A new shape for restructuring in the EU?

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Rules to create a more harmonised EU-wide approach to restructuring and insolvency were first mooted in the aftermath of the financial crisis of 2008-9. However, it took until June 2019 for the EU Commission to approve the Directive, which finally comes into force this summer.

The key aim of the directive is to introduce more preventive and early intervention measures into restructuring and insolvency laws to give debtors in financial difficulties more breathing space and avoid insolvency where possible. Although this could limit creditors ability to act it is also expected to result in more and quicker out of court procedures, similar to 'pre-pack' (pre-packaged insolvency) schemes often used in the UK.

We welcome the changes, since ultimately recovery rates should be higher if companies can be restructured earlier and kept viable. The harmonisation between EU countries will also be beneficial for lenders with security in several jurisdictions within one transaction, which is often the case in investments we make.

Within our direct lending capability at the international business of Federated Hermes, our strategy from the outset has been to focus on lending in Northern European jurisdictions (Nordic, Germany, UK and the Benelux) where historically recovery rates have been the highest in the Europe and hence offer the highest protection to our investors[1]. So, the key question for us is does the directive necessitate a change in approach?

Short-term impact

Given that these changes will be implemented across countries gradually, we don't expect any sudden deterioration of creditor rights in the historically creditor-friendly countries we lend into. What's more, while new laws following the directive will create new processes and frameworks, in practice business culture and procedural habits will prevail at least in the short term. We therefore think it unlikely that the directive will immediately level out differences between member states. On this basis, we currently see little benefit to our investors in expanding our lending jurisdictions to Southern European countries with a tradition of long restructuring processes.

One positive short-term development, which was set in motion by the Directive and boosted by the Covid-19 pandemic, has been the introduction of UK-style pre-pack regimes across other European jurisdictions. These feature elements of both the US Chapter 11 and UK Scheme of Arrangement, enabling the potential to restructure a business outside of insolvency and out of court, through a scheme that is binding on creditors and shareholders. Both Germany and the Netherlands have recently adopted such schemes, and our lending strategy to those countries of co-operating with local banks and using local rather than default UK law means we are able to benefit from these positive developments.

UK divergence

Having left the EU before the implementation date, there is no obligation for the UK to implement the Directive. In consultation since 2016, and delayed due to Brexit, a new UK bill was finally sped through parliament in 2020, spurred by the impact of the pandemic. The scheme introduces a US-style cross-class cram down and represents the biggest UK reform for 30 years. Other new measures worth mentioning are a standalone moratorium, measures to protect supplies of goods and services and other emergency measures to protect debtors. The reforms give more control and protection to debtors and provide greater flexibility than the scheme of arrangement. Under the new scheme courts can approve a restructuring plan, and override votes against, if it can be proven that affected creditors will be better off than without the plan. The intention is for a more objective and impartial process than with creditors being solely in charge.

A UK scheme of arrangement has long been the preferred route for quick restructuring even for many non-UK Borrowers, as choosing English law as the governing law for contracts has essentially been the only requirement to access the scheme. We expect this preference to remain, mainly based on the existing precedents and tried and tested nature of the scheme, and now further strengthened by the advantages of the recent reforms. Any complications arising from the UK having left the EU are still to be played out. However, as formal recognition treaties are mainly applicable to formal insolvency proceedings, they would not impact the ease and value created by the UK Scheme of arrangements. That said, in the long term we expect the introduction of more reforms in EU member states to weaken the position of the UK scheme as the preferred choice.

A long time coming

The European Commission first decided a harmonised approach to restructuring proceedings was required in the aftermath of the global financial crisis more than a decade ago. An EU directive on concerning restructuring, insolvency and discharge of debt was finally agreed on June 20th, 2019. As part of its capital market union plan, the Directive aims to reduce the build-up of non-performing loans in EU banks, improve returns to creditors and encourage inward investment. It will require member states to make substantial changes to their national restructuring and insolvency laws by 17 July 2021.

1 For the purposes of our strategy, we define Northern Europe as Germany, Benelux, Nordic countries, the UK, Ireland and Austria. Southern Europe is defined as France, Italy, Spain, Greece and Portugal.

Interestingly, alongside the EU's common efforts, changes to laws at a national level across both southern and northern European countries over the last 10 years have independently converged towards each other. This trend suggests a widely-held view across jurisdictions that early intervention will ultimately lead to higher recovery rates for all stakeholders, including creditors.

Key features of the new EU Directive

As the Directive is trying to achieve early intervention, debtors are given access to a preventative restructuring framework when there is a likelihood of insolvency, but the business still has the potential to be viable. The framework set out in the Directive allows debtors to retain control of their assets and the day-to-day operation of their business while it is restructured and returned to viability. This move to a more Chapter 11-style debtor-in-possession process will be a significant change for a number of countries in the EU.

Debtors will be granted a stay of enforcement actions for a period of between four and 12 months, covering both secured and unsecured claims. The stay effectively means that creditors can take no actions and debtors are protected from any opening of insolvency proceedings for the duration of the agreed period. The only exceptions will be where creditors have been granted specific enforcement rights under valid loan documentation.

Restructuring plan processes will have to be set out, and member states will have the power to decide whether or not to exclude equity holders, as well as to set voting percentages up to a maximum of 75%. However, secured and unsecured creditors will always have to be in separate classes.

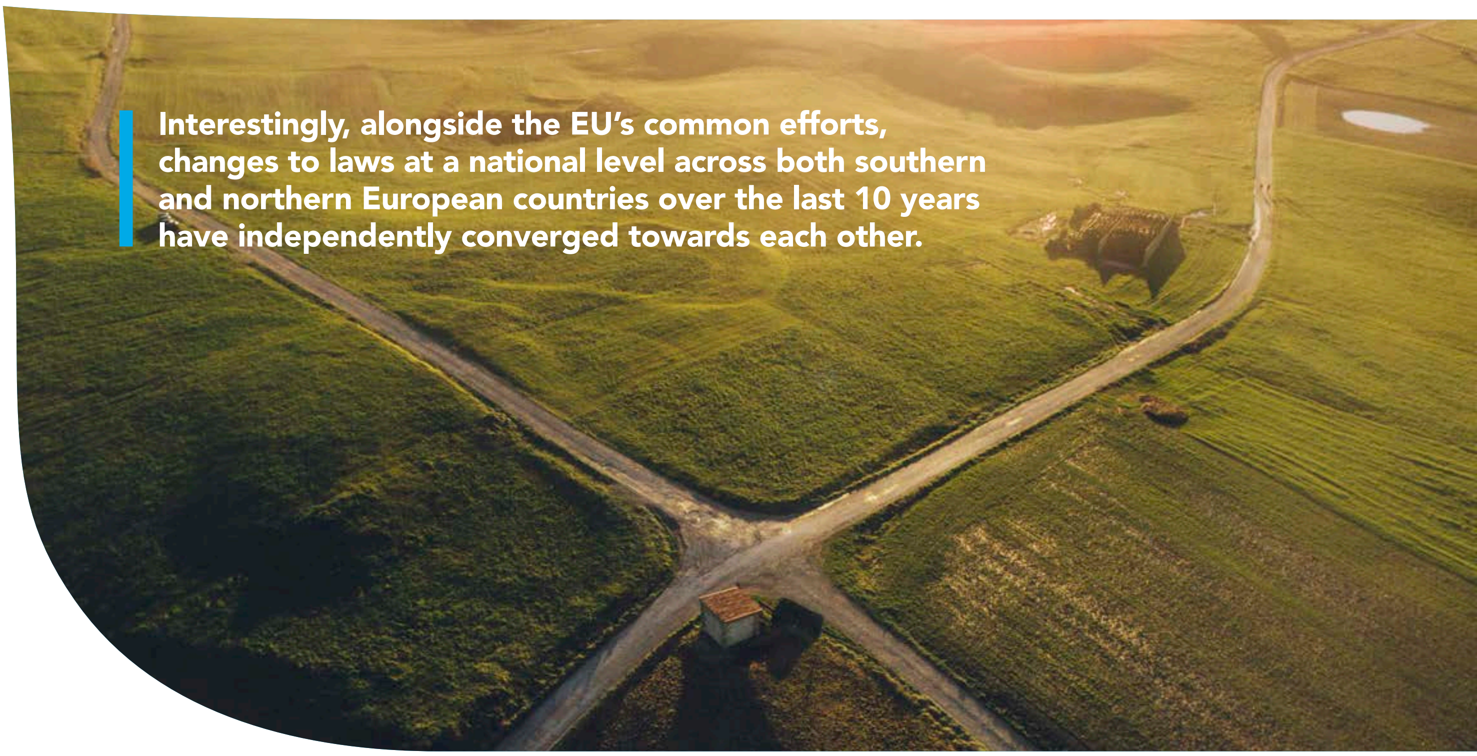
Another new aspect is the introduction of debtor-in-possession (DIP) financing, where protections are given to new and interim financings. Member states can limit the protection to financing provided for a restructuring plan which is approved if desired.

Country-specific implications

In Italy, many of the features of the Directive have already been enacted in a new Business Distress and Insolvency Code, which was approved on 10 January 2019 and went live on 15 August 2020.

French law already has a strong culture of prevention, so many existing procedures already comply with the directive. However, the introduction of requirements for separate classes of creditors and the best interest of creditors test will improve the position for creditors.

One of the most significant impacts of the Directive will be in Germany, which currently does not have pre-insolvency restructuring proceedings set down in law. Although debtor-in-possession proceedings exist, including the principle of stay and protective shield, they can only come into effect after a debtor has filed for insolvency.



A key element of the Federated Hermes Direct Lending strategy is to lend to companies in traditionally creditor-friendly jurisdictions, so those with recovery rates of greater than 80%, shorter restructuring processes and limited court involvement. World bank data regarding recovery rates and the length of insolvency processes show that the Nordic countries, Benelux and Germany score higher than France, Italy and Spain. One can draw the conclusion that in practice more factors impact the effectiveness of the processes than the framework itself. These can include the efficiency of the justice system and the independence of the parties within the process, for example the ability to delay.

The need for effective covenants

As senior lenders our greatest protection remains within the terms negotiated in the loan documentation and our consequent right to enforce our security ahead of other creditors. The pandemic has underscored the need for protections coupled with the ability for lenders to act swiftly when covenants are breached, as the best way to keep a company going and mitigate loss. The EU Directive recognises the benefits of acting on early signs of distress for debtors and creditors alike, and hence can be seen as a strong advocate for covenants in loan documentation.

In transactions where covenants are set very loosely or with major EBITDA adjustments so that covenants have no bite, firms can continue as zombie companies for some time. If a business is allowed to pass the point beyond which meaningful action is coming too late and there is no cash left , there can only be negative repercussions for all stakeholders, from staff and shareholders to creditors. It will be interesting to see if eventual default and recovery rates in the wake of Covid-19 lead more governments to call for stronger covenants in loan documentation.

Country-specific actions in the wake of Covid-19

Given the impact of Covid-19 on companies across industries, sectors and geographies, the importance of legislation which actively helps companies stay afloat where possible has been brought sharply into focus.

Many of the short-term changes EU member states have introduced as a response to Covid-19 have been aimed at providing debtor breathing space ahead of full implementation of laws to enact the EU Directive.

A Dutch scheme, which took effect from 1 January 2021, bears many of the hallmarks of the restructuring plan proceedings set out in the directive. It mixes elements of the UK scheme and the US Chapter 11, as well as incorporating additional benefits for debtors such as a debtor-in-possession process. The scheme also includes a variety of workout options such as debt-to-equity swaps, debt extension and controlled wind downs. A further advantage is the speed at which the scheme can work, with limited court involvement processes wrapped up in three to five weeks. The scheme is potentially available to non-Dutch debtors, given that choice of Dutch law and significant connection to the Netherlands would be sufficient to use the scheme, although significant connection is something of a loose term and may be open to interpretation.

Following in the footsteps of the Dutch scheme, a bill for a German scheme was published in Q4 2020. This includes tools for standalone pre-insolvency proceedings combining elements of a UK scheme of arrangement and US Chapter 11. It will provide greater protection to debtors but also favour creditors above shareholders in terms of directors' duties, which should aid easier restructurings. Like the UK scheme, the German scheme will allow a borrower to pre-negotiate a restructuring plan with creditors, who will be organised into classes based on their seniority within the capital structure, which will then be put to a vote. The plan is approved when 75% of the voting rights in each class are obtained (in the Dutch scheme two-thirds of voting rights in each class are required).

These two schemes open up new jurisdictions for flexible pre-solvency options beyond the UK and could impact the choice of law for many transactions going forward.

In France, legislation has focused on extending timelines such as longer insolvency test periods (a similar approach has been taken in Spain where debtors, who are given longer periods to reach solutions before the courts, would take actions under any liquidation plans). In Italy, meanwhile, a blanket suspension of judicial proceedings was introduced, reforms were postponed and protection under petitions for bankruptcy was extended by six months for pending cases. Almost inevitably such processes will therefore now take much longer, and the sort of quick procedures creditors would wish for are very unlikely to become the norm within the next few years. For Federated Hermes, these moves reconfirm our strategy not to lend into those jurisdictions.

In many other countries, including the Northern European jurisdictions, no legislative changes to the Bankruptcy Acts have been made so far. Instead, support packages offered to companies have been far reaching in terms of financial support and quick to access. In addition, there has been an extension to filing deadlines (as in Germany where the strict filing requirements for directors have been loosened until 31 March 2021 to allow more breathing space to allow for any problems that may arise due to Covid-19).

Safeguarding creditors rights

While these developments don't have a direct impact on our lending decisions, as senior lenders it's important for us to understand and monitor trends in insolvency processes across the countries where we invest.

As argued before, recovery rates for lenders are highest when action is taken most swiftly. With that in mind, moves to safeguard companies and employment with early restructurings which avoid the need for insolvency proceedings should be welcomed by senior lenders. Having said that, giving back more control to debtors reinforces the importance of robust loan terms which protect senior lenders. Our firm belief is that lenders should continue to hold firm on maintaining covenants and other protection mechanisms even when faced with harsh competition for deals.

The Covid-19 crisis has highlighted this issue, with loan agreements signed under so-called 'cov-lite' (covenant-lite) terms which leave lenders unable to take any action despite borrower performance deteriorating. The problem is further exacerbated by Covid-related EBITDA adjustments that if accepted by lenders could disguise more long-term structural problems unrelated to the pandemic.

Cov-lite lending goes against the spirit of the EU Insolvency Directive, which relies on identifying signs of distress early enough to take preventative measures and avoid a company becoming insolvent. We are hopeful that following the introduction of the Directive we could see more opposition to cov-lite structures which offer little control. Federated Hermes will continue to hold firm on our strategy of tight loan terms to protect our investors, including protecting creditor ranking. This could become increasingly important if governments, as tax creditors or creditors through pandemic-related support measures, are given priority over senior lenders – a move which has recently been under discussion in the UK.

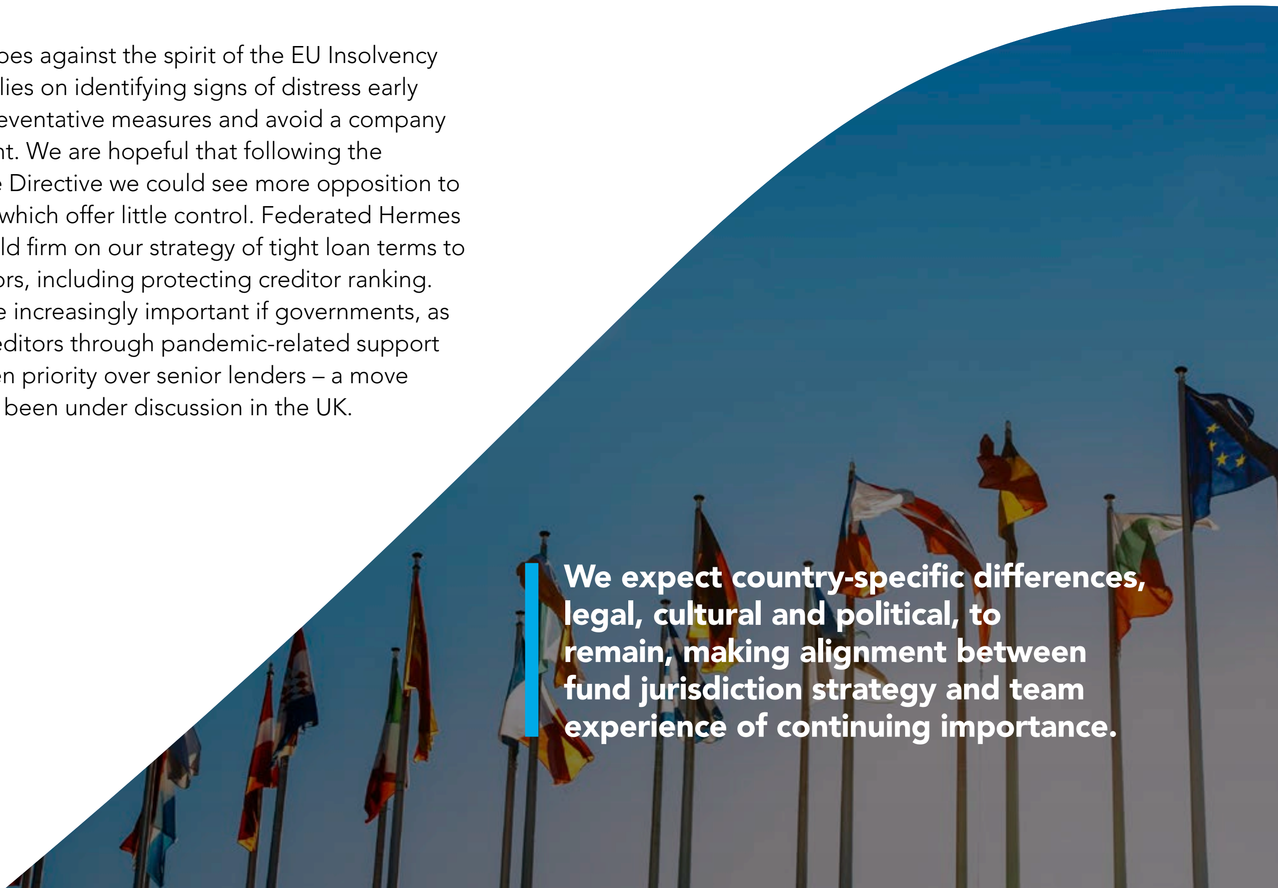
Where you lend to still matters

As we have seen, EU insolvency and restructuring trends are moving towards more debtor-friendly procedures. These aim to protect companies, directors and employees from insolvency through early intervention and a subsequently higher recovery rate. However, the consensus amongst the legal profession is that changes in individual countries will be gradual and slow regardless of the theoretical convergence between countries driven by the EU Directive.

With this in mind, we will continue our strategy of lending to Northern European jurisdictions including Germany and the Netherlands which have a strong heritage of creditor-friendly processes. This will allow us to benefit from the new schemes these countries have introduced, which though debtor friendly in their essence, are based on quicker procedures with less court involvement. We anticipate such schemes should lead to higher recovery rates for creditors overall.

Our expertise

The international business of Federated Hermes' Direct Lending team has a wealth of experience and a deep understanding of restructuring deals from different jurisdictions within the EU and beyond. Team members' experience and familiarity with specific legal systems and their predictability is another important element in the choices of jurisdiction we make in relation to our funds. As with many EU directives, greater alignment between countries will certainly be positive in terms of cross-border transactions. However, we expect country-specific differences, legal, cultural and political, to remain, making alignment between fund jurisdiction strategy and team experience of continuing importance.



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