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EU Commission's proposal for a Directive on the harmonisation of certain aspects of Insolvency Law - Pre-Pack Proceedings available soon in Germany?

With its Draft Directive, the EU Commission is paving the way for a harmonisation of material insolvency law within the European Union. This newsletter is intended to provide an initial overview of which areas are to be harmonised under the Draft Directive and especially what changes and impact the introduction of "pre-pack proceedings" would cause on the existing German insolvency law.

1. Key content of the EU Commission's proposal for a directive on the harmonisation of certain aspects of insolvency law

On 7 December 2022, the EU Commission presented a draft directive on the harmonisation of certain aspects of insolvency law in the Member States (COM(2022) 702 final, so far only available in English, hereafter: "Draft Directive"). If the draft were to become a directive (which can be assumed at present, but experience shows that it will take some time before this happens), this would be an important novelty. Up to now, the EU Insolvency Regulation ("EuInsVO", 2015/848 of 20 May 2015) has mainly addressed questions of insolvency jurisdiction and applicable law (in particular: the concept of the "centre of economic interests" or short "COMI"), i.e. essentially a sort of international procedural and private law for the area of insolvency law. In 2019, the EU took its first steps towards a harmonisation in the area of material restructuring and insolvency law with the Directive establishing preventive restructuring frameworks (2019/1023 of 20 June 2019). Through this directive, Member States were obliged to offer a pre-insolvency restructuring proceedings in their respective national law. With regard to insolvency law in a narrower sense, however - i.e. the matter that in Germany is mainly regulated by the Insolvency Code ("InsO") - the EU had so far not demanded any material minimum harmonisation outside of special areas such as bank and insurance insolvencies. This would now change with the Draft Directive. Among other things, the draft provides for harmonisation in the following areas:

i. Insolvency avoidance (actions)

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ii. Tracing assets belonging to the insolvency estate

iii. Introduction of so-called "pre-pack" proceedings

iv. Director's duty to request the opening of insolvency proceedings and civil liability

v. Simplified rules for winding-up of insolvent micro-enterprises

vi. Creditors' committee

If the Draft Directive essentially passes as currently proposed (it is probably more likely that there will still be substantial changes), we believe that the majority of the intended changes should pose only minor challenges for the German legislator when implementing them into German law. Mandatory insolvency filing deadlines and obligations already exist under German insolvency law, even with shorter deadlines than the maximum provided for in the Draft Directive. German insolvency avoidance rules would probably not have to be turned upside down either, as some of the minimum harmonisation proposals in the Draft Directive seem (very) strongly oriented towards existing German insolvency avoidance rules. The rules on the composition and scope of creditors' committees would have to be adapted in certain respects, but the concept of a "creditors' committee" as such is already firmly established in German insolvency law. Finally, German insolvency law already provides numerous competences and tools for the insolvency administrator, including the tracing of (displaced) assets, which are well tested in practice.

Since the regulations on the simplified winding-up of micro-enterprises shall not be examined in more detail here (although these regulations could have an "explosive impact" for the (German) insolvency administrator scene in particular, as they could significantly reduce the number of insolvency proceedings with a "classic" insolvency administrator), in our assessment the most important change by far from a German perspective is likely to be the introduction of so-called pre-pack proceedings. What the term "pre-pack" proceedings means, what concrete regulations the Draft Directive provides for in this regard and what need for change this is likely to engender for German insolvency law, will be presented and assessed here. In particular, the core question with respect to pre-packs is whether only the already existing "preliminary insolvency proceedings" have to be adapted in order to implement the Draft Directive into German insolvency law or whether a completely new procedure needs to be introduced that precedes the filing of an insolvency petition and thus the preliminary insolvency proceedings.

2. No uniform definition of the term "pre-pack proceeding"

The term "pre-pack" is not a universally defined (legal) term. In Germany it is mainly associated with the English "administration" and partly with the US "Chapter 11"

proceedings. Administration is an English restructuring/insolvency proceeding. An administration can be used to reorganise the legal entity or - and this is much more common in practice - to implement a "transferring restructuring", i.e. to sell the assets of the insolvent company as part of an "asset deal" and thereby save the company as a whole (but without the corporate entity as the legal entity). In order to minimise the "stigma of insolvency" and to avoid a costly going concern by the administrator, (i) the (insolvency) petition and the sale process are prepared simultaneously, (ii) the whole process is discussed in detail with the preferred candidate for the position of administrator and (iii) finally approved and implemented on the day the (insolvency) petition is filed. This whole procedure is then referred to as a "pre-pack".

The Draft Directive uses a very similar description of the term "pre-pack" (page 4, fn. 13):

> *"In pre-pack proceedings, the debtor's business or part thereof is sold as a going concern under a contract that is negotiated confidentially prior to the commencement of an insolvency proceeding under the supervision of a monitor appointed by a court and followed by a brief insolvency proceeding, in which the pre-negotiated sale is formally authorised and executed."*

As the Draft Directive also correctly acknowledges in Recital 25, in practice the biggest hurdle in a "pre-pack" is usually to ensure high standards of competitiveness, transparency and fairness of the sale process and thus to procure the best possible satisfaction of the creditors as a result.

3. What does the Draft Directive specifically provides for with regard to "pre-packs"?

a. Basic framework

The Draft Directive firstly provides that the Member States must establish in their national legal systems "pre-pack" consisting of two consecutive phases ("*preparation phase*" and "*liquidation phase*"). The aim of the preparation phase is to find an appropriate buyer for the debtor's business or parts thereof who can acquire the company free of debts (Article 19 (1) in conjunction with Article 28). The liquidation phase then serves to confirm and implement the "pre-negotiated" sale and the subsequent distribution of the realisation proceeds to the creditors. The Member States can depart from this "basic concept" by providing for a court-led public auction in the liquidation phase (Article 24 (3)). However, this is clearly a kind of "Plan B", which the legislator wants to offer to Member States that have difficulties with the new basic concept. For Germany this "Plan B" concept should be rather irrelevant (see remarks under paragraph **Error! Reference source not found.**).

b. Sales process

The Member States shall ensure that the sale process is carried out with sufficient competitiveness, transparency and fairness and according to market standards during the preparation phase (Article 24 (1)). Recital 26 of the Draft Directive states in this respect that the sale process must comply with the standard rules and practice concerning M&A transactions in the respective Member State, i.e. *inter alia*: Invitation to potential investors to participate, uniform provision of information, opportunity to conduct due diligence, as well as receipt of offers within the framework of a structured procedure.

Typically, this will be a confidential sale process, although the Draft Directive does not consider this to be mandatory. The criteria for the selection of the best bid must correspond to those criteria used to select between competing offers in winding-up proceedings (Article 30). The upmost benchmark is always the "best interest of creditors", which is defined in Article 2 (h) of the Draft Directive as follows: "*No creditor may be worse off under a liquidation in pre-pack proceedings than such a creditor would be if the normal ranking of liquidation priorities were applied in the event of a piecemeal liquidation of the assets*." However, as a key premise, the Draft Directive states that experience shows that a "transferring restructuring" will achieve a better value than a classic piecemeal liquidation of the assets (Recital 24). Therefore, to the extent that only one binding offer is reached in the sale process, it is assumed that this accurately reflects the business market price of the company (Article 24 (2)).

According to the Draft Directive, so-called "*credit bidding*" is to be expressly permitted (Article 33 (3) in conjunction with Recital 30). According to this, secured creditors can bid for the company with their secured claim within the framework of the sales process. However, this should only be possible if the value of the secured claim is significantly below the market value of the company.

Finally, the Draft Directive prescribes special safeguards and precautionary measures if the bidders are "*parties closely related to the debtor*". In this case, the relationship to the debtor must be disclosed to the other parties involved (administrator, court, co-bidders, etc.) and, in particular, other bidders must be given sufficient time to submit an offer (Article 32 (1)). This recognises the fact that such related parties - which would typically be the former shareholders or companies affiliated with them - have a considerable time advantage in the context of due diligence, because they already know the company for sale well. If only parties closely related to the debtor submit a binding offer to purchase, its acceptance is also subject to special safeguards - in this case, compliance with

the best interest of creditors is to be examined more closely (Article 32 (2) in conjunction with Recital 24).

c. Preparation phase and "*monitor*"

The preparation phase itself commences with a court application by the debtor to appoint a so-called "*monitor*" (Article 22), whereby the debtor remains in control of its assets and the day-to-day operation of the business - to German ears, this sounds like classic (provisional) self-administration under German law. The *monitor* has the following tasks:

- Documentation/Reporting of the sale process;
- Justification why the sale process is competitive, transparent, fair and meets market standards;
- Recommendation of the best bidder/bid;
- Justification why, from his point of view, the best bid is not clearly against the best interest of creditors (whereby, due to the above premise regarding the advantageousness of the "transferring restructuring", a settlement calculation is not required in every case; rather, the administrator should only plausibly demonstrate that the pre-pack sale price is not significantly lower than the proceeds that would be generated from a piecemeal liquidation, cf. Recital 24).

d. Liquidation phase / court confirmation

The Draft Directive does not contain details on the transition from the preparation phase to the liquidation phase (e.g. duration of the two phases, time of opening, etc.). It only stipulates that the *monitor* must be appointed as "*insolvency practitioner*" (Article 25) - applying the German terminology, it seems quite likely that the *monitor* will simply be a preliminary insolvency custodian and the insolvency practitioner will be a insolvency custodian in the main self-administration proceedings (and not a classic insolvency administrator) (cf. also Article 2 No. 5 in conjunction with Annex B EuInsVO, where the (preliminary) insolvency custodian is qualified as an insolvency practitioner). The liquidation phase is intended to be an insolvency proceeding within the meaning of EuInsVO (cf. Article 20 (1)), so that the courts of the Member State in which the debtor has its COMI have exclusive international jurisdiction. According to Article 21, these courts shall also have jurisdiction in matters relating to the scope and effects of the sale of the debtor's business or a part thereof in the pre-pack proceedings.

With the opening of the liquidation phase, the confirmation of the "pre-negotiated" sale, which has been examined by the *monitor* and found to be in good order, is supposed to take place. However, this may only be carried out if the *monitor* has

properly fulfilled his duties. The court examines whether this is the case on the basis of an opinion to be issued by the *monitor* (Article 26 (1)). However, the Draft Directive does not contain any specifications or details on how the court has to carry out this important examination in concrete terms. In practice, the details of this examination will be of crucial importance.

e. Accompanying measures

Pre-packs are accompanied by a number of "safeguard measures" designed to ensure the seamless and effective roll-out of the pre-pack proceedings. In detail:

- In the preparation phase, the debtor can benefit from a stay of individual enforcement actions if they may have an adverse effects on the proceedings (Article 23);
- The assignment of executory contracts shall not require the consent of the debtor's contractual counterparty (Article 27 (1) - this would be truly groundbreaking, as currently tripartite contract transfer agreements are required; and
- (Required) Interim financing should be allowed to be satisfied in priority to other creditors and for the purpose of collateralisation from the proceeds of realisation (Article 33 (1)).

Finally, the rights of creditors and shareholders to be heard in connection with the court approval of the pre-pack as well as consent rights/requirements of holders of secured claims to assets that are necessary for the continuation of the day-to-day operations of the debtor's business are to be disregarded under certain conditions (Article 34). Also, appeals against the court's approval or execution of the sale should only have suspensive effects under very narrow conditions (Article 29).

4. Necessity to amend German law and drafting options

German insolvency proceedings have always been structured into two parts, i.e. into "preliminary" insolvency proceedings and the subsequent "main" insolvency proceedings. It is also already common practice that a sale of the company is prepared in the preliminary insolvency proceedings, either in the form of an asset deal or alternatively by way of so-called insolvency plan proceedings (which can encompass an asset or a share deal). Moreover, this is regularly done under the care of a preliminary strong/weak insolvency administrator or, in the case of self-administration proceedings (including protective shield proceedings), a preliminary insolvency custodian; further preliminary creditors' committees play a central role in the decision-making process. Pre-negotiated sales are very often signed immediately after the opening of the main insolvency proceedings (often within a few days). In the

case of insolvency plan proceedings, this usually takes a little bit longer, as the creditor vote and subsequent court confirmation must be awaited. The necessary "objectivity" of the proceedings is ultimately achieved through a structured M&A process or confirmation by the majority of creditors and the insolvency court. In essence, therefore, the "basic structures" envisaged by the Draft Directive are not new to German insolvency law.

In the view expressed here, it should therefore be possible to implement the Draft Directive by making minimal changes to the existing self-administration or protective shield proceedings. Especially, the latter would essentially have to be better tailored to "asset deals". Thus, the preparation phase would correspond to our well-known preliminary insolvency proceedings. This also fits insofar as the support measures envisaged in the Draft Directive are either already contained or can probably be integrated there quite seamlessly.

However, this type of implementation is not completely obvious. Such a type of implementation would entail that the debtor would first have to file an insolvency petition in order to gain access to the preparation phase. Both the description of the term "pre-pack" with the passage "*that is negotiated confidentially* *prior* *to the commencement of an insolvency proceeding*" and the consideration that "insolvency proceedings" otherwise in European legal usage also include the preliminary proceedings after the resolution of measures (see EuInsVO and case law of the European Court of Justice) could indicate that the preparation phase of the "pre-pack" must already commence before an insolvency petition is filed. This would require a completely new procedure that would, to some extent, take its place alongside the German Restructuring Code ("StaRUG"), which is based on the European Restructuring Directive. The preparation phase could then lead directly to insolvency proceedings - in Germany people have become accustomed to this because of the insolvency allowance which is generally paid by the state for three months; but it is by no means mandatory that there must be a three months period of preliminary insolvency proceedings. This would require an exception to the so-called prohibition of prior involvement of the *monitor/insolvency practitioner*. However, we consider it rather unlikely that the German legislator would actually introduce a new "pre-pack" proceedings, since an integration of the pre-pack into preliminary insolvency proceedings seems quite straightforward.

On the other hand, it is indisputable that a provision would have to be included in the German Insolvency Code ("InsO") according to which contractual relationships are also transferred to the acquirer in the case of an "asset deal" - and precisely without the explicit consent of the contractual counterparty. This proposal of the Draft Directive is indeed groundbreaking and could deprive insolvency plan proceedings,

which are the only means to implement "share deals" under German insolvency law, of a key advantage for the future. Apart from that, the current German regulations appear in part even more advantageous than those of the Draft Directive. In particular, the considerable documentation and justification effort that the draft imposes on the *monitor* does not yet exist. Frequently, the parties and the court "make do" with the vote of the (preliminary) creditors' committee on the M&A process and the submitted offers. If the current Draft Directive is implemented, this established process could even be significantly complicated and slowed down as a result.

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