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LONG TERM INVESTORS

Brussels, March 2017

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

Re: Reaction to European Commission Proposal for a Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures.

General Comments:

The private equity industry welcomes the publication of the European Commission Proposal on insolvency (the Proposal) as part of the Capital Markets Union project. We share the Commission's goal of breaking down barriers that impede the flow of capital. We also share the view 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 views the Proposal as very encouraging. The prescriptive and detailed nature of the proposed rules is conducive to introducing harmonised minimum standards across the EU. 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. 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 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. We also put forward suggestions on how the Proposal could be improved in the area of creditor protection, which we explain below.

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 recently 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 or family offices, etc.[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'stransformation 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

Specific Comments:

The private equity industry is of the view that having a variety of procedures, both court supervised and out of court, will mean that debtors, irrespective of their size and complexity will be able to choose a procedure which is appropriate to their needs.

- Subject matter and scope (Article 1)

Given the various meanings/tests applied in Member States, further clarification of the terms 'likelihood' and 'insolvency' is recommended. 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 at which point insolvency is likely to occur. We would therefore suggest more precise language in this section.

- Definitions (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. We recommend the same approach here.

The 'class formation test' in section 6 appears less nuanced than the class formation test in place in some EU Member States, for example, under a Scheme of Arrangement under English law. Similarly, on first reading the 'absolute priority rule', when compared to a Scheme of Arrangement, seems relatively inflexible and may give dissenting creditors (who are not in fact prejudiced by the restructuring) a blocking vote on a proposed restructuring plan.

- Early warning (Article 3)

The concept of 'early warning tools which can detect a deteriorating business development and signal to the debtor or the entrepreneur the need to act as a matter of urgency' requires further clarification. As a corollary of this, it is unclear why Member States could/should limit access to such tools to SMEs or to entrepreneurs. We also query whether debtors (and their officers) might use those tools to justify not taking bespoke financial/legal advice which, in the overwhelming majority of cases, would be necessary.

We submit that both creditors and management should have the ability to present restructuring plans. Company directors (or the liquidator) should be obliged to provide relevant company information by request of at least 20% of creditors, in order to enable such creditors to produce comprehensive restructuring plans.

- Availability of preventive restructuring frameworks (Article 4)

We fail so see how is it possible/useful to establish an effective legal regime for the effect of allowing creditors to launch preventive restructuring frameworks (with the agreement of debtors).

- Encouraging debtor in possession restructurings (Article 5)

Article 5 stipulates that the debtor accessing preventive restructuring procedures shall be able to remain totally or at least partially in control of its assets and day to day operation of the business, i.e. debtor-in-possession arrangements. We support this provision but we believe it should be subject to supervision from a suitably qualified mediator/ supervisor/ court. The supervision from a suitably qualified mediator/ supervisor/ court should only take place concerning relevant operations, i.e., those acts which could significantly affect the debtor's financial situation.

In our view, directors should not be personally liable for losses generated during this protected period (losses may be unavoidable during this period, and continuing to operate the company may be the best path forward for all stakeholders).

- Protection from creditor action by providing a stay on individual enforcement (Article 6)[4]

This proposed rule is logical as it provides the opportunity for restructuring procedures to be established without the impending pressure of filing for bankruptcy (although, of course, the same result might be achievable through an informal arrangement/standstill). In particular, we welcome the provisions in sections 8 and 9 of Article 6 that an individual creditor should be allowed to ask the court to lift the stay granted to the debtor subject to certain conditions. We query whether an affected creditor should also be able to challenge the initial (up to four month) stay, rather than just its extension (section 9(a) of Article 6 could only apply to an extended stay). An equitable stay should ensure that creditors whose rights are stayed are adequately protected or there is, at least, an assessment of whether the prejudice caused to the individual creditor by the stay is outweighed by the benefit to the restructuring/general body of creditors. A balance must be struck between depriving creditors (especially secured creditors) of their contractual or proprietary rights to enforce or repossess, and allowing the debtor breathing space to restructure.

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

[4] In section 9 there appears to be a typographical error. It should read "...the judicial or administrative authority may decide not to grant the stay of individual enforcement".

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.

With reference to section 8(a), a restructuring plan can be approved despite creditors' objections (see Article 9, section 6, and Article 11). Theoretically, therefore, no proportion of creditors can 'block the adoption of a restructuring plan'. Further drafting may be required. Also, this section should only apply to creditors with an economic interest in the debtor (see further below).

There is also, theoretically, the possibility of the stay expiring during the challenge period (or otherwise when waiting for the court's ratification of the restructuring). It may be appropriate to provide that the stay should remain in place in these circumstances.

- Measures to assist in the day to day continuation of operations (Article 7)

In some EU Member States, there is no obligation to file within a prescribed period (this is the case in the UK for example and it can be contrasted with Germany where this is an obligation). However, directors may be in breach of their statutory/fiduciary duties should they fail to do so. In other words, the obligation to file is different and distinct from the director's obligation to protect creditor interests. Presumably those obligations would continue during the stay and the directors may need to give careful thought to this and/or require express support from creditors (or key creditors) as to their trading strategy during the stay. Changes to the drafting may be needed to accommodate this (and regime differences in other Member States). Systems that set a short prescribed filing period are often problematic and counter-productive. In our opinion, the stay should also relieve the board from other filing obligations. It is also the case that internal rules may impose legal obligations to directors under penalty of criminal liability. Changes to this article are thus necessary to accommodate these factors.

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.

With reference to section 6, this would have the effect of preferring those creditors with debts maturing during the stay period, which may be a matter of chance. This may be objectionable to and create problems for directors who place forward orders during the stay where the stay fails or is lifted before its delivery date.

- Content of restructuring plans (Article 8)

We believe the most equitable approach would require that restructuring plans respect the absolute priority rule, i.e. no junior stakeholder should recover value until more senior classes are repaid in full.

Although there are jurisdictions where restructuring rules have been reasonably successfully applied to SMEs (such as Finland), we question whether, realistically, a typical SME could bear the costs and/or have the technical expertise to prepare and submit a detailed restructuring plan (experience across several EU Member States has shown that this has historically prevented SMEs from promulgating Schemes of Arrangement, because of the time/costs demands).

With reference to section 1(b) of Article 8, 'present value' should be defined (see also Article 13). With reference to section 1(g) of Article 8, our expectation is that the opinion or reasoned statement should be prepared by an insolvency practitioner or other qualified professional. This would add credibility and oversight to the proposed plan.

With reference to section 2 of Article 8, Schemes of Arrangement and Voluntary Arrangements are usually bespoke products in their respective Member States. We suspect that it may be difficult to produce a model that is of any practical assistance to debtors. Similarly, the proposed regime is very similar (in part) to the existing special restructuring proceeding (PER) set forth in the Portuguese Insolvency Code. Thus, to implement another pre-insolvency ruling may add a great deal of confusion to the national law.

- Ability to bind minorities (Article 9)

With reference to section 3 of Article 9, we believe this provision should be re-visisted 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 classes 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.

Section 4 of Article 9 should be made expressly subject to Article 11. We also query whether approval should be subject to a majority in number of creditors (in addition to a majority in value). Laying down a rule based on the majority in terms of number of creditors may be problematic in cases with a large number of small "retail" creditors. Securing a majority vote in such cases may prove cumbersome or unfeasible.

- Confirmation of restructuring plans (Article 10)

Company directors (or the liquidator) should be responsible for selecting the best restructuring plan, as confirmed by a third-party appraiser. Furthermore, formal verification should be sought from the court (i.e. not judging the merit of the plan), and finally, should be approved by a majority of creditors.

We suggest that prior to presenting the final plan, company directors or the liquidator should collect indications of interest from multiple potential buyers (e.g. via means of an auction). After the presentation of the restructuring plan (which should be approved by a majority of the relevant classes of stakeholders whose financial standing will be affected), there should be no further possibility to receive alternative plans (to maximise the likelihood of execution for investors proposing a plan).

- Cross-class cram-down (Article 11)

The principle of a cram-down in Article 11 is something which the private equity industry supports but should be subject to certain conditions. For example, factors such as the percentage of votes involved, the plan being fair and reasonable, and creditors in the dissenting class being no worse off than the other likely alternative are all relevant here. Cram down of dissenting creditors in each class should be subject to a simple majority vote. There should also be a recognition that any such process should allow creditors who have no economic interest in the debtor to be excluded or crammed-down.

Section 1(b) of Article 11 sets out an economic interest test, and this should be referred to consistently throughout (please see our next comments on Article 13 regarding valuation).

- Equity holders (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.

- Valuation by the judicial or administrative authority (Article 13)

This should include references to 'present value' throughout (instead it variously refers to liquidation value, enterprise value, and valuation). The terms 'liquidation value', 'enterprise value', 'valuation', and 'present value' seem to be used interchangeably throughout the Proposal. Of these, 'present value' has been given the most developed meaning and thus, in the interest of consistency, this should be used throughout. That is unless of course it is intended to ascribe a different meaning to each of these distinct terms, in which case these should each be defined to avoid inconsistent interpretation.

- 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?

- Appeals (Article 15)

The possibility of an appeal will affect certainty, and may prevent debtors from implementing the restructuring plan pending any appeal being heard. Clarification is needed as to what happens to the stay pending hearing of the appeal. Clarification is also needed as to how any steps taken in pursuance of the restructuring plan are unwound upon a successful appeal. From a practical standpoint, this Article may create confusion. In Portugal for example, appeals against judicial authorities' decisions are very different from appeals against administrative authorities' decisions. Furthermore, appeals against administrative decisions take much more time to be ruled than any others.

The prospect of financial sanctions against the debtor (who may not have any funds, absent the restructuring) or other creditors who, in good faith, supported the restructuring, is unpalatable. On another note, we fail to see how would it be possible from an economic standpoint for the debtor or creditors to support monetary compensations under Section 4 (a).

- Protection for new financing and interim financing (Article 16)

Any debtor-in-possession finance would, in all probability, have to be unsecured (or heavily subordinated), due the unavailability of surplus collateral. The most likely source of emergency funding would be a debtor's existing lender(s). Therefore, this proposal may be unworkable in practice. The US experience demonstrates the need for heavy court involvement on issues such as valuation of security that is being primed and in respect of adequate protections for those creditors who are primed/lose priority. In Finland, the floating charge gets the benefit of only 50% of any otherwise unpledged assets. Therefore, the priority (which also exists in Finnish restructuring) creates a meaningful supermajority.

- Protection for other restructuring related transactions (Article 17)

We suggest that the buyer should have no obligation over past liabilities (i.e. full protection of the new investor from hidden past liabilities, to buy a "clean" asset).

- Debt-discharge period for entrepreneurs (Article 20)

The 2nd chance for entrepreneurs by having a debt-discharge period is welcome although the maximum allowable period of 3 years is arguably too long. Member States will be given discretion here and may choose a shorter period but having such a shorter period definitively prescribed in the text would be more suitable. Shorter debt-discharge periods encourage entrepreneurs to get back to creating business ventures as opposed to enduring a lengthy and punitive debt-discharge process which discourages entrepreneurs from launching further initiatives after a failed venture.

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. The concept of a "waiting period" is neither necessary nor beneficial to the economy and especially not in the case of honest business failure.

- Directors' duties (Article 18)

The draft directive includes provisions which encourage directors to explore restructuring options by dis-applying mandatory filing requirements (article 18). According to Article 7, Member States shall not require debtors to file for insolvency procedures if the stay period expires without an agreement on a restructuring plan being reached, unless the other conditions for filing laid down by national law are fulfilled. Please see our comments on Article 7 above.

<u>Need for Enhanced Creditor Protection:</u>

The issue of creditor protection needs to be addressed as an appropriate safeguard to the rules mentioned above. As the Proposal currently stands, there is a risk that creditors may not receive an optimal reimbursement of the capital they have injected into the company.

The effect on equity holders in particular is noteworthy. While equity investors get a chance to vote on a restructuring plan, they may be subject to a cross class cram-down. Therefore, even if all the shareholders oppose the restructuring they may still be bound by it, if the restructuring plan would restore the viability of the business. This means for example, that an alteration of share capital may be imposed upon shareholders in a restructuring context (Article 12).

As part of the insolvency process, it is the role of courts to ensure that creditors are not being prejudiced. The fact that a restructuring plan is only endorsed by the court at the end of the negotiation process may unsettle potential investors.

Further Issues for Clarification:

Introducing common minimum standards will not necessarily result in a harmonised approach to insolvency laws. Practitioners and courts operate and apply and interpret legislation in different Member States in different ways. By way of example, one of the key concepts of the European Regulation on Insolvency Proceedings, "centre of main interests" (COMI), has been the subject of different interpretations in the different courts of the Member States. This has resulted in a number of referrals to the European Court of Justice, in order to clarify the meaning of COMI.

As mentioned above, we note that several rules in the Proposal are unclear. In particular, the proposed rules on directors' duties in Article 18 is drafted very loosely and this contrasts with the detailed nature of the other provisions in the text. This may be intentional in order to allow leeway for transposition by Member States but it does give rise to the possibility for widely varying interpretations.

Future Revision:

One notable absence from the text is a rule dealing with insolvency of a group of companies, as opposed to the company-by-company situation. The inclusion of such a rule would make group operations much more efficient. Such an approach would be consistent with that taken in the Recast EIR. We believe this is something which should be addressed in the current Proposal. If this is not possible then the question of insolvency of a group of companies should be expressly included in the review clause of the Directive in Article 33, in order to allow for proper analysis of this topic in the future.

Conclusion:

We would like to re-iterate our support for the Commission's Proposal. We fully share the Commission's goal of creating a Capital Markets Union and reforming EU insolvency law is an integral aspect of this. As outlined in this Position Paper, we are very supportive of the direction of the Proposal but we believe certain safeguards should be put in place in order to provide appropriate checks and balances on these proposed new rules.

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.

For more information, please visit www.investeurope.eu