

# Transposing the new EU Restructuring Directive into Belgian law, focusing on debt-to-equity conversions

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In the ordinary course of business, shareholders bear the entrepreneurial risk. Indeed, they risk losing everything they have invested in their companies if these companies become insolvent. Should their companies be turned around through a judicial reorganisation by way of both collective and amicable agreement, the entrepreneurial risk has been diverted to the creditors and replaced by their efforts to make concessions in respect of their claims. In this situation, the shareholders retain all their equity and gain back a healthy, valuable company should the procedure turn out to be successful. The new European Union directive encourages the prevention of the aforementioned risk diversion to creditors by allowing the inclusion of debt-to-equity conversions in restructuring plans and by sidelining dissenting shareholders. Nevertheless, awaiting the transposition of the EU directive, current Belgian company law provisions make it almost impossible to include such debt-to-equity conversions in restructuring plans.

The shareholder primacy theory states that a business should always endeavour to maximise its value for the shareholders. Indeed, the key motivation for starting a business is the creation of wealth for the owner.<sup>1</sup> However, value creation is inextricably linked to risks, especially the entrepreneurial risk that shareholders bear. Should the business become insolvent, shareholders risk losing everything they have invested in their company.

One way to limit the possible amount of financial loss that entrepreneurs could face is to set up a limited liability company. Since 2019, entrepreneurs can incorporate Belgian private limited liability companies without any starting capital, and the legislator encourages them to structure their business entities using this company form. This article therefore focuses on private limited companies in relation to the European Union Directive on Restructuring and Insolvency introduced in 2019 (the 'EU Restructuring Directive' or the 'Directive').

A company attracts not only equity but also resources from lenders, and will obviously have obligations towards its counterparties (eg, trade creditors). In return for the resources (borrowed), the company is bound to perform its obligations to the creditors, and

this performance is secured by all its assets. This is where equity and debt capital are distinguished: if the liabilities exceed the assets and this causes the company to go into liquidation, creditors will be paid first. If nothing is left for distribution, the shareholders' entire contribution will simply be wiped out and they will not receive anything from the liquidation proceeds.

Shareholders of insolvent companies bear the highest risk of not receiving any liquidation dividend, regardless of whether the company is declared bankrupt or undergoing informal reorganisation. However, when designing formal reorganisation proceedings, one often sees a reorganisation procedure as a rehabilitation tool that serves the interest of the debtor (ie, the shareholders) whereby the company could avoid liquidation. This leads to creditors having too little control over the process on one hand, and the debtor having the possibility of curtailing creditors too much when they exercise their (collective) rights of recourse on the other hand.<sup>2</sup>

Under Belgian law, the same criticism can also be valid: when companies file for judicial reorganisation by way of both collective and amicable agreement (in Dutch: *gerechtelijke reorganisatie door een collectief akkoord en minnelijk akkoord*), the entrepreneurial risk, which

is due to be borne by the shareholders, has been diverted to the creditors and replaced by their efforts to make concessions in respect of their claims. Even creditors who vote against the restructuring plan must undergo write-offs. The shareholders, on the other hand, retain all their equity and gain back a healthy, valuable company after the reorganisation procedure, possibly without any effort from their part and while piggybacking on the creditors. This seems to contradict the general principle that the shareholders – not the creditors – bear the entrepreneurial risk. This can be nuanced if shareholders have made additional investments already before the company files for the opening of a formal reorganisation procedure.

The EU Commission and Council have recognised this problem of risk-shifting to the creditors in reorganisation proceedings. It is true that debtors could propose to creditors a replacement of debt with a shareholder's interest. However, such issuance of shares to creditors leads to dilution of the shareholders, resulting in a change in shareholders' rights and entitling them to vote on the restructuring plan. They often vote against it, which ultimately results the absence of an approved restructuring plan, pushing the debtor into liquidation.

### The EU directive

Consequently, the new EU Restructuring Directive<sup>3</sup> was adopted, which also amended Directive 2017/1132.<sup>4</sup> This directive provides options to sideline shareholders when a company adopts restructuring plans, ensuring that there are minimum standards for preventive restructuring procedures available across Europe to enable debtors in financial distress to solve their problems at an early stage and avoid formal insolvency proceedings. Moreover, the Directive encourages the prevention of the aforementioned risk-shifting to creditors by allowing the inclusion of debt-to-equity conversions in a company's restructuring plan.<sup>5</sup>

A debt-to-equity conversion is an equity increase by way of contribution in kind (namely incorporating creditors' claims into the company's books, which in turn eliminates the outstanding debt). The debt and interest associated with it then becomes annihilated while new shares are issued to the creditor. The new shareholder then gets a share in the upside when the restructured company recovers, is eventually sold or floated. However, existing shareholders of the company could be reluctant to allow such debt-to-equity conversion because of its possible dilutive effect on their equity stake, depending on the size of the creditor's stake. Moreover, the conversion could consequently impact future shareholders dividends.

Given that debt-to-equity conversions have long been possible in the ordinary course of business (and the EU legislature recognises this) the Directive has allowed these types of conversions to be incorporated into restructuring plans of insolvent companies.

For over two decades,<sup>6</sup> Belgian law has allowed the conversion of debt claims into equity to be included in restructuring plans. But, despite this, debtors lack the legal tools to actually impose the conversion, so they could hardly use this mechanism.<sup>7,8</sup> One could argue that the current Belgian company law provisions – mainly those on contributions in kind – make it very difficult for creditors to apply debt-to-equity conversions. If the Belgian legislature envisages increasing the use of debt-to-equity conversions in reorganisation proceedings, it should find a way to eliminate these bottlenecks. In the next sections, we explain the current problems that creditors encounter in these situations.

### Bottlenecks in Belgian company law

In theory, it is the shareholders' general meeting that is authorised to decide on equity increases. The reasoning is that equity is used as a factor for allocating the rights and obligations of shareholders, and it serves to protect (minority) shareholders.<sup>9</sup> The legislature thus gave full discretion to the shareholders to decide on any changes to their rights. In a private limited company, the general meeting could delegate the power to decide on equity increases to the governing body, if this permission is stipulated in the company's articles of association. In addition, any equity increase that results in the issuance of new shares requires the articles of association to be amended with the amendment authenticated by deed, for example, by notarial deed or by bailiff's service of a judge's decision.

The fact that shareholders have full say is the main reason why debt-to-equity conversions are rarely carried out. Shareholders that oppose to the dilution of their equity stake would simply vote against such conversions at the general meeting, leaving creditors empty-handed. As regards restructuring plans, the debtor still needs a statutory majority of its shareholders to approve the debt-to-equity conversions even if the majority of creditors has adopted the plan.

The Belgian legislature is therefore expected to put the relevant provisions of Belgian company law out of action. Debt-to-equity conversions would still be allowed in restructuring plans and insolvency law would expressly exclude the possibility to the shareholders to obstruct the execution of restructuring plans.

The new EU Restructuring Directive offers three options that can sideline shareholders when a company adopts restructuring plans:

### *1. Shareholders could be 'affected parties' with voting rights*

National law systems can choose to give shareholders the right to vote on the approval of restructuring plans. If shareholders exercise this right and oppose the plan because, for example, it includes a debt-to-equity conversion, the plan could still become effective and bind the shareholders, even dissenting ones, following a so-called 'cross-class cram-down', whereby all creditors of any class will be bound by a restructuring plan. The Directive states:

'While a restructuring plan should always be adopted if the required majority in each affected class supports the plan, it should still be possible for a restructuring plan which is not supported by the required majority in each affected class to be confirmed by a judicial or administrative authority, upon the proposal of a debtor or with the debtor's agreement.'<sup>10</sup>

This gives rise to another question that the Belgian legislature must consider: which corporate body has the right to propose the restructuring plan to the judicial or administrative authority? Should this be the governing body or the shareholders' general meeting? One could imagine that the general meeting would not be eager to submit a plan that it had opposed.

### *2. Shareholders could be 'affected parties' without voting rights*

National law systems could have the scope of the definition of 'affected parties' cover shareholders so that the restructuring plan will bind them too, but nonetheless exclude their voting rights. In this scenario, shareholders will have to bear the consequences of a debt-to-equity conversion if the other affected parties approve the plan.

### *3. Shareholders could be non-affected parties and thus be excluded from the plan*

As a third option, national law systems could exclude shareholders from the scope of the definition of 'affected parties'. This implies that the shareholders do not have any voting rights and that the restructuring plan will not bind them. However, the Directive expressly states that EU Member States should ensure that equity holders (ie, shareholders) are not allowed to unreasonably prevent or create obstacles to the adoption and confirmation of a restructuring plan.<sup>11</sup>

This leads to the question 'how far should Member States go to ensure that shareholders cannot unreasonably block the adoption of restructuring plans?' Any adoption of a restructuring plan should not be conditional on the consent from equity holders

who, upon the valuation of the enterprise, would not receive any payment or other consideration if the normal ranking of liquidation priorities were applied. Member States can attain this by not giving equity holders the right to vote on a restructuring plan. Should the equity holders nonetheless have that right, then a judicial or administrative authority should be able to confirm the plan even though one or more classes of equity holders oppose it. This could take place through a cross-class cram-down mechanism. In addition, the Directive prevents shareholders from refusing debt-to-equity conversions.<sup>12</sup>

A second point about bottlenecks in Belgian company law is that private limited liability companies continue to be characterised by their private nature and structure. Belgian company law makes it difficult for external parties to subscribe to a company's newly issued shares. Any issuance of new shares in a private limited company requires a decision by the extraordinary shareholders' meeting of the company, deciding by a special majority of at least three-quarters of the shares. The same majority is needed if third parties wish to subscribe to the new shares.<sup>13</sup> This majority approval is not needed if the new shareholders belong to certain categories, or if the articles of association or the provisions of the shareholders' agreement deviate from the Belgian company law provisions. Such majority approval requirement is aimed at protecting family-owned businesses.

When classes of shares have been created and the issuance of new shares causes such classes to change, the decision to issue new shares must additionally have a special majority vote of at least three-quarters of the shares in each share class.

Other statutory provisions or provisions in shareholders' agreements could also impose additional restrictions – notably more stringent majorities – in the issuance of new shares or the possibility for external parties to subscribe to new shares, which would bind the company and, by extension, the creditors wishing to convert their debt claims into equity.

Another important issue relating to shareholder agreements concerns the survival and continued application of such agreements if the shareholding of the company changes substantially due to debt-to-equity conversions. Should (initial) shareholders have the right to demand that new shareholders accede to the shareholders' agreement without having any say on the contents of such agreement? Or should the adoption of a restructuring plan, which includes debt-to-equity conversions, automatically lead to the termination of existing shareholders' agreements or create the right for new shareholders, as part of the restructuring plan, to amend the existing

contractual provisions? The same questions arise with respect to the articles of association of the company, which could reproduce all or part of the provisions of the shareholders' agreement or contain specific provisions, and for the amendment of which a three-quarter-majority decision by an extraordinary shareholders' meeting is required.

Third, the Belgian legislature has devised a special procedure for limited liability companies that wish to increase its equity by way of contribution in kind. This procedure entails that specific requirements apply concerning the valuation of the assets that are contributed in exchange for shares, and that both the governing body and the statutory auditor of the company (or a chartered accountant if there is no statutory auditor) must draft valuation reports and submit them to the shareholders to substantiate the proposal to approve the contributions in kind.

Since the Ruling of 16 July 2019 by the Belgian Accounting Standards Committee (Commissie voor Boekhoudkundige Normen), a company's governing body no longer has full discretion to determine the valuation of the debt claims. The debt claims must be valued at nominal value (including expired interest) for which the equity should be increased by the same value.<sup>14</sup>

This brings us to another bottleneck, but one in terms of practice as opposed to theory: how will a company's governing body decide on how many shares a creditor should receive when its debt claim is converted into equity, and, *in fine*, how many shares should be diluted for existing shareholders? For insolvent companies, calculating the market value per share (and the valuation of the company as a whole) can be a difficult exercise. Moreover, what role should the court-appointed insolvency practitioner play as regards the fulfilment of formal requirements? On the one hand, their power is limited in most cases to negotiating the restructuring plan. On the other hand, the 'debtor in possession' principle still applies, meaning that the company's governing body still has all governing powers and remains liable towards the shareholders for the execution of its mandate.

The issue of tax consequences has already been solved by the Belgian Accounting Standards Committee as well. In the same 16 July 2019 Ruling, it states that converting debt claims into equity does not qualify as granting exceptional and gratuitous advantages (in Dutch: *abnormale en goedgeunstige voordelen*) that lead to no additional taxes for the (Belgian) company under the reorganisation procedure. Equally, on behalf of the company that converts its debt claims, debt-to-equity conversions do not qualify as debt discharge

(*kwijtschelding van schuld*).<sup>15</sup> Therefore, the intended conversion should not qualify as any kind of taxable income of the two companies.

Fifth, existing third-party agreements could also cause difficulties for debt-to-equity conversions, notably if such agreements contain change-of-control clauses. The change in the shareholding of a company that is caused by debt-to-equity conversions could lead to the termination or renegotiation of contracts, which is what an insolvent company would most likely want to avoid.

To conclude this section on bottlenecks, let us briefly extend the subject matter to companies whose liability is not limited. We highly doubt that they would include debt-to-equity conversions in their restructuring plans, since creditors that eventually become shareholders through a debt conversion would consequently incur unlimited liability with the insolvent company.

## Conclusion

In the ordinary course of business, shareholders bear the entrepreneurial risk. In reorganisation proceedings, by way of both collective and amicable agreement, the entrepreneurial risk shifts from the shareholders of a company to its creditors. Allowing debt-to-equity conversions in plans could correct the imbalance. The EU Restructuring Directive allows Member States to ensure that shareholders can no longer obstruct the adoption of restructuring plans. Although Member States should be able to put certain schemes in place to sideline the shareholders when they vote whether to adopt a restructuring plan, national legislatures should bear in mind the bottlenecks in national company law.

## Notes

- 1 BR Barringer and RD Ireland, *Entrepreneurship: Successfully launching new ventures*, (Pearson Prentice Hall, 2008).
- 2 NWA Tollenaar, *Het pre-insolventieakkoord. Grondslagen en raamwerk*, (Wolters Kluwer, 2016), III.
- 3 Directive (EU) 2019/1023 on preventive restructuring frameworks.
- 4 Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law.
- 5 Recitals 2 and 96 of the Directive.
- 6 This possibility was introduced by the Act of 17 July 1997 on judicial restructurings.
- 7 D De Marez and C Stragier, *Boek XX. Een commentaar bij het nieuwe insolventierecht*, 2018, 215 No 38 (*die Keure*), 6.
- 8 The Enterprise Court of Antwerp has already confirmed a debt-to-equity conversion in its judgment of 28 March 2014 (Enterprise Court of Antwerp, 28 March 2014, *Limb. Rechtsl.* 2014, (248) 251).
- 9 D Bruloot, *Vennootschapskapitaal en schuldeisers. Een onderzoek naar de effectiviteit van de (Europese) kapitaalregelen en alternatieve technieken van schuldeisersbescherming*, 2014, 17, No 31. (*Intersentia*)
- 10 Recital 53 of the Directive.
- 11 Article 12 of the Directive.

- 12 A Zenner, 'La directive du 20 juin 2019 sur la restructuration préventive, la remise de dettes et les déchéances et l'efficacité des procédures en matière de restructuration, d'insolvabilité et de remise de dettes', 2021, liv. 138, (*DAOR*), 49, para 65.
- 13 De Geyter, 'A'rt. 5:123 WVV', in H Braekmans, K Geens and E Wymeersch (eds.), *Vennootschappen en verenigingen. Artikelsgewijze commentaar met overzicht van rechtspraak en rechtsleer*, (Wolters Kluwer, 2021), 69.
- 14 Ruling No 2019.0471 of 16 July 2019, paragraph 38.
- 15 Ruling No 2019.0471 of 16 July 2019, paragraph 32.

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