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Cramped by cramdowns: national hurdles for EU insolvency plan

Proposal to harmonise rules on debt stays and holdout creditors touches on sensitive issues

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- In November 2016, the European Commission proposed a draft directive to set up a common business insolvency framework in the EU.

- The draft text aims to detect financial problems in advance, allowing viable enterprises to restructure and giving every businessman a "second chance" through debt discharge.
- Negotiations may be complicated in the Council of the EU, as the proposal requires some harmonisation of company law - an area characterised by wide national divergences.
- The financial industry favours the text, considered as a key building block of the Capital Markets Union, but lobbyists want stronger protection of creditors.
- The draft text is supposed to boost cross-border investment and help to clean NPLs from banks' balance sheets, but it is too early to assess the potential outcome.

The Council of the European Union is seeking a political compromise on an unprecedented attempt to harmonise insolvency rules in the 28 member states – a “very, very controversial” proposal, according to one lobbyist, which holds the promise of a partial solution to Europe’s bad loan problem, but already has some industry observers worrying about an erosion of creditors’ rights.

The draft text of the directive on insolvency harmonisation was published by the European Commission in November 2016 – the first time the EC has sought to standardise insolvency law. It creates an early warning system to detect possible problems well in advance, paves the way for agreeing restructuring plans and foresees the possibility of a cramdown on lenders to avoid restructurings being impeded by a few holdout creditors. The draft text also allows every "honest" entrepreneur in the EU to benefit from a second chance, with a debt discharge kicking in three years after the liquidation.

"It will be a difficult negotiation – company law is one of the most complex areas, deeply entrenched in national legal systems," says Pedro Oliveira, senior adviser for company law at lobby group BusinessEurope.

A first meeting on January 16 of the 28 national experts representing the member states on the council showed the issue is "very delicate", according to a diplomatic source.

"The 28 agree on the objectives of the text, but there will be a number of country-specific issues regarding the articulation with national law," says the source. "I don't see any problem with the first three articles, but the rest is very delicate."

The first provisions in the draft text are the broadest, dealing with general objectives. The following 15 pages are much more prescriptive and impose several detailed requirements.

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>
> *A diplomatic source*

Malta, whose government is chairing the Council of the EU between January and June, has already made clear it does not expect to reach an agreement during these six months. It has planned a total of eight expert meetings, on top of the first exchange of views among justice ministers, which took place on January 27.

Maltese justice minister Owen Bonnici said he hoped to make "extensive progress" during his country's rotating presidency. If the work goes fast enough, Malta will organise a second ministerial debate in June, at which it hopes to have some more concrete issues to debate.

It is the first time the EC has tried to harmonise the 28 national laws in this area. An EU regulation on insolvency proceedings already exists, but it only deals with cross-border issues and jurisdictional conflicts, and it does not infringe on national procedures.

Pedro Oliveira: "difficult negotiation"

The commission produced a more complete document in 2014, as part of its Capital Markets Union (CMU) initiative, but it was only a recommendation, so member states are not obliged to comply. The proposed directive last year mirrored this original recommendation quite closely, including restructuring at an early stage, the use of out-of-court processes, repayment moratorium periods for debtors, and debt discharge and ‘second chance' rules. It has not been implemented in any meaningful way by members, however.

"A few member states have undertaken reforms, but have chosen selectively among its provisions," the EC concluded in a March 2016 impact assessment. "There will be a continuing divergence of approach if no action is taken at EU level."

Flexible approach

In order to make sure the proposal is not rejected out of hand by member states, the EC's proposal only aims for a minimum level of harmonisation. It sets out several principles, but is quite broad regarding implementation.

"We give a wide margin of flexibility to member states to make sure they can adjust the EU directive to their national legal system," explained Andreas Stein, a legal adviser at the EC, during an event organised by Brussels think-tank Bruegel on January 18.

The text does not directly tackle insolvency law, but focuses mostly on approaches to debt restructuring. According to Stein: "Insolvency laws [have been] here for hundreds of years; it is very difficult to change them, but there is more movement and also greater convergence around restructuring."

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Gary Simmons, Association for Financial Markets in Europe

Finally, the draft contains several options and discretions, allowing it to be transposed into national law in various ways. For example, the early warning mechanism can be limited to small and medium enterprises. There is also room to extend the fixed stay period during which the enterprise can continue to do business without repaying loans, should the debtor remain illiquid when the set period ends. The three-year discharge period for unpaid debts can be restricted for any entrepreneur deemed 'over-indebted'.

"Of course, we would have preferred greater harmonisation, but the commission had to take into account the political reality. Given the complexity of insolvency law and other political constraints, I think this proposal can be very effective,"

says Gary Simmons, managing director of the Association for Financial Markets in Europe (Afme).

Anna Lekston

"Once the directive is adopted, it will also be important to ensure it is implemented consistently across EU member states," adds Anna Lekston, head of public affairs at Invest Europe, which represents private equity and venture capital investors.

At one point, the EC apparently considered making the whole system optional in order to facilitate its approval by member states. That would mean the creation of a harmonised 29th regime – alongside the 28 national ones – but the impact assessment drafted by the EU's executive body dismissed the option, saying "this approach brings extra complexity, as well as enforcement difficulties".

"A 29th regime would introduce an additional element of complexity, because those applying the law in the member states would have to know not only their own legal system but also a second system," says a source at the EC. "Litigation would arise in situations where at least some of the creditors would have more rights or more favourable treatment under the otherwise applicable domestic law."

Bones of contention

Despite the flexibility, the EC proposal will require several member states to make significant changes to their national systems; for example, regarding cramdowns, stay and discharge periods.

A cramdown allows the final restructuring plan to be imposed on a minority of dissenting creditors. This will be complicated for Croatia, Belgium, Austria, Slovakia, Portugal, Poland, Hungary and Greece, where a minority can obstruct the process. It could also be problematic in Ireland and Germany, where all creditors are automatically involved in the restructuring.

Several sources tell *Risk.net* that French banks and private federations are wary, as they would like to be sure the new scheme will allow the current French ‘conciliation' process to survive. The conciliation differs from the EU directive as it formally involves the court and usually builds on a consensus of all the

creditors. Sources say the French system works well, and that debtors and creditors would like to preserve it.

The proposed four-month stay period, during which the indebted entrepreneur can manage his business without interference from debtors, will also force some states to amend their laws. Some of these, including Sweden and the Czech Republic, have absolutely no similar provision. Others do have such a period, but will need to reduce its length; for example, in Romania, where the moratorium can run up to three years, or in Malta, where it initially lasts one year and can be extended.

> **In some German Länder, insolvency cases are dealt with by judges specialised in family law. They would require special training under the new EU directive**
>
> *Daniel Fritz, Hermann Wienberg Wilhelm*

Finally, the proposed three-year period to grant a debt discharge is likely to create some debate in the council, as national provisions diverge significantly. Current discharge periods run from only a few months in Luxembourg to 150 months in Greece. In Malta, there is no time limit at all. In Poland, it is not automatic and depends on court confirmation, meaning it can take up to four or five years. In Austria, discharge is only available if half of the debts have been repaid.

The draft text also stipulates that judges and practitioners dealing with insolvency and restructuring must receive "initial and further training". This could be a problem for some jurisdictions, says Daniel Fritz, insolvency administrator at Hermann Wienberg Wilhelm in Frankfurt: "In some German Länder, for example, insolvency cases are dealt with by judges specialised in family law. They would therefore require special training under the new EU directive."

From a more general point of view, agreeing on the text will require the council to shift towards a system that looks more like the US Chapter 11 bankruptcy protection concept – something that might seem unnatural for some diplomats. "In the EU, we mostly have a 'pro-liquidation' culture," says the EC's Stein, meaning liquidation is the most likely outcome in the case of insolvency.

Good timing?

Supporters of the proposal hope the timing will help it to go through, owing to support for pro-growth policies as part of the CMU, which is intended to encourage greater cross-border investment flows between member states.

"Member states might be more willing to take a step forward now. After the crisis, the EU was mostly focused on regulating the banks and financial sector. Now, the attention has shifted more towards the growth and jobs agenda," says Invest Europe's Lekston.

The financial industry used the very first consultation on CMU, back in 2015, to push for insolvency harmonisation. It is considered a significant part of the strategy because of its wide-ranging benefits, which will be felt by more or less every kind of debt investor, contrary to specific actions for venture capital or covered bonds in the CMU, which only deal with one specific type of financial product.

Finance ministers have so far been very enthusiastic about CMU proposals, but the insolvency harmonisation proposal will actually be handled by justice ministers, who have never worked on CMU before. Several justice ministries may suffer from regulatory fatigue after recently amending their national insolvency laws, including Cyprus, Croatia, the Netherlands, Portugal, Spain and the UK.

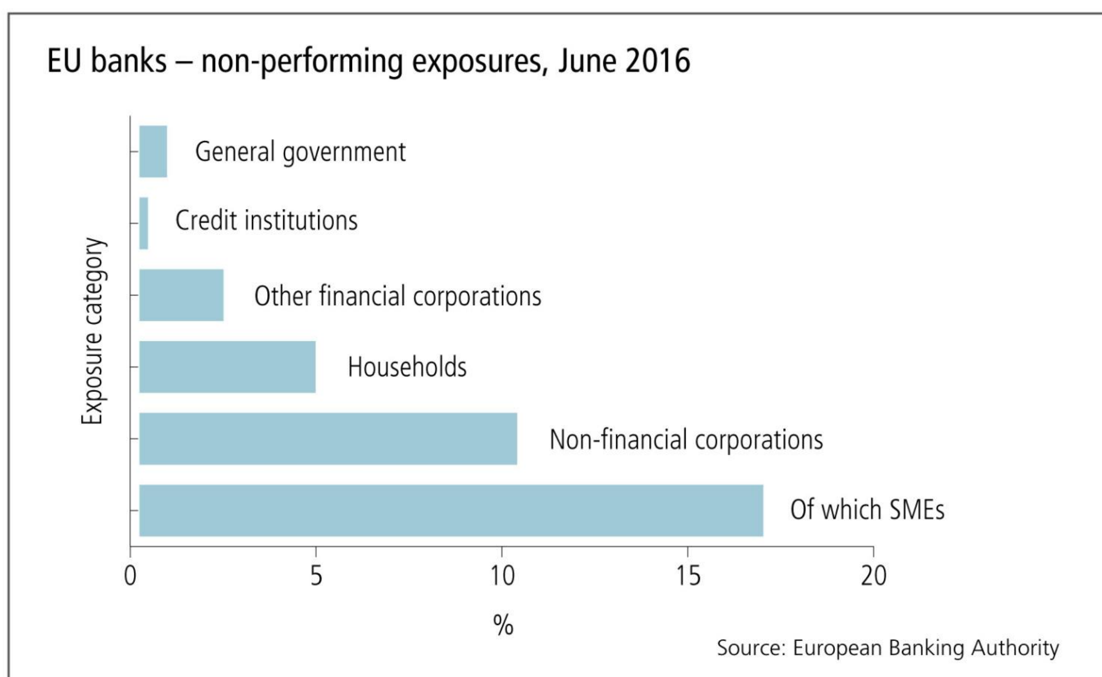
More generally, the UK's withdrawal from the EU is creating some uncertainty regarding the work carried out by the council. Insolvency in the UK is often executed through a special kind of court-approved agreement, called a scheme of arrangement. This quick and efficient method is not only popular in the UK, but is also widely used by companies and creditors in other EU jurisdictions who seek to move insolvency proceedings to the UK.

Investor protection

While strongly supporting the proposal, some market participants express regret that it does not provide better protection of creditors. The draft text foresees that a restructuring plan can be adopted when a majority of creditors agree. Cramdowns mean certain creditors will have losses imposed on them without any *ex ante* indication of what the creditor hierarchy might be.

"It is not about blocking the plan – it is about making sure there are the right safeguards," says one lobbyist.

As member states will probably be busy trying to protect national differences, lobbyists are mostly planning to reach out to the European Parliament when it considers this legislation. The parliament is traditionally less influenced by national bias and several sources hope its work will be faster than that of member states. The parliament's legal affairs committee has nominated Angelika Niebler, a German member of the European People's Party and a former lawyer, as rapporteur. She declined to speak to *Risk.net* before negotiations begin at the committee.



Europe's bad loan challenge

"Stronger insolvency frameworks facilitate the restructuring and continuation of debtors' operations, and therefore smooth the progress towards a rapid change of unsustainable debt levels," wrote the Association for Financial Markets in Europe (Afme) in a dedicated study published last year.

Relying on World Bank data, the Afme document showed states with stronger insolvency regimes (such as the US, France, Austria, Belgium and Switzerland) saw only a small increase in their non-performing loans (NPLs) between 2007 and 2014 – less than 5%. By contrast, Ireland and Greece, which lacked such a framework, had to deal with much more severe increases of 20% and 30%,

respectively. Of course, this data does not take account of the more drastic financial and economic crises in Ireland and Greece.

There is currently no precise estimation of what proportion of NPLs might be better tackled as a result of the EU's proposed insolvency harmonisation directive. But the draft text is well designed as it tries to support mainly SMEs, which are suffering from NPL rates of almost 17%, according to the European Banking Authority's (EBA) transparency exercise for June 2016.

The proposal is also close to a suggestion made by the International Monetary Fund in its September 2015 paper, *A strategy for resolving Europe's problem loans*, which encouraged the EU to harmonise the insolvency framework and boost out-of-court restructuring mechanisms.

Moreover, the draft allows member states to include natural persons within the scope of their insolvency law. According to the EC, this could help to reduce household NPLs, which stand at just under 5%, according to EBA data.

At the same time, officials are warning the text should not be viewed as a silver bullet for bad loans. "Tackling the NPLs is definitely not the primary goal of the text. It is mostly about helping viable enterprises in difficulty to survive," stresses an EU official.

Consequently, dealing with NPLs will also require other measures. EBA chairman Andrea Enria **has suggested** creating a European asset management vehicle to clean NPLs from bank balance sheets. The IMF paper emphasised the need to improve prudential oversight, to enhance debt-enforcement regimes, and to develop distressed debt markets.