Submission of the Insolvency Service of Ireland on COM (2016) 723, an EU Commission proposal for a Directive to increase the efficiency of restructuring, insolvency and discharge procedures

1 Introduction

The Insolvency Service of Ireland (ISI) is the statutory body established under the Personal Insolvency Act 2012 (the Act). It is responsible for the administration of bankruptcy estates and the operation of newly introduced alternative solutions to bankruptcy.

The Act contains a definition of 'insolvent' in relation to a debtor, namely, that the debtor is unable to pay his or her debts in full as they fall due. This is an important definition since it delineates the categories of debtors who may avail of the debt solutions. The Act does not distinguish between entrepreneurs and ordinary consumer debtors.

The Act sets out a number of roles for the ISI that include contributing to the development of policy in the area of personal insolvency. In furtherance of this role, the ISI sets out below its views on the draft Directive by reference to its Titles.

2 General

The timing of discussion on a draft Directive coincides with the coming into force later in 2017 of the Recast Regulation (EU) 2015/848 on insolvency proceedings which also includes debtors who are natural or legal persons, a trader or an individual and seeks to extend proceeding to promote the rescue of economically viable but distressed businesses and give a second chance to entrepreneurs. Many of these areas are covered in the draft Directive.

3 Title I – General provisions

1. The draft Directive distinguishes between debtors and entrepreneurs and states that the draft Directive shall not apply to natural persons who are not entrepreneurs.

2. Member States may (future tense) however extend the discharge provisions (Title III) to such natural persons who are not entrepreneurs. The Act deals solely with debtors who are natural persons without distinguishing between entrepreneur and non-entrepreneur. It is unclear if the pre-existence of the Act, which does not require an extension (future tense) under Article 1, falls within the ambit of the draft Directive.

3. Insolvency is not defined in the draft Directive. It is imperative that a definition of insolvency is included for debtor clarity on the application of the provisions of the draft Directive.

4. The 'absolute priority rule' is not contained in the Act. Imposing an absolute priority rule on the debt solutions in the Act could change the nature of personal insolvency practitioner/creditor negotiations that currently lead to debt solutions.

5. The definition of an over-indebted entrepreneur as 'a natural person exercising a trade, business, craft or profession, who is otherwise than temporarily unable to pay his debts as they fall due' aligns with the definition of insolvent in the Act, but the draft Directive does not include a similar definition for an over-indebted (by extension insolvent) person who is not an entrepreneur. While the draft Directive tries to draw a distinction between the entrepreneur debts of a natural person and the other debts of a natural person, this distinction does not currently apply, in Ireland. For example, at present a sole trader solicitor (a non-corporate SME in the draft Directive terms) will be personally liable for <u>both</u> the debts of his solicitor's practice <u>and</u> all other debts. If that solicitor were to seek a debt solution under the Act all debts, without distinction between entrepreneurial and other debts, would be included. The draft Directive definition, if implemented, would lead to an additional categorisation of personal debts that could have implications beyond the current context.

6. The draft Directive imposes an obligation on Member States to provide debtors with early warning signs which can signal to the debtor or entrepreneur the need to act as a matter of urgency. The wording in the draft Directive is loose and could be read as extending the role of the ISI into areas for which it is not currently responsible.

4 Title II - Preventive restructuring frameworks

1. The draft Directive proposes introducing pre-insolvency examinership-type provisions for non-corporate entrepreneurs along the lines of those for corporates. A prerequisite for pre-insolvency is that the entrepreneur has a likelihood of insolvency but is not yet insolvent. Therefore, Title II appears to apply to a debtor prior to that debtor becoming

insolvent within the meaning of the Act. Presently, the Act does not cater for pre-insolvency and the ISI has no remit in relation to pre-insolvency discussions or arrangements.

2. The point has been made above that the entrepreneurial debts of a sole trader are co-mingled with personal debts and that distinguishing them has implications, some of which may touch on constitutional property rights. For example, currently a lending institution which advances a loan to an entrepreneur sole trader would have full recourse against both entrepreneurial and non-entrepreneurial assets of that sole trader in the event of default. The draft Directive may restrict this right of recourse thereby affecting the current property rights of the lending institution.

3. The point has already been made that the ISI has no remit in relation to debtors pre-insolvency. However, in the event that the draft Directive brings pre-insolvency with its remit the ISI offers the following observations in relation to Title II.

    a. Article 4 1. obliges Member States to ensure that, where there is a likelihood of insolvency, debtors (generic term) have a framework to restructure their debts <u>or</u> business. This suggests that Title II applies to personal debts as well as business debts although the Title seems to concentrate on business debts.

    b. Articles 4 and 5 oblige Member States to limit the involvement of a judicial or administrative authority in a manner that is necessary and proportionate so that the rights of any affected parties are safeguarded. This is very loosely drafted and the words ‘necessary’ and ‘proportionate’ could be the subject of a range of interpretations.

    c. Article 6 provides for a stay on enforcement actions to the extent necessary to support restructuring negotiations. The Act has a similar stay for a 70-day period which can be extended by a court for a further 40 days, a total period that is less than 4 months; this time period is broadly in line with corporate examinership. The draft Directive provides for an initial stay for a maximum period of 4 months but provides that with extensions and renewals this could extend up to 12 months. It is difficult to comprehend how such a stay on enforcement for such a long period of time would not, by definition, prejudice the rights or interests of affected parties contrary to what is set out as an aim in Article 6 5. (b).

    d. Article 6 2. provides that a stay of individual enforcement actions may be general, covering all creditors, or limited, covering one or more individual creditors. It is difficult to envisage circumstances where a stay would be limited to one or more individual creditors in a manner that would not prejudice the position of these creditors viz-a-viz the other creditors.

    e. Article 6 9. provides that a creditor may request the lifting of a stay if prejudice arises but the creditor would, presumably have to incur legal costs, to assert the prejudice.

f. Article 7 is confused and must be read bearing in mind the distinction between the entrepreneur debts of a natural person and the other debts of a natural person referred to above. Article 7 1. provides that where a debtor becomes insolvent during the preventive restructuring period the debtor's insolvency obligations shall be suspended. Article 7 3. then provides for a derogation from Article 7 1. where the debtor becomes illiquid and therefore unable to pay his debts as they fall due during the stay period. These provisions seem to anticipate that an entrepreneur could become insolvent in relation to his non-entrepreneurial debts during the stay period for resolving his entrepreneurial debts and that the two insolvencies would not impinge on each other. These provisions require significant amplification so that national laws can be amended to conform.

g. Articles 9 through 11, when read together, appear to have a contradiction which may simply be a drafting error. Article 11 provides that one of the three conditions necessary for judicial or administrative confirmation of a restructuring plan is that the plan fulfils the conditions of Article 10 2. Article 10 2. provides that the restructuring plan has been adopted in accordance with Article 9. Article 9 refers to the adoption of a restructuring plan. These three circular references mean that it is unclear as to the individual status and priority of each of the Articles – this requires explicit clarification.

h. Article 9 4. provides that Member States shall lay down the required majorities for the adoption of a restructuring plan which shall not be higher than 75% of a class or interest in a class. The application of different percentages between Member States has the potential to lead to entrepreneurs seeking to establish their Centre of Main Interests (COMI) in Member States with the lower percentages.

i. Article 10 dealing with the confirmation of restructuring plans by a judicial or administrative authority accords with the ethos of the Act, namely, where creditor property rights are affected court intervention is necessary. Article 10 2. (b) and (c) may conflict or one may be unnecessary. Subsection (b) obliges the judicial or administrative authority to ensure that the restructuring plan complies with the best interests of creditors test while (c) obliges the judicial or administrative authority to ensure that any new finance to implement the restructuring plan is necessary and does not unfairly prejudice the interests of creditors. The double reference to creditor interests requires amplification.

j. Article 11 which is <u>permissive</u> provides that a restructuring plan that is not approved by each and every class of creditor may be confirmed by a judicial or administrative authority and become binding when three conditions are met. The first two conditions are similar to provisions in the Act. The third condition, the absolute priority rule, is not in the Act or examinership legislation. In general, the absolute priority rule would mean that a higher class of creditor, such as a secured creditor, who dissents from a restructuring plan must ultimately be paid in full before a lower class of creditor, such as an unsecured trade creditor, could receive any dividend. The imposition of the absolute priority rule on the Act would change the nature of creditor engagement with personal insolvency practitioners and could lead to a secured creditor absenting itself from the arrangement process in the knowledge that, if a court approved the arrangement, the absolute priority rule would mean the secured creditor would receive the entire dividend ahead of all unsecured creditors.

k. Articles 12 through 15 amplify the previous sections in Chapter 3. Article 14 2. is very broad and requires further clarification since it provides that creditors who are not involved in the adoption of a restructuring plan shall not be affected by the plan.

l. Article 13 introduces enterprise valuation that is subject to judicial or administrative oversight and mentions properly qualified experts without specifying the nature or qualifications of such experts. The primary purpose of the valuation is to arrive at an enterprise value for the purposes of applying the absolute priority rule. Given the likely level of oversight of the cross-class cram-down which relies on the absolute priority rule the oversight will focus as much on both the credentials of the expert and the enterprise value arrived at.

m. Articles 16 and 17 deal with new finance and protections for new and interim financing. New and interim finances are not catered for in the insolvency solutions provided for in the Act or in Bankruptcy.

n. Article 18 obliges Member States to lay down rules for directors where there is a likelihood of insolvency. Article 18 (c) obliges directors to take reasonable steps to avoid insolvency. It is unclear if this refers to reasonable steps to avoid insolvency of the director's corporate entity or the director's personal insolvency. Directors have entered personal insolvency arrangements where the reason for their insolvency was personal guarantees in relation to corporates of which they were directors. The manner in which this Article must be transposed into national law and its impact on the Act requires clarification.

5 Title III - Second chance for entrepreneurs

The Act sets out the current second chance provisions for personal insolvent debtors. It is assumed that the draft Directive, if it comes into force as it is, will require changes to the Act.

1. Article 20 of the draft Directive will oblige Ireland to reduce the maximum term of an insolvency arrangement from 6 years to 3 years. This reduction in term will reduce the period during which an insolvent debtor makes payments under an arrangement to his creditors and may result in a reduction in the number of arrangements that creditors are willing to enter into.

2. Article 23 relies again on the distinction between the entrepreneur debts of a natural person and the other debts of a natural person and provides that the discharge period for both may run in tandem, or not, if a Member States chooses to derogate. The interaction between the Act and the Title II provisions will require some legislative changes to the Act to cater for these Article 23 provisions.

6 Title IV - Measures to increase efficiency of restructuring, insolvency and second chance

1. Article 24 obliges Member States to ensure that restructuring, insolvency and second chance matters are dealt with in an efficient manner which ensures expeditious treatment of the procedures. While Ireland has Specialist Judges of the Circuit Court to oversee the operation of the Act, this obligation appears to place an onerous burden on the entire court system to process cases, initial and appeals to higher courts, in an expeditious manner.

2. Articles 25 through 27 address mediators, insolvency practitioners and other practitioners appointed in restructuring, insolvency and second chance matters. The Articles deal with training, voluntary codes, oversight mechanisms, appointment, removal and resignation of practitioners and sanctioning of practitioners. These areas are addressed to a greater or lesser extent in the Act and associated regulations which provide for personal insolvency practitioners' authorisation, regulation and training/CPD. The Act also sets out a range of sanctions for improper conduct.

3. The Act does not address two areas mentioned in Title IV, namely, practitioners' ability to deal effectively with cross-border elements and fees charged by practitioners. In relation to fees the ISI has no scrutiny or oversight role. It is worth pointing out that it is the creditor who ultimately incurs the practitioner's fees, so in the ISI's experience creditor negotiation of arrangements ensures that excessive practitioner fees do not arise.

7 Title V - Monitoring

The data collection requirements imposed on Member States under Article 29 are onerous. At present, the ISI is advised of the details of all arrangements that conform with the Act. However, a significant number of informal arrangements are made each year between debtors and creditors and, to the ISI's knowledge, no details are maintained in relation to those arrangements.

8 Conclusion

The views of the ISI are set out above. In summary, the following are the main areas that may impact on the Personal Insolvency Act and its operation:

1. The introduction of a distinction between entrepreneur and non-entrepreneur debts for natural persons is artificial, is not contained in Irish legislation and is not operated in practice;

2. The introduction of a preventative restructuring framework for pre-insolvency that may co-exist with insolvency arrangements under the Act requires significant clarification which in not provided by the draft Directive;

3. The potential impact of the 'absolute priority rule' on the manner in which insolvency arrangements are currently negotiated;

4. The impact of the reduction in the maximum term of an insolvency arrangement to 3 years on the creditor willingness to enter into insolvency arrangements; and

5. The data collection requirements imposed on Member States particularly in relation to informal arrangements that are continually being entered into between debtors and creditors.