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Corporate insolvencies in Europe: temporary framework amendments kick the can down the road

EXECUTIVE SUMMARY

The economic consequences of the COVID-19 pandemic are of unprecedented scale in Europe. The double shock of supply and demand has resulted in the halting - at least partially - of production in many companies due to the impossibility for some employees to go to work, and in a fall in consumption¹ because of mobility restrictions. The decline in revenues has deteriorated the liquidity of companies, fostered an increase in payment delays and, ultimately, of illiquidity. In most European countries, the occurrence of a situation of illiquidity compels the director of the company to declare it within a given deadline to the competent authority who will then initiate an insolvency proceeding, failing which he will be held personally liable. However, in order to simultaneously protect the structure and the recovery capacity of their economies once the pandemic is under control, the vast majority of European governments have: 1) implemented measures to support corporate liquidity, such as deferrals (or cancellations) on social security contributions and taxes, or state guarantees on loans granted by banks and 2) temporarily amended the legal framework regulating insolvency proceedings.

Nevertheless, given the magnitude of the economic shock and the temporary nature of these measures, the latter will not prevent a substantial surge in insolvencies once they expire. As a result, insolvencies are expected to rise sharply across Europe in the second half of 2020 and in 2021. Germany, the least penalized country, would still record a 12% increase in insolvencies between end-2019 and end-2021. France (+21%) and Spain (+22%) will be more affected by the crisis. However, the largest increases in the number of insolvencies are expected to occur in the Netherlands (+36%), the United Kingdom (+37%) and Italy (+37%). While the hierarchy regarding the increase in insolvencies is roughly similar to that of growth forecasts, some discrepancies are apparent. In some cases, these can be explained by the lack of temporary amendments to insolvency proceedings (like in the Netherlands). The responsiveness of insolvencies in periods of economic contraction is also linked to the cost of the procedure (lower in the United Kingdom and the Netherlands).



¹ - In its economic outlook report dated 9 May, INSEE estimated the loss of household consumption during the lockdown period in France at 33% compared to a "normal" period.

Many European countries have made temporary amendments to the legal framework of corporate insolvency proceedings to cope with the crisis

From March onwards, in anticipation of the consequences on corporate liquidity caused by containment measures, the governments of the main European economies temporarily adjusted the legal framework for insolvency proceedings. On 16 March, the German government proposed a new law² that suspends the otherwise criminal liability for failure to file when required. There is a temporary suspension of the duty to file for insolvency (usually within 21 days of a situation of illiquidity and/or over-indebtedness) until 30 September 2020 (retroactive to 1 March). If the debtor was not illiquid on 31 December 2019, a rebuttable assumption is established that the insolvency has occurred due to the COVID-19 pandemic. According to the law issued on 27 March, this measure can be extended until 31 March 2021 by a decree of the Federal Ministry of Justice. It also stipulates that creditors cannot initiate insolvency proceedings during the three months following its promulgation (i.e. until 28 June).

On 17 March, the Spanish Government adopted Royal Decree 8/2020, which, during the state of alert, suspends the obligation for company directors to initiate insolvency proceedings within two months of illiquidity. In order to reinforce this mechanism, the Government adopted on 28 April a new Royal Decree (16/2020) that extends this suspension until 31 December. Moreover, until this date, judges will not agree to process petitions for compulsory insolvency proceedings filed by creditors after the state of alert was declared.

In France, ordinance No. 2020-341 dated 27 March established that until the expiry of a period of three months after the end of the state of health emergency, cash-flow insolvencies (i.e. situations of illiquidity) should be assessed in light of the debtor's situation as at 12 March 2020. Furthermore, ordinance No. 2020-596 dated 20 May delimited this provision to 23 August 2020 (included). This means that until 24 August, the company director is no longer obliged to file for insolvency within 45 days of the company becoming cash-flow insolvent,

failing which he normally would have been liable for late filing. At the same time, creditors will not be able to apply for the insolvency of a debtor unless they can evidence a cash flow-insolvency as at 12 March 2020 or fraud on the part of the debtor.

In the United Kingdom, the suspension of the principle of *wrongful trading*, according to which any director who concludes "that there is no reasonable prospect of the company avoiding an insolvent liquidation" must initiate an insolvency proceeding, failing which he will be held personally liable, was announced on 28 March. However, the government only introduced the Corporate Insolvency and Governance Bill on 20 May. According to this bill, legislation on wrongful trading will be suspended until one month after the Corporate Insolvency and Governance Bill comes into force (retroactive to 1 March). During this period, creditors cannot bring winding-up petitions against a company on the basis that it is unable to pay its debts as they fall due, where the company's inability to pay results from the impact of the pandemic on its business (retroactive to April 27). However, a creditor may still present a winding-up petition where they have reasonable grounds to believe that the company would still have been insolvent, even if the impact of COVID-19 on its business were to be disregarded. If the provisions in this bill came into force in June, then these measures would expire in July. However, the bill mentions their possible extension.

In Italy, Legislative Decree no. 23 issued on 8 April 2020 stipulates that, until 30 June, neither the directors nor the creditors of the relevant company may file an insolvency petition; only the public prosecutor's office is empowered to do so (retroactive to 9 March). In addition, the decree suspends, until 31 December, the obligation for directors to recapitalize or, failing that, to put into liquidation any company whose share capital has fallen below the legal minimum.

The Netherlands is an exception in Europe: the government has not implemented any emergency insolvency measures since the beginning of the pandemic. However, it has decided to expedite the legislative process of the reform (presented to Parliament in July 2019) on out-of-court restructuring plans that have the option of both public and confidential insolvency proceedings (*Wet Homologatie Onderhands*

THE LESSONS TO BE DRAWN FROM PREVIOUS EXPERIENCES OF TEMPORARY AMENDMENTS TO THE LEGAL FRAMEWORK ON CORPORATE INSOLVENCY PROCEEDINGS IN EUROPE

Similar measures that suspend the obligation to initiate insolvency proceedings in the event of illiquidity or over-indebtedness were introduced three times in recent years in Germany due to floods. However, unlike the containment measures to control the pandemic, the shock then affected only part of the country and a minority of companies, thus limiting the lessons that can be drawn from these comparisons. In 2002, following the floods that affected the north-eastern part of the country and Bavaria, the obligation was suspended from August to December. However, this did not prevent a 20% increase in insolvencies compared to the last five months of 2001 and versus a 16% increase in the previous semester (Table 1). The effect was also limited in the subsequent episodes in 2013 and 2016-2017, as insolvencies followed the trend of the previous months and no peak was recorded in the next months.

TABLE 1
Annual evolution of the number of insolvencies during periods of suspension of obligations in Germany

Period of suspension	During suspension	6 months before	3 months after
August / December 2002	20%	16%	9%
July / December 2013	-6%	-10%	-7%
June 2016 / March 2017	-7%	-5%	-10%

Sources: National data, Coface

Akkoord: "WHOA"), so that it may come into force on 1 July. One of the reasons for this exception is that the Dutch legal framework does not mention an obligation for company directors to initiate insolvency proceedings. However, creditors do have the possibility to initiate them. Thus, the Government's objective is that, once the new arrangements are effective, the majority of the many challenges expected in this extremely deteriorated economic context will be overcome by restructuring the debt of profitable companies facing difficulties, which then would not be forced into insolvency proceedings in the absence of an efficient restructuring mechanism.

The collapse of the number of insolvencies in France during the lockdown period is misleading

The rapid effectiveness of these amendments to the legal framework for insolvencies has been confirmed by recent developments: in France, the number of insolvencies fell by 72% year-on-year (YoY) in April (**Chart 1**). These figures follow the trend recorded in March, after the implementation of containment measures: the number of insolvencies fell by 88% YoY over the period from 18 to 31 March³ (after -1% in the first part of the month).

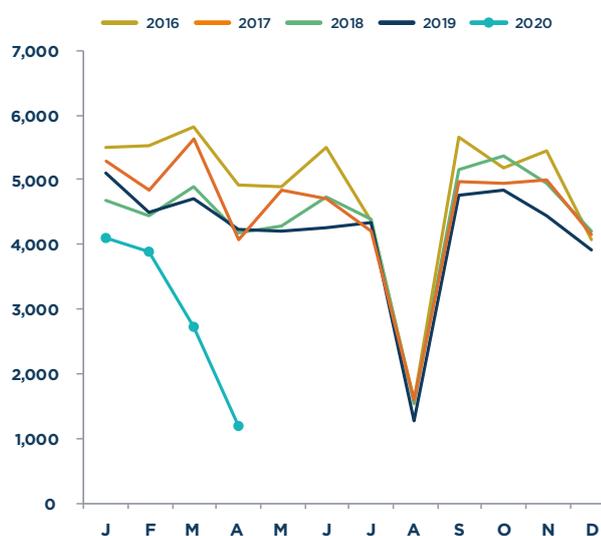
As the opening of an insolvency proceeding has become de facto voluntary, only the most distressed companies, with no prospect of recovery once the health crisis under control, made this choice in the first weeks of lockdown. Thus, between the start of containment and the end of April, fewer than 1,500 companies filed insolvency proceedings, compared to nearly 6,500 at the same period last year. However, this drop in the number of insolvencies is temporary and should be followed by a strong rebound. The latter should happen in several phases when activity resumes: following the expiry of public support measures like short-time work, when the payment of contributions deferred during the crisis is due - for sectors whose deferral will not be transformed into cancellation - or when the suspension of the obligation to declare cash-flow insolvencies expires.

Although the French government has decided to gradually reduce the short-time work scheme (of which the coverage was reduced from 100% to 85% of the compensation paid to the employee on 1 June) and to spread over 36 months the payment of social security contributions deferred during the crisis (to avoid a sudden withdrawal of support measures), a wave of insolvencies seems inevitable in the second half of 2020.

While the size of this wave of insolvencies could be reduced, in France and in the rest of Europe, by extending the measures suspending the obligation to file for insolvency proceedings, it would only be partially postponed to the following year.

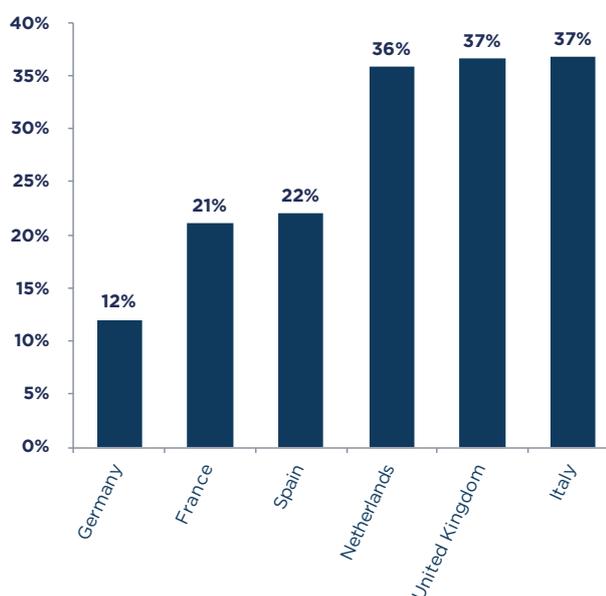
In total, according to Coface's forecasting model⁴, the number of insolvencies in France will have increased by 21% between end-2019 and end-2021 (**Chart 2**).

CHART 1
Monthly corporate insolvencies in France



Sources : Ellisphère, Coface

CHART 2
Evolution of corporate insolvencies by country between 2019 and 2021



Sources : National data, Coface.



3 - Part of this decline may also be attributable to difficulties in the functioning of companies and commercial courts during the lockdown. The ordinance dated 25 March 2020 aims to maintain the functioning of courts during containment.

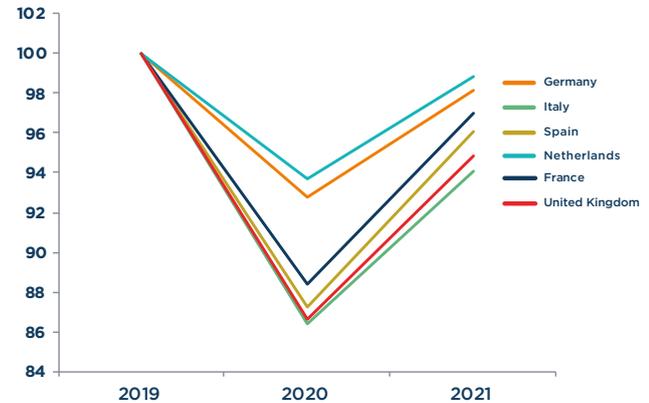
4 - Coface's forecasting model for France includes three variables: "evolution of insolvencies in the previous quarter", "GDP growth two quarters prior" and "evolution of the confidence index in the construction sector in the previous quarter". All are significant within a confidence interval of 97% or more.

Towards a differentiated and delayed growth of insolvencies in Europe, despite the regulatory changes

Similar to France, the extent of the increase in insolvencies expected by Coface in other European countries (**Chart 2**) reflects the fall in GDP in 2020 and the only partial recovery of activity in 2021. However, a comparison between European countries reveals some differences: according to Coface's GDP growth forecasts, the Netherlands and Germany should be the least affected countries, with GDP in 2021 less than 2% lower than in 2019. France and Spain would do worse, the United Kingdom and Italy being at the bottom of the pack (**Chart 3**). The 2021 GDP of the latter would be 5% and 6% lower respectively compared to 2019. The hierarchy in terms of the increase in insolvencies is almost the same, with Germany as the least penalized country and Italy as the most affected country (**Chart 2**). The Netherlands, where the number of insolvencies is particularly sensitive to changes in activity, is the

exception, with an increase in insolvencies comparable to Italy and the United Kingdom, despite a less significant loss of activity.

CHART 3
GDP in volume (100 = 2019)



Sources: National data, Coface.

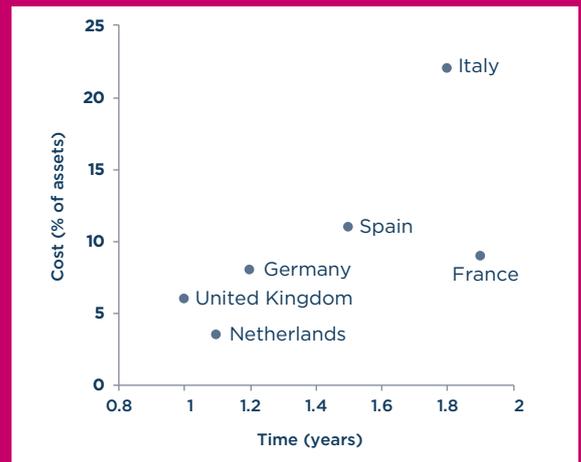
THE SENSITIVITY OF INSOLVENCIES TO ACTIVITY IS DUE TO THE FLEXIBILITY OF THE PROCEDURE

The lack of uniformity in the legal framework for insolvency proceedings at the European level affects the number of insolvencies and thus limits the analysis of their growth. For instance, the insolvency rate is about ten times higher in France and Germany than in Spain, where that of very small enterprises (VSE) is almost nil (0.1%), while that of other companies is relatively similar to France (around 1.5%). One of the specificities of the Spanish legal system that explains this difference is the potential personal cost for entrepreneurs who file for insolvency: since the limitation of their liability is only partial, their personal property and future income can be exposed to the demands of creditors. In order to circumvent the insolvency proceeding, VSEs prefer financing through mortgages (mainly on real estate). In the event of difficulties in meeting payment deadlines, they can sell the mortgaged collateral. The use of this method of financing de facto excludes the vast majority of VSEs with payment difficulties from the number of insolvencies strictly speaking. Beyond this specificity, more broadly, the main barriers to the use of insolvency proceedings are duration and cost (lawyers, court fees, taxes).

According to the World Bank's Doing Business 2020 ranking, insolvency proceedings in Europe are relatively heterogeneous both in terms of duration, ranging from an average of one year in the United Kingdom to almost two years in France, and, above all, in terms of cost (Chart 4). While the cost is 3.5% of assets on average in the Netherlands, or 6% in the United Kingdom, it is 11% in Spain - despite a decline in 2011 following reforms - and up to 22% of assets in Italy. This difference in procedural costs is an important factor for debtors when arbitrating between insolvency proceedings and alternative solutions, such as - for instance in Italy - voluntary liquidation, which is shorter and cheaper as there is no court supervision, resulting in fewer insolvencies in the country. On the other hand, the cost factor may also be decisive in the event of an extreme difficulty: filing an insolvency proceeding or trying to continue business given the cost of the procedure. Thus, the low cost of insolvency proceedings seems to be a fundamental reason for the responsiveness of insolvencies in the United Kingdom and, even more so, in the Netherlands, during periods of economic contraction.

CHART 4
Cost and duration of insolvency proceedings in Europe

Sources: Coface,
Doing Business 2020



5 - K. Ait-Yahia, B. De Moura Fernandes, P. Weil, Coface Panorama: Companies in France: fewer business insolvencies, but still just as many "zombies", COFACE, March 2018

6 - M. Garcia-Posada, J. S. Mora-Sanguinetti, Why do Spanish firms rarely use the bankruptcy system? The role of the mortgage institution, Banco de Espana, 2012

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