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Strelia Insolvency and Restructuring Newsletter

January 2022: **Debt-to-equity swaps in the context of reorganisation proceedings and the transposition of the EU Directive on preventive restructuring frameworks**

When a company faces financial distress, concessions are to be made and decisions to be taken in view of its turnaround. In the ordinary course of business, the shareholders bear the entrepreneurial risks and have the ultimate decision-making power. In judicial reorganisation proceedings, the risk and also the decision-making power, is shifted to the creditors as they are the ones having to make the efforts and concessions. Indeed, under the current Belgian law on judicial reorganisation proceedings by *amicable* agreement, the decision-making power on the agreement is shared by the debtor and the creditors. In reorganisation proceedings by *collective* agreement, the decision on adopting the plan is taken exclusively by the creditors.

Shareholders' risks

As soon as a company is incorporated, its business should always endeavour to maximise value for its shareholders.

However, in times of financial difficulty, company shareholders must accept lower dividends and ultimately might have to add funding to the company in order to realise a turnaround. The general theory states that the shareholders bear the risks in their enterprises. Should the company have insufficient assets to repay its liabilities (its creditors), shareholders risk losing everything they have invested as they will not receive any liquidation proceeds in case of bankruptcy.

During the stage of financial difficulty, a company may rely on specific mechanisms and rules provided by the law to create a framework that enables it to reorganise and revive the company. From the moment these mechanisms and frameworks enter into the picture, creditors are expected to make concessions. Some or all of them will be urged to reduce their claims and waive their rights by adopting a restructuring plan for the company. Oddly, the involvement of shareholders is limited in judicial reorganisation proceedings.

Transferring the risks to creditors is done to various extents. The higher degree of formality required by the legal mechanism or instrument applied to the reorganisation, the greater the risks and efforts that will be shifted to the creditors, which means the lesser burdensome it becomes for the shareholders.

Belgian and EU legislators are in favour of greater involvement of shareholders in these formal reorganisation proceedings. This can be obtained by including shareholders in restructuring plans or by allowing a conversion of the creditors' claims into equity. The technique of debt-to-equity swaps combines an effort of both the creditors and shareholders as the latter see their shareholding diluted. As a result, if debt-to-equity swaps are considered, shareholders will want to play an active role in the process and may jeopardise the restructuring plan in order to prevent the dilution of their shareholding. Restructuring frameworks differ from one jurisdiction to another. At EU level, the European Commission, Council, and Parliament adopted the Directive on Preventive Restructuring Frameworks[1] to harmonize restructuring and insolvency laws across Member States.

[1] Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency), among

Belgium will soon transpose the Directive into its national law. The question for the Member States is how to combine the shareholders' entrepreneurial risk; the need to involve creditors in the adoption of a restructuring plan; the effectiveness of creditors' involvement in that process; and the importance of striking a balance between creditors' risks, efforts, and voting rights, on the one hand, and those of the company's shareholders, on the other hand.

One instrument that can be used to facilitate the reviving of the company and to involve creditors in the decision-making is the debt-to-equity swap. When this is included in a restructuring plan, it enables to combine the creditors' efforts with those of the shareholders. Even though debt-to-equity swaps are currently possible under Belgian law, practical issues arise with the implementation of such conversions in restructuring plans.

Reorganisation tools under Belgian law

Although the basic assumption of entrepreneurship is that the shareholders bear the entrepreneurial risk, this is no longer the case when a company is being restructured through reorganisation proceedings. In Belgian reorganisation proceedings it is mostly (or only) the creditors who must make concessions to make the company viable again and ensure its continuity.

Companies in distress can resort to different tools or procedures provided by Belgian insolvency law, such as out-of-court solutions, as well as court-supervised procedures, known as judicial reorganisation proceedings.

Out-of-court reorganisation solutions

The out-of-court solutions aim at restoring the financial situation of a company by reaching an amicable agreement with at least two creditors on reorganising the debtor's assets or business activities, pursuant to Articles XX.36 to XX.38 of the Belgian Code of Economic Law ("BCEL"). Parties are free to determine the terms of the agreement.

Such reorganisation is restricted to only the parties involved and cannot have any effects on third parties (Article XX.37 BCEL). Creditors that are not involved in the amicable agreement can benefit nevertheless: the turnaround realised by the amicable agreement may allow the debtor to pay its other creditors, whereas without the agreement this might not be the case.

In terms of effort to revive the company, the amicable agreement can include one or more creditors' acceptance to make concessions that serve to aid the revival of the company. In theory, it could also require certain efforts by shareholders.

Judicial reorganisation proceedings

In judicial reorganisation proceedings the debtor seeks a solution to its financial difficulties under the supervision of the court. The proceedings are specifically aimed at preserving the continuity of all or part of the company's assets or business activities. Unlike out-of-court solutions, which are confidential, the opening of judicial reorganisation proceedings is published in the Belgian Official Gazette.

Belgian insolvency law provides three types of judicial reorganisation proceedings: (i) by amicable agreement, (ii) by collective agreement, and (iii) by transfer of undertaking .

(i) Judicial reorganisation by amicable agreement

Debtors can decide to negotiate an **amicable agreement** with their creditors under formal judicial reorganisation proceedings, pursuant to Articles XX.64 to XX.66 BCEL. If reaching an amicable agreement with a few creditors enables debt repayment to be rescheduled and the company's continuity to be assured, this method would be most appropriate. In some cases, agreeing with a few creditors and reaching a consensus on

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others.

some well-defined measures—under court supervision—will be sufficient to turn the company around, to the benefit of all stakeholders. In case of a reorganisation by amicable agreement, only the creditors involved bear the risk and make certain efforts.

(ii) Judicial reorganisation by collective agreement

If a company's financial difficulties are serious enough to involve all creditors in the restructuring plan, it might be difficult to obtain every single creditor's approval. Therefore, Belgian insolvency law provides for reorganisation proceedings by **collective agreement,** pursuant to Articles XX.67 to XX.83 BCEL, whereby all creditors vote on a restructuring plan. For the approval of the plan to be valid, there is a double majority requirement: (i) the majority of the creditors must vote in favour of the plan and (ii) this majority represents at least half of the principal amount of the total debt due. In principle, the court confirms such plan if the required majority of the creditors accepts it. Its confirmation makes the plan binding upon all creditors, including dissenting creditors.

In general, all the effort is born by the creditors. However, several measures, techniques and ideas can be included in the restructuring plan, which ultimately is ought to satisfy the needs and interests of both the debtor and the creditors. The debtor, *i.e.*, the company's management and governing body, negotiate with the creditors and propose the plan. Such plan could include, amongst others, instalment payments, debt reductions or granting new credit, whereby the creditors mainly bear the burden of making the effort in varying degrees and even unequal ways.

(iii) Judicial reorganisation by transfer of undertaking

A debtor can choose to transfer all or part of its business activities if it wishes to preserve its continuity, pursuant to Articles XX.84 to XX.97 BCEL. If the court allows the transfer, it will appoint a court mandatary, who will be in charge of the organisation and completion of the transfer to the purchaser. Pending completion, the distressed company continues to run its operations.

In case of a judicial reorganisation by transfer of undertaking, there is in principle no risk shifting from the shareholders to the creditors without the shareholders being affected. Once the transfer of undertaking is realised, often the company will be put into liquidation and the proceeds of the transfer will be distributed in application of the priority rules in case of bankruptcy, in which shareholders are ranked last.

Risk shifting from shareholders to creditors in restructuring plans of reorganisation proceedings

When a company becomes insolvent, the greatest risks that shareholders face are not being able to receive any liquidation dividend and losing their initial equity. Remaining assets are used to pay creditors before the shareholders. If there is nothing left for distribution after the creditors are paid, the shareholders' entire contribution will simply be wiped out, and they will not receive anything from the liquidation proceeds.

However, if a company files for judicial reorganisation proceedings, all creditors (in case of a collective agreement) or some of them (in case of an amicable agreement) are asked to make concessions for the revival of the company. Creditors' contributions can imply reduction of their debt claim, payment terms, removal of interests and penal clauses, etc., whereas shareholders are in principle not involved in the restructuring plan or are at least not expected to under Belgian insolvency law.

If the judicial reorganisation proceedings are successful, the shareholders shall retain their equity and gain back a valuable company, possibly without any effort from their side, whereas the creditors would have had written off their claims to rescue the company.

Therefore, in the context of judicial reorganisations by amicable or collective agreement, the entrepreneurial risk is transferred to the creditors. This risk, originally borne by the shareholders, becomes the creditors' burden as they have made concessions in respect of their claims. Even creditors who vote against the restructuring plan might be forced to undergo write-offs of their claims.

This risk-shifting should however be nuanced. In practice shareholders often make additional contributions before a company applies for judicial reorganisation proceedings. Generally, shareholders will have contributed significant funds to their companies in order to avoid insolvency proceedings as much as possible. Nevertheless, the fact remains that under Belgian insolvency law shareholders are not expected to make any concessions.

The debt-to-equity swap as a restructuring mechanism

Debt-to-equity swap entails the exchange of a creditor's debt claim for equity in the company in view of writing off the debt that the company owes to this creditor. The conversion of the creditor's claim is recorded in the company's accounting records, which in turn eliminates the outstanding debt. The debt and interest associated with the debt claim then becomes annihilated while new shares are issued to the creditor. The shares are issued through an equity increase by way of a contribution in kind, and the amount of which is equal to the value of the debt claim.

From a creditor's standpoint, such conversion can be a useful tool in the debtor's financial restructuring. It allows the creditor to get shares on the upside when the restructured company recovers or is sold or floated. The conversion can also be advantageous for the debtor: it increases the prospects of claim recovery by reducing the company's overall debt burden without an accompanying decrease in the company's assets. It can especially be a useful mechanism if the debt is too high to be reduced in a restructuring plan. However, existing company shareholders are often reluctant to allow such debt-to-equity swap because of its dilutive effect on their equity stake.

As a debt-to-equity swap implies an equity increase by way of a contribution in kind, the formalities required by law for contributions in kind must therefore be complied with. This implies, amongst others, a shareholders' decision to increase the company's equity and two special reports.

Belgian insolvency law has – in principle – allowed for over two decades the inclusion of debt-to-equity swaps in restructuring plans, pursuant to Article XX.72 of BCEL. Theoretically, two situations are conceivable if a debt-to-equity swap is included in a plan which is approved by the majority of creditors: either a creditor wishing to obtain shares in the insolvent company could convince the majority of other creditors that such swap would benefit them too, and thus succeed in becoming a shareholder, either a majority of creditors can impose a debt-to-equity swap of a debt claim on another creditor, even if that creditor itself has voted against such conversion. Exception to the latter situation is made for secured creditors (with a security such as mortgage, pledge, or retention of title) pursuant to Article XX.74 BCEL. Secured creditors cannot be affected by a restructuring plan unless they have approved it. As a result, "forced" debt-to-equity swaps concern mostly ordinary debt claims.

Despite the possibility offered by Belgian insolvency law to include a debt-to-equity swap in restructuring plans, this type of conversion is rarely a part of Belgian debtors' restructuring plans due to the lack of shareholders' support.

The actual Belgian legal framework lacks legal tools to effectively "force" such conversions on the shareholders. Indeed, even though a debt-to-equity swap is included in a restructuring plan which is adopted by majority vote of the creditors, the shareholders still have the power to block the debt-to-equity swap by voting against the equity increase at the stage of the implementation of the plan. Therefore, in practice, debt-to-equity swaps are rarely seen in restructuring plans without the consent of the shareholders.

Debt-to-equity swap in the EU directive on preventive restructuring framework (2019/1023)

The EU Parliament and Council recognised the above-mentioned problem of risk-shifting to the creditors in formal reorganisation proceedings and therefore allowed the possibility to include debt-to equity conversions in company restructuring plans in the Directive on Preventive Restructuring Frameworks.

The Directive emphasises the role of shareholders in these restructuring frameworks since, in many jurisdictions, such as Belgium, they are not affected by a restructuring plan, and reorganisation through formal proceedings is therefore done solely at the expense of creditors. The Directive stresses that whilst the legitimate interests of shareholders or other equity holders should be protected, it must be ensured that they cannot unreasonably prevent the adoption of restructuring plans that would bring the debtor back to viability. Therefore, restructuring measures must be able to affect the interests of the debtor's equity holders.

The interests of the debtor's equity holders can be affected in many ways: the existing shareholders can be confronted with a dilution of their shareholding if the creditors' debts are converted into equity; their shares can be cancelled without replacement; or they can be obliged to provide equity injection or non-monetary restructuring assistance by drawing on, for example, their experience, reputation, or business contacts.

To successfully affect the interests of the equity holders in the restructuring plan (which includes debt-to-equity swaps), hold-out problems (i.e., when equity holders refuse to participate) must be addressed.

To that end, the Directive suggests different alternatives: (i) by making the shareholders a part of the restructuring plan (as "affected parties") with or without voting rights, or (ii) by leaving shareholders out of the restructuring plan, but only if they are not allowed to unreasonably prevent or create obstacles to the adoption and confirmation of the plan. In all approaches, Member States must bear in mind that its national company law requirements should not jeopardise the effectiveness of the process of adoption and implementation of the restructuring plan. Therefore, Member States should be able to derogate from the requirements laid down in Directive (EU) 2017/1132 concerning the obligations to convene a general meeting and to offer shares to existing shareholders on a pre-emptive basis, to the extent and for the period necessary to ensure that shareholders do not frustrate restructuring efforts by abusing their rights under that Directive.

Transposition of the Directive on Preventive Restructuring Frameworks in Belgium

The question remains how the Preventive Restructuring Directive shall be transposed into Belgian insolvency law. As described above, under current Belgian insolvency law, no role is assigned to the shareholders within the framework of judicial reorganisation proceedings. Although the possibility to include a debt-to-equity swap in the restructuring plan is provided in the BCEL, it is rarely implemented in practice given the many obstacles under company law which allow the shareholders to block the conversion.

At the time of this contribution, no law has been enacted yet. For the time being, the expected orientation of the Preventive Restructuring Directive's transposition as regards to the role of the shareholders can be summarised as follows.

in accordance with the wording of the Directive on Preventive Restructuring Frameworks, shareholders will presumably be included as "equity holders", whose interests are affected by the restructuring plan, under the denominator of "affected parties". Voting rights will be granted to these equity holders, thereby also allowing for the imposition of a restructuring plan on a class of equity holders through the cross-class cram-down. In principle, the court shall confirm a restructuring plan when it has been adopted by all affected parties, *i.e.*, when in each class of affected parties, a majority of 50% voting in favour of the plan is reached. When such majority requirement is not met, the court may nevertheless confirm a plan following a cross-class cram-down. Once the plan is confirmed by the court, all affected parties and the debtor itself are bound by it.

In view of the rationale of the Directive on Preventive Restructuring Frameworks, it seems logical that the possibility to include debt-to-equity swaps is retained in the insolvency legislation. To overcome the existing issues associated with such conversions in restructuring plans, it seems the Belgian legislator will choose to override the applicable provisions in company law. This is in line with the Preventive Restructuring Directive, which allows Member States to derogate from company law in order not to jeopardise the effectiveness of the adoption and implementation of a restructuring plan.

If the applicable company law provisions will be overridden, it could be deducted that no general meeting of shareholders should be convened in view of increasing the debtor's equity, nor can the existing shareholders block the entrance of third parties in the company's shareholding in case of a private limited liability company.

The question remains if overriding the applicable provisions of the company law will be sufficient to eliminate shareholders' blocking power. When analysing the Dutch Act on Court Confirmation of Extrajudicial Restructuring Plans (CERP), the Dutch legislator not only puts aside the provisions of company law, but also the provisions written down in the article of association or in shareholders' agreements. A point to be considered by the Belgian legislator as well.

It will be interesting to follow the developments of the transposition of the Directive under Belgian law, and to see whether the inclusion of the shareholder in restructuring plans will lead to a more frequent application of debt-to-equity conversions in practice.

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