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Briefing note

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European Proposal for the harmonisation of restructuring law

On 22 November, the European Commission published its legislative proposal for harmonising restructuring law across Europe. The Proposal, which includes a draft Directive on preventative restructuring frameworks, "second chance" and measures to increase the efficiency of restructuring, insolvency and discharge procedures, first needs to be agreed by the European Parliament and Council. Once the text is finalised, Member States will have up to 2 years to implement the measures.

What does the Proposal seek to achieve?

It wishes to promote minimum standards in relation to three aspects of restructuring and insolvency law across Europe.

The first: by prompting Member States to adopt preventative restructuring frameworks aimed at ordinary corporate entities which include the following features:

- the possibility to commence proceedings at an early stage with the benefit of a breathing space from enforcement action;
- allowing a debtor to remain in possession;
- allowing creditors to adopt a restructuring on a specified majority and bind the minority who do not support the proposal. This includes the ability for the court to cram down dissenting creditors who are not in agreement across different classes[1] and also applies to shareholders; and
- protecting new finance.

The second: this relates to the introduction of a maximum discharge period of 3 years for the debts of individual entrepreneurs, so that they are given a second chance as long as they act in an honest manner.

The third: measures to raise the efficiency of restructuring, insolvency and discharge procedures. This aspect is something which did not form part of the earlier recommendation, upon which the Proposal is based.

Why now?

The European Commission wants to increase opportunities for companies in financial difficulties (especially those in the SME market) to enable them to restructure at an early stage to avoid liquidation and loss of jobs.

It is also considered that the harmonisation of certain aspects of insolvency law will remove barriers to the development of capital markets in the EU, giving more certainty to companies and their investors.

How?

The Proposal takes the form of an EU Directive and will require national law implementation before it takes effect. This may also mean that there are certain aspects of the Directive which may not be enacted in a uniform manner. Indeed, the Directive does appear to be flexible in some respects, not least that it is advocating a minimum standard rather than being too prescriptive about the exact form of restructuring framework.

When does it take effect?

The wording of the Directive needs to be agreed by the European Parliament and Council under the European legislative decision procedure. This may take a number of months. Once the final text of the Directive is agreed upon, Member States will have 2 years to implement the Directive. Wholesale changes may not be required if national law is already compliant with the minimum standards promoted by the Directive.

[1] See "Key concepts defined by the draft Directive".

How Member States currently measure up

Along with the Proposal, the European Commission has published individual country guides which analyse their current World Bank rankings in relation to insolvency proceedings.

The country guides also seek to identify aspects of the Proposal that will improve individual country regimes. These appear to be based on responses to the Commission's recommendations from January 2014 and a comparative law study published by Leeds University in January 2016.

Experts from our local offices have sought to summarise the key themes from the Proposal in more detail and indicate in the table below how key Member States already measure up to the Proposal.

Initial reactions across Europe on the Proposal

Philip Hertz, global head of our restructuring and insolvency practice, comments: "*the Proposal is the result of various recommendations encouraging Member States to improve the restructuring mechanisms available locally. Many individual Member States' insolvency laws have already seen significant convergence to a model that promotes rescue over liquidation. This means that the impact of any final Directive will vary depending upon the national stage of development. Some jurisdictions in particular may already consider that their regime is compliant. It should also be borne in mind that any final Directive will only set a minimum standard and it will be interesting to see how competitive jurisdictions become with perhaps many taking the opportunity to improve their regimes so that they can be seen as "best in class.*"

Scope

The draft Directive excludes entities that benefit from bespoke reorganisation and winding up regimes such as insurance and reinsurance undertakings, credit institutions, investment firms and collective investment undertakings, central counterparties, central securities depositories and other specified financial institutions.

Nor does it apply to individuals who are not entrepreneurs; i.e. consumers are not included, although the consumer debts of an entrepreneur can be included or coordinated for the purposes of the discharge.

The draft also states that the Directive will be without prejudice to existing pieces of European legislation, namely the Directives which cover settlement finality in payment and securities settlement systems, financial collateral arrangements, and OTC derivatives, central counterparties and trade depositories. These without prejudice provisions are designed to maintain stability in relation to financial market transactions. The Explanatory Memorandum which accompanies the draft Directive states "This is important in order to avoid overlaps between these instruments and the current proposal which would impact on secured creditors' ability to enforce their financial collateral security provided by a corporate entity, including margins provided to central counterparties (CCPs) or to central banks/the ECB or of financial collateral arrangements concluded with a non-financial corporate with a financial institution. Without a carve-out of such transactions from the stay provisions, financial market's stability may be harmed".

The Directive is also expressed to be without prejudice to workers' rights guaranteed by a specified list of EU Directives.

Availability of preventative frameworks

Stefan Sax, partner in our Frankfurt office, comments: "*it is good news that the Proposal promotes access to preventative frameworks and also seeks to limit the involvement of judicial/administrative oversight. This recognises that it may be more cost effective and quicker to restructure without too much court involvement. But it will be a concept which some jurisdictions, including Germany, will find to be a significant change to the present approach. Although when it comes to fundamental aspects of the plan it is noted that the court is involved. So for example, for the adoption of a restructuring plan the court will need to examine the class formation of creditors. Also, where the plan affects interests of dissenting parties or includes the provision of new finance, it must also be confirmed by the court within 30 days of the request for confirmation being made. This will provide important comfort, especially to creditors.*"

Ilse van Gasteren, Counsel in our Amsterdam office notes *"in the Netherlands we have already been developing a new restructuring scheme, which will in many respects meet the aims of the draft Directive, including a cross-class cram-down. The new Dutch scheme is anticipated to be introduced in 2017, it takes much inspiration from the UK scheme of arrangement and also aspects of Chapter 11 of the US Bankruptcy Code."*

Debtor in possession

Giuseppe De Palma, partner in our Milan office, notes: "*the restructuring framework promotes a debtor in possession process, but also envisages, as Stefan mentioned, court involvement where necessary. In Italy, the legislation has already adapted to improve the rescue mechanisms available and very much anticipates the main themes of the Directive.*"

Stay of individual enforcement

Iain White partner in our London office, comments: "*debtors will no doubt welcome the protection offered by the stay. In particular, the stay provides protection against enforcement of individual claims (including secured claims) initially for a maximum period of 4 months, which can be extended to up to 12 months in certain circumstances, as such it may provide a useful breathing space for entities seeking to restructure. There are some creditor safeguards which are also proposed in relation to the extension of the stay, including a requirement that there has been progress on the restructuring plan and creditors are not unfairly prejudiced. Likewise, the stay can be lifted if it is clear that the debtor does not have the requisite creditor support for the restructuring plan or it is requested by the debtor or practitioner appointed to the debtor.*"

Measures to assist in the continuation of day to day operations

David Towers, partner in our London office, notes: *"the draft Directive includes provisions where the termination, acceleration or any modifications of contractual arrangements can be disapplied. This very much echoes the approach in the US Chapter 11 process.*

Additionally, there is scope in the Directive for Member States to limit these provisions to essential contracts only. During the stay the debtor must also pay ongoing obligations in the ordinary course."

Content of the restructuring plans

Adrian Cohen, coordinating partner of the European Practice, observes: "*the draft Directive sets out minimum requirements for the content of the plan, including a valuation on the present value of the business and extent of its liabilities. It also requires the inclusion of details about the rationale used to classify creditors, which must be formed in a way that allows creditors with rights that are sufficiently similar, to justify considering the members of that class as a homogenous group with a commonality of interest. This is reminiscent of the UK scheme approach to classes.*

Plans can be adopted on the approval of a specified majority of each class which is not to exceed 75%, and, where the majorities are not achieved in each class the, provided certain conditions are met (including adherence with the absolute priority rule[2]*), there can be a cross class cram down.* [3]

From a lender's perspective the inclusion of the ability to cram down secured creditors may not be welcomed, but the reality is that most national systems have a mechanism already which provides for the majority to bind a minority. In the UK, for example, a scheme of arrangement facilitates a minority of secured creditors within the same class to be bound by the majority. The Directive goes further and adopts a US Chapter 11 cram down mechanism, where classes can be crammed down across different classes. Lenders should take some comfort from the fact that the absolute priority rule applies in cases of cross creditor cram down, which will afford them protection and ensure that they retain any priority status. In the draft Directive it suggests a minimum of affected classes to approve the plan as at least one, but also permits Member States to vary this minimum. Interestingly, the UK government has already been consulting on a cross class cram down mechanism, so this may be something which we will see in the future in the UK, even after Brexit."

Effect on equity holders

Reinhard Dammann, partner in our Paris office and member of the panel of experts who advised the Commission, adds *"interestingly, under the draft Directive, Member States shall ensure that equity holders may not unreasonably prevent the adoption or implementation of a restructuring plan which would restore viability of the business. In order to achieve this objective, there is an option for the Member States to include provision in their legislation to allow equity holders who are to be affected by the plan i.e. in a debt to equity swap, to vote on the plan in a separate class and as such be subject to a potential cram down. Such debt to equity swap within pre-insolvency proceedings may raise some constitutional concerns. Consequently, such mechanism could be included into formal insolvency proceedings, which would work as a threat to overcome the nuisance value of equity holders".*

[2] See "Key concepts defined by the draft Directive".
[3] See "Key concepts defined by the draft Directive".

Tomas Richter, Of Counsel in our Prague office who served on the same expert panel adds "*while it is useful that the Commission is proposing the loosening of the Second Company Law Directive whose rules on alterations of share capital have been long causing difficulties and hold-outs in restructuring situations, it should be observed that the proposed provision is so open-ended that no reasonable measure of coherence across the Member States can be expected. In multi-jurisdiction situations, the planning of recapitalisations will be for the brave (and well-advised) only*."

The viability and honesty of the plan

Tomas continues "*another crucial aspect of the restructuring plans which can be proposed under the draft Directive is the inclusion of an opinion or reasoned statement by the person responsible for proposing the plan. This is required to explain why the business is viable and how the plan is going to result in avoiding insolvency and restore a debtor's long term viability. Clearly, these are malleable concepts and there is nothing within the draft Directive that indicates the consequences (if any) of this statement being wrong or misleading. Having said that, a number of Member States will have in place general standards of good faith or similar anti-fraud rules, and one must presume that national courts will have the power to use these tools to prevent the abuse of the measures proposed in this Directive.*"

Valuation and rescue finance

Iñigo Villoria, partner in our Madrid office, makes the point: *"the draft Directive states that where a challenge is made to a restructuring plan on the grounds that it breaches the "best interest of creditors test"*[4] *a liquidation approach to valuation should be used. However, where there is a cross class cram down and the plan is challenged on the basis of the absolute priority rule, an enterprise value based on going concern shall be used. In such cases, the courts can call upon experts to assist them in the process of determining the appropriate value.*

In Spain, we have already seen many reforms to improve the restructuring framework, so for example we already have rescue finance provisions. Under the draft Directive, rescue finance is promoted by affording it priority at least in relation to unsecured claims and also protecting it from being unwound at a later date if there should be a subsequent insolvency."

Duties of directors

John MacLennan, partner in our London office, notes: "*the draft Directive includes provisions for Member States to ensure that they have rules which oblige directors to: (i) take immediate steps to minimise the loss for creditors, workers and other stakeholders; (ii) have due regard to the interest of creditors and stakeholders; (iii) take reasonable steps to avoid insolvency; and (iv) avoid deliberate conduct that threatens the viability of the business. Such duties may already be part of some insolvency regimes. Certainly from the English law perspective they are covered already and in fact the duties set out in the draft seem to be inspired by the English approach. But for certain jurisdictions which impose a mandatory filing period, these provisions will represent a fundamental shift in the obligations of directors when dealing with distress.*"

[4] See "Key concepts defined by the draft Directive".

Discharge from debts for entrepreneurs – maximum of 3 years

Steve Jacoby, partner in our Luxembourg office, comments: "*the draft Directive includes a maximum 3 year period after which individual entrepreneur debtors are automatically discharged from their debts and any disqualification period also comes to an end. The maximum period may be extended in cases where the debtor has acted dishonestly or in bad faith. Member States also have the freedom under the draft Directive to exclude certain types of debts from this discharge, such as secured claims and criminal penalties. The maximum period for discharge may assist in deterring individual debtors from forum shopping for the jurisdiction with the most favourable regime.*"

Measures to increase efficiency

Reinhard Dammann, from our Paris office notes: "*some may consider that the Directive contains some aspects which seem to go beyond the original recommendation from which it is derived. In particular, there are measures designed to improve efficiencies such as ensuring that judicial and administrative authorities are appropriately trained and have the necessary specialism and expertise to deal with cases in an efficient manner. Likewise, Member States are encouraged to have in place training for insolvency practitioners, to ensure that they are competent to deal with the distressed situation under the new restructuring framework. The draft Directive also encourages insolvency practitioners to adopt voluntary codes of conduct and Member States to have in place effective oversight and*

regulatory mechanisms. The draft Directive also includes provisions for the use of electronic communication for claims, restructuring plans, voting and lodging appeals. These aspects show that the Commission is in tune with the practicalities of resolving distressed businesses in today's world."

Monitoring of procedures

Bert De Mayer, partner in our Brussels office, states: "*perhaps the most challenging aspect of the Proposal for Member States will not be the measures themselves but keeping track of them. To assess whether the Proposal is working, the draft Directive imposes an obligation on Member States to collect statistics, not just on the number of restructurings but also details regarding the types of debtors, length of the procedures, costs and creditor recovery rates. Whilst it is easy to see the obvious benefits that may be derived from having reliable annual statistics, the cost and efficiency of collecting this data will be no mean feat and will impose a significant administrative burden on Member States.*"

However whilst appreciating the burden on Member States, Tomas Richter from Prague observes "*taking a "macro view" of the proposed Directive, the Member State's duty to produce and publish reliable statistical data on national insolvencies and restructurings under proposed Article 29 is to be welcomed. The fact is that in the EU, we often argue about rules and solutions to problems on which there is a real paucity of information, and the situation varies greatly from one Member State to another. If adopted, Article 29 could over time lead to a much improved understanding of how insolvencies and restructurings really work and what is their relative importance across the EU.*"

Beyond Brexit: the UK perspective

Of course, one could take the view that the decision on leaving the European Union means that in the UK there may be less interest in the Proposal, but perhaps a wiser course would be to ensure that the UK restructuring and insolvency regime remains at the forefront of international insolvency development. To this end, the UK government's proposals for corporate insolvency reform which were published over the Summer appear to incorporate aspects now contained in the European Commission's Proposal. We understand that they are continuing to develop these proposals with stakeholders. Therefore, even once the UK leaves the European Union the measures contained within the Directive may be very relevant for the UK. It also goes without saying that given the international nature of business, an appreciation of how other Member States facilitate restructuring is often key to finding the right solution to a distressed situation.

Key concepts defined by the draft Directive

- "**cram-down of dissenting creditors**" means the confirmation by a judicial or administrative authority of a restructuring plan that has the support of a majority in value of creditors or a majority in value in each and every class of creditors over the dissent of a minority of creditors or the dissent of a minority of creditors within each class
- "**a cross-class cram-down**" means the confirmation by a judicial or administrative authority of a restructuring plan over the dissent of one or several affected classes of creditors
- "**best interest of creditors test**" means that no dissenting creditor would be worse off under the restructuring plan than they would be in the event of liquidation, whether piecemeal or sale as a going concern
- "**absolute priority rule**" means that a dissenting class of creditors must be satisfied in full before a more junior class may receive any distribution or keep any interest under the restructuring plan

How key Member States currently measure up to the proposals contained in the Directive

Restructuring framework	UK	Spain	France	Germany	Italy	Luxembourg	The Netherlands	Belgium
No insolvency requirement to commence a rescue process	✓	✓	✓ (for certain process must not be insolvent)	✗	✓	✓	✗	✓ (in reorganisation proceedings)
Stay on enforcement (including security)	Administration/ CVA (small companies only)	✓	✓ (up to 2 months pre-insolvency)	✓ (but only in formal process)	✓(but only in formal process)	✓ (but only in formal process)	✓ (but only in formal process)	✓ (during claims verification)
Debtor remains in possession	✓ Consensual, in administration insolvency practitioner appointed	✓	✓	✗	✓	✓	✗	✓ (in reorganisation proceedings)
Cram down mechanism	Schemes (not across classes) CVAs (not secured creditors)	✓	✓	✓ (but only in formal process)	✓(only in concordato preventivo)	✓	✗	✓ (in reorganisation proceedings - not secured creditors)
Protection for new financing	✗	✓	✓ (but only in formal process)	✓ (but only in formal process)	✓(but only in formal process)	✗	✗	✓
Discharge for individual debts with maximum of 3 years	✓ (12 months)	✗	✓	✓ (but only where 35% creditors paid)	✗ (debtor may apply for discharge)	✗	✗	✓ (but no maximum term of 3 years)

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