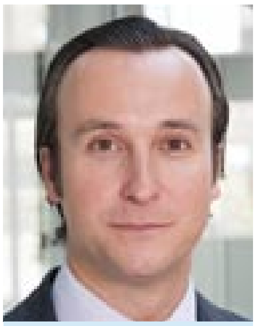
The Preventive Restructuring Directive – What next: A Pre-pack Directive?

Adrian Thery writes on the change of paradigm in corporate restructuring



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> *The change of paradigm imports into the insolvency arena the distinction between ownership and control*

The Directive (EU) 2019/1023 on preventive restructuring frameworks ("the Directive") was passed on 20 June 2019 bringing about a change of paradigm in corporate restructuring. A change that should allow the States of the European Union to catch up with countries adhering to the Anglo-Saxon model, both in restructuring and insolvency matters and also upstream, in financial matters, due to the influence of the insolvency legislation on the provision of credit *ex ante*.

This change of paradigm imports into the insolvency arena the distinction between ownership and control that, despite later than in the US, was also being observed in Europe as a result of the proliferation of listed companies. The features of listed companies had already permeated the European corporate law. Although because up until the 2008 downturn listed companies rarely went bust, the insolvency regime in the European Union continued to be focused on privately or closely held companies, in which ownership and control were fused together. Thus it made no sense to consider the restructuring of a company without the involvement of the owner/entrepreneur, because the business simply could not operate without him/her.

The Directive requires the Member States to adapt their insolvency regimes to enable a restructuring of the capital structure at publicly traded companies. At this type of company, the members of the capital structure are simply investors, either in debt or equity. Therefore, their position is expendable and there is no operational consequence for any investor classes which are out of the money to be wiped out of the capital structure where there is a likelihood of insolvency.

The priority is to deleverage an over-indebted viable company and observe the subordination agreements entered into between investors. By introducing shareholder cram-down, the Directive thus aims for post-restructuring equity to be assigned to the class of creditors where the value breaks (the so called "fulcrum class"). This ensures that the rights of control associated with equity are assigned to the residual creditor.

The residual or marginal creditor is the creditor that gains or loses the first euro resulting from the rightness or wrongness of each corporate decision. It is in the interests of the law for the marginal creditor to hold the control rights over the company, in order to rule out moral hazard in corporate governance.

By introducing measures designed to ensure that the restructuring of the capital structure implies the reassignment of equity and of the resulting control rights to the fulcrum class (unless the restructuring is consensual – in which case post-restructuring equity is reassigned in a way that will be agreed among the classes themselves), the Directive seeks for the reorganisation of the company to involve the realignment of the company's interests (both those of the owners and of their appointed managers) with the interests of the community. With the Directive, restructuring now becomes in EU a new playground of the market for corporate control.

As we shall see, however, this regime is focused on public or listed companies. Firstly, because, as we have said, at these companies the role of the owner or the equity is expendable. And, secondly, because of the fragmentation of their capital, only listed companies have a problem related to owners and managers being contractually unable to provide the company's shares as security to creditors.

That problem does not exist at privately or closely held companies (typically SMEs): if the creditor does not have a security interest in the shares, it is only because he/she did not bargain for it. Consequently, the cross-class cram-down mechanism makes less sense at SMEs than at listed companies.

Alongside this, the existence of a restructuring surplus, which is the reason for the restructuring in the first place, will not be common at SMEs. It is therefore predictable that the complex restructuring mechanism devised by the Directive will not prove efficient for SMEs.

The Directive has been focused on restructuring because it embodies the example of a pre-insolvency solution. In view of the Member States' reluctance to cede ground on mature matters such as insolvency, pre-insolvency was the natural way for the EU to enter this area, and it has done this through the Directive.

Though, the Member States cannot now rest on their laurels and be confident that with the implementation of the Directive they have completed their restructuring and insolvency duties. Quite the opposite in fact, this is only the beginning. As we have explained, the Directive only actually covers the restructuring of large companies, but it does not comprehensively cover, despite its attempts, the needs of SMEs, and SMEs make up the bulk of businesses in the European Union.

If this is the case, how can EU members now fill the gap for SMEs? By improving the legal regime applicable to liquidation, not to the assets of the liquidated company but to the underlying businesses as going concerns.

The regime of liquidation of companies by insolvency proceedings, where the liquidation value for the business as a going-concern is higher than its piecemeal liquidation value, should allow for the underlying businesses to be transferred as a going concern free and clear of debt. Few regimes in the EU enable companies under liquidation by insolvency proceedings to be rescued effectively. A number of elements are needed to achieve this.

Legal certainty

The first is the legal certainty that the purchase of the company by the purchaser takes place free and clear of debt and liens. The legal certainty also has to enable visibility for the purchaser of the employees' rights in the event of the transfer of undertakings.

Treatment of debt vs executory contracts

Secondly, a clear distinction between the treatment of debt (which will come to be repaid with the price of the transfer) and the treatment of executory contracts is needed. An adequate treatment of the latter warrants special protection so that they can continue being performed normally, with the result that the insolvency proceedings will only affect the capital structure, not the underlying business, thereby avoiding the association of a commercial stigma with the proceedings themselves. Additionally, the liquidation regime should allow the liquidated company's contracts to be taken over by the purchaser without requiring the counterparty's consent, so that the transfer of the business in liquidation and the consequent transfer of business do not result in the disappearance of the attached network of contracts that is necessary for the business to operate (also determining special rules, in relation, for example, to intellectual property).

Bidding options

Thirdly, the entrepreneur should not be prevented, as it happens in certain jurisdictions, from bidding for his own business. Otherwise, the entrepreneur will wait until it is too late to seek insolvency proceedings, when there will be no business left to rescue.

Enhanced scrutiny

Fourthly, allowing the entrepreneur to bid for his own business implies a need for enhanced scrutiny by the insolvency practitioner and by the bankruptcy court to allow interested third parties to take part in the auction on an equal footing with the entrepreneur and to have access to the same information. The system must assure that if the entrepreneur wins at the auction, this is because it was objectively the best bidder under market principles, by eliminating any suspicion of fraud associated more with other eras and incompatible with the scrutiny of a judge and professional insolvency practitioner. The entrepreneur will be the natural purchaser for many small businesses, which will then be willing to make the highest bid to maintain the business and thus maximize recovery for creditors after a market process. Fraud should not be something to be presumed before the event (preventing the entrepreneur from bidding), but rather penalised ex-post on the credit record of entrepreneurs who put to auction their businesses more than once.

Last but not least, an effective and efficient liquidation regime is the cornerstone of the insolvency system. The main aim of the insolvency regime is to maximise recovery for creditors, eliminate inefficient competitors from the market, and reassign resources efficiently to the person who can make the most profitable use of them.

If the liquidation regime is not efficient, any liquidation will result in recovery for creditors that will tend to zero. This may have the perverse side effect of justifying almost any restructuring: if the liquidation value is inefficiently low, it contributes artificially to a restructuring surplus, which may appear to justify restructuring (whereas, under normal conditions, it would be better for the creditors to liquidate the company and reassign the business and its resources). The restructuring of companies that ought to be liquidated is the source of macro-economic issues related to debt overhang and a zombified economy.

At a time when the European countries should reassign their resources effectively (including credit, which otherwise becomes trapped in zombie companies instead of being put to good use in innovative projects), the need for a rescue regime for businesses through liquidation by insolvency proceedings should become a priority of the legislative policy.

In short, following the publication of the Directive, the Member States, or otherwise the European Union (in view of the implications on the free movement of capital and the freedom of establishment, among others), should work on improving the regimes of liquidation by insolvency proceedings. A restructuring regime will never be effective if it is not built on an efficient regime of liquidation by insolvency proceedings that allows the rescue of businesses through their transfer to third parties as going-concerns. ■

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