WHITE PAPER

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All Change In Europe—New Chapter 11-Style Restructuring Regime Is On Its Way!

On 26 June 2019, the new Harmonisation Directive[1] was formally published in the Official Journal of the European Union. As a result, by 17 July 2021, each Member State must include in its respective insolvency and restructuring laws a US Chapter 11-style debtor-in-possession regime which will radically change the future landscape of the European restructuring market. In this White Paper, we consider the key features of the Directive and its implications for stakeholders.

To date, EU legislation in the area of corporate insolvency and restructuring has largely been limited to cross-border recognition and cooperation without any attempt to harmonise substantive insolvency laws across Member States. The new Directive is a first step in this direction.

1 Formally known as the Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventative restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency).

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OBJECTIVES

The Directive's principal objective is to reduce some of the existing barriers to the free flow of capital which are, in part, caused by the differences in each Member State's restructuring and insolvency laws. The Directive aims to achieve this objective by harmonising such laws and requiring each Member State to enact a framework which ensures that:

- Viable enterprises and entrepreneurs that are in financial difficulties have access to effective national preventive restructuring frameworks which enable them to continue operating;
- Honest insolvent or over-indebted entrepreneurs can benefit from a full discharge of debt after a reasonable period of time (a "second chance"); and
- The effectiveness of procedures regarding restructuring, insolvency and discharge of debt are improved, in particular with a view to shortening their length.

KEY FEATURES

The key features of the Directive include:

- **Restructuring Plan**: Debtors will be permitted to propose a restructuring plan for adoption by the affected parties and to request a cross-class cram-down of creditors.
- **Debtor-in-Possession Proceeding**: Debtors should have access at the earliest opportunity to a restructuring proceeding for the purpose of restructuring viable businesses. Like Chapter 11, the debtor should remain in control of the company, save in certain circumstances where Member States consider it necessary that an insolvency practitioner should be appointed.
- **Stay of Individual Enforcement Actions**: Debtors shall be permitted to apply for a stay of individual enforcement actions for a period of four months (extendable to 12 months in certain circumstances). However, this stay will not preclude the enforcement of financial collateral arrangements within the meaning of the *Financial Collateral Arrangements (No. 2) Regulations 2003 (SI 2003/3226)* such as charges over shares or deposits.
- **Insolvency Termination Clauses Not Enforceable**: In order to help preserve the goodwill of the debtor, creditors will not be entitled to withhold performance, terminate or otherwise rely on insolvency termination clauses (otherwise known as *ipso facto* clauses) contained within their contracts with the debtor by reason of the stay or the debtor taking steps to propose a restructuring plan. Further, for the duration of the statutory stay, suppliers may not terminate supply contracts as a result of non-payment in the period prior to the stay.

THE RESTRUCTURING PLAN

The objective of the restructuring plan will be to ensure the survival of the company on a going-concern basis. The underlying terms of the plan are not prescribed by the Directive, thereby ensuring that debtors have a wide array of restructuring options at their disposal which can be tailored according to the circumstances of each case. Such tools may include, for example, a debt-for-equity swap, extension of maturity or debt write-down.

The process for the approval of the restructuring plan is very similar to an English scheme of arrangement and generally encompasses the following key elements:

- **Class Division**: For the purposes of voting on the plan, creditors will be divided into classes based on there being a sufficient commonality of interest among creditors in the same class. As a minimum, secured and unsecured creditors will comprise two separate classes.
- **Creditor Approval**: Affected creditors (only) will be permitted to review and vote upon the plan. The approval threshold is a majority in value of each class with no numerosity test. However, Member States are permitted, upon transposing the Directive into national law, to increase the approval threshold to a maximum of 75% in value of each class and may include a numerosity test.
- **Court Sanction**: As a minimum, court sanction will be required to confirm a plan where: (i) a cross-class cram-down is proposed; (ii) the plan provides for new financing; and/or (iii) the plan involves the loss of more than 25% of the workforce (if such loss is permitted under national law).
- **Cross-Class Cram-Down**: The binding effects of a restructuring plan are generally limited to the affected parties that were involved in the adoption of the plan. The debtor may request that even dissenting classes of creditors are nonetheless bound by the terms of the restructuring plan (known as a "cross-class cram-down") provided that, amongst other things:

- Subject to certain exceptions, the Absolute Priority Rule[1] is observed;
- The plan complies with the "best-interest-of-creditors" test (in other words, no dissenting creditor should be worse off under a restructuring plan than it would be either in the case of liquidation or in the event of the next-best-alternative scenario if the restructuring plan were not to be confirmed); and
- The plan has been approved by a majority of the voting classes, provided that at least one class is: (i) a secured creditor class; (ii) senior to the ordinary unsecured creditors; or failing that (iii) an otherwise affected or impaired party (excluding shareholders and any party who would not otherwise stand to receive a dividend in a liquidation scenario).

THE END OF FORUM SHOPPING?

Earlier drafts of the Directive provided limited flexibility for Member States with regard to both the scope and implementation of the Directive. However, following extensive negotiations during the approval process, the Directive now provides considerable opportunity for divergence among Member States. For instance, as noted above, Member States can set the creditor approval threshold anywhere between a basic majority (over 50%) and 75% in value. Member States also have the option to include a numerosity test (which is currently applicable within the context of an English scheme of arrangement). The UK Government has advised that it will set a creditor approval threshold of 75% in value but that it will dispense with the numerosity test. By way of comparison, in the Netherlands and France, approval thresholds of 66-2/3% have been proposed, also with no numerosity test. In Italy, it is proposed that, in respect of creditor agreements (*concordato preventivo*), the approval threshold will be 51% in value, whereas in respect of restructuring agreements, the threshold will be 60% in value (or, provided that no stay of individual enforcement actions is requested by the debtor, 30% in value).

In relation to class composition, Member States are permitted to place workers and equity into separate classes, and in the case of Small- to Medium-Sized Enterprises, or SMEs, creditors could be permitted to vote in one class. Provision for new money and the role of insolvency practitioners may also vary between Member States, potentially resulting in material differences among jurisdictions. Given the above, far from abating the trend of forum shopping in Europe, this trend is likely to continue in circumstances where more options are likely to be available and the decision as to where to restructure may ultimately be deteremined by the relevant controlling stakeholder(s).

Another objective of the Directive is, in part, to promote the repatriation of insolvency proceedings so that stakeholders have (so it is intended) greater certainty as to where a company will be restructured in the event of distress. The recent trend of forum shopping in the European restructuring market has to a large extent been driven by the lack of suitable restructuring tools available in certain jurisdictions. The Directive seeks to address this issue.

However, in practice, the availability of viable restructuring tools comprises only part of the analysis when considering where to a restructure a company. The other part of this analysis, and often the determinative factor, relates to the available legal infrastructure—the relevant court system, the impartiality and experience of the judiciary and the predictability of legal proceedings. In order to address the perceived deficiencies in legal infrastructure across Europe, the Directive will require Member States to ensure that members of the judiciary, together with insolvency practitioners, are suitably trained and have the appropriate expertise to preside over and advise on restructuring and insolvency cases. These are welcome changes which should, in due course, provide for a more mature and sophisticated restructuring landscape across Europe.

CHAPTER 11 FOR EUROPE?

Whilst the Directive incorporates many of the key features of US Chapter 11, it does not include any mechanism to provide new super senior financing to the debtor whilst it is being restructured (often referred to as "debtor-in-possession" or "DiP" financing). In many restructurings, a company's access to new money is determinative as to whether it can survive as a going concern. Therefore, the absence of debtor-in-possession financing which can prime existing lenders is perhaps the Directive's most fatal flaw. That said, Member States will be permitted to accommodate new financing where appropriate. Moreover, in certain jurisdictions where new money can be subject to claw-back in the event of subsequent insolvency, Member States will (subject to certain local law exceptions) now be required to ensure that as a minimum, new and interim financing is adequately protected in the event of subsequent insolvency. These steps will certainly assist in facilitating the availability of new money to debtors in distress.

Whilst the EU is keen to ensure that debtors have access to a debtor-in-possession restructuring proceeding, it also wants to avoid the perceived incumbent and sometimes prohibitive costs of Chapter 11 proceedings. In order to achieve this, the EU has proposed a more streamlined proceeding with minimal court oversight and no committee representations which are an integral feature of a Chapter 11 proceeding. In practice, these steps will help to ensure that enterprises of all sizes can access the new proceedings. However, it will be interesting to observe if the lack of judicial oversight in certain situations provides scope for abuse and challenge, particularly in the context of valuations of the debtor's business and assets. Given the amount of flexibility offered to Member States when transposing the Directive, the degree of similarity to a Chapter 11 will naturally differ between Member States.

IMPLICATIONS FOR STAKEHOLDERS

The implications of the Directive for each financial stakeholder of a debtor will, to some extent, depend on how the Directive is implemented in each Member State. It is also important to note that the new regime is permitted to sit alongside any existing restructuring tools and proceedings currently available in Member States. Consequently, in the United Kingdom, for example, debtors could continue to use English schemes of arrangement and company voluntary arrangements in the usual way.

For jurisdictions such as the Netherlands which do not, at present, have a restructuring tool available to restructure complex capital structures, the new "Dutch scheme", which is expected to come into force in 2020, will represent a significant advancement for all stakeholders.

For jurisdictions such as France, where at present creditors are for voting purposes generally organised into three separate classes—lenders, bondholders and suppliers—the creation of new creditors classes is likely to loom large in determining how investors are going to invest and which kind of security package they are going to negotiate.

For other jurisdictions where the restructuring landscape is largely dominated by court-appointed insolvency practitioners, such as Germany, or in others where creditor rights are treated as paramount, the availability of a debtor-in-possession proceeding will undoubtedly provide much greater leverage to debtors and sponsors alike. However, the treatment of equity holders in the restructuring plan will be critical as to how these dynamics play out in practice. This could have a significant effect in jurisdictions such as Spain, where equity holders have traditionally been able to exercise a high degree of leverage in restructuring situations.

With regard to lenders in particular, the availability of a holistic restructuring tool to restructure a debtor's entire capital structure will undoubtedly provide greater scope to rescue companies on a going-concern basis. However, the Directive includes certain provisions which could be potentially problematic for lenders and distressed investors in particular. For instance, where a cross-class cram-down is to be imposed, Member States will have flexibility to derogate from the Absolute Priority Rule where it is necessary to achieve the aims of the restructuring and it does not unfairly prejudice the rights or interests of any affected parties. The Directive expressly refers to two possible scenarios on this point, including where it is considered fair that: (i) equity holders retain certain interests under the plan despite a more senior class being obliged to accept a reduction of its claims; or (ii) essential suppliers covered by the provision on the stay of individual enforcement actions are paid before more senior classes.

Further, when determining if a senior class of creditors has been satisfied in full before a junior class of creditors can receive any distribution, Member States will have flexibility to determine what "payment in full" means. For instance, provided that the principal outstanding is not compromised, Member States will have the flexibility to provide that debt may simply be extended out. In practice, this could mean that significant maturity extensions are imposed on senior lenders. There is also scope to satisfy a claim by equivalent means which could mean the lenders are forced to accept a different instrument whilst still having been regarded as having been repaid in full.

NEXT STEPS

Member States now have until 17 July 2021 (subject to certain extensions, if required, for up to one year) to implement the Directive into local law. In practice, some Member States are well progressed towards implementation. For instance, the Dutch Scheme will become effective in 2020.

In Spain, a working group has been formed under the auspices of the Ministry of Justice with the instruction to draft a proposal for the transposition of the Directive into local law. There has been no public announcement as to the expected date of delivery of such draft text.

In France, a law published in April 2019 enables the French Government to rule, within two years, by way of orders, on both the transposition of the Directive into local law and the simplification and improvement of the efficiency of financing securities. The concomitance of these reforms is likely to be an opportunity to modernise the existing restructuring tools in France and set up a better equilibrium to the benefit of the secured creditors in the absence of survival of the company on a going-concern basis.

In Italy, a new insolvency code has been recently enacted ("New Code") and will be effective from 14 August 2020. In line with the Directive, the provisions of the New Code create, *inter alia*: (i) a new preventive restructuring framework; (ii) new rules encouraging new and interim financings by both lenders and equity holders whose claims can be satisfied with priority over both secured and unsecured claims in the case of subsequent insolvency (the same will also apply to essential suppliers' claims); (iii) new tools providing for the repayment in full of creditors who did not adhere to restructuring plans; and (at the same time) (iv) the possibility to satisfy a claim by equivalent (e.g., by issuing a new instrument on different terms but where the principal outstanding is not compromised) and to extend to dissenting creditors any stay of individual actions or maturity extensions. Moreover, it is already envisaged that the New Code will be supplemented and amended before becoming effective, thus being further aligned to the Directive (e.g. with respect to cross-class cram-down provisions and possible derogations to the Absolute Priority Rule, which in Italy has so far been applied strictly).

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ENDNOTES

1 The Absolute Priority Rule stems from US bankruptcy law and is the principle that junior creditors cannot receive a distribution unless senior creditors have first been paid in full. It is most often referred to within the context of a US Chapter 11, whereby some of the more controversial (and often invalidated) Chapter 11 plans purport to benefit subordinated creditors at the expense of more senior-ranking creditors, thus violating the rule.