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8 Things You Need To Know About EU's Insolvency Proposal

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Did the European Commission read our article this summer? Because in November, harking back two years to its "recommendation," which most of the industry had forgotten, the commission, now by directive, will mandate European Union members to introduce, by 2018, very deep reforms to their national insolvency laws. Member states must put in place a legal framework enabling the early restructuring of businesses and to give honest but bust entrepreneurs a second chance. The commission is now going way beyond its previous Pan-European insolvency project of mutual recognition of insolvency procedures and entering the world of harmonizing laws. The aim is to trigger huge change in European cultural attitudes toward financial distress, to promote the saving of companies, and to tackle the great overhang of nonperforming loans across the community.

Howard Morris

Why? For the same reasons that we argued the U.K. should adopt the reforms proposed by the British government last May, to enable the efficient development of the debt and equity capital markets. The EU knows that the patchwork of antiquated insolvency laws and practice across the community impedes and discourages the free flow of capital.

In our article, James Peck and I argued that, faced with Brexit dumping the U.K. out of the European Insolvency Regulation and losing recognition of U.K. insolvency processes in the EU bloc, the U.K., to save and indeed develop the U.K. as a financial center, should bring British insolvency and restructuring law as close as possible to that familiar to the world's most important capital market — the U.S. Capital flows most efficiently and cheaply when markets are familiar and predictable. If we can't look east post-Brexit, let's look west to the U.S. with whom we already share much in common. U.K. insolvency laws aren't so dissimilar to America's and have been converging for years; we use the same common law and speak the same language.

We also predicted the EU would, in the wake of the U.K.'s departure, go for harmonization of insolvency laws. It's doing just that and moving quickly. The Five Presidents' Report on "Completing Europe's Economic and Monetary Union" listed insolvency laws as among the most important bottlenecks preventing the integration of capital markets in the EU area and beyond.

I see the EU and the U.K. as two boxers; with their teeth they're now tearing at their gloves' laces, the gloves are coming off and this is going to be a real fight. The prize is huge. Each believes there can be only one heavyweight champion. The EU sees its future as a single capital market and to be that it must level and smooth its legal and regulatory topography into a single playing field. In restructuring, the model endorsed by the World Bank and favored by the investment community, or with which they are most comfortable because it is so familiar, is the U.S.' Chapter 11. The U.K. has to keep pace. The common law is popular around the world because of its flexibility and predictability of outcome, while the quality of the U.K.'s courts and professionals plus the English language give the country competitive advantages. But if the U.K. rests on its laurels, then its strength as a center for restructuring and its future as an important capital market is threatened.

The proposed directive is a serious piece of work disclosing serious intent but even here, as you will see, there are some naiveties and vast ambitions possibly exceeding the EU's reach, at least for a time.

Here are eight key things to know about the proposed directive:

1. The directive will be binding on the U.K. By 2018 or 2019, the U.K. must have enacted legislation to bring the strictures of the directive into force even though our time remaining in the EU may then be counted in months. In fact, much of what the EU wants, the U.K. already has. Some of the remainder is on its way, as with uncanny (or suspicious) prescience last May's reform proposals anticipated — without ever referring to the EU or the "recommendation" of 2014 — the proposed directive.

2. Member states will have to provide a restructuring framework that includes a moratorium procedure for debtor companies freezing hostile creditor action, barring litigation and the enforcement of security. In a very big change for the U.K., the US approach of allowing the existing management to remain in control, the so-called debtor in possession, will be part of the procedure and there will be no mandatory appointment of a trustee or insolvency practitioner. The U.K. has always taken the line that it is better to get rid of the failed or failing management, and we've always been a bit surprised that directors are consequently reluctant to begin an insolvency process that removes them from running their company. The U.K. government is continuing to look at the introduction of a new moratorium procedure, which received favorable feedback from respondents to its consultation.

3. The legal framework must enable a restructuring plan that includes a cram mechanism. Neither the much-vaunted U.K. scheme of arrangement nor the U.K.'s Company Voluntary Arrangement provides for the cramdown of dissenting classes of creditors. The new restructuring plan procedure will do so and in a way that is substantially the same as that under the U.S.' Chapter 11. While cramdown doesn't actually happen in Chapter 11 cases nearly so often as envious European lawyers might think, it does give more bargaining power to the debtor. The scheme of arrangement has been a magnet for non-U.K. companies coming to the U.K. to undertake their consensual restructuring. The new restructuring plan will have a powerful feature the scheme lacks, be available across the EU, and a company's plan will be recognized and be enforceable in every other member state. Again, the U.K. received support for this proposal.

4. Superpriority lending to keep a debtor trading while it organizes a rescue (DIP finance) has been proposed in the U.K. before. Now it must be introduced. U.K. banks have in the past successfully lobbied against a DIP lending regime. For perhaps 100 years or more, they have been the pre-eminent providers of debt finance to the SME sector and for obvious reasons are loath to lose any priority for their secured debt. But without DIP finance, trading through a U.K. insolvency is difficult without support from the creditor banks (and also because the U.K. market looks upon a company in administration as a dead man walking and value leeches out very quickly). Instead, we have become masters at the prepack sale, which disposes of the business immediately following the filing. At the moment, the U.K. government is

not intending to introduce this measure. Whether it does anything more may depend on whether Brexit happens before the directive binds the U.K. to its implementation.

5. Contracts essential to the debtor's business will be protected by a type of "ipso facto" rule, meaning they can't be terminated simply because of the debtor's insolvency or threatened insolvency. The U.K. already has this protection for essential utility supplies, and as it received positive responses to its proposals one can expect extension of the rules.

6. And for the workers, they will even have a vote on the new restructuring plan. This would be novel for the U.K. where only creditors have a vote in a scheme of arrangement or company voluntary arrangement.

7. The second chance, meaning the prompt discharge from bankruptcy of an honest entrepreneur, features prominently in the European Commission's plans. While the bust business person is a world apart from a failing corporate, the commission is right to see the way the system treats an individual bankrupt as indicative of the culture. Allowing, indeed encouraging, entrepreneurs to try even at the risk of failure is at the heart of laissez faire capitalism, and releasing them from debts they can't pay within a reasonable time not only encourages people to try to build successful businesses but represents the positive philosophy of free enterprise.

8. The commission calls for the introduction of early warning tools to detect a failing business and alerting the debtor to act urgently. In the U.K., directors have onerous duties imposing liability if they are negligent in running up losses without putting the interests of creditors first. The commission's ideas in this area include not only monitoring duties for the debtor but reporting duties under loan agreements and the idea of incentivizing or obliging third parties with relevant information, such as accountants, tax and social security authorities, to flag a problem. There is a starry-eyed innocence about some of these ideas that cut though the relationship between an adviser and its client, or set statutory authorities to sniff out and inform on distressed businesses. But more importantly, the need to call for structures that trigger early intervention shows how far some EU members have to go to achieve the commission's goals. And it is here that the U.K. has some advantage because it is already so far ahead.

The European Commission is opting for big change. Its own papers and the recitals to the directive recognize that each EU member country is starting from a different place, but in terms of the development of a rescue culture, they are all farther behind the U.S. approach and — importantly — attitude than the U.K. And it is here that an advantage remains for the U.K., an advantage that the U.K. can squander unless it gets on with its own reforms.

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