YOUNG SMES INSOLVENCY. THEORETICAL CONSIDERATIONS AND POLICY ACTIONS

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Compared with large firms, young SMEs in general are more leveraged and reliant on bank financing and have significantly higher chances to experience insolvency. High SME insolvency reflect in part the deep and prolonged recession that hit young SMEs hard, both through the collapse in domestic demand and the tightening of credit conditions. Despite the declines in sovereign yields, SME borrowing rates have declined by much less and remain high compared with those for large firms. SMEs present a particular set of challenges for restructuring and resolution. Given the large number of SMEs and their small sizes, lower reporting requirements, and heavy reliance on collateral, SME loan restructuring is more costly and riskier for banks than for large firms. If left unaddressed, the problems of SME indebtedness and insolvency pose a risk to the recovery and financial stability. High corporate debt and non-performing loans represent a significant drag on investment, as credit-constrained firms cut back on spending to repay debt. Young SMEs in particular, given their high leverage and lack of alternative financing, are more vulnerable to a growth slowdown or financial distress. SME weakness can in turn undermine banks' asset quality and profitability, constraining banks' ability to provide credit.

Keywords: young SMEs, insolvency, start-ups

1. Introduction

Small businesses today are being variously described as one of the pillars of economy [1] or the engine of growth for any country [2]. Though individually weak in terms of political influence, SMEs sector has emerged as one of the dominant economic players in most developed and emergent economies. Results of the sector therefore has a direct multiplier impact upon the growth of the national economy [3]. SMEs are also essential for a competitive and efficient market [4]. They are competitors of LSEs, offer them complementary services and absorb the turbulence of economy [5]. SMEs are also critical for poverty reduction as they contribute to employment growth at a higher rate than larger firms, and developing a well-prepared service sector capable of contributing to GDP through value addition over a large range of activities [6]. An increased number of SMEs bring more flexibility to the economy, facilitate technological innovation, and provide significant opportunities for the development of new ideas and skills [7]. SMEs are also responsible for generation of a large proportion of the applicable technical innovations in the economy, has the greatest dynamism in the market, make products and services at lower costs than large companies, and prove high flexibility and adaptability to market requirements and changes. In recent years, in many countries and regions of the world, including the European Union, SMEs are the only ones that create jobs. Last but not least, SMEs are seeds for future large companies, especially in new areas of the economy, its top branches based on complex and advanced technique and technology [8].

According to the economist Frank Knight, any true entrepreneur must face the uncertainty of the economic system in which they operate [9]. He stresses, however, that a successful entrepreneur needs capital, which it uses to put in practice profitable ideas. Therefore, innovation and creativity are closely related to the resources they allocate undertaking research - development. Innovation and creativity are the basis for most of the SMEs and especially for young ones. However, some of such start-ups might not succeed. Business failure itself should not bar the entrepreneur from carrying on business activity in any other more viable field of operation. This can be enabled by an efficient insolvency regime which allows the entrepreneurs to close down their business quickly and efficiently. In other words it should enable quick distribution of assets among the creditors so that it can be dissolved and the economic assets deployed in the enterprise redeployed in more viable activity.

Since the late nineteenth century legislation in Romania hardly stimulated entrepreneurial developments. According to current legislation, the entrepreneur is a person or a legal entity authorized individually or in combination with other authorized individuals or legal entities, organized in a company to conduct trade acts [10]. In Romania, a large number of companies are SMEs, they have a significant impact on the stability of the financial system [11]. According to available data, SME sector contributes 65% to GDP [12] and 65-67% to employment [13] while only 15% of loans are granted to SMEs [14]. However, although they have a significant role in the national economy, SMEs face challenges, both of fiscal and administrative nature. Currently, although it should be encouraged by all available mechanisms, SMEs see no tax liability and are suffocated by a policy of encouraging state facing a sharp increase in insolvencies and a high level of indebtedness.

Lack of financing, poor management of financial resources and the inability to pay debts on time oblige more and more entrepreneurs to enter the insolvency proceedings.

Insolvency procedure governed by Law 85/2006[15], is applicable whenever a company does not have sufficient cash funds to pay certain, liquid and payable debts. A debt is certain when its existence is firm, unequivocal, according to Art. 379 al. 3 of C. Proc. Civ. The debt is liquid when it has a has a very firm amount, when the iota is determined by the very act of debt or determined by documents and other erroneous acts emanating from the debtor, being recognized by it, be enforceable under a provision of law or stipulations contained in the act of debt, even if by this determination would require a great expense. A debt is payable when it reaches maturity, so its execution, if not done voluntarily, may be requested immediately by the creditor.

The procedure is set so by law, and its implementation is intended to cause the debtor to pay its debts. At the same time is a procedure that is intended to be equidistant between debtor and creditor, by which parties can choose a good solution for both. Art. 2 of Law 85/2006 provides that the purpose of this act, namely to establish a collective procedure to cover the liabilities of the insolvent debtor. Collective procedure is defined by law as a recognized procedure in which creditors participate together in tracking and recovery of their claims in the manner prescribed by law. The manner by which the purpose of the law is fulfilled are: general procedure of insolvency, the simplified procedure of insolvency, reorganization procedure and bankruptcy procedure, all of which are clearly regulated by law. Insolvency is defined in art. 3 pt. (1) as the state of the debtor's assets which is characterized by shortage of funds available for the payment of certain, liquid and payable debts.

By law, insolvency is presumed to be obvious when the debtor, after 30 days form debt' maturity, has not paid his debt to one or more creditors. Insolvency is imminent when it turns out that the debtor cannot pay at maturity liabilities incurred with the funds available on the due date.

After Romanian accession to the European Union in 2007, the international private law aspects regarding insolvency are mainly regulated by the Council regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings. The Regulation establishes a common framework for insolvency proceedings in the EU. The purpose of harmonised arrangements regarding insolvency proceedings is to avoid assets or judicial proceedings from being transferred from one EU country to another in order to obtain a more favourable legal position to the detriment of creditors. Except for insurance undertakings, credit institutions and collective investment undertakings, the Regulation applies equally to all proceedings, whether the debtor is a natural or a legal person, a trader, or an individual. According to the regulation, the courts with jurisdiction to open the main insolvency proceedings are those of the EU country where the debtor has his/her centre of main interests. This should be the place where the debtor usually administers his/her interests and that is verifiable by third parties. In the case of a company or legal person, this is the place of the registered office, in the absence of proof to the contrary. In the case of a natural person, in principle it is the place where his/her work is domiciled or the place of his/her usual residence.

The number of insolvencies increased continuously in recent years. According to data from the Romanian Trade Register Office [16] the number of bankruptcies recorded in 2013 increased by approx. 2% compared with 2012, when 25.842 cases were registered, and by 23% compared to 2011, according to Coface Romania study [17]. Over 26,000 companies, including large companies could not honor their debts year and had to ask for insolvency, and some of them have ceased activity completely. Four out of ten companies that became insolvent in the first 6 months of 2013 were operating in the wholesale and distribution, construction and trade, and in total 13 843 companies have come into bankruptcy during this period, slightly below the previous year[18].

The Bucharest region fared well compared to previous year, meaning that 2942 companies have problems, down 7% from 3156 in 2012. According to analysis by geographical area, the most affected region in 2013 in terms of evolution, with an increase of 37% compared to 2012 was South West region of the country, with a total of 3.109 insolvent companies from 2.264 in 2012, followed by Center with an increase of 15% from 3.030 companies in 2012 to 3471 the company in 2013. At the opposite is South region with a decrease of 11% in 2013 compared to 2012, from 4164 to 3712 insolvent companies.

In terms of gross number of insolvent companies, most affected regions were South East and North West, totalizing approximately 32% of insolvent companies.

The activities most affected were retail trade, 22% of insolvency cases recorded in this sector, and distribution, real estate developers, construction and manufacturing. These sectors are situated in a relationship of interdependence and thus insolvency problems of companies operating in a particular sector are transferred to the companies it works with.

2. Young SMEs insolvency related challenges

Six years since the global financial crisis, the problems of high levels of corporate debt and nonperforming loans still persist. Nonfinancial corporate debt as a share of GDP rose sharply before the crisis and has come down only slightly from its peak [19]. The pressure on corporates to deleverage has held back investment, which remains well below pre crisis levels [20].

Compared with large firms, young SMEs in general are more leveraged and reliant on bank financing and have significantly higher non-performing loan ratios. High SME insolvency reflect in part the deep and prolonged recession that hit young SMEs hard, both through the collapse in domestic demand and the tightening of credit conditions[21] [22]. Despite the declines in sovereign yields, SME borrowing rates have declined by much less and remain high compared with those for large firms

SMEs present a particular set of challenges for restructuring and resolution. Given the large number of young SMEs and their small sizes, lower reporting requirements, and heavy reliance on collateral, SME loan restructuring is more costly and riskier for banks than for large firms. In many cases, insolvency and out-of-court workout frameworks are ill-suited for young SMEs, limiting the restructuring options, while difficulties in foreclosing on collateral also prevent speedy liquidation and exit. Business survey studies find the legal systems of several European countries to be weaker than those of other advanced economies and a possible contributing factor to their higher levels of insolvency [23].

If left unaddressed, the problems of SME indebtedness and insolvency pose a risk to the recovery and financial stability. High corporate debt and non-performing loans represent a significant drag on investment, as credit-constrained firms cut back on spending to repay debt. Young SMEs in particular, given their high leverage and lack of alternative financing, are more vulnerable to a growth slowdown or financial distress [24]. SME weakness can in turn undermine banks' asset quality and profitability, constraining banks' ability to provide credit. The prevalence of young SMEs in Romanian economy is consistent with macro evidence suggesting that economies with a higher share of young SMEs have fared worse during the global crisis [25].

Addressing the SME debt overhang and non-performing loans can help lay the foundation for a more robust and sustained recovery. Evidence from past financial crises suggests that strengthening bank and corporate balance sheets simultaneously can reinforce them both and allow supportive macro policies to reinvigorate private demand [26].

Given the dominant role of young SMEs in the corporate sector, a policy strategy targeted to the specific challenges facing SME loan restructuring and resolution can help accelerate the balance sheet adjustment and strengthen prospects for a recovery [27].

SMEs face a number of legal, financial, and regulatory challenges to restructuring, some common with other EU counterparts, others specifics for Romania [28].

- Weak foreclosure and insolvency regime. Rehabilitation and liquidation procedures are lengthy, costly, and ineffective; equally, foreclosure is time consuming and expensive, delaying the realization of collateral. These delays and expenses lead to the rapid loss of value for creditors. Courts dealing with insolvency matters are often overburdened and in some cases lack experienced and specialized judges, while insolvency practitioners may lack capacity and proper supervision and clear incentives for successful rehabilitation [29] [30]. As a result, insolvency regime limit the ability to restructure viable businesses and liquidate nonviable ones in a timely and effective manner.
- Banks' restructuring capacity and bank supervision. Many smaller banks in Romania have little experience or operational capacity to restructure debts, especially for young SMEs. They often lack workout units, or such units are either understaffed or under-trained. Some lack the needed capital to recognize losses upfront and engage in voluntary restructuring. Insufficient or different rates of provisioning across banks have also led to collective action problems in restructuring [31]. Bank supervisors may also be slow in forcing creditors to recognize losses and write down bad loans, especially if fiscal resources are limited to address banking distress.
- Nonparticipation of public creditors. Romania suffer from relatively high accumulations of arrears to public creditors, but tax, social security, and public utility often do not participate to the extent necessary in debt restructurings due to legal and political limitations (for example, prohibition

to write down principal or a lack of clear rules of engagement) as well as fiscal constraints. Tax claims have a priority rank (or even a super-priority rank) in insolvency that in the first place may lead to lax tax enforcement and then create little incentive for tax authorities to participate in debt restructuring.

- Regulatory issues form obstacles. Tax disincentives to engage in a restructuring, such as debt forgiveness taxed as income, may also be an obstacle. Overprotective labour laws may prevent meaningful restructuring. Government may also face legal uncertainty to support specific debtors under EU state aid rules.
- Stigma and delays. Insolvency attaches a strong stigma, and business failure, even in good faith, is not socially acceptable. This not only decreases entrepreneurial activity but also leads to business rescues being attempted too late to be effective [32].

Restructuring distressed but viable young SMEs also faces a number of unique challenges [33].

- Lack or inadequacy of a "fresh start" regime. For unincorporated micro and small young SMEs, the treatment of individual defaulters (and in some cases their guarantors) is very severe, leaving full personal liability for many years beyond liquidation of the business. The lack of a "fresh start" for bankrupt owners who have demonstrated good faith in making payments reduces the incentives to seek protection and restructuring within the courts. Some personal insolvency regimes also fail to clearly distinguish between bona fide and fraudulent default, resulting in stricter standards for a fresh start [34]. As a result, progress in reducing unincorporated SME debt through insolvency remains very slow.
- Complex, rigid, and costly insolvency regimes. As recognized by EU reports [35], the complex, lengthy, and rigid procedures, required expertise, and high costs of insolvency often fail to adequately meet the needs of micro and small incorporated young SMEs. Many young SMEs are also owned and operated by families who have pledged their personal assets for business credit. In these cases, the insolvency regime in Romania generally do not well cover the overlap and conflation of business and household assets and liabilities, for example, home mortgages or personal guarantees to cover business debts [36]. As a result, business insolvency may lead to personal insolvency once a business fails, even where the business is a separate legal entity.
- Higher fixed cost to restructuring. Given that most SME lending is secured by real estate or a personal guarantee, banks have a strong incentive in the event of a loan default to enforce the guarantee or initiate foreclosure to realize the security and collect proceeds. Although individual debt restructuring may lead to higher total recovery value, the fixed cost associated with simultaneously restructuring a large number of distressed young SMEs may exceed that of foreclosure, which may be cheaper, faster, and more certain, especially in cases where value of collateral pledged exceeds the loan value.
- Lack of financing. Compared with large corporates, young SMEs are more leveraged and have less access to outside capital. Their high credit risk makes it difficult to secure needed financing for restructuring, including debtor-in-possession financing under insolvency [37]. The lack of reliable SME financial data also makes it difficult to assess their viability and the feasibility of restructuring plans.
- Businesses need efficient and speedy procedures for exit, especially for start-ups. Insolvency procedures help entrepreneurs close down unviable businesses and start up new ones. This ensures that the human and economic resources of our country are continuously rechannelised to efficient use thereby increasing the overall productivity of the economy. This also provides impetus to the entrepreneurs put their innovation and creative ideas into practice.
- The more time it takes to wind-up a business the more the loss in terms of loss of production capacity and loss of value of assets on account of depreciation resulting in lower rate of recovery from the assets of the business. Therefore, efficient insolvency regime will be helpful in controlling that extra cost and ensuring higher rate of recovery
- SMEs framework should provide adequate guidance in restructuring of young SMEs. It must monitor mergers, amalgamations, compromise and arrangement among young SMEs.
- The insolvency framework for young SMEs should address two issues in particular i.e. cost effectiveness and time required [38]. The value of the assets that most of the young SMEs possess is not high. The number of stakeholders is not very large either. Therefore, the cost of insolvency proceeding shall be kept minimal.
- Another important issue is to identify those cases where insolvency is just a farce, intended to defraud the creditors and other stakeholders. Therefore, the legal framework should specifically provide for deterring, detecting and punishing such fraudulent practices.

4. Recommendations

The following recommendations are based on a main principle: simpler and more flexible insolvency system. The focus should be on categorizing young SMEs, possibly differentiating the approach based on business size, turnover, or amount of liabilities rather than number of employees [39], or prioritizing on an especially vulnerable segment. International experience suggests avoiding multiple insolvency tracks by introducing SME specific instruments, but instead establishing simplified process within the current insolvency regime targeted at micro and small businesses and using segmentation primarily by amount of an SME's liabilities (for instance, a cap of young SMEs' liabilities to determine eligibility).

Some key features of modern insolvency law must include a rapid pre-pack in-court approval process, permitting the restructuring of secured and public creditors in insolvency, a temporary stay on all enforcement actions, and meaningful priority and protection for post-commencement financing to enable the financing of working capital [40]. Specifically for young SMEs, the following features are essential:

•Liquidation and foreclosure. For nonviable young SMEs, an efficient liquidation and foreclosure process is essential. Rehabilitating nonviable micro and small incorporated young SMEs (whose liquidation value is higher than their going concern value) makes little economic sense because their assets should be returned to useful economic life quickly to minimize further losses to creditors. In this regard, legal techniques that enable rapid enforcement/foreclosure out of court of collateral such as fiduciary arrangements should be explored [41];

•Simplified SME process. For viable but distressed young SMEs, the goal is to establish a tailor-made simplified process for micro, small young SMEs that would enable their quick and cost-effective rehabilitation. Elements should include a trustee or administrator to closely supervise the process and keep the courts continuously informed, relatively short and strictly enforced deadlines, availability of debtor-in-possession processes, ability to combine personal and business bankruptcy processes and more flexibility to repay administrative expenses [42].

•Fresh start. In line with the European Commission recommendations [43], a debt discharge or fresh start should be afforded to honest entrepreneurs within a reasonable period of time (that is, three years) that strikes an appropriate balance between debt discharge and debt recovery [44].

Many Romanian young SMEs are unincorporated SMEs such as either sole proprietors or partnerships. For these unincorporated young SMEs if they are nonviable with little prospects for recovery, a fresh start through liquidation may be personally, societally, and economically more desirable than rehabilitation.

For young SMEs, out-of-court debt restructuring frameworks, which, with the assistance of a mediator or export enable debt restructuring as consensually, efficiently, and less costly as possible, should be promoted. It is important that out-of-court debt restructuring occurs against the backdrop of or in the shadow of an efficient and robust insolvency law. Out-of-court frameworks are most efficient if they embed features of in-court processes, such as a stay or majority voting. Further, these frameworks should be enhanced by arbitration or government support in the form of an agency that takes the lead in facilitating discussions between creditors and debtors.

International experience suggests that a more active role by banking supervisors can help tackle problems of high non-performing loans while keeping financial stability concerns in mind [45]. In particular with respect to young SMEs, banking regulators should focus on the following issues [46]:

•Collateral. Banking regulators need to ensure the value of any collateral used for the purposes of loan loss mitigation is current and reflects the economic reality. This is of particular importance for SME loans in Europe, as collateral plays a significant role in young SME lending.

•Provisioning rules. Rules should be conservative enough to ensure banks have sufficient reserves to restructure or liquidate individual cases, but also be flexible enough to give banks space to manoeuvre concerning distressed loans.

•Strengthen capacity. Banking regulators need to ensure that banks have adequate operational capacity and expertise to restructure loans in-house. In cases where non-performing loans have reached systemically dangerous levels, regulators should require banks to segregate their management to a dedicated division, establish strong governance structures dedicated to non-performing loans management, and maintain detailed debt resolution strategies and action plans with operational targets. To the extent banks do not have such capacity, it needs to be developed or outsourced to third-party experts.

Government efforts should aim to involve public creditors and remove tax and regulatory obstacles to restructuring.

•Public creditors. All creditors should participate in debt restructuring on equitable terms, and insolvency laws should enable involvement (including being bound to a collective decision) of public creditors. To encourage and enable public creditors (such as tax and social security authorities) to participate in restructurings, consideration should be given to issuing clear guidance to specify the conditions under which public creditors may participate in debt restructuring. A safe harbour could be created in terms of liabilities for officials that apply such guidance in good faith. This would reduce or eliminate (super) priorities for tax and social security claims and avoid weak tax enforcement and undermining incentives of creditors in general to participate in debt restructuring.

•Adequate incentives. The government should actively address issues of competition law/state aid, data protection laws, overly protective labour laws, and tax laws, which may be perceived as obstacles to efficient workouts. In particular, the tax regime should not penalize debt write-offs by making it excessively difficult for creditors to obtain tax relief or by imposing an undue tax burden on debtors. Such work may need to be coordinated with the European Commission to ensure compliance with EU state aid rules [47].

To the extent fiscal space is available, Romanian authorities can explore whether temporary financing needs could be provided through a government fund. Funding mechanisms could include government guarantee schemes, securitizations, and other schemes in collaboration with development banks and agencies, consistent with EU state aid rules. However, such schemes should be administered with great caution as not to prop up nonviable young SMEs or to increase moral hazard. The development of a market for SME debt securitization could also help improve financing for young SMEs [48]. The European institutions could further explore whether European funding sources are available (European Investment Bank, European Investment Fund, structural funds) to further assist young SMEs with temporary liquidity shortages. Also, the government could establish centres that provide (legal and financial) expertise, assistance, or debt counselling to micro and small young SMEs.

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