Protecting new and interim financing: The stakes are high!

Paul Omar discusses how funding for business in a restructuring is addressed by the EU Directive

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The first axiom of insolvency is there is never enough money. For any restructuring to happen, however, funds are required in the firm's coffers to pay for the costs of restructuring, including the specialist advice necessary, and to provide the business with a bridge until revenue streams return online, income picks up and the restructuring savings emerge.

Other major costs will attend the implementation of any restructuring plan agreed with the creditors, including payments for necessary supplies governed by executory contracts.

The Directive on Preventive Restructuring and its view of financing

The Preventive Restructuring Directive (Directive (EU) 2019/1023) addresses the issue of interim and new financing. Always assuming that debtors can access restructuring and can persuade the creditors to approve any plan, the identity of who pays for the consequences of the plan will be an issue. Existing financial creditors may be unwilling to shoulder a further burden, adding to their exposure; a new creditor may well be more amenable, but may ask for protection from the application of the priority rule. For the directors, the risk is that their endeavours are in vain, perhaps because the negotiations fail or recovery hits the buffers further down the line. As a result, their dealings with the assets may raise the spectre of personal or vicarious liability as well as the application of clawback rules. The Directive has considered all these questions and attempts to create an inter-related framework to deal with the issues holistically. It defines two categories of financing: interim, pending the adoption of a plan, and new financing, as envisaged in and the subject of that plan.

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As such, Recital 66 sets us down the route of accepting financing as a precondition for success seen in the light of two particular needs: to operate the business during negotiations and to help in implementing a plan, once confirmed. Anticipating failure, the text also makes the point that exemption from future avoidance actions is necessary, all of which serves to promote a "culture of early restructuring". Though postulating that national rules on avoidance actions and liability for the extension of credit to debtors in financial difficulties (e.g., the French *soutien abusif*, since abolished) could constitute impediments to obtaining financing, Recital 67 does not wish to supersede them entirely. A permissible scope for their operation would include scenarios involving fraud, bad faith, related-party transactions and where parties receive undue entitlements from transactions.

The Directive also anticipates how interim financing should be treated pending the adoption of a plan. Given an uncertain outcome, parties may be very reluctant to engage in financing pending that adoption, albeit such funding might be critical for the business to bridge its difficulties. To that end, Recital 68 suggests that Member States also protect interim financing, but not to limit its availability by reference to plan adoption and/or confirmation, otherwise appropriate for new financing. However, protection should only extend to financing that is "reasonably and immediately necessary". This is provided that financing has been engaged for two permissible purposes: (i) continued operation or survival of the business; and (ii) preservation/enhancement of business value. While protection for new financing could be made subject to plan adoption/confirmation, nevertheless, for interim financing, protection could be extended on the basis of some form of *ex ante control* existing, e.g., approval by a practitioner, creditors' committee or a court. Any financing so protected should also attract a priority at the very least above the position of unsecured creditors in any subsequent insolvency.

This does not mean, however, that *carte blanche* will be given to all financing that does not otherwise infringe the conditions listed above. While the vagueness of the phrase "reasonably and immediately necessary" invites judicial interpretation, Recital 69 provides a gloss that might help this process. It recommends recourse to "estimates and projections", updated as necessary by the debtor, and that are made available to stakeholders. This will promote more certainty and lead to greater confidence that transactions do not risk being declared void. Member States may, in fact, provide that protection by defining a moment from which protection will begin to run for negotiation-related costs, even though no procedure has yet been opened or a stay granted. Optionally, for employee wages

and other non-negotiation-related costs, protection may be tied to the opening of proceedings and a stay.

While the Directive provisions proper seem fairly light-touch, it is in the Recitals that the very elaborate architecture of new and interim financing is really apparent. It goes without saying that the aim is to ensure the availability of protection occasioned by a genuine need for (re-)financing the business. However, all three elements must be present: (i) appropriate priority for the financing; (ii) an exemption from liability for providers and directors alike; and (iii) exemption from avoidance provisions, should the restructuring fail and proceedings are opened subsequently. The absence of any one of these elements, whether wholly or partially, will imperil what is a carefully constructed framework designed to promote financing arrangements in the most efficient manner, by minimising liability, albeit subject to tightly-drawn exceptions. The complexity of this, and many other elements, in the Directive text explains why most Member States availed of the facility to delay transposition. Nonetheless, by the time this is published, that deadline will have passed. The concern is that transposition may occur without the architecture being fully-formed, perhaps because the rationale for the need to maintain the unity of framework is not fully appreciated.

In this light, it is instructive to see how the Member States that have already proceeded to transposition have approached the subject. In the Netherlands, the *Wet Homologatie Onderhands Akkoord* (WHOA) inserts an Article 42a in the *Faillissementswet* to avoid the annulment of transactions that are "*necessary to continue the debtor's business during the preparation of a plan*" and "*in the interests of the general body of creditors and would not materially prejudice the interests of any individual creditors*". This facility is subject to a request to and granting of authorisation by the court. While the courts have begun producing guidelines through the jurisprudence defining what new money attracts protection and how to define material prejudice to any creditor,[1] the brevity of the provision suggests that recourse to the general rules for director's liability in the Dutch Civil Code is necessary. It will take time to elucidate the precise articulation between the liability rules and the specific context of preventive restructuring, which is not entirely encouraging.

In Germany, a similar provision in section 90(1) of the *Gesetz zur Fortentwicklung des Sanierungs- und Insolvenzrechts* (StaRUG) confers immunity on any legal transactions made in furtherance of a restructuring plan, including finance commitments entered into for the purposes of a plan subject to section 12. For interim financing, some protection is conferred by section 89(1) stating that any delays occasioned by transactions undertaken with view to the conclusion of a plan, including presumably any financing arrangements, do not render directors liable under any rule stipulating culpability for any delay in filing for insolvency. The focus on director's liability is also addressed in section 1 of StaRUG, which requires directors to react appropriately to threats to the business, but leaves untouched any duties in other legislation.

Also noteworthy, the French transposition in the Ordinance no. 2021/1193 of 15 September 2021, whose Article 31 (applying to *sauvegarde*) requires new financing to be the subject of express noting in any plan and confers a payment priority. Its Article 18 (applying to *sauvegarde accélérée*) also grants priority to new money proposals necessary for implementing a rescue plan (including any funds occasioned by a modification to such a plan). Nonetheless, in common with the Dutch text, no mention is made of director's liability and the application of avoidance rules in a subsequent insolvency may depend on a court taking the view of when insolvency supervened, which suggests that no specific protection is conferred on interim financing.

Summary

Given the variations in how some Member States have approached the Directive, the risk is that other Member States with varying experience of preventive restructuring may not appreciate the holistic approach in the Directive to the protection of new and interim financing. In fact, with the exception of Germany, the examples above do not really address the position of interim financing, preferring to concentrate on new financing for the purposes of a plan. Moreover, there is partial commonalty in the desire to protect against the risk of avoidance in subsequent insolvencies. Moreover, with respect to director's liability, the structuring of these rules (together with any exceptions) displays great divergence, mostly with reference to the general law.

This is not ideal, but it shows how such a text, necessarily complicated because many of its elements reflect the latest developments in insolvency and restructuring, will also engender difficulties in its transposition, given the varying stages of development of European jurisdictions. This is by no means the final such text, the Insolvency III initiative following hot on its heels, also with many topic areas potentially within its scope, each likely to prove problematic to interpret, transpose and apply. Nonetheless, the steep learning curve formed by this experience is a necessary one, if Member States are to better improve their domestic laws and embrace the modern age of insolvency represented by new approaches to restructuring that are intended to produce great benefit for a continent emerging from the pandemic and still subject to the resilience risks posed by global economic and political instability. ■

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Footnote:

1 See Clifford Chance, "One Year Dutch WHOA Scheme" (2022), available at: www.cliffordchance.com/content/dam/cliffordchance/briefings/2022/02/one-year-dutch-whoa-(scheme)-some-lessons-learned.pdf.

Does the business entity model still matter in Lithuania?

Ieva Strunkienė gives her thoughts on whether or not the legal form of an individual enterprise is still relevant for a modern business in Lithuania

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Currently, Lithuania is searching for a legal regime for simplified individual business insolvency proceedings

In Lithuania, there is a dual regime for the conduct of individual business activity,[1] i.e., two models of individual business activity conducted either in an incorporated or an unincorporated manner.

The unincorporated form of individual business activity can be commenced in three ways:

- by declaring the status of self-employment under an individual activity certificate from the date of their activity with the tax administration;
- from the date of acquisition of a business license; or
- from the date of registration of a farm.

The incorporated form of individual business activity, acting as a legal entity, starts from the moment the legal entity is registered in the Register of Legal Entities (**RLE**).

Currently, Lithuania is searching for a legal regime for simplified individual business insolvency proceedings. This raises issues over how legal rules govern the interaction between insolvency proceedings in respect of an individual enterprise (**IE**) operating in an incorporated form and those of its owner.

The individual enterprise is a specific form of individual business organization in Lithuania,[2] so it is very important to critically assess its relevance in the context of the modern business. First, the registration of an IE with the RLE is necessary, which requires the preparation of the founding documents. Registering an IE involves the increased cost of incorporation and time to launch business activities. Second, as a legal person, an IE must have a single-person management body – the head of the enterprise; information on his/her employment must be submitted to the National Insurance Fund Board, and the head of the enterprise must be paid a salary and the corresponding taxes. Third, not only is the owner of the IE a taxpayer, but also the IE itself, as it is subject to corporate taxes. Fourth, the accounting records of an IE must be kept in accordance with procedures laid down in accounting legislation. Fifth, the specific features of the IE may influence cases of lesser trust of company's contractors.

Sixth, the small scale of the IE's activities makes it difficult to recruit highly-qualified staff, which results in a lack of professional management. Seventh, the procedure for liquidating an IE (because of insolvency proceedings) is more complex, as the liquidation procedure is subject to provisions of the insolvency articles regulating legal persons and also partly subject to Law on Bankruptcy of Natural Person (**LBNP**). Eighth, an IE is a legal person with unlimited civil liability, which determines the peculiarities of its civil liability, i.e., despite the fact that an IE and its participant are separate entities capable of independently assuming obligations and consequent liability, and the principle of the separation of the assets of the IE and the IE participant is in place, in the event the IE does not have enough assets to settle its property obligations, the IE's participant has a secondary liability for the IE's debts.[3] Ninth, the insolvency of an IE is considered to be highly disadvantageous for the participant, while the insolvency process is highly advantageous for the creditors, as the relevant legislation provides for the discharge of the IE's obligations to its creditors not only out of the assets of the IE itself, but also out of the assets of the participant.

According to the model chosen by Lithuania, the IE insolvency process is prioritized in terms of time, i.e., is not possible to commence the bankruptcy proceeding of a natural person (Article 5(8)(6) of the LBNP) if the IE managed by him or her is subject to bankruptcy proceedings. The national regulator has stipulated that the insolvency proceedings of the IE must be completed, first, which also includes the claims of the creditors to the natural person as the participant in the IE. Where the proceedings against an IE are wound up, the IE ceases to be a participant in civil law relations and the claims of its creditors are extinguished, but the obligations of the owner (participant) of the IE as a natural person towards his personal creditors are not terminated.

Before the adoption of LBNP, it was not possible to write off debts of this kind and creditors had the right to enforce their debts indefinitely. The adoption of the LBNP changed this and enabled a natural person who is an entrepreneur to apply for the opening of bankruptcy proceedings against him/her in case there are still outstanding claims of the creditors to the IE