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EU DIRECTIVE ON RESTRUCTURING FRAMEWORKS: THE SAME, BUT DIFFERENT?

On 26 June 2019 a new EU Directive on preventive restructuring frameworks on discharge of debt and disqualifications, and measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt (the Directive) was published under number 2019/1023. Member States must implement the Directive by 17 July 2021, with possible extensions of up to one year. The Directive looks to ensure that there are minimum restructuring measures available across Europe to enable debtors in financial distress to solve their problems at an early stage and avoid formal insolvency proceedings. The Directive is advertised as promoting mechanisms which will prevent the build-up of non-performing loans and ensure that debtors have access to restructuring tools, leading to a reduction in the risk of those loans becoming problematic. However, the jury is out as to whether the measures will in fact deliver on these laudable aims.

Key issues

- Promotes minimum standards, but allows flexibility for individual Member States
- Access to early warning and preventive proceedings
- Stay on creditor action
- Cram down across classes
- Safe harbour for rescue finance

Philip Hertz, global head of restructuring and insolvency comments *"The Directive's approach to distress, aimed at restoring businesses to a healthy state, rather than liquidating them, is consistent with global restructuring trends*. *It is definitely seen as a welcome development*".

The ideas were first explored back in 2012 starting with a Commission recommendation and are now embodied in the Directive. (See our earlier briefings on the detail of draft proposals: European Proposal for harmonisation of restructuring law and A new EU landscape for restructuring: having your cake and eating it too?) In the legislative process, significant changes were made from the Commission's proposal submitted in the Autumn of 2016, including on several key parameters of the frameworks. A number of EU jurisdictions already have restructuring frameworks within their existing legislation, for example Miłosz Gołąb, partner in our Warsaw office observes "*The Polish insolvency/restructuring law framework has factored in most of the requirements of the Directive in its last major reform in 2016 (e.g. favouring Chapter 11-style restructuring proceedings over concurrent insolvency proceedings or an automatic stay of enforcement in most types of restructuring proceedings). Three years after that reform, it is evident to the courts and market practitioners that there is still room for improvement and for the practical aspects of the framework to function more efficiently (e.g. some* *of the new types of restructuring proceedings are almost unused and generally the proceedings still take too long to conclude for the distressed businesses to be able to survive). The Directive, therefore, will provide a further opportunity to review and potentially enhance the offering in Poland*".

Keys aspects of the Directive include:

Early warning tools and access to information - debtors will have access to early warning tools to enable them to identify circumstances that give rise to a likelihood of insolvency (e.g. advisory services; accountants, tax authorities to flag negative developments). Dorothée Vermeiren, partner in our Brussels office comments "*The Directive will serve to reinforce options which are already in place in a number of countries (such as Belgium) for a debtor and/or creditor to take action at an early stage when a company is experiencing financial difficulties or even non-financial difficulties (e.g. a loss of a key contract). The litmus test for the success of the Directive will be whether, apart from providing tools for SMEs to restructure, it will also facilitate cross border refinancings. In this regard it will be important to see how it interacts with existing local tools*". Reinhard Dammann, a partner in our Paris office also notes "*Although the provisions in the Directive are couched in terms that the warning tools are to signal to the debtor that action is required, the Directive may have unintended consequences. Not least in terms of employees who may prefer not to wait around for potential solutions to be found when provided with an assessment of the debtor's economic situation. It would be a pity if the good intentions of the Directive to help rescue businesses, in reality resulted in contributing to their demise. Furthermore, the directive may trigger an important change in French law since the opening of conciliation proceedings may have to be disclose to the workers' council, which is presently not the case".*

Availability of one or more preventive restructuring frameworks - the Directive provides that Member States must have at least one mechanism available that allows debtors who are in financial difficulties and face likely insolvency to remain in control of the day to day operations of their business and facilitate a restructuring and avoid a formal insolvency. It is specifically reserved to Member States to define what qualifies as "likely insolvency". Member States are also free to legislate that the framework will not be available to debtors who are "not viable" under a test that is defined by national law.

Ability to appoint a "practitioner in the field of restructuring"[1] in certain circumstances - i.e. where there is a general stay of enforcement; where there is cross-class cram down; where a debtor, or the majority of creditors requests such an appointment.

Stays on enforcement action - allowing negotiations for a restructuring to take place. Under the Directive a stay of enforcement (including in respect of third-party security providers) may be put in place for a maximum initial period of 4 months but can be extended for up to 12 months upon formal application and only if certain criteria are met. It may be automatic or court-ordered, and general or specific depending on the choices made by Member States upon implementation. The stay can also be refused up-front or lifted subsequently

[1] This is defined in the Directive as any person appointed by a judicial or administrative authority to carry out one or more of the following tasks: (a) assisting the debtor or creditors in drafting or negotiating a restructuring plan; (b) supervising the activity of the debtor and reporting to the judicial or administrative authority; or (c) taking partial control over the assets or affairs of the debtor

(e.g. where the restructuring no longer has the necessary support, or creditors are being unfairly prejudiced). The stay would normally suspend any mandatory obligations on the debtor to file for insolvency, however, Member States will have leeway on this point where the debtor is actually cash-flow insolvent.

Stays on enforcement action are an important aspect of any restructuring regime allowing negotiations for a restructuring to take place. Stefan Sax, a partner in our restructuring and insolvency team in Frankfurt notes "*The individual stay is perhaps one of the most important aspects of the Directive, this is because it will allow debtors time to formulate a restructuring plan, without the interference of action taken by individual creditors. Importantly the stay which can last up to 4 months (or longer if a formal extension is requested) is linked to supporting the negotiations of a restructuring plan, and safeguards apply such as ensuring that the stay does not unfairly prejudice creditors. Suspending the mandatory obligation on the debtor to file for formal insolvency proceedings may also be useful from the German perspective".*

Effect of stay on contracts (ipso facto provisions) - the Directive contains rules preventing creditors who are subject to the stay from withholding performance, terminating, accelerating or in any other way modifying essential executory contracts. These are defined as contracts which are 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 Directive indicates that Member States can extend these provisions to non-essential contracts, but it also allows for exemptions to be made in terms of netting arrangements, and close out arrangements in financial markets, energy markets and commodity markets. The exemptions, however, do not include contracts for the supply of goods, services and energy which are necessary for the operation of the debtor's business, unless they are traded on an exchange or other market. Subject to how Member States implement the Directive and express these exemptions, it is envisaged that these should not be problematic from the perspective of the financial markets.

Restructuring plans - can be promoted by the debtor, its creditors or the restructuring practitioner. The Directive sets out minimum requirements for debtor information and the terms of the restructuring plan. The restructuring measures can include mechanisms aimed at changing the debtor's capital structure, sales of assets or business, as well as any operational changes or a combination of both. Plans may be proposed "ex post", following a request of a stay and negotiations conducted under its protection, or "up-front" whereby the debtor files an agreement already negotiated with and agreed by the requisite majorities of stakeholders. "*This is an important feature of the Directive, allowing debtors who are able to negotiate substantial creditor support for the restructuring privately to file "a done deal" rather than "hang in the balance" while the negotiations and voting process unfold in the public eye over many months*," says Tomáš Richter, of counsel in our Prague Office.

Reasonable prospect statement - this statement is required to explain why the restructuring plan has a reasonable prospect of preventing the insolvency and ensuring the viability of the business. Subject to how Member States implement this aspect, there may be a requirement for the statement to be made or verified by an external expert or restructuring practitioner.

Voting on the restructuring plan - only parties affected by a plan will be eligible to vote. Individual Member States can also decide whether to exclude equity holders, creditors that rank below unsecured creditors, and related parties. Separate classes must be formed reflecting sufficient commonality of interest, with a minimum of separate classes for secured and unsecured creditors. Workers may be placed into a separate class depending upon the Member States enactment of the Directive. For SMEs, separation into different classes may be opted out by Member States entirely which Adrian Cohen, partner in our London office, says "*is fine as a matter of theory but in practice is a little worrying, given the fact that the definition of SMEs is left to the discretion of Member States. With a sufficiently high threshold in that definition, one may find that even sizeable companies are able to disregard the ranking of claims and put all creditors in one and the same class which may not always be a good thing. However, the lack of classification can be useful sometimes, for example we have a procedure in England known as the company voluntary arrangement (CVA) which has become popular in the context of retail restructurings. The CVA doesn't involve separating creditors into different classes, it does, however, have certain safeguards to protect secured and preferential creditors and also includes a right of challenge where for example creditors believe they have been unfairly prejudiced by the CVA*".

The majorities required for adoption of a restructuring plan are determined by Member States, but are not to exceed 75% of the amount of claims in each class (or where Member States opt for a headcount majority too, the number of affected parties in each class).

Confirmation of the restructuring plans - certain plans need to be confirmed by a judicial or administrative authority, this includes: those where there are dissenting parties affected by the plan; plans which include new finance; and plans which involved a reduction in the workforce of more than 25%. Once confirmed, the Directive provides that the plans are binding on all affected parties, even if they did not vote in favour.

Cross-class cram down - where not every class votes in favour of the plan, it may still be confirmed as long as certain conditions are satisfied. These conditions include where a majority of classes has approved the plan (provided that one is a secured creditor or senior to ordinary unsecured creditors class), or failing that, where at least one affected class (excluding equity holders) has approved the plan, as long as it ensures that the dissenting class is treated similar to others in that class and more favourably than any junior class (the so called "relative priority rule"), controversially introduced at a very late stage of the legislative process, and not really tested for its market impacts. No one gets more than the full amount of their claims. Member States may choose to derogate from these measures, for example they may increase the minimum number of classes or provide that claims in more senior classes are satisfied in full before any junior classes are paid (the so called "absolute priority rule"). Inigo Villoria, a partner in our Madrid office comments "*From the Spanish perspective, the classification of different creditor groups and the potential to cram down equity holders, will be a fundamental change to the current approach. No steps have been taken in Spain yet in anticipation of the Directive, so we will have to wait and see how this develops*." Reinhard adds "*The introduction of classes of creditors will be a very substantial change for French safeguard proceedings*".

Equity holders - generally speaking are not allowed to unreasonably prevent or create obstacles to the implementation of the restructuring plan. Member States may choose whether this is achieved by granting equity holders the right to vote on the plan or by other measures.

Workers - workers' rights under national and EU wide laws are not affected by the restructuring frameworks.

Valuations on the debtor's business – official valuations are only required when the restructuring plan is challenged either because the cross-class cram down conditions have not been met or dissenting creditors are worse off than in a liquidation or the next best alternative. However, as part of the information to be included in the plan, the debtor will have to provide its own valuation of the assets.

New financing - the Directive provides that new or interim financing is not liable to being unwound, and lenders should not incur liability as a result of such lending. Protection may be subject to circumstances where the financing has been formally approved. Optional super priority in a subsequent insolvency may also be provided for by individual Member States.

Concluding thoughts

The most significant changes introduced by the Directive will be the increased optionality for restructuring frameworks. This additional flexibility may be perceived as detracting from the original purpose of having a harmonised approach across Europe but in practice it may be a useful way of balancing minimum standards with local law requirements. These differences may result in arbitrage between the Member States, as the Directive allows Member States to pick and choose from the smorgasbord of restructuring options and debtors may seek the friendliest jurisdiction when it comes to a restructuring. "*This will no doubt be amplified by the fact that where the framework qualifies as proceedings eligible under Article 1 of the Recast European Insolvency Regulation and appears in its Annex A, it will have to be automatically recognised and enforced in all other Member States. It remains to been seen whether this sets off a race to the top, or the other way round*", adds Fabio Guastadisegni, partner in our Milan office.

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