AFME Response

A proposal for a Directive of the European Parliament and of the Council harmonising certain aspects of insolvency law

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The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the proposal for a Directive of the European Parliament and of the Council harmonising certain aspects of insolvency law. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME supports the objectives of the draft Insolvency Directive to reduce fragmentation across member state insolvency laws and to increase the predictability and consistency of insolvency proceedings, increase the recovery available to creditors and reduce information costs to investors. Although we support the objectives, AFME/AFME members have some concerns about the efficacy and/or utility of some of the proposals contained in the European Commission's Proposal for the draft Insolvency Directive, as we outline in our responses below.

Our response is categorised according to the major subjects of the proposed Directive.

I. Directors' Duties

Background: Directors of all EU companies to face mandatory three-month insolvency filing requirements and potential personal liability for losses resulting from delay in filing. Directors must ask the court to open insolvency proceedings within a maximum of 3 months after the directors became aware (or can reasonably be expected to have been aware) that the company was insolvent, but Member States may adopt/maintain even stricter national rules if they wish. Directors would be civilly liable to compensate creditors for damages resulting from any deterioration in recovery value that arose from the delay in filing. Germany already has similar rules.

AFME Response:

AFME supports the streamlining of proceedings by addressing the point at which Directors are required by applicable law to file for insolvency proceedings. Although there are some instances where it is appropriate that a Director is put at risk of statutory liability for damages incurred by creditors as a result of his or her failure to comply with this obligation, the strict criminal liability associated with filing duties in some Member States' insolvency regimes, Germany for example, is disproportionate and too punitive. Similarly, this is our position in relation to balance sheet sanctions. We note that creditors are increasingly likely to focus on directors' duties since, as is the dynamic in the market, contractual covenants are rarely breached and thus, are less useful to creditors to protect their interests.

It is important that the proposed Directive does not put too great a burden on Directors in these circumstances. While the proposals make it clear what Directors must do, lack of clarity around what Directors are permitted to do during the 3-month period will create uncertainty for Directors and may have a chilling or dampening effect on Directors' initiative to take steps that they believe are in the best interests of the company and its

stakeholders (including its shareholders and creditors) to try to save the company or otherwise improve its condition. It is unclear what payments or other actions Directors may take, and what liability may attach to taking such actions. In addition, it may be possible for a Director to incur potential liability for inaction during this period. We suggest that the Commission provide more clarity on what Directors are permitted to do during this period, without incurring liability, and to also provide a safe harbour for certain actions taken in furtherance of trying to save or otherwise preserve the company.

We agree that the obligation to file should be based on a liquidity test. Liquidity tests provide more certainty and are a more immediate and accurate measure of a company's ability to survive or restructure its liabilities. Balance sheet tests, on the other hand, are taken as of a certain date and are therefore less immediate than liquidity tests, and balance sheet calculations for each company will be subject to different company processes, accounting policies and other factors. Use of a balance sheet test would not be the best, most accurate or most immediate measure of a company's ability to continue as a going concern.

It is estimated that an overhang of pandemic-era debt will start to mature in 2025.[1] This is particularly true with respect to non-investment grade debt. Some of these borrowers may have trouble refinancing or otherwise resolving this debt, especially if economic and other conditions have not improved by that time. That will be the point when any reforms contemplated now will be most useful and most effective. Therefore, it is important that any changes to national insolvency laws pursuant to the proposed directive are implemented on a wide basis across the EU (to the extent possible, considering that this is a proposed Directive) and are designed to make the relevant frameworks and processes more certain, efficient and effective.

II. Pre-packs

Background: The proposals would introduce UK-style pre-pack proceedings in which the sale of the debtor's business is negotiated before the opening of insolvency proceedings and the sale executed shortly after the opening of such proceedings. However, there are some key differences from the UK-style pre-pack, including (a) limitations on secured creditors' ability to credit bid, (b) the need for a court to authorise the pre-pack sale, and (c) the fact that ongoing "executory" contracts necessary for the continuation of the debtor's business operations would generally be assigned to the purchaser through the sale – even without the consent of the counterparty (which contrasts with the UK pre-pack approach.

Secured creditors may participate in the bidding process by offering the amount of their secured claims as consideration to purchase assets over which they hold security. However, such credit bidding is only permitted if the value of secured claims is significantly below the market value of the business.

AFME Response:

One difficulty with this restriction is that it is unclear what is meant by "significantly below" market value. This is a subjective measure that, without further guidance, might result in widely different outcomes. In addition, it is not clear why the value of secured claims must be "significantly" lower than market value no matter how that word is defined.

[1] https://www.spglobal.com/ratings/en/research/articles/230207-credit-trends-global-refinancing-pandemic-era-debt-overhang-will-add-to-financing-pressure-in-the-coming-ye-12629900

We also believe that the requirement for court authorisation of a sale of assets or a business may undermine some of the purposes of the Directive. In a bond context, we believe that it is best to leave these matters to the terms of the relevant bond(s). In other contexts, once the pre-pack is approved, it is to the benefit of all parties that proceedings are carried out in a quick, clear, transparent and efficient manner. Differences in rules and practices in various member states increase uncertainty and complexity and may lead to undue delay or abuse. These differences occur between member states as well as between different parts of members states.
There are also marked differences between the quality, expertise, workload and competency of relevant court frameworks between and within member states.

We note that jurisdictions such as the U.S. and the UK do not require court approval of sales of assets of a company subject to (US) Chapter 11 proceedings or a (UK) administration and therefore are seen as desirable jurisdictions in which to agree pre-packs and other actions taken within the context of an insolvency proceeding. The insolvency proceeding itself (whether Chapter 11 or an administration) is subject to oversight by a court (for example, administrators in the UK are officers of, and owe duties to, the court and many US pre-packs are included in US Bankruptcy Court proceedings) and therefore creditors are generally protected.

To take the UK example, pre-pack sales of assets or businesses may occur almost immediately after the appointment of the administrator, without requiring separate court approval, because there strict rules on the criteria that an administrator must apply before agreeing to a pre-pack sale, and these criteria will have been considered by the persons appointed as administrators before they accept their appointment under the applicable court process. The are also ways to forego court approval under certain circumstances in the US. For example, there is a mechanism for a company to seek a solicitation of votes on a pre-pack Chapter 11 plan which, if approved, avoids the need for a Chapter 11 filing.

Parties in these jurisdictions would not necessarily run the same risks associated with timeline and court proceedings applicable to companies incorporated in or otherwise subject to the insolvency jurisdictions of EU Member States. While court intervention would be appropriate in some cases, there should be some flexibility permitted for the parties to agree to a resolution without the need for court or other official approval.

If the intention is to make more stakeholders use and appreciate insolvency proceedings in Member States, it would not be helpful to make these proceedings longer, more cumbersome and less certain. Considering the benefit to parties of a speedy and efficient resolution, we believe that the requirement for court authorisation of sales of assets of the insolvent company should be removed, and that the process for selling the assets or business of the insolvent company be left in the hands of the appointed insolvency official or other relevant parties (with court oversight where necessary), in each case acting in good faith, and that court approval only be required for specific and appropriate circumstances. In any case, the proposals would benefit from specific provisions designed to complete the process as quickly as possible under the particular circumstances.

III. Creditor Committees

Background: The draft Directive will harmonise provisions related to creditors' committees within insolvency proceedings, for example giving a general meeting of creditors the right to establish a creditor's committee It also requires minimum harmonisation for certain important aspects, for example the functions of the committee, the appointment of members; the composition of the committee; and limitations on committee members' personal liability (creditors' committee members exempt from individual liability for actions taken in that capacity, absent grossly negligent / fraudulent conduct, wilful misconduct, or breach of a fiduciary duty).

AFME Response:

In our view, it is not in creditors' interests to be required to seek court approval regarding creditor committees and to therefore need to navigate a lengthy and costly court process. In some ways, requiring court approval in all circumstances undermines the purpose of ensuring quick, efficient and relatively certain outcomes.

In any case, we believe that if court approval is required, it should only be mandatory in the case of "official" credit committees that are empowered to make decisions for creditors as a whole. Ad hoc creditor committees or meetings of creditors that are not empowered to take action on behalf of the creditors as a whole of the insolvent company should not require court approval.

AFME also believes that some flexibility should remain with respect to harmonising rules that are being introduced governing creditor committees, e.g. when they are to be set up, the timeline on court approval of establishment, avoidance of conflicts of interests etc. This is because numerous varying capital structures exist that require alternative approaches. We also anticipate that many member states will be aligned with this view.

We understand that an insolvency law regime where creditors are not required to seek court- approval may raise concerns about potential abuse and that this possibility may need to be addressed. We also note, however, that in many cases a court-appointed administrator is involved, which provides a degree of borrower protection.

IV. Avoidance Actions

Background: The draft Directive provides for three specific grounds for transaction avoidance within insolvency proceedings (a) preferences, (b) legal acts at an undervalue; and (c) actions intentionally detrimental to creditors. These are minimum harmonisation rules and Member States may maintain/adopt provisions that provide for a greater level of creditor protection. Acts benefitting creditor(s) may be declared void if perfected within 3 months before a request to open insolvency proceedings (however, if the act was done only to satisfy an existing claim, it is only void if the creditor knew (or should have known) that the debtor was unable to pay its debts (or that a request for the opening of insolvency proceedings had been submitted).

Acts by the debtor for no (or "manifestly inadequate") consideration may be voided if perfected within a year before a request to open insolvency proceedings. Acts by the debtor that intentionally cause a detriment to creditors may voided if (a) perfected within four years before the request to open insolvency proceedings and (b) the counterparty knew or should have known) that the debtor intended to cause a detriment to the general body of creditors - such knowledge would be (rebuttably) presumed if the counterparty was closely related to the debtor.

A party that benefits from the debtor's act that is declared void must compensate the insolvency estate for any detriment caused to the creditors by the debtor's act (which is not limited to the value obtained by that party.

AFME Response:

AFME members generally support the introduction of minimum harmonisation rules (common principles). We note however, that avoidance actions affect rights in rem, as well as certain other rights that are reserved to the member states. It is neither clear how and whether the Commission will have competency to propose

legislation in this area, nor how effective any such legislation would be across the EU, even if passed by the European Parliament and the Council. Therefore, it is unclear whether any perceived benefit from implementing, or attempting to implement, additional rules in this area will outweigh the effort, doubts about its utility or any unintended consequences.

It is also important that new or interim financing provided to a company in the period before its insolvency, in a good faith attempt to avoid insolvency, is adequately protected, and the same concern applies to any financing provided during any subsequent insolvency process that has recovery or rehabilitation as its objective. This would help to provide an incentive for lenders to provide financing to the company and would provide more certainty to both lenders and the company regarding ongoing financing and operations. While there are some Member States Europe that provide a level of protection to new and interim financing, we believe that the EU would benefit from more uniformity in line with encouraging the provision and protection of such financing.

V. Ability of insolvency practitioners and insolvency courts to access information held non-public databases (e.g. centralised bank count registries and asset registers) to identify and trace assets belonging to the insolvency estate.

Background: The draft Directive includes provisions to improve the ability of insolvency practitioners and insolvency courts to access information held in non-public databases, such as centralised bank account registries and asset registers, where necessary and proportionate for the purposes of identifying and tracing assets belonging to the insolvency estate. It would also impose a requirement for Member States to produce factsheets for investors containing practical information on the main features of their insolvency laws.

AFME Response

AFME members agrees that digitisation and use of technology will streamline the insolvency process across Europe. Issues with creditor access to assets and the tracing of assets that belong to the relevant estate will be mitigated. We must be mindful, however, of any potential dangers related to privacy or other breaches of parties' right. If this results in encroachment on rights to privacy, it would be helpful to provide a safe harbour from GDPR or similar rules for actions taken to meet requirements under the proposed Directive. It might be helpful to consider US regulation of the crypto market and to look to the crypto markets generally for examples of how some of these issues are being handled.

VI. Minimum Standards

While we generally support the efforts of the Commission to further harmonise and provide certainty to EU insolvency proceedings, we note that these proposals are minimum standards that repeatedly state that member states are free to impose more stringent measures, and that they are will be contained in a Directive rather than a Regulation. Therefore, member states will have quite a bit of latitude in how they implement and enforce these proposals. Therefore, we suggest that the Commission to takes an approach that, under these circumstances, would make insolvency proceedings in Member States simpler, more efficient, more transparent and fair. We believe that this will make Member States more attractive jurisdictions for companies that find themselves in an insolvency situation.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.
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