REPRINT FINANCIER WORLDWIDE

JANUARY 2014

FINANCIER WORLDWIDE corporatefinanceintelligence

DISTRESSED M&A AND INVESTING

Distressed M&A in Europe: what to look out for in 2014

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A number of recent or proposed legal and regulatory changes will play a significant role in shaping the European distressed M&A market in 2014. In this article we highlight four such changes.

The ECB's Asset Quality Review (AQR)

In November 2013 the European Central Bank (ECB) commenced a comprehensive assessment of the balance sheets of banks within the eurozone. This is a preamble to the assumption by the ECB of new supervisory tasks in November 2014. The purpose of this analysis is to assess the health of the balance sheets of the banks that will be subject to direct supervision by the ECB under the 'single supervisory mechanism'.

The AQR involves 130 credit institutions located in 18 member states across the eurozone. In total, approximately 85 percent of euro area bank assets will be subject to a forensic, granular analysis. The AQR is the largest ever such exercise undertaken in terms of the number of banks, aggregate size and geographic reach.

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The AQR is due to complete by October 2014. Many foresee that the AQR will expose large capital holes at many banks. Accordingly, banks may be required to take steps to attract additional capital, or to commence or continue the disposal of individual assets or portfolios of assets on their balance sheets. This measure is unprecedented in breadth and depth. As such, it has the potential to stimulate a significant amount of M&A and restructuring activity, creating exciting opportunities for distressed investors.

UK – continuing scrutiny of pre-packaged administrations

Pre-packaged sales from administration, or 'pre-packs', remain the subject of some controversy in the UK, particularly in circumstances where the sale is to a connected party.

Statement of Insolvency Practice 16 (SIP 16) was issued by the UK Insolvency Service in January 2009 to codify best practice and provide professional guidance on pre-packaged administrations. SIP 16 seeks to make pre-packs more transparent and to address any perceived unfairness, notably by way of a detailed report issued by the administrator following the pre-packaged sale.

However, concerns regarding the transparency and fairness of pre-packs have remained. In March 2011, the UK government invited views on potential new measures to address the perceived deficiencies of pre-packs, including pre-notification to creditors of a proposed sale to a connected party. Subsequently, in January 2012, the UK government concluded to take no further action.

However, in July 2013, businesswoman Teresa Graham CBE was appointed by the UK Department of Business, Innovation and Skills (BIS) to undertake a further review of the pre-pack procedure (the Graham Review). The stated goals of the Graham Review are to assess: (i) the long-term impact of pre-packs, notably as to whether they encourage growth and employment, and whether they provide the best value for creditors as a whole; (ii) how useful pre-packs are in the context of business rescue generally; (iii) whether pre-packs cause detriment to any particular group of creditors, particularly unsecured creditors; and (iv) whether there are any particularly harmful practices associated with pre-packs.

The Graham Review is independent and will include an empirical study of recent pre-pack cases. The report is expected to be complete by the spring of 2014.

The Graham Review is part of a wider BIS initiative to improve corporate transparency. The recent report by Lawrence Tomlinson on Banks' Lending Practices (the Tomlinson Report) should be seen in this context. The Tomlinson Report highlights two perceived areas of conflicts of interest relevant to pre-packs: first, where the insolvency practitioner appointed has been working closely with the company or its secured lenders prior to appointment ("maintaining independence and a fair hand for all parties involved appears extremely difficult"), and second, where the ensuing sale of assets is to a connected party.

If the conclusions of the Graham Review are that pre-packs cause harm, it is currently unclear what steps will be taken by way of further guidance or legislation. It is possible that previously mooted proposals regarding the mandatory provision of advance notice of pre-packaged sales to connected parties could be implemented. This would give the opportunity for unhappy creditors to make representations, table higher offers, or even apply for an injunction to restrain the proposed sale.

However, industry bodies are concerned that any such measures would undermine the very nature of a pre-pack. Pre-packs are designed to minimise insolvency stigma and optimise the 'business as usual' message by permitting as seamless as possible a transfer of the business or assets of an insolvent company to a purchaser, thus giving the best prospects of preserving brand integrity and preventing attrition of key customers and employees. Any requirement for pre-notification will arguably eliminate much of this upside.

France – executive seeks authority to make policy-driven changes to insolvency régime

The French insolvency system has historically been seen as unfriendly to creditors, particularly relative to its English and US equivalents. There is a wide automatic stay, the preservation of employment is prioritised over creditors' interests, and the appointed office holders have more influence and importance in the process than the creditors themselves. However, despite these handicaps, the overall economic situation in France is creating distressed M&A opportunities in a wide range of sectors.

Against this backdrop, the French government has sought to obtain from the legislature wide-reaching authority to make amendments to existing insolvency legislation through passing executive orders (*'ordonnances'*) with a view to simplifying and providing additional security to the viability of businesses (*'mesures de simplification et de sécurisation de la vie des entreprises'*).

Notably, the French government has sought the right to intervene in the following policy areas: (i) strengthening existing protective measures (e.g., facilitating the obtaining of grace periods by debtors seeking consensual solutions, and rendering contract terms void if their terms prevent the debtor from appointing a *mandataire ad hoc/conciliateur*); (ii) facilitating the availability of new financings in the context of conciliation proceedings; (iii) strengthening safeguard proceedings and extending the availability of 'accelerated safeguard proceedings'; (iv) rebalancing the relative rights of debtors, shareholders and creditors in safeguard and bankruptcy proceedings in order to better preserve jobs and the business of the debtor; and (v) accelerating the formal liquidation process for irremediably insolvent debtors.

The potential wide scope of these measures, together with the absence of any legislative discussion or scrutiny of their substance, will inevitably result in significant uncertainty. If such executive authority is ultimately granted by the French legislature, there is concern in the French legal and insolvency profession as to the potential for confusion and disruption of the existing relatively coherent legislative framework.

Germany – ESUG improves the distressed investing landscape

Until recently, creditors had limited rights to exert influence in a German insolvency process. Notably, international investors were concerned by their inability to choose the insolvency practitioner to be appointed and the disproportionate influence of shareholders in the preparation and approval of an insolvency plan. This resulted in limited opportunities for debt to equity swaps and other forms of restructuring commonplace elsewhere.

This paradigm has altered following the introduction of the German Law on Further Facilitating the Restructuring of Companies (*Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen, 'ESUG'*). ESUG was specifically introduced to make German insolvency law more competitive relative to other legal systems, notably US Chapter 11.

ESUG is widely viewed as having

succeeded in its aims, and has stimulated the German distressed M&A market. Notably, the reforms made to the insolvency plan process have facilitated the implementation of share sales and debt to equity swaps. Amongst other amendments, two key changes have had, and will continue to have, a significant effect. First, companies above a certain size threshold must establish a creditors' committee as soon as preliminary insolvency proceedings are opened. This enhances the position of creditors in the insolvency process, since the committee is entitled to select and appoint the insolvency administrator as well as to decide whether, and on what terms, incumbent management remain involved (in a form of 'debtor in possession' procedure). Second, insolvency plans have been extended in scope. Debt to equity swaps, capital reductions and increases, and cancellation of shares can be provided for in insolvency plans, and then implemented without separate shareholder approval, or even against the will of the shareholders (in a form of 'cram down').

These changes in German law expand and strengthen the ability of creditors to structure and implement a share transaction. It should be noted that the ESUG has no impact on asset sales.

As a further step, it is anticipated that the German legislature may seek to provide practical solutions (by way of consolidation or otherwise) for the insolvency of German corporate groups to seek to minimise value destruction resulting from the current fragmented German regional system of competing insolvency courts and insolvency administrators. ■