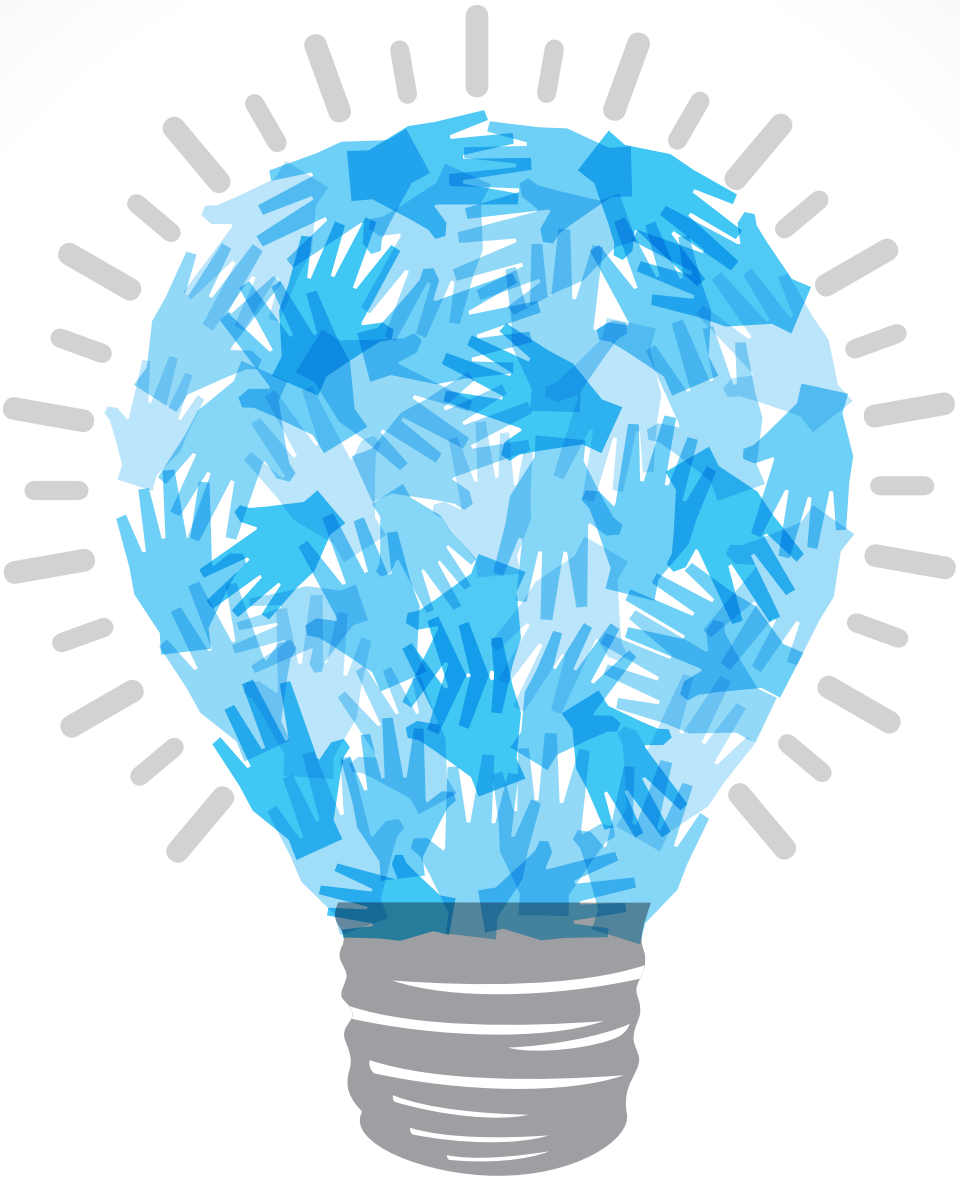

EU Seeks Harmony Among Its Members for Cross Border Insolvencies

BY SUSAN KELLY, PARTNER, SQUIRE SANDERS (UK) LLP

It would have been nice to have written this article about "European Restructuring and Insolvency Law," but this mythical beast does not exist. There are 27 countries in the European Union (EU), each with its own language and its own reorganization proceedings that aim to help distressed companies.

These different regimes are successful to a greater or lesser extent, making some member states more attractive than others as venues for reorganization. In particular, the laws of England and Wales provide such flexibility that they are becoming venues of choice for companies from all over, including the Netherlands, Germany, Greece, and Vietnam in the most recent cases. Scotland and Northern Ireland have slightly different, but very similar, laws. Southern Ireland is an independent country with a very different legal system.

Each year in Europe there are an estimated 200,000 company insolvencies. More than half of companies do not survive their first five years in business, and more than 1.7 million jobs are lost every year as a result. One in five of those companies has international operations that cross

national borders. With these statistics in mind, the EU has sought to introduce an element of harmonization across its member states to facilitate the effective operation of cross border insolvencies.

Differences in Approach

Since 2002, 26 member states (all EU members except for Denmark) have been subject to European Union Regulation (EC) No 1346/2000 on insolvency proceedings. The regulation was implemented with the goal of coordinating insolvency proceedings opened in several member states. It introduced the concept of "centre of main interests" (COMI) for determining where an entity is truly based, which becomes an issue whenever a debtor has assets or creditors in more than one EU member state.

Distressed companies that operate in various jurisdictions through a group of subsidiaries, in many cases, may not pursue a consistent strategy for the restructuring of the group because the insolvency tests are different in many jurisdictions. Obligations imposed on boards of directors of insolvent companies also differ in different jurisdictions, which also factors heavily in restructuring decisions. Four of the largest economic players in Western Europe—France, Spain, Germany, and the U.K.—illustrate these differences.

France. With the reforms in 2005, laws were put into place to restructure French companies, including in particular adding the promotion of ad hoc proceedings and conciliation, both confidential procedures, to the conventional procedures of rehabilitation and liquidation. Their aim is to find an amicable solution with the creditors of a company before it is drained of resources. The success of these procedures, particularly in the context of financial restructuring, cannot be denied, but they remain underused because directors often act too late.

In addition, the new law created a safeguard procedure—the French version of Chapter 11—that looks good on paper, but cannot be used by companies that are already insolvent and cannot pay their debts as they become due. This lack of coverage of insolvent companies resulted in many French companies liquidating in bankruptcy rather than reorganizing.

The aim of French insolvency procedures is to preserve a business and the jobs of its employees, not to protect creditors, whose repayment most of the time is very unlikely unless they have the benefit of retention of title clauses or a guarantee. But things could change as a new statute, which will come into force July 1, 2014, will move protection of creditors' interests to the forefront, similar to the English procedures.

Germany. German insolvency laws provide for comparably high hurdles before a creditor can file an insolvency petition against its debtor, particularly when compared to the right of a secured creditor in the U.K. to put its debtor into administration. Also, unsecured creditors in Germany are unlikely to recover any money unless they have the benefit of a retention of title clause.

Until 2012, German insolvency courts were solely responsible for appointing insolvency administrators. Often, a court routinely chose from its same list of approved insolvency administrators, creating something of a "closed shop" for those who served in the capacity. Particularly in the case of cross border insolvencies, administrators who were appointed rarely had sufficient experience regarding other jurisdictions to which an insolvency related to do their jobs well. In addition, there was no creditor involvement in the appointment of administrators, which resulted in a lack of transparency and unpredictable outcomes for creditors.

The changes and amendments to the German Insolvency Code based on the German Act Facilitating Corporate Restructurings in 2012 have overcome most of these obstacles, although it will take time for the new procedures to be fully applied by all insolvency courts.

Under the nation's much stricter rules, German directors are obligated to file for bankruptcy as soon as they realize that their company is insolvent. Failure to do so can result in criminal liability of directors, which is not the case in all other jurisdictions. This can cause problems in a cross border restructuring of a group of companies that includes a German subsidiary. The subsidiary's directors may feel compelled to file in Germany to avoid personal criminal liability rather than consider alternatives that might be more advantageous for the group as a whole.

Spain. The Spanish scheme is an out-of-court mandatory refinancing procedure that consists of a privately negotiated compromise between a company and its creditors that is subject to court approval after a very formalistic process. Strict adherence to the process is required if the scheme is to be approved by the court. In addition to being required to meet certain formal requirements of the Spanish Insolvency Act, the Spanish scheme must be supported by creditor financial institutions representing at least 75 percent of the total liabilities held by these institutions.

Amendments to the Insolvency Act that became effective on March 10, 2014, are intended to accelerate refinancing and restructuring agreements. The goal is to guarantee the survival of companies that have accumulated excessive financial debt but are still viable. The amendments introduced new ways of refinancing, allowing fresh money advanced to have priority for the following two years and to be fully secured. The amendments also provided for a stay of enforcement of securities for four months from the commencement of negotiations.

Spanish schemes did not previously affect secured creditors, but the amendments introduced a limited ability for cram down. Spanish schemes cannot be cancelled by a court if a company becomes insolvent, and once settlement agreements are approved by a court, the amendment eliminates the possibility of a later challenge. These amendments may improve the success of Spanish schemes.

United Kingdom. The fact that reorganization procedures differed among EU member states in the past often resulted in attempts to shift the COMI of the business of an insolvent company from one jurisdiction to another. The U.K. has become the

continued on page 26

continued from page 25

bankruptcy destination of choice for many struggling foreign companies that wish to avail themselves of two particular statutory insolvency regimes: administration/prepack and scheme of arrangement.

Administration is a relatively quick and straightforward procedure that allows a secured creditor to put a company into administration. This can be done either through a court hearing or an out-of-court procedure that merely requires papers to be filed with the court. Alternatively, the directors can initiate the process themselves. Once an administrator has been appointed, it is possible for the directors to buy the debt-free business from the administrator through a prepack sale, thereby giving their business a second chance.

Only small companies use the company voluntary arrangement procedure under English insolvency law. Larger restructurings are done using a scheme of arrangement under English company law. The Companies Act 2006 provides that a "company," for the purposes of the schemes of arrangement legislation, means any company liable to be wound up under the Insolvency Act 1986. This includes any unregistered company, such as foreign companies.

Although a company must be capable of being wound up by the courts of England and Wales before it can enter into a scheme of arrangement, there is no requirement that it be insolvent to do so. Schemes are often used for solvent restructurings, including internal reorganizations and mergers. The scheme of arrangement procedure is not currently covered by EU Regulation (EC) No 1346/2000, although there is heated debate as to whether it should be.

Under a scheme of arrangement, a company may make a compromise or arrangement with its members or creditors (or any class of them). Because the process requires court approval, the scheme must be fair and reasonable and represent a genuine attempt to reach agreement between a company and its creditors or shareholders.

A scheme is initiated through a hearing in which a company requests a court order empowering it to call separate meetings of each class of creditor and shareholder to consider the company's proposals. If those attending each meeting vote in favor of the scheme by a majority of three-quarters in value, the court is informed and is then asked to sanction the scheme.

This procedure is being used increasingly by non-U.K. companies if they can either shift their COMI to England or show sufficient connection with the English courts—for example, by using English law banking documents—and that the scheme would achieve its purpose by being recognized in the country where the company is based.

A recent example of a successful scheme of arrangement was *Re Magyar Telecom B.V.*[1] The company was incorporated and registered in the Netherlands, and its main business was the operation of telecommunications services in Hungary. The company's principal creditors were noteholders under a New York law indenture, subject to the nonexclusive jurisdiction of the New York courts.

The company's COMI was moved to England before the first hearing requesting the court to convene

meetings of creditors to vote on the scheme. The company was unable to service its obligations under the notes, having defaulted on payment of half-yearly interest. The directors of the company believed that if the restructuring was not implemented, the business would likely be forced to enter formal insolvency proceedings. Such a step would have resulted in a significant destruction of value for the company and significantly reduced recoveries for noteholders.

The court considered the EU Judgments Regulation as well as the requirements that the company should have a sufficient connection with the English jurisdiction and that the scheme looked likely to achieve its purpose. The court heard expert evidence that the scheme would be given effect in the U.S., the Netherlands, and Hungary.

The English court approved the scheme of arrangement, and an application was made to the U.S. Bankruptcy Court for the Southern District of New York for recognition of the scheme under Chapter 15 of the U.S. Bankruptcy Code. This case involved a sophisticated use of the complex cross border legislation available to achieve consensual financial reorganizations to preserve value and allowed the company to continue to reorganize and maximize returns for all stakeholders.

Recommendations for Reform

In 2012, the European Commission undertook a comprehensive consultation and review of how EU Regulation (EC) No 1346/2000 had operated during its first 10 years. The conclusion was that, at a high level, the regulation was operating satisfactorily, but had plenty of room for improvement. The report made several key recommendations, including:

- Rules should focus on giving viable businesses a second chance with the goal of safeguarding jobs
- The emphasis of the rules should move from liquidation to rescue and recovery
- Greater coordination and cooperation across member states were needed, with the use of secondary proceedings strictly limited

With these goals in mind, the European Commission proposed various amendments to improve the regulation, including:

- Extending its scope to include hybrid and pre-insolvency proceedings and removing the current limitation to formal liquidation proceedings
- Clarifying the concept of COMI to make identification easier
- Limiting the use of secondary proceedings to cases in which they are absolutely necessary to protect the interests of local creditors. There is a tacit acceptance that the system of secondary proceedings (which currently can only be liquidations) is open to abuse and can be counterproductive to the successful implementation of an efficient cross border insolvency
- Creating a system of free web-based public insolvency registers in each member state to improve the flow of information about company insolvencies, with the aim of having a single point of enquiry for the entire EU

continued on page 28

continued from page 27

- Coordinating rules relating to insolvencies involving groups of companies

The next step for the proposals to become law is for the EU Council of Ministers and the Parliament to approve the same text. The council's next meeting is in June, and if an agreement can be reached, a draft regulation will then be published. The council is being subjected to intense lobbying by interested U.K. restructuring bodies, and any measures that seem to be aimed at curbing English restructuring processes in particular will be resisted. If the regulation is approved, it will become effective in 2016.

On February 5, 2014, the European parliament voted overwhelmingly in favor of implementing the European commission's recommendations to reform the current system to promote the rescue and recovery of distressed companies across the EU with the intention of allowing viable businesses in financial difficulties to restructure. The main recommendations were:

- Insolvency proceedings opened out of court should still be covered by the regulation
- The introduction of a three-month "look-back" test regarding the location of a debtor's COMI for the purpose of opening insolvency proceedings
- Proposals for a new class of proceedings called group coordination proceedings in cross border group insolvency situations

On March 12, the European commission incorporated these ideas into a recommendation that would provide a coherent framework for national insolvency rules and asked member states to put in place appropriate measures within one year. The commission will assess the state of play 18 months after adoption of the recommendation, based on the yearly reports of the member states, to evaluate whether further measures to strengthen the horizontal approach on insolvency are needed. The recommendation has no binding effect on member states. If the commission's review shows no progress has been made in 18 months' time, it will have to consider whether to proceed with a draft resolution.

Some member states feel the commission did not go far enough on the issue of group coordination proceedings and would have preferred to see a system allowing for a single pan-European appointment. In other words, an insolvency practitioner appointed for the parent company in one jurisdiction would have powers to deal with all subsidiaries, wherever they were located.

The commission shied away from this compulsory coordination approach to dealing with multinational groups and preferred to continue with an entity-by-entity approach. The new rules, however, would place stronger obligations on insolvency practitioners and the courts in each member state to cooperate and communicate effectively with their counterparts in other member states.

It is also a great relief in the U.K. that the Parliament rejected the commission's proposal to exclude from the regulation any procedure that was not opened by a court hearing. This would have excluded most administrations and company voluntary arrangements, some of the more flexible English procedures used in cross border restructurings.

Susan Kelly is a partner in the Squire Sanders (UK) LLP Restructuring & Insolvency practice group. She leads the practice group in the U.K. and Europe and co-chairs Squire Sanders' international restructuring practice. Kelly's practice covers a broad range of insolvency, both contentious and noncontentious; lender security reviews and enhancement; reconstruction; turnaround; and business support. She has particular experience in acting for financiers, including top tier banks, major accounting firms, international asset based lenders, and multinational corporations.

Other Squire Sanders partners contributing to this article were Fernando González in Madrid, Spain; Andreas Lehmann in Frankfurt, Germany; Antoine Adeline in Paris, France; Ákos Erős in Budapest, Hungary; and Helen Kavanagh in Leeds, U.K.

Keeping Pace with Change

As the inexorable march toward corporate globalization continues unabated, it is vital that legislation keeps pace with the rapidly changing corporate environment. Companies are not constrained by national boundaries, and it is vital that the law provides an effective, efficient system for rescuing distressed businesses operating in multiple jurisdictions. It remains to be seen whether details of the legislation will live up to the rhetoric surrounding the recommendations. J

[1] *Magyar Telecom BV* [2013] EWHC 3800 (Ch) (3 December 2013).