Gravenbrucher Kreis

Statement issued by the Gravenbruch Circle on the provisions of the directive proposed by the European Commission of 22 November 2016 concerning preventive restructuring precedures

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Building on the Gravenbruch Theses "Pre-insolvency restructuring procedure in Germany?" of 14 January 2017,[1] the Gravenbruch Circle has decided to prepare a statement on the directive proposed by the European Commission of 22 November 2016[2], limited to the provisions of the proposed directive relating to preventive restructuring frameworks.

Preliminary remarks:

Germany has one of the world's best insolvency laws. According to a study prepared by the World Bank "Doing Business 2017 - Equal Opportunity for All" of 25 October 2016, it ranks 3rd out of 190 states in the field of corporate insolvencies.[3] National insolvency law contains in particular a number of rules that function very well, and in overall terms represents a good standard when it comes to restructuring companies. Existing German rules make it possible to restructure companies effectively and efficiently at an early stage in the process. Restructuring procedures conducted in accordance with applicable national law can be planned and are transparent; the costs thereby incurred are calculable and can be appealed. Minimum German standards for out-of-court and court restructuring extend far beyond the intention of the European Commission[4].

[1] Gravenbruch Circle, Gravenbruch Theses "Pre-insolvency restructuring procedure in Germany?" of 14 January 2017, retrievable under: https://www.gravenbrucher-kreis.de/app/download/13030986435/Thesen_Restrukturierungsverf_Jan2017.pdf?t=1484667590 (retrieval date: 28 February 2017).

[2] Proposal for a Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU of 22 November 2016, COM(2016) 723 final, available under: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016PC0723&from=EN (retrieval date: 28 February 2017).

[3] World Bank study "Doing Business 2017 - Equal Opportunity for All" of 25 October 2016, p. 208, available under: http://www.doingbusiness.org/~/media/WBG/DoingBusiness/Documents/Annual-Reports/English/DB17-Report.pdf (retrieval date: 28 February 2017); also see: http://www.doingbusiness.org/rankings (retrieval date: 28 February 2017).

[4] see footnote 2.

In view of the assessment and appraisal of the World Bank, as well as within the context of the recommendation[5] and current directive proposal of the European Commission[6], a supplementary amendment of the toolbox of German restructuring law may be required, and not a total paradigm shift - away from creditor satisfaction, and towards discharge procedures: a new tool that dovetails with out-of-court financial restructuring efforts, and supports these when these threaten to be thwarted by individual objectors. This means restructuring will not have to draw upon instruments of foreign law in order to be successful.

The decision that needs to be taken in response to every corporate crisis (liquidation or restructuring) needs to be taken at a very early stage by creditors in order to minimise further damage. Companies should have access to the restructuring framework only if they are solvent and moreover remain solvent for twelve months.

Against this backdrop the Gravenbruch Circle is submitting the following amendments to European legislators in respect of the provisions of the proposed directive of the European Commission of 22 November 2016, concerning the establishment of a preventive restructuring framework in EU member states:

Proposed amendments:

1. Concerning Art. 2 (2):

   'financial restructuring' means changing the composition, conditions, or structure of a debtor's ~~assets and~~ liabilities, including ~~or any other part of~~ the debtor's capital structure, ~~including share capital,~~ or a combination of those elements~~, including sales of assets or parts of the business,~~ with the objective of enabling the enterprise to continue in whole or in part;

   Subsequently, the term 'restructuring' in the proposal is amended to 'financial restructuring' throughout the text of the Directive.

   Reason:

   The objective of a preventive restructuring framework is to safeguard or to restore the economic viability of the company in question, outside insolvency proceedings, by restructuring the liabilities side of the balance sheet. Restructuring measures that extend further (such as mandatory

[5] Recommendation of the Commission of 12 March 2014 for a new approach to corporate failures and corporate insolvencies, C(2014) 1500 final, available under: http://ec.europa.eu/justice/civil/files/c_2014_1500_de.pdf (retrieval date: 28 February 2017).
[6] see footnote 2.

interventions in employee rights, rights to reject legal agreements and special termination rights) should not be available through pre-insolvency restructuring procedures. For this reason, the scope of the proposed directive should be limited to the intended impact on financial creditors. This is necessary, on the one hand, because the objective pursued by the European Commission with the creation of a preventive restructuring framework is to address the problem of so-called non-performing loans. This is stated on several occasions in the wording of the proposed directive. For example, the proposed directive states:

"[...] A well-functioning insolvency framework covering all these measures is an essential part of a good business environment as it supports trade and investment, helps create and preserve jobs, and helps economies absorb more easily economic shocks that cause high levels of non-performing loans and unemployment. These are all key priorities of the European Commission. [...]"[7]

"[...] In addition, the availability of timely preventive restructuring procedures would ensure that action is taken before companies default on their loans. This would contribute to reducing the risk that loans become non-performing loans in cyclical downturns, thus reducing the related negative impact on the financial sector. [...]"[8]

"[...] However, the resilience of non-performing loans in the European Union shows that further action needs to be taken to ensure that the negative feedback loop between poor asset quality, lagging credit developments and low growth does not become prevalent. Measures to increase the effectiveness of restructuring, insolvency and second chance frameworks would contribute to efficient management of defaulting loans and reduce accumulation of non-performing loans on bank balance sheets. [...] Finally, they can also serve to avoid future build-up of non-performing loans since loans on which performance ceases could be enforced more efficiently. [...]"[9]

"[...] Objective of the proposal

[...] More specifically, such frameworks aim to [...] prevent the build-up of non-performing loans [...]."[10]

"[...] The economic significance of well-functioning insolvency frameworks is particularly relevant in the financial sector when dealing with high levels of private debt and non-performing loans, which is the case in some Member States. [...]"[11]

[7] see footnote 2, p. 2.
[8] see footnote 2, p. 3.
[9] see footnote 2, p. 5.
[10] see footnote 2, p. 5.
[11] see footnote 2, p. 12.

"[...] The proposal will help prevent accumulation of non-performing loans. [...]"[12]

"[...] Efficient preventive procedures can contribute to limiting the occurrence of non-performing loans in cyclical downturns while ensuring a high recovery rate on loans whose value is impaired. [...]"[13]

"[...] [Preventive restructuring frameworks] should also prevent the build-up of non-performing loans. [...]"[14]

Planned interventions must be limited to interest-bearing receivables, in accordance with the debt reduction objective of the preventive restructuring framework (irrespective of their ranking and any possible collateral).

In addition, it is necessary to limit the scope of the proposed directive to planned effects on financial creditors, as pre-insolvency restructuring support merely provides contractual support for out-of-court refinancing, and does not entail any performance-related economic restructuring – even if, as a rule, this is an accompanying (financial) condition. Refinancing decisions are taken by the financial creditors alone, while the viability of a company is decided (only) within the context of overall/insolvency proceedings by all of the parties involved in the company (overall effect). In addition, performance-related restructuring remains possible at any time on a private autonomous basis, outside the scope of possible statutory restructuring and insolvency proceedings.

Furthermore, the circle of affected parties is also limited in Art. 114 Para. 2 AEUV. The so-called domestic market authority arising out of Art. 114 AEUV is limited pursuant to Art. 114 Para. 2 AEUV to the extent that provisions pertaining to taxes, to the freedom of movement and to rights and interests of employees are explicitly excluded. This illustrates the fact that specific groups of creditors need to be excluded from the scope of application of the preventive restructuring framework, and that not all claims and rights may be the subject of the restructuring framework. For this reason, the need to limit the circle of affected parties must also be set out in the proposed directive. This must furthermore be structured in a reasonable manner.

[12] see footnote 2, p. 13.
[13] see footnote 2, p. 18.
[14] see footnote 2, Consideration 2, p. 24.

2. Concerning Art. 5 (3):

Member States may require the appointment of a practitioner in the field of restructuring in the following cases:

(a) where the debtor is granted a ~~general~~ stay of individual enforcement actions in accordance with Article 6;

(b) where the restructuring plan needs to be confirmed by a judicial or administrative authority by means of a cross-class cram-down, in accordance with Article 11;

(c) where creditors affected by a stay or a plan request the involvement.

Reason:

A preventive restructuring framework can work only if the involvement of an objectively independent third party in the preventive restructuring procedure is ensured, if this third party has sufficient specialist expertise (see Art. 25 of the proposed directive), and is involved in the interest of all affected parties in a manner that boosts confidence in the procedure. A party of this nature needs to ensure that the interests are applied equitably, and that transparency prevails. This applies in particular if creditors reach the conclusion that individual involved parties, e.g. the management, no longer enjoy the level of trust necessary to negotiate and to implement the restructuring in the interest of the parties as a whole. In such cases, trust needs to be restored by an independent third party in the interest of the best-possible prevention.

3. Concerning Art. 6 (2):

Member States shall ensure that a stay of individual enforcement actions may be ordered in respect of all types of creditors, including secured and preferential creditors. The stay may only be ~~general, covering all creditors, or limited, covering~~ requested and ordered with respect to one or more individual financial creditors, in accordance with national law.

Reason:

A restructuring framework cannot make provision for a comprehensive moratorium to be imposed upon all creditors. This would otherwise be the equivalent of comprehensive legal proceedings, which is neither necessary nor reasonable for pre-insolvency proceedings. A general moratorium is available within the context of the already-existing provisions of restructuring-friendly insolvency proceedings (see only the rules pertaining to protective umbrella proceedings pursuant to § 270b InsO). Companies that require far-reaching enforcement

protection (and not just protection from individual objectors) are ripe for insolvency and cannot be given access to a preventive restructuring framework.

A general moratorium would give a preventive restructuring framework an excessive interventionist effect at the pre-insolvency level, based merely on the forecast made by the court on the likelihood of the restructuring negotiations being successful and the proposed restructuring being effective. Such forecasts are practically impossible to verify. Against this backdrop, the proposed directive also makes provision for the modest lifting of individual enforcement restrictions.

In addition, the scope of the individual stay of enforcement actions must be limited in line with the planned effects on financial creditors. The circle of affected parties of an individual stay of enforcement actions must focus on the scope of application of the preventive restructuring framework, and for this reason, as already explained in respect of Art. 2 (2) of the proposed directive, can only affect financial creditors. This will help in particular to avoid distortions involving documentary letter of credit insurers and suppliers, as these do not expect impairments within the context of a preventive attempted restructuring.

4. Concerning Art. 6 (9):

Member States shall ensure that, where an individual creditor or a single class of creditors is or would be unfairly prejudiced by a stay of individual enforcement actions, the judicial or administrative authority may decide not grant the stay of individual enforcement actions or may lift a stay of individual enforcement actions already granted in respect of that creditor or class of creditors, at the request of the creditors concerned. Member States shall ensure that a stay is only granted if the debtor proves that he will be able to pay his debt as they fall due for a period of 12 months.

Reason:

An individual short-term stay of enforcement actions may be established only after recourse to a court of law and following an individual assessment by the court. In this conjunction, preconditions for an individual stay of enforcement need to adhere to the principles of proportionality and the prohibition of discrimination, and for this reason may be ordered only insofar and to the extent that it is necessary to support the negotiations on the restructuring plan, the affected creditors are not unreasonably disadvantaged, and the debtor is otherwise only threatened by insolvency; solvency must be maintained for a period of twelve months. The activities of the court will then not be publicly announced.

5. Concerning Art. 6 (4) and (7):

   Member States shall limit the duration of the stay of individual enforcement actions to a maximum period of no more than ~~four months~~ two weeks.

   The total duration of the stay of individual enforcement actions, including extensions and renewals, shall not exceed twelve ~~months~~ weeks.

   Reason:

   As credit institutions record outstanding loans as "impaired" if the debtor fails to serve these for a period of more than three months (12 weeks), lengthy stay periods have the effect of unnecessarily generating non-performing loans, which is certainly the reverse of what the European Commission is aiming to achieve with the preventive restructuring framework. Against this backdrop, the maximum deadline should not be defined any longer than 12 weeks.

   In addition, protective measures for restructuring negotiations are normally necessary only for short periods. In cases in which longer protective measures are necessary, however, restructuring-friendly insolvency proceedings (§§ 18, 270a/b InsO) offer the right option, in contrast to a preventive restructuring framework.

6. Concerning Art. 7 (1) and (2):

   ~~Where the obligation of the debtor to file for insolvency under national law arises during the period of the stay of individual enforcement actions, that obligation shall be suspended for the duration of the stay.~~

   ~~A general stay covering all creditors shall prevent the opening of insolvency procedures at the request of one or more creditors.~~

   Reason:

   The provisions of Art. 7 (1) and (2) of the proposed directive must be scrapped without replacement. Insolvency petition obligations are anyway established only in the event of insolvency. If this happens, then insolvency will have occurred, and the pre-insolvency restructuring will have failed.

   In the event of over-indebtedness, then promising restructuring negotiations are expected to reach a positive outcome, meaning that the obligation to petition for insolvency will be established only if the restructuring negotiations are unsuccessful.

7. Concerning Art. 7 (3) and (6):

Replace with:

Member States shall ensure that creditors who withhold performance or terminate, accelerate or in any other way modify executory contracts to the detriment of the debtor by virtue of a contractual clause providing for such measures, solely by reason of the debtor's entry into restructuring negotiations, a requested for a stay of individual enforcement actions, the ordering of the stay as such or any similar event connected to the stay, may be suspended from executing such contractual rights only on the debtor's request and with retroactive effect for the duration of restructuring negotiation not exceeding two weeks, extendable to a maximum of 12 weeks.

Reason:

In the absence of a general moratorium, then restrictions concerning the rights arising out of current (supplier) transactions will not be linked. The aim of the proposed formulation is to enable the debtor to respond individually to disruptive actions by key creditors, in order to protect the restructuring negotiations. This means no new supply obligations are established.

8. Concerning Art. 9 (2):

Member States shall ensure that the plan only provides for a financial restructuring according to Art. 2. Affected ~~parties are~~ financial creditors' and shareholders' rights can be treated in separate classes ~~which~~ if necessary ~~reflect the class formation criteria~~. Classes shall be formed in such a way that each class comprises claims or interests with rights that are sufficiently similar to justify considering the members of the class a homogeneous group with commonality of interest. As a minimum, secured and unsecured claims shall be treated in separate classes for the purposes of adopting a restructuring plan. ~~Member States may also provide that workers are treated in a separate class of their own.~~

Reason:

Because the preventive restructuring procedure, as already described in respect of Art. 2 (2) of the proposed directive, needs to be limited to financial creditors, this consequently also means that the limitation of the planned effects to financial creditors also needs to be included here. Only those persons should be involved in the procedures (as well as in the

restructuring negotiations) who are required to make a contribution pursuant to the restructuring plan (no comprehensive procedure).

9. Concerning Art. 9 (4):

A restructuring plan shall be deemed to be adopted by affected parties, provided that a majority in the amount of their claims or interests is obtained in each and every class. Member States shall lay down the required majorities for the adoption of a restructuring plan, which shall be in any case not ~~higher~~ lower than 75% in the amount of claims or interests in each class.

Reason:

The sole basis for the legitimacy of a pre-insolvency plan with mandatory effects is the conviction of similarly affected parties that these sacrifices are sensible and justified. This consequently means that the actual basis for agreement in each class must be high.

The principal criterion for the legitimacy of the restructuring plan is therefore the actual support shown for the planned measure by the overwhelming majority of the affected parties. Against this backdrop, the necessary quorum needs to be significantly higher than a simple majority.

In addition, a high actual basis for approval in each class may if necessary also reflect constitutional misgivings that dissenting creditors may be bound by the restructuring plan, and that creditor rights could consequently be infringed.

10. Concerning Art. 11:

1. Member States shall ensure that a restructuring plan which is not approved by each and every class of affected parties may be confirmed by a judicial or administrative authority upon the proposal of a debtor or of a creditor with the debtor's agreement and become binding upon one or more dissenting classes where the restructuring plan:

(a) fulfils the conditions in Article 10(2);

(b) has been approved by at least ~~one~~ two-thirds of all classes 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 or other consideration if the normal ranking of liquidation priorities were applied~~;

(c) ~~complies with the absolute priority rule~~ does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or shares that is impaired under, and has not accepted, the plan.

~~2. Member States may vary the minimum number of affected classes required to approve the plan laid down in point (b) of paragraph (1).~~

Reason:

Sole basis for the legitimacy of a pre-insolvency plan is the conviction of similarly affected parties that this sacrifice is sensible and justified. As a consequence, the actual basis for approval has to be high not just in each class, but also in overall terms – and a "cross-class cram-down" has to be difficult.

In addition, the "absolute priority rule" is decidedly unclear and disputed in respect of many detailed questions, and can under no circumstances serve as the model for European restructuring law. Instead, the benchmark for a fair and equitable solution needs to be developed and fulfilled in the EU Member States.

11. Concerning Art. 12:

~~1. Member States shall ensure that, where there is a likelihood of insolvency, shareholders and other equity holders with interests in a debtor may not unreasonably prevent the adoption or implementation of a restructuring plan which would restore the viability of the business.~~

~~2. To achieve the objective in paragraph 1, Member States may provide that equity holders are to form one or more distinct classes by themselves and be given a right to vote on the adoption of restructuring plans. In this case, the adoption and confirmation of restructuring plans shall be subject to the cross-class cram-down mechanism provided for in Article 11.~~

Reason:

The provision set out in Art. 12 (1) and (2) of the proposed directive needs be scrapped, as the lack of legitimacy of the shareholders to co-determination cannot be presumed at the pre-insolvency level. For this reason, the entitlement to a veto in the shareholder group is individual in nature, meaning that the benchmark of a fair and equitable planned solution needs to be verified by the court. This adequately ensures the correspondingly open formulation of a new Art. 11 (1) c).

12. Concerning Art. 13:

    Replace Para 1 and 2 with:

    An enterprise value shall be determined by the judicial or administrative authority on the basis of the value of the enterprise as a going concern if the plan provides for the continuation of the business.

    Reason:

    At the pre-insolvency level, there are no grounds to accept an alternative breakup of the company, and for this reason the valuation as a going concern is to be assumed. Differentiation between the prohibition on disadvantaging and the cram-down valuation are not justified. From a German constitution law perspective (Art. 14 GG), the valuation must be applied at the going concern value.

13. Concerning Art. 16 and 17:

    Add to Art. 16 (1), (2), (3) and Art. 17 (1):

    [...], unless such transactions have been carried out fraudulently or in bad faith or if they occurred less than 3 months before the request to open insolvency proceedings according to national law.

    Reason:

    Procedural and restructuring finance, as well as transactions in conjunction with restructuring are protected from contestation and liability, with the exception of revocatory action of wilful intent due to wilful behaviour that is detrimental to creditors. The supplement would also make provision for contestation pursuant to §§ 130 - 132 InsO. In overall terms, this would preserve the German contestation standards.

About the Gravenbruch Circle

Since 1986, the Gravenbruch Circle has brought together representatives of Germany's leading insolvency law firms that are characterised by trans-regional restructuring expertise as well as comprehensive expertise in this field. Members undertake to ensure that they and their organisations exercise the highest quality and performance standards, documented by the exclusive certificate *InsO Excellence* that is verified by independent auditors. The Circle currently has 20 active members. Prof. Dr. Lucas F. Flöther has been the Spokesman of the Gravenbruch Circle since March 2015.

Since its inception, the Gravenbruch Circle has dedicated itself as a centre of expertise to the development and promotion of insolvency law and associated legal fields from a practical perspective. In addition, the Gravenbruch Circle contributes its experience of cross-border group insolvencies, and takes part in the continued development of international standards and rules in the restructuring field.

The interdisciplinary exchange of know-how and joint discussions within the Gravenbruch Circle facilitate detailed assessments and expert opinions. These are widely recognised by national and international specialists in the field of insolvency and restructuring law, and the views of Circle members are consulted during the course of legislative procedures.

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