POSITION PAPER

DIE FAMILIEN UNTERNEHMER

On the proposal of the European Commission for a Directive of the European Parliament and of the Council on preventive restructuring frameworks, the second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures, and amending Directive 2012/30/EU (Draft Directive of 22 Nov. 2016 COM(2016) 723 final)

Preliminary

DIE FAMILIENUNTERNEHMER in principle welcome the draft Directive referred to above on (inter alia) preventive restructuring frameworks (hereinafter: the EU-Draft). To put it in the well-known words of the German legal scholar Prof. Karsten Schmidt, restructurings are always particularly effective when they are "early, quick and quiet." As the individual countries in Europe still have very different rules and ways of dealing with the timely restructuring of businesses, one goal of the directive is to contribute to the harmonization of the differing legal positions in the various national states. This is to be welcomed.

From the German point of view the Directive is aimed particularly at certain states in the European Union which do not yet have very efficient restructuring frameworks in place. Germany has enjoyed a basically effective financial reconstruction and insolvency law, at latest since the so-called ESUG reform, which reinforced insolvency plan and debtor-in-possession administration from 1st March 2012.[1] But even from the German point of view the goal of the Directive, to make restructuring possible as early as possible, is sensible. Despite all the reforms in Germany, the German legislator has not as yet entirely succeeded in decisively reducing the deterrent effect of the word "Insolvency". This leads, as before, to belated filings for insolvency and failure to carry out a timely and thorough financial reconstruction.

An evaluation of the effects of the so-called ESUG reform in practice is being carried out in Germany in 2017. One should await the results of this evaluation and carefully review them before carrying out a final assessment of the EU-Draft.

Various regulatory aspects were also to be taken into consideration and the draft produced has here largely been successful. There was the risk that the promotion of preventive restructuring would lead to competitive disadvantages for healthy businesses as a business which enjoys the protection of a restructuring regime can produce more cheaply than its

[1] According to a much-quoted study by the World Bank, German restructuring law holds the third place worldwide, World Bank Study „Doing Business 2017 – Equal Opportunity for All" of 25 Oct. 2016, p. 208 accessible at http://www.doingbusiness.org/~/media/WBG/DoingBusiness/Documents/Annual-Reports/English/DB17-Report.pdf

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"healthy" competitors. DIE FAMILIENUNTERNEHMER therefore hold it to be essential that in practice in future only thoroughgoing restructurings with good prospects of success be made available. In many cases it will still hold true that for a business to leave the marketplace is preferable to a restructuring "at any price" – to the prejudice of creditors and competitors. DIE FAMILIENUNTERNEHMER adhere to the principle that the protection of creditors, as in the insolvency codes of Europe, serves to uphold the security of property rights. This corresponds to the principle that debtors should not, either de facto or de jure be able to escape their liability and their responsibility for their own debts by means of some over-lenient legal framework.

Finally, the process of competition should not be prevented from driving weaker participants out of the market. This may be a painful process, but in the view of DIE FAMILIENUNTERNEHMER it is economically unavoidable.

Overview of selected parts of the EU-Draft

The EU-Draft, to put it very briefly, includes the following "tools" to ensure the possibility of timely restructuring:

1. Moratorium

Arts. 6 and 7 of the EU-Draft contain provisions for a so-called moratorium. In particular the business which is to be restructured is to obtain a "breathing space" so that the negotiations for restructuring are safeguarded. For more precise time periods – while leaving room for the discretion of the national legislators – time limits for enforcement have been laid down, in particular for the stay of execution by individual creditors.

2. Restructuring plan, overcoming obstructionists

The EU-Draft includes numerous regulations as to the so-called restructuring plan. With the help of this plan – which is derived from the American "Chapter Eleven" procedure and the German insolvency plan – it is made possible to overcome the opposition of individual creditors who wish to block a successful restructuring. The regulations on this are to be found in chapter 3 arts. 8 – 15 of the EU-Draft.

3. Transaction protection and protection from recovery actions

The EU-Draft provides in particular for robust safeguards for loan and bridging loan arrangements and other transactions undertaken in the course of the EU-Draft restructuring procedure where this restructuring fails. This means e.g. in relation to the German legal position, that to a large extent in the case of subsequent insolvency – that is, where the restructuring process fails – the avoidance by the subsequent insolvency administrator of transactions undertaken during the restructuring process is ruled out.

4. Threshold requirements and start of the process where there is a "likelihood of insolvency"

At various points, the draft (cf. art. 4 EU-Draft) points out with reference to the threshold requirements that the restructuring process aims at avoiding an insolvency where there is a "likelihood of insolvency." The EU-Draft does not include a precise definition of what this threshold requirement means and how it is to be assessed. We would here enter a note of criticism: this is a weakness which could lead to starting an undesirable so-called "flight into restructuring".

5. Other provisions

The EU-Draft contains numerous provisions which can only be briefly mentioned here for reasons of space: provisions on dealings with employees and suppliers, in particular where there is a moratorium in place. In addition in Title III the EU-Draft contains provisions on the "second chance for businesses" and in Title IV on measures to increase the efficacy of restructurings, in particular with reference to administrative provisions. Titles III and IV are not covered by these observations.

Selected main points in our view requiring specific criticism and discussion

1. Competitive disadvantages for healthy businesses

As shall be shown in detail below, the EU-Draft contains weak points. These lead to the risk that non-viable businesses could be tempted to carry out a disguised insolvency process without the safeguards in favour of creditors of the insolvency process. This could have the result that unprofitable businesses be kept alive artificially, all at the cost of creditors who continue to deliver supplies to the business seeking restructuring.

This would operate in particular to the prejudice of competition as such and to the prejudice of healthy competitors and would thus also affect the property rights of others.

2. Unclear comparative analysis

The so-called comparative analysis is essential for the protection of creditors and thus indirectly for the protection of competitors. A restructuring plan (in Germany in particular an insolvency plan) must ensure that the creditors are at least not worse off with the restructuring plan than they would be without a plan. The EU-Draft defines the 'best interest of creditors test' in art. 2 fig. 9 as meaning 'that no dissenting creditor would be worse off under the restructuring plan than they would be in the event of liquidation…' In another place (in connection with the possibility of outvoting individual plan groups) the analysis is based

on the value of the enterprise 'as a going concern' (art. 13 (2) EU-Draft, per contra art. 13 (1) EU-Draft (where it is again liquidation value)). The EU-Draft thus talks partly about going concern value and partly about liquidation value, which raises questions as to the standard of comparison and thus also questions relating to the valuation of the business generally. The going-concern value – which may be the purchase price obtainable for the business on the market - should be the standard of comparison.

3. Cram down – prohibition on obstruction too broad

The EU-Draft makes it possible to overcome individual plan groups by forming classes in the restructuring plan. The restructuring plan can under certain circumstances (also dependent on the measures governing transposition into national law) come to be followed against the will of one or many classes. In particular given the background of the problems with the comparative analysis sketched above, the provisions on the so-called cram down, i.e. to overcome individual classes, would seem to go too far to the prejudice of creditors. The national legislatures should have the option of rejecting cram down provisions altogether.

4. Protection from insolvency recovery proceedings is problematic

At many points the EU-Draft proposes to require ('should ensure') the national legislator to provide that certain bridging loans and transactions during the preventive restructuring process be removed from the scope of insolvency recovery actions should the restructuring fail, i.e. in the event of a subsequent insolvency. Only if the transaction was carried out 'fraudulently or in bad faith' (art. 16 (1) and (3) of the EU-Draft) should it be possible to avoid it in subsequent insolvency proceedings. This goes too far. When clearly recognized standards for restructuring (e.g. as laid down in IDW Institut der Wirtschaftsprüfer (German Institute of Chartered Accountants) Standard 6) are breached, avoidance in the following insolvency proceedings should likewise be possible.

Otherwise there will be a risk of unsustainable restructuring concepts being used in connection with the preventive restructuring process to divert the last assets to individual creditors, which would be to the prejudice of the creditors as a whole.

5. Moratorium provisions too broad

Likewise some aspects of the provisions on the moratorium are too strongly weighted against the interests of the creditors as a whole. Thus it is intended pursuant to art. 7 (1) of the EU-Draft to require the national legislator to suspend the duty to file for insolvency during the preventive restructuring process. This could lead to businesses which should in fact file for insolvency 'taking refuge' under the 'cover' of the preventive restructuring process in order to escape the transparency provided for by regulated insolvency proceedings – for example in order to escape monitoring by the court and creditor bodies or to escape provisions governing voting procedures (as to this see also the following remarks on the lack of controls for the threshold test.)

In addition, the Directive should at least leave the national legislator more discretion in relation to the moratorium. The national legislatures should have the option of eschewing a comprehensive moratorium altogether, as well as the comprehensive suspension of the duty to file for insolvency. German experience shows that even in financial reconstructions under court control (e.g. under protective umbrellas) in exceptional cases a moratorium of three months maximum is sufficient.

6. Threshold criterion ('likelihood') not precisely defined and no check provided for; monitoring for non-insolvency?

The draft does not make it clear how far ahead of possible insolvency the provisions on preventive restructuring should apply. The concept of 'likelihood (of insolvency)' is not more closely defined in the EU-Draft. It is also not provided that the fulfilment of the preconditions for the threshold criteria in a given case must be subjected to effective controls by the national legislature. This leaves the risk open that businesses which should in fact file for insolvency 'take refuge' under the 'cover' of the preventive restructuring process (see also the foregoing paragraphs). It must be ensured that businesses which should in fact file for insolvency cannot start the procedure under the EU-Draft.

7. Operating or only financial reconstruction?

It must be clarified in the further discussion whether and to what extent the preventive restructuring process provided for only serves a financial reconstruction (e.g. only reduction of liabilities) or whether operative reconstruction measures (e.g. mechanisms to terminate unfavourable contracts) also seem appropriate.

8. The expertise of the judges concerned with the insolvency plan?

The EU-Draft provides for the confirmation of a restructuring plan (developed without court proceedings) by the judicial or administrative authorities within 30 days (art. 10 (4) of the EU-Draft). This period is too short. Apart from this it must – in particular from the German point of view – be ensured that the judges concerned have an adequate qualification – in particular in commercial matters (important topic: stronger concentration [specialization?] of 'restructuring courts.')

9. Neutral Trustee as Moderator?

At certain points the EU-Draft provides that the competent courts / administrative authorities may nominate a trustee (cf. art. 5 (2) of the EU-Draft). It should be emphasised that a really neutral, experienced trustee can make a significant contribution to settling disputes, particularly in a confrontational situation. The role of a neutral, experienced trustee should thus be more strongly emphasized than it is to date in the EU-Draft.

10. Unregulated voting procedures before confirmation of plan

The EU-Draft includes numerous provisions on the effect of the restructuring plan but not on the voting procedure (e.g. laying down voting rights.) DIE FAMILIENUNTERNEHMER doubt that the voting procedure, for which the EU-Draft lays down no rules, can be sensibly carried out in an 'unregulated space'. Voting rules – possibly moderated by an independent trustee outside the formal court proceedings – should be added.

11. Early warning systems

DIE FAMILIENUNTERNEHMER expressly welcome art. 3 of the EU-Draft, according to which the Member States are to ensure that businesses have access to early warning tools. Here the question is whether and to what extent such early warning tools need to be more specifically defined – on the national, specifically the German level (important topic: Obligation of integrated business planning? Other ideas on early warning tools?)

12. Protection of start-up businesses: idea of abolishing the duty to file for insolvency in cases of over- indebtedness

The discussion on preventive restructuring could be used – in Germany – for provoking thought on a more secure legal environment for so-called start-up businesses. Where the start-up fails, many start-up founders run the risk of finding out after the event that they have delayed obligatory filing because of an over-indebtedness of which they were not aware. In the view of DIE FAMILIENUNTERNEHMER, there could at least be discussion and consideration of protection of start-up businesses and a readjustment of the grounds for insolvency (abolition of the duty to file for insolvency in cases of over-indebtedness.)

Conclusion

If the draft is improved in the individual points addressed in this position paper, a regulatory framework could be found which is fair to both

- the aim of introducing restructuring measures earlier (in time)
- the appropriate preservation of various important features of our competition and property regimes such as creditor protection, protection of property rights and undistorted competition.

A compromise has to be found between the two aims and the Draft has already made great progress towards achieving one.

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