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Discharge and Entrepreneurship in the Preventive Restructuring Directive

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Abstract

The European Council adopted the Preventive Restructuring Directive (2019/1023/EU) on June 20th, 2019, that shall be transposed by July 17, 2021, with a possible extension of a maximum of one year for countries encountering particular difficulties in the implementation. The Directive signals a paradigmatic shift in EU policy on insolvency from the traditional focus on cross-border issues. The new Directive puts insolvency squarely at the heart of internal market regulation, following the EU's policy since the Great Recession of 2008 of promoting and strengthening the economy. Since 2016, the European Commission has issued several documents to facilitate insolvency procedures, leading to the recently adopted Preventive Restructuring Directive. Besides restructuring, the Directive promotes the discharge of pre-insolvency debt for entrepreneurs. The Directive does not require that discharge be extended to other natural persons but recommends it. This article discusses the relationship between entrepreneurs and non-entrepreneurs in an insolvency situation and concludes that a fair interpretation of the new Directive requires that the situation of the ordinary person with liability for business debt be closely scrutinised.

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1. INTRODUCTION

Insolvency law[2] found its place in the European Union legal arena during the past ten years. Since the 2008 "Great Recession", insolvency law has become part of the market regulation, as a tool to enhance growth and market efficiency and as an ingredient of the broader stabilisation of the European capital market.[3] Following its Recommendation of 2014,[4] the Commission published a Proposal in 2016 for a Directive on preventive restructuring frameworks, second chance, and measures to increase the efficiency of restructuring, insolvency, and discharge procedures,[5] which

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[2] Insolvency law traditionally refers to all judicial procedures launched by the inability to pay debts and to fulfil obligations as they are due (insolvency), covering all assets and debts of the debtor. Besides traditional bankruptcy, insolvency procedures include business reorganisations in insolvency situations and debt adjustments for individuals and households.

The preference for out-of-court mechanisms, particularly in the context of financial problems of large companies, has increased the importance of these alternative solutions. It is debatable if these restructuring mechanisms should qualify as insolvency procedures, although they are naturally connected to financial difficulties that otherwise might lead a debtor to file for insolvency. How to classify these procedures was one of the issues during discussion of the Insolvency Regulation (EU 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings, Recast). The Regulation included a list of national insolvency procedures; some of these new mechanisms were included (for instance, *preinsolvency procedures* under Spanish Insolvency Law), but others were left out (the case of the UK *schemes of arrangement* is particularly evident). The Directive on Preventive Restructuring and Insolvency may help to include restructuring tools in a broader concept of insolvency procedures.

[3] See Jean-Claude Juncker and others, "Completing Europe's Economic and Monetary Union" (2015); European Commission Communication "A new European approach to business failure and insolvency," COM (2012) 742(http://ec.europa.eu/justice/civil/files/insolvency-comm_en.pdf); European Commission Communication "Entrepreneurship 2020 Action Plan. Reigniting the entrepreneurial spirit in Europe" COM (2012) 795 at 4.1; Communication on the Single Market Act II COM (2012) 573 final at 2.2 key action 7.

[4] Commission Recommendation on a new approach to business failure and insolvency 2014/135/EU; 1500 final; see also European Commission Communication "Overcoming the stigma of business failure—for a second chance policy. Implementing the Lisbon Partnership for Growth and Jobs," COM (2007) 584 final.

[5] Proposal for a Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU; COM (2016) 723 final, including Explanatory Memorandum, available at http://ec.europa.eu/information_society/newsroom/image/document/2016-48/proposal_40046.pdf, In this article, we refer to the Explanatory Memorandum as EM 2016.

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reflected market promotion approach. The European Council adopted the Preventive Restructuring Directive on June 20, 2019.[6] The timeframe for Member States to implement the Directive is July 17, 2021, although those countries encountering particular difficulties in the implementation may use a possible extension of a maximum of one year, according to article 34.2.

The objective of the Directive is to contribute to the functioning of the internal market and remove obstacles to the exercise of fundamental freedoms, in particular the free movement of capital and freedom of establishment.[7]

Inadequate insolvency laws and procedures can unnecessarily destroy economic value. However, insolvency law's potential to promote market efficiency should not be exaggerated and, in any case, what type of insolvency law best promotes market efficiency is debatable. Nevertheless, insolvency law includes important considerations between the substantive rights of the involved parties. In an insolvency situation, the rights of all parties are, by definition, not fulfilled, and the issue is how the losses should be allocated equitably among them. The Preventive Restructuring Directive takes a cautious position on substantial issues, allowing Member States to deviate from several of its articles, which may dilute the Directive's ambitious goals.

This article focuses on the relationship between individual debtors and their creditors according to the PRD. In the spirit of market efficiency, the Directive promotes a fresh

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About the Proposal, see Gerard McCormack, "Corporate Restructuring Law: A Second Chance for Europe?" (2017) 42 ELR 532. See also the interesting policy suggestions included in Lorenzo Stanghellini and others, *Best Practices in European Restructuring* (Wolters Kluwer – CEDAM 2019). During the preparations for the Directive on Restructuring and Insolvency, a comprehensive comparative study of insolvency laws in the Member States was done by a group based at the University of Leeds. See Gerard McCormack, Andrew Keay, and Sarah Brown, *European Insolvency Law: Reform and Harmonization* (Edward Elgar 2017).

[6] Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (also referred to as PRD, Preventive Restructuring Directive or Directive).

[7] Dir 2019/1023/EU Prelims (1).

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start for a debtor who is an entrepreneur.[8] The call for a "second chance" for entrepreneurs has been part of the EU's policy of promoting small enterprises since 2008, under the initiative of the Small Business Act.[9] The discussion on discharge[10] has shifted from the classical social policy discourse that dominated European discussions in the 1990s and 2000s[11] to one of market efficiency.

Conflict between the rights of the debtor and those of the creditors is inherent to insolvency law. The rationale of insolvency law is to strike an equitable balance between the rights of the parties. A creditor's right to payment is the basis of other rights, including rights *vis á vis* other creditors, such as access to enforcement, priority before other creditors, and the right to participate in proceedings. However, the right to payment cannot be enforced at any cost but must be balanced against the basic rights of the debtor, especially when the debtor is an individual rather than a company, due to the role played by human dignity and human rights in this context.

Very formalistic views of bankruptcy tend to ignore the rights of the debtor, focusing instead on the division of property among creditors. In this viewpoint, insolvency is only a tool to maximise the return to creditors, whose interests are the driving force for insolvency regulation. Such an approach was common in Europe in the 19th and

[8] PRD recital (21), which states that it is "advisable" for Member States to extend discharge to consumers. Article 1(4) states that Member States "may extend" discharge to natural persons who are not entrepreneurs.

[9] European Commission Communication "'Think Small First' A 'Small Business Act' for Europe," COM (2008) 394 final. The recommendation to grant discharge to honest but unsuccessful debtors within three years has been consistently repeated in insolvency documents since 2012. See, e.g., COM (2012) 742, at 3.2 and 4 (n 2).

[10] This article uses the term "discharge" as an equivalent for "debt relief" or any other modification of debt releasing the debtor from personal liability totally or partly. Discharge usually follows from a court order releasing the debtor from personal liability. See generally Udo Reifner and others, *Overindebtedness in European Consumer Law. Principles from 16 European States*.Schriftenreihe des Instituts für finanzdienstleistungen Band 15. (Books on Demand: Norderstedt 2010).

[11] See e.g., Joint report by the Commission and the Council on social inclusion COM (2004) 7101, at 79. The social policy reasoning, however important, has only been part of the different motivations for the extension of discharge on the continent. Responsible credit and avoidance of strategic behaviour in debt collecting by creditors also played a relevant role. See Jason Kilborn, "Two Decades, Three Key Questions and Evolving Answers in European Consumer Insolvency Law: Responsibility, Discretion and Sacrifice" in Johanna Niemi, Iain Ramsay, and William C Whitford (eds), *Consumer Debt & Bankruptcy* (Hart Publishing 2009), 310 ff.

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20th centuries and is still present in some jurisdictions.[12] The basic question of whether insolvency law should be "creditor friendly" or "debtor friendly" has inspired extensive academic discussion.[13]

Acknowledging debtor's rights has recently become more important in the regulation of the company restructuring, but it has particular relevance for debtors who are natural persons. This view has influenced the attention on the insolvency of over-indebted individuals, which, in recent decades, has become common throughout Europe.[14]

Due to its market efficiency approach, the PRD limits debt relief harmonisation to entrepreneurs. This article analyses how limiting the scope of application may thwart the stated goals of the Directive and discusses the issue of fairness; if discharge is only accessible to entrepreneurs, it excludes others who are responsible for business debt. The possible impact on access to credit for small businesses and the intended goal of promoting entrepreneurship are also discussed.

EU legislation has not abandoned the trend to enhance discharge for individuals. The PRD also includes a recommendation to extend discharge to other natural persons, i.e., individuals who do not fit into the notion of entrepreneur. Thus, the limitation to entrepreneurs may be more a question of policy tools than policy principles.

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[12] For example, the German Insolvency Act now in force expressly states that the purpose of insolvency proceedings is to satisfy creditors using assets of the debtor and distributing the proceeds or, alternatively, achieving an agreement on a payment plan (§1 Insolvenzordnung 5.10.1994 BGBl. I S. 2866, in force since 1.1.1999). However, elements to protect debtors have been added to the law, including the possibility to discharge.

[13] The "friendliness" of insolvency law (either for debtors or creditors), however, is far from being a clear dividing line, but rather a continuum in which certain elements are stronger than others. Wood and Frouté classify friendliness according to, for example, how strong a position the secured creditors have. The stronger the rights of secured creditors, the more creditor-friendly the system. See Philip Wood, Principles of International Insolvency (Sweet & Maxwell 2010), 3–8; Philippe Frouté, "Theoretical Foundation for a Debtor Friendly Bankruptcy Law in Favour of Creditors" (2007) 24 EJLE 201, 202.

However, from the point of view of individuals as debtors, the right to discharge was initially introduced into English law during the 1700s and has been stronger in Anglo-Saxon countries than in Continental Europe. See Linda Elizabeth Coco, "Beyond Failure and Forgiveness: The Debtor's Place in American Fiscal Identity, Bankruptcy, and Capitalism" (UC Berkeley 2011), 43.

[14] For the most recent review of national insolvency laws in the EU, see McCormack, Keay, and Brown (n 5). See also Jason Kilborn and others, 'The World Bank Report on the Treatment of the Insolvency of Natural Persons' (2011). For academic assessments before the global financial crisis of 2008, see Frouté (n 13), 203.

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Part 2 of this article will discuss the new view of EU competence in insolvency law, examine what the upgrading of fundamental rights in the EU law should mean in the context of personal insolvency and presents the contents of the Preventive Restructuring Directive and, in particular, the discharge provision for entrepreneurs. Part 3 discusses current entrepreneurship as the background for EU policy and describes the experiences in tackling this issue of two nations that have recently (2013–2014) adopted reforms regarding the discharge of debt arising from the entrepreneurial activity of natural persons (Spain and Finland).[15] Part 4 will discuss the problems arising from EU policy and the wording of the PRD. Part 5 summarises the conclusions.

2. THE DEVELOPMENT OF EU LAW AND INSOLVENCY

2.1. A shift in European Union competence and principles on insolvency

The PRD alters the basis for the EU's competence in insolvency. The Directive grounds the EU's competence in the market integration as conferred in articles 4, 53 and 114 of the Treaty on the Functioning of the European Union (TFEU). This modification is a paradigmatic shift since the EU's competence for insolvency matters was previously based on cross-border cooperation and regulation of jurisdiction, limiting the scope of EU insolvency regulation to cross-border issues and putting special requirements on legislative procedure within the EU.[16] Consumer insolvency (consumer bankruptcy/ debt adjustment), in contrast, has been discussed in the EU as a social problem or a consumer protection matter, but no binding EU legislation has been enacted to date.[17]

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[15] For a comprehensive review of European insolvency laws on this matter, see McCormack, Keay, and Brown (n 5), 303 and Thomas Kadner Graziano, Juris Böjars and Veronika Sajadova (eds), *A Guide to Consumer Insolvency Proceedings in Europe* (Edward Elgar 2019).

[16] The Amsterdam Treaty in 1999 widened the EU's competencies in this regard and, soon after, the first Insolvency Regulation (1346/2000) was adopted. After Lisbon (2009), the EU's competence was regulated in art 81 of TFEU, and the Insolvency Regulation was renewed in 2015 (848/2015). The essence of the Regulation remained within cross-border cooperation but particular attention was paid to the definition of "insolvency procedure" due to the problems arising from the growing number of pre-insolvency procedures in Member States (refinancing-restructuring mechanisms).

[17] The EU has, however, commissioned several studies on consumer over-indebtedness. See Reifner and others (n 10); Nik Huls, Udo Reifner and Thierry Bourgoinie, *Overindebtedness of Consumers in the EC Member States: Facts and Search for Solutions.* (Kluwer 1994); Observatoire del'Epargne

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The significance of the EU's new approach towards insolvency cannot be overstated. Harmonised insolvency law has been subject to debate but never adopted as an EU policy.[18] An insolvency framework, however, is one of the most salient legal tools of an integrated market, as historical experience shows.[19] It remains to be seen whether the PRD is a first step towards a more complete harmonisation of national insolvency laws in the EU.

In personal insolvency, the Court of Justice of the European Union (CJEU) anticipated the shift in the basis of EU competence in 2013 in Radziejewski, a case concerning international jurisdiction in insolvency procedures for private individuals[20]. The decision placed debt adjustment law squarely within the purview of EU law, holding that insolvency laws granting too narrow of access to debt relief can be in breach of the fundamental right to freedom of movement in the common market if residence were a condition for discharge:

> 31 It must be held that national legislation […]which makes the grant of debt relief subject to a condition of residence, is capable of dissuading an insolvent worker […]from exercising his right to freedom of movement.[21]

According to Article 114 of TFEU, market regulation is within the ordinary legislative competence procedure of the EU. Articles 26 and 27 guide EU bodies in the

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Europeene, Centre for European Policy Studies and Personal Finance Research Centre, 'Towards a Common Operational European Definition of Over-Indebtedness.' (European Commission 2008).

[18] See a summary of the evolution on this subject in Klaus Pannen and Susanne Riedermann, *European Insolvency Regulation: Commentary* (Klaus Pannen ed, De Gruyter 2007), 8 ff.

[19] The key points in the history of US bankruptcy law are the adoption of the Bankruptcy Clause in the US Constitution in 1788 and the enactment of the first permanent Bankruptcy Act in 1898. This history is well researched; see e.g., David Skeel, *Debt's Dominion: A History of Bankruptcy Law in America* (Princeton University Press 2001). The unification of Germany is also a salient example, see Johan Thieme, 'Zur Entstehung Der Konkursordnung' in Wilhelm Uhlenbruck, Bernd Klasmeyer and Bruno Kübler (eds), *Einhundert Jahre Konkursordnung, 1877-1977* (1977)..

[20] Mr. Radziejewski was a Swedish national residing in Belgium since 2001 after he was employed by a Swedish employer. In 2011, he applied for debt relief in Sweden, but the application was rejected because Mr Radziejewski was not resident in Sweden and the procedure in Sweden (*skuldsanering*) was only applicable to Swedish residents. The referring court asked the CJEU whether the residence requirement could prevent or deter a worker from leaving Sweden to exercise his right to freedom of movement and were therefore contrary to Article 45 TFEU.

[21] C-461/11 Radziejewski v. Kronofogdemyndighet. See Johanna Niemi, "Consumer Insolvency in the European Legal Context" (2012) 35 JCP 443.

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development of the internal market to ensure balanced progress and respect for the differences in the development of various national economies, very material concerns within a novel area for EU law, such as insolvency.

Besides Article 114 TFEU, the EU's competence derives from Article 53 of TFEU, which specifically notes the position of self-employed persons in the internal market, providing for the ordinary EU legislative process in the coordination of their pursuit of activities.

The EU competence is governed by the principles of subsidiarity and proportionality (TEU art 5). In line with these principles, PRD sets the minimum standards on insolvency law, respecting the subsidiarity principle.[22] In the preparation of the Directive, the perspective on these paramount principles was that of financing and sources of investment, which were not considered relevant for debtors other than entrepreneurs.[23] The impact of this restrictive view on both entrepreneurs and others close to them is, however, problematic in many ways.

2.2. The role of the EU Fundamental Rights Charter

The shift in EU competence for insolvency matters opens the door for considerations of fundamental rights, which have gained a foothold in EU law since the adoption of the EU Fundamental Rights Charter (FRC) in 2000, later elevated to the level of Treaties by the Lisbon Treaty of 2009.[24] The FRC is binding law only in the application of EU law by the EU or national institutions, not in purely domestic legal issues. In the context of regulating the internal market, EU fundamental rights also become part of the applicable EU law and play a substantial role in the interpretation of the PRD.

The analysis of the fundamental rights in insolvency law traditionally gives primacy to the property rights of creditors. The human and fundamental rights framework does not address insolvency or over-indebtedness directly, but the growth in over-

[22] PRD recitals (12), (42) and (100).

[23] EM 2016 (n 5) , at 15-16.

[24] Treaty on the European Union, art 6.1.

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indebtedness of individuals and households has drawn attention to social rights as human rights that are relevant for the position of over-indebted debtors.[25] A holistic approach to human rights reinforces the view that an overwhelming debt burden may be considered a human rights issue.[26]

Article 16 of the FRC on the right to conduct business, in accordance with EU and national laws, also opens the door for recognising the fundamental rights aspects of the insolvency of an entrepreneur.[27] This provision sets clear limits to automatic or excessive prohibitions to conducting business after a bankruptcy, which have been characteristic of, and still remain in, some insolvency laws. Additionally, article 15 of the FRC recognises the right to work, pursue an occupation and seek employment. The regulation of debt collection and insolvency are germane to the exercise of these rights not only for entrepreneur debtors but also for private debtors.

In addition to specific rights, the principle embedded in the human and fundamental rights framework, according to article 1 of the FRC, is respect for human dignity.[28] It is not implausible to argue that a lifelong debt burden and rigorous debt collection and enforcement are incompatible with respect for human dignity.[29] In the Biblical

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[25] While the focus here is on the FRC, Ondersma has made a comprehensive analysis of the human rights framework in relation to discharge. See Chrystin D Ondersma, "A Human Rights Framework for Debt Relief" (2014) 36 U Pa J Int'l L 269. See also Johanna Niemi-Kiesiläinen and Ann-Sofie Henrikson, *Legal Solutions to Debt Problems in Credit Societies*, A Report to the Council of Europe. Juridiska Institutionen, Umeå Universitet 13/2006 34.

[26] The relevance of human rights to the protection of over-indebted individuals does not necessarily mean that protection should be offered through insolvency provisions, namely discharge. Other public policies may serve that purpose (e.g., social policies, subsidies, etc.). See Ondersma (n 25), 276. Social safety nets and generous insolvency policies for individuals may be seen as counterbalancing policies, Robert M Lawless and Elizabeth Warren, "Shrinking the Safety Net: The 2005 Changes in US Bankruptcy Law" (2005), 2.

[27] Insolvency Recommendation 2014/135/EU (n 4) recital (19) refers to the freedom of creditors to conduct business and their right to property. See also EM 2016 at 19.

A recent study by the fundamental rights agency of the EU, however, does not mention insolvency regulations. See the report of the Fundamental Rights Agency, *Freedom to conduct a business: exploring the dimensions of a fundamental right* (2015).

[28] Reference to human dignity is included in the Council of Europe Recommendation CM/Rec (2007) 8 of the Committee of Ministers to member states on legal solutions to debt problems, at 3(b), the first European soft law document to refer to discharge. See Ondersma (n 27) 319.

[29] During the past decades, several European scholars have discussed the ethical, economic and legal underpinnings of discharge of overwhelming debt burden. See e.g. Jukka Kilpi, *The ethics of bankruptcy*

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tradition, the Deuteronomy 15:2 tells the creditor to give relief to its debtors every seventh year. The secular tradition in Europe has not been that generous. Rather, poverty and lack of means are addressed with the means of the welfare transfers. In this vain, FRC article 34 recognises the right to social security in the face of social risks, such as unemployment.[30] Article 5 prohibits excessive cruelty of debt enforcement in the form of servitude and forced labour. These articles make a powerful argument for enacting means of alleviating overwhelming debt burden.

An adequate balance also requires consideration to the rights of the creditors. The Explanatory Memorandum to the PRD refers to the right to property in FRC article 17, albeit in relation to restructuring, not to discharge.[31] Considerations of the right to property are applicable with respect to both the debtor's right not to be unjustly deprived of its property and to creditors' rights to enforce their property rights. The fact that the real value of the creditor's claim may be small or null at the time of insolvency does not undermine the weight of this right in principle. The basic balance that legislatures need to strike in personal insolvency law is between the creditors' right to property and the debtor's right to dignity. The difficulty of achieving this balance can be seen in the provisions of the Directive regarding derogations, which expressly state that discharge rules may be affected by a debtor's behaviour that is detrimental to the legitimate interest of creditors.[32]

The right to a fair trial, recognised in FRC article 47, including the right to a public and fair hearing in an independent and impartial tribunal, which is elaborated on in article 6 of the extensive jurisprudence of the European Court of Human Rights

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(Routledge 1998); Thomas J. Jackson, *The Logic and Limits of Bankruptcy Law* (Harvard University Press 1986); Jacob Ziegel, "Facts on the Ground Reconcialiation of Divergent Consumer Insolvency Philosophies" (2006) 7 *Theoretical Inquiries in Law* 299 Johanna Niemi, "Personal insolvency". In Howels Geraint, Iain Ramsay and Thomas Wilhelmsson (eds), *Handbook of Research on International Consumer Law*, 2nd ed. (Elgar 2010) p. 363-380.

[30] Other human rights documents have more specific articles on social security. The European Social Charter (revised in 1996), a Council of Europe document, ties the level of social security to the European Code of Social Security (art 12). The specific trait of this treaty is that it allows states to pick and choose the articles they wish to be bound by. Art 12 is one of those nine articles from which a state must choose at least six. Part III, A.

[31] EM 2016 (n 5) at 19.

[32] That includes, for instance, the violation of obligations in the repayment plan, including that of "maximizing returns to creditors" art. 20.2 (a) or when derogation is necessary to "guarantee the balance between the right of the debtor and the rights of one or more creditors" PRD art. 20.2 (f).

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(ECtHR), is also pertinent to the design of insolvency proceedings and must be addressed from the debtor's and the creditors' perspective, the latter not only towards the debtor but also among the creditors and the different classes of creditors.

2.3. Directive on Preventive Restructuring and Insolvency

2.3.1. Goals and tools

The Preventive Restructuring Directive puts insolvency into the domain of the internal market regulation, in particular, the capital market. According to recital (1) of the Directive, its objective is "to remove obstacles of fundamental freedoms, such as the free movement of capital and the freedom of establishment." The Explanatory Memorandum that accompanied the draft Directive in 2106 emphasised the promotion of the capital market and framed its main objective as "to reduce the most significant barriers to the free flow of capital stemming from differences in Member States' restructuring and insolvency frameworks."[33] Furthermore, the aim was to "increase investment and job opportunities in the single market, reduce unnecessary liquidations of viable companies, avoid unnecessary job losses, [and] prevent the build-up of non-performing loans,"[34] especially during cyclical downturns, which should reduce "the related negative impact on the financial sector."[35] The protection of investors and the finance sector was identified as one of the aims of the Directive more emphatically than the antecedent documents.[36]

The different envisaged measures are grounded on the idea that the lack of harmonisation in insolvency law is a relevant shortcoming and "a higher degree of harmonisation in insolvency law is thus essential for a well-functioning single market

[33] EM 2016 at 5. The relationship between insolvency, restructuring and discharge and a better functioning of capital markets appears also in the recent progress update on this matter by the EU Commission, see "Capital Markets Union: progress on building a single market for capital for a strong Economic and Monetary Union" (COM(2019) 136 final), of 15 March 2019, 1 and 6.

[34] EM 2016 at 2 and 5. See also PRD art 4.1 and recitals (2)(3)(4).

[35] EM 2016 at 3.

[36] E.g., Commission recommendation on a new approach to business failure and insolvency (2014/135/EU).

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and a true Capital Markets Union."[37] Divergent insolvency laws and uncertainty about insolvency rules are seen as disincentives to cross-border investment within the internal market (e.g. PRD recital (15)).

However, the PRD has taken an ambivalent approach towards harmonisation. Its provisions mostly state what types of provisions should be included to the national insolvency laws but refrains from giving guidelines on their content. This flexibility allows different means of implementation by Member States, easing the adoption and implementation of the Directive. As stated in the Explanatory Memorandum, "the focus […] is on the addressing of most important problems that could be feasibly addressed through harmonisation."[38] Therefore, the Directive does not intend to harmonise "core aspects of insolvency" as substantive areas of national law, where the diversity among Member States makes intervention unadvisable. This intention is emphasised by the fact that several articles of the Directive allow Member States to opt out of a suggested measure or add additional conditions to a measure. The Directive therefore contains only minimum standards. This undermines the harmonisation effect, because many substantial elements, such as the "likelihood of insolvency" as the entry condition for restructuring in article 4.1, are not defined. This, added to the directive model, may lead to a tepid result in terms of harmonisation. [39]

The promotion of efficiency of the legal framework for insolvency and restructuring, as the leitmotif of the Directive, is divided into two main trajectories: early restructuring and a second chance for entrepreneurs. This latter, which is the focus of this article, may be identified with the discharge of debt by a private entrepreneur. A common framework on this matter would help to "increase the opportunities for honest entrepreneurs to be given a fresh start."[40] The second chance provision also aims at promoting investment because "evidence shows that shorter discharge periods have a positive impact on both consumers and investors, as they are quicker to re-enter the

[37] EM 2016 at 2.

[38] EM 2016 at 6.

[39] See Nicolaes WA Tollenaar, "The European Commission's Proposal for a Directive on Preventive Restructuring Proceedings" (2017) 5 Insolvency Intelligence; Horst Eidenmüller, "Contracting for a European Insolvency Regime" (2017) 341.

[40] EM 2016 at 5.

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cycles of consumption and investment”[41] and because a failure should not stigmatise nor compromise future activities.

2.3.2. Discharge for entrepreneurs

Article 20 of the PRD sets forth the important principle of discharge for entrepreneurs and the duty of the Member States to include it in their legislation. The goal, according to article 20.1, is to ensure that insolvent entrepreneurs have access to full discharge. Such measures include the end of any disqualification for discharged entrepreneurs[42] and a bar to national frameworks for business support, per articles 22 and 20.3, respectively. According to article 23, these benefits should be limited to honest debtors, so the Member States are encouraged to define access requirements to limit discharge to debtors in good faith.[43] The broad qualification of dishonesty, as described in the recitals of the Directive, provides for the Member States an ample discretion.[44]

According to article 21, the length of the discharge period should not exceed three years after the confirmation of a payment plan or, in the absence of such a plan, after the opening of the procedure. The maximum period may be extended only under “well-defined circumstances and where such derogations are duly justified.” Article 23.2 includes an exemplification of these justifications, such as violating the requirements of a payment plan or other obligations towards the creditors, not complying with the information or cooperation obligations, a repeated application for discharge, and failing to cover the costs of the discharge procedure. Moreover, according to article

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[41] EM 2016 at 4; PRD recital (15).

[42] Professional disqualifications, however, can be longer according to article 23.5.

[43] PRD, recitals (1)(78)(79)(38); EM 2016 at 6–7.

[44] PRD, recital (79) lists circumstances that may be taken into account in defining dishonesty: the nature and extent of the debt; the time when the debt was incurred; the efforts of the entrepreneur to pay the debt and to comply with legal obligations, including public licensing requirements and the need for proper bookkeeping; actions on the entrepreneur’s part to frustrate recourse by creditors; the fulfilment of duties in the likelihood of insolvency, which are incumbent on entrepreneurs who are directors of a company; and compliance with EU and national competition and labour law.

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23.2(f), a State may prolong the discharge period or restrict access to discharge if it is necessary to guarantee a balance between the debtor and one or more creditors.

Furthermore, per article 23.4, a longer discharge period and further restrictions to discharge may concern secured debt, criminal penalties and related obligations, tortious liability, maintenance obligations, and debts incurred during the discharge procedure.

According to article 23.3, a longer discharge period is specifically allowed if the main residence of the debtor is excluded from realisation[45] or protective measures have been implemented to safeguard the assets for the trade, business or profession.

As mentioned above, the PRD does not require but only recommends the Member States to enact discharge for other than entrepreneurial debtors.[46] However, article 23 includes a requirement to coordinate entrepreneur discharge with private debt discharge. It remains to be seen whether this article will be interpreted so that there is a requirement to include a discharge procedure for private debtors in national laws. This conclusion will also be supported by the CJEU's position in Radziejewski.[47]

3. ENTREPRENEURS AND INSOLVENCY

3.1. The role of debt relief in the promotion of entrepreneurship

Entrepreneurship has taken a central place in contemporary discourse on the invigoration of the economy.[48] In the third quarter of the 20th century, neoclassical economists predicted the obsolescence of entrepreneurship in favour of economies of

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[45] The rationale for this provision is the importance of the protection of a homestead. However, the usual relative value of that asset should be paid. See Nuria Latorre Chiner, "El Discharge y La Propuesta de Directiva Sobre Reestructuración Preventiva y Segunda Oportunidad" (2018) Revista de derecho concursal y paraconcursal 65 11.

[46] PRD, recital (21); PRD Article 1.4 has a more restrictive wording, allowing this.

[47] C-461/11 Radziejewski v. Kronofogdemyndighet; see note 21-22 and accompanying text.

[48] See OECD, 'Financing SMEs and Entrepreneurs 2017: An OECD Scoreboard. Highlights' (2017); Patrice Muller and others, 'Annual Report on European SMEs 2014/2015' (2016). Critically about small firm rhetoric, see Charlie Dannreuther and Lew Perren, "Uncertain States: The Political Construction of the Small Firm, the Individualisation of Risk and the Financial Crisis" (2013) 37 Capital and Class 37.

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scale, but this discourse has been eroded by the evolution of the market.[49] As manufacturing has increasingly transferred to countries with lower working costs, the gross domestic product (GDP) deriving from small firms and entrepreneurs has continuously increased in developed countries,[50] reflecting the shift from economies based on manufacturing to ones based on knowledge.[51] Hence, start-ups, such as innovative small firms working with IT applications, are valued, and investors look for promising ones. For example, SLUSH, a forum for start-ups and investors, who promise not only money but also mentorship, has gathered some 1,500 venture capitalists and 2,600 start-ups in Helsinki annually in November.[52] The EU has taken an active role to support start-ups and help them grow with a plethora of initiatives advanced in the Commission Communication *Europe's next leaders: the Start-up and Scale-up Initiative*.[53]

The penchant for start-ups also reflects changes in the labour market. Many salaried occupations, such as factory work, have become less common.[54] Often, entrepreneurship is promoted as a new chance for laid-off workers.[55] In many sectors of the economy, such as cleaning, construction and domestic care, new ways of organising work have evolved, subcontracting work that used to be done by salaried positions. In response, new terms emerge: *gig workers* or *gig economy* reflects the need to define these new scenarios where long-term employment relationships are replaced by short-term contracts with independent contractors.

This kind of entrepreneurship is not limited to manual labour. Many academic professions, such as editing, translating and journalism, are increasingly shifted into

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[49] See Iain Ramsay, *Personal Insolvency in the 21st Century. A Comparative Analysis of the US and Europe* (Hart 2017), 174.

[50] See Muller and others (n 51).

[51] See John Armour and Douglas Cumming, “Bankruptcy Law and Entrepreneurship” (2005) 300.

[52] http://www.slush.org/.

[53] COM 2016/0733/final.

[54] World Economic Forum, The Future of Jobs Report (2018).

[55] Entrepreneurship and self-employment are often used as synonyms. See, for instance, the methodology used for the empirical analysis in Armour and Cumming (n 54).

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self-employed contracts. Indeed, the border between entrepreneurship and salaried work is waning when self-employed professionals work solo for a few clients and each contractual relationship resembles an employment relationship without the benefits of salaried work, a challenging situation for legislators.[56]

Self-employment is more flexible than traditional work contracts, and it can be beneficial for both the employee and the employer. Often, however, self-employment can be a kind of "forced entrepreneurship" in rigid labour markets with high unemployment rates when the *employer* does not offer the option of an employment contract despite the intrinsic labour nature of the relationship. In addition, solo entrepreneurs seldom have the capital nor the resources to success by themselves. Family often gets involved, either with a contribution in kind or with an economic investment. Personal credit and guarantees often finance small-scale entrepreneurship.[57]

Entrepreneurship also includes the risk of failure. Many new enterprises fail within a few years, a challenge to any policy promoting innovative entrepreneurs.[58] The relationship between bankruptcy rules and entrepreneurship has been researched to some extent.[59] Personal bankruptcy rules may be more relevant than corporate law in

[56] In Spain, those economically dependent on one client, who pays at least 75% of their income on a regular, personal and direct basis have access to some rights traditionally reserved to employees, like certain paid leaves, under the Law 20/2007, of 11 of July.

[57] This includes personal earnings or savings, borrowing from friends or relatives, using a credit card in their name, guaranteeing business debts, or pledging a house or other personal assets as collateral, see Robert M. Lawless, "Striking Out on Their Own: The Self-Employed in Bankruptcy" in Katherine Porter (ed), *Broke: How Debt Bankrupts the Middle Class* (Stanford University Press 2012), 110.

[58] The concomitance between entrepreneurship and failure are often omitted by the narrative praising entrepreneurship (Robert M. Lawless, (n 63), 101 109). Newly founded firms, created by the self-employed, have survival rates of typically between 30–60% after the first five years. See European Commission, "Annual Report on European SMEs 2016/2017" (2017), 75 ff.; European Commission Communication, "Overcoming the stigma of business failure—for a second chance policy. Implementing the Lisbon Partnership for Growth and Jobs," COM (2007) 584 final, 3. The probability of failure increases in innovative activities, where the survival rates of new entrants are smaller. David B Audretsch, "Innovation, Growth and Survival" (1995) 13 Int'l J Indus Org 441.

[59] E.g., K Ayotte, "Bankruptcy and Entrepreneurship: The Value of a Fresh Start" (2006) 23 JLE&O 161; Wei Fan and Michele J White, 'Personal Bankruptcy and the Level of Entrepreneurial Activity' (2003) 46 Journal of Law & Economics 543.

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this context[60] because discharging debt after the failure of a business may mitigate the risk involved in entrepreneurship and stimulate the willingness to opt for self-employment, creating an insurance effect.[61] Consequently, alleviating risk is useful for new economic models in which the initial investment and risk are transferred to the *entrepreneur*, such as Uber. More lenient discharge procedures also serve to lessen the stigma of failure as a disincentive to entrepreneurship.[62]

The rigour[63] of access to discharge may affect entrepreneurship in two opposing directions.[64] First, easier access to discharge makes entrepreneurship more attractive for individuals. Ignoring other factors, such as cultural attitudes towards failure,[65] the possibility of benefitting from discharge lowers risk-aversion, which may increase the number of projects and stimulate risk taking. A consequence, however, may be that more lenient rules stimulate project abandonment and therefore increase the number of failures.[66]

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[60] See Douglas Cumming, 'Measuring the Effect of Bankruptcy Laws on Entrepreneurship Across Countries' (2012) 16 Journal of Entrepreneurial Finance 80; Michelle J White, 'Economics of Corporate and Personal Bankruptcy Law' (2014) and Michelle J White, 'Corporate and Personal Bankruptcy Law' (2011) 7 Annual Review of Law and Social Science 139.

[61] As traditionally conceptualised by neoclassical economic theory, Iain Ramsay, "Between Neo-Liberalism and the Social Market: Approaches to Debt Adjustment and Consumer Insolvency in the EU" (2012) JCP 435, following Barry E Adler, Ben Polak and Alan Schwartz, "Regulating Consumer Bankruptcy: A Theoretical Inquiry" (2000) 29 JLS 585.

[62] See Sharon A Simmons, Johan Wiklund and Jonathan Levie, "Stigma and Business Failure: Implications for Entrepreneurs' Career Choices" (2014) 42 Small Bus Econ 485, 488.

[63] See an effort and some limitations in Armour and Cumming (n 54) 310. The effect may relate also to exemptions of assets from bankruptcy, as shown in many studies. See e.g., the effect of the so-called homestead exemption in Fan and White (n 65) 563.

[64] See Armour and Cumming (n 54); Michelle J White, "Bankruptcy and Small Business—Lessons from the US and Recent Reforms" (2006) CESifo DICE Report 22.

[65] A negative view of failure is often referred to as a powerful deterrent for starting a business. See Joachim Wagner, "Taking a Second Chance: Entrepreneurial Restarters in Germany" 1.

[66] These effects may be globally positive in sectors where risk taking should be high to obtain significant outcomes for the projects but less so in others. Augustin Landier, in "Entrepreneur and the Stigma of Failure" (2005), proposed a model that differentiated conservative and experimental equilibria to study the global welfare effect of the connection, showing a trade-off between the ability to start new projects, the level of destruction and quality of failed projects, and entrepreneurs. The conservative model includes a high stigma for failure, but in experimental models, entrepreneurship was only slightly affected by stigma. Thus, experimental equilibrium provides a better environment for high-tech

Alternatively, easier access to discharge may have a negative effect on the supply of credit. Banks and investors, such as venture capitalists,[67] may be less willing to finance entrepreneurs because individuals would have more incentive to engage in high-risk projects and less incentive to do their best in order to repay loans. Rigorous bankruptcy law can serve as a filter for low-quality projects and provide an incentive to lenders and investors to risk their money in new projects.[68] Available data show that entrepreneurship quantitatively correlates to the existence of discharge in national bankruptcy rules[69] and positive effects of discharge outweigh negative effects on access to credit.[70]

3.2. Discharge and entrepreneurship at the national level

While national legislatures have recognised the precarious situation of small entrepreneurs at the verge of and in insolvency, regulation has proved challenging. Generally, EU Member States have introduced procedures that make the discharge of excessive debt for individuals possible, but the conditions and discharge periods vary. For entrepreneurs, the regulations are even more incoherent since access to bankruptcy may be limited to merchants or traders, including or excluding professionals. However, discharge does not necessarily follow from a bankruptcy procedure in several European countries.[71] While most debt relief procedures for individuals are open to

industries. Stigmatisation can be a consequence of social perception, but it is also induced by the restrictions of discharge.

[67] Venture capital is a common form of financing entrepreneurs in new technologies, where other sources are less attractive, see Armour (n 69) 91.

[68] See Armour and Cumming (n 54) 8. Also in John Armour, "Personal Insolvency Law and the Demand for Venture Capital" (2004) 5 EBOR 87 111.

[69] See Frank M Fossen, "Personal Bankruptcy Law, Wealth, and Entrepreneurship-Evidence from the Introduction of a 'Fresh Start' Policy" (2014) 16 ALER; Seung-Hyun Lee and others, "How Do Bankruptcy Laws Affect Entrepreneurship Development around the World?" (2011) 26 J Bus Venturing 505 516. Figures on the effect vary, however, partly due to the different methodological approaches (e.g. Armour and Cumming (n 54) 337 show that moving from not permitting a fresh start to granting them increased the average rate of self-employment by 3.9 percent). See also Lee and others 515.

[70] See the references in Armour and Cumming (n 54). Somewhat different conclusions on the US exemptions see Fan and White (n 65); White (n 71).

[71] For instance, several countries offer immediate discharge if no payment plan is possible (Belgium and Poland) while others offer discharge in proceedings different from bankruptcy (i.e., Austria, France, Denmark and England, among others). See Kadner Graziano, Böjars and Sajadova (n 15) 17 ff.

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persons who have ceased business activities, having on-going or new business may exclude an entrepreneur from access to such procedures.[72]

How the different Member States have approached this issue is not covered here, but two examples are presented because they provide valuable insight into the problematic relationship between discharge and entrepreneurship.[73] First, Spain provides an example of the complex connection between personal insolvency and discharge and how the rules have evolved towards a non-discriminatory approach for individuals. Second, Finland is noteworthy not only because of its detailed regulation but also because the Organisation for Economic Co-Operation and Development (OECD) has rated the Finnish system as the best among the OECD high income countries in resolving insolvency;[74] therefore, it may serve as a role model for future regulations.

3.2.1. Spain: entrepreneurship as the rationale for granting discharge

Spain was one of the last European countries to include discharge provisions in its national law[75] in 2013, precisely as a consequence of promoting entrepreneurship.[76] Although discharge was also applicable to non-entrepreneurs, important distinctions were made based on whether individuals were currently engaged in business activity.

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[72] See McCormack and others (n 5) 303.

[73] A broader, extensive, and delicate analysis on personal insolvencies and discharge in the European context may be found in two recent contributions: McCormack and others (n 5) and Kadner Graziano, Böjars and Sajadova (n 15). See also the critical analysis in Jan-Ocko Heuer, "Rules and Norms of Consumer Insolvency and Debt Relief: A Comparison and Classification of Personal Bankruptcy Systems in 15 Economically Advances Countries" (University of Bremen 2014).

[74] World Bank: https://www.doingbusiness.org/en/rankings?region=oecd-high-income. For a fascinating review of the critique of the WB rankings see Gerard McCormack, "Why 'Doing Business' with the World Bank May Be Bad for You" (2018) 19 EBOR 649.

[75] See about the causes in F Javier Arias Varona, 'Financial Crisis in Spain and Consumer Protection in the Absence of Special Rules for Consumer Insolvency' (2013) 2 ff. at http://dx.doi.org/10.2139/ssrn.2569160 and F Javier Arias Varona, "Spain" in Juris Bojars, Thomas Kadzner Graciano, and Veronika Sajadova (eds), *Consumer Insolvency Proceedings in the European Union and Switzerland: A Comparative Study* (2019).

[76] Law 14/2013 of September 27, 2013, that amended Law 22/2003, of Insolvency (SIA). The external influence of international institutions in the context of the 2008 crisis, however, should not be dismissed, as highlighted by Susan Block-Lieb, "Austerity, Debt Overhang, and the Design of International Standards on Sovereign, Corporate, and Consumer Debt Restructuring" (2015) 22 Ind J Glob Legal Stud 1. The position of the IMF was particularly relevant: Country Report nr. 13/245 recommended giving proper consideration to the introduction of discharge.

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Although the Spanish legislature did not use the term "entrepreneur," references to individuals with business activities, particular attention paid to them and quantitative limits to access the procedure point to a functional equivalence of the subjective scope. While later amendments decreased the differences between entrepreneurs and consumers, some still persist.

The 2013 amendment of the Spanish Insolvency Act (SIA) led to the creation of a two-path system, premised on the differentiation between individuals engaged in business activity and those with no such activity, identified as consumers.

An out-of-court payment agreement procedure[77] was designed to avoid the impoverishment and frustration that can inhibit "the entrepreneur [from starting] a new project."[78] The access was originally limited to individuals engaged in business.[79] The rule was later amended in 2015 to make it available to every individual with less than five million euros in debt. However, differences between entrepreneurs and non-entrepreneurs still persist in procedural deadlines, qualifications of mediators, exempted fees, contents of the agreements, and consequences of failing to reach an agreement.

Despite concerns about their efficacy, out-of-court payment agreement procedures are commonly used. According to the available data, the procedure was accessed around 1000 times in 2016, and it affected slightly more than 1300 individuals, both with and without business activity. To put these figures in context, the number of ordinary insolvency procedures for individuals in 2016 was 882 out of 4,754 total declared insolvencies. Critics argue that reaching an agreement through the out-of-court payment agreement procedure is unlikely, mainly due to the scarce interest of

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[77] The out-of-court payment agreement is a mediation procedure that cannot affect secured or public law debts. It requires the appointment of an insolvency mediator, who acts as a facilitator for the agreement. The agreement ultimately leads to a payment that shall not include debt moratoria lasting longer than three years and write-offs greater than 25% of every claim. To be approved, a plan requires a basic majority of 60% of the amount of debt or higher, depending on the extent of the compromises for creditors (art. 238 SIA).

[78] Law 14/2013 of September 27, 2013 Preamble (II).

[79] Several negative requirements must be met, according to art. 231 SIA, but the analysis of them is not necessary for the purpose of this paper. There are filters to avoid abuse or to exclude debtors in bad faith.

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creditors. Nevertheless, it may be useful for the debtor; filing the petition starts a three-month stay on creditors' actions, including secured claims if the collateral is their home or an asset necessary for business activity.[80] The stay is not extended to personal guarantors.

The differentiation between individuals with (entrepreneurs) or without (consumers) business activity, in force between 2013 and 2015, had an additional consequence. Discharge in a subsequent formal insolvency procedure depended on the use of this pre-insolvency mediation procedure. This dependence restricted the most favourable version of discharge to entrepreneurs.[81] Once the differentiation was eliminated, discharge no longer depends on the classification of the debtors.

A specific protection for entrepreneurs with solvency problems, the "entrepreneur with limited liability" (*emprendedor de responsabilidad limitada; 2013*), is a legal figure in itself. This particular tool is aimed at protecting the primary residence of individuals engaged in business or professional activities, that could be excluded from creditors' claims up to a certain maximum value. The limited scope of debts affected by this protection makes it in practice applicable only to small providers' claims, and the data show it garners scarce interest.[82]

In conclusion, Spanish law has evolved to provide tools to help insolvent entrepreneur debtors, but limitations in the model limit its effectiveness for both entrepreneurs and non-entrepreneurs.

3.2.2. Finland: a specific procedure for insolvency of entrepreneurs

Finland provides an example of a rather advanced version of debt adjustment for entrepreneurs. In 2014, the Finnish Debt Adjustment Act (DA) was amended to

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[80] See art 235 SIA.

[81] A more complete explanation of these differences may be found at the following site: http://www.creditslips.org/creditslips/2014/03/discharge-yesbut-how-much.html.

[82] See Fernando Gomá Lanzón, "El Emprendedor de Responsabilidad Limitada, Un Ejemplo Más de Derecho Inútil" https://hayderecho.com/2013/10/09/el-emprendedor-de-responsabilidad-limitada-un-ejemplo-mas-de-derecho-inutil/ accessed Jan 10, 2020; Jesús Alfaro, "De Leyes Perversas y Legisladores Bondadosos" (2013) 51 El Notario del Siglo XXI; Antonio Roncero Sánchez and Juan Ignacio Peinado Gracia, "Otro Ejemplo de Derecho Inútil: El Emprendedor de Responsabilidad Limitada" (2016) 8720 Diario La Ley.

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include new provisions allowing for the discharge of a private entrepreneur's business debt. This Act is one of three insolvency laws,[83] and its focus is on private debtors (consumers).

The aim of the new provisions for entrepreneurs is to allow for adjustment of a debt that derives from an unexpected event in either private or business activity.[84] Before the amendment, the DA already recognised the need to adjust a private debt if the entrepreneurial activity was profitable. For example, an entrepreneur could experience severe losses in a housing transaction that did not affect business activity as such. Section 45 of the new regulation seeks to help entrepreneurs whose situation is comparable to that of wage earners. Primarily, it is aimed at entrepreneurs who have encountered an unexpected misfortune that has led to a major loss of income, a large increase in debt, or an interim break in business.

The idea of the regulation is that the entrepreneur can resume normal business activities after the debt adjustment. Thus, debt adjustment is designed for those whose businesses can survive the procedure; that is, a debtor whose business makes a profit when the operating costs of the business and the living costs of the debtor and dependent family are deducted (profitability criteria). The business must be small scale.[85] The entrepreneurs may even take out new loans, on the condition that they can repay them.

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[83] The three acts are the Act on the Adjustment of Debts of a Private Individual (DA 57/1993 or Debt Adjustment Act), the Restructuring of Enterprises Act (ReA 47/1993), and the Bankruptcy Act (BA 120/2004). Together, they prescribe a path system in which the BA aims at liquidation, the ReA to business restructuring and debt relief, and the DA to discharge of private household debt. The Acts are available in English at www.finlex.fi.

[84] Government Bill 83/2014 31 69–70.

[85] The legislative drafts provide no specific criteria for considering whether the business is at a "small scale". The typical case is, however, a business which is run by a single person alone. The purpose of the law is that the scale-criteria shall be decided case by case and not, for example, only by the revenue, the balance sheet total, etc. (although they must be taken into account as parts of the comprehensive assessment). See the Government Bill 83/2014 68-69.

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During the Parliamentary hearings, a new requirement was added: the bankruptcy comparison (the best interest of creditors test). It states that a court may not confirm a debt adjustment plan if bankruptcy would yield a better outcome for creditors.[86]

In practice, the procedure relies on professional help. A state-funded enterprise, the Finland Helpline, was implemented to find an economic advisor to make an initial assessment of the debtor.[87] If the case seems to fulfil the solvency test and specific conditions of the DA, the debtor may file a debt adjustment claim in court. When the court opens the proceedings, a trustee is appointed.

The number of filings by entrepreneurs was around 150 during the first two years; of these, only a handful led to successful debt adjustment and confirmation of a payment plan. The profitability of the business was the most common obstacle to plan confirmation.[88]

There is also a fast track option for creditors with 80 per cent total debt if all the creditors with more than five per cent of total debt agree on adjustment.[89] In the normal procedure, the court hears from the creditors, but they do not vote. The court confirms a payment plan, which normally lasts for three years.

The preparatory works for the amendments of DA systematically underline that wage earners, the self-employed and small entrepreneurs are in similar situations when facing financial distress. In fact, despite relevant differences (entrepreneurs may have more control over their business), many small entrepreneurs are in comparable situation to wage earners. Their income may be (relatively) stable and book keeping

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[86]Report of the Law Committee of the Parliament 12/2014.

[87] https://www.suomi.fi/instructions-and-support/support-and-assistance/information-on-enterprise-finland-telephone-service.

[88] The number of filings, as well as the information about the most common obstacle to confirm a plan, has been received from the Enterprise Finland Talousapu counselling service, held by the Centre for Economic Development, Transport and the Environment, see https://www.suomi.fi/services/phoneservice/enterprise-finland-talousapu-counselling-service-centre-for-economic-development-transport-and-the-environment/1e2d4b82-36d7-4fa8-bdd6-4c5b46afc6bb.

[89] DA 38a § (1123/2014).

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accurate considering that their income may come from one source or on one account since the Finns usually pay by debit and credit cards.

Finally, the recognition of small entrepreneurs and self-employed persons in insolvency law is an important principle. If the system works, at least for a small group of debtors, it may provide a basis for further developments in insolvency law.

4. DISCUSSION

4.1. Conceptual (un)clarity

The concept of entrepreneur originates outside the law. It is an ambiguous concept even in social science and economics, with references to innovation, risk taking, opportunity identification, and value creation. Thus, its translation into a legal rule with the necessary legal certainty is difficult.[90]

The PRD identifies entrepreneur as “a natural person” engaged in business or professional activity (“trade, business, craft or profession”).[91] First, it should be acknowledged that the definition is not clear about many forms of precarious work. For example, it does not necessarily cover persons who have work contracts with more than one employer.

Another concern with this definition is how national legislatures ought to interpret the term “natural person.” Of course, discharge refers to individuals. However, the definition does not limit *how* entrepreneurs exercise their activity. It is customary to think that the use of a legal entity (incorporation) is somehow contradictory to the notion of an entrepreneur.[92] This limitation, however, is not present in the wording of the Directive.

Many small entrepreneurs incorporate a legal entity, typically a small company with limited liability. The use of small companies by entrepreneurs is well known and

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[90] See Armour and Cumming (n 54) and Ramsay (n 52) 176.

[91] PRD art. 2.1(13).

[92] See Charles J Tabb, 'Bankruptcy and Entrepreneurs: In Search of an Optimal Failure Resolution System' (2019) 93 Am Bankr LJ 325 (*if a business entity fails, its owner can simply liquidate it and then incorporate a new business unburdened by the prior company's debts. It is only individuals that cannot shed the stigma of insolvency*).

documented.[93] There are several reasons behind it, such as tax benefits. It is a natural step in developing business activity; it allows asset allocation and attracts investors. Even if corporate law underlines limited liability, for a small entrepreneur, incorporation of the business activity does not necessarily mean that the activity is separated from the personal sphere in economic terms. In fact, this is a naïve idea for small firms; the owner is often personally liable for the debts of the company,[94] and lenders do not differentiate between incorporated and non-incorporated entrepreneurs in their decisions.[95] Personal liability can be based on a contract, usually as a personal guarantee,[96] or a family home as collateral, or on law that prescribes personal liability for taxes or fees to pension funds. In practice, liability for the debts of the company ultimately lies with the entrepreneur, despite formal independence.

Relying on a purely formal analysis of the definition and considering that the activity must be exercised in the entrepreneur's own name is not only unnecessary but also inconvenient for the purpose of the PRD because fostering entrepreneurship is related to incorporated activities and the effects of bankruptcy laws.[97]

The aim of the PRD, to ensure discharge for entrepreneurs, does not necessarily require that entrepreneurs pursue activity in their own names, only that they are personally liable for the debts arising from the activity. The recitals of the Directive suggest that incorporating business activities should not exclude a debtor from discharge. A statement in recital (79) states that dishonesty, which may exclude a debtor from discharge, should be measured, among other circumstances, according to the "fulfilment of duties in the likelihood of insolvency, which are incumbent *on entrepreneurs who are directors of a company*" (emphasis added). This reference

[93] E.g., Lee and others (n 76) 517. The results for the CBP project in the US showed that 36.5% of bankrupted self-employed persons had an incorporated activity, Lawless (n 63) 109.

[94] See Armour (n 75) 89. A fine example is offered in Lawless (n 63) 102, which also highlights the financial ties between the company and its owner at 107.

[95] See Jeremy Berkowitz and Michelle J White, "Bankruptcy and Small Firms' Access to Credit" (2002) 5.

[96] In most cases, creditors demand personal guarantees, breaking the limited liability. See Armour and Cumming (n 54); Fan and White (n 65); 559; Frank M Fossen and Johannes König, "Personal Bankruptcy Law and Entrepreneurship" (2015) CESifo DICE Report 28 2.

[97] As suggested by Lee and others (n 76) 516 ff.

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clearly supports the view that the drafters of the Directive envisioned that owners and directors of small (probably also closed) companies and partnerships, can be included in the concept of entrepreneurs[98]. Of course, this interpretation may create a new, and possibly bigger, problem, which is to define up to what point an incorporated entity's activity may qualify as entrepreneurship.

A narrow interpretation restricting second chance to entrepreneurs with a business in their own name would contradict the general trend in insolvency law of ignoring the debtor's personal conditions in access requirements. In countries deriving their legal traditions from the Napoleonic code, including Spain, Portugal and Italy, bankruptcy used to be only accessible to debtors engaged in business and trade. The difficulty in determining the debtor's personal status as a precondition to access the procedure[99] explains the gradual abandonment of this approach. Similarly, the recent legal developments in Spain and Finland exemplify the technical problems connected to specific laws limiting discharge to a particular category of individuals.

In the context of the insolvency of natural persons, the 2013 World Bank Report acknowledged that the boundaries between the categories of business and non-business activity are not always clear and that this blurry line can also extend to the definition of debtor.[100]

The consequences of conceptual problems are apparent. Procedural costs are likely to increase because of additional screening mechanisms. There may even be an incentive to build fake entrepreneurial conditions in order to gain access to second-chance

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[98] However, note that according to recital (73) "[T]he concept of 'entrepreneur' within the meaning of this Directive should have no bearing on the position of managers or directors of a company, which should be treated in accordance with national law." The distinction between the directors and debtors implicit in this recital may be reconciled with the interpretation that we suggest in the text if it is understood to prevent interferences with the specific duties of directors of distressed companies, considering that this has been a recurrent concern in the legislative process.

[99] The amount of legal and academic doctrine is probably sufficient to highlight the problematic consequences of these types of limitations. Italy is a paramount example, see Salvatore Satta, *Diritto Fallimentare* (3rd edn, CEDAM 1996); Alessandro Nigro and Daniele Vattermoli, *Diritto Della Crisi Delle Imprese* (Mulino 2009) 57 ff.

[100] See World Bank Report on the Treatment of the Insolvency of Natural Persons 13 ff. The use of consumer credit to finance business and the irrelevance of the origin of debt is also noted in the INSOL Report of 2001 (INSOL International, "Consumer Debt Report. Report of Findings and Recommendations" (2001) 2, 3, 19).

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procedures.[101] Hence, strict analysis of that condition would be necessary. In addition, the difference between entrepreneur and non-entrepreneur may also affect the competent court if different courts have jurisdiction over commercial and civil matters, as is the case in Spain.[102] In these cases, a new procedural question will undoubtedly hinder the smooth development of proceedings.

4.2. Entrepreneurial timeliness

An additional conceptual problem is timeliness of the entrepreneurial activity. It should be clear that discharge must be accessible after business activity failed and thus has ceased. That is what insolvency law is all about. While in some countries, like Spain, liquidation bankruptcy can end with a discharge, that is not the case in many other countries, such as Finland, despite the (unused) opportunity to bring the bankruptcy procedure to a final conclusion by a composition regulated in chapter 21 BA. Business activity can also cease without a formal insolvency procedure but still leave the (former) entrepreneur with significant unpaid debt.[103] For second chance legislation to be relevant, it must also be available to former entrepreneurs. Accordingly, article 20(1) PRD allows Member States to limit the discharge procedure to situations in which the entrepreneurial activity (be it trade, business, craft or profession) has ceased. This provision is important, considering that a great number of national jurisdictions have already enacted debt adjustment procedures for natural persons, frequently drafted with a consumer or other private debtor in mind. They are

[101] Parallel scenarios offer examples of this strategical use. For instance, under Spanish law, secured creditors are affected by a temporary stay (basically, one year from the opening of the insolvency proceedings) if the asset is necessary for the business or professional activity of the debtor (art. 56 SIA). As the primary residence does not have that protection, it was often the case that debtors faked professional or business activity in their primary residence to prevent foreclosures.

[102] Under Spanish law, insolvency procedures are assigned to the commercial courts, without consideration to the personal conditions of the debtor. Since 2015, however, commercial courts only hear insolvency proceedings of individuals with business activity; other individuals are assigned to the common First Instance Courts. The application of this rule has turned out to be problematic because of the inherent difficulty of defining “business activity” (generally Courts decide according to whether the debtor receives a salary or is unemployed) and the problems caused by the timeliness dimension of that concept.

[103] According to the data shown by M. Lawless (n 63). p. 106, the inclusion of former self-employed debtors for the two years prior to bankruptcy raised the percentage of self-employed bankrupts to around 7%, almost doubling the percentage of debtors self-employed at the time of bankruptcy.

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often restrained by conditions, which may exclude many former entrepreneurs from discharge. For example, debtors with very recent debts can be excluded.[104]

Empirical studies show that former entrepreneurs seek discharge through consumer debt adjustment procedures. Sullivan, Warren and Westbrook showed in the early 1990s that a considerable percentage of consumer bankruptcies in the US were the consequence of failed business ventures.[105] In Finland, about one-third of the debtors in debt adjustment for private persons were failed businessmen and entrepreneurs.[106] In recent statistics, 8.4 per cent of debtors in German debt counselling, with private persons as the clientele, were self-employed.[107] Also in Germany, business failure was the cause of personal insolvency in 22% of cases.[108]

When transposing the PRD, Member States should not limit discharge to former entrepreneurs seeking relief after ceasing business activities. Such interpretation is not congruent with the aims of the Directive. Consequently, the relationship between debt and business activities should be taken into consideration, and not the current status (although, of course, this will make it more difficult to assess the condition as the passed time increases).

An opposite timeline problem of limiting discharge to entrepreneurs is the effect on entrepreneurship of former debt, which is not related to entrepreneurship. Discharge is a forward-looking concept, especially under a policy goal of promoting entrepreneurship. Thus, the timeliness dimension of the concept of entrepreneurship should also be considered in relation to future entrepreneurs. Overwhelming debt burden hinders the start-up of new businesses. Thus, to exclude a person who is in the

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[104] Examples of these kinds of limitations can be found in Finland and Sweden, for example.

[105] See Teresa Sullivan, Warren Elizabeth, and Jay Lawrence Westbrook, *As We Forgive Our Debtors: Bankruptcy and Consumer Credit in America.* (Oxford University Press 1989).

[106]See Jyrki Tala, Vesa Muttilainen, and Pekka Vasara, *Velkajärjestelyt Tuomioistuimissa 1994* (Research C, National Research Institute of Legal Policy 1994); Vesa Muttilainen, *Velkajärjestelyt Tuomoistuimissa 2005* (Research C, National Research Institute of Legal Policy 2007) 5.

[107] Insolvency and Restructuring in Germany—yearbook 2017. Schultze & Braun GmbH & Co. KG. https://www.schubra.de/en/publications/downloads/Yearbook2017.pdf

[108] See Wolfram Backert and others, "Bankruptcy in Germany: Filing Rates and the People behind the Numbers" in Johanna Niemi, Iain Ramsay and William C Whitford (eds), *Consumer Debt & Bankruptcy* (Hart 2009) 283.

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process of starting a business because of former debts, be they business related or of private origin, contradicts the aims of the Directive. Accordingly, the option to restrict discharge procedures to ceased entrepreneurs would seriously endangerthe basic aim of promoting entrepreneurship.

4.3. Limitation to entrepreneurs as a policy decision

While the goal of harmonising the discharge for entrepreneurs is the correct approach, the policy decision of limiting second-chance harmonisation to entrepreneurs is problematic. Following the Explanatory Memorandum of the P RD, the limitation is a consequence of the diversity in national laws and, over all, the subsidiarity principle.[109] However, the idea that consumer over-indebtedness "should be tackled first at the national level"[110] because consumers receive mainly local financing is not consistent with the rationale of promoting the markets for financial products across borders.[111] Actually, consumer credit is today international business.

But, overall, the policy problems of limiting discharge to entrepreneurs are related to fairness[112] and to the the inextricable connection between business and personal debt.[113] When promoting entrepreneurship, one cannot ignore its effects in the personal sphere both because failed entrepreneurs are likely to have accumulated business and personal debt and because their families are seriously affected.[114]

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[109] EM 2016 at 6 and 15.

[110] EM 2016 at 15.

[111] EM 2016 at 15: financial industry "indicated diverging national consumer insolvency laws as a barrier to selling retail financial products cross-border."

[112] The limitation was also critically reviewed by the European Economic and Social Committee in its opinion to the Proposal Opinion of the EESC to the Directive on Restructuring and Insolvency Proposal, 6.

[113] See Ramsay (n 67) 435.

[114] The effect is that the debt-to-asset ratio is lower, and the time needed to service the debt in full is considerably longer, see Lawless (n 63) 111.

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The PRD recognises the mixed nature of entrepreneurial assets and debts in the recitals,[115] and article 24 includes an obligation for the Member States to consolidate or coordinate procedures that affect either business or personal debt of the entrepreneur. The basic rule ensures that business and personal debt are included in the same procedure for obtaining a discharge. Nevertheless, Member States can address business/professional and personal debts in different procedures if there is some form of coordination and the rule does not mandate Member States to provide a possibility of discharge for personal debts.

A relevant point regarding the policy of limiting discharge to entrepreneurs involves how business and professional debt are transferred from the entrepreneur onto other persons. Access to finance by entrepreneurs usually requires guarantees.[116] Discharge may lower the *quality* of the projects, as indicated above, which makes guarantees even more necessary in the view of financial entities and investors. A guarantee reduces the monitoring costs of the creditors, that are at least partially transferred to the guarantor. Those who are close to the entrepreneur usually bear transferred monitoring costs cheaper.[117] Therefore, guarantors tend to be family members, relatives or friends, or those involved in business as employees or contract parties.

Thus, the legal position of private guarantors and other third parties liable for the debt of entrepreneurs should be considered when a discharge for an entrepreneur is initiated. This consideration does not mean that personal guarantees for another person's debt should be automatically discharged if the business fails. Such regulation would make guarantees worthless and decrease the availability of credit for small entrepreneurs. Personal guarantees still play an important role in the financing of entrepreneurship. Third-party guarantees are likely to enable business initiatives that otherwise would have difficulties in finding financing. It is, of course, necessary that a guarantor understands the risks. The important policy point is that, if the guarantor

[115] "Personal and professional debts […] cannot be reasonably separated, for example where an asset is used in the course of the professional activity of the entrepreneur as well as outside that activity," PRD recital (84).

[116] As governments usually know, guarantee schemes are a relevant tool to support entrepreneurs and SMEs, see OECD (n 19) 10.

[117] See, in a more general context, Avery Wiener Katz, "An Economic Analysis of the Guaranty Contract" (1999) 66 Uni Chi L Rev 47 ff.

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becomes insolvent as a consequence of paying the guaranteed debt, the guarantor should have access to discharge procedures under the same or equivalent conditions as the main debtor.

Such an outcome may not happen, however, under a model where harmonisation is only required for entrepreneurs when a Member State opts to limit discharge to entrepreneurs. This differential treatment of entrepreneurs and (non-entrepreneurs) guarantors in discharge procedures may lead to outcomes that are perceived as deeply unfair[118] and, overall, could jeopardise the overarching goal of the PRD to facilitate entrepreneurship because it would disincentivise guarantors and, thus, compromise the financing of entrepreneurs.

4.4. Entrepreneurs, discharge, and restructuring mechanisms

A mature insolvency system offers feasible procedures for ending a business (liquidation bankruptcy), restructuring a business in trouble, and accessing discharge for natural persons. The PRD, with its two-pronged approach, seeks to promote business restructuring as an option to avoid liquidation bankruptcy. In this section of the article, we ask whether the Directive provides a useful tool for restructuring for private entrepreneurs.

The Directive includes a detailed design for restructuring the finances of a debtor, resembling Chapter 11 of the US Bankruptcy Code. The restructuring procedure seems to be designed with big businesses in mind. While pre-insolvency arrangements that the Directive envisions may be feasible for micro, small and medium enterprises (MSMEs), it is doubtful whether small entrepreneurs have the resources and skills needed to guide them through a restructuring. It is also unlikely that a small entrepreneur would benefit from the protection of interim financing during the stay and new financing for the restructuring plan. Several provisions in the Directive are

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[118] This result will exacerbate the effect of the insolvency on the relatives of an entrepreneur in those countries where that relationship implies negative consequences in the procedure, such as subordination of claims. In Spain, for instance, subordination follows automatically for certain relatives (art. 93 SIA); in other countries it depends on the insider condition of the creditor. For a critical analysis see Juliet M Moringiello, "Mortgage Modification, Equitable Subordination, and the Honest But Unfortunate Creditor" (2011) 79 Fordham L Rev.

thought to facilitate the restructuring of MSMEs,[119] but it is questionable if they really make restructuring more suitable for these debtors, because they hardly ease the complicated and expensive restructuring procedures.

In addition, the suggested procedure for confirming a debt-restructuring plan may be risky for MSMEs. The requirement in article 12 PRD that equity holders may not unreasonably prevent the restructuring turns the regulation from a presumptively debtor-friendly one to a risky one. The starting point is pro-debtor: the debtor remains in possession, while the restructuring is negotiated, and any proposal requires their consent.[120] However, the very complicated voting rules and the fact that some rules in article 12 prevent the unreasonable blocking of a restructuring proposal by a debtor may lead to a very different outcome: that an entrepreneur may be seriously diluted in the participation of the company or even totally deprived of their assets. The Directive, however, allows the Member States to adapt this provision to the particular situation of SMEs.[121] This rule will be helpful for entrepreneurial activity incorporated in small companies, considering that, in many cases, the entrepreneur and the majority (or sole) shareholder are necessary to ensure the viability of the restructuring project.

The PRD with its complicated voting rules hardly promotes the early restructuring of entrepreneurs' undertakings, nor the development of voluntary debt adjustment procedures accessible to small entrepreneurs. To design such procedures is not a simple task, as is seen in the examples from Spain and Finland. However, such procedures would be needed if the promotion of entrepreneurship is to be taken seriously.[122] The discharge provision, as important as it is, does not replace the need

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[119] E.g., limiting access to early warning tools (art. 3.4), alleviating the need of separate classes for voting for the plan (art. 9.4), preserving the debtor's agreement in SMEs (art 11.1), or allowing Member States to adapt the provisions on equity holders to SMEs (art. 12.3).

[120] Article 11(1) requires that the debtor proposes or agrees to the cross-class cramdown. This provision is clearly a "debtor friendly" one, which Member States may limit to SMEs.

[121] Article 12(3) states that "Member States may adapt what it means to unreasonably prevent or create obstacles under this article to take into account, inter alia: whether the debtor is an SME".

[122] The promotion of agreements as an alternative to discharge (voluntary or imposed payment plans) has become increasingly common, although its efficiency is still unclear. See Jason Kilborn, *Former Entrepreneurs in Dutch Personal Insolvency Law: Comparison with US, UK, Germany, Denmark, and France* (2011) 18.

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for particular procedures on voluntary debt restructuring for MSMEs and entrepreneurs.

4.5. Limited harmonisation and effects at the national level

We agree with the sentiment of the PRD that the different national laws on insolvency, restructuring and discharge hamper the efficiency of the internal market. With this starting point, the harmonisation approach of the Directive is somewhat modest and has relevant limitations. The directive sets out minimum rules, allows the Member States to opt out of several articles and, as has been discussed above, limits the harmonisation of discharge to entrepreneurs. It must be asked whether the adopted policy is in congruence with the aims of the Directive, that is, the functioning of the internal (capital) market. Furthermore, given the variety of national laws on discharge, it must also be asked whether a more standardised policy would be necessary to achieve the aims of the Directive.[123] However, given the subsidiarity and proportionality principles in EU law, the cautious policy may be warranted.

With those principles in mind, there is reason to underline that the Directive promotes a general discharge policy. The Directive has preserved the approach contained in the 2016 Draft, inviting "*Member States to apply the same principles on second chance to all natural persons.*"[124], but with a not so innocuous change in the wording (the Directive uses the word "provisions", rather than "principles").[125] This soft-law approach follows the 2014 Recommendation, that did not include provisions for the insolvency of consumers but invited Member States to explore the possibility of applying the recommendation to consumers, on the same grounds (i.e., that the principles of the legislation on the insolvency of individuals should not be altered

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[123] The lack of harmonisation in consumer insolvency may encourage consumers to seek the most favourable regime, taking advantage of freedom of movement (PRD, recitals (5)(9)). Consumers' forum shopping has been source of concern (see Curt Wolfgang Hergenröder, "Entschuldung Durch Restschuldbefreiungstourismus?" (2009) 8 309) and the PRD does not change the situation. The relevance of this issue is, however, debatable (at least quantitatively) and seems more a symbolic problem than a real one. See Ramsay (n 52) 189 ff.

[124] EM 2016 at 16.

[125] "[A]lthough this Directive does not include binding rules on consumer over-indebtedness, it would be advisable for member States to apply also to consumers, at the earliest opportunity, the provisions of this Directive concerning discharge of debt," recital (21).

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attending to the debtor's activity).[126] The legislative process and its outcomes make clear that, even if excluded from the Directive, Member States should seriously consider aligning their provisions for entrepreneurs and non-entrepreneurs.

The effectiveness of this soft-law approach may be reinforced by the mandatory incorporation of discharge for entrepreneurs, which may act as a catalyst for a broader harmonisation of national laws regarding discharge for individuals. The political environment has proven to be a determinative element in the expansion and characterisation of personal insolvency regimes.[127] In the present political context, this form of harmonisation may be grounded on the need to find consensus at the EU level and, hopefully, lead to better results in the transferring of policies to the national level.

5. CONCLUSIONS

The PRD represents a relevant change in the EU's policy on insolvency, which is no longer based upon the principles of cross-border judicial cooperation. In the new approach, insolvency law is seen as part of market regulation and a tool to enhance growth and market efficiency. As a consequence, discussion about the insolvency of individuals and discharge abandons the classical social policy discourse and is grounded on nothing more than the promotion of economic growth and business activity.

The Directive acknowledges the need for harmonisation in insolvency law. However, the harmonisation required by the Directive is ambiguous because it allows Member States to choose the means to achieve the set goals and leave to the discretion of national legislatures the relevant substantive content. Options for Member States to deviate from the Directive dilutes the harmonisation goal.

This article has discussed the limitations of the regulation of discharge in the Directive. Firstly, the provisions are limited, quite general and conceptually somewhat imprecise, leaving ample room for divergent interpretations, which can lead to procedural costs,

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[126] Commission Recommendation 2014/135/EU, recital (15).

[127] See J Spooner, "Long Overdue: What The Belated Reform of Irish Personal Insolvency Law Tells Us About Comparative Consumer Bankruptcy" (2012) 86 Amer Bank L J 243 297; Ramsay (n 67) 428 ff.

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difficulties in application and hampering of the intended goal of promoting business activity.

Secondly, restricting discharge to entrepreneurs may unnecessarily limit the scope of discharge, leading to unjust discrimination of other individuals. Outcomes can be unfair, especially if persons affected by the entrepreneur’s insolvency without being entrepreneurs themselves (such as guarantors) do not have the same access to discharge.

The PRD, however, expressly admits that it would be good policy for Member States to extend discharge to non-entrepreneurs. This declaration implies that discharge harmonisation is split into two different legal tools: mandatory law for entrepreneurs and a soft-law recommendation for non-entrepreneurs. This option may be specifically explained by the difficulties of reaching a consensus for a broader extension of discharge. It is possible that, in the end, national laws will implement universal discharge rules for individuals, both because of the expansive effect of the existence of discharge for entrepreneurs and the effectiveness of the soft-law approach for individuals. Justice and more efficient promotion of business activity support the assertion that any discharge proposed for entrepreneurs be replicated for individual insolvency.