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ALERT MEMORANDUM

The EU Commission's Proposal on Pre-Pack Sales and Other Insolvency Matters

February 6, 2023

On December 7, 2022, the European Commission ("EC") published a proposal for a directive seeking to further harmonize the insolvency legislation of the EU Member States (the "Proposed Directive").[1]

The Proposed Directive primarily pursues the maximization of creditors' recovery, focusing on, among other things: (*a*) so-called "pre-pack" sales (including credit bidding), (*b*) insolvency claw-back actions, (*c*) directors' filing duties, and (*d*) creditors' committees in insolvency proceedings.

The Proposed Directive would become the third pillar of a developing EU insolvency and restructuring framework, adding to (*i*) EU Regulation 2015/848, which primarily concerns procedural and conflict of laws matters, and (*ii*) EU Directive 2019/1023, seeking to harmonize restructuring tools across the EU Member States.

The EC has recognized that discrepancies among the substantive insolvency laws of EU Member States is an obstacle to a well-functioning Capital Markets Union and that efficient insolvency laws are among the key criteria that investors consider when deciding whether and where to invest on a cross-border basis.

The Proposed Directive is presently under review of the EU Council and thereafter will need to be reviewed by the EU Parliament.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors.

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[1] Proposal for a Directive of the European Parliament and of the Council harmonizing certain aspects of insolvency law, CO(2022) 702 final.

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I. Pre-pack sales

Creditors' quick and meaningful recovery is a key goal of the EC agenda. The Proposed Directive seeks to boost this objective, particularly by means of the so-called "pre-pack" proceedings.

These proceedings are meant to ensure that the sale of the debtor's business (or part thereof) as a going concern is negotiated before the formal opening of the insolvency proceedings and swiftly completed thereafter.

Against this background, the EC has recognized that the laws of the various EU Member States either do not contemplate these proceedings or they do so in very different terms. Accordingly, the Proposed Directive intends to introduce these solutions in a structured and consistent manner.

Specifically, the Proposed Directive distinguishes between two phases: (*a*) a preparatory phase, whose goal is to identify an appropriate buyer for the debtor's business; and (*b*) a liquidation phase, where the sale is completed.

Preparatory phase

The preparatory phase occurs *before* the start of the insolvency proceedings. During this phase, the debtor initiates a process[2] intended to identify the highest bidder for its business. Pre-existing pre-emption rights cannot be exercised (nor granted to any bidder).

Although during this phase the debtor remains "in possession" of its business, the sale process is subject to the supervision of a "monitor"[3] appointed by the court upon request of the debtor.

Among other things, the monitor is to certify the competing and transparent nature of the process, and to recommend the highest bidder as pre-pack acquirer (including by stating[4] that the proposed price is not lower than the recovery in case of a piecemeal liquidation).

The monitor must facilitate the presentation of alternative bids if, for competition law reasons, there is a risk that the antitrust authority would not clear the acquisition or may do so only following completion of a lengthy procedure. In such case, the monitor is authorized to disregard the highest offer, if there are other suitable offers and a delayed closing could negatively affect the value of the debtor's business.

During the preparatory phase, the debtor may also request that the court grants protection from individual enforcement actions, *provided that*: (*i*) the debtor is insolvent or likely to so become; and (*ii*) this protection is instrumental to a successful outcome of the sale process.

Liquidation phase

The liquidation phase takes place once the preparatory phase has been completed and the debtor is admitted to insolvency liquidation proceedings. In such context, the court must appoint the monitor as the insolvency trustee for the proceedings.

Provided the opinion of the monitor confirms that the sale has been run in accordance with the criteria set forth in the Proposed Directive, the court authorizes[5] the sale to the bidder identified during the preparatory phase.

It should be noted that the Proposed Directive allows a degree of optionality to Member States in its implementation. In particular, Member States may elect that the preparatory phase may simply consist in the identification of a bidder without necessarily

[2] According to the recitals of the Proposed Directive, this should entail "*an invitation to potentially interested parties to participate in the sale process, disclosing the same information to the potential buyers, enabling the exercise of due diligence by interested acquirers, and obtaining the offers from the interested parties through a structured process.*"

[3] The monitor shall be paid by the debtor, if there is no liquidation phase; and by the insolvency estate if there is a liquidation phase, treating the monitor's compensation as a super-priority claim.

[4] The Proposed Directive does not require the monitor to seek a valuation of the business in every case, although it provides for greater scrutiny in case there is only one offer and this comes from a debtor's related party.

[5] In case of appeals against this decision, such appeal may suspend the sale only if the appellant provides adequate security to cover potential damages.

launching a competitive bid process. In that case, this bidder will act as a "stalking horse". Within 2 weeks of the start of the subsequent liquidation phase, the court must then launch a public auction using the offer of such initial bidder as a basis. If a different bidder prevails, the initial bidder shall be compensated for the expenses incurred or receive a break-up fee in a "*commensurate and proportionate amount*".[6]

Interim finance and credit bidding

If, pending these proceedings, interim finance is needed, the Proposed Directive requires the monitor to take the necessary steps to minimize its cost. In addition, the lenders' claims are treated as super-priority claims and may be granted security over the proceeds of the sale.

Moreover, the Proposed Directive also permits so-called "credit bidding": creditors whose claims are secured over the business may participate in the bidding process through their secured claims (which can be offset against the sale price). However, the Proposed Directive seeks to limit this ability, by providing that "*creditors who are the beneficiaries of those security interests may offset their claims in their bid only provided that the value of those claims is significantly below market value of the business*".[7]

Liabilities and executory contracts

Pursuant to the Proposed Directive, the business transferred to the pre-pack buyer may not include pre-closing debt and other liabilities, unless otherwise agreed by the pre-pack acquirer.

Moreover, all executory contracts[8] necessary to continue the business can be transferred to the pre-pack acquirer without the consent of the relevant counterparties.[9]

II. Claw-back actions

In the Proposed Directive, creditors' recovery is also pursued through a (limited)[10] harmonization of the rules applicable to bankruptcy claw-back actions. According to the EC, these actions, which "*enable the annulment of legal acts that are detrimental to creditors and have been perfected prior to the opening of insolvency proceedings*",[11] are instrumental to the protection of the value of the insolvency estate and therefore to the creditors' recovery.

According to the Proposed Directive, by means of a "claw-back action",[12] a "legal act"[13] is declared void by the court and the debtor's counterparty must compensate in full the insolvency estate. On the other hand, the claims of such counterparty that were satisfied with the "legal act" that is declared void revive.

Suspect period

The Proposed Directive seeks to avoid different types of transactions entered into over certain periods *prior to* the submission of a request to open insolvency proceedings (so-called "suspect period"). Specifically:

(i) 3 months: transactions "*benefitting a creditor or a group of creditors by*

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[6] Article 26(2) of the Proposed Directive.

[7] Article 33(3) of the Proposed Directive. Based on Recital (30), it appears that this provision is designed to prevent secured creditors from obtaining "*an undue advantage*", "*such as when the amount of their secured claim against the debtor's assets is above the market value of the business*".

[8] Also, if (*a*) termination is in the interest of the debtor's business or (*b*) the contract contains a public service obligation, the counterparty is a public authority and the buyer is unable, for technical or legal reasons, to perform such service, the court may terminate the contract.

[9] Except in case the buyer is a competitor of such contract counterparty, in which case the consent of the latter remains required (if so provided in the contract).

[10] Member States are allowed to introduce or retain rules that ensure a higher level of protection.

[11] Recital (5) of the Proposed Directive.

[12] "Avoidance action" in the Proposed Directive's language.

[13] "Legal act" is defined broadly as "any human behavior, including an omission, producing legal effects."

satisfaction, collateralization or in any other way”.[14]

The Proposed Directive exempts however certain transactions, including (*a*) acts that have satisfied a claim “*in the owed manner*”,[15] unless the creditor knew or should have known that the debtor was unable to pay its debts as they become due; (*b*) transactions that have been performed against “*fair consideration*”; and (*c*) interim finance granted during restructuring proceedings;

(ii) 1 year: transactions for no or “*manifestly inadequate consideration*”;[16]

(iii) 4 years: transactions by which the debtor *intentionally* caused a detriment to creditors generally (provided that the other party knew or should have known of the debtor’s detrimental intent).

With a view to providing certainty to the debtor’s counterparties, the Proposed Directive also provides that any such claw-back action may be brought only within 3 years after the opening of the insolvency proceedings.

III. Directors’ filing duties

The Proposed Directive sets out a specific time limit within which directors must submit an application for the opening of insolvency proceedings. In particular, directors must do so within 3 months after becoming aware (or after they could have been reasonably expected to have been aware) of the state of insolvency.

Failure to act timely results in the directors’ civil liability for the losses incurred by creditors as a result of such delay.

The Proposed Directive allows Member States to maintain or introduce stricter consequences.

IV. Creditors’ committees

The Proposed Directive further envisages the establishment of creditors’ committees in all insolvency proceedings[17] if the general meeting of creditors so decides.

The key role of the committee is to ensure that the interests of creditors are protected during the insolvency proceedings. To do so, the committee has the right to hear the insolvency trustee and be heard by the court, supervise the insolvency trustee, request information, be consulted on matters in which creditors have an interest (including sales of assets out of the ordinary course), and seek external advice. Moreover, Member States may elect that the committee has the power to approve certain decisions or actions.[18]

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[14] Article 6(2) of the Proposed Directive.

[15] Article 6(2). The Proposed Directive (Recital (8)) refers to these cases as “congruent coverages”. By contrast, examples of “incongruent coverage” (which are not exempted) are pre-payments, satisfaction of claims made with unusual means, collateralization of previously unsecured claims, granting extraordinary termination rights.

[16] Article 7(1) of the Proposed Directive.

[17] Except in case where the cost of setting up and operating the committee is disproportionate to the value that it may generate.

[18] In which case, however, the committee’s approval / rejection must also be open to appeal.