LAW SOCIETY SUBMISSION

EUROPEAN COMMISSION PROPOSAL FOR A DIRECTIVE ON INSOLVENCY, DEBT, RESTRUCTURING AND SECOND CHANCE

DEPARTMENT OF JOBS, ENTERPRISE AND INNOVATION
DEPARTMENT OF JUSTICE AND EQUALITY
OIREACHTAS COMMITTEE ON JUSTICE & EQUALITY

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ABOUT THE LAW SOCIETY OF IRELAND

The Law Society of Ireland is the educational, representative and regulatory body of the solicitors' profession in Ireland.

The Law Society exercises statutory functions under the Solicitors Acts 1954 to 2011 in relation to the education, admission, enrolment, discipline and regulation of the solicitors' profession. It is the professional body for its solicitor members, to whom it also provides services and support.

The headquarters of the organisation are in Blackhall Place, Dublin 7.

1. Introduction

1.1 The Law Society welcomes the opportunity to comment on the consultation (the "**Consultation**") launched by the Department of Jobs, Enterprise and Innovation and the Department of Justice and Equality regarding the EU Commission Proposed Insolvency Directive on "preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures", (the "**Proposed Directive**").

1.2 The Law Society supports the key objectives of the Proposed Directive namely: (i) to ensure that viable enterprises in financial difficulties, wherever they are located in the Union, have access to national insolvency frameworks which enable them to restructure at an early stage with a view to preventing their insolvency, and therefore maximise the total value to creditors, employees, owners and the economy as a whole; and (ii) to encourage greater coherence between the national insolvency frameworks in order to reduce divergences and inefficiencies which hamper the early restructuring of viable companies in financial difficulties and the possibility of a second chance for honest entrepreneurs, and thereby lower the cost of restructuring for both debtors and creditors.

1.3 The Law Society would like to make the following preliminary/high level observations in relation to the Proposed Directive.

2. Preventive Restructuring Frameworks

2.1 The Proposed Directive mandates Member States to ensure that, where there is likelihood of insolvency, debtors in financial difficulty have access to an effective preventive restructuring framework/procedure (the "**Framework**") that enables them to restructure their debts or business, restore their viability and avoid insolvency. The Proposed Directive requires that the Framework be available before a debtor becomes insolvent according to national law and suggests that a test of viability should not be made a pre-condition for entering negotiations and for granting a stay of enforcement actions.

2.2 The Law Society notes that the proposals contained in the Proposed Directive appear to be influenced by provisions contained in Chapter 11 of the United States Bankruptcy Code. Ireland has a long-standing corporate rescue culture in the form of examinership (which itself shares some of the characteristics of Chapter 11), which could be tailored to facilitate the Framework envisaged under the Proposed Directive. Alternatively and perhaps preferably, in light of the divergences between the provisions of examinership[1] and those required under the Proposed Directive, an additional procedure should be designed to implement the proposals under the

1. *No mandatory appointment of a practitioner to deal with restructuring, insolvency and second chance matters; no automatic stay or moratorium; limited judicial involvement; Framework cannot be proposed by creditors absent consent of debtor.*

Proposed Directive. In this regard the Law Society previously made a submission recommending a procedure which is a variation of the 'Company Voluntary Arrangement' procedure which is available in the United Kingdom which may be of assistance.

2.3 The Framework must include minimum specified characteristics, some of which are considered below insofar as the Society has comments in relation to same.

2.3.1 *Limit on the involvement of a judicial or administrative authority*

2.3.1.1 The limit on the involvement of a judicial or administrative authority to the extent it is necessary and proportionate so that rights of any affected parties are safeguarded is welcomed. The reduction of court formalities ought not to have an impact on creditors' rights since the confirmation of the restructuring plan by a court or an administrative authority is mandatory when dissenting parties' rights are affected and where the restructuring plan provides for new financing. Creditors should have access to the courts where their interests are affected by the Framework, including for example with regard to any associated action taken by the debtor in relation to a stay, interim financing or the conduct of the debtor's affairs whilst it is availing of the Framework.

2.3.2 *No mandatory appointment of an insolvency practitioner*

2.3.2.1 The Proposed Directive gives Member States a degree of flexibility with regard to the degree of control which the debtor's management should retain while subject to the Framework. The appointment by a judicial or administrative authority of a practitioner in the field of restructuring is not mandatory in every case although it is acknowledged that Member States may require this in certain instances. The qualifying language in Article 5(3) suggests that an insolvency practitioner can only be appointed where: (i) the debtor is granted a general stay of individual enforcement actions in accordance with Article 6; and (ii) the restructuring plan needs to be confirmed by a judicial or administrative authority by means of a cross-class cram-down, in accordance with Article 11. There may be additional circumstances where such an appointment is necessary, for example if there is some dispute between the current owner-managers in relation to the proposed rescue plan which is adversely impacting on the day-to-day operations which would be resolved by the practitioner being afforded specified executive powers (similar to examinership).

2.3.2.2 In order to exclude such transactions from anti-avoidance laws (other than where there is fraud or bad faith) it is open to Member States to require approval by a practitioner, or a judicial or administrative authority, of transactions such as new credit, financial contributions or partial asset transfers outside the ordinary course of

business made in contemplation of and closely connected with negotiations for a restructuring plan

2.3.3 *Debtors should have access to an optional moratorium or stay on individual enforcement actions*

2.3.3.1 There is no automatic moratorium on enforcement actions unlike with examinership where a stay operates from the filing of a petition in the Central Office (assuming an independent accountant's report is available). In the absence of a blanket moratorium the debtor may have to conduct a potentially detailed review to ascertain the individual creditors to whom the stay should apply and to adduce sufficient evidence to satisfy the Court that a stay is necessary to support the negotiations of a restructuring plan. If a number of applications are required, there might be increased costs.

2.3.3.2 The Proposed Directive does not deal with a situation where a creditor (not subject to a stay) seeks or take(s) an enforcement (or other) action, for example the appointment of a receiver by a secured lender. It should be clear as a matter of national law whether the debtor would then be able to petition for examinership.

2.3.3.3 There is a lack of clarity regarding the first trigger for calculating the period of the stay which can be up to a total maximum of 12 months. It seems to operate from the date of the initial stay rather than from when the preventive restructuring procedure is first initiated (which it is submitted is preferable for legal certainty and in light of the lengthy period involved). Further, the Proposed Directive does not deal with a situation where multiple stays on individual enforcement actions are obtained at different times. The potential length of the moratorium will cause lenders concern in the context of the 70 - 100 day period which currently applies to an examinership.

2.3.4 *Executory Contracts*

2.3.4.1 Member States are required to ensure that, during the stay period, *"creditors to which the stay applies may not withhold performance or terminate, accelerate or in any other way modify executory contracts*" (where there are outstanding obligations by both parties) *"to the detriment of the debtor for debts that came into existence prior to the stay".* Whilst such provisions might be in the interests of the debtor and limit the necessity to make duress payments to pre-stay liabilities (as can arise in the case of examinership), the counter-party is in an unenviable position of being forced to continue performing the terms of the contract. For example, a creditor which has supplied goods the subject of a valid retention of title right is potentially and arguably constrained and further, forced to continue to supply goods (albeit that the Proposed Directive envisages that post-stay debts that arise in the ordinary course of business would be discharged by the debtor). The Proposed Directive gives Member States a degree of flexibility regarding whether the restriction on

terminating executory contracts should be limited to "essential contracts[2]" which are necessary for the continuation of the day-to-day operation of the business. At a minimum this limit should apply as a matter of Irish law in order to preserve parties' freedom to contract, although in many cases it may be difficult to draw the line between which contracts are 'essential contracts' and which are not. Given the potential length of the stay period, the obligation on a counterparty to have to continue to perform a contract while not receiving payment of the pre-stay debt (i) may in reality cause a solvency difficulty for the counterparty if the relevant contract is important to its business and (ii) might constrain business decisions which the counterparty might otherwise make in circumstances where there is a risk that the rescue plan will not be successful.

2.3.5 *Ipso facto provisions*

2.3.5.1 Pursuant to the Proposed Directive, clauses in executory contracts allowing the creditor to terminate or refuse performance upon restructuring negotiations or requests for a stay will be unenforceable. Member States are required to ensure that *"creditors may not withhold performance or terminate, accelerate or in any other way modify executory contracts to the detriment of the debtor by virtue of a contractual clause providing for such measures, solely by reason of the debtor's entry into restructuring negotiations, a request for a stay of individual enforcement actions, the ordering of the stay as such or any similar event connected to the stay*". It is noteworthy that this restriction appears to apply to all creditors and not just those creditors to which a stay applies (by comparison with Article 7(4) discussed above). Such provisions constrain parties' freedom to contract rights and will be a significant concern to lenders and counterparties to contracts.

2.3.6 *Workers*

2.3.6.1 Workers are in principle exempted from the stay of enforcement. This has the potential to derail any preventative restructuring procedure, for example in the case of a disgruntled owner/employer who might no longer be a shareholder following implementation of the rescue plan. Member States only have the possibility to apply a stay of enforcement where they protect workers' claims by other means. For example, under current EU law, Member States have to put in place guarantees of the payment of workers' claims in the event of the employer's formal insolvency proceedings. Where Member States choose to extend the coverage of such guarantees to the Framework, they could apply the stay for as long as the guarantee lasts, but only up to the amount that the guarantee covers.

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2. Recital 21 gives some guidance as to what constitutes an essential contract "…Early termination would endanger the ability of the business to continue operating during restructuring negotiations, especially when it concerns contracts for essential supplies such as gas, electricity, water, telecoms and card payment services… ".

2.3.7 *Shareholders*

2.3.7.1 Member States must "*ensure that, where there is a likelihood of insolvency, shareholders and other equity holders with interests in a debtor may not unreasonably prevent the adoption or implementation of a restructuring plan which would restore the viability of the business.*"

2.3.7.2 There is a lack of clarity as to when it might be unreasonable for a shareholder to block a restructuring plan. In considering the optional provisions under the Proposed Directive, it is submitted that Ireland should allow shareholders to vote as a separate class in a restructuring plan to ensure that that they would, assuming the plan is adopted and confirmed, be crammed down and bound by the plan. The Courts would then be in a position to resolve any disputes regarding the valuation of the business and equity interest.

2.3.8 *Voting Thresholds*

2.3.8.1 The Proposed Directive provides that Member States lay down the required majorities for the adoption of a restructuring plan*, "which shall be in any case not higher than 75% in the amount of claims or interests in each class*". In the context of examinership, proposals shall be deemed to be accepted at meetings where a majority in number representing a majority in value vote in favour of the proposals. A threshold of 75% in value might prove high to obtain and the fact that it is limited to value rather than number might mean a dominant creditor in value carries or stops the vote over a majority of creditors in number.

2.3.9 *Cross-class cram-down*

2.3.9.1 Where the necessary majority is not reached in one or more dissenting voting classes, the plan may be confirmed if it complies with the cross-class cram-down requirements, being:

- the dissenting class is no worse off under the plan than it would have been in a liquidation (ie that it complies with the 'best interest of creditors test');
- the plan has been approved "*by at least one class of affected creditors other than an equity-holder class and any other class which, upon a valuation of the enterprise, would not receive any payment or other consideration if the normal ranking of liquidation priorities were applied*";
- the plan complies with the "*absolute priority rule*" - a dissenting class of creditors has to be satisfied in full before a more junior class can receive any distribution or keep any interest under the restructuring plan; and

- the plan provides a reasonable chance of preventing the insolvency of the debtor and ensuring the viability of its business.

2.3.9.2 Notwithstanding that unsecured creditors may not receive any dividend in a subsequent liquidations; the practice is to allocate a dividend as part of the examinership scheme of arrangement. This payment is facilitated by the investor in order to preserve the goodwill of the enterprise and ensure continuity of supply of services and goods. The application of the "*absolute priority rule*" could result in a class of creditors, for example preferential creditors, requiring to be paid in full (and therefore getting more than they would receive in a liquidation) before unsecured creditors could receive any dividend in the scenario.

2.3.9.3 The reference in Article 11(1)(a) to the Article 10(2) conditions being fulfilled which refers back to Article 9 causes some inadvertent and unintended confusion. Article 10(2)(a) refers to the adoption of a restricting plan which infers that there are no dissenting class of affected parties. It is presumed in the context of the above analysis that Article 11(1)(a) is intended to refer to Article 10(2)(b) and (c).

2.3.9.4 The definition of 'cram-down of dissenting creditors' in Article 2(7)[3] of the Proposed Directive is confusing. It suggests (i) two different tests looking at all of the creditors as a whole and then within classes; and (ii) a majority in value of claims over the dissent of a minority in number.

2.3.10 Financing

2.3.10.1 The Proposed Directive aims to encourage new financing and interim financing. New rescue finance or interim financing granted during a restructuring process will:

- be excluded from anti-avoidance laws (other than where there is fraud or bad faith);
- <u>at a minimum</u>, be senior to unsecured creditors; and
- the grantors of new financing and interim financing will be exempted from civil, administrative and criminal liability in the context of the subsequent insolvency of the debtor (other than where there is fraud or bad faith).

2.3.10.2 Access to interim financing is important in the context of facilitating rescue proposals and is reflective of the US equivalent Chapter 11 process. It might place creditors in a difficult position if the restructuring fails and could result in them not receiving a dividend or a lesser dividend than they might otherwise receive.

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3. *Cram-down of dissenting creditors means the confirmation by a judicial or administrative authority of a restructuring plan that has the support of a majority in value of creditors or a majority in value in each and every class of creditors over the dissent of a minority of creditors or the dissent of a minority of creditors within each class*

2.3.10.3 In examinership, the petitioner is required to satisfy the court that it has sufficient cash flow resources to trade during the protection period. Often the support of existing or new lenders is required which can be dependent on the lender receiving Section 529 certificates (which afford priority over preferential and unsecured creditors in the event of a subsequent liquidation).

3 No Stay Pending Appeal

3.1 The Proposed Directive stipulates that an appeal against a decision confirming a restructuring plan has no suspensive effects on the execution of that plan. Member States must ensure that, where an appeal is upheld, the judicial authority may either:

- set aside the restructuring plan; or
- confirm the plan and grant monetary compensation to the dissenting creditors, payable by the debtor or by the creditors who voted in favour of the plan.

3.2 From the debtor's perspective there are advantages to the fact that the appeal has no suspensive effects of the execution of the plan. The current examinership position would require the appellant to apply for a stay (there is no automatic stay on appeal of court orders).

3.3 It is harsh that compensatory awards could be made against creditors of the debtor who voted in favour of the plan and this is a risk creditors might not be willing to take.

4 Directors' Duties

4.1 Member States are required to lay down rules to ensure that, where there is a "*likelihood of insolvency*", directors have obligations "*to take immediate steps to minimise the loss for creditors, workers, shareholders and other stakeholders*" and "*to have due regard to the interests of creditors and other stakeholders*". The question of how conflicts would be resolved, where (for example) continuing to trade might benefit workers but would not necessarily benefit some financial creditors, is not specifically addressed.

5 Developing the Infrastructure to support the Proposed Directive

5.1 Significant Member State resources are required in order to develop the necessary infrastructure to implement the proposals set out in the Proposed Directive in practice. The Proposed Directive requires Member States to:

- ensure that debtors and entrepreneurs have access to (i) early warning tools which can detect a deteriorating business development and signal to the debtor or the entrepreneur the need to act as a matter of urgency; and (ii) information about such tools and any means available to them to restructure at an early stage or to obtain a discharge of personal debt;

- make a model for restructuring plans available online with certain minimum specified information, that can be adapted to the needs and circumstances of every case;

- put in place distance means of communications to facilitate certain actions being performed online;

- collect and aggregate data that is sufficiently granular to enable an accurate assessment of how the Proposed Directive works in practice;

- ensure that members of the judiciary and administrative authorities dealing with restructuring, insolvency and second chance matters receive training "*to a level appropriate to their responsibilities*";

- ensure that restructuring, insolvency and second chance matters are dealt with in an "*efficient manner which ensures expeditious treatment of the procedures and that the members of the judiciary in charge have the necessary expertise and specialisation*" and

- ensure that practitioners appointed to deal with restructuring, insolvency and second chance matters "*receive the necessary initial and further training in order to ensure that their services are provided in an effective, impartial, independent and competent way in relation to the parties*".

5.2 Accordingly, the success of what is proposed will depend on adequate resources being allocated to develop the infrastructure required to implement the proposals and the skills and experience of the courts and administrative bodies and insolvency professionals in each Member State. The potential challenges are highlighted by the fact that the relevant judicial or administrative authority would be required in certain circumstances to determine the liquidation value or the enterprise value of a business. While the Proposed Directive requires Member States to ensure that properly qualified experts are appointed to assist the relevant judicial or administrative authority in relation to such valuations, the proposed regime may

require judges to become actively involved in areas where they may have, despite the availability of training, no particular experience or expertise.

6. Aircraft Finance Industry

6.1 The Proposed Directive provides that the Framework applies to all debtors other than those listed in Article 1[4]. Whilst as mentioned above, the Proposed Directive appears to be influenced by the provisions contained in Chapter 11 of the U.S. Bankruptcy Code it does not appear to contain the equivalent US provisions in relation to aircraft. More specifically, in the US the right of the lender to take possession of the secured equipment is not hampered by the automatic stay provisions of Chapter 11 of the U.S. Bankruptcy Code.

6.2 Given the importance of the aviation sector as a whole to Ireland's economy, the Law Society recommends that further analysis on the Proposed Directive should be conducted in light of the Cape Town Convention and Aircraft Protocol (to which Ireland is a Contracting State and which the European Community has ratified) and Section 53 of the State Airports (Shannon Group) Act 2014.

The procedures envisaged by the Proposed Directive also could have a significant impact on the property rights of creditors and shareholders which, if there is a low level of judicial oversight in the process, might give rise to concerns as to whether it would be consistent with the Irish Constitution. This would need to be analysed.

We hope that the Departments and the Oireachtas Committee will find the above comments constructive and helpful. While the Society has provided comments on the above provisions in the short time frame allowed, we reserve our position in respect of the remaining Articles of the Directive. The Law Society is happy to engage and provide a more comprehensive assessment to Department officials and elected representatives, if required.

[4] The Proposed Directive does not apply to procedures that concern debtors who are insurance undertakings and reinsurance undertakings; credit institutions; investment firms and collective investment undertakings; central counter parties; central securities depositories; and certain other financial institutions and entities; and natural persons who are not entrepreneurs. Members States may extend the application of the Framework to over indebted natural persons who are not entrepreneurs (Article 1).

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