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Finance for Europe

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Association for Financial Markets in Europe

# AFME Response to the European Commission's proposal for a Directive on preventive restructuring frameworks and second chance

AFME fully supports the European Commission's proposed directive on preventive restructuring frameworks and second chance, which is a key step in developing a single market, as well as an important component of the proposed European capital markets union.

AFME believes that further harmonisation of minimum insolvency standards across Europe, as set out in the proposed directive, would help to facilitate more predictable and orderly outcomes for corporate restructurings. Under the current piecemeal approach, which results in sometimes significant divergences between Member States' insolvency and restructuring frameworks, investors need to evaluate and price the risks associated with operating in different legal systems. This generates unnecessary costs and constitutes a barrier to cross-border investments in the single market, as well as increasing the risk that viable companies may be forced into value and enterprise destructive insolvency because adequate restructuring options are not available at an early stage of a company's financial difficulties in every Member State. The challenges are greater for companies operating across borders.

More efficient restructuring and insolvency frameworks can contribute in a significant way to the efficient management of defaulting loans and avoid the accumulation of such loans on banks' balance sheets. The high level of non-performing loans in some parts of the banking sector limits these banks' capacity to offer loans to households and companies, resulting in economic stagnation.

A further problem is the lack of, or difficult access to, second chance opportunities for entrepreneurs in many EU countries which prevents them from starting new activities and potentially creating new jobs. Economic growth and prosperity is dependent on business innovation and entrepreneurship, while a system which discourages entrepreneurs from pursuing second chance opportunities acts as a drag on innovation and growth.

**EU insolvency law reform could boost growth and jobs across Europe**

In February 2016 AFME published new research showing that European insolvency law reform could boost GDP output and create jobs across Europe.

The report, entitled Potential economic gains from reforming insolvency law in Europe, was produced by AFME in cooperation with Frontier Economics and Weil Gotshal & Manges LLP. It showed that improvements in insolvency frameworks across the EU could increase GDP by

between €41 and €78 billion (or between 0.3% and 0.55% of EU28 GDP). The research also estimates that total EU employment could increase by between 600,000 and 1.2 million jobs.

The report found that many Member States stand to benefit from insolvency reform; some countries could add 2% to long-term GDP if they can bring their insolvency regime up to the standard of the European average.

Currently, national European insolvency laws vary in many respects. These differences can have a range of negative effects on financial markets and the real economy, including:

- increasing uncertainty among investors; discouraging cross-border investment;
- discouraging the timely restructuring of viable companies in financial difficulty; and
- making it harder to address the high levels of non-performing loans (NPLs) in the European banking system – a vital issue for banking union and the EU economy more generally.

The AFME report recommended:

- a Chapter 11-type stay of proceedings to enable quick and effective restructuring.
- granting super-priority status to new financing to provide working capital to a distressed company;
- giving creditors stronger rights to propose viable restructuring plans; and
- requiring national insolvency agencies to publicly report on outcomes.

**Comments on the Commission's proposal**

As stated above, AFME fully supports the European Commission's proposed directive, which seeks to address problems caused by divergent national insolvency regulations across Europe.

We particularly support the proposed directive because it addresses important issues such as stay of enforcement procedures, which are necessary to afford companies in distress an opportunity to agree a restructuring without fear of adverse creditor actions, as well as provisions for new and interim financing for companies in distress, which will sometimes be required to enable a distressed company with tight liquidity, but which is otherwise viable, to continue as a going concern during the restructuring.

The proposed Directive also includes useful provisions relating to valuation procedures, which are important both to determine what kind of proceeding is most appropriate and also to decide which creditors will have a remaining economic interest in the relevant enterprise.

Also, importantly, the proposal includes provisions related to specialisation of courts and judicial authorities, as well as those relating to qualifications for insolvency administrators and other practitioners. These aspects are very important because the effectiveness of any regulation is largely dependent on how well it is understood, administered and applied.

In addition, there are numerous provisions that should be especially helpful to small and medium-sized enterprises (SMEs). For example, the provisions relating to a second chance (including reasonable discharge and disqualification periods) for entrepreneurs, and those providing a safe harbour for directors, should help to incentivise parties to start or invest in

SMEs. These provisions should also help to reduce some of the negative stigma that is currently held in some quarters regarding a person whose business has failed. The proposed reforms to European insolvency law will also encourage and increase investment generally, which should make it easier for SMEs to obtain financing.

Finally, the requirements in Article 29 to collect and aggregate data on insolvency proceedings will fill an important information gap and make it easier to assess the effectiveness of insolvency reforms, with a view to instituting additional amendments or reforms as necessary.

The proposed directive is generally well designed to help achieve its stated goal of reducing uncertainty and costs for investors in assessing risk and therefore helping to reduce the cost of credit and raise recovery rates, which should increase incentives for investment. The proposal should also help to develop more mature and more liquid European capital markets and lower current barriers to the efficient restructuring of viable companies in the EU, rather than, as is too often the case in Europe, those companies going into liquidation, resulting in the loss of enterprise value, opportunity and employment. The provisions relating to second chance for entrepreneurs should be very helpful to incentivise European citizens to start new businesses, and also to incentivise investors to provide capital and financing to SMEs.

While, as stated above, AFME fully supports the Commission's efforts in this respect, we note that there are some areas in which the proposed Directive does not go far enough, or for which further clarifications or explanatory provisions may be necessary.

In this paper, we set out our general and specific concerns and, where appropriate, suggest amendments or clarifications to the language that we believe would address those concerns.

I. *General Comments*

- Creditor rights - The Directive does not address the issue of which party (or parties) are entitled to propose a restructuring plan. In particular, national European laws vary with respect to the right of a creditor to propose a viable restructuring plan. In some cases, creditors are left with no more than an up or down vote on a plan on which they have had no input, and also with no opportunity to propose a different, perhaps better, plan of their own. The Directive should make it clear that, under appropriate circumstances, creditors with a remaining economic interest in the company are able to structure and propose a restructuring plan for a viable debtor.

- There are a few provisions which, as currently drafted, provide that Member States or judicial and administrative officials "may" take or decline to take certain actions. In some of these cases, it would be more effective, and indeed create greater certainty that the stated purposes of the Directive will be reached, if these actions (or inaction) were required to be taken, rather than left to the discretion of the relevant parties.

- The Directive includes provisions where a particular action will be triggered by a specific state of affairs. For example, Article 6(9) states that a stay may be denied (or lifted) "where an individual creditor or single class of creditors would be unfairly prejudiced . . .". In this and other cases, however, there is no indication as to how, or by whom, a determination will be made as to whether such creditors are unfairly prejudiced. In other cases, it is unclear exactly which parties should be considered in assessing any effect on stakeholder rights.

- In the context of new and interim financing, the ranking of, and protections for, secured creditors remain unclear and in some cases may be unduly prejudiced by the proposed Directive. See our discussion below on Article 16(2).

- The Directive should provide guidance on how to distinguish a "viable" company from a "non-viable" company and who should make such determination, as this will have a significant effect on deciding the appropriate insolvency or restructuring procedure, as well as determining the rights and obligations of the parties involved.

- "We agree with Article 4(3) that the Directive should limit the intervention of the administrative and judicial authorities, since unnecessary involvement of those entities might result in increased time and costs related to restructuring plans implementation".

II. *Early warning mechanism (Recital 16)*

Current language

Possible early warning mechanisms should include accounting and monitoring duties for the debtor or the debtor's management as well as reporting duties under loan agreements. In addition, third parties with relevant information such as accountants, tax and social security authorities should be incentivised or obliged under national law to flag a negative development.

Analysis

The Proposal states that early warning tools should be put in place to incentivize debtors who start to experience financial problems to take early action, adding that third parties such as accountants, tax and social security authorities could be incentivized or obliged under national law to flag a negative development.

However, it is unclear how early warning tools should work in practice. Therefore, it would be important to specify how third parties could contribute to detecting financial distress of company.

For example, the alert mechanism procedure could be managed by national Revenue agencies/Tax authorities. Practical experience shows that Revenue Agencies are among the first creditors whose claims are not satisfied when companies enters into financial difficulties. In fact, usually, companies in financial difficulties first fall behind in payments to suppliers, then fail to meet their value-added tax (VAT) payment deadlines with Tax Agencies (this means in all likelihood that they are already in an advanced phase of crisis). Banks are often amongst the last creditors to become aware of a crisis. Therefore, Revenue Agencies are in a privileged position to detect whether a company is experiencing financing difficulties and are best placed to adequately manage an early warning mechanism.

III. *Definition of "absolute priority rule"*

This definition requires that a dissenting class of creditors must be "paid in full" before a more junior class may receive any distribution or keep any interest. It is not completely clear, however, what is meant by "paid in full" or what kind of arrangements would satisfy this test. Does "paid in full" mean that the creditor must receive the full amount of the credit that has been extended to the debtor (even if that amount is higher than the value of the secured assets)? If so, that might mean that lower ranked or unsecured creditors might receive less than they would in a liquidation, thereby violating the best interests of creditors test.

It could also, arguably, mean that the creditor must receive an amount equivalent to the market value of the secured assets? Or, perhaps, at least the liquidation value in compliance with the best interest of creditor's test? There are also certain specific arrangements, such as a moratorium agreement without a write-down, that might be deemed by some to be "full payment".

In any case, strict application of the absolute priority rule might encourage "gambling" by senior creditors who might vote against a reasonable restructuring plan if they thought that doing so would result in their receiving full payment to the detriment of other creditors. Similarly, junior creditors might believe that they would receive more in an insolvency scenario than in a restructuring where more senior creditors are paid in full under the test. We believe that further consideration should be given to this definition and to how the absolute priority test will work in practice.

IV. *Definition of "executory contract"*

Pursuant to Article 7(4), Member States shall 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 to the detriment of the debtor for debts that came into existence prior to the stay. Member States may limit the application of this provision to essential contracts which are necessary for the continuation of the day-to-day operation of the business.

Furthermore, by virtue of article 7(5) it has been proposed that Member States shall 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.

In the context of these provisions, we do not believe that the current definition of "executory contract" is specific enough to adequately safeguard the rights of certain relevant creditors. If a creditor knows that a company has entered into restructuring proceedings, it might expect a stay provision, for instance, to preclude certain precipitate action with respect to credit that has already been extended to the debtor, but it shouldn't also be forced to extend further credit to the debtor under undrawn credit facilities, revolving credit facilities, or other similar types of ongoing, but undrawn, credit arrangements.

In addition to this, the following language from the Capital Requirements Directive (CRR), annex 1, n. 4 (a) illustrates that these kinds of arrangements are to be considered "low risk": "Undrawn credit facilities comprising agreements to lend, purchase securities, provide guarantees or acceptance facilities which may be cancelled unconditionally at any time without notice, or that do effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness. Retail credit lines may be considered as unconditionally cancellable if the terms permit the institution to cancel them to the full extent allowable under consumer protection and related legislation."

In short, a reduced ability for lenders to implement loss reducing measures, e.g. preventing further credit to be drawn by borrowers, would likely lead to more losses for banks and result in lower recovery rates and higher LGD (loss given default).

For the reasons set out above, we propose to add the following language at the end of the definition of executory contracts:

> "; provided that executory contracts shall not include financial facilities such as undrawn credit lines, revolving credit lines and offers for financing."

IV. *Stay of individual enforcement actions (Article 6(1))*

Current language

*Member States shall ensure that debtors who are negotiating a restructuring plan with their creditors may benefit from a stay of individual enforcement actions if and to the extent such a stay is necessary to support the negotiations of a restructuring plan*

Analysis

The language above mandates a stay of creditor actions "if and to the extent such a stay is necessary to support the negotiations of a restructuring plan". There is no indication, however, of how, or by whom, a determination is made as to the necessity of the stay. This uncertainty could lead to disagreements over which party (or parties) is most appropriate to make the decision, or over the appropriate methodology or considerations involved, all of which could lead to delays at a time when the debtor is most vulnerable to adverse creditor actions and financial difficulties.

It should be clear how, and by whom, the decision is made as to whether a stay is necessary to support the negotiation of the restructuring plan.

VI. *Stay of individual enforcement actions (Article 6(4))*

Current language

*Member States shall limit the duration of the stay of individual enforcement actions to a maximum period of no more than four months.*

Analysis

Further consideration should be given to the appropriate length of the provisions related to stay of enforcement actions, both initially and with respect to any extensions. This will ensure that the stay is fair and does not unduly prejudice the relevant parties. The stay provision should not be so long that it ties up financing or otherwise discourages investment or is used oppressively or nefariously to subvert creditors' interests.

In addition, the length of the stay provision should be consistent with other regulations. For example, under the existing Capital Requirements Regulation (CRR), a bank has to consider a repayment claim as in default if the debtor is past due more than 90 days (Article 178 CRR). This appears to be inconsistent with a four month stay period. Therefore, consideration should be given as to whether a three month maximum duration would be more appropriate for a stay of individual enforcement action.

Careful consideration should be given to whether 12 months is the appropriate maximum time limit for any stay, as this may be an unnecessarily long time period that may tie up financing that could otherwise be available to the markets. In any case, any such extension

should only be granted in very limited circumstances when absolutely necessary and where the plan still has a reasonable chance of success**.**

VI. *Stay of individual enforcement actions (Article 6(9))*

Current language

*Member States shall ensure that, where an individual creditor or a single class of creditors is or would be unfairly prejudiced by a stay of individual enforcement actions, the judicial or administrative authority may decide not to [SIC] grant the stay of individual enforcement actions or may lift a stay of individual enforcement actions already granted in respect of that creditor or class of creditors, at the request of the creditors concerned.*

Analysis

It seems obvious that a judicial or administrative authority "may" decide not to grant, or to lift, a stay that would unfairly prejudice a creditor or group of creditors. In addition, it is unclear how, and by whom, it is determined whether a stay of individual enforcement action would unfairly prejudice an individual creditor or group of creditors. In order for this provision to be more effective, it should require a judicial or administrative authority, in relevant circumstances, to make a determination as to whether the stay will unfairly prejudice creditors, and if that is the case, not to grant the stay of individual action or, if appropriate, to lift a stay that has already been granted.

Proposed language

*Member States shall ensure that, at the request of the creditors concerned, the relevant judicial or administrative authority shall make a determination as to whether an individual creditor or a single class of creditors is or would be unfairly prejudiced by a stay of individual enforcement actions, and if this is the case, the judicial or administrative authority shall ~~may decide~~ not grant the stay of individual enforcement actions or shall ~~may~~ lift a stay of individual enforcement actions already granted in respect of that creditor or class of creditors*

VII. *Adoption of restructuring plans (Article 9(2))*

Current language

*Member States shall ensure that affected parties are treated in separate classes which reflect the class formation criteria. Classes shall be formed in such a way that each class comprises claims or interests with rights that are sufficiently similar to justify considering the members of the class as a homogenous group with commonality of interest. At a minimum, secured and unsecured claims shall be treated in separate classes for the purposes of adopting a restructuring plan. Member States may also provide that workers are treated in a separate class of their own.*

Analysis

Overall, the key structural feature of the cram-down framework is determining how creditor classes are constituted. The proposed Directive does not prescribe in any detail how this should be done, which is likely to result in different models throughout the EU, which might undermine the fundamental objective of the proposed directive to further harmonise EU insolvency and restructuring laws. The language above refers to classes being formed so that "each class comprises claims or interests with rights that are substantially similar" and that "as a minimum, secured and unsecured creditors should be

treated in separate classes". As noted below, English law scheme of arrangement class tests are referable only to "legal rights". The inclusion of "interests" here could make class composition considerations very complicated.

In the UK, for example, case law has established that creditor classes in schemes of arrangement (which is the English restructuring cram-down procedure) should be formed using a negative test: "classes must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest". Even with this narrower test, class issues often remain a significant area of dispute in English schemes and this is likely to be amplified in cross-border situations if the Directive does not prescribe a more specific method for determining creditor classes. Some courts tend to take an approach of minimising the number of creditor classes, since fractioning classes results in empowering minority creditors. It seems overall the Directive leans towards more rather than fewer creditor classes, which may make it harder to gain the necessary majorities to approve a restructuring plan and grant disproportionate leverage to minority creditors in fractured classes. Such a scenario could create very fertile ground for distressed hedge fund activity, with funds acquiring fulcrum debt interests and seeking maximum leverage in exchange for their consent to a restructuring plan. A regime with fissiparous creditor class tendencies also reduces the chance that restructuring plans will attain the consent levels required to be implemented, and in doing so undermines the prospects of viable businesses being successfully restructured.

The Directive should provide more specific and objective criteria for class formation and for determining which creditors or other stakeholders belong to which class(es) and this criteria should be calibrated in a way to limit the number of creditor classes, and should also include adequate creditor protections to safeguard minority creditors from oppression.

VIII. *Adoption of restructuring plans (Article 9(3))*

<u>Current language</u>

*Class formation shall be examined by the judicial or administrative authority when a request is filed for confirmation of the restructuring plan.*

<u>Analysis</u>

It is unclear what is meant by "examined" in the language above. Does this mean that the class formation must be confirmed? If so, under what criteria? If not, what is the form and purpose of such examination?

IX. *Adoption of restructuring plan (Article 9(4))*

<u>Current language</u>

A restructuring plan shall be deemed to be adopted by affected parties, provided that a majority in the amount of their claims or interests is obtained in each and every class. Member States shall 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.

Analysis

Careful consideration should be given to the effect of this provision on secured creditors. In some member states, secured creditors should always receive the full value of the collateral regardless of whether secured assets are sold off during the ordinary course of business (where the secured creditor's acceptance would be required) or through bankruptcy proceedings, e.g. as a foreclosure sale. In addition, certain kinds of secured assets (for example, real estate), might require different treatment under national insolvency laws. If these principles are not maintained, it might lead to unequal or unfair treatment between majority and minority secured creditors, or among different kinds of secured creditors.

One approach would be to afford individual member states some flexibility with respect to the treatment of secured assets and protection of the rights of secured creditors, and permit each country to take into account its existing legal framework and the respective rights of different kinds of creditors. Otherwise, the proposal may have the unintended effect of a reduced willingness to lend (especially by minority security holders) and/or increased prices to be borne by the debtor.

X. *Confirmation of restructuring plans (Article 10(1))*

Current language

*Member States shall ensure that the following restructuring plans can become binding on the parties only if they are confirmed by a judicial or administrative authority:*

*(a) restructuring plans which affect the interests of dissenting affected parties; . . .*

Analysis

Presumably, most restructuring plans will "affect the rights of dissenting affected parties", including those creditors that no longer have an economic interest in the enterprise and no reasonable expectation of recovery under any valuation test or other circumstance. This possibility is heightened by the somewhat vague and subjective "affected parties" definition and language. It should be clear that such intervention is necessary only if the plan negatively affects such interests, and it should be clear exactly which parties need to be considered to absolutely require confirmation of the plan by a judicial or administrative authority (i.e. the definition of "affected parties" needs to be tightened up). It is also unclear who would make the determination that the plan affects the interests of such parties (presumably the judicial or administrative authority?).

If these clarifications are not made, it increases the possibility that an out-of-the-money creditor or equity holder might be able to become a nuisance or otherwise delay or obstruct a reasonable and viable restructuring plan that has been agreed by the parties that still have an economic interest in the relevant enterprise.

XI. *Confirmation of restructuring plans (Article 10(3))*

Current language

*Member States shall ensure that judicial or administrative authorities may refuse to confirm a restructuring plan where that plan does not have a reasonable prospect of preventing the insolvency of the debtor and ensuring the viability of the business*

Analysis

In order to adequately protect creditors and other relevant parties, it should be clear that the restructuring plan shall not be approved if a determination is made that it does not have a reasonable prospect of preventing the insolvency of the debtor and ensuring the viability of the business. The current language appears to leave this as an option rather than a requirement. It should also be clear how, and by whom such a determination is made.

Proposed language

*Member States shall ensure that judicial or administrative authorities shall ~~may~~ refuse to confirm a restructuring plan if such parties make a determination ~~where~~ that the plan does not have a reasonable prospect of preventing the insolvency of the debtor and ensuring the viability of the business*

XII. *Cross-Class Cram-down (Article 11(1))*

Current language

*Member States shall ensure that a restructuring plan which is not approved by each and every class of affected parties may be confirmed by a judicial or administrative authority upon the proposal of a debtor or of a creditor with the debtor's agreement and become binding upon one or more dissenting classes where the restructuring plan:*

- *(a) fulfils the conditions in Article 10(2);*
- *(b) 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;*
- *(c) complies with the absolute priority rule.*

Analysis

In order to make it clearer that cross class cramdown is to be permitted if the conditions in (a), (b) and (c) above are met, it should be clear that the judicial or administrative authority shall confirm the restructuring plan, rather than merely having the ability to do so.

Proposed language

*Member States shall ensure that a restructuring plan which is not approved by each and every class of affected parties shall ~~may~~ be confirmed by a judicial or administrative authority upon the proposal of a debtor or of a creditor with the debtor's agreement and become binding upon one or more dissenting classes where the restructuring plan.*

XIII. *Cross-Class Cram-down (Article 11(2))*

Current language

*Member States may vary the minimum number of affected classes required to approve the plan laid out in point (b) of paragraph (1).*

In order to adequately protect all creditors, it would be helpful for the Directive to consider a minimum floor with respect to the number of affected classes below which a Member State may not apply a cross-cramdown.

XIV. *Valuation (Article 13)*

Current language

1. *A liquidation value shall be determined by the judicial or administrative authority where a restructuring plan is challenged on the grounds of an alleged breach of the best interest of creditors test.*

2. *An enterprise value shall be determined by the judicial or administrative authority on the basis of the value of the enterprise as a going concern in the following cases:*

   (a) *where a cross-class cram-down application is necessary for the adoption of the restructuring plan;*

   (b) *where a restructuring plan is challenged on the grounds of an alleged breach of the absolute priority rule.*

Analysis

Valuation is a very important aspect of any insolvency or restructuring procedure. Valuation has a great impact on which type of procedure (i.e. liquidation, restructuring, reorganisation) is most appropriate under the circumstances, and is also instrumental in determining which creditors or other stakeholders continue to have an economic interest in the relevant company.

However, it should not necessarily be required for a court to "determine" a valuation, even if there is a challenge by a creditor or class of creditors. Depending on the circumstances (including the desire to streamline the relevant procedures) a court should be able to confirm an already agreed valuation if it finds, after considering the relevant challenge(s), that it does not breach the relevant valuation test.

In addition, the provision is a bit unclear. Both challenges mentioned above refer to an "alleged" breach. This presumes that there may or may not be actual breach of the relevant test. The language seems to suggest that the liquidation or enterprise value *shall* be used even if the challenge of the restructuring plan is frivolous or otherwise unsuccessful. The requisite number of creditors should be able to agree and approve any valuation method that they choose as long as the plan does not violate the relevant tests.

Proposed language

1. *A liquidation value shall be determined, or confirmed, by the judicial or administrative authority where a restructuring plan is successfully challenged on the grounds of an alleged breach of the best interest of creditors test.*

2. *An enterprise value shall be determined, or confirmed, by the judicial or administrative authority on the basis of the value of the enterprise as a going concern in the following cases:*

   *(a) where a cross-class cram-down application is necessary for the adoption of the restructuring plan;*

   *(b) where a restructuring plan is successfully challenged on the grounds of an alleged breach of the absolute priority rule.*

XVI. *Effects of restructuring plans (Article 14(2))*

Current language

*Creditors who are not involved in the adoption of a restructuring plan shall not be affected by the plan.*

Analysis

It is unclear what is meant by "not involved in the restructuring plan". Could this be taken to include any creditor which, although an affected party and given an opportunity to participate, for some reason to refuses to (or is otherwise unable to) participate in structuring or negotiating the restructuring plan? When considered in conjunction with the "shall not be affected by the plan" language (which is also somewhat vague) this might be seen as suggesting that any such creditor would not be subject to the stay or cramdown provisions of an approved plan. This language should be revised to make it clear exactly what these terms mean and to ensure that this Article is consistent with the other provisions of the proposed directive.

XVII. *Protection for new and interim financing (Article 16(2))*

Current language

*Member States may afford grantors of new and interim financing the right to receive payment with priority in the context of subsequent liquidation procedures in relation to other creditors that would otherwise have superior or equal claims to money or assets. In such cases, Member States shall rank new financing and interim financing at least senior to the claims of ordinary unsecured creditors.*

Analysis

While the first sentence in Article 16(2) provides that new or interim financing "may" be given priority over existing financing that is equal or senior to it, the second sentence only guarantees such priority over "ordinary unsecured creditors". In order to sufficiently

incentivize creditors to provide financing to a distressed company, it should be clear that any new or interim financing would be considered as privileged vis-à-vis existing creditors in a potential insolvency proceeding, if necessary for a viable company to restructure its business. Such a privileged treatment is justified by the risk that creditors undertake by injecting new liquidity into distressed companies. Without a sufficient degree of predictability on the recovery of their claims, potential creditors are more likely to choose investments with a lower risk profile.

In any case, careful consideration should be given to the effect of rights granted to providers of new or interim financing vis-à-vis secured creditors. Assets that are already pledged to such creditors should not be diluted without the consent of the secured creditor. We therefore propose that the following language be added to the end of Article 16(2);

> provided, however, that any such priority should not affect or dilute the rights of any secured creditor(s) vis-à-vis the relevant secured assets without the agreement of such creditor(s)"

Any concerns about the fairness or necessity of granting such super priority status should be addressed by the judicial (or administrative)[1] officials that are charged with approving the plan. Presumably, the court or administrator would not approve super priority status to new or interim financing unless it was necessary in the context of the particular restructuring of a viable company and such financing was approved by the affected senior creditors whose interests would be subordinated to the new or interim financing.

**Conclusion**

In conclusion, we reiterate our full support of the proposed directive, and of the Commission's efforts to apply minimum insolvency standards across Europe as a means to increase certainty, incentivise investment, and foster an environment where debtors, creditors and entrepreneurs have more confidence that the regulatory framework is designed to both protect the rights of creditors and give viable companies and honest entrepreneurs a chance to restructure or try again if appropriate. While we think that there is still work to be done, we believe that the Commission's proposed directive is an important and valuable step towards an effective insolvency framework for Europe.

**Further Information**

Please contact Gary Simmons (+44 203 828 2723, or gsimmons@afme.eu) or Pablo Portugal (+32 2788 3974 or Pablo.Portugal@afme.eu) if you have any questions or need any additional information.

[1] If an administrator is appointed, the administrator should have the discretion to make a determination, subject to appeal to the courts if the administrators decision is challenged.