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ARTICLE

EU Directive on Insolvency, Restructuring and Second Chance

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Synopsis

On 28 March 2019 the European Parliament adopted a Directive on insolvency, restructuring and second chance (the Directive). This project has had a long tail, following a Commission Recommendation issued in 2014 and, after that had no impact, a draft Directive in November 2016. This Directive is now about come to fruition. It has three main aims to ensure that:

1. Member States have a *preventive restructuring framework* – which includes a restructuring plan;
2. entrepreneurs have a *second chance* through an effective debt discharge mechanism; and
3. to ensure that Member States put in place *measures to raise the efficiency of restructuring*, insolvency and discharge of debt procedures more widely.

The Directive's objectives are to contribute to the proper functioning of the internal market and to remove obstacles to the exercise of fundamental freedoms. It aims to ensure that viable enterprises and entrepreneurs in financial difficulties have access to effective national preventive restructuring frameworks which enable them to continue operating.

The Directive goes further than the EU Regulation on Insolvency Proceedings (Council Regulation 2015/848) (the 'EIR') which in the main provides for a framework to choose the correct forum and governing law for insolvency proceedings. The EIR does not tackle disparities between national laws. The Directive however aims to establish minimum, but substantive, standards thereby going further than the EIR.

In this article we will mainly focus on the preventive restructuring framework, touching on the Directive's other aims.

What is the preventive restructuring framework and what are its key features?

Where there is a likelihood of insolvency (but importantly where the debtor is not yet insolvent as defined by national law), Member States must *provide debtors with access to a preventive restructuring framework* that enables them to restructure, with a view to preventing insolvency and ensuring their viability. The preventive restructuring framework is available on application by the debtor, but Member States may permit creditors' and employees' representatives to apply with the agreement of the debtor.

Member States can decide to implement the Directive by means of one or more procedures which do not fulfil the conditions for the measure to be included in Annex A of the EIR – most notably the condition that such proceeding must be public.

Key features

- The *debtor is to be left in control of its assets* and the day-to-day operation of the business (apart from a few instances where an insolvency practitioner will need to be appointed).[1]
- The debtor should be able to apply to court for a *moratorium or stay against enforcement* (including secured claims and preferential creditors, except for employees' claims unless payment of these is guaranteed for the duration of the preventive proceeding). The initial period of the stay is limited to *four months*, but Member States may permit courts to extend it to a total duration of not more than 12 months. Note that, where a Member State chooses to implement the Directive in a way that the measure will not be covered by the EIR, then the total duration of the stay is to be limited to no more than four months if the centre of main interests of the debtor has been transferred to another Member State within a three month period prior to

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1 These circumstances are: (i) where a general stay of individual enforcement action is granted by the courts and the courts consider the appointment necessary to safeguard the interests of the parties; (ii) where there is cross-class cram-down; or (iii) where the debtor or a majority of creditors requests the appointment.

the filling of a request for the opening of preventive restructuring proceedings (Article 6(8)). Further, there should be certain safeguards in place (possible exclusions and conditions for lifting the stay).

- Any *mandatory insolvency filing rules for directors will be suspended* during the period of the stay. Creditors will also be suspended from initiating insolvency proceedings. Member States may however specify that such suspension will not apply where the debtor is cashflow insolvent, provided that a court can still decide to keep the stay in place if it is not in the general interest of creditors to open insolvency proceedings.
- Creditors to whom the stay applies and who have claims that at the start of the preventive restructuring framework had not been paid will be *prevented from withholding performance, terminating or otherwise modifying essential executory contracts* solely because the debts had not been paid. The Recitals (Recital 39) make clear that this affords the debtor protection against creditors who would otherwise put pressure on the debtor to pay those unpaid claims which would be reduced in the implementation of a restructuring plan. For these purposes 'essential executory contract' is to be an executory contract which is necessary for the continuation of the day-to-day operations of the business (including contracts concerning supplies, the suspension of which would lead to the debtor's activities coming to a standstill).
- The debtor will also benefit from a more *general protection against ipso facto clauses* – so that suppliers with contractual rights to terminate the supply contract solely based on the insolvency will not be able to invoke such rights.[2] It is interesting that the Recitals (Recital 40) refer to a situation where the debtor has duly met its obligations, but the text of the Directive itself is silent on this.

What is the restructuring plan?

- *The debtor will have a right to submit a restructuring plan*. It will be up to Member States to decide whether and when creditors and insolvency officeholders will also have the right to submit a plan.
- *Only 'affected parties' have a right to vote on the plan* – and on the flipside, unaffected parties should not be required to support the plan. Member States can decide to exclude certain persons from having a right to vote: (i) shareholders; (ii) creditors whose claims rank below the claims of unsecured creditors in a liquidation order; (iii) parties related to the debtor with a conflict of interest under national law.
- Affected parties are to be *divided into classes* to adopt the plan. Classes need to reflect a sufficient commonality of interest. As a minimum, secured creditors should be treated separately from unsecured creditors. Member States may also specify that workers are a class of their own. The Directive stipulates that the court will examine the class confirmation either when the plan is submitted for confirmation or, if Member States provide, at an earlier stage.
- *When is the plan approved?* A majority by value of affected parties in each class must vote in favour. Member States may also stipulate a majority in number in each class. The threshold will be set by each Member State, but must not be higher than 75% in the amount of claims or number in each class. Member States are also free to provide a participation threshold for the vote.
- *When does the plan need to be confirmed by the court?* If the plan (i) affects the claims or interests of dissenting affected parties; (ii) provides for new financing; or (iii) involves a loss of more than 25% of the workforce.
- *When can the court confirm the plan?* The Directive lays down certain criteria which must be met for the court to confirm the plan. In addition to procedural matters, these include, where there are dissenting creditors, whether the plan complies with the 'best interest of creditors' test. This means that no dissenting creditor is worse off under the plan than they would be under the normal ranking of liquidation priorities, either (i) in liquidation; or (ii) in the next best alternative scenario if the plan was not confirmed. The Recitals state that Member States should choose one of these two thresholds when implementing the test. A court will also be able to decline confirmation of the plan if the plan does not have a reasonable prospect of preventing insolvency or ensuring viability of the business.
- *What about cross-class cram-down?* Where some classes have not approved the plan with the requisite threshold, it can still be confirmed by a court where the plan:
  1. meets the 'best interests of creditors' test;
  2. has been approved by *either*
     - a majority of classes of affected parties if at least one of those classes is either secured or senior to unsecureds, *or*

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2 Note that Member States are able to provide that the stay does not apply to netting arrangements, including close out netting arrangements on financial markets, energy markets and commodity markets.

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  - by at least one class of affected or impaired parties (not being the shareholders or anyone who on a going concern value of the debtor would not receive anything in the liquidation priorities order);

3. dissenting classes are treated at least as favourably as any other class of the same rank and more favourably than any junior class (although Member States may derogate from this principle where necessary to achieve the aims of the restructuring plan); and
4. no class can keep more than the full amount of its claims.

Member States could increase the number of classes which need to approve the plan but cannot require consent of all such classes.

- *What about shareholders?* Where Member States choose to exclude shareholders from voting on the plan they must ensure 'by other means' that shareholders cannot 'unreasonably' prevent the adoption of a plan. Member States can adapt what is considered 'unreasonable' to take into account whether the debtor is an SME or a large enterprise, what the proposed restructuring is and what the type of shareholder is.
- *What about employees?* This was a hotly contested point. The Directive settles on the position that Member States are to ensure that workers' rights under individual and collective, national and EU law must not be affected, such as the right to collective bargaining or to information and consultation.
- *What about valuation?* Valuation is important for the court's confirmation of the plan: first, it must assess whether the 'best interest of creditors' test has been met; second, in cross-class cram-down, it must assess whether at least one impaired class (other than shareholders or those who would receive nothing in a liquidation) has approved the plan. The court will be able to appoint an expert on these issues.
- *What is the effect of the plan?* Plans which are confirmed by a court are binding upon all affected parties. The text of the Directive does not spell out the consequences of a plan that has been voted on by the requisite number of affected parties in each class. The Recitals state that such a plan should always be adopted (Recital 53).
- *Can the plan be appealed?* Yes – and whilst an appeal is not supposed to have suspensive force, Member States can derogate from this and suspend the execution of the plan if this is necessary and appropriate to safeguard the interests of a party. The court can set aside the plan or confirm it with or without amendments.

New financing and restructuring related transactions

Member States shall ensure that new and interim financing is not declared void and that the grantors of such finance do not incur civil, administrative or criminal liability because the financing is detrimental to the general body of creditors. Member States can restrict this protection to restructuring plans that have been confirmed by the court. Member States may provide that grantors of new or interim financing are also entitled to receive payment with priority in a subsequent insolvency in relation to other creditors who would have superior or equal claims. It is not entirely clear what this means but it appears to allow Member States to give priority to rescue financing over existing prior secured debt.

Where a debtor subsequently goes insolvent, certain transactions that are reasonable and immediately necessary for the negotiation of a plan are not void or unenforceable because they are detrimental to the general body of creditors. Such transactions include as a minimum the payment of fees and negotiating costs for the plan, professional advice in close connection with the restructuring and workers' wages.

Directors' duties

Member States are to ensure that, where there is a likelihood of insolvency, directors as a minimum have regard to the interests of creditors, shareholders and other stakeholders, the need to take steps to avoid insolvency and the need to avoid deliberately negligent conduct that threatens the viability of the business.

What are the measures to increase the efficiency of restructuring and insolvency?

Member States must have competent and well-trained courts and insolvency professionals and put in place appropriate oversight and regulatory mechanisms to supervise insolvency officeholders.

What's next?

The Directive needs to be formally adopted by the European Council, which is expected to happen at the Council meeting on 6/7 June 2019. Following this, the Directive will be published in the Official Journal of the EU and will enter into force 20 days later. Member States

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will then have two years to implement the Directive (plus an additional year if they encounter particular difficulties during implementation), so we are looking at an implementation date of June/July 2021 or, in special cases 2022.

A look around Europe – what does the Directive means for Member States?

In the UK and the Netherlands, domestic legislative insolvency reform is already taking into account the changes required by the Directive. Spain has a half way house, where further changes will be required but some improvements had already been made between 2013 and 2015. Germany will have to grapple hard with the Directive, as we detail below.

The UK

The implementation period of two years (plus an additional one if there are difficulties) means that, on the current Brexit trajectory, by the time the Directive would need to be implemented the UK is unlikely to be under a legal obligation to do so.

However, the UK may still choose to implement it in order to stay competitive. A number of aspects of the Directive have already been addressed by the UK in corporate insolvency reform proposals issued in August 2018 (the 'August 2018 proposals').

The current regime, if supplemented by the August proposals would meet the majority of the aims of the Directive. The UK already fares well in providing a second chance for entrepreneurs and efficient insolvency systems. The usual discharge period from bankruptcy (absent special cases) is 12 months – amongst the shortest in the EU. The UK's specially trained insolvency practitioners and designated business and property courts work well – 14th in the World Bank's resolving insolvent score with an average of one year to resolve insolvencies.

A tricky issue for the UK will be to define when there is a likelihood of insolvency where the debtor is not yet insolvent. The insolvency test in the UK is more fluid than in some other jurisdictions, where there is more of a hair trigger. It will be interesting to see how this definition is dealt with in practice.

The UK does not have a free standing moratorium – only available either consensually (as is common) or in the context of an administration. However, the August 2018 proposals include a free standing restructuring moratorium. We understand that due to wide criticism of the current proposed terms, significant work on this is still being undertaken in the UK.

Currently, if a contract provides for termination based on an insolvency trigger, parties in the UK are able (subject to few exceptions) to exercise such trigger. This would not meet the aims of the Directive. However, the August 2018 proposals include protections from ipso facto clauses that could meet the aims of the Directive.

The key criteria that the current UK scheme does not meet is cross class cram down. However, to the August 2018 proposals introduce a restructuring plan. If this comes into force, the UK plan would satisfy the stipulated criteria.

The UK dropped its proposals to introduce rescue financing. However, the UK does not have the same legal regime attaching criminal or civil liability to financiers lending to companies in distress. Certain aspects of the Directive will therefore not cause the UK much concern – others will need to be worked out to see how far the UK does want to go in terms of attaching priority to rescue financing.

The Netherlands

In the Netherlands, since 2012, a legislative overhaul of Dutch insolvency law under the name the 'Re-assessment of Bankruptcy law' (*Herijking Faillissementsrecht*) is taking place which aims to amend and modernise Dutch insolvency law. In the detailing of this legislative overhaul, the Dutch legislator already included the European Commission's Recommendation on a new approach to business failure and insolvency from 2014 (which ultimately resulted in the current Directive).

The legislative proposals under the Re-assessment program that focus on the enhancement of companies' ability to reorganise and on the modernisation of bankruptcy proceedings provide for similar features as set out in the Directive.

In addition, the Dutch legislator is considering to amend the current suspension of payments regime, in order to improve its effectiveness, for example by aligning the provisions regarding a composition plan with the legislative proposal that introduces a 'Dutch scheme'.

Furthermore, in light of a relaunch of businesses in bankruptcy, the protection of employees during a transfer of an undertaking is a hot topic of debate and currently being reconsidered by the legislator.

Germany

Germany is arguably one of the countries that will be most affected by the Directive. The reason is that Germany is one of the few remaining jurisdictions in the EU that does not provide for a preventive or pre-insolvency restructuring proceeding.

When the introduction of a pre-insolvency proceeding had been on the agenda of the German legislator, instead of implementing respective rules the so-called protective shield proceeding (*Schutzschirmverfahren*)

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was created as part of the German Insolvency Reform Act in 2011 (ESUG).

However, in contrast to a preventive process the protective shield proceeding requires the debtor to be technically insolvent and is therefore an insolvency proceeding. Most of the features of the preventive restructuring framework however are already incorporated in German insolvency law but the German legislator will have to spend significant time to work out how to harmonise the Directive with existing laws and/or replace existing pieces of legislation.

Spain

The Directive includes features already incorporated into the Spanish regulations back in 2013-2015, by means of the changes included in Article 5 *bis* (stay of enforcement following the pre-insolvency filing), the homologation procedure (ability to bind dissenting creditors and protection against claw-back), and the provisions enabling the second chance for entrepreneurs.

However, further changes must be implemented in Spanish legislation to incorporate all the compulsory Directive provisions.

Comment

Back in November 2016, we asked whether the draft Directive was Europe's answer to Chapter 11. The Directive was clearly influenced by Chapter 11, although, as with any piece of legislation that requires the buy-in of 28 Member States who all have different insolvency laws, the final text is very encouraging albeit in places weaker than the initial proposals.

Much will depend on how Member States implement the restructuring plan regime. The Directive provides for a framework with a range of options only. The new mechanisms should work better for European businesses than a US Chapter 11, especially for small and medium sized businesses. The costs of a Chapter 11 restructuring can be substantial, which is particularly problematic for smaller businesses (as US commentators have noted).

If fully embraced (and in particular, if not all 'watering down options' are taken up by Member States) the Directive will move Europe closer to the Chapter 11 model. This is good news for European restructurings. Where the UK will end up in this improvement process remains anyone's guess at the current Brexit uncertain time.

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