RPC

Make insolvency great again

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One of the great criticisms of the new President of the United States of America is that his companies filed for bankruptcy four times when he was a business mogul. In truth Donald Trump utilised various provisions of Chapter 11 of the US Bankruptcy Code to restructure his businesses. In an effort to encourage a similar level of entrepreneurial spirit, a mere 14 days after his election the EU Commission unveiled plans to adopt a pan-European regime which closely mirrors much of the US's Chapter 11.

New EU restructuring framework proposed

The Commission has revisited the long-identified issue of inconsistency among insolvency regimes across Europe. For example, until December 2013 a bankrupt in Ireland could expect to be discharged only after 12 years. Even now, in Germany a businessman who goes bankrupt will not have legacy debts cleared until seven years later, whereas since 2003 in England and Wales bankruptcy will usually only last for one year and a rescue culture for businesses is actively pursued. These discrepancies had led in recent years to so-called "forum shopping" where individuals or companies would actively seek a favourable jurisdiction to enter an insolvency regime (a strategy undertaken by the Luxembourg registered Greek telecom group Wind Hellas in 2009/2010, which shifted its centre of main interest to the UK, seemingly to benefit from the UK's ability to effect pre-packaged sales in insolvencies). They have also, according to the world bank, led to vastly divergent rates for creditor recovery, from 30.5% and 32.7% in Croatia and Romania respectively to 89.3% and 90.1% in Belgium and Finland.

Designed to combat this, establish a rescue culture throughout Europe, foster start-ups through protecting entrepreneurs' ability to do business after bankruptcy and safeguard jobs, the EU Commission published a proposal for a Directive "on preventative restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU", (the Proposed Directive).

The Proposed Directive aims to achieve this through the introduction of minimum standards to be met by Member States. For the UK, many of these have already been met if not exceeded; however, Title II of the Proposed Directive would represent a distinct departure from the UK's current restructuring framework.

In particular, the Proposed Directive intends to introduce a preventative restructuring framework, which is in effect a turnaround plan and would:

- limit the involvement of judicial and administrative authorities
- allow debtors to fully or partially retain control of their assets and day-to-day management of their business in the same manner as a "debtor in possession" under the US's Chapter 11

Any comments or queries?

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- remove any automatic requirement for the appointment of an insolvency practitioner
- allow debtors to apply for a four month stay in enforcement proceedings, with the option for the court to extend this by further four month periods up to a total of one year
- oblige Member States to create one or more preventative restructuring frameworks to which a troubled debtor could apply, or a creditor could request with the debtor's permission; which would facilitate the debtor remaining totally or partially in control of their assets and day-to-day management of their business
- strengthen the effects of using a restructuring plan.

The Proposed Directive would also ensure that honest bankrupt entrepreneurs could have their debts discharged at an early stage no matter where in the EU they are based. The cumulative effect of these measures aims to reduce cross-border barriers to business and promote a second chance culture for entrepreneurs.

The potential impacts of the Proposed Directive should not be underestimated particularly for those member states which do not have well developed pre-insolvency restructuring laws and regulations.

Increased recoverability of debts
On a macroeconomic level it is designed to act to increase recoverability of defaulting loans through implementing viable reorganisation plans. This is likely to have a stabilising effect on the economy through releasing locked in capital from balance sheets which is presently allocated to doubtful debt turning non-performing loans into loans a company can actually pay back thereby freeing up capital to be invested elsewhere.

Cram-down of dissenting creditors
Although largely following the spirit of the Commission's recommendations of 12 March 2014 titled "on a new approach to business failure and insolvency", the Proposed Directive goes further; introducing potential cram-down mechanisms which represent a further development and a major change for many EU insolvency regimes. The Proposed Directive would allow judicial authorities to approve a restructuring plan, against the wishes of dissenting creditors, this would even facilitate a cram-down mechanism provided that:

- at least one class of the affected creditors has approved it
- no dissenting class of creditors would be paid in full before a more junior class can receive any distribution under the plan.

Increased distress funding
The Proposed Directive also paves the way for an increase in rescue investors. At present investors are often loath to involve themselves with a company verging on insolvency. Most companies will grant security over any assets well in advance of an insolvency situation and so any financier will have to prove as an unsecured creditor and risk receiving a paltry return. There is also the risk that such transactions could be overturned by a future insolvency practitioner appointed to oversee the company.

Under the Proposed Directive any new and interim financing will be protected from being void, invalid or unenforceable unless carried out in bad faith. Furthermore Member States will be permitted to afford grantors of new and interim financing priority in the context of any subsequent liquidation compared to other creditors who would otherwise have superior or equal claims to money or assets. In any event the Proposed Directive requires member states to rank new and interim financing senior to ordinary unsecured creditors.

Rescue financing has traditionally been a risky investment, whilst it is possible to secure large concessions from companies flirting with insolvency this has almost always been outweighed by the risk of losing all but a few pennies in the pound of an original investment when the company goes insolvent. Following the proposal whilst rescue investors who support an ultimately unsuccessful struggling company will not be guaranteed a return of all, or even a majority of their money, they do find their situation improved; albeit at the expense of traditional financiers.

For all of the progress which the Proposed Directive represents in encouraging Member States to create and access a pre-insolvency toolkit, in some respects it is an uncomfortable halfway house as it does not homogenise certain key areas of difference between national insolvency laws. Importantly, the Proposed Directive does not advance any definition of "insolvency" which brings into question the practical impact of a measure which defines itself by reference to a concept which will be at the mercy of individual Member States, which will continue to lead to disharmony in its interpretation. For example, in Germany insolvency is measured through a balance sheet test of overindebtedness, illiquidity or imminent illiquidity; France uses a test of being unable to pay current liabilities from disposable assets, and in England the provisions of the Insolvency Act 1986 which we recognise as the "balance sheet" and "cashflow" tests, were subject to judicial scrutiny reaching the Supreme Court in 2013 in *Eurosail*[1]. The Commission has acknowledged that the Proposed Directive is not designed to be comprehensive and explains that this is done on the basis of a desire to recognise divergent social values unique to individual Member States and also the differing historical and economic developments.

The Proposed Directive also deliberately excludes from its scope certain key areas insurance and re-insurance undertakings, credit institutions, investment firms, collective investment undertakings and central counterparties and credit institutions, as well as a range of specified financial institutions and entities in relation to which specialised regimes will continue to apply.

Reaction to the Proposed Directive within the UK has been broadly positive with R3 highlighting that due to its relatively advanced nature the UK regime already meets many of the requirements of the Proposed Directive. In terms of cram-down the UK's scheme of arrangement mechanism is tried and tested. It can have a wide international effect and experience suggests it is quicker and simpler than the exemplar Chapter 11 reorganisation plans.

Brexit and beyond

If it is adopted in due course, Member States are obliged to implement the Proposed Directive within two years. For the UK this represents particularly acute timing given the UK government's stated intention to trigger the Article 50 notice to leave the EU.

As it happens, the UK government was already revisiting its own restructuring regime well in advance of the Brexit vote. The UK has always enjoyed a historic advantage over European regimes through a more rescue focused insolvency culture, and it is evident that the UK is determined to lead the charge in engendering a new version of a rescue culture: The Insolvency Service advanced the UK government's own proposals for the UK in May 2016. These set out means to:

- create a new moratorium period for financially distressed (but viable) companies which would prevent creditors from acting against a company
- require essential suppliers to continue to supply a distressed company without the use of termination clauses or ransom payments
- create a "new restructuring plan" to bind secure and unsecured creditors and to enable a "cram down" of classes of dissenting creditors
- encourage rescue finance .

R3, The Association of Business Recovery Professionals, welcomed the Insolvency Service's proposals in nuanced terms, noting that whilst the proposed tools would improve

1. [2013] UKSC 28

the UK's World Bank ranking they would not "lead to a significant improvement to the UK's business rescue landscape".

As with the Proposed Directive, the Insolvency Service's proposals would not require an insolvency practitioner to run the company during the moratorium. However, an IP would be required to supervise the process and to ensure that the company's management was not abusing the moratorium (and to bring the moratorium to an end if there was evidence of abuse). This was the cause of particular concern for some respondents to the government's consultation who argued the lack of a requirement for regulated insolvency practitioners to act as supervisors could lead to potentially unethical, untrained and unregulated "supervisors" acting to the ultimate detriment of a company.

Traditionally the UK has shied away from introducing cram down provisions and rescue finance, however, responses to the Insolvency Services' proposals showed 61% of respondents agreeing with the idea that a cram down would be appropriate in certain circumstances.[2]

With the introduction of the new Insolvency Rules scheduled for 6 April 2017 to simplify and modernise the UK's current insolvency regime, and the proposals tabled by The Insolvency Service, the UK government is clearly trying to maintain a competitive edge in insolvency and restructuring terms, whatever the effect of Brexit.

Perhaps the greatest obstacle in implementing the objectives of the Proposed Directive and the Insolvency Service's proposal will be in adjusting creditor attitudes to engage with the new regime. The US has always retained a strongly entrepreneurial spirit and a view that even the poorest in society are merely "temporarily embarrassed millionaires", this view is not widely shared across Europe.Together the UK and EU proposals attempt to change something more significant than merely the regulatory framework, they attempt to change the underlying social view of Insolvency. The UK has attempted this already through the Enterprise Act 2002. If the Proposed Directive is implemented it will be a big step forward for many member states which will be welcomed by many businesses operating on an international platform.

2. Paragraph 4.5, Summary of Responses: A Review of the Corporate Insolvency Framework, The Insolvency Service

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