insolvency and enforcement procedures to support NPL resolution.

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[22] https://eba.europa.eu/eba-statement-actions-mitigate-impact-covid-19-eu-banking-sector.

[23] On 25 March 2020.

[24] https://www.ebrd.com/what-we-do/sectors/legal-reform/debt-restructuring-and-bankruptcy/sector-assessments.html.

4.7 In parallel, national governments could consider minimising the role of the court and promoting the use of private enforcement channels. One approach would be to require all enforcement action to be conducted by private bailiffs and to restrict any involvement of the court, including by limiting the rights of appeal of private parties. This would require, however, significant efforts to improve professional capacity and regulation of bailiffs. A proposal for a new EU Directive on credit servicers, credit purchasers and the recovery of collateral 2018/0063 shows that the EU is already thinking in this direction. The proposal would require EU member states to respect the right of commercial parties to agree on the terms of private sale in an enforcement, subject to certain parameters.

# 5. Final observations

5.1 The full scale and duration of the Covid-19 crisis is unknown. However, it is clear that in addition to loss of human life, the crisis will result in significant corporate distress, higher insolvent liquidation of businesses and loss of employment and consumer distress in many countries across the world. Once any temporary moratorium or standstill is lifted, courts may be unable to cope with the high volume of liquidation, security enforcement and execution cases.

5.2 Contingency planning is needed to ensure a smooth exit from emergency measures and a return to ordinary business operations. It is clear that businesses and possibly banks will need support and fresh liquidity to survive this unprecedented and difficult period. Reform of insolvency laws and institutions and support for the SME sector will be critical to reduce the damage to the economy and allow businesses to restart their operations. The state (and the banking regulator in particular) may need to arbitrate between some businesses and banks in sharing the impact of the crisis, as has historically been the case for out-of-court workouts in periods of financial distress, for example in the United Kingdom under the London Rules. This will require a careful balancing act and national strategy.

5.3 Strong secured transactions, financial restructuring and insolvency frameworks are an essential part of the response to the Covid-19 financial crisis. This is the time for national governments to act quickly to address any weaknesses and to protect the economy and society from longer-term damage.

# Annex 1

## Overview of Covid-19 emergency standstill measures

Actions in response to the Covid-19 pandemic cover a wide range of measures, which, despite their identical aim to mitigate the impact of the crisis, are country-specific. The below table aims to provide a non-exhaustive, high level overview of the types of emergency standstill, insolvency, tax, employment and forbearance measures that have been introduced in different countries to support businesses and the economy in response to the Covid-19 crisis, with primary reference to the EBRD region. We note that while temporary emergency measures may be expedient to address the consequences of the crisis, in many areas, such as formal financial restructuring frameworks for viable companies that face temporary difficulties, the crisis has revealed the need for long-term reforms.

The data in the below table reflects information gathered by the EBRD from its network of law firms across the region and from a number of useful websites administered by the EU[25], the World Bank and professional advisers[26]. As the crisis is rapidly evolving, these websites should be consulted for the most up-to-date data.

[25] See EU Comparative Table of Insolvency Related Measures Adopted or Planned for Adoption in Member States as communicated until 16 April 2020: https://e-justice.europa.eu/content_impact_of_the_covid19_virus_on_the_justice_field-37147-en.do.

[26] EY Tax Covid-19 Response Tracker 28 April 2020: https://taxnews.ey.com/news/2020-0600-ey-tax-covid-19-response-tracker; A&O global survey: https://www.allenovery.com/en-gb/global/news-and-insights/publications/covid-19-coronavirus-global-survey-of-moratoria-and-forbearance-measures and A&O interactive map: https://www.allenovery.com/en-gb/germany/news-and-insights/publications/covid-19-coronavirus-measures-impacting-insolvency-proceedings-and-enforcement.

| Options | Core concepts | Scope of application | Jurisdictional examples |
| --- | --- | --- | --- |
| 1. | Defined class of beneficiaries | The Covid-19 lockdown and social distancing measures have disrupted nearly every sector of commercial activity. Nevertheless, there have been different approaches to defining the class of beneficiaries. Some national legislators have defined all businesses as beneficiaries.[27] Others have restricted the class of beneficiaries for certain emergency measures, either by reference to pre-defined, objective criteria or a more subjective criteria based on self-certification by the business: | |
| | | business size, for example, SMEs | Poland and Romania |
| | | business sector, for example, tourism, hospitality or catering services | Croatia and Russia |
| | | affected businesses[28] | Germany and Greece |
| 2. | Term of emergency measures | The duration of any emergency measure has been determined based on the approach of the legislator and/or the type of relief. There is no uniformity of approach, especially with respect to the duration of payment holidays. Payment holidays have varied from an initial period of a few months in some countries to the end of 2020 in other countries.[29] In many cases, there has been a deferral of financial reporting obligations to the summer of 2020.<br><br>Given the difficulties of assessing the timeframe of the crisis, some measures will remain in effect for the duration of the Covid-19 restrictions introduced by the relevant national government.[30] In some countries, the legislator has said that emergency measures and/or legislation will have retrospective effect. | |

[27] The emphasis on businesses and the extent of support offered to business has varied from jurisdiction to jurisdiction.  Some countries, such as Germany and Spain, have focused more efforts on addressing issues faced by consumers.

[28] This is more difficult to implement because it requires an assessment of the business. In some countries, there has been the additional requirement that affected businesses are not defaulting businesses, in other words, businesses that had outstanding payment defaults prior to the crisis.

[29] In Montenegro, businesses have been able to request a payment holiday of 90 days but in Hungary, loan repayments were suspended until end of 2020.

[30] For example, in Ukraine in relation to the law 3275 prohibiting banks from increasing interest rates under loan agreements that was introduced on 30 March 2020.

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| 3(a). | General standstill: suspension of loans/ interest | An automatic, general standstill preventing enforcement by creditors has been introduced, in some countries, by emergency legislation regulating the suspension of repayments under all commercial loan agreements for a defined period. This may apply to foreign lenders who lend regularly, but exclude IFIs, such as the EBRD. | Hungary[31] and Serbia |
| | | Another approach has been to limit the standstill to ordinary interest and default interest payments only. | Bulgaria |
| | | In some cases, the suspension of repayments has only been mandatory for banks when requested by the borrower. | Serbia and Slovenia |
| | | Alternatively, the suspension has been formulated in such a way that borrowers can opt out. | West Bank and Gaza |
| | | Some countries have prevented banks from applying penalties on borrowers for failure to perform obligations under loan agreements.[32] | Kyrgyz Republic |
| | | Emergency standstill provisions have not necessarily prevented the accrual of regular interest on loan repayments. | Serbia |
| | | The banking regulator has played a leading role in some countries in suspending payments by issuing a circular deferring payment of credit instalments (without any late payment interest or commission). | Egypt |

[31] Debtors under credit agreements, loan agreements and financial lease agreements concluded on a commercial basis and already existing on 19 March are granted a payment extension until 31 December. This does not apply to the EBRD, EIB and other international finance institutions since they are exempt from the Credit Institutions Act.
[32] Other countries, such as Ukraine, have prevented banks from raising interest rates on loan agreements.

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| 3(b). | Standstill: restrictions on insolvency procedures | A core emergency measure in many countries and better alternative to the suspension of loan repayment obligations at 3(a). above, has been: | |
| | | introduction of temporary restrictions on the rights of creditors to initiate insolvency proceedings; or | Latvia |
| | | general suspension of insolvency proceedings for a limited period. | Albania and Turkey[33] |
| 3(c). | Standstill: restrictions on enforcement of claims | In parallel with restrictions on insolvency procedures, some countries have suspended debt collection and enforcement procedures. | Albania, Jordan and Turkey |
| | | Other countries have suspended the calculation of interest and penalties in enforcement procedures during the emergency period. | Jordan and Moldova |
| 3(d). | Deferral of court procedural deadlines/ suspension of proceedings | Some countries have deferred procedural deadlines to grant parties to a court process more time. | Ukraine |
| | | In addition to the deferral of court deadlines, courts in some jurisdictions have been suspended for a defined period. | Greece and Jordan |
| | | Courts in other countries have continued to operate, where possible remotely and with judgments rendered in writing. | Latvia |

[33] http://www.paksoy.av.tr/En/briefings.

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| 3(e). | Mandated forbearance by banks | In some countries, banks have been instructed to restructure the loans of businesses, which face repayment problems or to accept the suspension of loan and interest payments for a defined period on application by the borrower. Elsewhere national governments have given banks a certain flexibility to decide on forbearance measures.[34] | Georgia and Cyprus |
| 3(f). | Voluntary forbearance by banks | Other countries in the EBRD regions that have introduced more limited emergency legislation measures for businesses have relied on voluntary forbearance by banks. In some cases, the provisioning requirements have been amended on a temporary basis to enable loan deferrals without penalties. | Albania, Armenia and Poland |
| | | In some countries, the banking regulator has issued guidance on voluntary forbearance by banks or the banking association has announced voluntary forbearance. | Jordan, Morocco and Uzbekistan |
| 4. | Reduction in interest rates | Central banks have reduced interest rates in response to the crisis. In addition, central banks have introduced a number of general regulatory relaxation measures for banks.[35] | Albania and Serbia |
| 5. | Force majeure | A number of civil laws contain force majeure provisions, which can be invoked by a borrower in order to defer its payments under the loan. | Greece |
| | | Some national governments have included the lockdown measures imposed within an illustrative list of force majeure events and have issued confirmatory certificates. | Ukraine |
| | | Other countries have attempted to limit the application of force majeure provisions to the Covid-19 crisis, by requiring additional steps to be taken for a contractual counterparty to declare a force majeure event. For example, counterparties to contracts with businesses (SMEs) may not rely on force majeure clauses without, for example, evidence of a prior attempt to renegotiation of the contract. | Romania |
| 6. | Business premises | Additional emergency measures have included a temporary moratorium on rental payments and a restriction on termination of lease agreements (for certain sectors, for example, hospitality). | Albania and Hungary |

[34] For example, in Bosnia and Herzegovina.
[35] In March 2020, the National Bank of Ukraine introduced certain measures to maintain the stability of Ukraine's banking and financial sectors. These included long-term refinancing loans for Ukrainian banks to support bank lending and liquidity; postponement of banks' stress tests and buffer capital requirements and suspension of on-site audits of banks and financial institutions.

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| | | There have also been automatic reductions in rent for businesses whose operations are mandatorily suspended. | Greece |
| | | Some countries have allowed businesses to defer the payment of certain utilities, for example, electricity, natural gas, water, telephone and Internet. | Romania |
| 7. | Tax relief | There have been various forms of tax relief offered to businesses depending on the country: | |
| | | waiver of certain state taxes on businesses, such as business property and land taxes | Kazakhstan |
| | | introduction of schemes entitling businesses to defer or reschedule payment of tax over a longer period (without sanctions) | Croatia[36], Greece and Egypt |
| | | lower social security contributions (for specific business sectors) | Croatia, Hungary and Egypt |
| | | deferral of corporate income tax return and payment of corresponding liability without sanctions | Romania |
| | | more flexibility around deductibility of unused tax losses. | Poland and Slovenia |
| 8. | Financial support | Financial support for businesses offered by national governments has taken various forms: | |
| | | government backed and guaranteed loans to businesses | Albania |
| | | state advances | Greece |
| | | special Covid-19 credit lines | Croatia |
| | | co-financing, or refinancing, or subsidising interest[37] | Armenia and Lithuania |
| | | preferential loans for companies operating in the country | Bulgaria |

[36] Companies that are affected by the extraordinary circumstances and have a decrease in monthly revenue of more than 20% year-on-year may request an interest free deferral for payment of taxes (VAT excluded) and social security contributions for limited period.
[37] https://www.gov.am/am/news/item/14159/

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| | | entrepreneur, micro and SME lines.[38] | Montenegro, Serbia and Tunisia |
| 9. | Corporate governance | A number of measures have been introduced to help companies navigate this period of financial distress: | |
| | | suspension of directors duties to file for insolvency (including both cash-flow and balance-sheet-insolvency) | Russia and Czech Republic |
| | | suspension of requirements of company boards to convene in person.<br>There has also been a ban, in some cases, on dividend distributions and manager bonuses in some countries to protect businesses and their creditors. | |
| 10. | Financial reporting | Generally, the timeline for financial reporting has been relaxed. Some countries have postponed the submission of annual and/or semi-annual financial statements (often until 30 June 2020). | Albania, Bosnia and Herzegovina |
| | | Other countries have suspended the mandatory external audit of financial statements of medium and large sized companies. | Moldova |
| 11. | Employees | A number of countries have introduced state support to businesses that cover a fixed percentage of the salaries of employees up to a maximum limit for a defined period. | Bulgaria[39] and Serbia |
| | | State support has included, in some cases, an exemption from social security contributions on salary received to preserve jobs. | Croatia[40] |
| 12 | Transition arrangements | Most countries in the EBRD regions have introduced some emergency measures in response to the Covid-19 crisis. Only a small minority have not responded.[41]<br>While the temporary emergency measures outlined above may be extended for the duration of the crisis, countries will need to consider | |

[38] In Turkey, there has been an increase the limits on guarantees provided by the Ministry of Treasury and Finance to a financial institution in connection with loans made to individuals and to legal entities including SMEs by amendment to the Decree on the Treasury Support to Credit Guarantee Institutions.
[39] Companies declaring a decrease in their income of at least 20% as compared to March 2019 are entitled to a salary compensation of up to 60% of the insurable income of their employees for January 2020.
[40] Financial aid to Covid-19 affected employers for HRK 3,250 (approx. €450) for March, HRK 4,000 (approx. €550) per employee per month, for the months of April and May.
[41] For example, Belarus.

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| | | any legislative transition arrangements in parallel with exit from lockdown.<br><br>These may involve a gradual reduction in legislative support in circumstances where full removal of such support would have a devastating effect on businesses and the wider economy. As part of this strategy, the relevant national government may consider the need for further long-term insolvency reforms.<br><br>Transition arrangements will be particularly important in countries where enforcement and insolvency procedures were suspended. Any automatic return to business as usual may result in courts being overwhelmed by the number of proceedings and unable to meet any procedural deadlines. |
| 13. | Insolvency law reforms | To date, no major insolvency law reforms have been announced in the EBRD regions in direct response to the Covid-19 crisis. However, the EBRD is aware of some ongoing legislative initiatives that will likely consider the impact of the crisis. We expect that many national governments will want to review their insolvency legislation as part of a return to normal business conditions. |