European Financial
Markets Lawyers Group

- The Vice Chairman -

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30 March 2017

Dear Sirs,
Dear Madam,

European Commission Proposal for a Directive on Preventive Restructuring Frameworks and Second Chance of 22 November 2016 – COM(2016) 723 final

The European Financial Markets Lawyers Group (EFMLG)[1] welcomes and supports the European Commission's initiative on developing a Capital Markets Union (CMU) which medium to long-term will strengthen Europe's economy. Removing barriers to cross-border investment and lowering the costs of funding will create stronger and more efficient capital markets, which create new potential for growth. One important "building block" of the CMU is the current Commission proposal for a new Directive on preventive restructuring framework and second chance (the "Directive"), which will increase the convergence of the insolvency and restructuring laws of the Member States and remove existing legal uncertainty.

The EFMLG followed the initial work on the Directive starting January 2016 and the public consultation of stakeholder groups, which followed in March and during the summer of 2016, with great interest. We share the overall positive response to content and approach of the Directive, including the proposal for minimum harmonized rules. However, we also support the request for a better balance of stakeholders' interest and safeguards that mitigate unintended consequences especially for the banking industry.

1. Articles 1 and 2 of the Directive. Concepts and Definitions

The Directive uses some concepts and definitions that are unclear and that might prove inoperative. One example is the concept of *"likelihood of insolvency"*, which, in the absence of a definition, will most

[1] The European Financial Market Lawyers Group (EFMLG) is a group of senior legal experts from the EU banking sector dedicated to analysing and undertaking initiatives intended to foster the harmonisation of laws and market practices and facilitate the integration of financial markets in Europe following the introduction of the euro. The members of the Group are selected, on the basis of their personal experience, amongst lawyers of those credit institutions based in the EU which are most active in the European financial markets, namely the banks of the Euribor and Eonia panels. More information about the EFMLG and its activities is available on its website at *www.efmlg.org*.

certainly be construed in different ways between Member States and even within a Member State, bringing about uncertainty on the assessment that creditors are able to make in relation to the last stage of their investment's life-cycle.

Another example is the concept of *"strong likelihood that a restructuring plan will be adopted"*, which, unless further detailed or clarified, will be hardly operative in practical terms, because it is very hard to assess.

Need for clarification is given for the definition of *"executory contracts"*, which is relevant for the stay of individual enforcement actions and which should not include any undrawn, overdraft or revolving lines of credits and offers for financing that have not been used at the time of the stay as it may lead to the debtor incurring new debts at a time when insolvency is already likely. Further clarification is also needed for the grounds and reach of the *"absolute priority rule"*.

Last but not least, all references in the Directive to *"unfair"*, *"unfairly"*, etc. should be replaced by references to *"proportionate"*, *"proportionally"*, etc. as the principle of proportionality has a more practical and operational track-record across EU jurisdictions, and it is more objective than the principle of fairness, whose practical applicability in the context of the proposal of Directive is rather unclear and much more complex.

2. Article 4(4) of the Directive. Creditors Ability to Initiate Restructuring Proceedings

Preventive restructuring frameworks shall be available on the application of debtors.

Member States shall determine whether the said frameworks should also be available on the application of creditors with the agreement or subsequent consent of debtors. This possibility should not be imposed by the Directive but rather left to the Member States, as in some countries there is a debtor's responsibility regime that could be affected in case the creditors apply for the restructuring framework.

It can happen, however, that the creditors are better placed to assess whether the debtor is viable and they know the functioning and commercial relationships of the debtor. Moreover, in principle, creditors want a viable debtor as much as the debtor itself. Nonetheless, to prevent abuses, the application of creditors should occur in agreement with or with the subsequent consent of debtors.

That is why Member States could decide to grant creditors the right of proposing a restructuring plan to the debtor. Finally, any plan approved by the creditors when they were the ones initiating the proceedings, should be validated by the court. This approach would strengthen the incentive for creditors to try to save viable businesses rather than file applications for insolvency procedures.

Accordingly, we propose the following wording: *"Preventive restructuring frameworks shall be available on the application of debtors.* ***Member States shall determine whether*** *the said frameworks should also be available on the application of creditors with the agreement or subsequent consent of debtors"*.

3. Article 5(1) of the Directive. Restrictions to the Debtor's Operation and Management

The fact that the debtor remains in control of its assets and the operation of its business may prove fruitful for all stakeholders, as the debtor is the one who best knows the operations, avoiding any efficiency and productivity losses related with the transitions in the management of the business. Nonetheless, the fact that the debtor is in financial distress may well be the consequence of poor management decisions. Furthermore, there is also the risk of dissipation of key assets in the debtor's estate.

Therefore, although we understand that, in principle, the debtor should remain in control of its assets and business operation (even more because the restructuring proceedings are meant to be a temporary situation in the business' life-cycle), in order to achieve a fair balance between the interests of the debtor and the legitimate concerns and interests of the creditors, it should be expressly set out that (a) the debtor actions are restricted to the ordinary management of its assets and the operation of its business in the ordinary course of business, and that (b) the debtor must seek court and creditors approval for any actions that fall outside that scope of action.

4. Article 6(4) and (7) of the Directive. Up to Four Months or Twelve Months Stay

The consequence of the proposed stay of individual enforcement actions (Article 4 (1) of the Directive) is that creditors will not be able to withhold performance or terminate, accelerate or in any other way modify executory contracts (Article 7(4) and (5) of the Directive). The maximum period of four months proposed for the first stay and the maximum period of twelve months for extended or renewed stays conflict with the regulatory framework established through Regulation (EU) No 575/2013 (CRR) and Regulation (EU) No 648/2012 (EMIR).

We took note of Article 31 of the Directive, which provides that the Directive *"...shall be without prejudice..."* to certain specified European acts, which includes the Directive 2002/47/EC (FCD), the Directive 2002/47/EC (SFD) and the above mentioned EMIR. However, although we welcome the implicit safeguards provided by Article 31 of the Directive, they are not broad enough. The level of protection provided by Article 31 of the Directive should be the same as the one that is given under Directive 2014/59/EU (BRRD). Further, it is unclear how the reference to the EMIR is to be construed.

a. Shortfall in Protection

The personal scope of the Directive 2002/47/EC (FCD) is limited. Article 1(3) FCD authorizes Member States to exclude non-financial corporates and entrepreneurs from the scope of the FCD. As reported by the Commission in 2006[2], some Member States considered the possibility of applying the Article 1(3)-opt out. Finally, Austria decided to apply a full opt-out, whereas other Member States like Czech Republic, Slovenia, Sweden, France and Germany applied at least a partial opt-out. The entities to which the opt-out right applies are defined in Article 1(2)(e) FCD. They are the same entities to which the Directive applies. Hence, it would be possible for Member States to reduce the protection given under Article 31 of the Directive, by simply using then opt-out under Article 1(3) FCD (an even if it is just for purposes of the Directive).

Further, the FCD (as amended by Directive 2009/44/EC) protects only financial collateral arrangements where the collateral consists of cash, financial instruments or credit claims (Article 1(4)(a) FCD). Other forms of collateral, like immovable property, receivable linked to commercial transactions, or physical collateral (like leased assets) are not protected. Close-out netting provisions (as defined in Article 2(1)(n) of the FCD) are only covered by the FCD if they form part of financial collateral arrangement. Hence, close-out netting provisions in master agreements for repurchase transactions and securities lending transactions (like the Global Master Repurchase Agreement or the Global Master Securities Lending Agreement) are covered whereas master agreements for derivatives (like the ISDA Master Agreements or the European Master Agreement) are only covered if they are supplemented by a credit support annex.

The above-mentioned shortfall in protection has considerable impact on the credit institution and investment firms that use collateral and contractual netting agreements for risk mitigating purposes.

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[2] Report from the Commission to the European Parliament and the Council - Evaluation Report on the Financial Collateral Arrangements Directive (2002/47/EC) dated 20 December 2006 (COM(2006) 833 final).

The regulatory recognition of credit risk mitigation techniques requires institutions to apply them upon default and in a "timely manner" (see only Articles 194(4) CRR for funded credit protection, Article 207(4)(a) CRR for the liquidation of financial collateral, and Articles 213(1)(c)(iii) and 215(1)(a) CRR for unfunded credit protection including guarantees). A "default" is defined as the obligor being past due for more than 90 days (see Article 178(1)(b) CRR). A stay of payment obligations for more than 90 days would mean that all risk mitigation techniques provided by debtors (other than those exempted under Article 1(2) of the Directive) would lose its eligibility. This would also impact obligors, even those not covered by the Directive, that assign receivables stemming from its commercial transactions as collateral, because the financing institution would not be able to collect under those receivables in a timely fashion (as required under Article 209(2)(e) CRR). The de-recognition of credit risk mitigation technique would result in a substantial increase in regulatory capital requirements Union-wide. It would at the least increase the costs of lending, which conflicts with the target of the CMU. The maximum period proposed by Article 6(4) of the Directive should therefore be reduced to 90 days (or three months).

The maximum period should be further reduced for financial contracts like derivatives, repurchase, securities lending and margin lending transactions ("Financial Contracts")[3]. It should be not more than 2 days (or 48hours) as provided for under Article 69 to 71 Directive 2014/59/EU (BRRD). Financial Contracts expose counterparties to considerable market risk and associated potential future counterparty credit risk (potential future exposure, PFE). Important instruments for mitigating counterparty credit risk are contractual netting and margin arrangements. Article 11(3) of the Regulation (EU) No 648/2012 (EMIR) and Article 2(2) of the associated Regulation (EU) 2016/2251 require all counterparties that are subject to the EMIR clearing requirement to use contractual netting and margin arrangements for its uncleared OTC derivatives.

The above mentioned Article 69 to 71 of the Directive 2014/59/EU are based on the Financial Stability Board's (FSB) Key Attributes of Effective Resolution Regimes of 4 November 2011 (recast 15 October 2014, the "Key Attributes"), which have been implemented by other FSB members (like the United States of America) as well. The Key Attributes recognize the importance of contractual netting and margin arrangements for the risk management of counterparties and clarify (under I-Annex 5 on page 51) that the short-term stay proposed by the Key Attributes should not affect other rights of counterparties under its contractual netting and margin arrangements: *"If a firm in resolution fails to meet any margin, collateral or settlement obligations that arise under a financial contract or as a result of the firm's membership or participation in an FMI, its counterparty or the FMI would have the immediate right to exercise an early termination right against the firm in resolution."* This consideration should also apply to other resolution regimes like the one established through the Directive.

Articles 206 and 296 CRR govern the regulatory recognition of contractual netting. They require credit institution and investment firms to ensure that the contractual netting agreement and the termination and close-out of Financial Contracts supported by them are operative upon the event of default and in a timely fashion. More explicit are the final rules of the Office of the Comptroller of the Currency (OCC) and the Board of Governors of the Federal Reserve System on the Regulatory Capital Rules (U.S. Basel III)[4], as amended by the Interim Final Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions5, which govern the regulatory recognition of contractual netting agreements used by U.S. Banks. The definition of "qualifying master netting agreement" in §_.2 of U.S. Basel III clarifies that *"...any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions, other than in receivership, conservatorship, resolution under the Federal Deposit*

[3] The term "financial contracts" is defined in Article 2(1) point 100 of the Directive 2014/59/EU of 15 May 2014 (BRRD).

[4] 78 FR 62018 (11 October 2013).

[5] 79 FR 249 (31 December 2014).

Insurance Act, Title II of the Dodd-Frank Act, or under any similar insolvency law applicable to GSEs". It is therefore likely that a stay of more than 2 days (or 48hours) will impact on the recognition of regulatory netting to the effect that credit institutions and investment firms would have to calculate their capital requirements on a gross basis.

A stay of longer than 2 days (or 48hours) would also impact on the risk management procedures and margin requirements imposed under Article 11(3) EMIR and Regulation (EU) 2016/2251 as it would increase the margin period of risk, i.e., the period of time during which the counterparty sees itself exposed to market risk. The amount of initial margin required for covering a longer margin period of risk, would increase exorbitantly.

Again, we took note of Article 31 of the Directive, but the protection provided by the reference to the Directive 2002/47/EC (FCD) is limited to financial collateral (i.e., covers not all types of collateral that institutions use for risk mitigation purposes) and is dependent on the Member States right to opt-out. The preferred solution is the approach taken by the BRRD which specifies clear exemptions for netting arrangement, set-off arrangements and security interests (including but not limited to those protected under the FCD).

b. Reference to EMIR

The reference to Regulation (EU) No 648/2012 (EMIR) is not clear. Although there is a clear conflict in policies, EMIR and the supplementing Regulation (EU) 2016/2251 do not provide for any protection or safeguard that could conflict with stays provided under the Directive. Contrary, as indicated by Article 31 Regulation (EU) 2016/2251, the European legislator assumed that close-out netting and financial collateral is legally enforceable in all Member States[6]. Provided the above explicit exemptions (for netting arrangement, set-off arrangements and security interests) are introduced, the reference to EMIR could be deleted from Article 31 of the Directive.

5. Articles 6(5) and Article 10 of the Directive. Extending and Revoking Stays

The judicial or administrative authorities' right to extend the stay of individual enforcement actions should not apply to Financial Contracts and should not last longer than 90 days (see above). We propose to include an additional condition in Article 6(5): *"and (c) creditors representing more than two thirds of the total aggregate value of credits support the extension of the stay."*

6. Article 7(1) and (3) of the Directive. Illiquid Debtor

A debtor becoming unable to pay its debt should not end the stay of individual enforcement actions. On a separate matter, further to the judicial and administrative assessment referred to in Article 7(3), the creditors should also be consulted and be given the opportunity to grant new money to the debtor (benefiting from the protection set out in Article 16), thus ending the situation of illiquidity.

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[6] Article 31 of the Commission Delegated Regulation (EU) 2016/2251 introduces specific rules for OTC derivatives with counterparties in third countries where legal enforceability of netting agreements or collateral protection cannot be ensured. There is no equivalent provision for counterparties in Member States.

7. Article 7(4) and (5) of the Directive. Stay of Termination Rights

As further outlined above, it is important to provide for sufficient safeguards for Financial Contracts and associated contractual netting and margin arrangements.

As discussed under Point 5 above, in the context of Article 31 of the Directive, a complete exemption is required for financial collateral arrangements with close-out netting provisions in the meaning of Article 2(1)(a) and (n) of the Directive 2002/47/EC. This includes all repurchase, securities lending and margin lending transactions (together the "securities financing transactions" or "SFT") governed by a standard master agreement. The exemption would also cover derivatives transactions documented under a standard aster agreement with collateral support annex.

The preferred safeguard for other Financial Contracts and associated netting arrangements would be to limit the maximum period for a stay of individual enforcement actions to 2 days (or 48hours) (see above under Point 5). Alternatively, if the maximum period specified in Article 6(4) and (7) of the Directive is 90 days, the Directive should use the condition specified in Article 68(3) of the BRRD (*"provided that the substantive obligations under the contract, including payment and delivery obligations, and provision of collateral, continue to be performed"*). This would ensure that upon a debtor's failure to pay or to post variation margin the counterparty could still exercise its contractual right to terminate and to close-out affected Financial Contracts.

8. Article 9 of the Directive. Credits of State

In some Member States, the credits of State entities cannot be affected by restructuring plans due to legal or customary restrictions. Nonetheless, such State entities have their voting rights unaffected. This framework leads sometimes to the uncooperative behaviour of such State entities, resulting, for instance, in the non-approval of restructuring plans agreed between the remaining creditors and a viable debtor, because of the difficulties to achieve the necessary voting majorities, if the votes of the State entities are considered. Therefore, those credits should form a separate class, which should be treated separately, and such State entities should not have voting rights in relation to the restructuring plan.

9. Article 11 of the Directive. Cross-Class Cram-Down

Cross-class cram-down should only be applied top down with clear majorities within each class of creditors and an overall majority. As regards Article 11(1)(b), we propose to rephrase the wording as follows: "*(b) has been approved by a majority of creditors*." Article 11(2) should read: "*Member States <u>shall put in place provisions defining the required majority and the numbers</u> of affected classes required to approve the plan laid down in point (b) of paragraph (1)*".

10. Article 13 of the Directive. Valuations

With respect to Article 13(2) of the Directive, in relation with the need of Valuations, the enterprise value should be determined, in our opinion, by the judicial or administrative authority on the basis of the value of the enterprise as a going concern only when a restructuring plan is challenged and such challenge affects the value of the company considered in the restructuring plan. We believe that this is the spirit of the actual wording of the Directive, but clarifying it at this stage would avoid subsequent problems.

11. Article 15(4)b of the Directive. Compensation Payments

Article 15(4)b of the Directive may have a pernicious effect. On the one hand, it might discourage creditors from voting in favour of the restructuring plan. Indeed, at the risk of having to pay a compensation to the dissenting creditors, the creditors will be extremely cautious when voting the plan (which is contrary to the principles underlying restructuring proceedings). On the other hand, for certain types of creditors (lower ranking creditors) this regime may even be construed as an incentive to voting against the plan and litigating afterwards.

Additionally, taking into account that the debtor is in financial distress, it is unrealistic to expect that the debtor will be able to compensate the dissenting creditors (thus the burden will be likely borne mostly by the creditors which voted in favour of the plan). Also, it is not clear whether the debtor and the creditors which voted in favour of the plan are heard for the purposes of the judicial decision awarding the compensation to the dissenting creditors. Therefore, Article 15(4)(b) should be deleted, in our view.

12. Article 31 of the Directive. Relationship with Other Acts

Article 31 indicates that the provisions of the Directive, including Article 7 of the Directive on the consequences of a stay, are without prejudice to certain specified European acts, which includes the Directive 2002/47/EC (FCD), the Directive 2002/47/EC (SFD) and the Regulation (EU) No 648/2012 (EMIR). As outlined above, Article 31 of the Directive should be supplemented by clear exemptions for netting arrangement, set-off arrangements and security interests that follow the techniques used in Directive 2014/59/EU (BRRD).

Yours faithfully,

Holger Hartenfels