ELB Blogpost 3/2023, 17 January 2023
Tags: COM(2022) 702 final, Proposal for a Directive harmonising various aspects of Insolvency Law, Capital Markets Union, insolvency law, avoidance actions, pre-pack procedure, simplified winding-up procedure, microenterprise
Topics: Free movement of capital

Completing the Capital Markets Union: The Commission's Proposal for a Directive Harmonising Certain Aspects of Insolvency law

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On 7th December 2022, the European Commission proposed a Directive for the harmonisation of certain aspects of insolvency law. With the objective to foster financial and economic integration in the European Union, the proposal is part of the Commission´s priority to advance the Capital Markets Union (CMU).

While the free flow of capital is one of the fundamental freedoms recognised in the Treaty on the Functioning of the European Union (TFEU), the completion of the CMU is a long and ongoing process that requires legislative measures to be adopted on a step-by-step basis. Following a first action plan in 2015 and based on a report of a high-level forum on the CMU, a second action plan was adopted by the Commission in 2020. This plan sets out sixteen key measure necessary for the completion of a CMU, which target more accessible financing for European companies, aim to enhance the level of retail investor´s participation in capital markets and to integrate national capital markets into a genuine single market (COM(2020) 590 final, 6-7).

One of the proposed actions addresses the divergence between national insolvency regimes, which are regarded as a long-standing structural barrier to cross-border investment (COM(2020) 590 final, 12). The reason is that national legislation not only regulates the insolvency proceeding itself, but also provides rules for the recovery of asset values from the debtor´s enterprise and its distribution amongst the creditors (Commission Staff Working Document, SWD(2022) 395 final, 3). Unharmonized national insolvency legislation leads to legal uncertainty on the outcomes of insolvency proceedings, which influences the willingness of banks and other providers of equity and debt financing to invest and provide financing across borders (SWD(2022) 395 final, 4). A harmonised insolvency framework is thus considered as a crucial pre-condition of credit, not only when the insolvency occurs, but also in relation to incentivizing investors to enter into a credit/debit contract (SWD(2022) 395 final, 156).

The legal basis of the proposed Directive will be Article 114 TFEU. The proposal does not address all aspects of insolvency law comprehensively but focuses on those facilitating cross-border investment. Furthermore, the proposal only sets out minimum harmonisation requirements, allowing the Member States to adopt or maintain stricter provisions if they provide a greater protection for the general body of creditors (Article 5). Due to its limited cross-border relevance, consumers are also excluded from the scope of the Directive (Article 1 (2) (h)).

I. EU Legislation in the area of Insolvency Law

Although the proposed Directive will be the third piece of EU legislation on insolvency law, upon adoption it will be the first to focus on the harmonisation of material insolvency law.

EU legislation already adopted are the EU Insolvency Regulation (EU) 2015/848 and the Directive on Restructuring and Insolvency (EU) 2019/1023. Regulation (EU) 2015/848 introduced uniform rules on international jurisdiction and applicable law that, in cases of cross-border insolvency, determines in which Member State the insolvency proceedings have to be opened and which law is applicable. The Regulation also ensures that judgments taken by the courts having jurisdiction are recognised and enforceable in the territory of all Member States.

Following the first action plan on building a CMU in 2015, the Directive on Restructuring and Insolvency was adopted in 2019. The Directive obliges Member States to provide certain minimum standards for a preventive restructuring procedure. Aiming to prevent insolvency, the preventive restructuring procedure is only available to debtors in financial distress before they become insolvent (i.e. when there is only a likelihood of insolvency). Another feature of the Directive is that insolvent entrepreneurs must have access to a full discharge of debt within a period of no longer than three years after the opening of the insolvency procedure (Articles 20-21).

II. Key Topics of the Proposed Directive

The proposed Directive focuses on the harmonisation of material insolvency law. Its objectives are to facilitate a higher recovery value of the debtor’s assets, a shorter duration of insolvency proceedings, and a predictable and fair distribution of recovered value among creditors (COM(2022) 702 final, 9). These are the key topics of the Directive:

II.1. Avoidance Actions and Asset Tracing

Important instruments for the recovery of asset values from the debtor’s enterprise are avoidance actions which ensure that legal acts that have been perfected prior to the opening of insolvency proceedings to the detriment of the general body of creditors can be declared void (Article 4). Even though, avoidance actions are already 'a standard part of all insolvency regimes', national legislation so far diverges considerably (SWD(2022) 395 final, 160). Those differences relate to the type of legal acts that can be object of avoidance actions, the legal conditions to be fulfilled and the calculation of the 'suspect period' in which acts can be challenged (SWD(2022) 395 final, 160). By adopting a principle-based approach (SWD(2022) 395 final, 160), the Directive establishes a minimum set of harmonised conditions for avoidance actions, including the preference of certain creditors by the debtor, transactions that involve no or manifestly inadequate consideration, and fraudulent actions. Here, the minimum suspect period ranges from three months (for preference to creditors) up to four years (for fraudulent actions) prior to the filing of the insolvency proceedings.

Another important tool for the recovery of the debtor’s estate is asset tracing. It facilitates the identification of misappropriated assets or their proceeds belonging to the debtor’s estate. For this purpose, national law enables insolvency practitioners to gain access to bank account information, beneficiary ownership information and certain national asset registers. The proposed Directive enables the insolvency practitioner to exercise in other Member States the powers conferred by the law of the Member State where the main insolvency proceedings have been opened.

II.2. Pre-Pack Procedure

Based on the assumption that a higher price can be achieved by selling the business (or part thereof) as a going concern rather than by piecemeal liquidation, the so-called pre-pack procedure aims to maximise the recovery value of the debtor’s business at an early stage (Recital 22). Different to the preventive restructuring procedure, the pre-pack procedure will also be available to businesses which are already insolvent.

The pre-pack procedure allows for the sale of the business to be prepared and negotiated before the formal proceedings are opened (preparation phase), followed by a short insolvency procedure where the court authorises the sale and the proceeds are distributed amongst the creditors (winding-up phase) (SWD(2022) 395 final, 196). Member States shall ensure that the sale process is competitive, transparent, fair and meets market standards (Article 24(1)). During the preparation phase, the debtor can benefit from a stay of individual enforcement actions whereas the liquidation phase ensures that the acquirer obtains the debtor´s business or part thereof free of debts and liabilities (Articles 23 and 28).

II.3. Simplified winding-up procedure for microenterprises

Probably the most innovative feature of the new Directive is the introduction of a simplified winding-up procedure for microenterprises. These are enterprises with less than 10 employees whose annual turnover and/or annual balance sheet does not exceed EUR 2 million. Taking into account that approximately 90% of all insolvency proceedings concern microenterprises, the practical impact of this new procedure will be significant.

Under the simplified procedure, the winding-up procedure largely remains in the hands of the debtor and the court. Consequently, an advantage of the simplified winding-up procedure is the saving of considerable costs as compared to an ordinary insolvency procedure which in turn increases the distributable estate (Recital 35).

An important feature of the winding-up procedure is that the debtor remains in control of his/her assets and the day-to-day operation of the business (Article 43). The debtor is also responsible for the observation of the formal requirements in the initial stage of the procedure. Based on standard forms to be provided by the Member States' court, the debtor's request for the opening of a simplified winding-up procedure has to list all the microenterprise assets and the details of all creditors and their claims (Article 41). Based on this application, the court has to inform the creditors about the winding-up procedure and to invite them to lodge their claims (Article 45). For the liquidation of the debtor's assets an electronic auction system has to be established (Article 50). It is also left to the court's responsibility to establish the final list of assets that constitute the insolvency estate (Article 48).

In addition to regulating the procedure, the proposal also establishes that the opening and conduct of simplified winding-up proceedings may not be denied on the ground that the debtor has no assets, or its assets are not sufficient to cover the costs of the simplified winding-up proceedings (Article 38(3)).

II.4. Other Features of the Proposed Directive:

The proposed Directive envisages the obligation for directors of legal entities to submit a request for the opening of insolvency proceedings no later than three months after the director became aware (or should have become aware) that the legal entity is insolvent (Article 36). Non-compliance entails the director's civil liability for damages that occurred as a result of the failure to comply with this obligation (Article 37).

Also, the rights of creditors through their representation in the creditors' committees will be improved. To this end, the Directive establishes that a creditors committee must be established if the general meeting of creditors so decides (Article 58 (1)). Furthermore, minimum harmonisation rules in relation to key aspects of the committees are established. These include the appointment of its members and composition, its working methods and functioning, as well as the personal liability of its members.

Finally, by obliging Member States to produce and keep updated a standard fact sheet with practical information on the main features of their national insolvency legislation, the Directive aims to strengthen the transparency of national laws on insolvency proceedings (COM(2022) 702 final, 20).

III. Outlook

Prior to the Commission's proposal, the European Parliament and the Council already signalled their general approval to the (minimum) harmonisation of insolvency legislation. This general support, however, does not mean that every single measure of the proposal will be adopted. Especially for the simplified winding-up procedure, opposition can be expected from some Member States. While the need to simplify the procedure for microenterprises is evident, its implementation might be problematic in practical terms. For most Member States it is a completely new procedure which requires new organisational structures at a national level. In addition, responsibilities previously exercised by the insolvency practitioner will be shifted to the court and the debtor, whose faithfulness is preconditional for the success of the new procedure. As insolvency practitioners also function as an investigator for the detection of the debtor's assets in order to be able to initiate liability claims and avoidance actions, their disposal could result in a decrease of the recoverable asset value. The reason is that under the simplified procedure creditors have to initiate avoidance actions on their own, but will not always have access to the relevant information and documents necessary for these claims.

Another shortcoming of the proposal is the lack of a harmonised definition for insolvency. Only for the winding-up of microenterprises, the proposal determines that the enterprise is deemed insolvent in case of illiquidity (Article 38 (2)). While some Member States equate insolvency solely with illiquidity (i.e. the inability to pay debts when they are due) others additionally consider a company insolvent when it is over-indebted. These divergent definitions can have a considerable practical impact, especially with regards to the director's obligation to file insolvency proceedings in case of insolvency. Similarly, the fact that the Directive will only provide for minimum harmonisation rules might impede the proposal's aim to facilitate a predictable outcome of the insolvency proceedings. These few points of criticism notwithstanding, one cannot call into question the overall benefit of the new Directive being an important move towards harmonising insolvency laws at EU level.