MOVING "IN SYNC"? TOWARDS GREATER INSOLVENCY HARMONISATION

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EU member states make up almost a third[1] of the 38 economies where the EBRD invests. A further five EBRD countries of operations are candidate countries for joining the EU (European Union).[2] The new European Commission 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 (the proposed Directive), which is expected to be adopted in the first half of 2019, may therefore have a significant impact on the EBRD regions. While EU member states are not required to implement the proposed Directive into national legislation until three years from the date of its entry into force, some member states, such as France and The Netherlands, have already indicated that they may reform in advance of the implementation date. Meanwhile the United Kingdom, although set to exit from the EU, announced in August 2018 a proposed comprehensive reform of its insolvency rescue regime in line with the proposed Directive.[3]

The proposed Directive sets out certain goals which EU member states are expected to reflect in their national insolvency legislation to ensure access to a preventive or early restructuring framework for debtors in financial difficulty. It is to be distinguished from the recently recast European Union Regulation on Insolvency Proceedings,[4] which has direct effect and is aimed at coordinating effective administration of cross-border insolvency proceedings, as

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well as from initiatives such as OHADA,[5] which has created a cross-border regime of uniform commercial laws, including insolvency laws that are directly applicable in OHADA member states. As secondary EU legislation, the proposed Directive is derived from principles and objectives set out in EU treaties. A key objective of the proposed Directive is the harmonisation of differences in insolvency laws at EU level, which have been identified as an impediment to the integration of EU capital markets and the Commission's objective of a Capital Markets Union, by establishing certain minimum substantive standards.[6] Consequentially the proposed Directive provides that the EU Directives on settlement finality in payment and security systems, financial collateral arrangements and on over-the-counter derivatives, central counterparties and trade repositories, which guarantee a certain level of financial stability for capital markets, should all prevail in the event of any conflict with the proposed Directive.[7]

While there has been some cross-fertilisation to date among EU member states in the area of insolvency law;[8] the proposed Directive represents the first time that the EU has taken a serious step towards imposing some degree of harmonisation among EU member states in national insolvency law, albeit with significant freedom for manoeuvre. The proposed Directive stops short of harmonisation of all insolvency law and excludes from its scope liquidation procedures which account for the vast majority of insolvency proceedings. It also does not touch

concepts of what constitutes “insolvency” and “likelihood of insolvency”, which are linked to the so-called “trigger” to commence insolvency and rescue procedures and are interpreted differently throughout the EU with reference to cash flow and balance sheet insolvency tests and sometimes a combination of both. Likewise it leaves the definition of small and medium-sized enterprises (SMEs) to national legislators, presumably since this could be problematic to align across the EU given the different profile of many member state economies.

The proposed Directive builds on the Commission’s 2014 recommendation on a new approach to business failure and insolvency (the **Recommendation**),[9] which focused on ensuring that member states had a procedure to enable businesses to restructure at an early stage to prevent insolvency. The Recommendation was founded on the following six principles: early recourse to the restructuring procedure; minimised court involvement; allowing the debtor to remain “in possession” or control of its business during restructuring; a court-ordered stay or moratorium to prevent dissipation of assets; the ability to cram down or bind dissenting creditors to a restructuring plan and protection for new finance provided in accordance with a court-sanctioned restructuring plan.[10] The Recommendation was, however, non-binding, which resulted in limited member state compliance.

The proposed Directive covers three main areas related to business or commercial insolvency: (i) preventive restructuring frameworks for debtors in financial difficulty; (ii) procedures for discharge of debt incurred by insolvent entrepreneurs that is, natural persons who exercise a trade, business, craft or profession;[11] and (iii) measures linked to the increase in efficiency of procedures relating to restructuring, insolvency and the discharge of debt. It does not apply to natural persons who are not entrepreneurs or to certain categories of debtor which are typically treated separately for insolvency purposes, such as insurance undertakings and credit institutions. For the purpose of this Article we will focus on areas (i) and (iii) relating to businesses which are legal persons, as this is core to the Bank’s insolvency-related activities.

The term "restructuring" is broadly defined in the proposed Directive as "*measures that include changing the composition, conditions or structure of a debtor's assets and liabilities or any other part of the debtor's capital structure, such as sales of assets or parts of the business and, where so provided under national law, the sale of the business as a going concern, as well as any necessary operational changes or a combination of those elements*". This definition recognises that restructuring does not only concern the rescheduling of financial liabilities but will often require significant operational changes or divestments, including a transfer of ownership of the business. Nevertheless the proposed Directive does not expressly require member states to support a transfer of the business as a going concern within the context of preventive restructuring. It is also not entirely clear to what extent the proposed Directive will, in practice, promote a sale of the business as a going concern and change in ownership, which is often accompanied by a change in management. The proposed Directive requires member states to have in place a preventive restructuring procedure which allows the debtor and its management to remain in possession and does not envisage a creditor-led procedure which would be more likely to lead to a sale of the business.

THE NEW PREVENTIVE RESTRUCTURING FRAMEWORK

The text of the proposed Directive was extensively debated among member states and the EU institutions and the end result is a compromise which allows member states certain flexibility. All member states are required to have a framework for preventive restructuring which enables debtors that are at risk of insolvency, in other words not necessarily insolvent, to restructure and preserve their business. While many countries in the EU allow businesses threatened by insolvency to access statutory restructuring tools, this may not be the case for all; a significant number of countries, including Bulgaria and Hungary, still do not have any preventive restructuring procedure outside of mainstream insolvency proceedings which include the possibility of a reorganisation plan. Title II of the proposed Directive imposes a number of key obligations on member states relating to the preventive restructuring framework. In addition to the requirement for debtors to remain totally or partially in possession of their business referred to above, member states must ensure: (i) the availability of a stay if necessary which may cover all claims, including preferential and secured claims; (ii) an initial duration of any stay on individual enforcement action capped at a maximum of four months, capable of extension, if duly justified, to a maximum of 12 months or termination in certain circumstances, in each case with judicial or other administrative body approval; (iii) limitations on the ability of creditors and other third parties to rely on so-called "ipso facto" clauses, such as contractual termination clauses, against businesses, which are subject to a preventive restructuring procedure and provisions aimed at ensuring the continuation of essential executory contracts. These measures are aimed at providing businesses with a stable platform needed to carry out a restructuring.

Title II of the proposed Directive also sets out certain minimum provisions for restructuring plans relating to debtors, including the basic information which such plans must contain and requires that member states ensure that affected parties are separated into different classes according to "sufficient commonality of interest"

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for voting on a restructuring plan. As a minimum member states are required to recognise that secured and unsecured creditors must vote as separate classes. This is an interesting development, since a number of EU member states still exclude secured creditors from voting on a restructuring plan unless they relinquish their security rights. Any restructuring plans which affect the claims or interests of dissenting affected parties and provide for new financing must receive judicial or relevant administrative authority approval, which can only be granted provided a number of conditions established by the proposed Directive are met. Another innovative feature of the proposed Directive is that it requires member states to allow a restructuring plan to be imposed across all classes of creditors, provided certain conditions are met, in two scenarios: the first, where a majority of affected classes vote in favour of the plan, provided at least one of such classes is a secured creditor or ranks ahead of ordinary unsecured creditors and the second, where at least one voting class of affected or impaired parties, other than equity holders or out of the money creditors, votes in favour of the plan.[12]

While there was general agreement among member states on the importance of a preventive restructuring framework, some member states were concerned about non-viable businesses being able to use this to delay inevitable insolvency (liquidation) proceedings. The compromise text of the proposed Directive allows member states to impose a viability test. It also allows member states to give creditors a greater role by allowing creditors, as well as the debtor, to initiate a preventive restructuring procedure. Member states may also limit the number of times that a debtor may access the procedure or the involvement of any administrative or judicial authority. Although the proposed Directive envisages that member states should have a "debtor-in-possession" restructuring procedure, similar to the US Chapter 11, where the debtor remains fully or at least partially in control of its business, an insolvency practitioner may be appointed by the court or administrative authority where necessary on a case-by-case basis or where required by national law, subject to a number of specific cases where a practitioner must be appointed, including if there is a general stay on enforcement actions and an insolvency practitioner is necessary to safeguard the interests of the parties.[13] The position reflects a compromise between the Commission, which was concerned that making the appointment mandatory could add significant cost, particularly for smaller debtors and frustrate a preventive restructuring, and some member states, which viewed the appointment of the insolvency practitioner as central to the success of any restructuring.

THE JUDICIARY AND INSOLVENCY PRACTITIONERS

Title IV of the proposed Directive requires member states to provide support for certain measures to improve practical implementation of any preventive restructuring framework and increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, including in particular measures to support judicial and administrative authorities and insolvency practitioners, which have long been an important focus area for the Bank's projects in the field of insolvency.[14] Member states are required to ensure that members of the judiciary or any administrative authorities receive appropriate training and have the necessary skills to discharge their duties. This task will be more challenging for member states that do not have a commercial court system or first instance courts with a commercial division, such as Cyprus and Greece. In civil courts of general jurisdiction the pool of judges who may manage an insolvency case is of course larger, making it difficult to target any training needs.

Member states are similarly under an obligation to ensure that insolvency practitioners receive "suitable training" and have the "necessary expertise" for their responsibilities in procedures concerning restructuring, insolvency and discharge of debt. Unlike judges, insolvency practitioners do not necessarily have the status of public servants, since they are for the most part a private sector group of professionals. It is therefore not entirely clear what the recommended course of action is for member states, which allow a measure of independence to the profession, to fulfil this requirement.

The proposed Directive defines an insolvency practitioner as "*any person or body appointed by a judicial or administrative authority to assist the debtor and its creditors to draft or negotiate a restructuring plan, supervise the activity of the debtor during negotiations on a restructuring and/or take partial control over the affairs and assets of the debtor*". While most EU member states require that the insolvency practitioner is a natural person on policy grounds, including the need for personal and direct accountability, this is not the case for all countries. In Poland the insolvency practitioner can be a partnership, as well as a natural person, and in Hungary practitioners are all firms, subject to the requirement to have at least two professionals with liquidation and asset controller qualifications, two economists, two licensed auditors and two qualified lawyers. The definition of "insolvency practitioner" in the proposed Directive does not apply to a liquidator, whose purpose is the liquidation of the debtor business and who will generally take *total* control of the debtor's business. This differentiation is, however, artificial since in most EU member states there is no separation of the profession into liquidators and administrators or restructuring practitioners, or even allowed specialisation within the profession.

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The proposed Directive addresses selection, appointment and removal of practitioners, requiring the conditions for eligibility to the profession and the process for appointment, removal and resignation of practitioners to be "clear, transparent and fair". Member states are required to allow the debtor and creditors to be able to object or request the replacement of the insolvency practitioner due to conflicts of interest. However the proposed Directive does not require member states to allow the debtor or the creditors a role in the determination of the initially appointed practitioner, a proposal which is supported by the EBRD.[15] The proposed Directive instead specifies that the process for appointing an insolvency practitioner is required to give due consideration to a practitioner's experience and expertise. This is at odds with the appointment system in a number of EU countries, including Croatia, Latvia and Lithuania, which relies on a "randomised" system of appointment based on computer selection where the past record of the insolvency practitioner is rarely taken into account.

Another important feature of the proposed Directive's focus on the insolvency practitioner profession is the obligation of member states to put in place "appropriate oversight and regulatory mechanisms" for insolvency practitioners. It is not readily apparent from the broad drafting of this provision how member states will, in fact, demonstrate compliance, particularly since the regulatory frameworks are so divergent among member states. In all EBRD EU countries of operations and in France, the insolvency practitioner is required to be licensed or registered and some measure of regulation can be undertaken by the licensing authority. Nevertheless in other jurisdictions, the insolvency practitioner is considered more as a "specialisation" rather than a profession. In Austria and Germany, which are often used as benchmarks for EBRD countries of operations, insolvency practitioners are not required to be licensed or registered. The Bank through its Legal Transition Programme (LTP) is working on a number of insolvency practitioner reform projects with the European Commission via the Structural Reform Support Service in Cyprus, Croatia and Greece, which seek to address regulatory impediments and strengthen expertise within the insolvency practitioner profession.

THE ROLE OF TECHNOLOGY FOR THE FUTURE OF INSOLVENCY

Often the data relating to insolvency procedures is incomplete or missing. An important provision introduced by the proposed Directive to increase efficiency in preventive restructuring procedures is the requirement for member states to improve technology and data collection for procedures concerning restructuring, insolvency and discharge of debt. The proposed Directive provides that member states should ensure that the parties to the procedure, the insolvency practitioner and the judicial or administrative authority are all able to perform a certain number of actions electronically, including filing of claims and notifications to creditors. This is expected to be challenging in certain countries where there are many older members of the insolvency practitioner profession or judiciary, less exposed to the use of modern technology. Member states are also required to collect sufficient minimum data on restructuring, insolvency and discharge of debt procedures, although the proposed Directive does not require such data to be gathered automatically through an electronic system.

In Croatia* and Cyprus* the EBRD is working on strengthening the framework for insolvency and restructuring practitioners (IRPs)

Both projects in Croatia and Cyprus aim to analyse the existing regulatory framework for IRPs to identify the areas that need to be strengthened, including regulation, supervision and discipline, and focus on building a sustainable framework for capacity building and training of IRPs.

The projects incorporate the drafting of a training methodology programme for the main regulatory body of IRPs in accordance with international and European best practice covering training roles and responsibilities, content of training and establishing a continuing professional development culture. Both projects then cover the practical training of IRPs in core areas and a training of trainers.

Croatia and Cyprus are very different in terms of models of insolvency practitioner regulations. In Cyprus one of the key issues is the harmonisation of the regulatory and cooperation framework between the three separate licensing and supervisory bodies and the government ministry responsible for such bodies to ensure a consistent regulatory approach. This is in contrast to Croatia where the Ministry of Justice is responsible for licensing all insolvency practitioners and any continuing professional development and where a principal focus is not only the professional qualifications of existing IRPs, but also prospective IRPs.

* These projects are funded by the European Commission via the Structural Reform Support Service.

If these provisions are implemented properly, the proposed Directive will provide important visibility on the use of insolvency procedures, as well as the issues and trends for each member state. These provisions of the proposed Directive continue the trend towards greater technology set out in the recast European Union Insolvency Regulation.[16] The Regulation required member states to establish and maintain in insolvency registers information concerning insolvency proceedings that would be published as soon as possible after the opening of such proceedings. In addition it provided that the European Commission would establish a decentralised system for the interconnection of insolvency registers to serve as a central, public electronic access point to information with a search service in all the official EU languages. The proposed Directive also requires member states to put in place one or more early warning tools, with the option of using new IT technology, to signal to the debtor the need to take preventive action.[17]

In summary the proposed Directive represents in many ways a remarkable effort to establish certain minimum standards for national insolvency frameworks in the EU. It is significantly more prescriptive than any principles-based guidance published to date on insolvency frameworks by international organisations.[18] The proposed Directive proposes a fundamental shift in European national legislation on business insolvency towards a more US “Chapter 11” model, which remains one of the most widely recognised successful examples of a corporate rescue procedure. It represents an important benchmark for the EBRD regions for preventive restructuring and will be of interest to all economies seeking to improve the prospects of early restructuring of viable businesses within a protective legislative framework, irrespective of whether they are EU member states. Of course the proposed Directive also leaves open a number of questions, including most importantly how truly harmonised EU member states legislation will be once it is implemented and whether this legislative initiative will satisfy major concerns relating to proper functioning of the Capital Markets Union. In this respect the proposed Directive is likely to be the first of many more attempts to create a more coherent approach across the EU towards preventive restructuring, insolvency and discharge procedures.

1 Countries where the EBRD invests, which are also EU member states are: Bulgaria, Croatia, Cyprus, Estonia, Greece, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic and Slovenia.

2 Albania, Montenegro, North Macedonia, Serbia and Turkey.

3 Insolvency and Corporate Governance, Government response dated 26 August 2018.

4 Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings OJ L 141, 5.6.2015, p. 19–72.

5 OHADA stands for "Organisation pour l'Harmonisation en Afrique du Droit des Affaires" (Organisation for the Harmonisation of Business Law in Africa). Insolvency proceedings in all 17 sub-Saharan African member states are regulated by the revised Uniform Act organising insolvency proceedings which entered into force on 24 December 2015.

6 Recital (i) of the proposed Directive. It is also of importance to the Single Market and to the Commission's work on the Banking Union, which seeks to prevent the accumulation of non-performing loans in the banking sector.

7 Article 31(1) of the proposed Directive. Directives 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems, OJ L 166/45, 11.6.1998; Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2012 on financial collateral arrangements, OJ L 168/43, 27.6.2002; Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, OJ L 201/1, 27.7.2012.

8 For example the English Companies Act scheme of arrangement has been adapted into Spanish law.

9 12 March 2014, C (2014) 1500.

10 Restructuring law: recommendations from the European Commission by Kristin van Zwieten, EBRD *Law in Transition* online 2014.

11 The proposed Directive requires member states to have at least one procedure which can lead to a full discharge of the debt of an entrepreneur within a maximum of three years, thereby ensuring such person has a second chance at a business.

12 Article 11 of the proposed Directive.

13 Article 31(1) of the proposed Directive.

14 From 2012 to 2014 the EBRD carried out an assessment of the insolvency practitioner profession across 27 countries of operations where the profession was relatively well developed. A comparative overview of the results of the assessment can be found online: https://www.ebrd.com/what-we-do/sectors/legal-reform/debt-restructuring-and-bankruptcy/sector-assessments.html

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15 EBRD Assessment of Insolvency Office Holders, Section 4.4, Appointment of the insolvency office holder pages 55 to 60 A comparative overview of the results of the assessment can be found online: https://www.ebrd.com/what-we-do/sectors/legal-reform/debt-restructuring-and-bankruptcy/sector-assessments.html

16 Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings OJ L 141, 5.6.2015, p. 19–72.

17 Article 5 of the proposed Directive.

18 For example, the UNCITRAL Legislative Guide on Insolvency Law (2005) or the World Bank Principles for Effective Insolvency and Debtor Creditor Regimes (2015).