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The pre-pack regulation in the EU Commission proposal for a second insolvency directive

Adrian Thery[1]

Abstract

This article draws an analysis of the pre-pack as set forth in the recent EU Commission proposal for a second insolvency directive. We explain the context in which this proposal is born, as well as its main features regarding the pre-pack. Also, this proposal for a directive unveils a certain normative foundation for pre-packs that this article aims to describe. In view of the increasing market interest in pre-packs, this proposal for a Directive is likely to supply a normative context to the professional community.

Key words: Second Insolvency Directive, pre-pack, monitor, transfer of undertakings in bankruptcy proceedings, acquisition free and clear of debt, insider, person connected with the debtor, business succession, auction, game theory, rejection of contracts, intellectual property, interim finance, secured creditor, priming lien, preemption right, right of first refusal, anti-trust, European Insolvency Regulation.

1 Adrian Thery is Partner and Head of the Restructuring & Insolvency Department at Garrigues (Spain), Adrian.Thery@garrigues.com.

1. Introduction

1. On 7 December 2022 the European Commission published its proposal for a Directive harmonising certain aspects of insolvency law (COM(2022) 702 final). Following Directive (EU) 2019/1023 or the First Insolvency Directive), this new Proposal is the seed of what is called upon to be the Second Insolvency Directive ("the Proposal" or the "Second Insolvency Directive").

2. Both the First and the Second Insolvency Directive are part of the European Commission's priority to advance the capital market union (CMU) among the Member States. Harmonised insolvency legislation is a critical factor for achieving this, as the Preamble to the Proposal has underlined.

3. The First Directive focused essentially on the second chance mechanism, as well as on restructuring plans and their flanking measures (pre-insolvency moratorium, appointment of a restructuring expert and new money protection). In other words, it focused on restructuring processes (to the extent that it is known as the "preventive restructuring" Directive). This Second Insolvency Directive is called on to tackle a number of other matters more on the side of winding-up proceedings: avoidance actions (Title II of the Proposal); tracing assets (Title III); pre-pack proceedings (Title IV); directors' duties (Title V); winding-up of microenterprises (Title VI); creditors' committees (Title VII); and measures enhancing transparency (Title VIII).

4. It has been said for some time[2] that there is a need for the European Union not to confine itself to legislating on restructuring processes, as it did in the First Insolvency Directive, and tackle winding-up (or bankruptcy liquidation) proceedings as well. The basis of any well-structured insolvency system is liquidation[3]; restructuring is an add-on. Liquidation may be fragmented (i.e.

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2 THERY MARTI, A., 'The Preventive Restructuring Directive – What next: A Pre-pack Directive?' (2020) 80 Eurofenix, p. 18: *"Following the publication of the Directive [2019/1023], the Member States, or otherwise the European Union (in view of the implications on the free movement of capital and the freedom of establishment, among others), should work on improving the regimes of liquidation by insolvency proceedings. A restructuring regime will never be effective if it is not built on an efficient regime of liquidation by insolvency proceedings that allows the rescue of businesses through their transfer to third parties as going-concerns"*.

3 TOLLENAAR, N., *Pre-insolvency proceedings: a normative foundation and framework* (OUP 2019), p. 56: "***It is submitted that the statutory liquidation system must be the frame of reference****. The main reasons for this can be briefly stated as follows: a) liquidation is the essence of debt enforcement; b) liquidation is the most objective and efficient method of distributing value; and c) payment in non-cash rights based on fair market value distorts priority. (…) Liquidation is the essence of debt enforcement. The right of creditors to enforce their claims is a right to liquidation: the right to seek the compulsory conversion of the debtor's illiquid assets into liquid currency and the subsequent payment of the claims in liquid currency. To deny cred-*

piecemeal sale) or unitary (i.e. sale of the business as a going-concern): opting for the latter shall depend on the existence of a going-concern surplus. In turn, as a last step, restructuring of the corporate debtor instead of its liquidation shall take place provided a restructuring surplus exists with respect to the going-concern liquidation value.

5. Liquidation of businesses as a going-concern is therefore at the core of an insolvency regime. Pre-pack is in many cases the most effective and efficient instrument to achieve the liquidation of insolvent debtor corporate legal entities and the transfer of their business as a going-concern (whenever a going-concern surplus exists) at the highest price available in the market. This is due to two key factors: (i) the Pre-pack implies the existence of an auction as a price maximization device[4]; and (ii) the Pre-pack is structured so that, as we will see, it allows to run the optimal auction in such a manner that the underlying business does not suffer from the usual stigma associated by bidders and stakeholders to the coexistence of a simoultaneous fully-fledged bankruptcy proceeding. Therefore, pre-pack proceedings are one of the highlights of the future Second Insolvency Directive. In this article we will focus on Title IV of the Proposal, which precisely deals with the pre-pack. The pre-pack is regulated in Articles 19 to 35 of the Proposal, and Recitals 21 to 31 also refer to this procedure.

6. The momentum for the EU's harmonising activity on pre-pack occured on April 28 2022 with the judgment by the Court of Justice of the European Union (CJEU) in the *Heiploeg* case (C-237/20). Following that judgment, delivered in relation to a Dutch pre-pack, the CJEU conditioned the eligibility of pre-packs (for the purpose of the application of the bankruptcy exception in relation to transfers of undertakings and the protection of employment, under Article 5(1) of Direc-

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itors the ability to liquidate is to deny them the ability to enforce their claims. (...) It can be concluded from the previous sections that paramount consideration when choosing a system as the initial frame of reference is that the system ensures the effective enforcement of rights and thus the ability to enforce payment in cash. The guiding principle of an enforcement system is not to "maximize value" but to maximize cash proceeds. ***The primary objective should therefore be a system that generates the maximum proceeds in cash for the creditors as a group by developing the best possible forced sale process (for an enterprise as a going-concern).*** *"* (emphasis added).

4 BULOW, J and KLEMPERER, P. "Auctions Versus Negotiations", The American Economic Review, Vol. 86, No. 1 (Mar., 1996), pp. 180-194: *"When a company is approached by a potential buyer or buyers, its options may be either to negotiate or to put the company up for auction. Our analysis implies that if the board expects at least one extra serious bidder to appear in an auction, then it should generally not negotiate and should directly begin an auction."*

tive 2001/23[5]) on the requirement for them to be governed by "statutory or regulatory provisions"[6] (as compared to the regime of the Netherlands, where the foundation for the pre-pack was primarily court practice). This determination by the CJEU in Heiploeg case is one of the factors that triggers the principle of subsidiarity and allows the European Commission to provide the Member States with harmonised rules on pre-packs. Rules which are, moreover, compatible with Directive 2001/23/EC of 12 March 2001 on the approximation

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5 In Spain, the Recast Insolvency Act ("TRLC") opted for the dual option offered by Article 5.1 of the TUPE Directive: not transferring to the acquirer the debts arising from an employment relationship that are covered by the Spanish Wage Guarantee Fund (Article 224.1.3 TRLC); and the possibility of an agreement with the workers in the event of collective measures affecting employees (Article 220.2 TRLC). Also, importantly, the Spanish Recast Insolvency Act has vested exclusive jurisdiction on bankruptcy courts (Article 221 TRLC) to demarcate the limits for the business succession (i.e. to determine which particular labor contracts shall be associated with a specific business and which shall not) in case of insolvency of the debtor transferring a certain business. This is also compatible with the TUPE Directive.

6 Paragraphs 53 to 55 of the Heiploeg judgment:*"53 It is necessary in that respect to verify, in each situation, whether the pre-pack procedure and the insolvency proceedings at issue were carried out with a view to the liquidation of the undertaking as a result of the established insolvency of the transferor and not with a view to the mere reorganisation of that undertaking. In addition, it is necessary to establish not only that those proceedings have as their primary objective to satisfy to the greatest extent possible the claims of all the creditors, but also that the implementation of the liquidation through the transfer of the undertaking or a part thereof as a going concern, as prepared in the pre-pack procedure and carried out following the insolvency proceedings, enables the achievement of that primary objective. Accordingly, the aim of the use of the pre-pack procedure, for the purposes of liquidating a company, is to enable the insolvency administrator and the supervisory judge appointed by the court after the declaration of that company's insolvency to increase the chances of satisfying the creditors' claims.*
54 It is clear however from the file before the Court that the pre-pack procedure at issue is governed solely by rules derived from case-law and that its application by different national courts is not uniform, with the result that, as the Advocate General pointed out in point 83 of his Opinion, it is the source of legal uncertainty. In those circumstances, the pre-pack procedure set out in the case-law of the referring court cannot be regarded as providing a framework for the implementation of the exception contained in Article 5(1) of Directive 2001/23 and does not meet the requirement of legal certainty.
55 It follows that, notwithstanding the considerations set out in paragraphs 47 to 53 above, the answer to the first question is that Article 5(1) of Directive 2001/23 must be interpreted as meaning that the condition which it lays down, according to which Articles 3 and 4 of that directive are not to apply to the transfer of an undertaking where the transferor is the subject of bankruptcy proceedings or any analogous insolvency proceedings 'instituted with a view to the liquidation of the assets of the transferor', is satisfied where the transfer of all or part of an undertaking is prepared, prior to the institution of insolvency proceedings with a view to the liquidation of the assets of the transferor and in the course of which that transfer is carried out, in the context of a pre-pack procedure which has as its primary aim to enable, in the insolvency proceedings, a liquidation of the undertaking as a going concern which satisfies to the greatest extent possible the claims of all the creditors and preserves employment as far as possible, provided that that pre-pack procedure is governed by statutory or regulatory provisions."

of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings (the "TUPE Directive[7]").

2. The need for legal regulation of the pre-pack for the effectiveness of the bankruptcy court's judgments on transfers of undertakings and the protection of employment. The pre-pack as an eligible procedure for the purposes of the European Insolvency Regulation

7. The Heiploeg judgment stemmed from two references for preliminary rulings by Dutch Courts and is particularly relevant for the functioning and effectiveness of pre-pack bankruptcy proceedings. The CJEU revisits an issue on which it had already pronounced judgment a few years earlier in the *Smallsteps* case (C-126/16): identification of the requirements for application of Article 5(1) of the TUPE Directive. That Article 5(1) allows the disapplication of Articles 3 and 4 of the TUPE Directive, that require the employment contracts to continue and all employee/employer relationships to be transferred to the transferee, where the transferor is the subject of bankruptcy proceedings and those proceedings fulfil certain conditions. Namely, they must be *"bankruptcy proceedings or (…) analogous insolvency proceedings which have been instituted with a view to the liquidation of the assets of the transferor and are under the supervision of a competent public authority (which may be an insolvency practitioner authorised by a competent public authority)."*

8. The Heiploeg judgment focuses on clarifying these conditions. Firstly, in relation to the phrase "*instituted with a view to the liquidation of the assets of the transferor*", the CJEU reiterated the view it gave in the Smallsteps case and recalled that the proceedings of which the transferor is the subject must have as their aim the liquidation of the undertaking[8]. And after establishing this, the

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7 The acronym commonly used for Directive 2001/23: Transfer of Undertakings and Protection of Employment (TUPE).

8 In a new context where there is a proliferation of bankruptcy institutions (many of which may not be labeled formally as "liquidation", but still share substantially many of the liquidation features), it is not clear which is the characteristic feature of liquidation that enables this exceptional labor regime to be applied to bankruptcy institutions. On this precise point, scarce literature can be found in relation to the normative foundation of this requirement of a bankruptcy liquidation in order for the transfer of undertaking being eligible for the exceptional regime on protection of employment. The basis appears to be quite vindicative: the ordinary legal regime for workers may only vary if the employer disappears as such. This effectively happens in the event of a bankruptcy transfer of the business; the business

CJEU held that this requirement would be satisfied *"where the transfer of all or part of an undertaking is prepared, prior to the institution of insolvency proceedings with a view to the liquidation of the assets of the transferor and in the course of which that transfer is carried out, in the context of a pre-pack procedure which has as its primary aim to enable, in the insolvency proceedings, a liquidation of the undertaking as a going concern which satisfies to the greatest extent possible the claims of all the creditors and preserves employment as far as possible"*.

9. Later, to reply to the second question referred for a preliminary ruling, the CJEU focused on another of the conditions set out in Article 5(1): that the proceeding must be "*under the supervision of a competent public authority*". According to the Court, for this condition to be fulfilled in a pre-pack, one necessary element is that the transfer of the undertaking is prepared "*in the context of a pre-pack procedure prior to the declaration of insolvency by a "prospective insolvency administrator", under the supervision of a 'prospective supervisory judge'*" and the other is that the agreement concerning that transfer is concluded and performed "*after the declaration of insolvency with a view to the liquidation of the transferor's assets*".

10. Lastly, the Heiploeg judgment makes the inclusion of pre-packs in Article 5(1) of the TUPE Directive subject to the condition that they are governed by *"statutory or regulatory provisions"*. According to the court, in the Netherlands *"the pre-pack procedure (…) is governed solely by rules derived from case-law and (…) its application by different national courts is not uniform, with the result that, as the Advocate General pointed out in point 83 of his Opinion, it is the source of legal uncertainty. In those circumstances, the pre-pack procedure set out in the case-law*

continues to exist, the employer disappears. But this may also occur now with non-consensual restructuring plans. Properly considered, the basis for the change of regime for workers should not be sought in whether, anecdotally, there is a change of employer. Instead, it should be found in whether, as a result of insolvency, in a bankruptcy proceeding under supervision (leaving aside the requirement for liquidation, which is questionable) *an auction of the business takes place* (directly – through liquidation – or indirectly through an auction of the insolvent company's capital structure – restructuring –) *without a consensual outcome* (in other words, without agreement between shareholders/employer and creditors)*, regardless of who is the final acquirer*. An insolvency-related auction and the simple resulting risk for the employer of a change in control of the company occurring (and by extension also of the business) should be sufficient to justify the occurrence of the bankruptcy exception to the TUPE regime, without the need for formal liquidation to take place. The change of employer will be the best outward display that the insolvency-related auction has taken place, with the mentioned risk. However, there may be other displays, yet more subtle. From an academic standpoint, more detailed reflection about this subject will be needed as bankruptcy law, and its intertwinement with employment law, becomes more refined.

of the referring court cannot be regarded as providing a framework for the implementation of the exception contained in Article 5(1) of Directive 2001/23 and does not meet the requirement of legal certainty".

11. In this context, as we discussed in the introduction, it is understandable that the European Commission picks up the baton in response to the CJEU's invitation and, through the Proposal, takes the initiative to harmonise the pre-pack rules. To close the circle, Article 20(2) of the Proposal expressly clarifies that: *"The liquidation phase of pre-pack proceedings must be considered as a bankruptcy or insolvency proceeding instituted with a view to the liquidation of the assets of the transferor under the supervision of a competent public authority for the purpose of Article 5(1) of Directive 2001/23/EC."*

12. In short, a pre-pack is an eligible procedure for the purposes of Article 5(1) of the TUPE Directive if, as per the Heiploeg judgment, it is governed by statutory or regulatory provisions[9], and in particular, in accordance with Article 20(2) of the Proposal, where it also fulfils the provisions of the Second Insolvency Directive.

13. Similarly, Article 20(1) of the Proposal determines the eligibility of the liquidation phase in the pre-pack as an insolvency proceeding able to fall within the scope of the European Insolvency Regulation. Therefore, the phase in which a pre-pack is completed and formalised (the liquidation phase) may benefit, with all its effects, from recognition in every European jurisdiction and from the other associated advantages. Recognition of the liquidation phase of the

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9 Although it is best for the pre-pack to be governed by statutory or regulatory provisions, truth is that for legal systems in which, although the pre-pack is not governed by such provisions, a high level of legal certainty is guaranteed – for example, because there is a settled and foreseeable court practice – the exception to Articles 3 and 4 of the TUPE Directive as set out in Article 5.1 could come into play. It does not seem likely that the CJEU would choose in absolute terms to identify "legal certainty" in terms of the existence of "statutory or regulatory provisions". In fact, the European Court of Human Rights (ECHR) has ruled several times that the rights contemplated in the European Convention of Human Rights (ECHR) may be restricted by a practice in the case law or even in administrative practice, if absolute legal certainty is guaranteed. Furthermore, the Advocate General listed the conditions that in his view a pre-pack procedure ought to fulfill to guarantee an acceptable level of legal certainty and which appear absolutely reasonable: *"provide the relevant operators with a framework that will enable them to assess on a case-by-case basis, ex ante, on the basis of clear and certain criteria, the consequences and costs of using such a procedure"*. However, if in a certain Member State a practice based on case law actually exists which guarantees the fulfillment of these conditions when it comes to handling the pre-pack procedure, it may seem too extreme for it to be excluded from Article 5.1 of the TUPE Directive on account of it not being governed by a statutory or regulatory provision.

pre-pack also entails an indirect recognition of its preparation phase – although no real decisions are strictly speaking taken during this phase that would actually need recognition. Moreover, the monitor may also be included among the insolvency practitioners recognised by the European Insolvency Regulation. And so, since the pre-pack may be combined with a moratorium as a flanking measure as we shall see in para. 6, and a moratorium is (provided it is public) also a recognisable instrument under the European Insolvency Regulation, the various modular elements that may converge in the pre-pack context are all devised to fall within the scope of the European Insolvency Regulation.

3. The principles applicable to the pre-pack

14. The principles applicable to the (proposed) pre-pack may be summarised as follows:

i. The pre-pack is divided into two successive phases: the preparation phase and the liquidation phase (Article 19(1) of the Proposal). The preparation phase is a pre-bankruptcy phase to select the acquirer of the business, at which time the monitor is appointed.

   The liquidation phase is (Recital 21 and Article 20(1)) a bankruptcy phase strictly speaking (i.e. commences after bankruptcy proceedings have been opened) in which, after a favourable report has been obtained from the monitor who has now become the insolvency practitioner, the transfer of the business is approved by the court and executed. The proceeds of that transfer are finally allocated among the creditors according to their ranking.

ii. A pre-pack is an optimised realisation procedure, which is preparatory for the bankruptcy transfer of businesses, and its aim is to maximise the proceeds in benefit of the creditors. The reason it allows this maximisation lies in the fact that the competitive process to select the best bidder is carried out in a pre-bankruptcy context and not in a fully-fledged bankruptcy proceeding. Therefore, the stigma attached to bankruptcy is avoided, for both any potentially interested parties and any of the debtor's operational counterparties (suppliers, customers etc.).

   In fact, if the pre-pack is used properly in a specific jurisdiction, and the operational counterparties of the wound-up debtor travel with the business to the acquirer and are not affected by the bankruptcy proceedings (Article 27(1) of the Proposal), then the pre-pack will not have any stigma of bankruptcy attached to it: the operational counterparties holding exec-

utory contracts will simply see it as a method of implementing a solution to a financial problem (over-indebtedness) rather than an economic one (inviability due to not being profitable). Operational counterparties will not withdraw their support to the business even if the debtor enters bankruptcy proceedings (similarly to what happens in the UK with the scheme of arrangement, which only affects financial creditors). If, however, the power to terminate contracts in bankruptcy is in practice misused or over-used, then operational counterparties will pull out at the first signal of distress: not even the pre-pack will manage to shake off the stigma of bankruptcy. All the new mechanisms (whether bankruptcy or pre-bankruptcy procedures) will continue to be as ineffective as their predecessors.

iii. The pre-pack procedure is simply a realisation mechanism and does not replace domestic substantive bankruptcy rules, which will therefore continue to apply, in relation to:
   - ranking of claims and rules on proceeds distribution (Article 19(2));
   - criteria for selecting the best bid, in order to make the transfer of the business to that bidder (Article 30); and
   - release of security interests (Article 34(3)).

iv. The preparation phase starts with the appointment of the monitor by the court (Article 22(1)). In the preparation phase the debtor remains in possession of its powers of management and disposal (Article 22(4)). Once the preparation phase has ended, the decision as to whether to start the liquidation phase will be made by the debtor (Article 22(5)).

    If the liquidation phase is opened then, if it was preceded by the preparation phase, the court will appoint the monitor as insolvency practitioner (Article 25). Hence the monitor must meet the criteria required for an insolvency practitioner so as to be able to be appointed to this role when the insolvency order is issued (Article 22(3)).

    In the following para. 9 we further explain the monitor's duties and responsibilities. But it is important to stress here that, as the name suggests, the monitor does not directly carry out the competitive process. Instead, that individual simply "monitors" how a third person (the debtor or an advisor appointed by the debtor) performs that function. Accordingly, the monitor can later provide evidence to the bankruptcy court as to whether the selection of the best bidder was handled in an appropriate manner.

v. The sale process to be carried out in the preparation phase must be competitive, transparent and fair in addition to meeting market standards (Article 24(1)).

   Recital 26 explains what the Proposal means by "market standards": *"Complying with market standards in this context should require that the process is compatible with the standard rules and practice on mergers and acquisitions in the Member State concerned, which includes an invitation to potentially interested parties to participate in the sale process, disclosing the same information to potential buyers, enabling the exercise of due diligence by interested acquirers, and obtaining the offers from the interested parties through a structured process."*

   It may be seen, therefore, how the Proposal seeks for the market standards observed by sponsors in M&A transactions, for selling their businesses and maximizing their price, to be transplanted to the insolvency context for the sale of viable businesses of insolvent companies. All things considered, both cases involve profitable, and therefore economically viable, businesses; the only difference between the two lies in whether or not the owner company is over-indebted. This factor should be irrelevant for maximising the sale price, as long as the law is able to provide the sale process of insolvent companies' businesses with sufficient stability to be carried out in the same way as in any other scenario. This is precisely what the pre-pack procedure seeks to achieve.

   Pre-pack standards shall therefore replicate as much as possible those followed in M&A processes involving solvent companies. They consist, basically, of processes in which first a market sounding process is conducted to identify and make direct contact with potentially interested parties in a given business, after providing them with a teaser. Those interested parties are invited to participate in the process, after signing a non-disclosure agreement. Interested parties who have signed a non-disclosure agreement are provided with an info-memo, so that they can submit their first non-binding offer. The makers of non-binding offers are given access to the complete set of information in a data room to conduct the necessary due diligence so as to be able to submit a binding offer. Finally an auction process is structured to ensure that the submission and selection of binding offers will be carried out in a way that will maximise the price.

In other words, the sale consists of a structured process, adapted to the circumstances of the business in question, and aimed: from one angle, at whetting the appetites of potentially interested parties, staggering their access to the relevant information, while at the same time facilitating the submission of a binding purchase offer; and from another angle, at building an optimal auction process from the standpoint of getting the most out of that appetite and of ensuring that the resulting offer will be in the upper band of the price range that the interested parties are prepared to pay.

Although the binding offers will generally be made in the type of auction known as an English or ascending auction, this does not have to be the case. In fact, the type of auction that will enable the price to be maximised based on the characteristics of the business and the number and profile of the potential bidders could be, for example, an Anglo-Dutch auction or a second price sealed bid (or Vickrey) auction.[10]

Hence the competitive process is an auction in the economic meaning of the term, according to its most general sense as a device for maximising the price of things. However, this competitive process is not what is usually identified in any given jurisdiction with its internal "auction" strict legal concept, but rather has the flexibility associated with a properly prepared "direct sale". Hence the Proposal refers in Recital 26 to a "structured" competitive process: the structure regarding the rules on access to the information, and regarding the election of the type of auction to optimise the price, will differ in each case depending on the circumstances.

The Proposal does not require the sale process to be public. Disclosure may actually be harmful to the debtor or its underlying business. Especially where there are alternative methods of achieving a competitive process such as, for example, as the Proposal itself mentions, one including an "invitation to potentially interested parties to participate in the sale process". Therefore, the pre-pack process (or at least its preparation phase) may be "open, not public", as occurs in M&A processes.

Lastly, if the sale process to be conducted in the preparation phase meets the mentioned requirements and it produces only one bid, it will have to be considered that the price offered in the bid reflects the (fair) market value

10 MOCHÓN, A. and SÁEZ, Y. "Understanding Auctions", Springer Texts in Business and Economics, 2015.

of the business (Article 24(2)). As we shall see, there is an exception to this where there is only one bid and it comes from an insider (Article 32(2)).

vi. The business shall be acquired "free and clear" of any debts and liabilities, unless the acquirer expressly accepts them (Article 28). The fact of the acquirer being an insider with the debtor does not, in principle, take away the insider's entitlement to benefit as an acquirer from this debt discharge (Article 32), although it requires enhanced scrutiny of the sale process, as we shall see in further detail in para. 8.

vii. The acquirer of the business may be assigned, without the need for the contractual counterparty's consent, any reciprocally binding executory contracts which are necessary for the continuation of the business (Article 27(1)). In the opposite case, this type of contracts may be rejected, where this is in the interest of the business, except in the case of licenses of intellectual property rights. We will return to this last exception in para. 7.

4. The monitor's role and accountability

15. The appointment of the monitor is a characteristic element of a pre-pack. Such appointment starts the preparation phase (Article 22(1) of the Proposal).

16. The monitor's role is, as the name suggests, to supervise the competitive sale process carried out at the debtor's initiative (who may carry it out directly or delegate in a third party or advisor). It is important to underscore that monitors shall not carry out the competitive process, but simply supervise it. In their designated role, monitors may warn the debtor or its advisors to make them consider, attempt to ensure, or prevent, certain matters if they want the monitor's report ultimately to be favourable once the liquidation phase is opened.

17. In the preparation phase, the monitor shall document each step of the competitive process (Article 22(2)(a)) and, at the end of each phase, the monitor will have to provide the following information to the court:

- Justify whether and, if so why, the sale process has been competitive, transparent, fair and met market standards (Article 22(2)(b)).

- Where they so decide, recommend the best bidder to the court so that that bidder may become the acquirer of the business, based on the applicable

selection criteria and if the bidder is eligible according to those criteria (Article 22(2)c)).

- Determine whether the best bid is considered to meet the best-interest-of creditors test (Article 22(2)(d)).

18. The monitor's reports must be drawn up in writing and made available in digital format to the court and other interested parties (Article 22(2), final paragraph).

19. Obviously, the monitor will only be able to report effectively and objectively if he or she has not been personally involved in any of the monitored activities. Otherwise, there would be a basic conflict – not to mention confusion – between the actor in the process and its monitor: it would be like asking the board of directors to audit the financial statements they have prepared.

20. It is important to note how the provisions on the pre-pack in the Proposal emphasize this separation of functions and how it only confers monitoring powers on the monitor (not the power to carry out the activity that needs to be monitored). And is important to underline this point, due to the temptation that may arise in certain jurisdictions to confer directly on the monitor the function of carrying out the competitive process, which then the monitor will not monitor but rather carry out in person. This is extremely inadvisable because, in addition to not being compatible with the Directive, it risks pushing the monitor into a conflict of interest.

21. Therefore, under the Proposal for a Second Insolvency Directive, the monitor's main mission is not to seek and receive bids uncritically, but rather to report to the court as to whether the best bid obtained in the competitive process that has been carried out (directly or indirectly) by the debtor meets the necessary requirements for it to be authorised by the judge. Anything that departs from this function will not be effective for achieving the pre-pack's purpose.

22. The monitor's function to report favourably as to whether the best bidder in the competitive process should become acquirer of the business carries a high level of responsibility. It is not in vain that expedient court authorisation for the transfer proposed after bankruptcy proceedings have been opened pivots primarily on that report. Consistently with the importance that the monitor's report has for the court's decision, the Proposal sets out a harsh liability regime for the monitor in Article 31:

"Member States shall ensure that the monitor and the insolvency practitioner are liable for the damages that their failure to comply with their obligations under this Title causes to creditors and third parties affected by the pre-pack proceedings."

23. There is therefore a direct causal link between the monitor's liability in respect of their report (Article 31) and the court's ability to authorise the pre-pack (Article 26(1)). Without the monitor's accountability, the bankruptcy court would not be able to place its trust in the merits of the transfer for the purpose of authorising it.

24. The trend towards using pre-bankruptcy mechanisms lies in the delegation of functions to other operators, such as the restructuring expert in restructuring plans or the monitor in pre-packs. It is therefore justified for these professionals to receive commensurate fees, although equally their liability regime has to be demanding, because their work shapes the courts' decisions. Hence the strict content of Article 31 of the Proposal, which the Member States will very much have to bear in mind as the linchpin of the pre-pack.

25. The monitor's liability is due, logically, to the fact that mistakes may be made. The monitor is not always expected to report favourably on the best bidder proposed by the debtor: there will be cases when the monitor has to give an unfavourable report (and there may even be cases when, if following the preparation phase the debtor files for bankruptcy and winding-up proceedings but does not propose making the transfer to the best bidder that was selected in that phase, the insolvency practitioner may wish to reinstate the best bidder disregarded by the debtor).

26. In other words, the monitor may say yes to the proposed pre-pack transfer, and report favourably on it. But he or she may as well say no. At the risk of stating the obvious, the monitor's "yes" has a value because it could have been a "no". In other words, a favourable report by the monitor will have a legal value as long as the monitor is independent. And this is in turn connected with the matter of the monitor's fees.

27. The Proposal does not go into the monitor's fees in detail. It simply states, in Article 22(5), that the monitor's fees will be paid by the debtor if after the preparation phase the subsequent liquidation phase does not occur (which reinforces the optional nature of the liquidation phase for the debtor and the absence of any powers in this respect for the monitor); whereas if the consecutive liquidation phase ensues, then the monitor's fees will be a preferential

administrative expense. The Proposal says nothing about a potential success fee for the monitor, which is quite clearly a thorny issue.

28. At this point, there are two ways of looking at a hypothetical and potential success fee for the monitor in the context of a pre-pack: a right way and a wrong way. The wrong way consists of linking the monitor's fees to whether the transfer of the business takes place, which is tantamount to considering that any transfer of a business is positive by definition. For a start, this view is incompatible with the monitor having to report, among other factors, as to whether a piecemeal liquidation process might be better than the projected transfer of the business as a going-concern (best interest of creditors test). This view of the success fee undermines any credibility and independence that the monitor may have when it comes to reporting to the court on the transfer proposed by the debtor: where the monitor receives €1 million if the transfer is made and receives nothing if it is not, it is not hard to see how the monitor's credibility from the court's standpoint may be questioned if a favourable report is submitted. This would be similar to allowing an auditor to receive a success fee if the shareholders' meeting approves the financial reports examined by that auditor, while at the same time relying on such auditor to report any qualifications in relation to the financial statement prepared by the managing body that in the first place has offered the success fee to the auditor.

29. Alongside the wrong option, there is a right one: looking at the potential success fee for the monitor from the standpoint that the rewarded "result" is not whether or not transfer occurs (which clouds the monitor's independence for their essential function), but rather whether the price at which that transfer will take place is higher than the original estimate of its value. This aligns the monitor's incentives with those of the judge, the estate and creditor's recovery. The monitor's success fee could therefore be a commensurate proportion of the higher value that the monitor has prompted by overseeing that the process is competitive, according to a sliding scale based on usage and practices in M&A transactions. The reward serves therefore to align the interests involved (not to misalign them in an extremely unfortunate way), and at the same time it makes the fee amount subject to the higher value achieved by reason of the competitive nature of the process (to which the monitor is able to contribute if he or she does his job properly at the beginning of the process), instead of to the existence of a transfer, when the suitability itself of the transfer is the main subject of the monitor's final report and may be tainted by the temptation of the fee.

30. The matter of the monitor's fees is critical and may mean the difference that will enable the pre-pack to be able to work properly and fulfil the expected function as an efficient bankruptcy device.

31. Lastly, Article 29 of the Proposal states that, if the option exists in a Member State of filing an appeal against a court's decision relating to authorisation of the transfer of a business, that appeal will only stay that decision effectiveness in the event that the appellant (unless the appellant is an individual and the court exempts that individual at its discretion) provides security that is adequate to cover the potential damage caused by the appeal if it is dismissed.

32. The fact of one Member State not allowing an appeal does not mean that the monitor's liability cannot be sought under the applicable insolvency legislation (or, otherwise, in any declaratory proceedings that may be available). And it cannot be argued that a court authorising a transfer that had a favourable report by the monitor validates the monitor's work: the court only decides as to the legality of the transfer proposed by the debtor and places its trust in the monitor's work without judging it for opportunity reasons – and without prejudice of the monitor's liability –.

33. And even if a Member States allows for an appeal, Article 29 of the Proposal takes as a rule that a possible appeal will not stay the effectiveness of the court's decision on the sale. In such a case, if the appeal revokes the authorisation for a transfer (due to finding that the monitor's report should have been unfavourable in the first place) and in the meanwhile such transfer has already been performed, this would clear the way for the injured parties to make a claim based on the potential liability of the monitor.

34. The monitor's exposure to this liability is a determining factor for disciplining the market and thus for the pre-pack to work adequately. The rules on appeals complete the circle for the accountability in respect of the monitor's key function in the pre-pack proceedings.

5. The complete pre-bankruptcy auction (pure pre-pack) or the stalking horse bid with a subsequent post-bankruptcy auction (imperfect pre-pack)

35. The Proposal starts out from a model in which the competitive process takes place completely pre-bankruptcy, i.e. before the opening of bankruptcy proceedings. This has a dual aim. The first aim is to allow the success of the

system pivot on the correct performance of the monitor's functions (and, if this is not the case, hold the monitor personally liable). The second aim is to keep alive the potential bidders' interests in taking part in the pre-bankruptcy competitive process: if bidders perceive they can skip the pre-bankruptcy competitive process because they will always have a chance to re-enlist in a second auction to be opened post-bankruptcy, then the preparation phase that characterizes the pre-pack is bound to fail and the whole system with it.

36. However, because certain Member States (France, for example) are familiar with models involving competitive processes with subsequent second auctions, the European Commission agreed to make its Proposal easier to digest for all states. Therefore, an option was included in the Proposal allowing the pre-pack to consist of a pre-bankruptcy competitive process with immediate authorisation as soon as bankruptcy proceedings are opened, provided there is a favourable report by the monitor to the business transfer proposed by the debtor (which we refer to as the "pure pre-pack model"); or a pre-bankrupcy competitive process which, as transpires from Article 24(3) and Article 26(2) of the Proposal, does not necessarily have to be governed by the principles in Article 24(1), provided that the stalking horse bid selected in the preparation phase is subject to a second auction after bankruptcy proceedings have been opened ("imperfect pre-pack model").

37. The pure pre-pack model is used in the United Kingdom and in the Netherlands, which are the jurisdictions where the pre-pack mechanism was devised, a mechanism that pivots on the essential role and resulting liability of the monitor. The imperfect pre-pack model, by contrast, takes its cue from section 363 sales in the U.S., in which there is no monitor appointed in the prior competitive process. Therefore, the debtor carries out this process independently and the second auction becomes the only safeguard that the final price is the best available in the market.

38. In the imperfect pre-pack model the monitor's participation is redundant and unnecessary. A monitor is not necessary if there is to be an auction in the presence of the court after the opening of bankruptcy proceedings. No saddlebags are needed for that journey (or expenses associated with appointing the monitor). The beauty of the monitor is that it saves the subsequent second auction after the opening of bankruptcy proceedings and gives an incentive to all interested parties to take part in the pre-bankruptcy competitive process, supervised by the monitor.

39. Inversely, the mere existence of the second auction is perverse because it encourages potential interested parties to do exactly the opposite: to keep ambushed until that second auction is held and not take part in the supervised pre-insolvency competitive process, when this is the heart of the pre-pack but is nevertheless undermined in the imperfect pre-pack.

40. Also, the harsh liability regime in Article 31 of the Proposal doesn't make any particular sense in the imperfect pre-pack model. The monitor's function is not so essential as this model requires greater involvement by the court and therefore should not warrant the same level of fees for the monitor as in a pure pre-pack, nor, therefore, the same liability regime.

41. For all these reasons, Member States would be well-advised to choose the pure pre-pack model.

42. As an aside, even the name "stalking horse bid" given in the U.S. to the bid submitted before the second auction is very illustrative. In the absence of a monitor, U.S. law itself assumes that the stalking horse will be an insider with the debtor. It therefore refers to this stalking hunting technique to describe the procedure: a "stalking horse" means a horse used as cover by hunters. By contrast to certain European jurisdictions (such as Spain or France), in the U.S. there is no obstacle to insiders acquiring businesses if they make the best bid. The provisions in the Proposal on the participation of insiders are discussed in para. 7, and I believe, as in the Proposal, that they should be allowed to take part in the auction together with the other interested parties, and that, if their bid is determined to be the best following a process meeting market standards, then it should be authorised, and benefit from the customary judicial resolutions associated with bankruptcy business transfers (including the "free and clear" acquisition). However, it is one thing whether an insider may bid for a business and benefit from a "free and clear" acquisition, and a different matter is which model of pre-pack is more adequate. In my view, allowing an insider to benefit from the "free and clear" acquisition of businesses should mean, not only the safeguards in Article 32 which we shall see in para. 7, but the counterpoint is also that those insiders should not have an initial advantage over the other potential bidders (as happens in the imperfect pre-pack model[11]).

11 Note also that, as transpires from Article 26(2) of the Proposal, in the imperfect pre-pack the length of a second auction after the opening of bankruptcy proceedings is restricted to a four-week period, which in turn must start not later than two weeks after the opening of the liquidation phase. So it may

In other words, insiders and non-insiders should take part in the competitive process on an equal footing (as happens in the pure pre-pack model). This provides an additional reason for Member States to choose this last model out of the two options offered in the Proposal.

43. Lastly, in cases where a Member State chooses the imperfect pre-pack model, the Proposal grants, in Recital 27 and in Article 26(2), a number of protections to prevent the stalking bid being given undesirable advantages which may freeze competition in the auction after the opening of bankruptcy proceedings:

"Member States shall ensure that the protections granted to the initial bidder in the preparation phase, such as expense reimbursement or break-up fees, are commensurate and proportionate, and do not deter potentially interested parties from bidding in the liquidation phase."

44. The term "break-up fee" captures what could be called "termination fees", namely the fee the stalking horse bidder is entitled to receive for the costs incurred to study the business and prepare a bid which, on certain occasions, may both arouse the interest of third parties and prompt competition. In the U.S. there are regular studies[12] as to the acceptable amounts for break-up fees, based on usage and practices: they usually amount to around 2% to 3% of the enterprise value of the target. But note that, beyond "break-up fees", the Proposal does not provide any other type of advantages or protections for the stalking horse bidder, and the key is that they must be commensurate and not deter interest from third party bidders, which ought to be a priority in any auction.

45. Article 33.2 is clear in this respect by setting forth that the Member States must ensure that no preemption rights (right of first refusal or similar) are granted to bidders. Obviously, the grant of a preemption right to a bidder kills off competition in any auction (interested parties without preemption rights will pull out of the auction on realising that they are at a disadvantage with respect to the bidder that benefits from a preemption right), and therefore it

happen that the debtor takes six months, for example, to select its stalking horse bid, whereas the other bidders (who may not necessarily have had the chance to take part in that first phase), will only have four weeks to decide and prepare their bid in the subsequent second auction.

12 See for example the "Transaction Termination Fee Study" that Houlihan Lokey regularly publishes on its website (http://cdn.hl.com/pdf/2023/2022-transaction-termination-fee-study.pdf).

undermines the auction's aim of maximising the price and producing a result in line with market standards.

6. Pre-insolvency moratorium as a flanking measure

46. Article 23 of the Proposal makes clear that the moratorium under Article 6 and Article 7 of the Restructuring Directive is designed to serve as a flanking measure, to both a restructuring plan and a pre-pack:

"Member States shall ensure that during the preparation phase, where the debtor is in a situation of likelihood of insolvency or is insolvent in accordance with national law, the debtor can benefit from a stay of individual enforcement actions in accordance with Articles 6 and 7 of Directive (EU) 2019/1023, where it facilitates the seamless and effective roll-out of the pre-pack proceedings. The monitor shall be heard prior to the decision on the stay of individual enforcement actions."

47. This reaffirms that the key factor for the new restructuring system brought by the First Insolvency Directive and the Proposal for the Second is not so much whether formally and anecdotally there is a restructuring or bankruptcy liquidation, but rather whether, ultimately, both imply a transfer of the business, either to creditors (restructuring) or to a third party (liquidation). And whether that process of transferring the business is what has to be protected, regardless of who is the purchaser (in other words, not only where it is purchased by its creditors). Considering that such transfer process will take place through an auction (among creditors – restructuring plan – or with the inclusion of third parties – sale of a business or pre-pack –), the important factor is to give that auction the stability it needs to achieve its aim of maximising the price: that stability is achieved by allowing a pre-pack to be combined with the moratorium. The other legal measures in the Proposal that we have seen and shall see are all also aimed at achieving an optimal auction, as we shall summarise in the last section.

7. Mandatory assignment or rejection of contracts: the important exception for intellectual property licenses

48. Article 27 of the Proposal concerns the mandatory rejection and assignment of contracts associated with the business to the acquirer and without the need for the counterparty's consent. In a few European jurisdictions, the rejection of contracts had traditionally been included in their insolvency legislation, following the US example. However, the mandatory assignment of contracts

without the counterparty's consent is more unusual in Europe (and especially striking in Germany).

49. In the first point of Article 27, the Proposal calls on Member States to ensure that the acquirer is the assignee, without the need for the counterparty's consent, for any executory contracts which are required for the continuation of the business activity. An exception is provided where the acquirer is a competitor of that counterparty. No express exception is provided for contracts that were entered on the basis of the personal attributes of one or both parties ("*intuitu personae*"), but that does not prevent each Member States to reflect on this particular issue and include the exceptions they deem fit.

50. In the second point, Article 27 requires Member States to ensure that the court may, again in relation to executory contracts associated with the business, reject those contracts where any of the following conditions applies (which we refer to as "rejection in the interest of the pre-pack"):

 - Where the rejection is in the interest of the business; or

 - Where the contract contains public service obligations which the acquirer is not qualified to carry out.

51. Then, in the final paragraph of Article 27.2, the Proposal introduces an exception to the contracts that may be terminated by the court. In other words, the Proposal mandates that Member States should prevent the exempted contracts from being rejected by the court: those relating to licenses of intellectual property rights. We refer to this exception to the power of rejection in the interest of the pre-pack as the "IP exception".

52. This IP exception had already been supported in Europe[13], although, again, it is founded on what has been learned from experience in the U.S. In fact, the U.S. Chapter 11 system has been used for some time with the rejection of contracts in the best interests of the estate. But because they have handled sales in

13 THERY MARTI, A. The Preventive Restructuring Directive – What next: A Pre-pack Directive?' (2020) 80 Eurofenix, p. 18: *"the liquidation regime should allow the liquidated company's contracts to be taken over by the purchaser without requiring the counterparty's consent, so that the transfer of the business in liquidation and the consequent transfer of business do not result in the disappearance of the attached network of contracts that is necessary for the business to operate (**also determining special rules, in relation, for example, to intellectual property**)."*

bankruptcy proceedings of larger businesses over a longer period of time, the U.S. have more experience.

53. The IP exception originates from the 1985 decision in the *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc*. case. Richmond was a debtor in bankruptcy proceedings which, before the proceedings, had granted to Lubrizol a patent license for a metal coating process. After a petition for Chapter 11 had been filed, Richmond sought to reject the license in order to recover the patent and license it again. The court approved the rejection of the license and held that Lubrizol would be able to seek damages (as a pre-petition claim), but it would not be able to seek specific performance of the license or continued use of the patent.

54. The U.S. court found it had no other option than to take that decision under the law at that time. In spite of its decision, the court still reflected on the perverse effect that the decision could entail:

"It cannot be gainsaid that allowing rejection of such contracts [licensing agreements for intellectual property rights] *as executory imposes serious burdens upon contracting parties such as Lubrizol. Nor can it be doubted that allowing rejection in this and comparable cases could have a general chilling effect upon the willingness of such parties to contract at all with businesses in possible financial difficulty."*

55. The decision in Lubrizol caused huge concern in the U.S. market: the absence of protection for licenses in the event of bankruptcy proceedings on the licensor could affect future transactions which might involve licenses of intellectual property rights. As a result, the development of new technology in the U.S. could also be impaired. In effect, the impact of the licensor's bankruptcy proceedings on the licensed intellectual property rights could be extreme if the rights are lost following the rejection of contracts in bankruptcy, causing losses as a result in respect of the considerable sums that are usually invested by licensees in developing those licenses: the deterrent effect on investing in intellectual property could therefore be devastating for the U.S. economy, in which new technology is a core element.

56. Therefore, in 1988, only three years after the Lubrizol case, the U.S. Congress recognised the prevailing concern and approved an ad hoc law to protect the rights of intellectual property licensees in the event of bankruptcy: the Intellectual Property Bankruptcy Protection Act.[14]

14 Intellectual Property Bankruptcy Protection Act §§ 101(35A), 365(n).

57. This law introduced section 365(n) into the U.S. Bankruptcy Code ("USBC"). This section provides the debtor's licensee counterparties with a certain degree of protection in the context of reorganization plans[15], by protecting them from rejections made without their consent in relation to any executory contracts under which the license had been granted. Therefore, the licensee has the right to object to rejection of its contract and retain any rights in intellectual property that it had immediately before the opening of bankruptcy proceedings. Its rights to enforce include any mainly the exclusivity provision (but exclude however any other right to specific performance). These rights retained under Section 365(n) remain in effect throughout the original term of the contract that had been sought to be rejected, and any period for which the licensee has the right to extend the contract under the general contract law.

58. The European Commission therefore took its cue from the U.S. Intellectual Property Bankruptcy Protection Act[16] to give similar protection to IP licenses[17], and with it, to investments in new technology in the European Union[18].

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15 In relation to US bankruptcy business transfers, the referred section 365(n) USBC may conflict with 363(f) USBC, which allows the buyer to acquire such property free and clear of interests (namely any types of encumbrances or interests or in it). This conflict has been resolved by the US case-law, again in favor of protection of the licensee, resulting in the licensee having the same protection in a reorganization than in a liquidation. In particular, *In re Dynamic Tooling Systems, Inc.*, 349 B.R. 847 (Bankr. D. Kan. 2006) and, more clearly, *In re Crumbs Bake Shop, Inc.*, 522 B.R. 766 (Bankr. D.N.J. 2014) weighed up the interplay of the various interests between the acquirers of businesses and the licensees of intellectual property rights, and concluded that licensees' rights prevailed over acquirers' rights under the principle of statutory construction that the specific governs the general (namely section 365(n) USBC is the specific rule which prevails over section 363(f)).

16 Industries in the U.S. making intensive use of intellectual property rights accounted for 41% of GDP in 2019. Moreover, intellectual property-intensive industries accounted directly for more than 47 million jobs in the U.S. In addition to those jobs, a further 15.5 million jobs depended on supplies of intermediate goods and services by intellectual property-intensive industries. In total, intellectual property-intensive industries generated 62.5 million jobs in the U.S. in 2019, or 44 % of total employment (source: USPTO, "Intellectual property and the U.S. economy: Third edition").

17 The U.S. definition of intellectual property is not exactly the same as the definition used in Europe. In the period between the introduction of the law described above in 1988 until 2019 it was not clear in the U.S. whether the special bankruptcy protection available to patent licensees also applied to trademark licensees. In May 2019, however, the Supreme Court of the United States ruled in favor of this being so in *Mission Product Holdings, Inc. v. Tempnology LLC (In re Tempnology LLC)*, 559 B.R. 809 (B.A.P. 1st Cir. 2016).

18 In the EU, also in 2019, industries that make intensive use of intellectual property rights (such as patents, registered trademarks, industrial designs and copyright) generate 45% of GDP (€6.6 trillion) in the EU annually and account for 63 million jobs (29% of all jobs). A further 21 million people are employed in sectors that supply these industries with goods and services (source: UEIPO, "Intellectual property rights intensive industries and economic performance in the European Union", 2019).

59. Lastly, Article 27.3 of the Proposal contains a conflict rule determining that the law applicable to the assignment or rejection of executory contracts must be the law of the Member State where the liquidation phase in the pre-pack was opened.

8. The position of closely related parties

60. Article 32.1 of the Proposal states that Member States should ensure that parties closely related to the debtor (i.e. insiders) can acquire the business. Insiders are defined in Article 2.q) of the Proposal.

61. Acquisition of the business by an insider will also bring along the feature that the acquisition is "free and clear" of debt as per Article 28, provided the following conditions are met:

a) The bidder must have disclosed to the monitor and to the court its connection with the debtor;

b) Other participants in the pre-pack process must have received adequate information on the existence of an insider bidder; and

c) Non-insider bidders must be granted sufficient time to make an offer.

62. As long as these conditions are met, if the insider is the best bidder and the business is transferred to that insider, then the insider will benefit from the "free and clear" acquisition to the same extent as any other acquirer would have been entitled to.

63. This provision in the Proposal is crucially important, especially for the few Member States that are in the unfortunate position of continuing to place restrictions for insiders to be able to acquire a business belonging to the debtor. Restrictions on the acquisition by insiders are terminal for bankruptcy procedures, which suffer from misuse and low usage[19].

19 Vid. GURREA MARTÍNEZ, A., 'The Low Usage of Bankruptcy Procedures: A Cultural Problem? Lessons from Spain', (2020) 27 U. Miami Int'l & Comp. L. Rev. 272. GARCÍA-POSADA, M. & MORA SANGUINETTI, JUAN S., 'Are there Alternatives to Bankruptcy? A Study of Small Businesses Distress in Spain', (2014) 5 J. OF THE SPANISH ECON. ASS'N 287.

64. The main reason for low usage of bankruptcy procedures lies precisely in the fact that, because of these restrictions, business owners do not see bankruptcy institutions as a potential solution to their problems: if in bankruptcy proceedings anyone in the world has the chance to acquire the business, except for the existing business owner, even if that owner is the best bidder, then bankruptcy is not a valid solution for the person who has to make the decision to file the bankruptcy petition in the first place.

65. The Proposal makes no judgment of intentions: it does not start out from the assumption that the insider has wilfully caused bankruptcy or presume either that the pre-pack has a fraudulent aim. Instead, the Proposal starts out from the fact that, if there is no reason why an insider should be disqualified, then the rule should be that the insider – on an equal footing with any other bidder – may participate in the pre-pack and benefit from the "free and clear" acquisition. The justification for this rule starts out from equal rights and non-discrimination. Although it goes further, because enabling the participation of an insider in the competitive process – inside or outside a pre-pack – also works in favour of the system and the creditors themselves for the following reasons, among others:

   - If an insider is able to submit for the business what might objectively be the best bid, disqualifying the insider from the acquisition implies lower recovery for the estate, and therefore, a loss to creditors.

   - The participation of an insider in the competitive process sends signals to the market that the business for sale is a good investment[20] and contributes to attracting the attention of potentially interested parties: the fact of an insider remaining interested in the business, despite insolvency, means that it is valued by one of the parties who knows it best.

   - If the law allows insiders to acquire a business on an equal footing, then insiders will naturally cause debtors to resort to bankruptcy proceedings when applicable (instead of considering bankruptcy institutions as a last resort, which will happen whenever insiders are prevented from acquiring

20 Namely, the business sale does not hide an adverse selection issue; or in other words, the business is not actually, as may be suspected at first sight in relation to bankruptcy sales, a dud or "lemon" (AKERLOF, George A., 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism', (1970) 84(3) The Quarterly Journal of Economics.

the debtor's business even if they are the best bidders). In fact, if insiders are interested in acquiring the business of the insolvent debtor, they will try to ensure that the bankruptcy proceedings take place sooner rather than later, because they will want to prevent that the business is impaired by debt overhang.

- If the law allows insiders to acquire a business on an equal footing, then it will be possible for them to obtain finance for that acquisition. Finance providers will tend to prefer to fund bidders who have the most complete information. Obtaining this finance will enable insiders to bid a higher price. This allows the pre-pack (and the sale of businesses generally) to become a procedure that is similar economically to a non-consensual restructuring: a refinancing of the business through a different company.

- Restrictions to business acquisition by insiders actually encourage disguised or "sub-rosa" business sales to insiders. In such sales, because it is not known at the relevant time whether there is an insider lurking in the process, the associated protections and enhanced scrutiny cannot be applied.

66. The equal footing of insiders with respect to rights downstream at the time of the acquisition of the business implies the necessary equal opportunities, this time for the other third party bidders upstream during the previous competitive process. This equal footing for bidders in a competitive process when an insider is participating is guaranteed by what is defined as "enhanced scrutiny".

67. The Proposal also requires this enhanced scrutiny where an insider participates in the competitive process. The components of this enhanced scrutiny are the insider's duties of transparency (letters a) and b) of Article 32.1). And from the other angle, the rights of other bidders to equal opportunities in relation to preparing their bids, particularly in relation to access to information (information symmetry) and to sufficient time to prepare their bids (Article 32.1.c)). Enhanced scrutiny of the competitive process to ensure these equal opportunities (for non-insider third bidders) proves to be an essential counterweight where an insider participates in the process.

68. Lastly, Article 32.2 of the Proposal provides that, where the insider's is the only bid (which is a more concerning case than if the insider's bid was the best of several offers), the Member States will have to introduce additional safeguards

for the authorisation and execution of the sale of the business. In other words, where the only bid is made by the insider, the general presumption in Article 24.2 that the bid is deemed to meet the market price does not apply. And the additional safeguards include the duty of the monitor and the insolvency practitioner to reject that offer if the bid does not satisfy the best-interest-of-creditors test (in other words, if the price bid by the insider for the business is lower than the estimated value from piecemeal liquidation).

69. All things considered, this Article 32 is probably one of the most relevant in the Proposal and its correct implementation is of crucial importance in jurisdictions where restrictions to acquire exist for related parties. Not so much for large businesses, for which the restructuring plan will be the dominant solution. More so definitely for microenterprises, and for small and medium enterprises, where, in the event of insolvency, if not even the insider can acquire the business, it is not only business fabric that is lost, but also livelihoods.

9. Interim finance in the pre-pack

70. Article 33.1 of the Proposal regulates the debtor's option to obtain interim finance in the context of the pre-pack and enters into a few of the characteristics of that interim finance:

- Interim finance must have the lowest possible cost (Article 33.1.a)). The most appropriate way of ensuring that the finance has the lowest possible cost will be to carry out an auction for that interim finance. Article 33.1.a) of the Proposal allows the monitor to have a say in this: the quality of the auction of the interim finance may impact the quality of the auction of the business. And the natural providers of interim finance will in many cases be the potential interested parties in the acquisition of the business.

- Interim finance providers are entitled to take priority for recovering that finance over the other existing creditors (Article 33.1.b)). To the point where security interests may be provided for that finance over the price that will be obtained with the transfer of the business (Article 33.1.c). As a result, if the finance provider is the best bidder, that bidder may partially offset the interim finance against the price that has been paid for the acquisition (Article 33.1.d)).

71. In the context of the pre-pack, an intuitive solution may be to ask the bidders to provide the finance to the debtor for the pre-pack to continue running, by way

of a condition (or "ticket to ride") for being able to participate in the competitive process. The necessary amount of interim finance is divided up into an amount per head for each of the bidders and its repayment is secured against the price that the winning bidder will have to pay. The Proposal provides an authorisation card for this in Article 33.1.

72. The main question that arises from this article is over the priority that interim finance may have, not with respect to the existing claims, but with respect to the existing security interests. In other words, whether security interests may be provided for the interim finance which entail to prime any pre-existing first lien security interests. This is an important decision that the Member States will have to make when transposing the Second Insolvency Directive.

73. In my personal opinion, priming liens entail certain dangers, not only for the specific secured creditors that suffer its effects ex post, but also ex ante from the standpoint of prior access to credit, inasmuch as it undermines the certainty of the ranking of security interests in force when credit is extended. See here the analysis provided in this respect[21] on interim finance and new finance under the First Insolvency Directive.

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21 THERY MARTI, A. 'Los marcos de reestructuración preventiva en la propuesta de Directiva de 22 de noviembre de 2016 (y II)', (2018) 28 Revista de Derecho Concursal y Paraconcursal:*"The second conceivable preference is one that not only operates with respect to the pre-existing unsecured claims, but is also able to be placed ahead of the secured claims. In other words, it has real super-seniority status, able to prime pre-existing first liens without their consent: fresh money therefore is secured with collateral benefitting from what is known as a "priming lien" (non-consensual seniority) with respect to pre-existing secured claims; the priming lien is usually associated with the financing provided to debtors in Chapter 11 in the U.S. (referred to as "DIP financing"). From the Impact Assessment accompanying the Proposal, and as occurs with the non-consensual release of guarantors (see Section II.5.d of the first part of this article) it appears that the European Commission has discarded the option of allowing the Member States to introduce non-consensual priming. The reason is the impact new financing may have on the rights of existing creditors: if the impact of fresh money with super-seniority status already causes concern for the European Union (as transpires from that Impact Assessment), there will be even more reason for concern if the super-seniority claim is secured with priming liens, in other words, it is guaranteed through new security interests which additionally allow the new claim to rank ahead of pre-existing secured claims.*
An elegant and balanced solution to the problem of new financing and new security interests is that adopted by the Czech Republic. Under Article 357 of the Czech insolvency law, creditors holding collateral have a preferred right to provide financing to the debtor after the commencement of the restructuring process. If, however, those creditors do not take that opportunity to provide new financing to the debtor, then a third party who does provide that financing may obtain new security interests in collateral which are not placed ahead of –but do share the same ranking as–pre-existing security interests, without requiring the consent of their holders.
In this way they avoid the problems arising from compulsory priming (which only makes the pre-existing secured creditor suffer the risk of insufficient cover), and from the strict inalterability of collateral (which

74. I personally believe that, at the most, the interim finance provider should have equal ranking with the existing security interests (in which case, if the collateral does not cover the debt of both lenders completely, then both should bear the loss pari-passu, including the new finance provider, who will need to consider whether it is worth providing finance based not only on the value of the collateral, but also on the business viability and its value as a going-concern).

75. And I also believe that a mandatory priming lien should not be allowed. Indeed, due to the priming nature of such lien it is either: (a) the pre-existing secured creditor who will suffer all the loss if the collateral does not provide a sufficient cushion or buffer that covers both the debt secured by the pre-existing lien and also the new priming security interest; or (b) the unsecured creditors who ultimately suffer the loss, even if the collateral is sufficient to cover the debt from the pre-existing secured lender and the priming lender, if the interim finance has funded nothing but increased losses associated with an unprofitable business that has been subject to the pre-pack of a going-concern but should perhaps have been liquidated piecemeal.

76. In other words, priming liens are a bankruptcy feature that may maximize the risk of inviable loss-making businesses being sold as going-concerns, instead of liquidated piecemeal – as they should be from an economical standpoint.

10. The rights of creditors, in particular secured creditors

77. Article 34 of the Proposal focuses on the protection of creditors in the pre-pack, by providing that they should have a right to be heard (Article 34.1). The right to be heard is granted to all creditors in an economic sense: in other words, for both creditors in the strict sense, and for shareholders as residual creditors, in line with the U.S. definition of capital structure introduced in the First Insolvency Directive. For instance, in Spain, that right to be heard for shareholders may either be understood to be met through the insolvent debtor's right to be

prevents, if the need arises, to unleash all the potential of the collateral). Additionally, if a third party provides financing it is because it considers this a way to become reasonably secured, and the remaining risk of insufficient cover (shared equally with the existing secured creditor) motivates it not to finance economically unviable companies, thereby aligning its interests with those of the other unsecured creditors. The pre-existing creditor, for its part, shares its security, though with the peace of mind that no third party will expectably provide new financing unless it is because it foresees that (no matter whether the potential shortfall in recovery is divided into two) the underlying asset will cover the debt."

heard, which embodies and aims to cover the shareholders' common interest in the insolvency proceedings.

78. Article 34.2 of the Proposal provides that the Member States may articulate – only if they so choose – two exceptions to this right to be heard:

- The creditors or shareholders that are out-of-the-money. This exception seems somewhat questionable and hard to accept, from the standpoint that these creditors or shareholders may be out-of-the-money as a result of some sort of irregularity that they will indeed want to report through their right to be heard. This makes it seem recommendable not to choose to include this exception. Moreover, restructuring plans do not strip interested parties purportedly out-of-the-money of their right to object to, or challenge, the sanctioning of the plan in question.

- The counterparties to executory contracts whose claims are going to be paid in full in the pre-pack. This exception makes sense from the standpoint that, if those counterparties are not going to be affected by the pre-pack, there is little use in giving them the right to be heard or to object (similarly to how that they do not have that right either for restructuring plans, under the First Insolvency Directive).

79. Article 34.3 of the Proposal provides that the requirements for releasing security interests will be the same in pre-pack proceedings as in general insolvency proceedings.

80. Elsewhere, Article 34.4 of the Proposal is a nod to the States that require the express consent of the secured creditors in order to be able to release their security interests (in other words, the States in which, unlike Spain, the insolvency courts cannot release security interests without the authorisation of the secured creditor).

81. It is still of interest to see which requirements the EU lawmakers have found to be relevant to be able, in the context of the pre-pack, to release the security interests over assets or rights necessary for the business to continue trading. Such requirements are as follows (the wording of the Proposal appears to imply that, for the release of security interests, any of these requirements must be met, although it appears more reasonable to interpret that none of them must be met):

- The secured creditors fail to prove that the bid considered in the pre-pack does not satisfy the best-interest-of-creditors test. In other words, they have not provided proof that, in the relevant counterfactual[22] – in this case a piecemeal liquidation (instead of the unitary or going-concern liquidation via the pre-pack at hand) –, they would have recovered a greater value.

- Secured creditors have not filed (directly or through a third party) an alternative binding purchase offer that allows the insolvency estate to obtain a better recovery than with the proposed pre-pack bid.

82. It may be seen how in these cases the relevant factor for the Proposal is that resistance to release of security interests should not be discretional or *ad nutum*, but rather based on a just cause. And the two conceivable causes for a secured creditor being able to object to that release are (i) that the transfer in bankruptcy proceedings proposed in the pre-pack does not meet the best-interest-of-creditors test or (ii) that the secured creditors have not been allowed to make their own purchase bid so as to be able to defend their position adequately in the auction.

83. Outside these causes, it seems hard to find any others able to justify a veto by a creditor to their security interest being released. Unless there is a willingness to allow bankruptcy proceedings to be used to keep secured assets permanently ostracised instead of returning them to the economic cycle at the price the market is prepared to pay, whatever that may be.

84. Lastly, we will refer to Article 33.3 of the Proposal, which gives secured creditors the option of credit bidding in the auction, although subject to certain restrictions:

22 In a restructuring plan, the relevant counterfactual for the purpose of the best-interest-of-creditors test is liquidation (i.e. comparing the restructuring value with the higher of the possible liquidation values: piecemeal or going-concern liquidation). And in a going-concern liquidation under the pre-pack, the relevant counterfactual is a piecemeal liquidation. Therefore, conceptually there are only three scenarios able to be compared with each other for the purpose of the best-interest-of-creditors test: a proposed restructuring plan, a going-concern liquidation and a piecemeal liquidation. Otherwise, without a certain amount of conceptual clarity, a counterfactual analysis is inviable due to the infinite number of possibilities. Under this same reasoning, it makes no sense to have a counterfactual consisting of an unknown and undefined "best alternative solution" or "next-best-alternative scenario" (an option timidly provided to Member States in Article 2(6) of the First Insolvency Directive), which is being disregarded with good judgment by a great many Member States.

"Member States shall ensure that, where security interests encumber the business subject to the pre-pack proceedings, creditors who are the beneficiaries of those security interests may offset their claims in their bid only provided that the value of those claims is significantly below market value of the business."

85. Limiting the ability of certain secured creditors to credit bid is something that certain courts have done in the US[23]. However, the Proposal has, on this point, as we shall see, far less drastic consequences than in the US.

86. The contemplated scenario is as follows: imagine that a creditor has a claim secured over a given asset. The ex-ante estimation of value of the asset is 100, whereas the secured debt amounts to 120. The fact that a creditor is able to credit bid 120 for an asset appraised at 100 deters potential competitors from participating in the auction of the asset: any third party potentially interested in the asset will immediately realise that it is a waste of time to bid for it, because the secured creditor will credit-bid the whole amount of its claim and will win the auction. This is what is known in the U.S. as the chilling effect of credit bidding.

87. This deterrent effect of a competitor who has an unlimited ability to bid a secured claim undermines the auction's basic function as a mechanism for maximising the price and efficiently reallocating assets to the person that can use them to offer the greatest benefit to the community and can thus bid more for them. From the standpoint of legislative policy, that deterrent effect may be acceptable in the case of non-operating assets (an empty building with no operations), but it is much more questionable in the case of a going concern, where other interests are involved alongside those of the secured creditor.

88. Therefore, in a pre-pack context, the Proposal takes a stand to prevent credit bidding being able to deter third parties from participating in the competitive process. The mechanism that the Proposal uses consists of restricting the amount that the creditor can bid in cases where there are undersecured (or undercollateralized) claims: the creditor is only allowed to credit bid an amount

23 See *In re Fisker Automotive Holdings Inc.* 510 B.R. 55 (Bankr. D. Del. 2014). *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010) (*"a court may deny a lender the right to credit bid in the interest of any policy advanced by the Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment."*). *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009).

lower than the estimated market value of the business over which the creditor's security interest was provided.

89. However, it is important to explain an essential matter that is only implicit in the Proposal. The Directive does not say that (as certain courts have done in the US) the secured claim loses its security as a result of the debt exceeding the market value of the collateral. Therefore, the restriction on the creditor's ability to bid its secured claim does not mean that the claim loses the security interest in respect of the portion of the claim that cannot be used in the bid: it only means that the creditor cannot credit-bid that portion of its claim, although the security interest remains for all other purposes.

90. Returning to our example: the creditor holding a secured claim for 120 is restricted to credit-bidding 80 of its claim, and a third party bids 110 and wins the auction, the 110 in this third party's bid will still have to be distributed fully and exclusively to the creditor whose secured claim amounts to 120[24]. Similarly, if with the same restriction, it is the secured creditor that wins the auction and that creditor bid 120 (80 in a credit bid and 40 in cash), the 40 that the creditor will pay in cash will have to be repaid to him himself because that amount will continue to be captured by the creditor's security interest (i.e. the secured creditor will "round-trip" the cash component of his bid).

91. This means that the winning secured creditor will have to pay part of the bid in cash, with no further consequence than the resulting administrative hassle. But this hassle also causes the creditor to reflect as to whether it could not be saved (because the creditor believes that the cap placed on the credit bid is reasonable); in other words, it forces the creditor not to follow automatic steps in the auction (automatically credit-bidding the full secured claim), but rather to act rationally and proportionately (setting a cap for his bid in line with his collateral valuation, in order to avoid the potential hassle of the cash round-tripping).

24 Assuming that, in the jurisdiction at hand, the ex-ante estimation of value does not limit the final recovery if proceeds are eventually higher than estimated.

92. The beneficial effects of this measure operate in a number of directions:

– Secured creditors are prevented from bidding uncritically the highest amount of their secured debt, which, in the case of an undercollateralized claim, deters third parties from participating in the auction.

– Secured creditors are encouraged to reflect as to what the minimum price really is:
    - with which they would be satisfied and prepared to accept that a third party, rather than they themselves, should acquire the collateral;
    - above which they are interested in this auction fulfilling its function of maximising price, also and especially in favour of the secured creditors themselves (instead of acquiring the collateral and later auctioning it later again in another different auction);
    - above which, if they change their minds mid-auction, they will still have the chance to credit bid and bid in cash (knowing that the cash will return to them).

– Interested parties in the collateral are given an incentive to participate in the pre-pack, instead of competing in any parallel auction that the creditor may organise behind the scenes for his secured claim. Industrial bidders will be more inclined to participate in a pre-pack type process and they are of most interest to the community as acquirers of a business. Whereas opportunistic investor bidders will be the ones most willing to participate in the behind-the-scenes auction of the secured claim (in view of the difficulties that an industrial bidder may see for converting that claim into ownership of the business and which, in part, prompt the highest discounts – or lowest prices – associated with the bids of investor bidders in comparison with those of industrial bidders).

– It makes interested third parties, especially industrial parties, perceive that they have a real chance of winning the auction if they participate, because the undercollateralized creditors will no longer automatically be allowed to credit bid the whole of their secured claim.

93. This credit-bidding administrative restriction is another important measure, directed at optimising the pre-pack sale auction by enhancing competition even in cases where secured creditors are undercollateralized. Still, we must stress that all the other priorities associated with secured claims are preserved under Article 33(3) of the Proposal.

11. Preemption rights

94. As we mentioned briefly at the end of section V, the Proposal observes with concern that certain bidders may have preemption rights that will allow them to acquire the business or any of its parts with priority over other bidders. The reason is straightforward: any priority may pervert an auction and damage its effectiveness by freezing competition. In fact, the granting or recognition of any preemption right for a bidder kills off competition in an auction, because interested parties without a preemption right will pull out of the auction when they realise that they are at a disadvantage. Therefore, a preemption right undermines the auction's aim to maximise price and achieve a market outcome. Consequently, Article 33(2) of the Proposal states categorically that Member States must ensure that no preemption rights are conceded to bidders.

95. Recital 29 to the Proposal is related to Article 33(2), and appears to give that scope to the term "concede" used in that article, not only in relation to the grant of new preemption rights in the course of the pre-pack, but also to the recognition in the pre-pack of preemption rights granted prior to the pre-pack:

"The possibility to enforce preemption rights in the course of the sale process would distort competition in the pre-pack proceedings. Potential bidders might abstain from bidding because of rights that would discard their offers at the holder's discretion, irrespective of the time and resources invested and the economic value of the offer. In order to ensure that the winning offer reflects the best available price on the market, preemption rights should not be conceded to bidders, nor should such rights be enforced in the course of the bidding process. Holders of preemption rights that were granted prior to the commencement of the pre-pack proceedings, instead of invoking their option, should be invited to participate in the bidding."

96. This Recital 29, in conjunction with Article 33(2), invites Member States to reflect on an element like preemption rights or rights of first refusal, which, due to being commonplace, may have an important impact on the effectiveness of the auction at the heart of the pre-pack:

- A preemption right is different from a call option. A call option gives the right to purchase at a specific price. A preemption right does not. Therefore, if it is intended to disable a given call option, it will have to be attacked via avoidance action, or rejection of contracts or any other applicable mechanism for rendering it invalid. However, to disable a preemption right this is not necessary, as pointed out by the Proposal.

- The aim of a call option is to be able to purchase, at the option-holder's discretion, at a pre-determined price. By contrast, the aim of the preemption right is not to give its beneficiary the right to purchase at that pre-determined price, but rather only to have the chance to buy without a loss for the seller. Because, in most cases, the seller is solvent when the preemption right is granted, it is presumed that it will be able to choose its purchaser freely, and there will be no need for an auction, it grants the preemption right to its counterparty as a right that will be consecutive to the selection of the prospective purchaser.

- However, where the seller that granted a preemption right to a third party enters insolvency, then the selection of the purchaser is no longer unrestricted, but rather creditors' interests require that selection to be made through an auction as a mechanism for maximising the price. The problem then is that, as we have seen, recognition of the preemption right may challenge the effectiveness of the auction, if the preemption right is recognised as a consecutive step to the auction concerned: nobody will want to participate in the auction in the first place if they know that later the person holding a preemption right may come along and step in the shoes of the person who, in principle, won the auction.

- The solution provided by the Proposal is as straightforward as it is effective, and, again, it is based on U.S. law[25]: in the event of bankruptcy proceedings, the preemption right, even if was conceived as a consecutive right to the selection of the prospective purchaser, may be replaced by, and channelled as, an invitation to the holder of the preemption right to participate in the auction concerned.

- In fact, the preemption right is generally articulated as a consecutive right, not because this is an essential element of the right, but precisely because, in the absence of bankruptcy proceedings and an auction, the holder of the preemption right can only guarantee its right on the basis of the conceptual scenario that there is a prospective purchaser. Therefore, the structure for exercising the preemption right consists of the seller first selecting a prospective purchaser and then giving the holder of the preemption right the chance to step into the position of that purchaser.

25 See *In re Mr. Grocer, Inc.*, 77 B.R. 349 (Bankr. D.N.H. 1987). *In re Adelphia Communications Corp.*, 359 B.R. 65 (Bankr. S.D.N.Y. 2007). *In re Chicago Investments, LLC*, 470 B.R. 32 (Bankr. D. Mass. 2012).

– But if an auction exists, the structure for exercising the preemption right no longer needs to be consecutive: the priority may simply be implemented as an invitation to its holder to participate in the auction. If the holder of the preemption right wins the auction, it is because that holder is prepared to pay at least the same as the other bidders or prospective purchasers (in other words, the preemption right does not imply a loss for the seller). If, by contrast, the holder of the preemption right loses the auction, it will be because that holder was not prepared to pay the same amount as was offered by the prospective purchaser that won.

– The key factor is that the preemption right does not give entitlement to purchase at a specific price, but rather only gives entitlement to be given the chance to purchase. This chance to purchase takes place: after the selection of the purchaser, in non-structured discretional processes; or simultaneously with the selection of that purchaser, in structured processes such as an auction. In other words, by replacing the preemption right with an invitation to participate simultaneously in the auction.

– Accordingly, no loss arises for the seller, because the preemption right does not prevent the seller obtaining the best price available in the market. Nor does a loss arise for the holder of the preemption right, because that holder continues not to have the right to purchase at any predetermined price, but, with the invitation to participate in the auction, the holder continues to have the chance to purchase.

97. This is a way of reconciling the effectiveness of the auction implicit in the pre-pack, with the exercise of the preemption right.

98. The Member States' reflections when transposing this disablement of the preemption right in an insolvency-related auction (in the context of a pre-pack, but there is no reason why it should not be applied similarly outside that context) will have to focus[26] on deciding whether that disablement occurs with respect to statutory rights (of first refusal) as well as with respect to contractual preemption rights. In principle, if it is considered that exercising the

26 Other elements may be considered, such as: whether the contractual preemption rights falling within the disablement in bankruptcy proceedings may arise from both non-executory and executory contracts; if the preemption right that has been disabled exceptionally as a result of the transfer in bankruptcy proceedings must, where it arises under a contract that is assigned to the acquirer, continue to be valid for subsequent transfers; etc.

preemption right through an invitation to the auction does not cause a loss to the holder of that preemption right, then there is no apparent reason for not applying the same solution regardless of whether the rights are contractual or statutory. Unless the basis for any specific statutory priority may exceed that explained above and legislative policy reasons make it advisable to exclude it from the non-recognition rule.

12. Pre-pack bids by competitors with anti-trust relevance

99. Article 35 of the Proposal and the related Recital 31 regulate the impact on the pre-pack stemming from the fact that a certain purchase offer for the business may be subject to a future decision by the competition authorities on anti-trust matters.

100. If that authority's decision could take a long time (several months) to be obtained, the resulting delay for the court decision on the pre-pack process may cause serious losses to the estate. Either because in the intervening period other alternative offers may be lost which are not subject to that clearance (even if for a lower price than the offer that is), and ultimately the best bid does not receive the relevant clearance. Or else because, even though there are no other alternative offers, the business does not have the financial independence to retain its activity and it uses, in the waiting period for the competition authorities' decision, resources that would have improved recovery for creditors should a piecemeal liquidation have been performed.

101. The Proposal promotes that in these circumstances alternative purchase offers should be submitted, to prevent the debtor being captive of a single offer from a competitor for its business, with the problems described (Article 35(1)). The Proposal encourages the articulation of procedures that will ensure a quick exchange of information between the monitor and the competition authorities, which will speed up the decisions of those authorities (Article 35(2)); although the Proposal does not go as far as the U.S. which set out special, simplified and expedited anti-trust procedures where the target business is under a Chapter 11 proceeding (section 363.(b) USBC).

102. Lastly, the Proposal expressly provides that, where a given purchase offer entails a risk from an anti-trust standpoint, it may be disregarded, if the following conditions apply (Article 35(3)):

(i) it is not the only existing offer; and

(ii) the delay in the sale of the business, due to the need for anti-trust authorisation, would result in damage to the debtor's business (typically, as a result of the use of resources in the intervening period, by comparison with another offer that does not imply a delay while waiting for that clearance).

103. In short, it is sought that the circumstance of a competitor of the debtor taking part as bidder in a competitive process for the sale of the debtor's business cannot carry the risk of the competitor managing to cause the auction to fail as a result of the clearance needed from the anti-trust authorities. Otherwise, perverse incentives may exist for competitors to participate in pre-packs: if the auction fails (with the resulting dismantlement of the business), the debtor's market share will naturally accrete to the competitor, without the payment of any price in exchange, causing a loss to the debtor's estate.

13. Closing remarks

104. We have seen how the regulations on the pre-pack in the Proposal seek to create a legal framework that provides the sequence of elements needed to craft the optimal auction to maximise the price of the insolvent debtor's business.

105. The main challenge with respect to the auction of businesses in bankruptcy are (i) the debtor's insolvency and the stigma associated with the opening of bankruptcy proceedings and (ii) how to preserve and optimize the going-concern value. This makes it necessary to structure the auction into a competitive sale process in which the essential part takes place in what we could call the pre-insolvency "sunken part" (the preparation phase) and culminates with completion of the transfer within bankruptcy proceedings (the liquidation phase), provided that the monitor in that first part has reported to the court in the second phase in favour of the transfer to the selected bidder.

106. At that point, the elements brought by the Proposal come into play at different levels that are relevant in any auction, although adapted to the particular circumstances associated with bankruptcy proceedings:

a) Preventing certain bidders or other interested parties from being able to make the auction fail:

- Ensuring stability of the auction by allowing the insolvency to be neutralised by a combination of the pre-pack and the pre-insolvency moratorium and the option of obtaining interim finance;
- Transfer of the business free and clear of debt and liens in favour of the acquirer;
- Demarcation of the limits of business succession, especially labour-wise;
- Imposition of mandatory assignment of necessary contracts without the need for the consent of the assigned counterparty;
- Option to disregard competitor's bids that may compromise the pre-pack with anti-trust implications.

b) Seeking the participation and competing bids of all bidders potentially interested in the business:
   - Ensuring that the sale process is open and competitive, through the monitor's supervision and potential warnings of a subsequent unfavourable report if the process is not adequately conducted;
   - Allowing insiders with the debtor to participate, with the same rights and conditions as the other bidders;
   - Enabling credit bidding (by the interim finance provider or by secured creditors).

c) Preventing certain bidders acquiring or using advantages in a way that is incompatible with the aim of the auction, without prejudice to third parties:
   - Prohibiting the grant of new preemption rights;
   - Replacing any potential existing preemption rights with an invitation to participate in the competitive process;
   - Limiting the protections in favour of interim finance providers;
   - Limiting the protections in favour of a potential stalking horse bid to a commensurate break-up fee;
   - Limiting the ability of secured creditors to credit bid in cases involving undercollateralization, without limiting the priority associated with their security interest.

107. In short, the measures in the Proposal for a Directive are nothing more than a translation into law of the rules and economic incentives that must exist for the auction (of a business as a going concern of an insolvent debtor) to be able to meet its function in the best way possible. All these measures achieve their purposes and are articulated procedurally in the pre-pack.

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