The European Commission has for the first time put forward its proposal for a set of mandatory European Rules on business restructuring and insolvency. The proposal’s key objective is to reduce the significant barriers to the free flow of capital stemming from differences in member states’ restructuring and insolvency frameworks. The aim is for all member states to have in place a minimum legal framework for effective preventive restructurings coupled with measures to make all types of insolvency procedures more efficient by reducing their length and associated costs and improving their quality. It is not intended to create an EU-wide restructuring and insolvency regime but to ensure coherence between member states’ regimes. For the first time, with the implementation of the Directive, each EU member state will have a set of pre-insolvency restructuring tools based on principles common throughout the European Union, thus greatly facilitating creditors who will be able to rely on similar rules regardless of the country of incorporation of the debtor. Whether or not Brexit has occurred by the time the directive becomes effective, it is likely that the UK will also adopt a similar regime no later than the rest of the EU.

If adopted in this form, the new European restructuring regime will create:

- A mandatory stay;
- Leave the debtor in possession and control of the business while the restructuring plan is being negotiated;
- Provide for restructuring plans to be approved by majority votes of affected classes;
- Provide for cross class cram-down or cram-up;
- Remove any blocking power of the money creditors or shareholders;
- Allow for DIP financing in Europe; and
- Reduce the role of the courts to plan confirmation to bind dissenting affected creditors.

The proposal is in addition to the EU Insolvency Regulation. That dealt with resolving conflicts of jurisdiction and applicable laws in cross border insolvencies. This proposed directive addresses both domestic and cross border restructurings and is intended to facilitate both and avoid the need to file for potentially more value destructive insolvency proceedings.

The proposal is important to anyone carrying out business in the EU or investing in EU businesses. It will also contribute to managing defaulting loans and help to avoid the accumulation of those loans on banks’ balance sheets. The existing very high level of non-performing loans on the books
of European banks is impairing the ability of the banking sector to provide new credit to the economy.

The proposal does not harmonise core aspects of insolvency processes such as: rules on conditions for opening insolvency proceedings, the definition of insolvency, and the ranking of claims and general avoidance actions, all of which remain specific to each member state. The proposal also leaves member states some flexibility as to how to integrate the new regime. This recognizes that some member states already have elements of well-functioning frameworks in place and these will be unaffected.

The directive will apply to all sizes of enterprise and to all entrepreneurs whether or not they are incorporated. It will not apply to purely contractual consensual restructurings.

The new rules will require member states to:

- ensure companies in financial difficulties have access to early warning tools to detect a deteriorating business situation and ensure restructurings are undertaken at an early stage. This may involve accounting and monitoring duties of the debtor and the debtor's management as well as reporting duties under loan agreements;

- provide businesses with a flexible preventive restructuring framework limiting the role of national courts to where it is necessary and proportionate to safeguard affected parties—these procedures must be available to debtors, or to creditors, with the agreement of debtors;

- provide for the debtor to remain in possession during the preventive restructuring process;

- provide a stay on enforcement of up to four months (extendable up to 12 months with judicial approval) to progress the restructuring plan, precluding the opening of insolvency proceedings, security enforcement, and any contractual rights of termination or acceleration;

- provide for restructuring plans to be proposed (by a debtor or a creditor with the debtor's agreement) which can be approved by majorities of each class of affected stakeholders but with the possibility of cram-down and cram-up. The rules will prevent dissenting minority creditors and shareholders from being able to block restructurings provided that their legitimate interests will be safeguarded. A court/administrative confirmation will be required to bind dissenters;

- provide protection from attack for new financing provided during the preventive restructuring; and

- continue to provide complete protection for workers who will continue to have the benefit of full labour law protection provided under EU law. Preserving the rights of employees and job preservation are a key focus of the draft directive.

**A summary of the specific proposals on restructuring plans**

The plan needs to be public and contain details of:

a. The identity of the debtor or its business;

b. A valuation and a reasoned statement of the causes of the financial difficulties;

c. The identity of the parties affected by the plan and their affected claims;
d. The classes of affected parties which have been identified for approving the plan;

e. The identity of any non-affected parties (which may be generic) and why they are outside of the plan;

f. The terms of the plan; and

g. A statement as to the viability of the business and why the plan is likely to result in the debtor avoiding insolvency and restoring its long-term viability.

The plan needs to be approved by affected creditors voting in classes. Secured and unsecured creditors will always form separate classes, while member states may decide if workers are to be placed in a separate class. The class formation is reviewed at the stage of judicial confirmation of the restructuring plan. The required majorities (calculated by amount of claim) in each class will be set down in national law but cannot exceed 75%.

Even if the plan is not approved by all affected classes, it may still be confirmed if it complies with the cross-class cram-down provisions of the proposed directive.

Any restructuring plan which affects the interests of dissenting affected parties or which provides for new financing will need judicial/administrative confirmation.

In order for a plan to be confirmed, it must meet “the best interests of creditors test.” This is that no dissenting creditor would be worse off under the plan than they would be if there was a liquidation, whether piecemeal or as a going concern. The plan must also have a reasonable prospect of preventing insolvency and ensuring viability of the business. The confirmation hearing should take place within 30 days of filing a request for confirmation.

Dissenting creditors can be ignored using a “cross-class cram-down mechanism” if (i) the plan has been approved by at least one class of affected creditors other than an equity holder class and any other class which, upon a valuation of the enterprise, would not receive any payment by reason of its ranking in a liquidation and (ii) the plan satisfies the “absolute priority rule.” This means that a dissenting class of creditors must be satisfied in full before a more junior class may receive any distribution or keep any interest under the restructuring plan. The valuation for the cross-class cram-down mechanism is the going concern valuation.

The corollary of the absolute priority rule is that no class of creditors can keep or receive under the plan economic value greater than the full amount of their claims.

If there is a likelihood of insolvency, then equity holders will be prevented from unreasonably blocking the plan. This may be through the cross-class cram-down mechanism.

Two valuations may be required for confirmation. A liquidation value for the "best interests of creditors” test, and a going concern valuation for any cross-class cram-down analysis or if there is any challenge under the absolute priority rule.

Once the plan is confirmed, it is binding on all parties identified in the plan. It cannot bind creditors not involved in the adoption of the plan.

There will be an ability to appeal a judicial confirmation on an expedited basis. If the appeal is upheld, the plan could be set aside or confirmed with monetary compensation to the dissenting creditors payable by the creditors who voted in favour of the plan.
Summary of protection for new or interim financing into a preventive restructuring and other financial transactions

New and interim financing to support the enterprise through the restructuring or to implement the restructuring plan cannot be declared void, voidable, or unenforceable in a subsequent insolvency absent fraud or bad faith. Similarly, any civil or criminal liability for such financing will be removed.

Interim financing will be protected whether or not the restructuring is approved, provided that is reasonably and immediately necessary for the survival of the business or preserves or enhances its value. New financing will need to be approved when the plan is confirmed by the court.

To encourage new and interim financing, member states may legislate to confer priority on such financing ahead of existing creditors in any subsequent insolvency but at a minimum so it ranks at least senior to ordinary unsecured creditors.

Transactions in the course of negotiating a restructuring will be similarly protected. That will include the payment of reasonable fees and costs and any new transactions outside the ordinary course of business which are closely connected with the restructuring, such as sale of part of a business or a debt for equity swap.

Other provisions

There will be a requirement that if there is a likelihood of insolvency, directors will have obligations:

a. To take immediate steps to minimise the loss to creditors, workers, shareholders, and other stakeholders;

b. To have due regard to the interests of creditors and other stakeholders;

c. To take reasonable steps to avoid insolvency; and

d. To avoid deliberate; or grossly negligent conduct that threatens the viability of the business.

There will be a limit on the period for discharge of failed entrepreneurs of three years (absent dishonesty or bad faith).

There are provisions to improve the professionalism of judges and practitioners dealing with restructuring and insolvency, including ensuring appropriate training for bankruptcy judges to be appointed across the EU, and that restructurings are dealt with by judges with the necessary expertise and specialisation.

There are also provisions to ensure restructuring professionals taking appointments have the appropriate skills and are subject to at least voluntary codes of practice and are appointed with due consideration to their expertise and experience. Additionally, provisions require that their work be subject to oversight and regulation and that their fees are governed by rules which incentivise timely and efficient resolution.

To aid that efficiency, provisions are included for electronic administration of restructuring processes.

The changes override EU company law regarding general meetings of shareholders and shareholder pre-emptive rights to the extent that it would cut across a preventive restructuring.
Exclusions
The new framework will not apply to insurance and reinsurance businesses, credit institutions, investment firms, collective investment undertakings, or central counterparties, all of which have their own separate regimes.

The changes will have no impact on financial collateral and settlement finality.

Next steps
The proposal will now go forward to be legislated at the EU level, which will take several months. It may be subject to some further variation in the EU legislative process, but it is unlikely that the overall shape of the proposal will change significantly. Once enacted as an EU directive, member states will then be required to adopt local laws to transpose the directive’s provisions into their legal systems within a timeframe that is still to be finalised in the proposed directive’s text. Currently, it is anticipated that the majority of the proposed directive’s provisions must be adopted locally within two years of it entering force at the EU level and within three years of such date for its provisions on increasing efficiency and second chances.

In reality, once the directive is in final form, many member states (including the U.K. whether or not Brexit has occurred) are likely to update their own restructuring law to incorporate the minimum standards in the directive well before the deadline in order to be competitive and attract investment.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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