Restructuring Regimes at the Cross-Roads: Reform or Reflect?

February 2017

Introduction

Against a very uncertain background, the European Commission and the UK Government are reaching for the same panacea: reform. On 22 November, the Commission's long awaited draft harmonisation directive finally arrived, described in the press as Europe's answer to Chapter 11. Meanwhile, the Insolvency Service is mulling over the responses to its consultation on reforming the UK's corporate insolvency framework, an exercise which proposed a series of reforms that, if enacted, would go a long way to meet the requirements of the directive. In this briefing, we consider the proposals and the forces driving them, and ask whether this is the right time for the Government to pursue a reform agenda.

What is the harmonisation directive?

At present it is a draft, or 'legislative proposal'. 'Harmonisation directive' is an abbreviation; its full name is so long and unwieldy that we are consigning it to a footnote[1]. It sets out an ambitious agenda for the partial harmonisation of EU Member States' restructuring and insolvency regimes. If enacted, each Member State would have two years to ensure that it has a 'preventive restructuring framework' in place that meets the criteria set out in the directive. It also contains measures intended to increase the efficiency of insolvency processes in general[2]. It is still early days though. The European Council and Parliament need to approve the proposal, which may be amended along the way. From the UK perspective, the time frame means that Brexit is likely to intervene.

What is the status quo?

The EC Insolvency Regulation (or ECIR) provides a framework that governs jurisdiction and guarantees mutual recognition of insolvency proceedings across the EU (except Denmark). It came into force in 2002, and has been broadly effective in simplifying some of the cross-border elements of complex restructurings. From 22 June, a substantively revised version will include measures that aim to facilitate communication and cooperation in restructurings involving groups of companies. However, until now, the *contents* of Member States' restructuring and insolvency procedures have been a matter for domestic law. The directive still falls short of complete harmonisation – plenty of matters remain outside its scope, but nonetheless, substantive harmonisation is turning up the heat.

---

[1] Proposal for a directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU.

[2] As well as measures that aim to give individual 'entrepreneurs' a 'second chance'. This article focuses on the corporate aspects of the proposal.

Why the harmonisation drive?

The Commission thinks that some degree of harmonisation of domestic insolvency law is essential for the effective functioning of the single market. It believes that differences in national insolvency procedures make it harder for investors to assess credit risk and deter cross-border investment. The Commission also believes that in some Member States the insolvency framework steers viable businesses towards liquidation instead of restructuring, and that greater incidence of preventive restructuring frameworks would reduce the volume of non-performing loans in some jurisdictions, freeing up capital for fresh investment.

This isn't the Commission's first foray into harmonisation territory. The harmonisation directive's most recent antecedent was the 2014 Recommendation on a new approach to business failure and insolvency, which detailed the matters the Commission believed should be incorporated into Member States' domestic law to achieve a base level of consistency across the EU. The Recommendation had no legal force; the Commission hoped that Member States would comply voluntarily. It was disappointed with the result, noting that a significant number of Member States implemented the suggested reforms in part only.

What would this 'preventive restructuring framework' look like?

Each Member State would need to ensure it has a preventive restructuring framework that offers companies the following, whether in a single procedure or across several:

Debtor in possession: a procedure that allows the company undergoing the restructuring to remain at least partially in control of its assets and the day-to-day running of its business. The appointment of an insolvency practitioner cannot be mandatory in all cases.

Moratorium: the company must have access to a stay against enforcement actions to protect it during the restructuring. The stay must be capable of preventing all types of creditor (including secured and preferential creditors) from taking action against the company, although whether the stay is general (covering all creditors as a matter of course) or limited (covering one or more individual creditors, as necessary) appears to be a matter for national law. The stay cannot exceed 12 months, including extensions and renewals.

'*Ipso facto*' clauses: counterparties must in some circumstances be prevented from relying on clauses that allow them to terminate or modify contracts with the company solely because it seeks the protection of a stay or enters restructuring negotiations.

Affected parties' right to vote: all creditors who would be affected must have the right to vote on the adoption of a restructuring plan. Creditors are to be grouped together in a class if they have rights and interests sufficiently similar to justify treating them as a homogenous group with a commonality of interest. Secured and unsecured creditors cannot be placed in the same class. The threshold for approval is to be set by national law but cannot exceed 75% by value within each class.

Cross-class cram-down: drawing inspiration from Chapter 11, classes of creditor which do not vote in favour of the plan will not be allowed to prevent its implementation if they are 'out of the money' (i.e., if they would not receive anything on a liquidation). Various other criteria must be satisfied, for instance at least one affected class must approve, and the plan must satisfy the 'absolute priority' rule (meaning the claims of each class of dissenting creditors must be satisfied in full before a more junior class can receive anything).

Member States are also required to protect the new and interim financing necessary to enable successful restructurings, in particular by making sure it is not susceptible to attack in subsequent insolvency proceedings. They may also allow providers to take priority in such proceedings.

What is the UK Government up to?

The UK Government initially put up some resistance to the harmonisation project. When the Recommendation came out, the Department for Business, Innovation and Skills (as it was then) was sceptical. It highlighted that the UK's 'flexible and effective' regime was very much in keeping with the general themes of the Recommendation, and already recognised across the world for its efficiency, emphasis on business rescue and high levels of returns to creditors. It didn't propose launching a reform agenda off the back of the Recommendation.

However, back in May last year, the Government began an exercise that it described as '*a review of the corporate insolvency framework: a consultation on options for reform*'. It put forward four specific proposals for consultation – (i) the introduction of a new stand-alone restructuring moratorium, (ii) further limitations on the use of 'ipso facto' clauses to protect supplies deemed essential to troubled businesses, (iii) the introduction of a flexible, multi-class restructuring procedure, with provision for cross-class cram-down, and (iv) a variety of measures to incentivise rescue finance.

These proposals foreshadowed key aspects of the draft directive's preventive restructuring framework. This is hardly surprising as the Government and the Commission are both inspired by some common themes and sources, in particular the World Bank's *Doing Business* report and its work on restructuring and insolvency.

Reform or reflect?

So quite how controversial is the harmonisation directive? That rather depends where in Europe you are. Some EU Member States will need to reform their corporate insolvency legislation radically in order to comply. From a UK perspective, however, none of the requirements are alien. Though we don't at present have a stay which meets all the criteria, moratoria are native to our restructuring landscape, from the statutory stays in administration and small company CVAs, to the market developed use of schemes of arrangement or lock-up agreements to set up a stay. While we don't have a formal mechanism for cross-class cram-down, companies are able to achieve it in certain circumstances, for instance by using a pre-packaged administration sale, if necessary twinned with a scheme of arrangement. In other words, we already have a market-friendly, tried and tested regime, which has been adapted to achieve similar results and which could be bolstered in line with some of the draft directive's requirements without ripping up our existing framework.

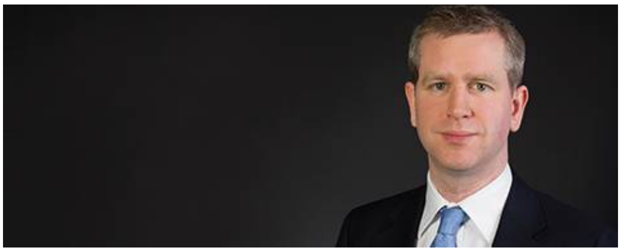
Assuming that the UK Government presses ahead with its plans for a 'hard, fast Brexit', we may not have to comply with the directive – negotiation of the final text is likely to take some time, and the current draft envisages a two-year period for Member States to reform their regimes. Unless the Government changes tack, it seems unlikely that ongoing formal participation in the EU's insolvency harmonisation project will be on the agenda.

However, now more than ever, we want our restructuring framework to remain competitive. We are currently a restructuring jurisdiction of choice for creditors and investors the world over. A lot of that has to do with factors that will not be affected by Brexit, in particular the appeal of English law, the tried and tested nature of our procedures, and the expertise of our judiciary. But some other European jurisdictions are starting to reform their restructuring procedures, with a view to making them more competitive internationally as well as effective domestically. Now the draft directive is out, we can expect more jurisdictions to follow. We need to ensure we stay ahead of the game – particularly as a hard Brexit may increase the risk that we lose the ECIR framework of jurisdiction and mutual recognition, which may make other EU jurisdictions more attractive for cross-border restructurings in certain circumstances.

If there is an EU-wide race to comply with the directive, then we have a head start, and we should maintain it. We should use this as an opportunity to make our restructuring regime as good as it can be, drawing on the Commission's proposals where we believe the case is made out.

However, we should be wary of a rushed job. Any proposed legislation coming out of the Government consultation should ideally be given time for detailed scrutiny, and we should be careful not to jeopardise our competitive advantage with rushed reforms.

Ian Johnson
Partner
T +44 (0)20 7090 4732
E ian.johnson@slaughterandmay.com



Tom Vickers
Partner
T +44 (0)20 7090 5311
E tom.vickers@slaughterandmay.com

Nicky Ellis
Professional Support Lawyer
T +44 (0)20 7090 4406
E nicky.ellis@slaughterandmay.com