Loopholes of the European directive 2019/1023 on preventive restructuring frameworks: a law & economic analysis

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Introduction

- The European directive 2019/1023 (the "**Directive**") will be gradually transposed by the Member States by 17 July 2021.

- As it is the fruit of numerous political compromises, the Directive gives a lot of room for maneuver to Member States in their transposition efforts.

- However, a Law & Economics analysis of the Directive shows that numerous aspects, either left to the Member States or simply ignored by the Directive, would have strongly deserved to be dealt with, in the interest of the Capital Markets Union:

I) Implementing **claw-back (avoidance) actions rules** preventing the debtor from engaging in abusive behavior before the opening of a preventive restructuring framework;
II) Fostering **transparency**; and
III) Ensuring the **sophistication** of judges and insolvency/restructuring practitioners, especially when dealing with the most complex cases.

PART I

The absence of claw-back rules

PART I. The absence of claw-back rules

1. The risk of a violation of creditors' rights by the debtor to the benefit of other stakeholders

- In the absence of efficient claw-back rules, the debtor is not prevented from engaging in opportunistic behavior:

  (i) **as soon as it anticipates its insolvency** and

  (ii) **before restructuring proceedings have been triggered**,

  (iii) **in violation of the absolute priority rule**.

- Insolvency needs to be considered as the expected inability of the debtor to repay its future obligations given his discounted cash flow prospects, as opposed to:

  (i) the notion of "cash insolvency" (like in France); or

  (ii) the notion of "balance sheet insolvency" (like in Germany).

PART I. The absence of claw-back rules

1. The risk of a violation of creditors' rights by the debtor to the benefit of other stakeholders

- The debtor might **enter into agreements** violating the absolute priority rule through transfers of assets or assets dilution (excessive risk taking)
    - Example: repaying the unsecured debt of banks with the proceeds of a secured debt issuance organized with the same initial banks, thus violating the rights of other unsecured creditors

- In order to avoid such opportunistic maneuvers, European law needs to implement claw-back rules by the **creation of a suspect period / claw-back period** that:
    - Has a delay (i) that starts running in the past **as soon as the debtor has become insolvent** and (ii) is **sufficiently long** to cover all relevant transactions without creating too much legal uncertainty (up to 2 years prior bankruptcy in case of fraud) ; and
    - Allows the unwinding of all operations violating the absolute priority rule

PART I. The absence of claw-back rules

2. The risk of a violation of creditors' rights by shareholders

- Shareholders need to be effectively treated **as the most subordinated creditors** when restructuring proceedings are triggered, which implies to forbid them to violate creditors' rights by provoking an undue transfer of wealth to their benefit and to the latter's detriment.

- In most continental Europe countries, the protection of creditors is dealt with not only by insolvency law but also by company law :

    - This dichotomy leads **to the preservation of artificial and old-fashioned legal concepts**, and especially the concept of ”legal capital” that became useless with the surge of financial innovation

    - This allows shareholders to **benefit from legal loopholes** allowing them to be paid before creditors (e.g. issuance of high yield debt to finance a distribution of dividends in LBO transactions: “**dividend recap**,” share buybacks at a time when the company is insolvent)

PART I. The absence of claw-back rules

2. The risk of a violation of creditors' rights by shareholders

- Such **loopholes can be avoided** by:
  - Implementing an *ex post* control of possible violations of the absolute priority rule, as opposed to the ex ante sets of prohibition prevailing in most countries;
  - Allowing to unwind transactions (i) beyond the sole currently impermissible "hidden" distributions mentioned by the Capital directive and (ii) that happened during the suspect period (iii) **whether or not some shareholders were unaware of the financial situation of the company**

PART I. The absence of claw-back rules

2. The risk of a violation of creditors' rights by shareholders

- These new sets of rules would be in line with Article 19 of the Directive which creates « *duties of directors where there is a likelihood of insolvency* »

- Example: the US fraudulent transfer law according to which capital and dividend distributions cannot happen unless there is "surplus capital," which depends on an appraisal of the company's value (≠ formal criterion of the book value)

PART II

The need for greater transparency

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1. Why do we need market transparency? — Primary markets

- **Transparency is key to foster primary bond markets**. Once a company faces difficulties, strong information asymmetries arise between the management, shareholders and the company's creditors.

- The asymmetries faced by creditors are of various intensity depending on the relation they have with the company. Typically, banks, who have a strong relationship with the company and the means to obtain information by themselves, are much better informed than bondholders.

PART II. The need for greater transparency

1. Why do we need market transparency? — Primary markets

- Information asymmetries to which bondholders are exposed are even stronger when information about the company is not appropriately conveyed to the market: banks can exploit their insider position to the detriment of the less well-informed creditors (e.g. by obtaining the reimbursement of their unsecured claims with the proceeds of secured debt issuances in violation of the rights of bondholders).

- Emphasis therefore needs to be put on market transparency at the European level in order to **avoid undue transfers of wealth** from outsiders (e.g. bondholders) to insiders (e.g. banks) **discouraging *ex ante* the subscription by potential investors to new debt issuances**.

PART II. The need for greater transparency

1. Why do we need market transparency? — Secondary markets

- **Transparency is also key to foster secondary bond markets**. It:
  - Allows **impatient creditors** who cannot or do not want to finance their debtor's restructuring to assign their claims to specialized distressed debt investors who are ready and skillful enough to deal with such debtors (and, eventually, to accept debt equity swaps);
  - Contributes to market efficiency, thus allowing (i) companies to be financed at a cost reflecting their fundamental value and (ii) an optimal market allocation of resources.

PART II. The need for greater transparency

2. The dangers of confidential restructuring frameworks

- In some European countries (especially France), **confidential restructuring frameworks** mask the difficulties of the debtor to those creditors who are not invited to participate in the negotiations. This is the source of numerous perverse effects, among which:

    - A climate of distrust between the company and bondholders in case the latter suspect that the company might solicit a confidential procedure since (i) banks are generally part of such procedures and (ii) are able to draw from them advantages to the detriment of bondholders
    - The absence of a competitive new money / DIP financing market
    - The absence of competition between restructuring plans leading to the plan drafted by managers and the main creditors being presented as the only possible solution
    - The ability of controlling shareholders to preserve their option on the assets of the debtor, while the company might already be insolvent: this entails an unnecessary postponement of the restructuring of the company's balance sheet

PART II. The need for greater transparency

3. Conclusion

- Although it can have some limited benefits, the confidentiality of restructuring frameworks greatly impedes market transparency, which in turn carries a lot of perverse indirect effects and can incentivize creditors who participate in the negotiations to fraudulently bypass the absolute priority rule

- Transparency must be the principle; even if some confidentiality can sometimes be welcome (e.g. confidentiality of the negotiations between the parties), the **difficulties of the debtor** must at the very least be disclosed to the market, even if the debtor has filed for bankruptcy proceedings

- This advocates for a **general principle of transparency** in European law, with only limited and carefully chosen exceptions

PART III

Ensuring the sophistication of judges and insolvency practitioners

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1. Fostering judges and insolvency practitioners' skills

- Judges and practitioners of restructuring proceedings who do not have the necessary skills to appropriately deal with restructuring procedures are an importance source of uncertainty for creditors, which is *in fine* passed on the cost of credit. This can lead to the violation of certain creditors' rights when the enterprise value is not correctly appraised

- Judges and practitioners need nontrivial financial skills, especially when they need to engage in going concern valuations in order to determine the classes of "in the money" creditors and the distribution of the restructuring value

- It is not sufficient to say that members of the judicial and administrative authorities and practitioners "dealing with procedures concerning restructuring, insolvency and discharge of debt receive suitable training and have the necessary expertise for their responsibilities" (art. 25 & 26 dir.).

- The European Union itself must contribute to the financing of the education of judges and practitioners

PART III. Ensuring the sophistication of judges and insolvency practitioners

2. Accepting a reasonable amount of *forum shopping*

- Regulation 2015/848 on insolvency proceedings and the "COMI" rule forbids the efficient allocation of cases among European jurisdictions by limiting the ability of debtors and creditors to mutually choose the appropriate jurisdiction to deal with their cases
- Forum shopping can be beneficial to all parties when the debtor and all the relevant creditors contractually agree on it
    - Forum shopping thus becomes a strong factor of predictability *ex ante*
    - It allows an efficient allocation of cases to the judges that have the necessary skills to deal with them (especially in the presence of international and complex cases)
    - Every European court cannot have the same skills to deal with complex cases ; accepting that some of them are more able to deal with complex cases is a practical necessity
    - See the American example where the biggest and most complex cases are systematically dealt with by the courts of the Delaware and the Southern district of New York

PART III. Ensuring the sophistication of judges and insolvency practitioners

3. Will Amsterdam be the new London post-Brexit?

- Primary aim of the Dutch Bankruptcy Act: ultimately satisficing the creditors

- Personal liability of the managers if they refrained from opening proceedings although they know or should have known that the company was insolvent

- In case the company has prospects to become profitable again, a composition plan (partial payment and suspension of payments to unsecured creditors) can be adopted by a majority of unsecured creditors

- Secured creditors (e.g. banks in most cases) can purely and simply ignore the composition plan, with the sole exception of a possible 2 to 4-month cooling-off period

- After the Brexit, secured creditors might push in favor of a location of the COMI in Holland in order to benefit from this favorable regime

- But this regime does not sufficiently protect bondholders: this leaves the possibility for other countries to try and compete for London's place

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