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Topical issues

The proposed Directive on preventative restructuring frameworks

A major step along the path of harmonising insolvency law across the EU

Summary

On Tuesday, the European Commission issued a proposal for a Directive on "*preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures*" (the "**Directive**"). If implemented, it would significantly close the gap between Member States' existing restructuring and insolvency frameworks, placing a greater emphasis on corporate rescue and significantly reducing the ability of shareholders and "out of the money" creditors to block a viable restructuring proposal.

This alert considers the proposals contained in the Directive relating to corporate debtors which, crucially, would require each Member State to provide debtor companies with the necessary tools to allow viable businesses to be restructured, rather than being forced into liquidation.

While Brexit means that the United Kingdom is unlikely to be required to implement the terms of the Directive, given that its implementation deadline would probably be 2020 at the earliest, it may still choose to adopt similar provisions. Proposals contained in the recent Insolvency Service consultation on the future of UK insolvency law correspond very closely to a number of key provisions contained in the Directive.

The path towards greater insolvency law harmonisation

Regulation (EC) No 1346/2000 on Insolvency Proceedings, which came into force in 2002, and the Recast 2015 Regulation which applies from June next year, both focus on resolving conflict of law issues in cross-border insolvency proceedings and ensuring recognition of insolvency-related judgments across the EU. They do not, with one technical exception, attempt to harmonise Member States' substantive insolvency laws.

There was, however, a clear focus on such harmonisation in the Commission's 2012 report on "*A new European approach to business failure and insolvency*" which highlighted areas where differences between domestic insolvency laws could hamper the functioning of an efficient single market. This report was followed, in 2014, by the Commission's adoption of a recommendation encouraging Member States to put in place pre-insolvency procedures to help viable debtors to restructure. Take-up of the recommendation by Member States was patchy, but many of the provisions now contained in the Directive had their origins in that recommendation.

The harmonisation of domestic insolvency law remained a priority issue, with the Five Presidents' report of 22 June 2015 on "*Completing Europe's Economic and Monetary Union*" highlighting insolvency law as being among the most important bottlenecks preventing the integration of EU capital markets. Following this, the Commission published the Capital Markets Union Action Plan which indicated that it would take forward a legislative initiative on business insolvency, building on national regimes that worked well. Less than a year later, it published the Directive.

What is contained in the Directive?

The Directive does not attempt to harmonise core aspects of formal insolvency procedures such as the conditions for opening insolvency proceedings, definitions of insolvency or the ranking of claims. This is unsurprising, as deciding, for example, which creditor claims should be prioritised depends on balancing a range of cultural, economic, social and political considerations, with the final balance struck varying considerably between jurisdictions.

Instead, the Directive focusses, as far as corporate debtors are concerned, on ensuring that a statutory framework is put in place in each Member State which maximises the chances of a company with a viable business being able to restructure its debts before it is forced into liquidation. The five main elements of this framework, which would not be available to credit institutions or insurance undertakings, are set out below.

Key proposal 1 – The framework for a restructuring plan

The Directive requires each Member State to have in place, as part of its domestic insolvency legislation, a restructuring procedure with the following characteristics:

> flexibility as to which creditors should be included: a proposed restructuring plan would not need to include all of the company's creditors, although it would need to disclose "*the identity of non-affected parties, whether named individually or described by reference to one or more categories of debt, together with a statement of the reasons why it is not proposed to affect them*"

> voting by class: those creditors whose rights are being affected should vote in separate classes. The proposed test for a class of creditors echoes the test currently used in UK Schemes of Arrangement, with the Directive providing that "*classes shall be formed in such a way that each class comprises claims or interests with rights that are sufficiently similar to justify considering the members of the class a homogenous group with commonality of interest.*"

There appears to be some flexibility in relation to class composition in each Member State but the Directive provides that secured and unsecured creditors should "as a minimum" be treated as separate classes for the purposes of voting on a restructuring plan. Significantly, the Directive also provides that "*Member States may also provide that workers are treated in a separate class of their own*"

> voting threshold: a restructuring plan will be deemed to be adopted if "*a majority in the amount of their claims or interests is obtained in each and every class. Member States shall lay down the required majorities for the adoption of a restructuring plan, which shall be in any case not higher than 75% in the amount of claims or interests in each class*"

> judicial approval: if adopted, a restructuring plan which either provides for new financing or "*affects the interests of dissenting affected parties*" would need to be confirmed by a judicial or administrative authority.

The relevant authority is required to reject a plan if it does not satisfy the "*best interests of creditors test*" (as would be the case if a dissenting creditor was worse off under the restructuring plan than they would be in the event of liquidation) or if the plan "*does not have a reasonable prospect of preventing the insolvency of the debtor and ensuring the viability of the business*"

> protection from subsequent challenges: if the plan is adopted and confirmed, Member States are required to ensure that "*any transaction, payment, debt-equity swap, guarantee or security carried out to further the implementation of*" that plan "*or closely connected with such implementation is not declared void, voidable or unenforceable as an act detrimental to the general body of creditors in the context of subsequent insolvency procedures, unless such transactions have been carried out fraudulently or in bad faith, irrespective of whether such transactions were deemed to be in the ordinary course of business*"

Key proposal 2 – Cramming down "out of the money" creditors

The Directive provides that "*where the necessary majority is not reached in one or more dissenting voting classes, the plan may still be confirmed if it complies with the cross-class cram-down requirements.*" The requirements in question, which are clearly influenced by Chapter 11 of the U.S. Bankruptcy Code, are that:

> the dissenting class is no worse off under the plan than it would have been in a liquidation;

> the plan has been approved "*by at least one class of affected creditors other than an equity-holder class and any other class which, upon a valuation of the enterprise, would not receive any payment or other consideration if the normal ranking of liquidation priorities were applied*";

> the plan complies with the "*absolute priority rule*" so that a dissenting class of creditors has to be satisfied in full before a more junior class can receive any distribution or keep any interest under the restructuring plan; and

> the plan provides a reasonable chance of preventing the insolvency of the debtor and ensuring the viability of its business.

Key proposal 3 – Limiting shareholder leverage

The Directive requires Member States to "*ensure that, where there is a likelihood of insolvency, shareholders and other equity holders with interests in a debtor may not unreasonably prevent the adoption or implementation of a restructuring plan which would restore the viability of the business.*" This provision invites a number of questions, particularly in relation to the question of when it might be unreasonable for a shareholder, protecting its equity interest, to block a restructuring plan.

In order to address potential debates surrounding the value of the business, and thus the value of any equity interest, one solution would be to allow shareholders to participate in the process, leaving it to the courts to resolve any valuation or fairness issues. The Directive therefore provides that Member States "*may*" allow shareholders to vote as a separate class in a restructuring plan, in which case they would, if the plan was adopted and confirmed, be crammed down.

The unanswered question is that of how a debate as to whether equity was being undervalued in the restructuring process would be resolved in those Member States which chose not to allow shareholders to participate in that process. This would, as is made clear in the Recitals to the Directive, be a matter for the relevant Member State to resolve.

Key proposal 4 – Availability of a preventive restructuring procedure

The preceding proposals relate to the implementation of a restructuring plan. This assumes that the debtor company has been given the opportunity to develop and negotiate such a plan with its stakeholders, rather than being forced into liquidation before a restructuring solution emerged.

In order to ensure that a debtor company is given this opportunity, Member States will be required to ensure that, where there is likelihood of insolvency, debtors in financial difficulty should have access to an effective preventive restructuring framework that enables them to restructure their debts or business and avoid liquidation. This framework would have the following characteristics:

> a debtor in possession procedure: "*Member States shall ensure that debtors accessing preventive restructuring procedures remain totally or at least partially in control of their assets and the day-to-day operation of the business*"

> optional supervision: "*the appointment by a judicial or administrative authority of a practitioner in the field of restructuring shall not be mandatory in every case" although it is acknowledged that Member States may require this "where the debtor is granted a general stay of individual enforcement actions*"

> moratorium: a debtor which is negotiating a restructuring plan with its creditors may be granted a stay of individual enforcement actions "*if and to the extent such a stay is necessary to support the negotiations of a restructuring plan.*"

Such stay, which would not apply to the enforcement of financial collateral, "*may be ordered in respect of all types of creditors, including secured and preferential creditors. The stay may be general, covering all creditors, or limited, covering one or more individual creditors, in accordance with national law*" but it would be lifted where an individual creditor or a single class of creditors was unfairly prejudiced by that stay

> duration of moratorium: the stay of individual enforcement actions would be limited initially to a maximum period of no more than four months, although this period may be extended up to a year if the relevant judicial or administrative authority is satisfied that (i) progress has been made in the negotiations on the restructuring plan, (ii) the continuation of the stay does not unfairly prejudice the rights or interests of any affected parties and (iii) "*the circumstances of the case show a strong likelihood that a restructuring plan will be adopted.*"

The moratorium would end early if "it becomes apparent that a proportion of creditors who under national law could block the adoption of the restructuring plan does not support the continuation of the negotiations"

> termination rights: "*Member States shall ensure that, during the stay period, creditors to which the stay applies may not withhold performance or terminate, accelerate or in any other way modify executory contracts to the detriment of the debtor for debts that came into existence prior to the stay. Member States may limit the application of this provision to essential contracts which are necessary for the continuation of the day-to-day operation of the business*"

> Ipso facto provisions: "*Member States shall ensure that creditors may not withhold performance or terminate, accelerate or in any other way modify executory contracts to the detriment of the debtor by virtue of a contractual clause providing for such measures, solely by reason of the debtor's entry into restructuring negotiations, a requested for a stay of individual enforcement actions, the ordering of the stay as such or any similar event connected to the stay*"

Key proposal 5 – Protection for new financing, interim financing and other restructuring related transactions

The Directive contains the following three provisions which are intended to encourage new and interim financing as part of the restructuring process:

> priority: "*Member States may afford grantors of new or interim financing the right to receive payment with priority in the context of subsequent liquidation procedures in relation to other creditors that would otherwise have superior or equal claims to money or assets. In such cases, Member States shall rank new financing and interim financing at least senior to the claims of ordinary unsecured creditors*"

> protection from insolvency claw-back: "*new and interim financing shall not be declared void, voidable or unenforceable as an act detrimental to the general body of creditors in the context of subsequent insolvency procedures, unless such transactions have been carried out fraudulently or in bad faith*"

> protection from lender liability: "*the grantors of new financing and interim financing in a restructuring process shall be exempted from civil, administrative and criminal liability in the context of the subsequent insolvency of the debtor, unless such financing has been granted fraudulently or in bad faith*"

Similar protections apply to the payment of reasonable fees and costs incurred in connection with the negotiation or implementation of a restructuring plan or which are closely connected with such negotiations.

How will the proposals improve the restructuring and insolvency framework in each Member State?

Based on the Commission's own views, we set out in this table the benefits that the Commission expects the proposals contained in the Directive to bring for each of the 28 Member States.

Areas which may require further consideration

While the Directive contains many interesting features, there are areas which may require further careful consideration as it progresses through the legislative review process. These include the following:

> Developing the infrastructure to support the legislation: the proposals contained in the Directive are clearly influenced by provisions contained in Chapter 11 of the United States Bankruptcy Code. The question is whether Member States will have the necessary infrastructure to make the new "European Chapter 11" work as effectively as (or even better than) its U.S. counterpart. The success of what is proposed will, as acknowledged by the emphasis on training contained in the Directive, depend on the skills and experience of the courts and administrative bodies and on the development of a cohort of experienced and trained insolvency professionals in each Member State.

The potential challenges are highlighted by the fact that the relevant judicial or administrative authority would, under the current proposals, be required in certain circumstances to determine the liquidation value or the enterprise value of a business. While the Directive requires Member States to ensure that properly qualified experts are appointed to assist the relevant judicial or administrative authority in relation to such valuations, the proposed regime may require judges to become actively involved in areas where they may have, despite the availability of training, no particular experience or expertise

> opt-outs: the drafting of the Directive gives Member States a degree of flexibility when implementing its terms. Areas where there is currently discretion include potentially significant issues such as:

> the degree of control which the debtor's management should retain while subject to the preventative restructuring procedure;

> the duration of the stay of individual enforcement actions during the preventative restructuring procedure;

> whether the restriction on terminating executory contracts should be limited to "*essential contracts*";

> the required majority for the adoption of a restructuring plan;

> the decision whether or not to have legislative provisions permitting the cram down of shareholder claims; and

> how employees should be treated for voting purposes in a restructuring plan. To put this into context, if employees were permitted to vote as a separate class, and approved a plan, it might open up the possibility of that employee vote permitting the cram down of financial creditors in certain jurisdictions.

The existence of such opt-outs, and potential flexibility concerning class composition when voting on a restructuring plan, may significantly influence the outcome of restructuring negotiations from jurisdiction to jurisdiction, contrary to the underlying policy objective.

> Areas of uncertainty: a number of provisions currently lack clarity. Two examples of this are:

> "Early warning tools": the Directive refers to giving debtors access to "*early warning tools*", which could include "*third parties with relevant information such as accountants, tax and social security authorities [being] incentivised or obliged under national law to flag a negative development*" but it is unclear exactly what these tools are and how they would work in practice

> Directors' duties: Member States are required to lay down rules to ensure that, where there is a "*likelihood of insolvency*", directors have obligations "*to take immediate steps to minimise the loss for creditors, workers, shareholders and other stakeholders*" and "*to have due regard to the interests of creditors and other stakeholders*". The question of how conflicts would be resolved, where (for example) continuing to trade might benefit workers but would not necessarily benefit some financial creditors, is not specifically addressed

What happens next?

How do proposals get to agreement in first reading stage

The publication of these proposals kicks-off an EU legislative process known as the "ordinary legislative procedure". This entails the European Parliament and the Council of the EU each considering their position on the proposals before entering into informal "trilogue" negotiations facilitated by the European Commission. Once agreement is reached and endorsed by the European Parliament plenary and the Council of the EU, the legislation is published in the Official Journal of the EU.

The ordinary legislative procedure typically takes around 18 months, but in the past more complex pieces of legislation have taken around 24 months. The Directive will also need to be transposed into the domestic law of Member States, a process which may take up to two years according to the timetable set out in the Directive. Accordingly,
the new proposals are realistically only likely to start entering into force in 2020 at the earliest.

How is this likely to affect the United Kingdom?

As Member States are given up to two years from the date of entry into force of the Directive in which to comply with this Directive, it is probable that the United Kingdom would cease to be a Member State before this deadline expires, and that it would therefore be under no obligation to implement the Directive. There may, however, still be considerable pressure for the United Kingdom to adopt similar provisions, in order to ensure that its current market-leading insolvency regime remains attractive. This may encourage the implementation of proposals contained in the recent Insolvency Service Consultation on the future of UK insolvency law, given that these proposals correspond very closely to the requirements of the Directive.

Putting the Directive into its wider context

The Commission's emphasis on encouraging the rescue of companies which encounter financial difficulties highlights its desire to boost entrepreneurial activity across Europe by giving viable businesses a second chance.

Significantly, the proposals underpin, and were announced at the same time as, the Commission's new Start-up and Scale-up Initiative looking to give innovative EU entrepreneurs the opportunity to create world-leading companies. The Directive should also be seen alongside the Commission's sweeping financial services reform package published the following day. Together, they target economic recovery and growth, aim to tackle Europe's NPL burden and further support the development of an efficient single market and true Capital Markets Union.

Such measures do not, however, mark the end of the road. More work is expected on benchmarking loan enforcement regimes across the EU, as well as further enhancing the effectiveness of national judicial systems and insolvency regimes. The EU project may have been dealt a blow back in June, but the Commission's flurry of proposals suggest it is very much looking to the future.

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