On behalf of the Public Affairs Executive (PAE) of the EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY

Brussels, November 2018

Position paper on the Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures

The Public Affairs Executive (PAE) welcomes the opening of interinstitutional negotiations on the insolvency file following the respective positions reached at Council and Parliament level. Our in-depth analysis of the Council and Parliament mandates suggests that both entities are committed to preserving the ambitious nature of the Commission proposal which is of paramount importance to the private equity industry. Indeed, we share the view of the institutions that, in some cases, inefficiency and divergence of insolvency frameworks make it harder for investors to assess credit risk, particularly in cross-border investments, preventing the integration of capital markets in the EU.

The European private equity industry considers that the more convergence there is in relation to restructuring laws, the easier and more cost effective it will be to assess the risks when making cross border investments. Risk assessment is particularly important since our industry invests in companies at an early stage of their development or in undertakings which are underperforming. In this light, we believe that the Proposal will be helpful to the private equity industry in performing its vital function of fundraising and investing in companies across borders.

In this context, we encourage policy makers to make sure that the final text is workable and thus reflects the fact that restructuring plans are highly tailor made, require a combination of business analytical skills and grasp of complicated legal issues which may involve business critical confidential information and are often negociated under great time pressure.

In the broader debate on insolvency proceedings, the legal framework is only one aspect of the risk analysis, and how Member States interpret and apply the law in practice will also be key. Many Member States rely upon court supervised restructuring processes at the moment and the light touch approach set forth in the Proposal will represent a significant challenge to some Member States. Notwithstanding these difficulties, we urge policymakers to maintain the ambitious nature of the Proposal.

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In particular, the Public Affairs Executive identified a number of important points which need to be addressed to make the directive workable and efficient:

- **The need to have a cross-class cram-down clause which is workable and fair. In particular we consider that subjecting the approval of the cram-down approach to the approval of a majority of classes would deprive this clause of any practical use.**

- **The need to prevent the use of a double majority test during votes (in terms of claims and number of creditors) which would seriously impair the chances to find an agreement at this stage.**

- **The need to have a short discharge period for entrepreneurs which would work as an incentive towards entrepreneurship.**

- **The access to a stay of individual enforcement action should be open to companies which are already insolvent**

What is private equity?

Private equity is a form of equity investment into private companies which are generally not listed on the stock exchange. It is a medium to long-term investment, characterised by active ownership. Private equity ownership builds better businesses by adding and strengthening management expertise, providing strategic guidance on delivery of operational improvements and helping companies to access new markets. Venture capital is a sub-segment of private equity focused on start-up companies. Venture capital funds back entrepreneurs with innovative ideas for a product or service who need investment capital and strategic advice in growing their companies.

The European Commission in the Capital Markets Union Green Paper and subsequent Action Plan acknowledged private equity's contribution to the real economy. The Green Paper stated "[a]s an alternative form of funding to traditional bank loans or issuing debt or equity, private equity and venture capital play an important role in the European economy" and then went on to ask "[h]ow can the EU further develop private equity and venture capital as an alternative source of finance for the economy?"[1]

Private equity funds raise capital from institutional investors such as pension funds, insurance companies, sovereign wealth funds and family offices amongst others.[2] Private equity funds are managed by specialist investment managers (typically also investors in these funds) who invest capital and expertise in companies across a wide variety of sectors, including consumer, industrial, engineering, life sciences, bio-technology, computer software, infrastructure, and at various stages of the life of the company.

Private equity funds provide institutional investors access to the necessary skills required for finding, analysing, valuing and negotiating the investment into interesting unlisted companies with value creation potential. The managers of private equity funds are actively involved in the management of the companies, through board participation and beyond, guiding the management team on strategic matters and, where necessary, assisting on operational issues. The managers of private equity funds remain involved with these companies until they are ready to take the next step in their development under the stewardship of new owners. A private equity fund holds a portfolio company for a period of between 5 and 6 years, on average.[3]

The vast majority of companies which receive private equity financing are Small and Medium-sized Enterprises (SMEs), a hugely important sector for the EU economy, responsible for driving jobs, growth and innovation.

A particular sub-set of the private equity industry is involved in turnaround scenarios. This is where a private equity fund invests in a company which is underperforming with a view to returning that business to a sustainable growth path. Through the introduction of fresh capital and re-structuring the business and by taking an active role on the board, the managers of private equity funds are able to oversee the company's transformation into one that is once again profitable and growing.

[1] European Commission Green Paper on Building a Capital Markets Union, February 2015, pp. 17 & 19
[2] For more information on the investors into private equity funds, please see our 2015 European Private Equity Activity Handbook, pp. 13
[3] Invest Europe Research

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Main concerns of the industry

- **The cross-class cram-down clause [Article 11]**

Under the Commission proposal, a restructuring plan which fails to be approved by each class of affected parties can still be confirmed by a judicial or administrative authority. We welcome this possibility but it should be subject to certain conditions to make the cram-down a workable and fair option.

In terms of workability, we consider that subjecting the approval of the cross-class cram-down approach to a further threshold requiring the approval of a majority of classes (as proposed by the Parliament) would deprive this clause of significant practical use. By doing so, the legislator would make it more cumbersome and very unlikely that a plan will be approved. This risks leaving many companies with no option but to declare bankruptcy despite the existence of viable alternative options.

Instead, encouraging the court to have overall oversight and ruling on fairness would be a more flexible option. The PAE, thus, is very supportive of the Council approach, making the cram-down clause conditional upon the realization of a '<u>fairness test</u>'. This fairness test can take either of 2 forms: (a) a dissenting voting class of affected creditors is satisfied in full by the same or equivalent means if a more junior class is to receive any payment or keep any interest under the restructuring plan; or (b) dissenting voting classes of affected creditors are treated at least as favourably as any other class of the same rank and more favourably than any junior class

<u>Recommendation:</u>

We support a mixed Commission/Council approach as regards Article 11 and recommend that the cross-class cram down clause is subject to:

- the adoption of the plan to the vote of "at least one voting class" (Commission proposal)
- a fairness test (Council approach)

- **Debt-discharge period for entrepreneurs [Title III]**

The Commission, Parliament and Council all underline the fact that entrepreneurs who have gone insolvent have more chances to be successful the second time. However, the inability to pay debts and the legal consequences deriving from insolvency constitute strong disincentives for entrepreneurs to start a new business and to contribute to growth and job creation in Europe.

In light of this, we support the debt discharge period in the proposal but we propose a shorter period, to encourage entrepreneurs to get back to creating business ventures as opposed to enduring a lengthy and punitive debt-discharge process.

In any case, we are convinced that a period longer than 3 years would send the negative message that the Union is not supporting entrepreneurship and is ready to see entrepreneurs in effect sanctioned for an extensive period of time for an unsuccessful venture. This would be very detrimental to the EU economy in the long-term by preventing the emergence of new and successful companies. For instance, it could be argued that one reason why the US economy is able to recover faster from recession than the EU is the US personal bankruptcy regime. The US regime allows honest debtors to return to new businesses without multi-year waiting periods. It is this incentive towards entrepreneurship that the proposal should encourage with the inclusion of a debt discharge period which is not overly lengthy. Otherwise, potential entrepreneurs will likely feel that taking a risk on a new business venture is not worthwhile due to the punitive length of exclusion from entrepreneurial activity they will face, if unsuccessful.

Recommendation:

We support the Commission and Council approach as regards Title III and recommend that the discharge period be no longer than 3 years.

- **Voting Majority [Article 9]**

Under the Commission proposal, the voting majority shall be defined under national law based on the amount of the creditors' claim or equity in a class.

On this point, we are deeply concerned by the option envisaged by the Parliament and Council to allow for a 'double majority votes'. This double majority would subject the adoption of a plan to the approval of a majority in terms of claims and number of creditors.

We would like to point out that the adoption of a restructuring plan is already subject to a majority vote in each and every class. By adding a request for a double majority vote in each, the legislator would seriously impair the chances to find an agreement at this stage. The legislator should not let a large number of small creditors which only own a fraction of the debts and which, as such, are less likely to be involved and interested in the restructuring/rescue of the company, impair the chances to find an agreement to preserve the activity and jobs of the undertaking.

Recommendation:

We support the Commission text on Article 9 which states that a voting majority shall be defined under national law and based on the amount of the creditors' claim.

- **Super-seniority rule [Recital 31 and Article 16]**

Typically, a company will have two broad options to relaunch its activity. These include a reduction in costs, and/or attracting new investments to finance growth. In this context we underline that new financing should be encouraged when it would enable a continuation of the company. As such, we strongly support giving new lenders priority at least over unsecured claims in subsequent insolvency procedures.

Recommendation:
We support the Commission approach and recommends not making any change to the Commission drafting of Recital 31.

- **Access to the stay of individual enforcement action [Recital 18 and 19; Article 6 and 7]**

We are concerned by the proposal from the European Parliament to prevent the possibility for companies which are already insolvent to have access to a stay of individual enforcement action. A stay is meant to create favourable conditions for the company to discuss a restructuring plan with a view to safeguarding the future of the companyand its workforce.

We fail to see why an insolvent company should not be given the possibility to discuss a restructuring plan under the best possible conditions. Indeed, by refusing insolvent companies a stay, the legislator would be indirectly pushing some viable undertakings towards formal bankruptcy rather than giving them time to consider their restructuring options.

In addition given the fact that a stay of enforcement is meant to *enable* negotiations on a restructuring plan, we consider that a judicial or administrative body should be in a position to lift, or not to grant, such a stay when it appears that there is no support for continuing the negotiations. The same option should be open when requested by debtors or a majority of creditors. As such, we consider the Parliament's additions to Article 6(8)(b) as very helpful.

A single creditor should not be able to block the continuation/adoption of a stay which could lead to the adoption of a plan beneficial to the majority of creditors. As such we would recommend <u>not</u> adopting Article 6(8)(ba) and (bb) from the Parliament's text.

<table><tr><td><u>Recommendation:</u>
We partly support the approach of the Parliament (AM 59) and recommends adopting the changes to Article 6(8)(b).
However we would recommend <u>not </u>adopting in the very same amendments Article 6(8)(ba) and (bb).</td></tr></table>

- **Workers' Rights**

We recognize that workers, whose interests may be affected by plans involving a change in work organisation or contractual arrangements, are also stakeholders in an insolvency situation and may be given a role as proposed by the Commission.

In such cases, however, workers (acting through their representatives) should be subject to the same procedures and limitations as creditors, who are also stakeholders. Giving workers a separate veto right, could prevent the adoption of many plans representing the best overall solution for insolvent businesses and their creditors.

Recommendation:
We recommend not adopting Amendments 21 and 31 from the Parliament's text.

Other areas of concern:

- **Definitions and changes in the drafting**

We consider that the text would benefit from more precise drafting to enhance legal certainty and limit discrepancies in the application of the directive at national level.

- Clarification of the terms 'likelihood' and 'insolvency' [Article 1]

  Although the opening section of this Article simply lays down the aims of the proposed Directive, cultural and legal differences across the EU are likely to result in a subjective and different understanding regarding the point at which insolvency is likely to occur. We would therefore suggest more precise language in this section.

  As such we would support the clarification brought through the Parliament text in Amendment 44.

- Use of the term 'liquidator' [Article 2]

  In Regulation (EU) 2015/848 of May 2015 on insolvency proceedings (recast) (the Recast EIR) the term 'liquidator' has been replaced with the term 'insolvency practitioner' throughout, reflecting the recast EIR's greater emphasis on rescue and rehabilitation.

  Therefore we welcome the Parliament's amendment [AM 43] on this point but we underline that this change should be done consistently throughout the text (*see* Recital 17).

- Definition of the terms 'relevant progress' and 'strong likelihood' [Article 6] – Commission and Parliament positions only

  The terms 'relevant progress' (in section 5(a)) and 'strong likelihood' (in section 6) require further clarification. The lack of clarification may well result in widely diverging interpretations of these terms across different Member States. 'Relevant progress' should of course only capture advances which give rise to the reasonable expectation that a restructuring plan will be agreed upon. Otherwise, if too small a threshold of 'relevant progress' is determined, then the stay of enforcement actions will simply act as a time delay to the formal insolvency proceedings. Similarly for 'strong likelihood', we believe that additional guidance in the Directive to reduce the subjectivity of this term would be welcome.

- Concept of 'essential contract' [Article 7 section 4]

  With reference to section 4, the concept of 'essential contract' requires further clarification. To give two examples, could overdrafts and hedging arrangements be designated as 'essential contracts'? We also consider that it would be appropriate to allow affected creditors to challenge a debtor's decision to categorise their contract(s) as essential.

In light of this, we support the clarification made by the European Parliament in amendment 59 and according to which "an executory contract is essential when it is necessary for the continuation of the day-to-day operation of the business, including any supplies where a suspension of deliveries would lead to the company's activities coming to a standstill".

- Definition of present value [Article 8 section 1(b)]

  With reference to section 1(b) of Article 8, 'present value' should be defined.

  On this specific point, we would support the Council's text which takes a more workable path - ie "details of the debtor's assets (together with an estimate of their respective values) and liabilities at the moment of the submission of the restructuring plan".

- Meaning of the terms "*debtor may not unreasonably prevent*" [Article 12]

  A clear definition of what the phrase "*debtor may not unreasonably prevent*" means should be made. Again, we believe that it would be preferable to provide guidance in the Directive in order to avoid subjectively varying interpretations across Member States.

  As such, we tend to support the provision of the Council according to which "Member States may adapt what is unreasonable under paragraph 1 to take into account, inter alia, whether the debtor is a SME or a large enterprise, the proposed restructuring measures touching upon the rights of equity holders, the type of equity holder, whether the debtor is a legal or a natural person, or whether partners in a company have limited or unlimited liability".

- Clarification of the section on the effects of restructuring plans [Article 14]

  We believe that Section 2 of Article 14 requires expansion in order to provide clarity. What does 'not involved' mean? Could this mean creditors who did not vote, or those who did not receive notice?

  In order to make this point clearer, we would be in favour of making a reference to national law as is the case in the Council's text.

- **Class creation [Article 9]**

With reference to section 3 of Article 9, we believe this provision should be re-visited as there is currently the possibility of debtors getting the class composition wrong. Time and costs could be wasted formulating a plan, voting etc., predicated on defective class composition. We believe that a more logical approach would be to have a two-stage process, with class composition being approved at the outset rather than being examined by the judicial or administrative authority only when a request is filed for confirmation of the restructuring plan. This approach would increase the probability of successful implementation. Experience from Member States' domestic law shows the difficulty of establishing creditors' respective interests. The general position is that robust valuation evidence is required.

As such, we support the Council's approach on Article 9 which makes it possible for a Member State to provide that a control of class formation can be done before confirmation of the restructuring plan.

Contact

For further information, please contact the Public Affairs Team (publicaffairs@investeurope.eu) of Invest Europe.

About the PAE

The Public Affairs Executive (PAE) consists of representatives from the venture capital, mid-market and large buyout parts of the private equity industry, as well as institutional investors and representatives of national private equity associations (NVCAs). The PAE represents the views of this industry in EU-level public affairs and aims to improve the understanding of its activities and its importance for the European economy.

About Invest Europe

Invest Europe is the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors.

Our members take a long-term approach to investing in privately held companies, from start-ups to established firms. They inject not only capital but dynamism, innovation and expertise. This commitment helps deliver strong and sustainable growth, resulting in healthy returns for Europe's leading pension funds and insurers, to the benefit of the millions of European citizens who depend on them.

Invest Europe aims to make a constructive contribution to policy affecting private capital investment in Europe. We provide information to the public on our members' role in the economy. Our research provides the most authoritative source of data on trends and developments in our industry.

Invest Europe is the guardian of the industry's professional standards, demanding accountability, good governance and transparency from our members.

Invest Europe is a non-profit organisation with 25 employees in Brussels, Belgium.

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