CLIFFORD CHANCE

# MORE HARMONISATION OF INSOLVENCY LAWS IS ON ITS WAY ACROSS EUROPE

**Key issues**

- EU measures proposed to harmonise insolvency laws
- New pre-pack insolvency processes
- Simplified liquidation
- Standardising mandatory duty for directors to file for insolvency
- Standardising claw back action
- Availability of asset tracing registers and online auctions
- Fact sheets on different insolvency laws

On 7 December the European Commission published its proposal for a directive seeking to level the playing field across the EU Member States in relation to certain aspects of insolvency law. The Proposal for a Directive of the European Parliament and of the Council harmonising certain aspects of insolvency law (2022/0408 (COD)) is seeking to converge insolvency rules, with the aim of making them more efficient and effective in terms of creditor recoveries. In order to achieve this it is looking to create common standards across all EU Member States which in its view will facilitate more cross border investment. As such this proposal for harmonising certain aspects of insolvency law forms part of the wider EU Capital Markets Union initiative announced in 2020, which is a key project designed to further financial and economic integration across the EU.

The current proposal addresses some key areas of insolvency law and how they are applied in practice. The proposal does not extend to insurance undertakings, credit institutions, investment firms, central counterparties, central securities depositories, other financial institutions, or public bodies. Nor are individuals affected save in limited circumstances relating to debt discharge. Unlike the EU Restructuring framework directive from 2019 (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, which emphasised the importance of pre-insolvency/rescue measures, the latest proposal is focused on formal insolvency. It includes the streamlining of the liquidation process by introducing new measures designed to facilitate pre-pack insolvencies and a simplified liquidation for microenterprises. The proposal also includes a maximum period of 3 months by which directors are obliged to file for insolvency proceedings once an entity becomes insolvent. Transactions in certain periods before a formal insolvency are also the subject of the suggested standardisation in terms of the types of transactions that are caught (preferences, acts for no or inadequate consideration, and legal acts that are intentionally detrimental to creditors), along with the length of the look back period and limitation period. Other practical measures in the proposal include ways in which insolvency practitioners can trace and sell assets, and the drawing up of fact sheets on each Member States' law.

The proposal is still subject to the scrutiny of the European Council and Parliament, so it will no doubt develop over time. Once the wording of the proposed directive has been finalised, Member States will have up to 2 years to implement it into national law.

Ilse van Gasteren, co-ordinator of our European restructuring and insolvency team, comments:

"*As a firm that is often called in to assist with complex cross border cases, this proposal to harmonise some key areas of the insolvency law is really welcome. As the Commission identifies in its proposal, having a predictable and efficient insolvency regime not only avoids disorderly wind downs, but also simplifies and encourages greater investment in the first place, by reducing the risks and improving recoveries, this in turn provides greater access to funding.*"

In this briefing we look at some of the highlights of the proposed reforms as drafted at present.

## Directors' duty to request the opening of proceedings

The proposal will oblige Member States to ensure they have legislation in place which obliges directors where they are aware or can reasonably be expected to be aware of the insolvency to file for insolvency proceedings within 3 months. If they fail to do so they will be liable to creditors for damages incurred as a result of their failure to commence insolvency proceedings.

Inigo Villoria, partner in our Madrid office highlights the fact that:

*"In Spain directors are already under a duty to file for formal insolvency within 2 months of a company being unable to meet its liabilities, so the change which says Members States should have legislation that obliges directors to act no later than within 3 months of the insolvency, will not really change the practice in this respect."*

Dorothee Vermeiren, partner in our Brussels team also notes that:

*"Notwithstanding the proposed harmonisation of the deadline to file for insolvency, directors will still need to be mindful of the local liability they may incur during this 3 month period, e.g. for wrongful trading."*

## Transaction avoidance

The proposal addresses the following transactions that may be avoided on insolvency:

- Preferences: legal acts (such as payments and the granting of security) benefitting creditors can be declared void if they were perfected (i) within 3 months prior to the submission of the request for the opening of the insolvency proceedings, under the condition that the debtor was unable to pay or (ii) after the submission of the request for the opening of insolvency proceedings. If a due claim of a creditor was satisfied or secured in the owed manner, the legal act can only be declared void if the preceding conditions were met and where the creditor knows or should have known that the debtor is unable to pay its mature debts or that a request for the opening of insolvency proceedings has been submitted. Exceptions to the above include, amongst others, legal acts performed directly against fair consideration to the benefit of the estate, and legal acts that are not subject to avoidance actions in accordance with Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (FCD) and Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems (SFD). While these exemptions will be useful, they may not extend to all financial contracts, including for example netting agreements or derivatives that do not fall within the protections of the FCD or SFD.

- Legal acts of the debtor for no or manifestly inadequate consideration: these may be declared void where they were perfected within a time period of 1 year prior to the submission of the request for the opening of the insolvency proceedings or after the submission of such request.
- Legal acts intentionally detrimental to creditors: legal acts by which the debtor has intentionally caused a detriment to the general body of creditors can be declared void where (i) those acts were perfected either within a time period of 4 years prior to the submission of the request for the opening of insolvency proceedings or after the submission of such request and (ii) the other party knew or ought to have known about the detriment to the general body of creditors. "Legal act" is defined as any human behaviour, including an omission, producing a legal effect.

Cristina Weidner, head of the German restructuring and insolvency teams notes:

"*Harmonising key areas such as transaction avoidance and directors' duties will make life much simpler from an investor's perspective. Already many of the individual Member States' regimes share a common approach to these aspects, but further refinements to introduce standard minimum requirements will be welcomed and make credit risk analysis much more straightforward. Further clarity would, however, be welcome on the exemptions in relation to financial contracts. For example, it would be useful for a more expansive approach to be taken in relation to netting agreements and derivative contracts which fall outside the protections currently envisaged. The lack of clarity may undermine their role and importance in risk management .*"

## Pre-pack proceedings

This is comprised of two phases: (i) a preparation phase to find a buyer and (ii) a liquidation phase to approve and execute the sale and then distribute the proceeds.

- Preparation phase: a monitor is appointed upon request of the debtor to report on the sale and ensure the sale process is competitive, transparent, fair and meets market standards. The monitor must recommend the best bidder and confirm it does not breach the best-interest-of-creditors test (no creditor would be worse off when compared to a piecemeal liquidation). Where only one binding offer is made that offer is deemed to reflect the business market price. A stay against individual claims may operate during the preparation phase.

In the course of the preparation phase, the debtor remains in control of its assets and the day-to-day operation of the business.

- Liquidation phase: the court appoints the monitor as insolvency practitioner and authorises the sale (if the monitor confirms the sale process has been properly adhered to). In the absence of this a public auction may be pursued instead, but there are strict time limits imposed, so that it must be initiated within 2 weeks of the opening of the liquidation phase and completed within 4 weeks.

Executory contracts which are necessary for the continuation of the business are to be assigned to the purchaser and the assignment does not in principle require the consent of the counterparty. We assume that these provisions are not intended to impact upon financial contracts, but are intended to facilitate a transfer of the business operations, but the current proposal does not expressly exclude them. The business is sold free of debts/liabilities and the release of any security is to be on the same basis as would apply in a winding up, which generally speaking, would mean that the secured creditor retains its priority in any proceeds. Creditors' consent to release security may not be required in certain limited circumstances (again we assume on the basis that it retains its priority in any proceeds). Offers subject to potential delays for competition clearance may be disregarded where there is an alternative offer and a risk that a delay would damage the debtor's business.

Delphine Caramalli, head of the restructuring team in Paris, adds:

"*For a number of Member States having a formal and express pre-pack process will be a complete novelty, whereas for other jurisdictions, such as France, where a sale as a going concern is already available in the context of confidential conciliation proceedings, the proposal will simply echo what happens in practice already. I am a great advocate of the legislative framework offering distressed debtors more options and the formal pre-pack will be a game changer for a number of jurisdictions*".

"*The pre-pack would be a great novelty for Germany where the existing restructuring regimes would clearly benefit from these improvements*", says Cristina Weidner from Germany.

## Creditors' committees

Under the proposals, Member States will facilitate the creation of creditors' committees which can be established by a general meeting of creditors or appointed by the court. Member States can exclude the formation of such committees where it is not cost effective to do so, or where there are only a limited number of creditors. Creditors' committees must fairly represent the different interests of creditors or groups. Under the proposal they are also obliged to act in the interests of the creditors as a whole and act independently of the insolvency practitioner. The proposal includes a list of rights, duties and powers which the committee has which include the duty to supervise the insolvency practitioner, the duty to report to creditors more widely and the right to receive information from them and, where Member States provide, approve certain decisions or legal acts. Members of the committee are exempt from individual liability unless they have committed grossly negligent, fraudulent conduct or wilful misconduct, or breached fiduciary duties to creditors they represent.

Stefanie Ferring, a partner in our Luxembourg team comments:

"*The proposals recognise the vital part creditors can play in a formal insolvency, formalising their roles and having a standard approach to creditors' committees across the Member States including the ability to participate across borders recognises the international nature of the different stakeholders and complex finance structures*".

## Measures enhancing the transparency of national insolvency laws

This comprises a key information fact sheet, which is to set out the insolvency processes available in each Member State, giving investors an insight on how insolvency proceedings operate, providing details on how creditors may file claims and how those claims may be treated in terms of priority in the formal process.

## Simplified winding up procedures

These are aimed at microenterprises and are designed to offer a streamlined route to realise and distribute assets, including the use of an electronic auction system for the sale of assets. Where there are no assets, or the assets are of a low value that do not justify the costs, the process allows for immediate closure.

The simplified winding up proceedings are to be debtor in possession to control assets and manage the day-to-day operations. Member States can however specify circumstances where an insolvency practitioner can be appointed, where the decisions of the debtor are subject to an approval process, or the disposal is entrusted to a creditor. Some of the standard liquidation protections apply such as the stay on individual enforcement actions and the ability to pursue avoidance actions. We assume that it was not intended that the stay should apply to financial contracts, but they are not expressly excluded. In terms of the claims process, the debtor files the list of claims and creditors have a short window to file claims omitted or dispute the claims.

Fabio Guastadisegni, partner in our restructuring and insolvency team in Milan, is very positive about the practical impact:

*"Some of the measures aimed at making the formal processes more efficient will definitely be an improvement, for example in Italy the average length of liquidation proceedings is approximately 7 years. I would hope that the approach to harmonisation will considerably reduce this."*

Philip Hertz, global head of the restructuring and insolvency team, concludes:

"*It is encouraging to see further development of the harmonisation of insolvency laws across the EU. Not only will it encourage international investment and lower the costs of capital, but it will also assist in expanding further the toolbox available to ensure that, in formal insolvency situations, the processes are managed as efficiently as possible wherever they are taking place*."

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