The new EU Directive on restructuring and insolvency and its implications for Austria

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After more than two years of discussions and debate, the new European Union Directive on Restructuring and Insolvency (the 'Directive') was finally published in the Official Journal of the EU on 26 June 2019. EU Member States will have to implement the Directive by 2021, with certain key jurisdictions potentially aiming for an earlier date. To reach a European consensus, concessions were necessary. The Directive therefore offers considerable flexibility. Its implementation may look very different across the various Member States, with some introducing a more restructuring-friendly legal environment than others. This article gives a summary of certain key elements of the Directive and takes a look into the crystal ball on the potential implementation in Austria.

Introduction

Looking at the legal environment for restructurings in the European Union, it is important to observe that there is currently no harmonisation on substantive insolvency and restructuring law in place. The well-established Recast European Insolvency Regulation[1] (the 'EIR') mainly provides for rules on cross-border cooperation, mutual recognition between the Member States, jurisdiction and applicable law, but touches very little upon substantive law. Many key concepts in insolvency and restructuring, such as insolvency tests, directors' liability or avoidance rules, are therefore still subject to the national laws of Member States; the same holds true for insolvency and restructuring (court) proceedings. Consequently, the insolvency regimes in Members States vary considerably.

The Directive is the first piece of harmonisation of substantive insolvency law within the EU – this is a major step forward. However, the EU has not attempted a thorough harmonisation of national insolvency laws (which likely would have been difficult to accept for a number of Member States), but focused on certain key concepts and minimum standards for preventive, pre-insolvency restructurings. The aim is to establish viable and more uniform restructuring options throughout the EU.

While setting certain minimum standards and defining a broad framework, the Directive still leaves Members States with a lot of flexibility on how to individually implement it. It is therefore up to Member States to turn the opportunities offered into a more restructuring-friendly regime (similar to the English scheme of arrangement, the not yet implemented 'Dutch scheme' or the United States' Chapter 11) or not. However, expectations are that the outcomes will be quite different in the various Member States. Phenomena like forum shopping will therefore likely continue to exist in the EU.

It will be interesting to see whether the new procedures will become viable alternatives to the English schemes and the US Chapter 11 given that these currently have the benefit of being well tested and embodied into an experienced legal system and community. The Directive, however, has laid the ground for a new race to the top. Not least against the background of the as yet unresolved Brexit, some dynamic can be expected in that regard.

In this article, we give a first overview of the main elements of the Directive and its possible consequences for Austria.

Objectives of the Directive

The Directive seeks to tackle the following three key areas:

- Every Member State should have a preventive restructuring framework available for debtors in financial difficulties prior to insolvency (ie, in case of a 'likelihood of insolvency' – see below).
- Entrepreneurs should be given a 'second chance' by imposing a maximum three-year discharge period.

- The efficiency of insolvency and similar procedures shall be increased.

We will focus hereafter on the first bullet point, which is likely to also have the largest impact in practice and received most attention in the discussions around the Directive so far.[2] The objectives of the Directive in this context are quite straightforward: Preventive restructurings shall be strengthened and fostered. The EU is highly ambitious in this respect. Harmonisation of local laws shall support the Internal Market, preserve values, reduce non-performing loan (NPL) quotas and prevent forum shopping. It is worth mentioning that the Directive explicitly focuses on small and medium-sized enterprises (SMEs), which represent around 99 per cent of all companies within the EU, but at the same time aims to facilitate the restructuring of enterprise groups irrespective of where their members are located.

It is doubtful that all of the above can actually be achieved with the Directive. Although, it can be assumed that the EU as a whole and the Internal Market will benefit from not fully harmonised, but, at least, more comparable insolvency and restructuring regimes. This should increase legal certainty and trust between Member States and facilitate cross-border restructurings (especially of enterprise groups).

Selected key concepts of the Directive

Restructuring of companies when there is likelihood of insolvency

The Directive focuses on allowing debtors in financial difficulty to restructure their businesses via a preventive restructuring framework when there is a likelihood of insolvency. At the same time, non-viable businesses with no prospect of survival shall be liquidated as quickly as possible.

The key terms 'likelihood of insolvency' and 'insolvency' itself are not defined by the Directive; they must be determined by Member States. For the relevant period between likelihood of insolvency and actual insolvency, the Directive mentions a period of several months or longer. It will therefore be interesting to see how Member States implement this concept. It will especially be important that Member States make a clear distinction between 'likelihood of insolvency' and forecast based insolvency tests such as the Austrian over-indebtedness (*Überschuldung*; ie, a balance-sheet test that is combined with a forecast of up to two or three years). In this context, discussions as to whether balance-sheet tests shall be kept as equivalent to liquidity tests will probably gain new momentum.

The role of courts and practitioners in the field of restructuring

The initial proposal of the Directive arguably intended to keep the involvement of courts ('judicial or administrative authorities') and insolvency practitioners ('practitioners in the field of restructuring') to a minimum and emphasised a focus on a concept where the debtor-in-possession would agree to a restructuring with the majority of its key creditors. Finally, courts and especially insolvency practitioners are given a much stronger role than probably initially intended. This is now likely closer to concepts many Members States (one of them being Austria) are already familiar with.

In a nutshell, courts are involved whenever rights of third parties are affected (eg, confirmation of a moratorium, sanctioning of a restructuring plan and appointment of an insolvency practitioner). In practice, it remains to be seen whether the involvement of courts will be an obstacle, in particular when court involvement is linked to certain information or other rights of third parties. Too much publicity can jeopardise the success of every restructuring.

The role of insolvency practitioners is not clearly defined by the Directive. They must be appointed in 'sensitive' matters (eg, in the case of a general stay of enforcement actions or a cross-class cramdown; see further below), and while intended to support the debtor in drafting and negotiating a restructuring plan, a practitioner can also be appointed for monitoring and administrative tasks.

Under the Directive, solely the courts, and therefore neither creditors nor the debtor, have a formal say regarding the selection of the appointed practitioner.

Stay of individual enforcement actions

Courts can grant a stay of individual enforcement actions, which can either cover all (general stay) or only individual creditors or creditor classes (individual stay). Courts can refuse a stay if it is not necessary for the implementation of a restructuring plan or if it would not support the negotiations of such plan. It may not only include a stay of individual enforcement actions but also a suspension of a possible duty to file for insolvency, a suspension of creditor's rights to file for insolvency and far-reaching protection against the termination of contracts (inadmissibility of *ipso facto* clauses).

The stay may initially be granted for a period of up to four months and may be extended to a maximum of up to 12 months.

Statutory moratoria, like the stay under the Directive, mostly exist within formal insolvency proceedings. The Austrian Insolvency Code (*Insolvenzordnung*) provides for a collective moratorium, a protection of assets and the inadmissibility of *ipso facto* clauses as well; still, the stay under the Directive partly goes beyond these provisions. The challenge for Member States will be to keep a balance between such protection in the pre-insolvency stage and within formal insolvency proceedings (one could especially argue that protection within formal insolvency proceedings should go further as in the pre-insolvency period).

The restructuring plan

The restructuring plan is *the* key instrument of the Directive. The driver of a plan is usually the debtor company, but Member States can also provide for rights of insolvency practitioners or creditors to present such a plan. Besides detailed formal requirements, planning calculations, restructuring measures and any interim or new financing that may be necessary for the implementation of the plan must be submitted and/or explained to the court.

In practice, restructuring usually means financial restructuring with a particular focus on the liability side. Under the Directive, the term restructuring is to be understood more expansively. It means measures aimed at restructuring the debtor's business that include changing the composition, conditions or structure of a debtor's assets and liabilities or any other part of the debtor's capital structure, such as sales of assets or parts of the business and, where so provided under national law, the sale of the business as a going concern, as well as any necessary operational changes, or a combination of those elements.

If more than one creditor class is affected by the restructuring plan, a class formation must be undertaken. The formation of two classes (secured and unsecured creditors) is, however, already sufficient. For SMEs, the formation of classes is optional. Such mandatory class formation may be new to many Member States, including Austria.

The Directive does *not* require a minimum quota to be offered in the plan (such as the 20 per cent minimum quota to be provided in a restructuring plan (*Sanierungsplan*) offered under the Austrian Insolvency Code). The Directive suggests a rather high 75 per cent capital majority (based on affected claims) for the plan approval. Member States can also provide for a lower, but not higher, threshold and can also add an additional numerosity test (ie, a minimum percentage of the number of creditors required for the plan approval). The majority is basically required in every class (still, a plan can nevertheless be approved because of a cross-class cramdown, see further below).

As soon as third-party rights are affected, a judicial confirmation is required that also binds dissenting minorities.

Finally, each plan must meet the *best-interest-of-creditors test* (see further below).

Cross-class cramdown

Member States must provide for the possibility of a cross-class cramdown. This concept can be vital for successful restructurings as it allows courts to sanction a plan even if it is not approved by *all* affected classes. The Directive allows that it can even be sufficient if only *one* class agrees that is 'in the money'. Individual creditors or creditor classes can thus be prevented from torpedoing a promising and sensible restructuring.

A precondition is that either the *absolute priority rule* (the 'APR') or the *relative priority rule* (the 'RPR') is respected. While details are to be determined by Member States, the idea behind it appears straightforward:

- The APR follows the waterfall principle. A senior class must not be impaired as long as classes junior to it receive payments; conversely, the latter may only receive payments if all classes senior to it are not impaired.
- Since the APR may be inflexible in some circumstances, the RPR suggests that, despite the impairment of senior classes, junior classes may still receive payment as long as senior classes are treated: (1) at least as well as other equally-ranked classes; and (2) better than all junior classes.

The question of which of these rules (APR or RPR) is better has been intensively discussed between European (especially academic) scholars.[3] Promotors of the RPR argue that it would allow, for example, shareholders or subordinated creditors, who can both be key for a successful restructuring, to receive a 'treat' while senior classes might still have to accept debt reductions. This can be justified by the fact that the *best-interest-of-creditors test* must always be observed anyway (see further below). Promoters of the APR argue that this rule would bring certainty as it complies with basic civil and property law principles while relative priority would bring a lot of uncertainty and the risk for a re-distribution of value from creditors to shareholders.

It will be interesting to see how Member States implement the concept of cross-class cramdown and especially whether the APR or the RPR prevails.

Debt-to-equity swap

If allowed under the respective national law, debt-to-equity swaps can also be included in a restructuring plan.

However, Member States are not obliged to implement this instrument. In any case, the Directive provides that shareholders must not unreasonably prevent or create obstacles to the adoption, confirmation and implementation of a restructuring plan.

Legal remedies

Member States must ensure that there are legal remedies in order to determine whether the *best-interest-of-creditors test* and the *fairness-test* (APR or RPR; see already above) are complied with.

In the *best-interest-of-creditors test*, the liquidation scenario or the next best alternative scenario may be used as a comparison. In practice, restructuring measures are often tested against a hypothetical liquidation scenario (this also holds true for Austrian in-court restructurings in which the insolvency court must assess whether a proposed restructuring is appropriate in comparison to an alternative liquidation). In the negotiations on the Directive, it was argued that this comparison does not fit as the Directive explicitly addresses distressed, but still solvent, companies. Even if the restructuring via a restructuring plan fails, the company would therefore not necessarily have to be liquidated but could possibly still be restructured otherwise (eg, within a formal insolvency proceeding). The inclusion of the next best alternative scenario therefore seems sensible.

In order to perform the *best-interest-of-creditors test* and the *fairness-test*, the debtor company must be evaluated (probably with the assistance of an expert). Given the above arguments (liquidation may not work as comparison scenario), the going-concern value and *not* the liquidation value will likely have to be considered in such valuation.

The provisions of the Directive in this regard are, however, rather rudimentary and do not mention who has to bear the costs of the procedure (especially the valuation). Such costs could act as a deterrent both on the debtor side (especially for SMEs) and on the creditor side (in particular for small creditors).

Fresh money[4]

Interim and new financing, which often form the basis for a successful restructuring, shall be protected if required for negotiations on or the implementation of the restructuring plan. Member States may link such protection to an *ex ante* judicial control or the judicial confirmation of the restructuring plan. In that case, such financings shall no longer be subject to avoidance/clawback claims solely based on the grounds of preferential treatment. Importantly, grantors of such financing shall also be protected against liability for a possible delay in insolvency caused by their financing.

Relationship to EIR

Cross-border recognition and enforcement of proceedings within the scope of the EIR shall be supported by the Directive. However, Member States are *not* obliged to implement procedures which at the same time fall within the scope of the EIR. It is important to note that proceedings have to comply with certain publicity requirements in order to fall under the EIR. Still, publicity often makes restructurings practically impossible, which is the reason many restructuring tools are ‘silent’ and, for example, also not included in the EIR (such as United Kingdom schemes). Hence, there are good reasons to implement proceedings which are, or at least can be, outside the scope of the EIR. If so, recognition and enforcement, of course, can also not be based on the EIR but must be achieved on the basis of the other relevant EU regulations.

Implications of the Directive for Austria

Status quo dominated by private workouts

Today, restructurings in the Austrian market are dominated by a well-functioning out-of-court private workout practice. Although such workouts must rely on a contractual, consensual basis, commercial and practicable solutions can often be found as the main players (especially banks, courts and advisers) are very professional and tend to act in line with (non-binding) ‘gentlemen’s agreements’.[5]

However, such private workouts have certain obvious weaknesses, for instance:

- no instrument to cramdown dissenting minorities (therefore, minority creditors can ‘blackmail’ the debtor and the other creditors and torpedo the restructuring);
- no statutory moratorium (therefore, directors can be pressured to file for insolvency under the Austrian duty to file within 60 days); and
- no protection of fresh money (therefore, banks are sometimes reluctant to provide interim or new financing).

This reality is not new to the Austrian legislature. In the 1990s, the Business Reorganisation Act (*Unternehmensreorganisationsgesetz* or URG) was passed in order to allow pre-insolvency reorganisations within formal proceedings. However, such proceedings have never been accepted in Austrian practice, especially as this Act allows for neither a statutory cramdown nor a moratorium.

If an out-of-court restructuring cannot be achieved, in-court restructurings take place within formal insolvency proceedings under the Austrian Insolvency Code. This may be either under a restructuring plan (*Sanierungsplan*), where the debt is settled by a 20 or 30 per cent minimum quota or under a sale of the whole or parts of the business to a new entity (*übertragende Sanierung*). Both routes are broadly tested in practice. In both cases, dissenting minorities can be outvoted and a moratorium protects the debtor's estate. However, both require collective and public proceedings with mandatory and comprehensive court involvement, as well as the appointment of an administrator who either administers or, at least, supervises the debtor's estate (ie, only limited debtor-in-possession). Finally, such proceedings require at least imminent insolvency (*drohende Zahlungsunfähigkeit)* of the debtor which is why they usually come rather late.

A look into the crystal ball

What we originally heard from several sides is that the legislature considered implementing the Directive rather quickly. At the time of writing, the Austrian government has just collapsed and an interim 'expert' government has taken office. General elections are expected to be held in September 2019. These developments, of course, also put a question mark on the implementation of the Directive, in particular as regards timing.

In the authors' opinion, the Directive could close the aforementioned gaps that exist in the otherwise well-functioning Austrian restructuring market. Our legislature could 'cherry pick' and implement preventive, pre-insolvency instruments to cramdown holdout creditors, an individual or, if necessary, also a collective stay in order to protect the debtor company within a sensible restructuring and protection for interim and new financing. Such instruments could be available in confidentiality, without mandatory appointment of an insolvency practitioner and with minimum court involvement.

From today's perspective, it is, however, difficult to foresee whether the legislature will go down this route. The work at the Ministry of Justice has started, but no official statement or draft bill is available yet. It is likely that the legislature will take this opportunity to reform the unsuccessful URG. It is also rather likely that the implementation in Austria will bring instead another rather comprehensive preventive proceeding that includes certain entry hurdles (eg, viability tests) and possibly the strong involvement of courts and insolvency practitioners. If so, this would probably be a perpetuation of the current regime with the amendments as mandatorily required by the Directive, but no big leap.

It would, however, be desirable if the legislature made more extensive use of the offered opportunities so that the restructuring market could decide on a case-by-case basis which instruments fit the relevant restructuring. In that regard, it may also be sensible to leave it to the involved players (especially the debtor and its creditors) whether a 'silent' restructuring with only limited court involvement (and outside the scope of the EIR) or a collective and public proceeding is the more promising route to follow.

Summary

The Directive gives Member States a lot of flexibility, which is why no comprehensive substantive harmonisation can be expected. Differences between Member States will remain and forum shopping will also continue to exist in the future. Still, the European restructuring market will benefit from increased quality and comparability within the Internal Market. The Austrian legislature should, in particular, use the Directive to provide slim and tailor-made instruments in order to support the already well-functioning private workout practice.

Notes

1 Regulation (EU) 2015/848 (Recast).
2 This article focuses on arguably the most current aspects of the Directive. Aspects like special rules for employees, directors and other detailed questions that would go beyond the scope of this article are not addressed. Also, Titles III and IV of the Directive, which provide for a second chance for entrepreneurs and for measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, are not addressed in further detail.
3 See, eg, https://stephanmadaus.de/2019/03/12/die-neue-european-relative-priority-rule-der-restrukturierungsrichtlinie-das-ende-des-europaeischen-insolvenzrechts/ (promoting the RPR) and https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3350375 (promoting the APR) accessed 25 June 2019.
4 Similar rules are provided for other transactions required for a restructuring (eg, restructuring costs or consultancy fees).
5 Eight principles on out-of-court restructurings which are basically comparable to the eight International Association of Restructuring, Insolvency and bakruptcy professionals (INSOL) Global Principles for Multi-Creditor Workouts.

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