KEY POINTS

- Although the UK pre-insolvency reforms aim to achieve broadly the same outcomes as the proposed European pre-insolvency reforms, there are some key points of divergence.
- The proposed UK restructuring plan incorporates the absolute priority rule but allows deviation from it which could offer a comparative advantage to debtors in the UK when compared with jurisdictions such as Germany or Spain.
- Participants may prefer some of the features of the European Restructuring Directive which the UK may not choose to adopt such as debtor in possession financing.

Feature

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Dutch and UK responses to the EU Restructuring Directive

This article explores the direction of travel of European pre-insolvency reforms by considering the EU Directive on Preventive Restructuring (the Directive), the Dutch *Wet homologatie onderhands akkoord* (WHOA) and aspects of the pre-insolvency regimes of certain other member states. The article then examines key differences between the European reforms and the proposed UK pre-insolvency reforms (the UK Reforms) to posit the potential impact on the competitiveness of the UK restructuring market.

INTRODUCTION

The Directive published on 26 June 2019 aims to prevent the insolvency of viable enterprises and entrepreneurs across the European Union by facilitating early access to preventive restructuring frameworks. The Directive prescribes minimum standards requiring member states to introduce, *inter alia*, debtor-in-possession tools to help debtors restructure their debts with minimal risk of minority hold-out creditors frustrating fair and credible restructuring arrangements.

Several European jurisdictions have developed or are in the process of developing their own pre-insolvency regimes: in some cases, as a result of their experiences during the global financial crisis and in other cases to proactively align their domestic laws with the Directive. The most recently developed pre-insolvency regime is the *Wet homologatie onderhands akkoord* (WHOA) which is currently under consideration in the Dutch parliament. If adopted, the WHOA would incorporate aspects of the US Chapter 11 procedure and the English scheme of arrangement. In parallel, the proposed UK Reforms have widely been consulted on by the UK government but have not yet been brought to parliament as draft legislation.

The article is structured as follows:

- Section 1: description of the preventive restructuring framework under the Directive;
- Section 2: description of the WHOA and aspects of certain other member states in the context of the Directive; and
- Section 3: comparative analysis of the European reforms and UK Reforms to analyse the future competitiveness of the UK's restructuring market.

SECTION 1: THE DIRECTIVE'S PREVENTIVE RESTRUCTURING FRAMEWORK

Debtors who face "likelihood of insolvency" are eligible to apply

Subject to certain exclusions, the preventive restructuring framework will be available to all debtors who face a likelihood of insolvency but are not yet insolvent under their respective national law. Member states are also free to allow creditors' and employees' representatives to apply with the agreement of the debtor.

Debtor in possession

The debtor should be left in possession of its assets and the day-to-day operation of its business subject to the requirement for an insolvency practitioner to be appointed if:

- a general stay of enforcement is granted by the courts and the courts consider such an appointment necessary to safeguard the interests of the parties;
- there is a cross-class cram down (ie if at least one class which is in the money has accepted a plan, the debtor (or restructuring expert) may request that the court sanctions that plan and thereby imposes it on dissenting creditor classes); or
- the debtor or a majority of the creditors request such an appointment.

Stay of individual enforcement actions

Debtors are to be allowed to apply to the court for a stay against enforcement of claims (including, secured claims and preferential creditors, except for employees' claims unless payment of these is guaranteed for the duration of the preventive proceeding). Member states have the discretion to provide for the stay to apply for the benefit of third party security providers including collateral givers and guarantors.

The initial period of stay is limited to four months but member states may grant longer stays (although the total period of stay is to be no more than 12 months, member states can provide for an indefinite stay if the debtor becomes insolvent under national law). Extensions or a new stay of enforcement actions can only be granted where:

- relevant progress has been made in negotiations on the restructuring plan;
- the stay does not unfairly prejudice the rights or interests of any affected parties; and
- insolvency proceedings which could end in the liquidation of the debtor under national law have not been commenced.

Courts may lift a stay on individual enforcement where:

- the extension no longer fulfils the objective of supporting negotiations;
- requested by the debtor or the insolvency practitioner;
- so provided for in national law;
- one or more creditors are unfairly

prejudiced by the stay; or

- the stay gives rise to the insolvency of a creditor.

During the period of stay on enforcement actions, mandatory insolvency filing rules for directors are suspended and creditors are suspended from initiating insolvency proceedings which could end in the liquidation of the debtor.

Essential contracts

Creditors to whom the stay applies, and whose claims came into existence prior to the stay, will not be allowed to withhold performance of, terminate, accelerate or, in any other way modify essential executory contracts (contracts which are necessary for the continuation of the day-to-day operations of the debtor's business, the suspension of which would lead to the debtor's activities coming to a standstill), provided that the debtor complies with its obligations under such contracts which fall due during the stay. Member states have the discretion to extend these protections to non-essential executory contracts as well.

Prohibition of *ipso facto* clauses

Creditors are not allowed to invoke *ipso facto* clauses (clauses that allow suppliers to terminate supply contracts solely on account of the debtor's insolvency, even if the debtor has met its obligations) which make reference to negotiations on a restructuring plan or a stay or any similar event connected to a stay.

Rescue finance

Generally speaking, member states are required to provide that in the case of the subsequent insolvency of the debtor:

- new and interim financing shall not be declared void; and
- grantors of such financing shall not incur any liability on the ground that such financing was detrimental to the general body of creditors.

Member states may also provide that grantors of such financing would receive payment in priority to other creditors that would otherwise have superior or equal claims.

Provision for a restructuring plan

The debtor and, if a member state so decides, creditors and insolvency officeholders, will have the right to submit a restructuring plan. The Directive provides the following guidelines in respect of the restructuring plan:

(a) Only affected parties (creditors and, where applicable under national law, shareholders, whose claims and interests are directly affected by a restructuring plan) have a right to vote on the plan.

(b) Affected parties should be divided into classes for the purposes of voting based on commonality of interest (at a minimum, secured and unsecured creditors should vote in different classes).

(c) For the plan to be approved, a majority of affected parties in each class must vote in favour. Member states may stipulate a majority in number in each class; however, any threshold set must not be higher than 75% of the amount of claims or number of affected parties in each class.

(d) The restructuring plan needs to be confirmed by the court if it: (i) affects the claims or interests of dissenting affected parties; or (ii) provides for new financing; or (iii) involves a loss of more than 25% of the workforce. In order for the court to confirm the plan, it would need to satisfy itself that the plan complies with the "best interests of the creditors", ie that no dissenting creditor is worse-off under the plan than it would be under the normal ranking of priorities either in a liquidation or in the next best alternative scenario if the plan was not confirmed (member states have the discretion to choose which comparator to adopt). Once the restructuring plan is confirmed by the court it is binding upon all affected parties: creditors not involved in the adoption of a restructuring plan under national law are not affected by the plan.

(e) Cross-class cram down can be confirmed by the courts where, *inter alia*:

(i) the plan meets the "best interests of creditors" test;

(ii) the plan has been approved by either: (i) a majority of the voting classes of affected parties (provided that at least one of those classes comprises secured creditors or is senior to the ordinary unsecured creditors class); or (ii) at least one voting class of affected parties (other than shareholders or those who would receive nothing in a liquidation). Member states may increase the number of classes which need to approve the plan but cannot require consent of all such classes;

(iii) dissenting classes are treated at least as favourably as any other class of the same rank and more favourably than any junior class; and

(iv) no class can receive or keep the full amount of its claims, although derogation from the above is permissible where necessary to achieve the aims of the plan and where the plan does not unfairly prejudice the rights of affected parties.

(f) The courts only decide on a valuation of the debtor's business where a plan is challenged based on a failure to: (i) meet the "best interests of creditors" test; or (ii) satisfy the cross-class cram down criteria above. The court will be able to appoint an expert on these issues.

(g) Once the plan is confirmed by the court, it is binding on all affected parties. The plan can be appealed, and member states have the discretion to determine whether an appeal should have suspensive effects on the enforcement of the plan. If an appeal is upheld, the court can set aside the plan or confirm it with or without amendments.

SECTION 2: THE WHOA AND OTHER EUROPEAN REFORMS

Restructuring plans under the WHOA

Under the WHOA, if a debtor is reasonably unlikely to be able to continue paying its liabilities as they fall due, it may propose a restructuring plan which affects the rights of some or all of its creditors and/

or shareholders. A creditor, shareholder or works council or employee representative body (if any) may also initiate a restructuring plan by requesting that the court appoints a restructuring expert who can then propose a restructuring plan. A court will allow the appointment only if it is reasonably likely that the debtor will not be able to continue paying its liabilities as they fall due and if the appointment would be in the interests of the joint creditors of the debtor. A debtor may also apply to court for the appointment of a restructuring expert if it deems itself incapable of preparing a restructuring plan. A restructuring plan could include various compromises such as payment deferrals and/or haircuts, amendments to the terms of debt instruments or debt-for-equity swaps. In addition, a restructuring plan could affect the rights of preferential and secured creditors as well as guarantors and co-debtors – which could be useful when restructuring entire debtor groups.

Stay on individual enforcement

Prior to finalising a restructuring plan under the WHOA, a written declaration proposing the restructuring plan is required to be submitted to court. When making such submission, if a debtor undertakes to offer a restructuring plan within two months of that declaration, it may request that the court orders a general stay against creditor action for a period of four months (which could subsequently be extended for a further four months) to support the implementation of the plan. The court would order the stay if it appears necessary for the continuation of the debtor's business as a going concern or if doing so appeared to serve the joint interests of the creditors (and not materially harm the interests of any third party).

Class constitution

Once a restructuring plan under the WHOA is finalised, it is presented to creditors and shareholders that would be affected by the restructuring plan and are entitled to vote on it. The debtor is required to divide the relevant creditors and shareholders into different classes such that if the rights they would have in the event of liquidation in the debtor's bankruptcy or the rights that are offered to them under the restructuring plan are dissimilar or incomparable then they would have to be allocated in different classes. Subject to complying with the foregoing, the debtor has discretion to constitute different classes if there is a proper and reasonable justification for making a distinction between them.

Voting and cross-class cram down

A class of creditors or shareholders is considered to accept a plan if at least two-thirds (by value) of its members who vote on that plan cast their vote in its favour. The WHOA allows cross-class cram down. With regard to vertical cram down, the WHOA incorporates a form of relative priority: a court may confirm a plan even if it deviates from the rules of statutory or contractual priority if there are reasonable grounds for such deviation and the interests of the said creditors or shareholders are not prejudiced by it. Incorporating this form of relative priority addresses earlier criticisms levelled at the absolute priority rule that such a rule would prevent voluntary "gifting" of recoveries by a senior class to a junior class and thereby discourage creditors with multiple holdings across different classes from approving the plan. The Directive encourages member states to adopt the relative priority rule in their vertical cram down provisions but, notably, makes an exception for member states to implement the absolute priority rule; therefore jurisdictions such as Spain (where cram down is permitted under the Spanish Scheme but unsecured creditors cannot cram secured creditors) or Germany (where lower ranking creditors cannot receive any value out of a plan if a dissenting senior class is being crammed – the definition of the absolute priority rule) could still comply with the Directive.

Minority creditor protection

Once a WHOA restructuring plan is confirmed by the court, it may not be challenged on appeal. Therefore, dissenting creditors seeking to oppose the restructuring plan should do so in the 8-14 day period between the vote and the court sanction hearing. The WHOA offers minority creditor protection by allowing a court to refuse to sanction a restructuring plan if:

(a) dissenting creditors or shareholders would be worse off under the restructuring plan than they would have been in a liquidation of the debtor's assets in bankruptcy;
(b) the restructuring plan is inconsistent with the statutory order of priority without any justifiable business reason; or
(c) if the restructuring plan does not give the dissenting creditors the right to opt for a cash payment equal to the amount they would expect to receive in cash in a liquidation of the debtor's assets in bankruptcy.

A dissenting creditor or shareholder can invoke the protection under paragraph limb (a) above in any circumstance but cannot invoke limbs (b) and (c) if in fact all the classes have voted in favour of the restructuring plan.

Executory contracts and *ipso facto* clauses

To safeguard the implementation of a restructuring plan, the WHOA:

(a) temporarily overrides contractual amendment, suspension or termination provisions which are based on the preparation and offering of a restructuring plan, the appointment of a restructuring expert or any other event or action directly related and reasonably necessary to the implementation of the plan; and
(b) provides that if a stay on enforcement has been ordered by the court and the debtor has provided a counterparty with security for the continued performance of a contract during the stay period then any breach of performance by the debtor of that contract prior to the stay will not constitute grounds for amending, suspending or terminating that contract.

The above safeguards appear to be in line with the provisions of the Directive.

Limb (b) above on the one hand seems narrower than the Directive by affording continuity only where security has been provided to the counterparty, however, in our view such a requirement falls within the margin of appreciation allowed to member states to prevent unfair prejudice being caused to counterparties in such situations.

Rescue finance

Several European jurisdictions provide (in their existing or new restructuring frameworks) some form of protection for providers of new or interim financing to debtors undergoing a restructuring. Under the WHOA, any legal act performed after a plan is filed with the court and which has been approved by the court is protected from annulment: it is recognised that this provision would allow the creation of new security over unencumbered assets in favour of new or interim financing and protect such security from clawback risk. The Dutch court would approve any such act, at the request of the debtor, if:

(a) it is necessary to continue the debtor's business as a going concern during the preparation of the restructuring plan; and

(b) at the time of the approval, it is reasonable to assume that the interests of the creditor group would be served and that no individual creditor's interests would be materially harmed.

Other European jurisdictions such as Italy provide a debtor with greater flexibility to protect new or interim financing. The Italian bankruptcy code was amended in 2010 to allow:

(i) claims arising out of creditor loans; and

(ii) 80% of the claims arising out of shareholder loans, in each case, which were entered into to implement a court-approved restructuring plan to be granted super-priority status over other secured and unsecured claims (subject to certain exceptions for claims secured by mortgage or pledge).

SECTION 3: EUROPEAN REFORMS vs UK REFORMS

In this section we only consider certain aspects of the UK Reforms which are expected to result in significant differences for debtors restructuring in the UK versus debtors restructuring under the European frameworks discussed above.

Ipso facto

Unlike the more restricted scope of the ban on *ipso facto* clauses envisaged by the Directive and the WHOA discussed above, the UK Reforms provide for a general prohibition on the operation of *ipso facto* clauses such that suppliers in contracts for the supply of *any* goods and/or services cannot terminate a contract on the basis of the counterparty having entered formal insolvency proceedings, pre-insolvency procedures or a restructuring plan. At a high level, this would imply that the ban on *ipso facto* clauses is wider under the UK Reforms (and therefore more debtor-friendly) than the Directive as it extends to all supplier contracts and not just essential contracts; however, this depends on how "goods and services" will be defined. As drafted, the UK Reforms prevent termination based on liquidation or terminal insolvency proceedings, which seems like a debtor-friendly advantage, but it is hard to see the justification for this if the UK Reforms are aimed at the business continuing.

While the Directive bans any amendments, suspensions or terminations of an agreement, the UK Reforms only consider termination. Consequently, under the UK Reforms a contract could potentially allow for an amendment of terms on the grounds of a restructuring plan being proposed thereby diluting the effect of the ban. Further, the UK Reforms allow suppliers to terminate the contracts on certain grounds (eg non-payment, giving notice as specified in the contract or any other ground specified in the contract) which might render the protections weak in practice. It is understood that the UK government is giving further thought to these provisions.

Stay on enforcement actions

In compliance with the Directive, all EU regimes are all required to provide a minimum stay of four months, with possible extensions if certain qualifying conditions are met up to a maximum of 12 months. In contrast, the UK has a very short initial stay of 28 days albeit allowing for a further extension of 28 days and more if certain conditions are met (extensions beyond 56 days require 50% of the secured creditors and 50% of the unsecured creditors to vote for such extension although the court may grant a further extension without creditor consent in cases where it is impractical to obtain). It remains to be seen whether a stay of 56 days will be sufficient in complex cases, but any longer period would require greater scrutiny on creditor safeguards during the stay. Unlike the 12-month maximum imposed by the Directive, the UK Reforms do not provide a maximum period of stay. Since creditor consent is required for extensions beyond 56 days, the UK approach allows debtors the time required for complex restructurings whilst ensuring that creditors' interests are not unfairly compromised.

Cross-class cram down and absolute priority rule

As with the WHOA, under the proposed UK restructuring plan, at least one class of affected creditors must vote in favour of the restructuring plan in order for it to be confirmed by court. The proposals incorporate the absolute priority rule but allow deviation from it if:

- necessary to achieve the aims of the restructuring; and
- just and equitable in the circumstances.

The flexibility created by the above qualifications could offer a comparative advantage to debtors in the UK when compared with jurisdictions – such as Germany or Spain – that have an unqualified absolute priority rule or where the inability to cram down secured creditors' rights could encourage individual creditors to frustrate credible restructurings by insisting on receiving returns which are disproportionate in the circumstances.

Biog box
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The exploitation of the absolute priority rule in such a manner is likely to become more problematic given the increased use by creditors of credit default swaps which could result in such creditors acquiring a net short position vis-a-vis the debtor. A creditor with a net short position may prefer to vote against a restructuring plan which could preserve a debtor's business because that creditor would receive a higher return under its credit default swap if the debtor was wound up in a formal insolvency process.

The above qualifications under the UK Reforms (in theory) allow the court to prevent creditors from insisting on the absolute priority rule to frustrate viable restructuring plans. However, the UK government has emphasised that a "high threshold" is required to meet the above qualifications and that the absolute priority rule will be followed "in most cases". In addition, there is a general aversion among English courts to engage in commercial assessments in scheme of arrangement and insolvency cases because courts consider that the relevant parties are best placed to assess their commercial positions. If an English court approaches the question on whether the above qualifications are met in the same manner, then the likelihood of a dissenting creditor successfully insisting on the absolute priority rule would increase. Therefore, the comparative advantage to debtors seeking to restructure in the UK (over Germany or Spain) is very much dependant on whether the courts would be empowered by the relevant legislation to play a more commercial role in the confirmation of restructuring plans. If the result is, as the UK government has indicated, that the absolute priority rule will be followed "in most cases" then the UK may offer debtors a comparative disadvantage over other European jurisdictions that transpose the relative priority rule under the Directive.

Rescue finance

Similar to a US Chapter 11 style debtor-in-possession financing (DIP Financing), the Directive allows member states the discretion to provide that debtors undergoing restructurings can grant security to new lenders over property already subject to security on a senior, *pari passu* or subordinated basis.

In the US context, DIP Financing is considered an important value-enhancing mechanism which increases the probability of a debtor's survival by increasing its financing options. The UK government considered introducing DIP Financing but decided against it; reasoning that, in addition to the difficulties arising from interfering with creditors' existing property or security rights, many UK reorganisation processes occur consensually and so, if a debtor's business is viable, existing lenders are likely to provide new money – thus reducing the need to introduce DIP Financing measures. This view makes sense where a debtor's constituency of creditors is homogenous and has similar risk appetites.

In practice, most large-scale restructurings feature a wide range of creditors with divergent interests and risk appetites: a highly leveraged debtor might benefit from a wide range of financiers in a restructuring and there could therefore be advantages in implementing the super-senior priority option under the Directive. With access to a wider range of financiers, debtors in jurisdictions like Italy would have stronger negotiation positions when compared to debtors restructuring in the UK that would be reliant on securing the unanimous consent of existing secured lenders to provide further funding on a senior secured basis. Having said that, the adoption of such provisions would require complex creditor protection provisions (such as the adequate protection provisions in a US Chapter 11) to ensure that existing secured creditors do not have their positions eroded without justification.

CONCLUSION

The Directive provides a clear set of principles which will underpin insolvency reforms across the EU in the next two years (apart from a few excluded provisions, member states have to implement the Directive by July 2021). As seen from the example of the WHOA, these principles will likely make the EU jurisdictions quite attractive from a debtor perspective and provide second chances to companies on the verge of insolvency, particularly when coupled with automatic EU recognition which UK procedures would lose following a "hard" Brexit. Although the UK Reforms aim to achieve broadly the same outcomes as the proposed European reforms, there are some key points of divergence. It will be interesting to see whether these differences make the UK proceedings more attractive (by giving participants greater flexibility for example in relation to the absolute priority rule) or whether participants will prefer some of the features of the Directive which the UK may not chose to adopt (such as DIP Financing).

The UK government is encouraged to look closely at what other EU jurisdictions (such as the Netherlands) are doing to implement the Directive to ensure that the UK maintains its reputation in a post Brexit world. ■

Further Reading:

- Has Newton had his day? Relativity and realism in European restructuring (2019) 4 JIBFL 233.
- Restructuring reform in Europe: the European Commission's draft Directive (2017) 3 JIBFL 149.
- LexisPSL: Banking & Finance: Brexit – worst case scenarios for R&I lawyers.