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13. Changing legislation to encourage pre-insolvency solutions

1. The pace of reform

Historically legislation for business distress had concentrated on protecting creditor recovery which was unsurprising as law-making bodies were dominated by the holders of capital. Progressively this was recognised as a drag on economic growth and discouraged entrepreneurship. It was the 1978 US Bankruptcy Reform Act which significantly changed the balance between creditor and debtor interests. *Chapter 11* of the Bankruptcy Code which covered most corporations introduced the concept of debtor-in-possession which permitted management to conduct the ordinary course of business protected against creditor actions while a restructuring plan was prepared and submitted for court approval. Over time, *Chapter 11* has evolved through experience, custom and practice, case law and legislation amendments, all aimed at making the process more efficient. However, the process is still lawyer intensive which adds cost and reduces cash available for both unsecured stakeholders and for future working capital of the restructured business. This has led to an increasing trend to pre-filing consensual creditor compositions often led by experienced and trusted turnaround professionals with a focus on operational improvements to support a plan with creditor financial concessions which would be lower than losses they would incur in bankruptcy. Leveraging concessions off the threat of bankruptcy to arrive at a better solution for all stakeholders is a natural evolution driven by commercial reality and will not be restricted to the United States.

With the dot.com financial crisis at the turn of the millennium important front runners in the new communications industry became over leveraged and distressed. Most were US corporations which took advantage of *Chapter 11* to restructure at home but whose European subsidiaries were exposed to more creditor-aligned insolvency processes. Lawyers and professionals began to challenge the default position of European insolvency and found ways to navigate around the liquidity problems of the group subsidiaries. As noted in *Chapter 11* and in the cases of Schefenacker and La Seda de Barcelona, imaginative ways to preserve stakeholder value were used by forum shopping to shift centre of main interests (COMI) or in UK Schemes of Arrangement. This provoked a local reaction with piecemeal legislation changes to stop the flow of work out of their territories with limited success. Only France, and to a lesser extent the United Kingdom, had a comprehensive process from early out-of-court compromise and voluntary arrangements through debtor and creditor conciliation to a more formal legal process.

Local professionals often through professional associations such as the Turnaround Management Association (TMA) and International Association of Restructuring, Insolvency & Bankruptcy Professionals (INSOL) lobbied for more fundamental reform to both improve recoveries for all stakeholders and to speed up processes. Academic studies sometimes funded by governments also published proposed change. Following the banking crisis of 2008/9 and the subsequent clogging up of the European banking industries' arteries with large amounts of non-performing loans (NPLs), the European Union responded with, among other actions, the passing of EU Directive 2019/1023 which required all member states to have a pre-insolvency process with a moratorium to enable viable but distressed businesses to restructure with a restructuring plan protected from creditor actions. Progressively through 2020 until the time of writing, all EU members and the United Kingdom have introduced legislation in accordance with Directive 2019/1023. More detail of these changes in the main European jurisdictions is contained in the companion book to this, *Investing in Distressed Debt in Europe: The TMA Handbook for Practitioners, Second Edition*, 2023 (ISBN 9781787429376) published by Globe Law and Business. Below these implications are explored in the main European countries from the perspective of turnaround management and turnaround managers.

2. The United Kingdom and the Corporate Insolvency and Governance Act 2020 (CIGA)

The United Kingdom has a highly efficient insolvency process managed by a regulated group of insolvency professionals (IPs) who take control, manage or dispose of an insolvent company's assets in the interest of the creditors in accordance with absolute priorities of security and legal preference without recourse to a court, thus benefiting from a faster and more commercial approach than most other European jurisdictions. It also has an early-stage voluntary stage process (CVA) where management continues with the benefit of protection from creditors but under an IP's supervision. It has been used successfully to extricate concessions from landlords on onerous leases and to negotiate creditor financial concessions but suffers from the stigma of association with being an insolvency process with an IP as supervisor, many of whom do not have operational company-side experience to effect operational change and instil confidence in employees, customers and suppliers. It is less effective at implementing operational change and accordingly suffers in comparison with *Chapter 11*.

Before the referendum to leave the European Union in 2016 consultations were in progress with a wide group of interested parties in anticipation of an EU directive introducing a moratorium. There was general acceptance of the benefits of a moratorium, debtor-in-possession and a restructuring plan, the most contentious point being the role and status of the monitor. The turnaround community wanted certified turnaround professionals (CTPs) to be recognised as suitably qualified professionals for the role, but with pressure from the secured creditor and IP community it was restricted to IPs. With the vote to leave the European Union this process was put on hold, but it reappeared and was passed in the form of CIGA in July 2020 together with temporary restrictions on creditor action during the COVID crisis.

CIGA applies to small and medium-sized enterprises (SMEs) and smaller companies with a limited amount of publicly traded debt. Its main points were a moratorium for 20–40 days for a financially distressed but otherwise viable debtor to submit a restructuring plan to court and, if approved, to be implemented subsequently over 365 days under supervision by a suitably qualified professional, the moratorium period, however, to be supervised by an IP who would also opine on viability. The government does, however, have a power to make changes to the definition of a qualified person through regulations although at the time of writing this appears to be some distance away. It is to be hoped that the position will be reviewed and changed in the near future. CIGA contains useful cross-class cram downs that make it practical against dissenting creditors. It has been welcomed as a process by the established restructuring community with reservations from the turnaround community as it does not achieve the full benefits envisaged by all stakeholder communities. Unsecured creditors are the constituency particularly affected if the IP as monitor underestimates the viability and operational turnaround potential of the business and moves to insolvency when a turnaround and restructuring with operational improvements saving jobs and going concern value may have been possible if a turnaround manager had been responsible as monitor.

Representations by the turnaround community to be recognised as suitably qualified professionals on the grounds that they add more operational expertise to the plan preparation potentially saving more going value have not as yet been successful. However, in an independent academic review undertaken to assess the first three years of CIGA it was recognised that there was an argument in favour of extending the category of those qualified to act as monitors beyond IPs. It also highlighted an issue with low take up of the CIGA process, only 45 in three years. The review noted the reluctance of IPs to adopt the moratorium process citing risk and unfamiliarity, preferring instead to recommend insolvency, which seems to actually defeat the intent of the legislation to avoid insolvency in order to preserve going concern value. In certain quarters the influence of vested interests of the banks and insolvency professionals in restricting supervision to IPs and potential conflicts of interest is noted. The APPG report on Fair Business Banking 2020 highlighted this conflict. It should also be noted that secured creditors are protected in CIGA to the extent that they should receive no less than in the alternative process, ie, insolvency. They are supposedly sophisticated investors trained in risk assessment, notwithstanding their failings in the 2008 financial crisis. Why they should have greater influence in the definition of qualified professionals to supervise a moratorium over other stakeholders such as unsecured suppliers when they already have preference over other creditors begs a question.

From a turnaround management perspective it is to be hoped that this anomaly can be rectified in the future and professionally qualified turnaround managers can be recognised as monitors giving the debtor the option to engage with an IP or a turnaround professional who can work with the process through initial plan preparation including operational improvements, the monitoring process, the plan court submission and the plan implementation. As we have seen with *Chapter 11*, as CIGA evolves it will become more frequent that a consensual restructuring will be agreed before the need to enter the moratorium saving time and expense and saving more value for all stakeholders.

3. French restructuring: a progressive process of consensual out-of-court and court-based restructuring

French restructuring underwent a considerable period of change in the 15 years prior to EU Directive 2019/1023. It is considered a debtor-friendly regime and has provided great scope for turnaround management activity to support consensual restructuring in near-insolvent companies and also to be active in the court-based process sometimes acting as president of a company in a judicial reorganisation replacing management if the court deemed that appropriate for a successful outcome. Business failures in 2020 were at the lowest level for over 30 years highlighting the benefit of the pre-insolvency processes introduced progressively over the years since 2005. Conversely, to most jurisdictions EU Directive 2019/1023 when enacted in French law in September 2021 shifted processes to a better consideration of creditor interests, mainly through changes to thresholds required for plan approvals. This will not affect the voluntary and consensual proceedings which most SME companies use but will likely have an effect on the structure and approval processes on court processes particularly in larger cases as time unfolds and precedents are established.

As a matter of general principle, French restructuring law divides between voluntary and consensual out-of-court proceedings and more formal judicial insolvency proceedings. In the former there is no automatic stay and the company is not liquidity insolvent. There are two voluntary processes, *mandate ad hoc* and *conciliation*, both with debtor in possession in which a turnaround manager although not mandated to interfere with management, can play a significant role,

Mandate ad hoc is the first step where the debtor may request from the court the appointment of a *mandataire ad hoc*, a turnaround manager, who is usually suggested by the debtor. There is no legal maximum time period and any standstill arrangements are voluntary although in practice normally accepted by creditors. The *manadataire*'s function is to facilitate negotiations with creditors which are made easier if operational and management improvements can be demonstrated. No creditor is bound to accept the arrangement agreed by a majority and legal action isn't barred. All agreements are confidential. In practice, agreements target financial and significant creditors although a debtor may petition the court for a deferral period to facilitate implementation. *Conciliation* is available for a company which has been insolvent for less than 45 calendar days. The debtor petitions the court for the appointment of a *conciliateur* who may be recommended by the debtor to facilitate a consensual agreement in confidence over a duration of up to six months. Creditors in practice adhere to a standstill. Agreements usually involve debt deferrals for a period up to 24 months. *Conciliation* agreements are usually either acknowledged by the court or approved by the court which become binding on creditors party to the agreement. As in *mandate ad hoc*, compromises and agreements are facilitated by management and operational change that a turnaround manager can achieve. Also, the debtor may request the court to appoint the *conciliateur* to monitor the implementation of the agreement during its period of performance.

Solvent companies facing difficulties which they cannot solve without restructuring concessions can initiate restructuring as *sauvegarde accélérée* with an automatic stay for a two to four-month period particularly to overcome opposition from dissenting creditors in a prior *conciliation* process by application to the court with a *plan de sauvegarde*, a pre-pack plan with cram down, which becomes effective if supported by the majority of affected parties and confirmed by the court. A longer period is available during a six to 12-month period, *sauvegarde*, if a plan has not been prepared in the conciliation period. If the plan is adopted by a majority, it will be confirmed by the court. If not and the company is still insolvent, the *sauvegarde* will convert into insolvency proceedings, *redressement judiciare*.

Although insolvency is not the normal territory of the turnaround manager, it is not unknown for turnaround managers to be involved in a *redressement* if there is a core viable business that could be saved by significant operational improvement. In the case of ATI Industries, a manufacturer of crematorium ovens and incinerators, a turnaround manager was appointed as president with court approval who over time implemented a successful turnaround plan which resulted in a €4.5 million sale to a private equity buyer. Extensive management and operational change turned the company from losses to profit. The loss-making UK subsidiary was also closed but only with aid from a UK turnaround manager to implement changes to increase otherwise unrecoverable receivables and tax losses for the parent company benefit before liquidating the company in a UK creditors' voluntary liquidation.

4. Germany: a creditor friendly jurisdiction with an untested new pre-insolvency process

As described in previous chapters, the practicality of German turnaround and restructuring has been heavily influenced by legislation that puts great store on the strict definition of financial solvency, both liquidity and balance sheet, and of directors' duties and liabilities, to the extent that practising operational turnaround as part of a broad-based restructuring process contains a greater degree of risk both civil and criminal than in other jurisdictions. While the original *Insolvenzordnung* of 1999 drew much from *Chapter 11* it remained unattractive because of the domination of sometimes unpredictable insolvency courts and judges. Most operational turnaround has been practised higher up the decline curve than elsewhere in Europe and restructuring becomes balance sheet restructuring and a strict judicial rather than a consensual process. Historically this encouraged forum shopping by debtors to assist going concern value preservation, mainly to the United Kingdom to benefit from schemes of arrangement and more recently to Holland to benefit from WHOA. To an extent this was reduced by the introduction of ESUG in 2012 but restructuring was still dominated by the creditors' role in the office holder appointment and in the proceedings in general.

In response to Directive EU 2019/1023 Germany introduced a pre-insolvency regime, StaRUG, aimed at rescuing companies to avoid unnecessary insolvency proceedings. It is an early-stage process requiring that the debtor is neither cash flow nor balance sheet insolvent but that without action it would be unable to pay debts as they fall due in the ordinary course of business within the next two years. It enables the debtor to select creditors to include in the restructuring plan, mainly financial creditors including shareholders, and to seek a 75% majority by class cramming down dissenting creditors. It has the advantage that it excludes trade creditors necessary for the ongoing business activity. It has the disadvantage that it is not available to debtors that are balance sheet or cash flow insolvent or even given the risk of directors' liabilities, close to the zone of insolvency. It is almost irrelevant to companies needing turnaround operational improvements while in near distress. At the time of writing, it has been used in only a small number of SME cases. It will be severely tested in practice by the proximity of the Netherlands and the flexibility in value preservation of WHOA.

This is an extract from the chapter 'Changing legislation to encourage pre-insolvency solutions' by Alan Tilley in Turnaround Management: Unlocking and Preserving Value in Distressed Businesses, Second Edition*, published by Globe Law and Business.*

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