Cross-border NPL transactions after Brexit, with a focus on insolvency-related issues

Pan-European Financial Institutions Webinar – Session 4

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Introduction

Today’s Panel

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Webinar Agenda

- Brexit – A brief overview
- Overview of the NPL Market and Outlook
- Licence issues for UK Buyers
- Case study - Enforcement Issues
- Case study - Recognition of schemes of arrangement / restructuring plans
Brexit - A brief overview
Brexit – A brief overview

Brexit – an end:

1. EU-UK relationship no longer governed by EU Treaties
2. UK no longer in the EU Single Market and Customs Union
3. UK no longer part of EU harmonised rule-making

... and a beginning:

1. EU-UK relationship now governed by a new and bespoke set of arrangements
2. Market access now based on international agreement
3. High alignment at present, but future divergence possible (with consequences)
Overview of the NPL Market and Outlook
Following the financial crisis in 2008, the NPL ratio in the European Union increased from two percent in 2006 to a peak of 7 to 8 percent in 2012/2013; banks across the European Union have managed to gradually decrease their NPL ratios since then.

NPLs were at a historically low level in June 2018.

The biggest transactions were, amongst others, sales from German Land Banks and from the German “bad banks” EAA and FMS-WM.

Countries such as Greece, Italy, Portugal and Spain remain key markets for NPL deal activities.

Key factors driving the loan sale market are:

- Well capitalised investors from across the world,
- Increased regulations,
- Government reforms and
- High capital requirements.
Overview of the NPL Market and Outlook (3)

Outlook

• Analysts are likely to state that the NPL levels could peak following the COVID-19 pandemic reaching an all-time high since the financial crisis.

• According to the ECB, banks are “all over the place” dealing with the potential peak.

• However, the European Central Bank estimates, based on earlier stress tests, that in a severe but plausible scenario, NPLs at euro-area banks could reach €1.4 trillion in 2021/2022.

• Public guarantee schemes as well as payment deferrals granted by states will play a decisive role when tackling the increase of NPL ratios in the EEA.

• A roundtable of the European Commission together with public and private stakeholders provides for a mix of (i) a further development of the secondary market for distressed assets and (ii) a reformation of the insolvency and debt recovery frameworks taking into account a just balance of creditors’ and debtors’ interests (https://ec.europa.eu/finance/docs/law/201216-communication-non-performing-loans_en.pdf).

• By further developing a secondary market for distressed assets, banks are likely to remove NPLs from their balance sheets and focus on new lending helping the economy to recover.

• The newly incorporated German StaRUG (Gesetz über den Stabilisierungs- und Restrukturierungsrahmen für Unternehmen) could be a role model preserving a company from the insolvency and arranging for a joint solution with creditors and debtors; the existence and increase of NPLs could thus be impeded.
Does NPL trading require a lending licence in Germany?

- In most of the EU member states, buying and holding loans does not per se trigger a licence requirement for the purchaser. There are however certain exceptions such as e.g. The Netherlands (when loans are provided to consumers) and Italy which we are going to talk about on the next slides.

- In other countries, such as Germany, the acquisition of loan claims by UK banks does not, as such, trigger a licence requirement. However, for Germany, this is only true where the purchased claims derive from fully drawn loan agreements and provided that the claim will not be amended following the acquisition. Amendments that require a new credit decision, such as, for example, prolongation or change of commercial terms, can constitute licensable lending business.

- BaFin can grant an exemption from licence requirements under section 2, paragraph 5 of the KWG. This is in cases where a credit institution from a third country provides licensable services in Germany, provided that it is supervised in its home country and a supervision is not necessary due to the nature of the services provided. However, BaFin is generally rather reluctant to grant this exemption.
Licence Issues for UK Buyers (3)

Does NPL trading require a lending licence in Italy?

• The activity of Foreign Financial Intermediaries (“FFI”) is regulated under the following regulatory framework:
  - the Decree of the Minister of Economy and Finance no. 53 of 2015, which implements the Italian Banking Act (“IBA”);
  - the supervisory instructions for financial intermediaries issued by the Bank of Italy (“Circular no. 288 of 2015”).

• The following EU FFI may operate in Italy:
  a. EU financial intermediaries admitted to mutual recognition (i.e. financial intermediaries having their registered office in an EU Member State when the controlling interest in the latter is held by one or more banks having their registered office in the same EU Member State (article 18.2 IBA)) (a) through the establishment of a branch or (b) through the freedom to provide services (articles 15.3 and 16.3 IBA);
  b. EU financial intermediaries not admitted to mutual recognition (i.e. financial intermediaries that do not meet the definition under let. a) above) through a branch only, subject to authorisation by the Bank of Italy and the enrolment in the register of financial intermediaries (articles 106 and 107 IBA), provided that specific requirements are met;

• Non-EU FFI are allowed to operate in Italy exclusively through the incorporation of an Italian subsidiary, duly authorised by the Bank of Italy and enrolled in the register of financial intermediaries (articles 106 and 107 IBA):
  ! Please note that such authorisation is subject to the fulfilment of specific requirements (e.g. corporate structure, paid-up capital, consent of the home country authority to the incorporation of the subsidiary in Italy, etc.).
Is a fronting bank structure permissible in Italy?

• The Fifth Criminal Section of Italian Supreme Court (judgment no. 12777 of 2019) has declared illegal for lack of bank authorisation a fronting structure, through which an Italian licenced lender (the Italian Bank Lender of Record, "IBLOR") and a foreign bank grant loans to Italian clients.

• Specifically, the critical aspect of the transaction was identified by the Court in the absence of protection of Italian clients from the interference of the foreign lender, which had direct rights of action towards them.

• A number of substantial criteria were defined by the Italian Supreme Court, in order to determine whether the loan is actually granted by the foreign bank. Inter alia, the most relevant are:
  - the foreign bank's sharing in the customers' insolvency risk;
  - the foreign bank’s ability to interfere in the day-by-day credit relationship;
  - the foreign bank’s exposure, in excess of that of the Italian bank;
  - inclusion of each loan in the Bank of Italy’s Central Credit Register, only in respect of the credit exposure retained by the Italian bank (rather than the loans as whole).

• In light of this judgment, there are risks and uncertainties for similar fronting operations, including risk of criminal liability under Italian law.
Since January 2021, UK credit institutions or UK branches of foreign credit institutions no longer benefit from European passporting rights, which previously allowed them to provide certain regulated services (e.g. deposit-taking, lending, payment services, investment services) across the EEA without requiring separate authorisation in the other EEA member states in which they operate.

By the end of the first quarter 2021, the EU and the UK will begin discussions on granting the UK equivalence for each of the single market directives under which UK firms were previously able to access the EU market.

Where the ‘equivalence’ route is not available, the ability of UK firms to provide services and sell products to clients in the EEA, cross-border from the UK, will be significantly more difficult if not impossible. Relying on the reverse solicitation concept does not constitute a permanent business model.

In order to replicate the market access that UK firms enjoyed in the past, they will need to establish locally-authorised EEA branches or subsidiaries. EEA authorised subsidiaries will benefit from EEA passporting rights, but branches will not.

Banks, which used the passporting under the EU single market do not have this option anymore.
3. Licence Issues for UK Buyers (6)

Brexit - loss of passporting – implications in Italy

- In light of the end of the Brexit transition period on 31 December 2020, Italy recognised a **grace period** in order to allow specific UK intermediaries (e.g. banks and investment firms) to **obtain an appropriate authorisation** for their own activities:
  - **Article 22.2 of Law Decree no. 183 of 2020**, as converted into Law no. 21 of 2021, states that specific UK intermediaries **which applied** **within 31 December 2020**, to be authorised to operate as a third-country company – or to set up an Italian intermediary to which the activity is to be transferred – **and for which the authorisation procedure is still pending**, may **continue to provide their services or the activities already carried out before the end of 2020**.

  - The grace period lasts until the authorisation is obtained and, in any case, **no later than 30 June 2021**.
  - There are **limitations** to the activities that may be carried out during the grace period.
  - UK FFI are not included among the definition of intermediaries.

- In the event of a **denial of authorisation**, the relevant UK intermediaries must cease their activities in Italy avoiding prejudices to their clients, save for the actions necessary for the orderly termination of the existing relationships, to be terminated as soon as possible and, in any case, no later than three months from the communication of the denial, in compliance with the notice periods for the termination of the contracts.

- When **an intermediary ceases its activity** in Italy (i.e. has not applied for authorisation or the latter has been denied), cash, goods and financial instruments belonging to the clients must be returned to them.

- With respect to **credit agreements**, the termination of the activity does not entail a change in the terms and modalities for the payment of interest and repayment of the principal by the customer, without prejudice to the customer's right of early repayment.
In its current form, the proposed Directive on Credit Servicers and Credit Purchasers will impose an additional burden on UK based NPL investors as, following Brexit, **UK credit purchasers will not be “domiciled or established in the Union”**.

The Directive sets out a **common framework** and requirements for loan servicers and loan purchasers, including NPL investors. The Directive applies to:

- credit servicers acting on behalf of a credit institution or on behalf of a credit purchaser in respect of a credit agreement issued by a credit institution established in the Union; and
- credit purchasers of a credit agreement issued by a credit institution established in the Union.

In its current form, the Directive stipulates additional requirements that will apply **where the credit purchaser is established or domiciled outside the EU**. For example:

- A credit purchaser that is not established in the EU **shall designate in writing a representative that is established in the EU** whenever a transfer of a credit agreement is entered into. This representative shall be responsible for the obligations imposed on credit purchasers under the Directive;
- the representative shall appoint an **EU credit institution** (or a subsidiary of a credit institution) or an authorised credit servicer to perform credit servicing activities in respect of credit agreements entered into with consumers (if any).

Discussions between the European Parliament, the Council of the EU and the European Commission are ongoing and the text of the Directive is likely to change – watch this space!
Case study - Enforcement
Structure Chart for Enforcement Case Study

- **Performs Less Well Limited**
  - **Germany**
    - Real estate in Germany
    - Shares in German company
  - **Italy**
    - Shares in ItalianCo
    - Intercompany loan owed by ItalianCo
  - **The Netherlands**
    - Shares in DutchCo
    - Intercompany loan owed by DutchCo
  - **England**
    - Real estate in England
    - Shares in English subsidiary
Enforcement of security granted by Performing Less Well Limited

• Performing Less Well Limited:
  – is the sole borrower under English law debt documents.
  – is an English incorporated debtor with COMI in England.
  – has granted English law fixed and floating security over all of its assets.
  – has not granted local law security over assets outside England and Wales.
English law enforcement (1)

- **English assets**
  - Appoint a receiver over the English real estate or shares:
    - Out of court process
    - Receiver will sell the assets and pay the proceeds to the appointing creditor, having first paid anything which ranks in priority
  - Appoint an administrator if the chargee holds a qualifying floating charge over all or substantially all of the debtor’s assets
    - Appointment can be in court or out of court
    - Administrator owes duties to all creditors and is an officer of the court
  - Sale by creditor as mortgagee
    - Less common due to duties imposed on mortgagees
  - Where the security over the shares is a security financial collateral arrangement, the creditor can take steps to appropriate the shares
English law enforcement (2)

- Overseas assets
  - Is the English security recognised over the overseas asset in the relevant jurisdiction?
    - Germany (*not acceded to Hague Trust Convention*)
    - The Netherlands
    - Italy
  - In practice, where the asset has value, local law security will have been taken and perfected over the asset
  - Any receiver or administrator would need recognition in relevant jurisdiction before dealing with assets
    - Post-Brexit, UK no longer party to / bound by the Recast Insolvency Regulation (RIR)
      - Receivership: always outside the RIR; recognition issues same as before;
      - Administration no longer accorded automatic recognition or assistance in EU member states
        - Recognition as a matter of German law?
        - Recognition as a matter of Dutch law?
        - Recognition as a matter of Italian law?
English law enforcement (3)

- Where creditor has a remaining unsecured claim against the debtor it could:
  - petition the English court for the compulsory liquidation of the debtor
    - Creditor would rank *pari passu* with all other unsecured creditors
    - Only worth doing if debtor has unsecured assets or there are voidable transaction claims against the company or claims against the directors for wrongful trading
    - Liquidator would deal with remaining assets for benefit of all creditors
      - No issue with English assets;
      - Would it need recognition before dealing with assets in Germany, Italy or the Netherlands?
  - seek a judgment for the unpaid debt
    - Only really available if debtor is not in an English insolvency process
    - May be an easier route to recognition and enforcement over assets in other jurisdictions
Schemes and plans
Schemes and plans in England

• Scheme of arrangement
  – A compromise or arrangement between a company and its creditors, its members or any class of either
  – Could be used by any company in the Group:
    – Test is whether the company is liable to be wound up under the Insolvency Act 1986
    – Overseas companies would need sufficient connection and court would have to be satisfied the scheme would have practical effect in relevant jurisdictions
  – Generally, as a matter of English law, not treated as insolvency proceedings
  – Recognition?

• Restructuring plans
  – Like a scheme but:
    – Company has to be suffering from or likely to suffer from financial difficulties and the plan must be intended to address those difficulties;
    – Dissenting classes can be crammed down provided the conditions are met:
      – No member of the class is worse off under the plan than they would be under the relevant alternative, and
      – At least one class with a genuine economic interest in the relevant alternative has approved the plan
  – Has recently been held as a matter of English law to be an insolvency proceeding
  – Recognition?
Restructuring options in Germany

Company in financial distress

- Solvent Liquidation
- Restructuring via insolvency plan
- Liquidation in insolvency proceedings
- Preventive Restructuring
- Distressed M&A

in insolvency proceedings
outside insolvency proceedings
German scheme - Overview new StaRUG

Recovery mediation (Sanierungs-moderation)

Notification
- Stabilisation instruments (Stabilisierungs-anordnung)
- Out-of-court plan reconciliation (außergerichtliche Planabstimmung)
- Judicial plan reconciliation (gerichtliche Plananab-stimmung)

Restructuring plan

Insolvency

100%

Recovery settlement (Sanierungs-Vergleich)

Notification

100%

Safe Harbour

Judicial confirmation

Insolvency plan

>75%

Insolvency

>50%

Judicial confirmation
Restructuring options in the Netherlands

• Up until 1st January 2021 the restructuring options for a company (or a group of companies) in financial distress were limited
  – Outside bankruptcy, an out-of-court settlement scheme or composition offer (*buitengerechtelijk akkoord*) could only be achieved if all (100%) of the creditors approved the settlement scheme/composition offer

• Since 1st January 2021 a new legislative proposal has entered into force on the basis of which a company (or group of companies) may offer its (their) creditors a Restructuring Plan / Dutch Scheme
  – WHOA (*Wet homologatie onderhands akkoord*)

• **Dutch Scheme – Key characteristics**
  – **Initiative**
    – Debtor as well as creditors, shareholders and works council
  – **Entry Requirement**
    – Debtor can reasonably be expected to become insolvent
Dutch Scheme – Key characteristics

• **Process**
  – Public v Private
  – DIP procedure

• **Classification creditors**
  – Determination on the basis of similarity of new and existing rights
  – A separate class must be formed consisting of small trade creditors and tort claimants
  – Secured creditors will be placed in two classes

• **Voting**
  – Each class votes separately
  – If at least one class of creditors (or shareholders) has voted in favour of the composition, the court can be asked to confirm the Restructuring Plan
Restructuring options in Italy

- Turn around plan pursuant to art. 67, para 3, let. d) of the Italian bankruptcy law ("IBL")
- Debt restructuring agreement pursuant to art. 182 bis IBL
- Composition with creditors "blank" petition pursuant to art. 160, para 6 IBL
- Composition with creditors proceeding on a "going concern" basis
- Composition with creditors proceeding on a "winding up" basis

Financial crisis → Rescheduling / consolidation → Bankruptcy

- Pay if you can
- Write-off of outstanding debt

- Super-priority DIP financing ("in prededuzione")
- Default interests write off
- Interests write off
- Indebtedness write off

- Sale or valorisation of assets
- Winding up and short-term realisation

- Debt to equity swap
Useful links and further information
Useful links and further information

• More information on Brexit and how it might affect you can be found on our Brexit hub;
• Our publications website, Hogan Lovells Engage, has a number of articles on the new Dutch WHOA, the German scheme and the UK restructuring plan:
  – Restructuring under plan proceedings in Germany;
  – New German Restructuring law finally comes into force;
  – New ways of restructuring in Germany;
  – The Dutch restructuring scheme;
  – Article on insolvency reform in the UK which includes the restructuring plan;
  – Article on the first use of the cross-class cram down in a UK restructuring plan:
  – Compromising Debts in the COVID 19 era, looking at the draft Dutch and German legislation, the UK restructuring plan and similar measures in Australia;
• Please register on the Engage page if you would be interested in receiving updates on these and other related topics of interest.
Mechanics of German scheme (1)

- Only companies which are pending illiquid – but not yet over-indebted or illiquid – have access to the new restructuring tool. Illiquid or over-indebted companies may be restructured in insolvency proceedings only (via insolvency plan proceedings or distressed M&A).

- Liabilities towards employees may not be restructured under the new tool.

- The new tool allows restructuring via a restructuring plan.

- The restructuring plan becomes binding only in relation to dissenting creditors if it is approved by the court.

- Preparing, discussing and voting on the restructuring plan can be done without involvement of the court.

- The company may also apply for
  - A termination of existing contracts by the court
  - Certain stabilising measures (e.g. stay of execution)
Mechanics of German scheme (2)

- Restructuring plan classifies the involved creditors into different groups.
- Involved creditors must accept the plan by a 75 % majority vote in each group.
- Dissenting groups may be crammed down under certain conditions.
- The restructuring plan can modify:
  - unsecured claims (e.g. haircut, deferral, etc.);
  - secured claims
  - claims and rights of shareholders
  - claims in relation to collateral provided by a subsidiary of the company (if a fair compensation is granted)
German Scheme - Safe Harbour rules

- A preventive restructuring pending with the court does not lead to the assumption of
  - an immoral contribution to a delayed filing for insolvency;
  - a transaction which intend to disadvantage other creditors
- No interdiction of payments within the normal business operations in case of a subsequent illiquidity or over-indebtedness as long as the preventive restructuring matter is pending with the court

- **Suspension of claw-back rules in a subsequent insolvency for**
  - provisions of the restructuring plan and
  - Transactions made in order to implement the restructuring plan
- **exemption:**
  - Court approval was based on wrong or incomplete information by the company
  - Awareness of the other party
German Scheme - Modifications to the Insolvency Code

• Insolvency grounds:
  – Insolvency filing must be made without undue delay but at the latest within 3 weeks in case of illiquidity and within 6 weeks in case of over-indebtedness.
  – Prognosis period for over-indebtedness fixed to 12 months (so far according to the prevailing view the current and the following business year); in 2021 however only 4 months for companies affected by COVID-19 pandemic.
  – Prognosis period for pending illiquidity fixed to 24 months.

• Debtor-in-possession proceedings:
  – Generally, more difficult to access debtor-in-possession proceedings and protective shielding proceedings (Schutzschirmverfahren)
  – However, in 2021 illiquid companies which have been affected by COVID-19 pandemic may access protective shielding proceedings, exceptionally.
German Scheme - Modification of directors’ duties

- Relaxation of general interdiction of payments in case of over-indebtedness and if restructuring matter is pending (for payments within the ordinary course of business, in particular for payments which are necessary to continue the company’s business operations).

- Intensification of duties in case of pending illiquidity: Directors must preserve the interests of the company’s creditors.

- Directors are personally liable to creditors of the company for damages arising from a breach of management’s duties when a restructuring matter is pending with the restructuring court.
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