Debt-to-equity swaps in reorganisation proceedings under Belgian law

Bart de Moor and Marine Callebaut discuss whether creditors should reasonably be expected to bear the business risks and be responsible for the efforts to turn the company around

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A general theory in company law states that the equity holders bear the risk in their companies. In times of financial difficulty, company equity holders have to accept lower dividends and ultimately add funding to the company in order to realise a turnaround, or eventually lose their investment in case of bankruptcy.

Other types of stakeholders are employees or creditors that could be affected by the company's financial difficulties as well, but in principle they do not have to bear the business risk associated with running a business.

As soon as a company is subject to restructuring frameworks, however, there is a shift: the creditors are expected to make concessions. Some or all the creditors will be urged to reduce their claims and waive their rights or are even forced to reduce their claims by adopting a restructuring plan for the company. Oddly, in formal reorganisation proceedings, the involvement and effort of equity holders is limited or even inexistent. A risk transfer occurs when a company decides to file for formal reorganisation.

Belgian and EU legislators have campaigned for greater involvement of equity holders in formal reorganisation proceedings. This can be obtained by including equity holders in restructuring plans and allowing a conversion of the creditors' claims into equity. This article will explain the reorganisation tools currently available to companies in distress under Belgian Law with a focus on debt-to-equity swaps in light of the provisions of the Directive on Preventive Restructuring and Insolvency in that respect.

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The impact of reorganisation measures and proceedings on the risk allocation in companies in distress

Entrepreneurs run businesses with the goal of making profits and creating wealth for themselves. Running a business also entails facing uncertainties, unexpected market conditions, and other risks. In fact, companies are often faced with financial difficulties. In principle, the entrepreneurial risk is borne by the equity holders.

Equity holders' risks

The equity holder primacy theory states that as soon as a company is incorporated, its business should always endeavour to maximise value for its equity holders. Indeed, what motivates running a business is the creation of wealth for the owner. As will be discussed below, in Belgian reorganisation proceedings, it is mostly (or only) the creditors who must make concessions to make the company viable again and ensure its continuity, not the equity holders.

Out-of-court solutions

A company can try to reach an amicable agreement with a few creditors to reorganise the debtor's assets or business activities. In terms of efforts to turn around the company, the amicable arrangement can include acceptance by one or more creditors' to make concessions that serve to aid the revival of the company. In theory, it could also require certain efforts by equity holders, but this is rarely the case and defeats the purpose of the amicable agreement.

In court judicial proceedings

In judicial proceedings the debtor seeks a solution to its financial difficulties under the supervision of the court. Belgian insolvency law provides two types of judicial reorganisation proceedings: one by amicable agreement and one by collective agreement. Furthermore, a transfer of undertakings is possible to save the viable economic activity.

Debtors can decide to negotiate an amicable agreement with some of their creditors within formal judicial reorganisation proceedings. If reaching an amicable agreement with a few creditors enables the debt repayment to be rescheduled and the company's continuity to be assured, this method would be most appropriate.

If a company's financial difficulties are such that the involvement of all creditors in the restructuring plan is required, it might be difficult to obtain every single creditor's approval. Therefore, Belgian insolvency law provides reorganisation proceedings by a collective agreement whereby the creditors vote on a restructuring plan, and the court confirms if the required majority of the creditors accepts the plan. For the approval of the plan to be valid, there are majority requirements. In general, all the effort is borne by the creditors.

A debtor can choose to transfer all or part of its activities to preserve their continuity. The

court will appoint an insolvency practitioner, who will be in charge of the organisation and completion of the transfer. Pending completion, the distressed company continues to run its operations. During this process, the insolvency practitioner will collect bids from candidates-transferees.

In case of a transfer of undertakings, there is no risk shifting from the equity holders to the creditors. Both share the loss. Once the transfer of undertaking is realised, the company will be put into liquidation or bankruptcy and the proceeds of the transfer will be distributed in application of the priority rules of bankruptcy. In principle, the creditors may expect a higher dividend from the proceeds of the transfer of undertakings than they presumably would obtain in bankruptcy proceedings.

Risk shifting from the equity holders to the creditors in a restructuring plan

When a company becomes insolvent, the greatest risks that equity holders face is not being able to receive any liquidation dividend and losing their initial investment. Remaining assets are used to pay creditors before the equity holders. If there is nothing left for distribution after the creditors are paid, the equity holders' entire contribution will simply be wiped out, and they will not receive anything from the liquidation proceeds. The equity holders are then out of the money.

However, if a company files for judicial reorganisation proceedings, all creditors (in case of a collective agreement) or some of them (in case of an amicable agreement) are asked to make concessions for the revival of the company. This risk, originally borne by the equity holders, becomes the creditors' burden, as they have made concessions in respect of their claims.

The Debt-To-Equity swap as a restructuring mechanism

Analysis of the mechanism

A debt-to-equity swap entails the exchange of a creditor's debt claim for equity in the company in view of writing off the debt that the company owes to this creditor. The debt and interest associated with the debt claim then becomes annihilated while new shares are issued to the creditor.

This mechanism allows the creditor to get shares on the upside when the restructured company recovers or is sold or floated. The conversion is also advantageous for the debtor: it increases the prospects of claim recovery by reducing the company's overall debt burden without an accompanying decrease in the company's assets. It can especially be a useful mechanism if the debt is too high

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to be reduced in a plan. However, existing equity holders of the company are often reluctant to allow such debt-to-equity swap because of its dilutive effect on their equity stake.

Debt-to-equity swaps under Belgian law

A debt-to-equity swap is often used in a non-insolvency context. The creditor participates to the equity increase pursuant a mandatory procedure provided by the Belgian Code of Companies and Associations ("BCCA").

Issues arising in the framework of a restructuring plan through collective agreement including debt-to-equity swap

Theoretically, two situations are conceivable if a debt-to-equity swap is included in a plan which is approved by the majority of creditors: either a creditor wishing to obtain shares in the insolvent company could convince the majority of other creditors that such swap would benefit them too, and thus succeeds in becoming an equity holder, either a majority of creditors can impose a debt-to-equity swap of a debt claim on another creditor, even if that creditor itself has voted against such conversion. An exception to the latter situation is made for secured creditors (with security such as a mortgage, pledge, or retention of title). Secured creditors cannot be affected by a restructuring plan unless they have approved it. As a result, "forced" debt-to-equity swaps concern mostly ordinary debt.

Debt-to-equity swaps are hardly ever a part of Belgian debtors' restructuring plans, because of the lack of equity holders' support. Indeed, their support is required, since at the implementation stage, the equity holders who do not want a dilution of their shareholding can simply vote against the equity increase associated with the debt-to-equity swap. As a result, a restructuring plan that includes a debt-to-equity swap would find itself ineffective in practice. This makes it difficult for creditors to implement forced debt-to-equity swaps through a formal restructuring plan. Until now, the Belgian legal framework has lacked legal tools to effectively "enforce" such conversions on the equity holders.

Power of equity holders to decide on equity increases

Pursuant to the BCCA, the equity holders have the power to decide on equity increases. The decision to increase the company's equity is valid if a statutory majority votes in favour of it, i.e., 75% of the equity holders present must vote in favour, and a quorum of 50% attendance must be reached. The BCCA sets out a special procedure for limited liability companies wishing to increase their equity by way of contribution in kind. For insolvent companies, determining the market value per share (and the valuation of the company as a whole) can be a difficult task.

Debt-To-Equity swaps in the EU Directive on Preventive Restructuring and Insolvency (Directive 2019/1023)

The EU Parliament and Council recognised, in Recitals 2 and 96 of the Directive, the above-mentioned problem of risk-shifting to the creditors in formal reorganisation proceedings and included in the Directive the possibility to include debt-to equity conversions in company restructuring plans.

The Directive suggests different alternatives. In theory, it provides two approaches to prevent equity holders from holding out on participating in a debt restructuring:

(i) By creating a class of affected parties: the equity holders—with or without voting rights—are part of the restructuring plan (Recitals 57 and 58 of the Directive);

(ii) By other means: the equity holders could be left out of the restructuring plan if they are not allowed to unreasonably prevent or create obstacles to the adoption and confirmation of a restructuring plan (Article 12 of the Directive)

The Transposition of the Debt-To Equity swap in the new Belgian law

The new Belgian law that will enter into force on 1 September 2023 provides two types of reorganisation proceedings with a vote of the affected parties on a restructuring plan. One type concerns the SMEs that count for most of the enterprises. The other type concerns large companies.

The reorganisation proceedings with a vote on a restructuring plan that apply to the large enterprises do not provide for the possibility to adopt a debt-to-equity swap that can be imposed to the creditors and existing equity holders against their will.

The restructuring plan of the reorganisation proceedings for SMEs can contain a debt-to-equity swap that can be imposed to the creditors and to the existing equity holders. If the plan is adopted and authorised by the court, it is binding upon the creditors and the equity holders. The law provides for the possibility that in case the company or its general assembly of equity holders does not execute the plan, the court can issue an order obliging the company to execute the plan.

Under the new law and the new provisions, the chances for a successful inclusion of a debt-to equity swap in a restructuring plan will increase substantially and we will see if in practice the tool will often be used. ■