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The UK opts to play solo while the EU aims to bring harmony from discord

Howard Morris, head of restructuring at Morrison & Foerster in London, considers whether the EU can achieve its stated harmonisation goal, and what that means for the restructuring business in the UK

Leaving the orchestra

Very quickly the legal profession got to grips with the likely consequences of Brexit for restructuring and insolvency. We published our briefings and our articles, all saying the same thing. And since then we've been trying to read the runes and urging government in its negotiations with the EU to pay attention to insolvency as the economy's plumbing but not expecting much[1]. No one I know in the restructuring business has expressed anything but regret that the UK will upon leaving the European Union no longer enjoy the recognition of its insolvency proceedings in the EU under the European Insolvency Regulation (EIR). I've not heard anyone suggest, either, that the UK should stop giving recognition to insolvency proceedings in the EU[2]. For restructurings, we comfort ourselves that the recognition and enforcement of schemes of arrangement in other countries ought not to be affected as this is a matter of private international law. But some do harbour a fear that the comparative ease and lack of controversy with which the English courts have until now been provided with suitable expert opinions that a scheme of arrangement will be recognised in another country might be affected by a change in sentiment among those European experts towards the UK. We may see challenges to the recognition and enforcement of schemes in EU states, a muscular resistance to the weakening grip of the UK on the European restructuring market.

In many areas and certainly in the development of an EU approach to insolvency and restructuring, the UK has played a significant role in debate and the decisions that have been made. If not a driving force, we have certainly been vocal in the counsels of the EU. At the EYES on Insolvency conference in Amsterdam in January this year, looking at the road ahead for EU insolvency development, distinguished speakers expressed regret that the EU will soon be without the voice of the UK.

When the UK leaves the EU, even if will is found in the negotiations to agree a multilateral treaty to recreate the EIR, that is not the end of the story by any means. The EU is looking to create a pan-European insolvency regime, a "framework", each member state meeting minimum standards that would bring them to a previously unimagined level of harmonisation and a restructuring environment with a distinctly Chapter 11 character[3] and out of the EU, the UK won't be a part. The subject of this article is whether the EU can achieve its harmonisation goal and, by implication, what that means for the restructuring business in the UK. The proposed Directive will

1/. The UK government's position in its paper "Providing a cross-border judicial cooperation framework" is that it wants, post-Brexit, "an agreement with the EU that allows for close and comprehensive cross-border civil judicial co-operation on a reciprocal basis, which reflects closely the substantive principles for cooperation under the current EU framework". The UK has identified the EIR as falling within the scope of that framework. https://www.gov.uk/government/publications/providing-a-cross-border-civil-judicial-cooperation-framework-a-future-partnership-paper.

2/. This may now be moot. The effect of the European Union (Withdrawal) Bill (EUWB), if enacted as drafted, will be to repeal the European Communities Act 1972 (ECA) thus, in effect, repealing the EIR as it automatically became UK law by virtue of S.2(1) of the ECA, and then immediately to enact it as UK law, again, by clause 4 of the EUWB. However, dissatisfied that the EU's Member States will no longer be obliged to recognize UK proceedings, the UK government might use its so-called "Henry VIII" power (clause 7, EUWB) to repeal that rump of the EIR. The reasoning would be that with the Model Law and the common law, recognition of insolvency proceedings in Member States can be acquired in the UK exactly as for any other country. If the EIR is to be restored in any shape or form it would be better that it is mutual.

3/. Proposal for a Directive of the European Parliament and of the Council on preventative restructuring frameworks, second change and measures to increase the efficiency of restructuring, insolvency and discharge and amending Directive 2017/30/EU COM(2016)723 http://ec.europa.eu/information_society/newsroom/image/document/2016-48/proposal_40046.pdf

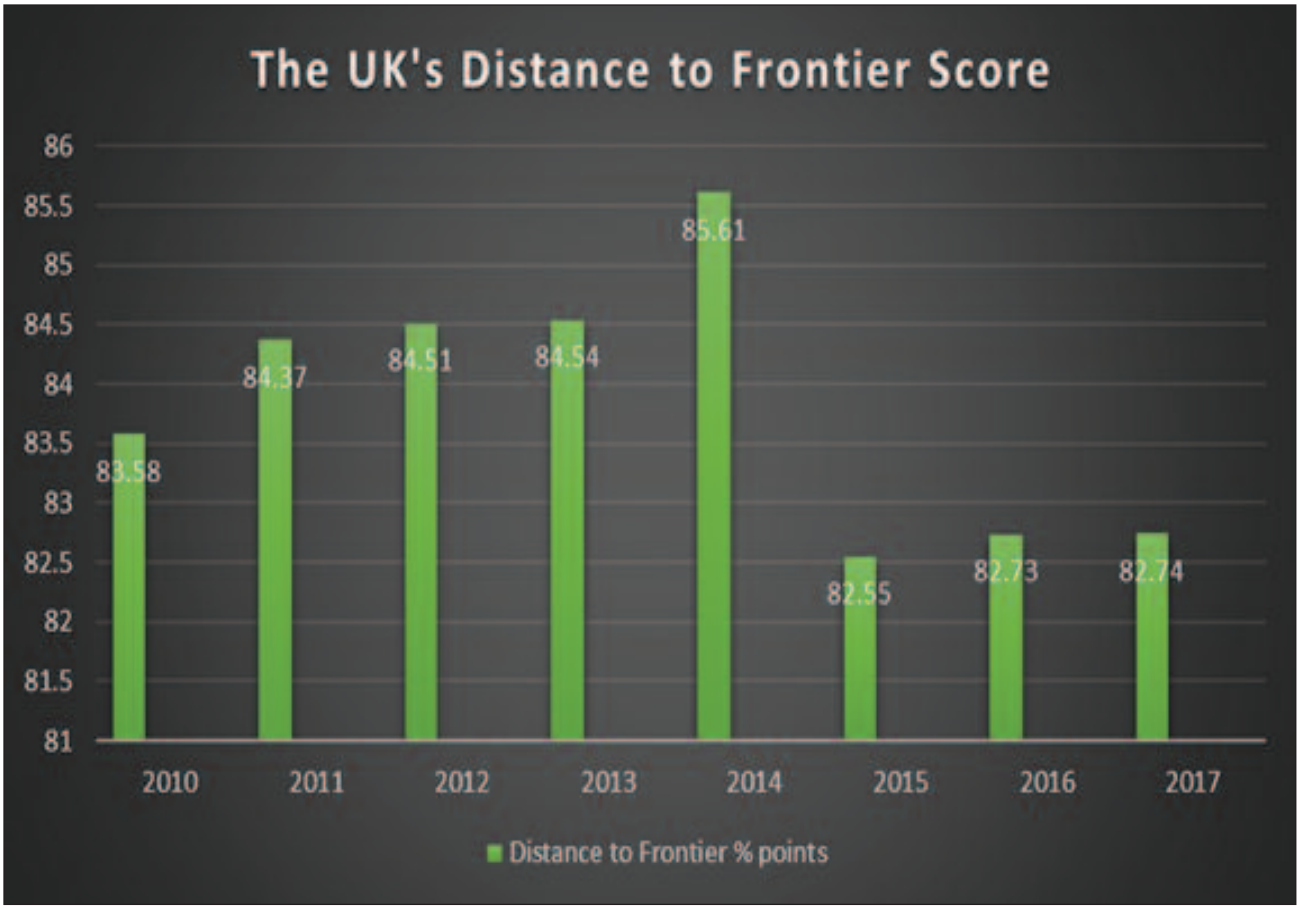
mandate the harmonisation of substantive insolvency laws across the Union. The UK may even still be a member when the Directive comes into force.

We, too, were set on significant reforms[4], a new moratorium with the debtor in possession, a plan of reorganisation permitting cross-class cram down and a species of ipso facto rule. The idea of super priority DIP financing was dropped during the extended consultation (as it was when last canvassed in 2009). Now it seems that with so much legislative business focused on Brexit and the government weakened by the general election, the prospect of introducing those reforms has grown distant.

When commercial deals are made the thinking as to what law should be used to solve a restructuring problem, insofar as careful thought is given to the issue, is wrapped up in the decision on governing law and forum. We must not underestimate the power of sentiment in making these decisions. Sentiment is not simply irrational emotion but an intuitive response to political, cultural, social and psychological factors including what is "market", what is common or usual or, even, the fashion for that type of deal. And these factors, sentiment, influence decision making by individuals, businesses and courts. At conferences across Europe our competitor lawyers are now suggesting that English law is broken in consequence of the vote to leave the EU. With Paris and Frankfurt and Berlin holding trials in English as a means of attracting legal business, along with broader government initiatives to tempt business from the UK, the country is in a ferocious contest to retain its primacy as a legal centre and our disproportionate share of complex, international restructurings.

The World Bank chimes in

The insolvency system the proposed Directive contemplates and our own proposed reforms are eerily similar. Both sets of reform proposals are intended to meet the best practice principles on which the World Bank has, since 2015, based its vision of an efficient insolvency system, its "resolving insolvency" analysis. It was then that the World Bank changed its measures and the UK, which had for so long, done ever so well in the insolvency rankings of the World Bank, took a dive. That's because the World Bank changed its metrics to



DATA: THE WORLD BANK

4/.https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/525523/A_Review_of_the_Corporate_Insolvency_Framework.pdf.

SAJID JAVID, IN INTRODUCING THE UK'S PROPOSED INSOLVENCY REFORMS IN MAY 2016, WAS FRANK IN WANTING THE UK TO MOVE UP THE WORLD BANK'S RANKINGS FOR DOING BUSINESS.

embrace an approach to insolvency much more like Chapter 11[5] and the UK's system is light on those features.

The World Bank uses a mathematical expression for a nation's overall performance, "distance to frontier", meaning the distance to the "best performance across all economies in the Doing Business sample since 2005". The UK's resolving insolvency distance to frontier, applying the new measures, fell from 95.33 to 82.04. The Secretary of State for Business, Sajid Javid, in introducing the UK's proposed insolvency reforms in May 2016, was frank in wanting the UK to move up the World Bank's rankings for Doing Business. It may seem juvenile for countries to be in cut-throat competition for places on this league table – do international commercial deals really depend on a World Bank ranking? – but in restructuring there is a powerful reason for aiming to reduce that distance to frontier. And if the UK doesn't reform we could become, in the eyes of investors, a backward outlier unable to respond to all the voices in increasingly complex and atomised capital structures.

Flourishing by becoming familiar

James Peck and I in our article *Flourishing by Becoming Familiar*[6] argued that capital market investors will feel at home if the insolvency system is efficient and familiar. The more those conditions are met, the cheaper insolvency risk will be priced. In short if US investors, and most hedge funds and specialist investors in distressed corporate debt, actors that are now key to the international restructuring industry, are either US based or are culturally strongly American in character and personnel, feel familiar with how a debtor can be restructured and the role and influence they can have as an investor in debt or equity, the more willing they will be to invest. So an efficient system that looks like Chapter 11 is going to be more attractive to international capital. Philosophically we might pick holes in Chapter 11 and variations on its themes but economically and pragmatically, it is the global direction of travel.

The European Commission is of this opinion. The purpose of the EU Commission's ambitious insolvency harmonisation plan, something never before attempted, is an important part of creating Europe's single capital market. The "Five Presidents Report"[7] of June 2015 lists 'insolvency law among the most important bottlenecks preventing the integration of capital markets in the euro and beyond.' Advantage will be gained by the EU, it believes, by having a homogenous approach to restructuring and insolvency. If that approach looks like Chapter 11 then the hedge fund and other investors will be more comfortable.

The European Commission's theme

The EC's proposed Directive is not a

5/. See the World Bank's "Creditor Rights and Insolvency Standard" http://siteresources.worldbank.org/GILD/Resources/FINAL-ICRStandard-March2009.pdf and the World Bank's "Principles for effective insolvency and creditor and debtor regimes" http://documents.worldbank.org/curated/en/518861467086038847/pdf/106399-WP-REVISED-PUBLIC-ICR-Principle-Final-Hyperlinks-revised-Latest.pdf.
6/. https://media2.mofo.com/documents/160727brexitrestructuringinvestors.pdf.
7/. The Five Presidents' Report: Completing European Economic and Monetary Union https://ec.europa.eu/commission/publications/five-presidents-report-completing-europes-economic-and-monetary-union_en.

diabolical scheme to undermine the post-Brexit UK robbing it of its restructuring business. Far from it. The genesis of the proposed Directive goes back at least seven years and during that time, right up to the Brexit vote, the UK was an important player in the process of deciding upon and pursuing this ambitious reform agenda.

In 2010 INSOL, at the instance of the European Parliament's Committee on Legal Affairs, produced a report[8] that showed the widely differing approaches to restructuring across the Union, the encouragement the different systems give to forum shopping and the obstacles this creates to the recognition of cross-border restructurings and reorganisations. The European Parliament accepted the conclusions in November 2011, the key role of the law in enabling corporate rescue recommended harmonisation of insolvency laws. Tasked with this mission the European Commission a year later set itself the goal of introducing "modern insolvency laws that help basically sound companies to survive".

Over the next two years, through the financial crisis and no doubt informed by its effects, the EC developed its thinking. It gauged the public attitude through consultations and in March 2014 published its Recommendation[9] calling for member states to reform and align their insolvency laws. The proposed Directive goes farther than the Recommendation not just in mandating reform and harmonisation but in specifying deeper reforms than in the Recommendation. In so doing the Commission makes its task of getting all member states to introduce the minimum standards for insolvency laws more difficult. But before we look at this, it is worth considering the broader difficulty the EU encounters in harmonising laws.

The proposed 2017 Directive goes further than the 2014 Recommendation

At the heart of the proposed Directive is the harmonisation of laws in two areas; restructuring and giving a second chance to bankrupt entrepreneurs. There will also be improvement to the associated insolvency rules and processes and the collection and publication of data on insolvencies.

The EC believes that viable businesses are being liquidated because there is no accessible means for their restructuring. With an eye to the continuing heavy weight carried by European banks, the Commission considers that a more efficient and consistent means of restructuring will reduce the problem of accumulated non-performing loans. A central goal of the insolvency framework is the introduction of a debtor in possession reorganisation process, compassed about by a moratorium on hostile creditor action, with access to new credit and protection from the termination of executory contracts.

"A well-functioning EU single market requires a coherent restructuring and second chance framework capable of addressing the cross-border dimensions of firms, as interaction between companies located in different Member States has become increasingly common. EU action will therefore add value by facilitating cross-border investing in the EU, ensuring that viable businesses in financial difficulty, wherever they are located in the single market, will be able to benefit from a wider range of

HOWARD MORRIS

8/. Harmonisation of insolvency law at EU level
http://www.europarl.europa.eu/meetdocs/2009_2014/documents/empl/dv/empl_study_insolvencyproceedings_/empl_study_insolvencyproceedings_en.pdf.
9/. Commission Recommendation on a new approach to business failure and insolvency C(2014)1500 final
http://ec.europa.eu/justice/civil/files/c_2014_1500_3n.pdf.

accessible tools to prevent their insolvency. At the same time, entrepreneurs will benefit from being able to use reasonable discharge periods in their Member States. This could not realistically be achieved by the Member States acting alone. In addition, ensuring that cross-border creditors and investors involved in such a restructuring process have at their disposal appropriate safeguards will have positive economic effects. The proposed rules will create legal certainty for creditors and investors who want to lend in other Member States; the necessary information will be available so that they can take informed decisions."[10]

Fugue

This article is not a critique of the proposed EU framework but it is worth noting issues that will make the harmonisation harder. First, the EC wants to keep court involvement in restructuring minimal. But, in a reorganisation process that divides creditors into classes, permits cram down of classes (so long as the absolute priority rule is applied) almost inevitably, therefore, threatens arguments about valuation (anticipated by Article 13 of the Draft Directive). Chapter 11 is a court-driven process, relying on specialist judges in a specialist bankruptcy court. To picture a similar regime without access to sufficient judicial and professional infrastructure is naïve.

Secondly, the EC is fixed on its reorganisation plan as the means of restructuring, it does not allow for the pre-pack sale, the quick business disposal that has become so efficient albeit not without a share of criticism in the UK. Thirdly, the EC has in mind some early-warning tools to alert debtors to trouble ahead. What can they be?

But, as I said, my purpose is not to identify flaws in the detail but to look at whether constructing this framework of minimum standards and lifting it into place across the whole EU is likely, in practice, to be a successful reality.

One of the aspects of the EU loathed by some is the perceived homogenisation of law by harmonisation. The UK has been far from alone in resisting changes to its laws to achieve harmonisation. Harmonisation has in fact proved extremely difficult to achieve. The harmonisation of laws isn't itself a central goal of the EU but rather a tool to establish and implement the Four Freedoms.

Originally harmonisation of laws required unanimity among EU member states. This changed with the Single European Act from 1987 followed by the Maastricht, Amsterdam and Nice treaties introducing and expanding qualified majority decisions.[11]

Much of the harmonisation that has been achieved has been by decisions of the EU Court, ruling against laws as being discriminatory or in breach of the Union's fundamental rights. The best -known decision was in 1979 in the *Cassis de Dijon* case obliging EU member states to accept most standards set by other EU states. This compelled member states to accept compromise on harmonisation to avoid the lowest standard being the general law.

In 1985 the EC published a White Paper on a "new approach" to harmonisation. A pragmatic and rather more subtle method of harmonisation was posited and it is this new approach that the proposed Directive on insolvency adopts. The new approach focuses only on the essentials, the core rules that must be changed while all else is a matter of mutual recognition.

The current state of the EU's insolvency and restructuring laws is best described as the product of regulatory competition, another means of harmonising laws. In harmonisation by regulatory competition each state decides on its own laws and business flows to the state with the regulatory climate that best suits the business. Other countries follow suit. Look at Delaware in the US; through regulatory competition it has become the preferred location for incorporation of substantial businesses and, as we know, for Chapter 11 filings. Delaware also demonstrates that business doesn't necessarily flow to the jurisdiction with the weakest rule of law or most lax regulation. Reputational and political factors see to this.

To arrest the flow of business elsewhere states change their regulation to adopt the standards of the winner in the regulatory competition and we have indeed in recent years seen European countries reform and develop their insolvency laws to provide means of restructuring to avoid their companies going to London. And yet regulatory competition has not seen Member States adopting consistent insolvency laws.

Harmonisation of the standards of physical products is one thing but harmonisation of rights and responsibilities, entitlements and obligations is quite different and it is in this area that EU harmonisation has made the least progress.

Simon Deakin[12] describes how harmonisation of corporate law "has stalled, above all, on the question of

10/. See footnote 1.
11/. Article 95 of the Treaty Establishing the European Community as amended by the Maastricht Treaty, introduced qualified majority voting for the majority for most of the directives to create the single market.
12/. Regulatory Competition Versus Harmonisation in European Company Law https://ideas.repec.org/p/cbr/cbrwps/wp163.html.

how to treat stakeholder groups, in particular employees." The failure, he says, reflects a fundamentally different philosophical outlook between member states on corporate governance.

In insolvency and restructuring the challenge to harmonisation is another set of local interests informed by the culture of the member states and the expectations of local stakeholders and actors as described by Professor Federico Mucciarelli[13], who calls them the "distributional rules", like the different rankings of creditors, treatment of shareholders' set-offs and the termination of executory contracts. Professor Mucciarelli argues that there is an intrinsic difficulty in harmonising the law in these areas. "These distributional rules" affect equal treatment of creditors in the distribution of a debtor's assets and are a highly-sensitive matter as they embody a specific balance of values and interests. Reform of distributional rules therefore requires a high level of political legitimacy and consensus."

"Another defining element of harmonisation is the object to be harmonised. On a macro-level it seems to be the legal orders that converge as a whole due to the process of harmonisation even though it is quite clear that the result will not be a uniform law within Europe. Yet, the actual object of harmonisation is much smaller and subject to many debates. It is the "law". What is law? This is a moot question and the understanding of law diverges in the Member States and the various schools of thought, but for our purpose it suffices to state that law is more than rules, it is also the application and use of these rules by courts, administrative bodies and even sometimes private actors, i.e. the legal practice. Art 95 EC speaks of "laws, regulations or administrative provisions' referring primarily to approximation by the means of positive (statutory) law. This must, however, also include approximation at the level of application and interpretation. Negative harmonisation, on the contrary, affects any national measure at a broader scale, hence also administrative and judicial practice, and case-law. Indirectly, the approximation of laws means also an approximation of policies, as Member States are barred from enacting their own legislation once an area has been harmonized. Legislation is meant to govern the behaviour of individuals in order to attain the purpose of the norm. After harmonisation has taken place this is guaranteed at the European level, thus creating a common European policy".[14]

The shift from fugue to sonata is plagued with problems - composers have long wrestled with finding a way to reconcile these two ways of thinking

Sonata

The Recommendation fought shy of calling for the adjustment of distributional rules. But the proposed Directive is not so timid. To make its corporate reorganisation tool work there must be a priority given to DIP lending. Secondly it calls for the introduction of an ipso facto rule, barring the termination of executory contracts because of insolvency - contracts necessary for the debtor in restructuring proceedings to survive. The entire reorganisations process, leaving the debtor's management in control, suppressing creditor actions and, in the personal sphere, the discharge of bankrupts and the concept of giving debtors another chance, runs straight into the deeply held attitudes about how, whether corporate or individual, those who welch on their debts should be treated. I'd hazard that societal attitudes to debtors are rather more visceral than the rules around incorporation of companies, which have proved so difficult to harmonise.[15]

The proposed Directive calls for the training of judges and insolvency professionals. The EC sees that its harmonisation plan is not simply about rules but calls for radically changed attitudes, a new dispensation – the rescue culture. The UK knows from its own experience of the great reform of 1985/1986 that creating a rescue culture is not easy. The EU will find emplacing its insolvency framework and actuating it across the community with attitudes directed to the expressed ambitions of the EC, will take time, effort and investment. Will something short of the project's completion be a real threat to the UK's powerful position in restructuring? With the loss of the EIR and the wider consequences of Brexit, the UK is going to be less well-equipped to attract restructuring business. But we must be mindful of sentiment and an EU inspired by our rejection of the project, to bring itself, in time, into harmony.

13/. Not Just Efficiency: Insolvency Law in the EU and Its Political Dimension, European Business Organisation Law Review 14: 175-200 http://eprints.soas.ac.uk/16957/1/Not%20Just%20Efficiency%20EBOR%202013.pdf
14/. Professor E J Lohse on "The Meaning of Harmonisation" is the Context of European Community Law – a Process in Need of Definition" from the "Theory and Practice of Harmonisation" edited by M. Andersen and Camilla Bark Andersen.
15/. See Deakin, footnote 10 infra.