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# The recast European Insolvency Regulation: incremental gains for distressed debt investors

**KEY POINTS**

- Investors seek reliable information, legal certainty, predictability of outcome and the opportunity to participate in a rescue and/or restructuring which will recover value.
- The Recast European Insolvency Regulation (the 'Recast EIR') should, at least in part, help investors meet those objectives.
- It is hoped that the Recast EIR will encourage greater investment (including distressed investment) in Europe, due to its increased emphasis on rescue and rehabilitation, by imposing mandatory obligations of cooperation and coordination between office-holders and courts, by facilitating group insolvency processes, and by creating interconnected insolvency registers to share information.

## KEY CONCEPTS

In 2002, Council Regulation (EC) 1346/2000 on insolvency proceedings (the '2000 EIR') introduced a regime governing the administration of insolvent corporates or individuals operating in more than one EU member state. Regulation (EU) 2015/848 on insolvency proceedings (recast) (the 'Recast EIR') will apply to insolvency proceedings commenced on or after 26 June 2017. As both regulations contain similar terms, 'EIRs' is a reference to both the 2000 EIR and the Recast EIR.

The EIRs ensure recognition of insolvency proceedings throughout the EU (except Denmark) and determine the law applicable to such proceedings. They apply only where the debtor's centre of main interests (COMI) is situated in a member state (other than Denmark) and do not apply to insolvency proceedings on foot in other jurisdictions. The EIRs are only binding on participating member states and are of limited practical use where assets are situated outside the EU.

## RELEVANCE OF THE INSOLVENCY REGULATIONS TO DISTRESSED DEBT INVESTING

Many investor claims in the context of distressed debt investing may either fall outside the scope of the EIRs or fall to be determined by a law other than the law of the main insolvency proceedings (see below). Insurance undertakings, credit institutions, and collective and other investment undertakings are excluded from the scope of the EIRs.

Furthermore, despite recent enlargement in the scope of proceedings covered by the Recast EIR, some tools commonly used for the solvent restructuring of a debtor will continue to fall outside the scope of the EIRs. These include the English law scheme of arrangement procedure, commonly used for the restructuring in the UK of overseas companies.

The correct categorisation of a distressed claim will determine whether the EIRs are directly relevant. Debt claims acquired under syndicated loans through a transfer or assignment could amount to a claim against the borrower and the EIRs would apply to the insolvency proceedings of that borrower. Alternatively, where the investor has entered into a risk participation with an existing lender, while the investor will clearly be interested to receive timely and accurate information regarding any insolvency proceedings relating to the borrower, it may have no direct claim in the borrower's insolvency; rather, a separate contract with the lender of record. Investments may be made through capital market instruments, often held in a settlement system where the investor's direct counterparty is not the issuer. If the issuer becomes insolvent, the EIRs will not be relevant to determine the claim of the investor against its immediate counterparty. Investors may take synthetic positions through contracts for difference (or may participate in hedging documentation in relation to a company's debt obligations to third parties), in which case the EIRs will have no bearing on the investor's claim against its counterparty.

Distressed debt investors will commonly adopt a multi-strategy approach, investing in instruments at different levels of the capital structure (potentially including direct or synthetic equity stakes). An investor may therefore be faced with multiple exposures, some being within the scope of the EIRs and some outside their scope.

## MAIN, TERRITORIAL AND SECONDARY PROCEEDINGS

The EIRs envisage there being one set of main insolvency proceedings, with the possibility of multiple territorial (or secondary) proceedings. The Recast EIR places a greater emphasis on rescue and rehabilitation, and is extended to proceedings which provide for restructuring of a debtor at a stage where there is only a likelihood of insolvency, proceedings which leave the debtor fully or partially in control of its assets and affairs, and proceedings providing for a debt discharge or a debt adjustment.

The Recast EIR will not apply to confidential procedures, as it would be impossible for a creditor or a court located in a different member state to know that such proceedings have been opened, making it difficult to provide for recognition on an

# Insight

EU-wide level.

Annex A of the Recast EIR sets out, for each member state, an exhaustive list of proceedings which are within its scope. In the UK, this includes a court-supervised winding-up, a creditors' voluntary winding-up (with confirmation by the court), administration, voluntary arrangements under insolvency legislation (such as company and individual voluntary arrangements) and bankruptcy or sequestration. However, none of the types of receivership available under English law (which have no equivalent in most other member states) fall within the EIRs' scope.

Under the Recast EIR secondary proceedings are no longer required to be winding-up proceedings, a position which had formerly been widely criticised as frustrating efforts to rescue group companies or divisions in other member states. In order to avoid the delay and expense of opening secondary proceedings, the Recast EIR allows the insolvency practitioner in the main proceedings to give a unilateral undertaking, in respect of assets located in any member state in which secondary proceedings could be opened, to the effect that when distributing those assets or the proceeds received as a result of their realisation, it will comply with the distribution and priority rights that creditors would have under national law if secondary proceedings were opened in that member state. These are referred to as 'synthetic' (or 'virtual') proceedings.

## CROSS-BORDER RECOGNITION OF INSOLVENCY PROCEEDINGS: SCOPE

There are several exceptions to the general rule that the law applicable to insolvency proceedings is that of the state where proceedings are commenced. Of most relevance to distressed debt investors are rights *in rem*, set-off and securities held in a payment or settlement system.

To the extent that the law where assets are situated protects the rights of a secured creditor and permits enforcement (notwithstanding the debtor's insolvency), these rights will trump any contrary provisions in the law of the main insolvency proceedings. In this context revised and improved *situs* rules contained in the Recast EIR are helpful. However this exemption will not always be available (eg if assets are not situated in a member state). Despite the importance of the rights *in rem* exemption, there are also some significant concerns about its scope. It is unclear how it sits alongside the possibility of an insolvency practitioner making a payment to a secured creditor to extinguish its security right (especially in situations where the creditor is under-secured), or an obligation on a secured creditor to contribute to the general costs of the insolvency proceedings. The interrelation between moratoria on enforcement and enforcement of collateral is also unclear.

The Recast EIR provides that set-off rights potentially remain available to an investor, whether or not the law of the relevant insolvency proceedings permits set-off in the circumstances. However, given that set-off receives very different treatment from one jurisdiction to another, there is uncertainty as to the scope of the term 'set-off' for these purposes.

## WHERE ARE DISTRESSED ASSETS SITUATED FOR THE PURPOSES OF THE RECAST EIR?

The Recast EIR contains more detail as to where assets are deemed to be 'situated'. Registered shares in companies (unless they are held via an intermediary and constitute 'book entry securities') are deemed situated where the issuer has its registered office. Financial instruments, the title to which is evidenced by entries in a register or account maintained on behalf of an intermediary ('book entry securities', which includes bonds held through a clearing house such as Euroclear or Clearstream) are deemed situated in the member state where the register or account in which the entries are made is maintained. Cash in a bank account is deemed situated in the member state indicated on the account's IBAN number.

## RESTRICTIONS ON MOVING A DEBTOR'S COMI TO ACHIEVE A FAVOURABLE OUTCOME

The Recast EIR contains new provisions designed to curb abusive COMI-shifting. Companies commonly engineer an artificial COMI shift in order to make use of proceedings not available in their home jurisdiction, often to the disadvantage of unsecured creditors. English courts, for instance, have jurisdiction to appoint an administrator to a foreign company if the insolvent company's COMI is in the UK. This has led to overseas companies becoming subject to English 'pre-packaged administrations'. In the Recast EIR the presumption that a corporate debtor's COMI is in the place of its registered office will not apply if the registered office has shifted in the preceding three months – a measure designed to curb abusive forum shopping.

## GROUPS OF COMPANIES

The Recast EIR introduces procedural rules on the coordination of insolvency proceedings of members of a group of companies. These include rules providing for coordination and cooperation between courts and insolvency practitioners, and the new possibility of synthetic (or virtual) secondary proceedings. Some commentators have expressed concern that the new group coordination procedures are complex and may prove difficult to put into practice.

## IMPROVED ACCESS TO INFORMATION FOR CREDITOR AND MORE USER-FRIENDLY PROCEDURES FOR SUBMITTING CLAIMS

The Recast EIR requires member states to establish national registers of insolvency proceedings by June 2018. These must display core information about proceedings, including practical details to inform creditors and enable them to file claims. A second phase (applicable from June 2019) entails the interconnection of national registers. Further provisions in the Recast EIR aim to facilitate the prompt and cost-effective exchange of information and filing of claims across the EU. It remains to be seen whether this will improve communication for distressed investors in practice.

*Biog box*
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## BREXIT

It is hoped, given the success of the 2000 EIR, that there will be a collective desire, both in the UK and in the remaining ('rEU') member states, to retain the effects of the Recast EIR regime as far as possible, whether as part of a withdrawal treaty or via a series of bilateral agreements between the UK and rEU member states. Bilateral arrangements could, however, result in inconsistent and unpredictable outcomes for pan European insolvencies. A less attractive outcome still is that the UK is forced to rely on the vagaries of private international law in each rEU member state. Any such 'halfway' solutions to the gap left by the EIRs would increase the risk of competing insolvency proceedings between the UK and individual rEU member states, due to the removal of the rule requiring automatic recognition of insolvency proceedings. There could also be increased uncertainty for UK insolvency practitioners seeking the assistance of rEU courts (and vice versa). ■

*A longer version of this article appeared as a chapter in the book* Investing in Distressed Debt in Europe: The TMA Handbook for Practitioners, *published by Globe Law and Business (November 2016).*

*Further reading*

- What now for administrations and schemes? The Brexit fall-out (2016) 5 CRI 174
- Back to the future: the impact of Brexit on the restructuring landscape (2016) 8 JIBFL 476
- RANDI Blog, 13 June 2016: Recast Regulation – key dates