

# Pre-Pack Proceeding - A Hybrid and Derogatory Safeguard Tool. Member States’ Future Obligation of Integrating a New Mechanism in Their National Insolvency Law

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## Abstract

*Harmonizing Member States’ insolvency frameworks has been a goal for the European Union for the past years, dating back to 2016, when the European Commission issued a Proposal for a Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency, and discharge proceedings [COM (2016) 723 final], based on the Commission’s Recommendation regarding a new approach to business failure and insolvency [C(2014) 1500 final]. This led to the Directive (EU) 2019/1023 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. One key topic addressed by the “Directive proposal” [COM(2022) 702 final] is the “pre-pack proceeding”, meant to offer an efficient alternative for safeguarding businesses.*

*Underlining the achievements of this Directive proposal by regulating pre-packed administrative proceedings is our scope in this paper.*

**Key words:** liquidation, insolvency, pre-pack proceedings, safeguard, reorganization

**J.E.L. classification:** K29

## 1. Introduction

“A «pre-pack» is not a legal term of art. It describes a negotiated transaction, usually a sale of assets or business to a third party or directors, hammered out with major creditors prior to formal appointment, and completed immediately or shortly after formal insolvency commencements” (Brown, 2009, p.164). Historically, the origin of pre-pack administration proceedings derives from the English *scheme of arrangement*, a proceeding which aimed at avoiding bankruptcy in the 19<sup>th</sup> century.

At the European level, England was the first country to introduce a scheme of arrangement in 1883, a system which was also implemented by the U.S.A. in 1898 (Cioroiu, 2023, p.109). Nowadays, pre-pack proceedings consist of a hybrid and derogatory safeguard tool, used in several jurisdictions around the world to maximize business value, while protecting creditors’ best interest. One characteristic of such proceedings is the fact that they consist of a synergy of both liquidation (which usually aims at eliminating a business from the economic circuit), and business safeguard (which aims at keeping a business in the economic circuit).

When corporate insolvency occurs, directors have the obligation of requesting the opening and undergoing insolvency proceedings, which, as a rule, are a dichotomous concept, consisting of either liquidating a business, or safeguarding it. Therefore, insolvency proceedings integrate two opposed remedies for a business facing financial distress, whether balance-sheet insolvency or cash-flow insolvency. However, as an exception, pre-pack proceedings merge both of these remedies, while offering advantages for all parties : (1) they aim at preserving the business value as a whole, therefore avoiding an unnecessary bankruptcy, which has a positive impact upon the economy in general; (2)

they ensure that the best interest of creditors is fulfilled, avoiding unnecessary conflicts which usually occur in an insolvency proceeding; (3) they exonerate insolvent business directors from a time-consuming and costly legal proceeding. Furthermore, pre-pack proceedings are pre-negotiated with creditors in an out-of-court environment, thus easing Courts' activity.

The Directive proposal aims for Member States to integrate this safeguard mechanism into their national law, as an alternative to classic liquidation proceeding which are well known to be less effective and time-consuming for all parties, if the business still has added value while facing insolvency or likelihood of insolvency. It is to be noted that, according to an INSOL Europe report called Study on a new approach to business failure and insolvency – Comparative legal analysis of the Member States' relevant provisions and practice (Bariatti *et al*, 2014), 13 of the Member States did not provide legal frameworks for preventive restructuring before the entry into force of the Directive 2019/1023.

This paper aims to analyze what does the Directive proposal try to achieve by regulating pre-packed administrative proceedings, considering that safeguard proceedings are still a new concept for several Member States.

## 2. Theoretical background

Safeguard proceedings of insolvent companies, as well as early intervention through pre-insolvency warning tools have become a subject of interest at the European level in the last decade, considering that merely 4%-6% of European bankruptcies are fraudulent (European Commission – Enterprise and Industry Directorate-General, 2011, p.3) and the stigma behind failure not only is not justified nowadays, but also it shouldn't automatically be linked to fraud. In an effort to provide a second chance to honest entrepreneurs who faced insolvency and overindebtedness, the European Commission continues to provide healthy alternatives to bankruptcy, which Member States will have to integrate in their insolvency legal framework in the near future, after the entry into force of the Directive proposal.

„The pre-pack approach, in particular, has emerged as an innovative corporate rescue method that incorporates the virtues of both informal (out-of-court) and formal (judicial) insolvency proceedings” (Bo Xie, 2016, p.vi). Basically, typical insolvency formalities occur out-of-court, meaning that directors of financially distressed or insolvent businesses anticipate the need of taking measures in order to limit a potentially negative impact upon stakeholders or creditors.

Article 19 of the Proposal Directive suggests that the whole proceeding is based upon two phases: (i) a preparation phase, and (ii) the liquidation phase.

- (i) While the business, as a whole or a part, is still economically viable, directors draft a plan concerning either selling the business, or selling its assets. This plan is amicably negotiated outside of typical insolvency formalities, and the aim is to convince creditors to manifest a positive vote upon the plan. However, the aim of the preparation phase is to find a third-party which usually doesn't participate in insolvency proceedings: the buyer. This person is an investor, having the economic capacity of acquiring the business, in whole or in part, or the business' assets, as an ongoing concern, thus maximizing the value and raising the creditors' claims recovery rates. During this phase, two problems may arise: (1) the debtor may underestimate the business value, due to the vulnerability caused by the state of insolvency, and (2) the debtor finds more than a buyer that are prepared to acquire the business. The European legislator anticipated both of these problems, and offers solutions as following: (1) to avoid the sale of the business below market price, Member States shall ensure that the debtor will appoint a monitor, who is usually a licensed specialist, such as a lawyer or an insolvency practitioner, which will make sure that the transaction will meet legal standards; (2) to maximize the value of the acquisition, an auction could be organized, which will unfold under the Court's supervision. During the preparation phase, if the debtor faces insolvency or insolvency likelihood, a stay of individual enforcements is possible until the second phase. This is justified by the fact that the commencement of this proceeding is voluntary and creditors may approve the plan considering that a pre-pack proceeding usually offers higher recovery rates of claims in comparison to a classic insolvency proceeding. Furthermore,

the debtor remains in possession, until the liquidation phase. These specific insolvency effects are justified by the fact that the proceeding aims at maintaining both business value, as well as buyers’ interest. In the French legal system, this first phase unfolds within the conciliation proceeding (Vidal *et al*, 2016, pp. 251-253), because the ad-hoc mandate does not suffice (Saint-Alary-Houin, 2016, p. 631).

- (ii) The liquidation phase consists of submitting the pre-negotiated plan to the Court, which will approve its execution if all legal requirements are fulfilled, while also approving the distribution of the proceeds to the creditors. If the debtor is in a state of insolvency, a request for opening formal insolvency proceedings could be simultaneously submitted, along with the pre-negotiated plan. It is to be noted that the Court’s role is limited in comparison to a standard insolvency proceeding, because most of the formalities are unfolded out-of-court, and the judicial phase only concerns the outcome of the acquisition. Before approving the acquisition, the Court shall request the monitor’s opinion regarding the fulfillment of legal provisions, considering that the monitor’s attributions are also limited in comparison to a standard insolvency proceeding. However, the monitor has both judicial and economic related obligations. If the Court appreciates that the sale price is below market price, not transparent, competitive and fair, or that the best interest of creditors test is breached, the acquisition will not be approved and, if the debtor is in a state of insolvency, the Court will order the commencement of formal insolvency proceedings. If more buyers manifest their interest of acquiring the business, a public auction will take place, under the Court’s supervision. Taking into consideration the fact that the pre-pack proceedings unfold faster than standard insolvency proceedings, the Directive proposal limits in time this final phase. Thus, the public auction should commence in two weeks after the opening of the liquidation phase, and it should last no more than four weeks. After the acquisition, creditors’ claims should be covered. The ranking of creditors and distribution rules are to be decided by Member States, providing that their national legal framework complies with the European law. The business will be acquired without debts, even if the sale price is not enough to cover all creditors’ claims. Also, ongoing contracts will also be transferred to the acquirer, unless (a) the latter is a competitor of the acquired business, or (b) the Court decides otherwise, under limited conditions. As a closing remark regarding the liquidation phase, it is important to underline the fact that a judicial step is absolutely necessary, because the pre-pack proceeding will allow a cram-down, meaning that the will of the majority of creditors will be imposed upon the will of the minority of dissenting creditors; such a mechanism requires a Court’s decision in order to be binding.

### 3. Research methodology

The European legislator aims at making safeguard proceedings a rule, while liquidation would only be reserved to non-viable businesses. This is the reason why Directive (EU) 2019/1023 imposed Member States’ obligation of regulating early warning tools in their national framework. Since a small part of European bankruptcies are fraudulent (up to 6%), bankruptcy and overindebtedness are nowadays considered to be a normal effect of the competitive market, as opposed to an intentional and fraudulent action meant to prejudice the creditors.

When the Directive proposal will enter into force, all Member States will need to introduce pre-pack proceedings in their national law. Jurisdictions such as France and Germany have used this tool for more than a decade. „Within the European Union, the matter of business transfer is of particular interest, from the perspective of economic growth and jobs, which is why policies are being promoted for stimulating business continuity through transfer, as an alternative to business liquidation or incorporation, regardless of the business organization form, yet providing a particular attention to enterprise transfer.” (Tuleaşcă, 2016, p. 55). Considering the fact that the European legislator continues the reform in insolvency-related matters by having all Member States introduce a new safeguard tool in their legal system, and also the fact that the Directive is yet to enter into force at the time of this paper, we considered useful to use *the theoretical research method*.

## 4. Findings

### 4.1. A derogatory safeguard tool. Particularities.

Pre-pack proceedings are a **hybrid safeguard tool**, since they consist of merging two opposed, well-know proceedings: a safeguard proceeding and a liquidation proceeding. However, they are also a **derogatory type of proceeding**, since they have numerous particularities and may be viewed as a ”particularized safeguard mechanism”.

”Professor Corinne Sain-Alary-Houin has described it as an «instrumentalized» safeguard (...)” (Pérochon, 2014, p. 467). Pre-pack proceedings have numerous particularities in comparison to standard insolvency proceedings, as shown below:

- i. Generally, the parties involved in a pre-insolvency or insolvency proceeding concern debtors and creditors, as well as supervisory bodies. However, in pre-pack proceedings, a third-party is involved – the business acquirer – who doesn’t usually participate in other safeguard proceedings.
- ii. Most steps unfold out-of-court, and the proceeding is opened only after obtaining a forecasted result. Thus, finding the acquirer, followed by negotiations with creditors, drafting, voting, and adopting a plan happen prior to the opening of the proceeding, saving time and unnecessary costs for all involved parties. It is to be noted that the content of the plan is freely determined, but it needs to pass the best interest of creditors test, which involves creating a fictive worst-case scenario.
- iii. The first step of the pre-pack proceedings may take place under another regulated safeguard proceeding, as is the case of the French legal system. Such an approach eases the unfolding, since the licensed specialist appointed by debtor’ request will make sure all legal requirements are fulfilled. It is important to underline the fact that the Directive proposal imposes that the sale of the business would take place only at market price and under fair and competitive context, under the penalty of converting the pre-pack proceeding into a formal insolvency proceeding. Given these circumstances, debtors will have to make sure that the sale process meets the Directive proposal’s conditions, to avoid the commencement of insolvency or even bankruptcy proceedings. Taking into consideration the fact that the first phase of pre-pack proceedings is compatible with any other pre-insolvency proceedings (separating creditors’ claims into classes, drafting a plan and, in some cases, requesting the commencement of insolvency proceedings simultaneously, negotiating the plan, voting the plan etc.), Member States could regulate debtors’ option for the first phase to unfold within another type of pre-insolvency proceeding.
- iv. To sustain the urgency of this mechanism, the Directive proposal limits in time the public auction. If the business would be subject to an auction in the liquidation phase, it must be initiated in a period of maximum 2 weeks and should only last maximum 4 weeks. Usually, public auctions are not limited in time.
- v. Ongoing contracts are to be transferred to the acquirer unless they are a business competitor or in other limited situations described by the Directive proposal. Generally, the liquidation of a business is followed by terminating ongoing contracts, to limit debtors’ overindebtedness.
- vi. In order to avoid potential abuse, the Court may reject a request of authorization of the acquisition, if economic criteria are not met, even if creditors approve the plan. Usually, in safeguard proceedings, creditors hold full control of opportunity decisions, while the Court’s control is limited to judicial aspects.

### 4.2. Advantages of pre-pack proceedings

Pre-pack proceedings objective is to offer an alternative tool for safeguarding the business value, while maintaining its activity, including ongoing contracts (with small exceptions). The key factor of a pre-pack proceeding consist of the sale of the business, either as a whole or a viable part of it, as

a going-concern, to a third-party who usually doesn't play a role in a typical insolvency proceeding: the buyer.

One of the main advantages of this mechanism is that **the outcome is predictable by all involved parties**.

Generally, after opening a safeguard proceeding, creditors cannot always predict the unfolding of the proceeding, thus pre-packed proceedings offer a higher degree of predictability, since negotiations occur before the opening of the proceeding. In addition, such mechanisms require a **minimum intervention of supervisory bodies**'.

Another main advantage consists of **lower liquidation costs**, therefore **maximizing creditors' claims recovery rates**, as well as a **time-saving alternative**. In the French legal system, the proceeding's confidentiality is mandatory to all involved parties. However, the Directive proposal doesn't yet establish a confidentiality requirement.

### 4.3. Disadvantages of pre-pack proceedings

Even if this mechanism provides several advantages, it also generated criticism, especially because the Directive proposal seems to exempt them from the Acquired Rights Directive, following the European Court of Justice judgement in the Heiploeg judgement (C-237/20), which stated that in the case of the transfer of assets in a pre-pack procedure, the transferee has the right to derogate from the maintenance of workers' rights, if this procedure is regulated by legislative provisions or administrative rules (Gant, 2023).

In the French legal system for instance, the proceeding doesn't have any effects upon workers' rights (Saint-Alary-Houin, 2016, p. 635); however, the European Court of Justice decision is binding in all Member States.

Additionally, this mechanism was also criticized because it leaves room for potential abuse of the competition of the business in question, by allowing it to be sold below market price; however, the Directive proposal addressed this issue by providing that in such case, the Court will not allow the acquisition authorization.

### 4.4. Business transfer in the Romanian Legal system

The Romanian legal system doesn't yet regulate pre-pack proceedings; however, the transfer of the business, in whole or in part, is regulated by Law no. 227/2015 regarding the Fiscal Code, which, in article 32 (1) letter d), states that „asset transfer is an operation by which a company transfers one, more or all branches of its activity to one or more companies, without being dissolved, in order to obtain participation titles in the capital of the beneficiary company”.

In order for the business transfer to not be qualified as a supply of goods, therefore being an exempted operation from VAT, the Methodological Norms of 2016 for the application of Law no. 227/2015 provides several conditions, the most important being that the recipient of the assets must prove the intention to continue the economic activity following the transfer, and not immediately liquidate the activity or, as the case may be, sell any stocks.

Therefore, in the present, the Romanian legal system only has a fiscal perspective upon business sales.

In order to be qualified as a safeguard proceeding, after the entry into force of the Directive proposal, the Romanian legislator needs to modify the Law no. 85/2014 regarding pre-insolvency and insolvency proceedings, setting rules for the commencement of pre-pack proceedings, the cram-down or cross-class cram-down mechanism, the conditions of the stay of individual enforcement actions commenced by creditors, the circumstances of debtors' request of simultaneously entering formal insolvency proceedings etc.

## 5. Conclusions

Pre-pack proceedings are an alternative to bankruptcy, aiming at preserving the business value, even if it faces insolvency or likelihood of insolvency. This type of proceeding tries to maximize the main principles of restructuring proceedings, taking into consideration the interest of all parties

involved. They may be considered as a semi-collective proceeding since it doesn't have any effects upon employees.

The Directive proposal doesn't set specific rules regarding pre-packs, but rather it sets flexible, general rules and objectives, which Member States will be able to freely determine. It is to be noted that there are two types of insolvency regulated across Member States: balance-sheet insolvency and cash-flow insolvency; some Member States recognize both as grounds to commence specific judicial proceedings.

Therefore, Member States will have to take into consideration the Directive proposal's objectives and regulate another type of safeguard proceeding, adapting it to the concept of insolvency they use. Member States such as Italy have already regulated pre-pack proceedings, after the entry into force of Directive (EU) 2019/1023.

However, Member States which already offer this alternative will have to adapt to the Directive proposal's rules and update their legal framework if they don't comply with its standards. Being categorized as a safeguard proceeding, pre-pack proceedings should also enter the field of application of the Regulation 2015/848 on insolvency proceedings (Lienhard, 2020, p. 332).

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