New European regulation to pull insolvency regimes closer together, but jurisdictional preferences will persist as no federalisation in sight – Conference Coverage

Proprietary

The adoption of the new European Regulation on Insolvency proceedings (EIR) on 20 May, 2015 raises hope for more streamlined debt restructuring processes and harmonisation between European jurisdictions, according to several participants in the 4th European Insolvency and Restructuring Congress held in Brussels on 25 June 2015.
The new text aims to extend the scope of European regulations beyond the domain of liquidation and cover all insolvency proceedings. It also addresses the issue of recognition of judicial decisions in other member states, while making recommendations on preventive proceedings.

However, the new text is not aiming to eliminate all differences between the member states and create a unique debt-restructuring regime.

Opening up jurisdiction for the main proceedings, it also improves secondary proceedings, and requires member states to set up national insolvency registers in place with the aim of allowing courts to know whether there are other proceedings open about the debtor elsewhere in the Union.

All rosy?

Despite many significant improvements, the EIR fails to address a handful of issues, according to Dr. Stephan Madaus, professor of law at Martin Luther Universitat Halle-Wittenberg.

“The concept of 'centre of main economic interest' (COMI) for a whole group is not present in the EIR,” he said. “It’s only possible where a company and all its affiliates have the same COMI.” He added that coordination of cross-border processes remains difficult under the new regulation, while there may be ambiguity with regards to the concept of “local creditors” as defined by Article 2(11) of the EIR.

The specificities of each jurisdiction and the resulting advantages create a fertile ground for legal forum shopping, a phenomenon the EIR precisely aims to regulate. However, the UK scheme of arrangement defined under the Companies Act – which has been left out of the EIR’s domain of application – remains the preferred tool for larger companies and more complex workouts, several participants noted. The conclusion on the suitability of a jurisdiction should not, however, be made solely by balance sheet-driven considerations, two participants noted.

The new regulation follows a set of recommendations made to the by the European Commission last year. These recommendations are already being applied by many member states, pending the entry into force of the EIR, which is not expected to happen before September 2017.

The aim of the Commission is to increase credibility and reliability of the proceedings, participants noted. The local context and the impacts of restructurings will always remain a significant factor, said an EU Commission official.

“It’s rather unlikely for the Commission to federalise all insolvency rules across the board,” he said. “National laws and economic contexts should be taken into account. The Commission is working on improving the legal systems, because it will lead to improvements in the economy in general.”

One of the drivers behind the adoption of the EIR was the discrepancy between recovery rates across Europe, and that despite recent legislative efforts in many jurisdictions, including the larger ones. And this is a major deciding factor when it comes to choosing which jurisdiction to initiate the proceedings in.

“There is a huge difference between recovery rates from one jurisdiction to another,” noted Marc Ferracci, professor of economics at University of Paris Panthéon-Assas. “The recovery rate does not necessarily depend on the size of the jurisdiction or how sophisticated it is. For instance, out of 31 OECD surveyed members, France ranked 25th in mortgage debt recovery rate with 45% compared to an average of 65%.”

The EIR is considered “a landmark achievement” for the Commission, which can be used in cross-border disputes, according to a second EU Commission official.

“The Commission has convinced the legislators in the member states on her vision,” she said. “The main aim was to bring the rules in line with the modern world; that is facilitating rescue of firms, and giving entrepreneurs a second chance. There is a cross-border dimension in one out of every four insolvency cases in Europe. The EIR will no doubt have a significant impact.”

However, opinions may vary on the merits of the EIR and its perceived penchant for putting a company’s survival above the interests of its creditors. Creditors preferring rapid repayment – even if partial – to claim reinstatement may be worse off with the new rules in place.

“The goal of the new regime is to support restructurings, not liquidation,” said Hans Joachim Weidtmann, restructuring banker and Managing Director at Commerzbank AG. “This could be a problem for some creditors who would rather have the assets of the company sold to third parties in order to recover part or all of their claims, and also some bank lenders may be more likely to be in this category, given their preference for keeping debt rather than converting claims to equity for example.”

The bond maturity wall; where to restructure?

With the growing number of high yield corporate bond issuance, the number of restructuring cases is likely to increase.

“There were 275 issues in 2014, and another 261 in 2014,” said a restructuring lawyer. “Last year’s issues amounted to cUSD 110bn.”

This massive increase compared to some 10 years ago in the post-credit crunch issues is likely to create a “maturity wall” in the next couple of years, according to the participants in a bond restructuring workshop held in the conference.

“You can expect the number of restructuring cases to explode. By 2004-05, there were around two handfuls of high yield corporate bonds in Europe, but today that figure is somewhere between 400 and 500,” noted an investment manager. “There was almost no issuance between 2007 and 2010, but since 2010 there have been a lot of new cases. The wider high-yield market started in 2011. Given the five to seven years life span of many of these bonds, we are going to face a maturity wall in the next couple of years.”

The cross-border nature of many of these transaction and the involvement of international players in them, a broader array of choices opens up to issuers when it comes to restructuring their debts; hence the question of which jurisdictions are best-suited to restructure high-yield bonds.

Many European countries have tried to make their legal systems more appealing for debt workouts. The German Schutzschirmverfahren (Protective Shield) of 2012 and the new Dutch scheme of arrangement (due to enter into force in the next couple of years) are examples of this legislative effort. However, bond restructuring still remains a rather uncharted territory in many European jurisdictions.

“Bond restructurings are quite new in the Nordic countries, but definitely a growing market” said JohanHäger, partner at Roschier law firm. “Nordic bond financing started in Norway, and then spread to Sweden, Denmark and Finland. There is a strong trend towards bond financing as companies can reach higher leverage levels and more flexibility this way.”

Liquidity in the capital markets and standardisation of practices across Europe has made bond issuances and refinancing a simpler affair, noted Johan Häger.

“The debt structure normally includes a super senior RCF with priority over the high-yield bonds, and the covenant package is becoming more and more standardised. These are typically cov-lite products, governed by the local law of the issuer.”

However, this perceived simplicity may be misleading given the possibility of cross-defaults especially in tougher financial contexts, according to the restructuring lawyer.

“For now it is easy for companies to refinance their debt, but if interest rates start to go up in the US, Europe can go through the same situation as the emerging markets once went through,” he said. “Bear in mind that in almost all of these debt structures there is an RCF element with covenants attached. If those covenants are breached and not waived, the breach will be transferred to the main structure through cross-defaults. The idea that these are cov-lite structures is a fallacy. One idea would be to get rid of the RCF first. When you look at the maturities, it is well worth it to look at the RCF maturities too, and see if they can be dealt with.”

UK scheme still the king

The EIR will be a step in the path to harmonisation of insolvency proceedings across the continent. Yet it is unlikely to have an immediate impact, and various jurisdictions will keep their distinct characteristics, the participants noted. “I don’t think there will be a dramatic change,” commented the restructuring lawyer. “I think there will be an internationalisation of the processes.”

He went on to add that most domestic jurisdictions are mainly focused on SMEs.

However, when it comes to restructuring the balance sheet of larger companies, an escapade to London and The Rolls Building of the High Court with the aim of using the UK Scheme of Arrangement remains a favourite option.

Defined under the UK Companies Act of 2006 in its current version, it allows debt issuers to restructure and avoid painful and stigmatising insolvency proceedings. In recent years, the scheme has been made available to companies with initially less than obvious links to the UK through a series of landmark cases including the German car park operator Apcoa and the Ukrainian energy firm DTEK. Since its inception back in the 19th century, the Scheme has evolved significantly, and is today a robust tool for debt workouts in near insolvency situations in which the unanimous creditor consent requirement cannot be met.

“The Scheme has had more comebacks than Frank Sinatra,” a lawyer involved in Apcoa Parking’s restructuring said. “Of course it is not needed when there is unanimity, but in the absence of unanimous support, it is a very attractive tool because of its extensive jurisdiction. There is nothing in the English statutes that defines what a Scheme should – or should not – do. You can do almost anything with it, including cramming down holdout creditors. The scheme can save a company from falling into insolvency. And don’t forget the advantage of first class judiciary, as well as tried and tested case law in England.”

Despite the significant costs, these advantages, together with the relative ease with which English judges tend to recognise jurisdiction to hear cases, have lured many large non-British companies to London for restructuring purposes. That includes a host of German names including PrimaCom, Tele Columbus, Rodenstock, and of course Apcoa.

“It is not a suitable process for a coffee shop, but when it comes to a company like Apcoa with around 5,500 employees and 36 OpCos spread across different jurisdictions, I think it is the appropriate tool,” commented Stefan Sax, partner at Clifford Chance who acted as counsel to Apcoa in its debt restructuring Scheme of Arrangement. “I am always asked why we didn’t use the German Schutzschirm instead. The answer is because there is no German insolvency proceeding for dealing with 12 jurisdictions and 36 operation companies. We could have put the German companies into a German insolvency, but the commercial reality asked for something else. Moreover, there were cash pooling agreements between the group’s subsidiaries, which meant that insolvency proceedings amounted to quite an atomic blow.”

However, the relatively low 50% (in numbers) and 75% (in value) creditor support requirements mean that dissenting creditors may feel disarmed against a workout proposal they perceive as unfavourable.

“In many cases the UK Scheme may be the only viable solution, especially when a company has several subsidiaries across Europe,” said Dr. Volker Kammel, partner at Reed Smith (formerly Jones Day), who acted as legal counsel for one of Apcoa’s dissenting creditors. “But I think the downside, at least as far as the Apcoa case was concerned, is that minority rights were not adequately protected. Apcoa showed that a company in financial difficulty can propose a Scheme that ignores the advantages and better rights of minority creditors, and get away with it. I would say that the judge was under considerable pressure, given the risk of job losses, etc. and considered liquidation as the only alternative.”

Whether cases like Apcoa or DTEK – in which the Ukrainian company restructured originally New York law-governed bonds via the Scheme after changing its COMI and governing law to UK – have been a step too far remain open.

“[What happened in Apcoa’s case] was all there already,” said the first lawyer involved in the process. “It was just a further push of the envelope, just like DTEK. People will continue to be innovative.”

However, a fourth lawyer involved in the matter warned against excessive optimism.

“It is worth noting that the judge indicated that he reached his judgment on a very fine line, and the Court of Appeal did grant [holdout creditor] FMS leave to appeal,” he said. “Cases like Rodenstock and Apcoa are open to debate at appellate level. The fact that leave to appeal was granted may be an indication. Having said that, if there is a better place in Europe for carrying out debt restructurings, the onus is on the dissenting creditors to show evidence for that.”

Apcoa avoided the appeal phase after the holdout creditor FMS Wertmanagement reached an agreement with the majority creditor Centerbridge.

And if there’s a consensus on the Scheme’s efficiency when it comes to streamlining balance sheets, it is less so when other factors – including social policy concerns – are taken into account.

“The only question in an insolvency is not creditor recovery rates,” said Hon. Leif Clark, arbitrator and former judge. “There are other external issues, including broader economic ones such as the fate of the employees. These external concerns make insolvency a public law issue, and not just a matter of private recovery, precisely because of those wider implications."

by **Hossein dabiri**