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ALERTS

Finance, Insolvency & Restructuring Alert - The Winds Of Change Intensify Over Europe: Recent European Union Actions Firmly Embrace The “Rescue And Recovery” Culture For Business Recovery

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A lingering misperception among American businesspersons and some commercial lawyers is that it is a fool’s errand to commence an insolvency case seeking reorganization in a European nation because those national laws prescribe liquidation rather than rehabilitation. These business leaders often dismiss out-of-hand insolvency relief on the continent for a troubled European subsidiary and elect to wind up the company’s affairs outside the judicial system. While this perception was in many respects valid as late as the 1990s, the current reality is that, because of significant harmonization of national insolvency laws since the millennium, many of these laws now provide for business reorganizations in accordance with what Viviane Reding, the European Commissioner responsible for Justice, Fundamental Rights and Citizenship, has labeled the “rescue and recovery culture” of the European Union (EU). Indeed, the EU has within the last few months taken two extremely significant steps to accelerate the pace of this harmonization of national insolvency laws to warp speed so as to extend this culture to business enterprises established in the 28 EU member states.

Harmonization of National Insolvency Laws to Foster Business Reorganizations

One of these actions taken by the European Union was the Recommendation of the European Commission (the EU's executive arm that is responsible for proposing legislation) that all Member States adopt within one year insolvency legislation embodying five principles promoting the culture of "rescue and recovery." The recommendation was published on March 12. In this document, the Commission stressed the need for adopting “modern laws and efficient procedures. . .to help businesses, which have sufficient economic substance, overcome financial difficulties and [give] entrepreneurs a ‘second chance.’” However, the Commission noted that insolvency laws in many EU countries “currently channel viable enterprises in financial difficulties towards liquidation, rather than restructuring.” One common deficiency in the laws of these states is the absence of early restructuring procedures and processes; included in this group are the states of Bulgaria, Hungary, the Czech Republic, Lithuania, Slovakia and Denmark. Another impediment to rehabilitating viable but troubled businesses is a long waiting period before an “honest entrepreneur” may obtain a discharge of debts. Countries in this category include Austria, Belgium, Italy and Poland. The Commission concluded that this divergence among the insolvency laws of the EU Member States

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Creditors’ Rights, Restructuring and Bankruptcy “has an impact on the recovery rates of cross-border creditors, on cross-border investment decisions, and the restructuring of groups of companies.” The Commission recommends a “more coherent approach at EU level” in order to “improve returns to creditors and the flow of cross-border investment” and to impact positively “in terms of entrepreneurship, employment and innovation.”

The five principles of insolvency legislation developed by the Commission after a period of public consultation with interested parties in 2013 are the following:

- Facilitating the restructuring of troubled businesses “at an early stage, before starting formal insolvency proceedings, and without lengthy or costly procedures to help limit recourse to liquidation.”
- Authorizing debtors to restructure in the absence of formal court proceedings.
- Permitting debtors to seek a temporary stay of creditor enforcement actions for an initial period of four months up to a maximum of 12 months to allow debtors to adopt a restructuring plan during the stay period.
- Facilitating the process for the adoption of restructuring plans to increase the chances of debtor reorganization.
- Permitting the granting of a discharge by no later than three years after an insolvency proceeding is commenced.

After 18 months have elapsed, the Commission will “assess the state of play. . .to evaluate whether further measures to strengthen the horizontal approach on insolvency are needed.” The Commission’s recommendation does not specify what these “further measures” might be.

Although this development is brand new, the initial reaction of the European insolvency "community" has been favorable. In a communication to the author of this piece, Dr. Christoph Paulus, a Professor of Law at Humboldt University zu Berlin and a leading international insolvency expert, wrote: "Many will not approve of this call of the Commission. It is nonetheless a more correct, resolute and well-considered step in a direction in which insolvency law assumes a central meaning for the economy of an entire country and, with that, for the economy of the European Union."

Approval of Revisions to the European Insolvency Regulation by the European Parliament

The action taken by the EU in 2014 to accelerate the march toward insolvency laws that stress reorganization over liquidation is the European Parliament’s approval on February 5 of the European Commission’s revision of the European Insolvency Regulation (EIR), promulgated by that body in December 2012. The EIR came into force on May 31, 2002 and binds all European Member States (other than Denmark, which opted out) and regulates the procedure for the commencement of cross-border, “collective” insolvency cases within the EU. A “collective insolvency proceeding” is one that involves “the partial or total divestment of a debtor and the appointment of a liquidator;” these proceedings are listed in

Annex A to the EIR. Cross-border cases subject to the EIR arise when, for example, a company headquartered in Germany commences a “main proceeding” for itself in that state and then initiates a “secondary proceeding” in another member state, e.g., Poland, with respect to its assets there. The EIR mandates that, in order for the German company to obtain insolvency relief from a German court, that entity must have its “center of main interests” or “COMI” in Germany and, in order for the secondary proceeding to be commenced in Poland, the German company must have an “establishment” there, viz., a “place of operations where the debtor carries out a non-transitory economic activity with human means and goods.” If these jurisdictional requirements are satisfied in the German and Polish courts and these insolvency proceedings are opened there, the judgments rendered by those courts must be recognized by the courts of all other member states (EIR, Articles 16, 17 and 25).

Although the EIR has functioned relatively well in practice, the Commission recognized during the course of its review of this mechanism during 2012 that, in certain respects, these cross-border procedures actually hindered rather than fostered rehabilitation of financially troubled business enterprises. First, the “collective insolvency proceedings,” listed in Annex A as being subject to the EIR, fail to include certain out-of-court rehabilitation proceedings that provide relatively quick relief to troubled businesses and, in certain instances, permit cramdowns of certain “holdout” creditors. These proceedings include the popular and often-invoked English “schemes of arrangement” and the French sauvegarde and conciliation procedures. Second, all secondary insolvency proceedings must, by definition, be winding-up/liquidation proceedings. Finally, the EIR presently contains no provisions for handling insolvency proceedings initiated by company groups, e.g. a parent and its affiliates.

The revisions to the EIR, in furtherance of the EU’s “rescue and recovery” culture, have specifically addressed these three problematic areas in the existing EIR. First, the revision provides for the inclusion within the EIR’s scope of “national procedures which provide for the restructuring of a company at a pre-insolvency stage” and “proceedings which leave the existing management in place” as contrasted with the appointment of a liquidator; this goal is accomplished by broadening the definition of “insolvency proceedings” in new Article 1(1) of the revision. Second, the revision “abolishes the current requirement that secondary proceedings have to be winding-up proceedings. . . . The amendment insures that opening of secondary proceedings does not thwart the rescue or restructuring of a debtor as a whole.” Finally, the revision includes new provisions concerning the commencement of insolvency proceedings by members of a group of companies. For example, the revision requires liquidators of the member companies to cooperate with each other and grants each liquidator standing in the proceedings concerning another member of the same group of companies.

With the approval of the Commission’s revisions of the EIR by the European Parliament, the European Council must now conclude its own review of these suggested changes, which is expected to be accomplished by June of this year. If the Council approves the revisions but suggests specific changes or if the Council fails to approve the revisions altogether, the Commission, the Council and Parliament are expected to confer in an attempt to reach agreement on a compromise revision of the EIR.

Conclusion

Businesses in the United States will undoubtedly be affected in many ways by these upcoming changes to national insolvency laws by EU Member States. In fact, just recently Spain amended its insolvency laws in ways that will further the EU's "rescue and recovery" culture and France is in the process of accomplishing the same. American companies with financially troubled European affiliates may decide that recent changes to the national insolvency laws in Member States where their affiliates have their COMI may influence decisions to commence reorganization proceedings overseas. American creditors of European companies in insolvency proceedings in EU Member States may see their recoveries increase as a result of rehabilitation proceedings in these states, as contrasted with anticipated returns on their claims in liquidation proceedings. In sum, the EU's commitment to change in order to increase the chances of business reorganizations and to improve creditor recoveries should give American companies, well versed in the rescue culture of our own Chapter 11, pause to consider restructuring alternatives on the European continent.

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