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EU Insolvency Harmonisation Proposals: Directors' Duties, Pre-Packs and Transaction Avoidance

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At a Glance

The European Commission published a draft Directive harmonising certain aspects of insolvency law, on 7 December.

Status Quo: EU insolvency rules are currently fragmented along national lines, delivering differing outcomes with different degrees of efficiency – resulting in large divergences in recovery value for investments in insolvent companies across the EU.

Objectives: The draft Directive aims to reduce differences in national insolvency laws, increase predictability of insolvency proceedings, maximise the recovery of value from the insolvent company for creditors, reduce information costs for investors, and thereby facilitate cross-border investment.

Main Proposals:

- ▶ **Directors' Duties** – Directors would be under a duty to file for insolvency proceedings no later than three months after becoming aware that the company is insolvent. Directors would be personally liable for damages incurred by creditors as a result of failure to comply with this obligation. See further [page 3](#).
- ▶ **Pre-packs** – Introduction of 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 necessary ongoing contracts would generally be assigned to the

purchaser, even without the consent of the contractual counterparty/ies. See further [page 4](#).

- ▶ **Avoidance Actions** – Minimum harmonisation rules, with three specific grounds for avoidance actions (namely preferences, acts at an undervalue, and intentionally detrimental actions) – with specified consequences for such actions. See further [page 5](#).

Nature: Directives provide for minimum standards; European Member States are permitted flexibility as to how they implement those standards into their own national law. Accordingly, even post-implementation, rules across Member States would not be identical.

Timing: The draft Directive will now proceed through the usual, lengthy European legislative procedure, which can take from 18 months to a few years. Once implemented, Member States will have two years in which to transpose the Directive into national law. Of course, as the UK is no longer a Member State, it will not be required to implement the Directive.

Impact: Via targeted convergence of EU insolvency laws, the Directive should facilitate ease of understanding of insolvency processes and assist in maximising recovery values of insolvency estates. However, imposing an obligation on directors to file for insolvency without undue delay – ostensibly, to avoid potential asset value losses for creditors – looks set to hamper rescue efforts in practice. See further [page 7](#).

Directors' Duties

Directors of all EU companies to face mandatory three-month insolvency filing requirements and potential personal liability for losses resulting from delay in filing

Rationale

The draft Directive notes that:

- ▶ directors are among the first to realise if a legal entity is approaching or surpassing the brink of insolvency; and
- ▶ a late filing for insolvency by directors may lead to lower recovery values for creditors.

Filing requirement

- ▶ The Directive would require Member States to impose an obligation on directors to 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.
- ▶ Member States may adopt/maintain even stricter national rules if they wish.

Consequences of breach

- ▶ Directors would be civilly liable to compensate creditors for damages resulting from any deterioration in recovery value that arose from the delay in filing.

Application to shadow / de facto directors

- ▶ The Directive makes clear that the term “director” should be interpreted broadly – potentially extending to shadow and de facto directors.

Comment

- ▶ Some EU jurisdictions (most notably Germany) already impose a similar mandatory filing obligation on directors - but many do not. This seems a retrograde step and reversion to the lowest common denominator.
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Pre-packs

Pre-pack sale processes to be introduced, with necessary contracts to transfer to Newco even without counterparty's consent — but limitations on credit bidding

Process options

- ▶ Member States should either:
 - A. ensure high standards of competitiveness, transparency and fairness of the sale process conducted in the preparation phase, or
 - B. provide that the court runs a brief public auction after the opening of the liquidation phase of the proceedings.

A. Competitive preparation phase

- ▶ If this option is selected: a “monitor” (who will become the insolvency practitioner, once proceedings are opened) would be responsible for ensuring that the sale process is competitive, transparent, fair and meets market standards compatible with standard M&A practice in the relevant Member State.
- ▶ Basic standards include: inviting potentially interested parties to participate in the sale process; disclosing the same information to potential buyers; enabling due diligence by interested acquirers; and obtaining offers through a structured process.

B. Public auction in liquidation phase

- ▶ If this option is selected: the offer selected by the monitor during the preparation phase should be used as an initial “stalking horse bid” during the auction.
- ▶ The debtor should be able to offer incentives to the “stalking horse bidder” – including expense reimbursements / break-up fees, in case a better offer is secured through the public auction.

Ongoing contracts

- ▶ 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. This contrasts with the approach in UK pre-pack administration sales.

Credit bidding

- ▶ Secured creditors would be permitted to participate in the bidding process by offering the amount of their secured claims as consideration for the purchase of assets over which they hold security.
 - ▶ **However**, to avoid giving secured creditors an “undue advantage” in the bidding process, credit bidding would only be available where the value of secured claims is significantly below market value of the business.
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Avoidance Actions

Harmonisation of avoidance actions into set categories with prescribed consequences

Harmonisation

- ▶ The draft Directive provides for three specific grounds for transaction avoidance within insolvency proceedings: preferences; legal acts at an undervalue; and actions intentionally detrimental to creditors.
- ▶ These are minimum harmonisation rules; Member States may maintain/adopt provisions that provide for a greater level of creditor protection.

Preferences

- ▶ Acts benefitting creditor(s) would be capable of being declared void if perfected within 3 months prior to a request to open insolvency proceedings on the basis that the debtor was unable to pay its debts.
- ▶ However, if the relevant act was undertaken merely to satisfy an existing claim, it could only be declared void if the creditor knew or ought to have known that the debtor was unable to pay its debts (or that a request for the opening of insolvency proceedings had been submitted).
- ▶ Legal acts performed with fair consideration for the benefit of the estate would also be protected.

Legal acts at an undervalue

- ▶ Legal acts of the debtor for no / “manifestly inadequate” consideration would be capable of being declared void if perfected within a year prior to a request to open insolvency proceedings.

Legal acts intentionally detrimental to creditors

- ▶ Legal acts by which the debtor has intentionally caused a detriment to the general body of creditors would be capable of being declared void if (a) such acts were perfected within four years prior to the request to open insolvency proceedings and (b) the counterparty knew or should have known of the debtor’s intent 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.

Consequences

- ▶ The party which benefitted from the legal act declared void would be obliged to compensate the insolvency estate in full for the detriment the relevant act caused to creditors. (Notably, this is not limited to the value actually obtained by that party.)

Protection for new/interim financing

- ▶ New or interim financing provided during an attempted restructuring – including in the course of a preventive restructuring process – should be protected in subsequent insolvency proceedings.
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Other

Certain other elements intended to enhance and harmonise insolvency laws across the EU

Creditors' committees

- ▶ The draft Directive includes provisions to harmonise the role of creditors' committees within insolvency proceedings – e.g., to ensure a creditors' committee is established if the general meeting of creditors so decides.
- ▶ It provides for minimum harmonisation rules in relation to key aspects e.g., the appointment of committee members; composition of the committee; function of the committee; and limitations on personal liability of members of the creditors' committee.
- ▶ Specifically: members of a creditors' committee would be exempt from individual liability for actions taken in that capacity, absent grossly negligent / fraudulent conduct, wilful misconduct, or breach of a fiduciary duty – e.g., the duty to represent the interests of the body of creditors.

Simplified winding-up proceedings for microenterprises

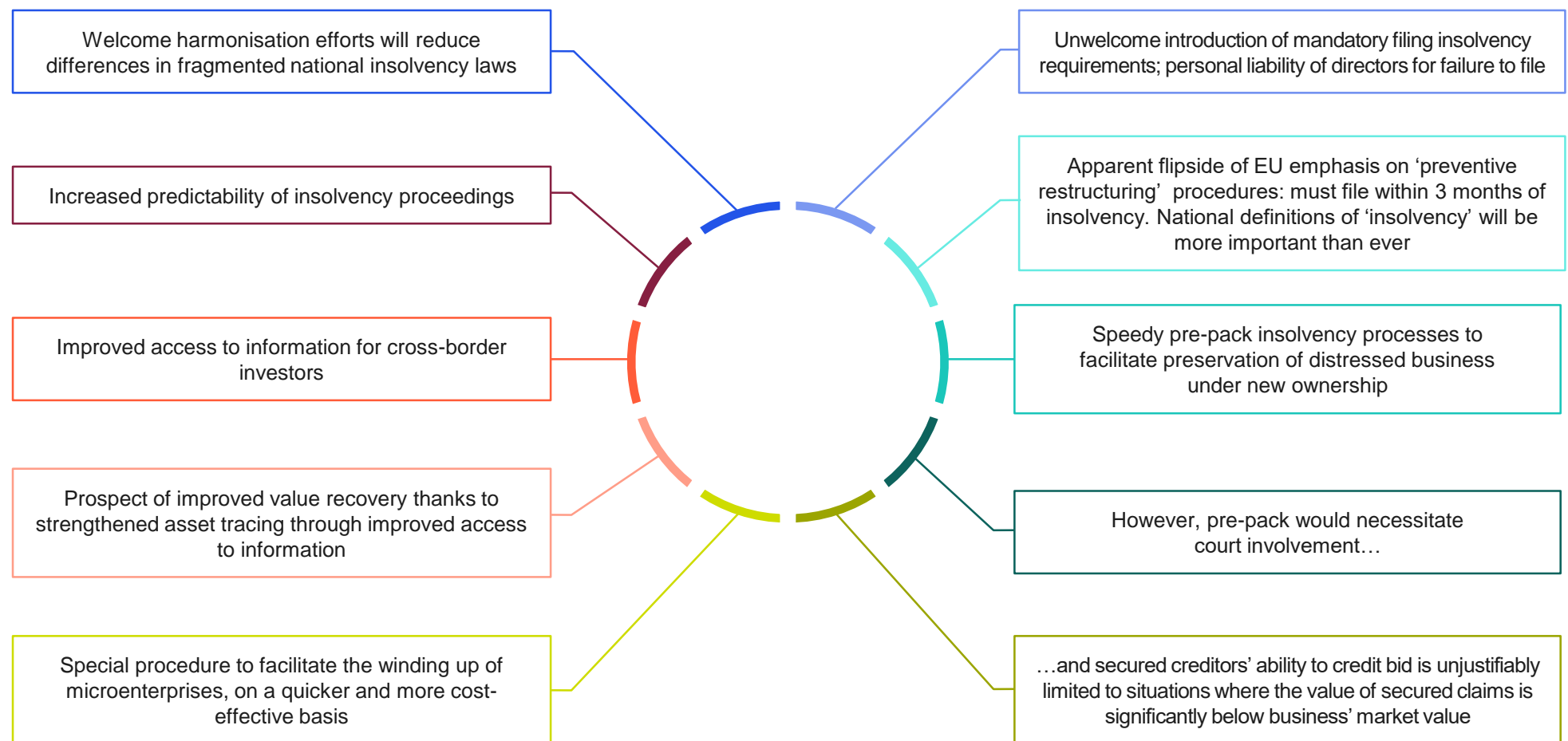
- ▶ The draft Directive contains rules on simplified winding-up proceedings for microenterprises. The objective is to ensure that microenterprises – even those with no assets – are wound up in an orderly manner, using a swift and cost-effective proceeding, which need not involve the appointment of an insolvency practitioner.

Asset tracing and transparency

- ▶ 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.
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Anticipated Impact

Important pan-EU impact in the medium term (once draft Directive is implemented then transposed into national laws of Member States)



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