Reimagining Rescue

Professor Rebecca Parry
Professor of Insolvency Law
Nottingham Law School

and

Paul J. Omar
Professor of International and Comparative Insolvency Law
Nottingham Law School

Editors

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About the Contributors

Francisco Garcimartin is a Professor at the Madrid Autonoma University, Madrid, Spain. Email: francisco.garcimartin@uam.es

Lézelle Jacobs is a Lecturer at the University of the Free State, Bloemfontein, South Africa. Email: jacobslm@ufs.ac.za

Alexandra Kastrinou is Senior Lecturer at the Nottingham Law School, Nottingham Trent University, Nottingham, the United Kingdom. Email: alexandra.kastrinou@ntu.ac.uk

Gerard McCormack is Professor of International Business Law at the University of Leeds, the United Kingdom. Email: G.McCormack@leeds.ac.uk

Rimvydas Norkus is a Professor at the Mykolas Romeris University and President of the Supreme Court of Lithuania, Vilnius, Lithuania. Email: r.norkus@lat.lt

Juana Pulgar Ezquerra is Professor of Commercial Law at the Complutense University of Madrid, Madrid, Spain. Email: Juana.Pulgar@ashurst.com

Bernard Santen was formerly a Senior Researcher at the Leiden Law School, Leiden University, Leiden, the Netherlands. Email: b.p.a.santen@law.leidenuniv.nl

Tom Smith is Queen's Counsel and Barrister in Chambers at South Square, Gray's Inn, London, the United Kingdom. Email: tomsmith@southsquare.com

Pál Szirányi is Legal Officer in the Civil Justice Policy Unit at DG Justice, European Commission, Brussels, Belgium. Email: Pal-Lajos.sziranyi@ec.europa.eu

Adrian Thery is a Partner in Garrigues. Madrid, Spain. Email: adrian.thery@garrigues.com

Robert van Galen is Partner and Chairman of the Restructuring and Insolvency Team, NautaDutilh N.V., Amsterdam, the Netherlands. Email: robert.vangalen@nautadutilh.com

Melissa Vanmeenen is a Professor in the Faculty of Law, University of Antwerp, Antwerp, Belgium. Email: melissa.vanmeenen@ua.ac.be

G. Ray Warner is a Professor of Law at the St. John's University School of Law, New York, United States. Email: ray.warner@stjohns.edu

Editorial Preface

The advent of the European Insolvency Regulation ("EIR") in 2000, and which came into force in 2002, brought a new framework for the coordination of cross-border insolvency proceedings. Though its paradigm of main and secondary proceedings was not always convenient, leading to strategies evolved in practice to effect COMI-shifts, the structure it gave to the conduct of such cases was a great improvement on the rules of private international law and traditional recognition and enforcement frameworks. Over the years, the implementation of the EIR, aided by interpretations offered by the European Court of Justice (now Court of Justice of the European Union), led to increasing familiarity by judges and practitioners with the particular demands of cross-border and the need to foster good practice by courts and insolvency professionals alike.

In 2012, mandated by Article 46 of the EIR, the European Commission published the first of the drafts that would eventually become the Recast EIR, adopted in early 2015 and which is due to come into force in 2017. Many of the difficulties encountered in practice and which were reflected in the case law have been dealt with, while others, deemed contentious still, await further consideration. Already, though, much speculation in print has occurred as to the way in which the Recast EIR will work, compared to its predecessor. One of the issues that the Recast EIR attempted to deal with was that occasioned by the extension of the EIR to the workings of groups, a feature that was not intended in the way the text was first conceived. Through the use of collocation of COMI of group entities and/or the treatment of subsidiaries as emanations of their parent, the ability to create synergy in cross-border restructurings was promoted. This led, incidentally, to a virtual competition between jurisdictions whose laws were perceived to be favourable to restructurings, workouts and other forms of turnaround.

The by-product of this process was to bring to the fore consideration at member state level of the strengths and weaknesses of domestic procedures. From the introduction of rescue in the mid-1980s to the development of pre-insolvency measures in the 2000s and the more recent rise of the pre-pack version of rescue, national systems have attempted to respond to stakeholders' needs for better crafted and tailored procedures able to give proper support to rescue attempts. Over the period that the EIR has been in operation, many member states have reformed their laws, some more often than others. The result has been to place a premium on the development of good and effective domestic procedures alongside the availability of strong international structures able to deal with cross-border rescues. The two go hand in hand!

The intention behind the present text, consisting of papers delivered at two conferences: a Joint Conference with the Academy of European Law in Trier, Germany on 19-20 March 2015 on the theme of reforms to the EIR and a further

Joint Conference with the Nottingham Law School in Nottingham, the United Kingdom on 25-26 June 2015 on the topic of reimagining rescue, is that it will form an up to date account of viewpoints on reform measures taking place at national and European levels. It is particularly noteworthy that members of both INSOL Europe and the Academic Forum have been engaged in the process by which various texts have been elaborated, from the Recast EIR to the texts that are likely to emerge as a result of the most recent European Commission Experts' Group as well as initiatives within domestic arenas. Furthermore, many members have also added their voices to deliberations and studies looking into how the legal and regulatory structures for insolvency law and policy are being developed across the European Union. The skills and talent of members of the Academic Forum have played a more than modest role in shaping the texts that have emerged and those that are forthcoming.

As such, the papers here are truly cutting edge and will increase awareness of the impact of insolvency law within domestic, regional and global contexts. Submissions for this collection have come from prominent academics, doctoral students and other researchers, practitioners and policy-makers in the field representing a number of jurisdictions from common law, civilian and mixed traditions within Europe and further afield. This has ensured that the contents of the research and analyses included in this text are of the highest quality and will be useful and thought-provoking. It is hoped that this will render the contributions here as well as the further references they contain of great value for researchers in the field.

In summary, we would like to express our appreciation to all those who have assisted in making the project a success, not least the contributors themselves, but also the administrative staff members of INSOL-Europe, particularly Caroline Taylor and Wendy Cooper, together with other members of the team. Special thanks go to Myriam Mailly and Emmanuelle Inacio, INSOL Europe Technical Officers, and Jennifer Gant, Chair of the Young Academics' Network in Insolvency Law, who helped organised the submission of conference papers by contributors. If not otherwise noted by the contributors, the law is stated as at 30 June 2016.

Rebecca Parry
Professor of Insolvency Law
Nottingham Law School, Nottingham Trent University
Email: rebecca.parry@ntu.ac.uk

Paul J. Omar
Professor of International and Comparative Insolvency Law
Nottingham Law School, Nottingham Trent University
Email: paul.omar@ntu.ac.uk

A Note on the Academic Forum

The INSOL Europe Academic Forum, founded in 2004, is a constituent body of INSOL Europe, a Europe-wide association of practitioners in insolvency. The Academic Forum's primary mission is to engage in the representation of members interested in insolvency law and research, to encourage and assist in the development of research initiatives in the insolvency field and to participate in the activities organised by INSOL Europe. The membership of the Academic Forum includes insolvency academics, insolvency practitioners with recognised academic credentials as well as those engaged in the research and study of insolvency. The Academic Forum meets annually in conjunction with the main conference of INSOL Europe and also arranges half-yearly conferences around suitable themes of interest to the practice and academic communities. Previous meetings have taken place in Prague (2004), Amsterdam (2005), Monaco (2007), Leiden and Barcelona (2008), Brighton and Stockholm (2009), Leiden and Vienna (2010), Milan, Venice and Jersey (2011), Nottingham and Brussels (2012), Trier and Paris (2013), Leiden and Istanbul (2014), Trier, Nottingham and Berlin (2015) as well as a further visit to Berlin (2016). A number of smaller events, including University seminars and colloquia, are also co-hosted by the Academic Forum with institutions across Europe.

At Paris, Professor Christoph Paulus (Humboldt University Berlin, Germany) was elected Chair of the Academic Forum for a three-year term. Anthon Verweij (Leiden University, the Netherlands) serves as Secretary to the Board, while Florian Bruder (Max Planck Institute, Germany), Jessica Schmidt (University of Bayreuth, Germany), Jennifer Gant (Chair of the Young Academics' Network in Insolvency Law), Emmanuelle Inacio and Myriam Mailly (INSOL Europe Technical Officers), Rolef de Weijs (Amsterdam University, the Netherlands) and Michael Veder (Radboud University Nijmegen, the Netherlands) are ordinary members of the Board. Professor Rebecca Parry (Nottingham Trent University, the United Kingdom) is the Editor of the Conference Proceedings series and ex officio a member of the board. A Supervisory Committee has also been established as a consultative board for Academic Forum projects whose membership includes senior insolvency academics and practitioners.

With sponsorship made available by Edwin Coe LLP over a seven-year period from 2007-2014 and Shakespeare Martineau from 2015 onwards, the Academic Forum has been able to offer young scholars travel grants to attend its conferences. The sponsorship has also permitted for an annual lecture to be given by a scholar of international repute. These have included Professor Jay Westbrook (University of Texas, the United States), Gabriel Moss QC (3/4 South Square, Gray's Inn, the United Kingdom), The Hon Mr Justice Ian Kawaley (Supreme Court of Bermuda), Professor Karsten Schmidt (President of the

Bucerius Law School, Germany), Professor Bob Wessels (Leiden Law School, the Netherlands), Professor Ian Fletcher QC (University College London, United Kingdom), Professor Rosalind Mason (Queensland University of Technology, Australia) and Professor Axel Flessner (Humboldt University Berlin, Germany).

These lectures and many of the presentations at the Academic Forum conferences have been collected in the conference proceedings booklets that have been regularly published since the publications series arising from conferences was inaugurated in 2009 by reports from the 2008 Leiden and Barcelona events. The intention is that conference proceedings booklets will be published from all of the conferences listed above and will accompany other publications in the Technical Series produced by INSOL Europe and the Judicial Wing. Overall, the publications are intended to form a comprehensive report of the conferences and contain accounts of recent research in the insolvency field useful for academics, judges, policy-makers and practitioners alike.

The Academic Forum's next meeting is scheduled to take place in conjunction with the INSOL Europe conference in Cascais, Portugal on 21-22 September 2016, with further conferences being planned for 2017 and beyond. Details of academic conferences will be posted at the Academic Forum website at: www.insol-europe.org/academic/ as and when available. An on-line registration facility for academic conferences as well as further information about the work of the Academic Forum can also be obtained via the website as well as a dedicated Facebook page.

A Note on the Academy of European Law

The Academy of European Law is a non-profit public foundation that provides training in European law to legal practitioners. Its patrons include most EU member states and it is supported by the EU. ERA organises conferences and seminars around Europe. It also has an e-learning platform and publishes a legal journal titled "ERA Forum".

The Academy of European Law began its work in Trier in March 1992. Its genesis was associated with the rapid pace of European integration during the late 1980s and 1990s. With the Single European Act in 1986 and the Maastricht Treaty in 1992, the scope of European legislation became wider than ever before. It was clear that lawyers, judges and other legal practitioners at all levels and in almost all fields of law would need regular training and a forum for debate in order to keep up-to-date with the latest developments. In 1990, the European Parliament recommended that the Commission invest in a centre for the continuing education of lawyers in order to improve the application of European law. At about the same time, Peter Caesar, the Minister of Justice of the German Land of Rhineland-Palatinate, together with Horst Langes and Willi Rothley, Members of the European Parliament from the same region, were drawing up proposals for an Academy of European Law to be established in Trier. In 1991, the European Parliament endorsed these proposals in a report drafted by the Dutch MEP James Janssen van Raay.

An Association for the Promotion of the Academy of European Law was established to turn the idea into reality. The association continues to support the Academy's work and is known as the "Friends of ERA". The Luxembourg Government, led by Prime Minister Jacques Santer and Justice Minister Marc Fischbach, also lent its support, and the European Commission agreed to the Parliament's decision to provide the Academy with regular funding. Trier was chosen as the location of the Academy because of its proximity to the judicial capital of the European Union in Luxembourg. On 8-9 November 1991, the project of an Academy of European Law was formally launched at a ceremony in Trier with, as founding patrons, the Grand Duchy of Luxembourg, the Land of Rhineland-Palatinate and the City of Trier. In the intervening years, a majority of EU Member States has joined the foundation.

Many other leading figures in the field of European law have actively supported the launch of the Academy. Notable among these was Ole Due, then President of the European Court of Justice, who together with many of his fellow judges began a tradition of close co-operation between the Court in Luxembourg and the Academy. The Academy took possession of its purpose-built premises, provided by the Land of Rhineland-Palatinate, in the summer of 1998, where its activities are hosted. The Academy has also built up a specialised library that includes publications on all areas of Community law from both the European and national perspectives. Since 1999, it has also served as a European Documentation Centre with an up-to-date archive of all official EU publications in English, French and German.

PART I
THE TRIER PAPERS

Chapter 1

Annex Proceedings and the Continued Interplay with the Brussels Ia Regulation

Rimvydas Norkus

1 Introduction*

On 10 January 2015, a recast version of the EU Regulation of the European Parliament and of the Council No. 1215/2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters[1] ("Brussels Ia") became applicable.[2] The same as its predecessors Brussels I Regulation[3] and Brussels Convention,[4] it excludes from its scope "bankruptcy, proceedings relating to the winding-up of insolvent companies or other legal persons, judicial arrangements, compositions and analogous proceedings" (Article 1(2)(b) Brussels Ia).

The intention[5] of the European legislator to leave jurisdiction in these matters to be regulated by Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings[6] ("EIR") and its proposed recast version ("EIRa")[7] did not resolve questions concerning the applicability of one or another regulation to numerous proceedings featuring connections to insolvency. The proceedings "deriving directly from the insolvency proceedings and which are closely linked to them" are broadly referred to as annex proceedings. These proceedings are independent civil proceedings, and the judgments in these proceedings can be handed down not necessarily by the insolvency court but also by another court.

Since there are no express provisions on such proceedings either in EIR or in Brussels Ia, the concurrence of the two instruments comes into being when it comes to jurisdiction to resolve this type of case and recognition and enforcement

* This chapter was previously published at: (2015) 16(2) ERA Forum 197.

1 OJ L 351 of 20 December 2012, pp. 1–32.

2 Ibid., Article 81.

3 OJ L 12 of 16 January 2001, pp. 1–23.

4 OJ L 299 of 31 December 1972, pp. 32–42.

5 *Fletcher* [2], p. 347.

6 OJ L 160 of 30 June 2000, pp. 1–18.

7 Proposal for Regulation of the European Parliament and of the Council amending Council Regulation (EC) No. 1346/2000 on insolvency proceedings. 20 November 2014, No. 15414/14 ADD 1.

of their legal results. The concept expressed in *Schlosser*,[8] *Virgos-Schmit*[9] reports and also endorsed by the CJEU in *F-Tex*[10] is that the two Regulations should be interpreted so that proceedings should not fall within both but within one or the other without leaving any gap between them.[11] Nevertheless, it is conceivable that there are some questions which are on the borderline of the two instruments, as well as questions which will not come within the scope of application of either Regulation No. 1346/2000 or Regulation No. 1215/2012.[12] Therefore, the main purpose of this article is to assess the interplay between the above mentioned legal instruments and to analyse problematic aspects of annex proceedings.

2 Main Differences stemming from the Applicability of EIR or Brussels I

2.1 The Scope

The current EIR is applicable to collective insolvency proceedings which entail a partial or total divestment of a debtor and the appointment of a liquidator (Article 1(1) EIR). In the revised version of the EIR, the scope of the Regulation will be extended with the aim of including pre-insolvency proceedings and debtor-in-possession proceedings.[13] However, there are no changes in the approach that the revised EIR will remain applicable only to those proceedings which are listed in Annex A to the Regulation. It causes no difficulty to determine that proceedings listed in Annex A fall within the scope of EIR[14] and not within Brussels Ia. Annex proceedings are individual proceedings featuring certain connections to insolvency proceedings, therefore there is an ambiguity as to the Regulation applicable to these. Unlike collective proceedings listed in Annex A, there is no explicit provision in the EIR as to what extent this Regulation is applicable to in proceedings which are not collective insolvency proceedings, but which feature close connection to those proceedings. However, some implications may be drawn from the systemic analysis of both texts.

8 OJ C 59 of 5 March 1979, para. 53.

9 *Virgos/Schmit* [16], para. 77.

10 Case C-213/10 *F-Tex SIA v Lietuvos-Anglijos UAB 'Jadecloud-Vilma'* [2012] ECR I-(19 April) ECLI:EU:C:2012:215.

11 *Magnus/Mankowski/Rogerson* [9], art 1 note 29.

12 Case C-213/10 *F-Tex SIA v Lietuvos-Anglijos UAB 'Jadecloud-Vilma'* [2012] ECR I-(19 April) ECLI:EU:C:2012:215.

13 Report from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the Application of Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings, Strasbourg, 12 December 2012, COM(2012) 743 final.

14 Case C-116/11 *Bank Handlowy w Warszawie SA and PPHU «ADAX»/Ryszard Adamiak v Christianapol sp. z o.o.*[2012] ECLI:EU:C:2012:739 point 33.

The scope of Brussels Ia Regulation, which definitely is a new cornerstone of private EU law, like its precursors, is based on a long-standing principle of its general applicability[15] with some exceptions which should be interpreted narrowly,[16] whereas the EIR sets forth independent criteria for the scope of the Regulation. Different approaches concerning the construction of the two legal instruments presuppose that the scope of the EIR is not an "exact opposite" of the Brussels Ia Regulation in the relevant field, as it should in principle be in order to avoid regulatory loopholes.[17] "Bankruptcy, proceedings related to the winding-up of insolvent companies or other legal persons, judicial arrangements, compositions and analogous proceedings" are excluded from the new Brussels I Regulation. Although the phrasing of Article 1(2)(b) Brussels Ia itself causes no particular problems, the Regulation remains silent on autonomous criteria (or a direct link to the EIR) of how and whether particular proceedings, in the eyes of the Regulation, should be evaluated as "analogous proceedings" and thus excluded from Brussels Ia. Even assuming the fact that both Regulations are interrelated, in reality, the change in scope of one Regulation does not necessarily have an influence on the applicability of the other legal instrument.[18]

In the light of the *F-Tex* case, where the Court held that the relevant sphere of EU private law should in principle be gapless, it seems logical that one or another of the above mentioned legal instruments should include a provision expressly stating that all the relevant questions which do not fall within the scope of one regulation are to be included into another automatically. The main criterion and a starting point for consideration for the sake of simplicity and efficiency of application should be as plain and as straightforward as possible. The question which should determine which instrument is applicable is whether an action at hand is in its essence related to insolvency. If a right to an action is of an independent nature with a possibility to raise it even without one of the parties being insolvent, then it should, in principle, be governed by the Brussels Ia; if the right to an action has its roots in insolvency, the EIR should apply. Ideally, the above-mentioned criteria should be sufficient to determine whether either Brussels Ia or the EIR is applicable

15 Study by Directorate General for Internal Policies Policy Department C: Citizens' Rights and Constitutional Affairs, Possibility and terms for applying Brussels I Regulation (recast) to extra EU disputes, PE 493.024. (2014), p. 9.

16 Case No 2T-89/2014, Decision of 13 August 2014 of the Court of Appeal of Lithuania [2014].

17 *Virgos/Garcimartín* [17], p. 56.

18 Recital 7 in the preamble to Regulation Brussels I states that the intention on the part of the EU legislature was to provide for a broad definition of the concept of 'civil and commercial matters' referred to in Article 1(1) of that Regulation and, consequently, to provide that the Article should be broad in its scope. By contrast, the scope of application of the EIR, in accordance with Recital 6 in the preamble should not be interpreted broadly (judgment in Case C-292/08, *German Graphics Graphische Maschinen* [2009] EU:C:2009:544, paragraphs 23 to 25).

to a particular dispute. In the sphere where risks of disputes over competence are very high, ambiguity or over complication of jurisdictional rules undoubtedly lead to devastating effects: the paramount principle of fast and efficient insolvency proceedings may be rebutted if complex procedural matters have to be resolved prior to approaching the essential questions.

In its report on the application of EIR, the Commission has acknowledged the fact that 15 Member States have pre-insolvency or hybrid proceedings which are currently not listed in Annex A of the Regulation in their legal systems, as well as the fact that a substantial number of such proceedings are currently not covered by the EIR, which means that their effects are not recognizable throughout the EU by virtue of Articles 16, 17 and 25 of the EIR.[19] Furthermore, forasmuch as these proceedings may perfectly fall within the "analogous proceedings" exclusion, [20] this type of proceeding may be excluded from the Brussels regime altogether. It is self-evident that the current state of affairs is highly unsatisfactory since it is quite reasonable to assume that pre-insolvency and hybrid proceedings are arguably more progressive forms of insolvency proceedings, giving a distressed debtor the possibility to get over their financial difficulties and the possibility to preserve an employer and a taxpayer, thus protecting wider interests.[21]

Luckily, the proposed EIRa will be much broader in scope than its predecessor and is expected to cover hybrid and pre-insolvency proceedings as well.[22] Proceedings falling within the scope of the revised EIR no longer need to be insolvency proceedings and it is sufficient that they "are based on a law relating to insolvency".[23] For the purpose of simplification, all the procedures included in Annex A to the Regulation are referred to as "insolvency proceedings".[24] If the new types of proceedings which at the present moment do no fall within the scope of the old text are included in Annex A of the proposed Recast version of EIR, this, in the eyes of the Regulation, will create new types of insolvency proceedings, thus

19 Report from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the application of Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings, Strasbourg, 12 December 2012, COM(2012) 743 final.

20 OJ L 351 of 20 December 2012, Article 1(2)(b).

21 *McCormack* [10], p. 31.

22 Recitals 10 and 11 in the preamble lay down that the scope of this Regulation should extend to proceedings which:
- promote a rescue of economically viable but distressed businesses;
- provide for a restructuring of a debtor at a stage where there is only a likelihood of insolvency and proceedings;
- leave the debtor fully or partially in control of his assets and affairs;
- provide for a debt discharge or a debt adjustment of consumers and self-employed persons;
- grant a temporary moratorium on enforcement actions brought by individual creditors where such actions may adversely affect negotiations and hamper the prospects of a restructuring of the debtor's business.

23 OJ L 160 of 30 June 2000, Article 1(1).

24 OJ L 160 of 30 June 2000, Article 2(a).

creating novel types of annex proceedings as well – proceedings related to newly included types of insolvency proceedings.

Therefore, the applicability of criteria developed by the CJEU concerning various questions related to those proceedings will inevitably emerge when the EIRa becomes applicable. It is self-evident that the jurisprudence of the CJEU, based on an old instrument and excluding pre-insolvency and hybrid proceedings, may not be well suited for the evaluation of the types of insolvency proceedings newly included into the Regulation, since they may derogate from classic concepts of insolvency by a considerable margin. Therefore, it is not clear whether the existing jurisprudence of the CJEU will be sufficient to fill possible gaps.

2.2 Jurisdiction

One of the main differences stemming from the applicability of either EIR or Brussels Ia Regulations is jurisdictional issues. Jurisdictional rules in Brussels Ia are based on a private international law approach. Therefore, the Regulation differentiates issues of jurisdiction within the EU from the questions of competence in non-EU cases.[25] The central rule of allocation of competence to resolve disputes laid down in the Recast Brussels I Regulation is founded on the well-known principle that jurisdiction is generally based on the defendant's domicile irrespective of his or her nationality.[26] As a rule of general jurisdiction, as it is sometimes referred to, it applies to whatever the matter falling within the *ratione materiae* of the Regulation. Although the rule has been adopted from Article 2 of the old Brussels I Regulation, the basis of the rule has its roots in Roman law and its *actor sequitur forum rei* principle.[27]

25 Study by Directorate General for Internal Policies Policy Department C: Citizens' Rights and Constitutional Affairs, Possibility and terms for applying Brussels I Regulation (recast) to extra EU Disputes, PE 493.024. (2014) pp. 6–7. "The '*private international law*' approach is based on the basic and fundamental difference between issues of judicial jurisdiction and issues of territorial allocation of disputes in different domestic courts within a Member State: the approach focuses on judicial jurisdiction (though the rules might sometimes be equally applied for territorial allocation of disputes). The '*procedural law*' approach consists of using the procedural rules on territorial allocation within a State as a basis for judicial jurisdiction in international disputes."

26 OJ L 351 of 20 December 2012, Article 4, Recital 15 of the preamble of the Regulation.

27 *Kruger* [7], p. 61.

It should also be noted that derogations from the *actio sequitur forum rei* principle are possible[28] under the Brussels Ia. This is of particular importance especially when it comes to the assessment of the interaction between the *vis attractiva concursus* principle and the due process rights of the defendant.[29] Despite the fact that the core features of the jurisdictional regime of the old regulation were preserved in the new text, some of the changes, especially those concerning its applicability to third state defendants, are worth a separate mention. The old Brussels I Regulation applied only if the defendant was domiciled in the European Union.[30] It was only a matter of exclusive jurisdiction or of a jurisdictional agreement in favour of the EU court that the Regulation could be applicable despite the defendant having his domicile outside the European Union.[31]

In addition to the above mentioned heads of jurisdiction which remain unchanged, the Brussels Ia removes the condition of domicile in the EU in Articles 17 to 18 (cases concerning consumer contracts where the defendant is a non-consumer) and 20 to 22 (cases concerning individual contracts of employment where the defendant is an employer). Therefore, the territorial reach of the Recast Brussels I is significantly widened.

The EIR jurisdiction is based on a concept of centre of the main interests (COMI), giving the court at debtor's COMI the right to exercise universal insolvency jurisdiction.[32] The notion of COMI is subject to autonomous interpretation.[33] Article 3(1) of the EIR gives the Member State within the territory of which the

28 Article 7(2) (corresponds to Article 5(3) of the old instrument) lays down that proceedings in matters relating to tort, delict or quasi-delict may be decided in courts of the place where the harmful event occurred or may occur;
- Article 21 (in its essence corresponds to Article 19 of the old Regulation) allows an employer domiciled in a Member State to be sued in the courts of either the Member State in which the latter is domiciled or in another Member State:
  - in the courts for the place where the employee habitually carries out his work or in the courts for the last place where he did so;
  - if the employee does not or did not habitually carry out his work in any one country, in the courts for the place where the business which engaged the employee is or was situated;
- Article 24(1) (former Article 22(1) of Regulation No 44/2001) states that disputes regarding immoveables are to be decided in the courts of the Member State where the property is situated;
- Article 25 of the Brussels I a Regulation (corresponds to Article 23 of the old Brussels I) allows parties to agree that a court or courts of a Member State are to have jurisdiction to settle any disputes which have arisen or which may arise in connection with a particular legal relationship;
- Article 26(1) (in its essence corresponds to Article 24 of the Brussels I Regulation) allows the court before which a defendant enters an appearance to have jurisdiction.

29 Critics do emphasize that attraction of claims to the insolvency court might infringe due process rights and legitimate expectations of the defendant.

30 OJ L 12 of 16 January 2001, Article 4.

31 OJ L 12 of 16 January 2001, Articles 22 and 23.

32 *McCormack* [11], p. 129.

33 Case 341/04, *Eurofood IFSC Ltd.* [2006] E.C.R. 1-3813 para. 31, Case C-191/10 *Rastelli Davide e C. Snc v Jean-Charles Hidoux* [2011] 2011 I-13209 para. 31.

COMI is situated the exclusive power to open main insolvency proceedings with EU-wide effect.[34] This kind of effect is created by virtue of Articles 3, 4, 16 and 17 of the EIR. Under Article 4(1), the law applicable to insolvency proceedings and their effects shall be that of the Member State within the territory of which such proceedings are opened. This means that lex fori concursus determines all the effects of the insolvency proceedings, both substantive and procedural, on the persons and legal relations concerned,[35] save for a few exceptions.[36]

Secondary insolvency proceedings may be opened in a Member State where the insolvent debtor has an establishment, however, territorial insolvency proceedings are limited to assets in that country. The opening of a secondary proceeding in its essence bars the effect of the main proceedings in respect of creditors and assets located in that particular country, thus creating an exemption from the general principle laid down in Article 3(1) of the EIR.

Annex proceedings are essentially independent civil proceedings which may be determined by the insolvency court or by another court. Therefore, it is necessary to establish whether a certain question does fall within the scope of Brussels Ia, which would allow it to rely on its jurisdictional rules and, most importantly, *actor sequitur forum rei principle*, or whether it is subject to the *vis attractiva concursus* principle and therefore falls within the competence of the insolvency court at the debtor's COMI or a court opening secondary insolvency proceedings. Since the claimant is the subject who has an intention to modify the current *status quo* in one way or another, it is he who ought to appear before the defendant's court. In other words, there is a general legal expectation of the defendant to be sued in his domicile.[37] Cases in which the subject-matter of the dispute warrants another rule of jurisdiction should be well justified.

While from the perspective of the insolvency administrator, concentration of annex proceedings in the forum of a Member State which opened insolvency proceedings

34 *Omar* [13], p. 226.

35 OJ L 160 of 30 June 2000, Recital 23.

36 EIR permits some exceptions to this general rule and allows certain matters to be governed by a different law. These include rights in rem of creditors or third parties (Article 5), rights to set-off (Article 6), reservations of title (Article 7), contracts relating to immoveable property (Article 8), rights and obligations of the parties to a payment or settlement system or to a financial market (Article 9), contracts of employment (Article 10), effects of insolvency proceedings on the rights of the debtor in immoveable property, a ship or an aircraft subject to registration in a public register (Article 11), community patents and trademarks (Article 12), detrimental acts (Article 13), questions concerning the protection of third-party purchasers (Article 14) and effects of insolvency proceedings on lawsuits pending (Article 15).

37 "The rules of jurisdiction should be highly predictable and founded on the principle that jurisdiction is generally based on the defendant's domicile. Jurisdiction should always be available on this ground save in a few well-defined situations in which the subject-matter of the dispute or the autonomy of the parties warrants a different connecting factor." (Recital 15 in the preamble to Brussels Ia).

can be seen as significant facilitation of pursuit of his actions, at the same time it may undermine the legitimate expectations of the defendant to be sued according to the rules of general jurisdiction (Art. 4(1) Brussels Ia). Hence, effectiveness and efficiency of insolvency proceedings may conflict with the legitimate expectation of the defendant. Therefore, the defendant's protection guaranteed on the basis of the jurisdictional principle *actor sequitur forum rei* can only be ousted by an overarching insolvency–specific interest.[38] Criteria to describe actions which fall outside the scope of Brussels Ia and which are subject to rules of jurisdiction in EIR should be a result of a careful balancing act of these diverging interests.

It is discernible that the *Gourdain*[39] principle indirectly establishing jurisdictional rules for the insolvency-related actions *de lege lata* does not find its reflection[40] in the current text of the Regulation in its entirety when it comes to the main purpose of this principle – to establish jurisdictional rules – Article 1 EIR governs "collective insolvency proceedings which entail the partial or total divestment of a debtor and the appointment of a liquidator", while Article 3 lays down rules of jurisdiction concerning the opening of main or secondary insolvency proceedings.

Thus, the Regulation contains no jurisdictional rules as to actions "deriving directly from the insolvency proceedings and which are closely linked to them" whatsoever. It is merely mentioned in Article 25(1) subparagraph 2 EIR that rules on recognition and enforceability of judgments concerning the course and closure of insolvency proceedings shall also apply to judgments deriving directly from the insolvency proceedings and which are closely linked with them, even if they were handed down by another court.

In addition, some insights on applying the EIR in respect of annex proceedings may be found in Recital 6[41] of the preamble to the Regulation. Until the CJEU reached its decision in the *Deko Marty* case, different solutions had been discussed by commentators concerning the applicability of different legal instrument to

38 *Laukemann* [8], p. 102.

39 Case 133/78 *Henri Gourdain v Franz Nadler* [1978] ECR 1979 p. 733.

40 It is rather unusual since jurisdictional rules laid down in a certain legal instrument and rules concerning recognition and enforcement of foreign judgments are usually interrelated in the sense that application of certain algorithm to allocate the competence in sphere of private international law allows for recognition of the resulting judgment under the same legal instrument.

41 In accordance with the principle of proportionality, this Regulation should be confined to provisions governing jurisdiction for opening insolvency proceedings and *judgments* (emphasis added) which are delivered directly on the basis of the insolvency proceedings and are closely connected with such proceedings. In addition, this Regulation should contain provisions regarding the recognition of those judgments and the applicable law which also satisfy that principle.

annex proceedings.[42] In *Deko Marty* the CJEU held that Article 3(1) EIR "must be interpreted as meaning that it also confers international jurisdiction on the Member State within the territory of which insolvency proceedings were opened in order to hear and determine actions which derive directly from those proceedings and which are closely connected to them" (Point 21), thus putting the debate to an end. Although, as we will see *infra*, this did not resolve all the questions as to what constitutes an action which derives directly from and is closely connected to the insolvency proceedings.

The state of affairs is slightly different under the revised version of the EIR. Article 6(1) of the Revised EIR indicating that "the courts of the Member State within the territory of which insolvency proceedings have been opened in accordance with Article 3 shall have jurisdiction for any action which derives directly from the insolvency proceedings and is closely linked with them, such as avoidance actions" which is, apparently, a codification of *Deko Marty* and fills the legislative lacuna as to jurisdictional rule applicable in respect of related actions. The rule is further explained in Recital 6 of the preamble to the Regulation.[43] The revised EIR even takes a step further expressly stating that annex proceedings are excluded from the Brussels Ia Regulation,[44] although emphasizing that the mere fact that a national procedure is not listed in Annex A to the EIRa should not imply that this procedure is covered by Brussels Ia. Although introducing jurisdictional rules as to annex proceedings, the EIRa is generally silent as to the criteria of what exactly

42 International jurisdiction in annex proceedings must be determined according to national law; partial or total applicability of Brussels I to annex proceedings; applicability of Art. 3(1) EIR to annex proceedings by virtue of analogy. *Simotta* [15], pp. 65–79.

43 This Regulation should encompass provisions governing jurisdiction for opening insolvency proceedings and actions which are deriving directly from the insolvency proceedings and are closely linked with them. This Regulation should also contain provisions regarding the recognition and enforcement of judgments issued in such proceedings.

44 Recital 7 of the preamble to the Regulation states that "bankruptcy, proceedings relating to the winding-up of insolvent companies or other legal persons, judicial arrangements, compositions and analogous proceedings and actions related to such proceedings are excluded from the scope of Regulation (EU) No 1215/2012…. These proceedings should be covered by the present Regulation. The interpretation of this Regulation should, as much as possible, avoid regulatory loopholes between the two instruments."

constitutes annex proceedings. The drafters merely provide a few examples, based on the jurisprudence of the CJEU.[45]

2.2.1 Is Jurisdiction in Annex Proceedings Exclusive Jurisdiction?

One more relevant question to be answered is whether jurisdiction in annex proceedings is exclusive or not and if so, how exactly the *vis attractiva concursus* principle works in the EIR, i.e. whether jurisdiction is exclusive *vis-à-vis* the Member State, or in respect of the particular court who has opened the insolvency proceedings. Since the Regulation is not intended to alter national rules of allocation of cases between the courts of a given Member State, both alternatives seem quite reasonable, especially giving due consideration to the fact that *vis attractiva concursus* may have different properties in the legal systems of Member States.

The text of the EIR does not give a direct answer to these questions, but a closer look at Articles 18 and 25 of the EIR might suggest that the Regulation acknowledges the possibility of claims submitted to courts which are not the insolvency court. The mere existence of such provisions gives a strong impression of non-exclusivity of jurisdiction as to annex proceedings.

This issue has not been addressed directly in *Deco Marty*. Nevertheless, in his opinion in the same case, Advocate General *Dámaso Ruiz-Jarabo Colomer* has carried out a significant analysis as to whether the jurisdiction laid down in Regulation No 1346/2000 is alternative or exclusive. The Advocate General suggests that jurisdiction to hear an action to set aside a transaction in the context of insolvency is *relatively exclusive*, which is to be construed as meaning that it comes within the powers of the liquidator. Accordingly, it is for the liquidator alone to bring the most appropriate actions in the course of the proceedings for the purposes of protecting the assets as a whole (Point 65).

45 Recital 34 in the preamble to the EIRa states actions which "derive directly from the insolvency proceedings and are closely linked with them" include:
- avoidance actions against defendants in other Member States;
- actions concerning obligations that arise in the course of the insolvency proceedings, such as advance payment for costs of the proceedings.

In contrast, actions for the performance of the obligations under a contract concluded by the debtor prior to the opening of proceedings do not derive directly from the proceedings. Where such an action is related with another action based on general civil and commercial law, the insolvency practitioner should be able to bring both actions in the courts of the defendant's domicile if he considers it more efficient to bring the action in that forum. This could, for example, be the case if the insolvency practitioner wishes to combine an action for director's liability on the basis of insolvency law with an action based on company law or general tort law.
Recital 15 in the preamble to the EIRa indicates proceedings that are based on general company law not designed exclusively for insolvency situations should not be considered to be based on a law relating to insolvency. Similarly, the purpose of adjustment of debt should not include specific proceedings in which debts of a natural person of very low income and very low asset value are written off, provided that this type of proceedings never makes provisions for payment to creditors.

The Advocate General observes that the same approach may also be inferred from the second subparagraph of Article 25(1) of the Regulation. With regard to the rules concerning the recognition and enforcement of judgments, that provision lays down an obligation to recognise judgments "deriving directly from the insolvency proceedings and which are closely linked with them, even if they were handed down by another court." Thus the Regulation provides that judgments arising from an action in the context of insolvency to set a transaction aside may be adopted by the court seised of the insolvency proceedings or by another court which is situated either in the same Member State or in a different one.[46]

The CJEU neither gave any comments on the suggestion of the Advocate General, nor directly answered the question. However, some passages in this judgment indicate the exclusivity of jurisdiction in annex proceedings. The CJEU held that "concentrating all the actions directly related to the insolvency of an undertaking before the courts of the Member State with jurisdiction to open the insolvency proceedings also appears consistent with the objective of improving the effectiveness and efficiency of insolvency proceedings having cross-border effects" (Point 22) and that "possibility for more than one court to exercise jurisdiction as to actions to set a transaction aside by virtue of insolvency brought in various Member States would undermine the pursuit of such an objective" (Point 24), which is to prevent forum shopping.

Despite the fact that the Court refrained from answering all the relevant questions, important conclusions may still be drawn from the judgment. The CJEU explained that the words "even if they were handed down by another court" at the end of the last sentence of the second subparagraph of Article 25(1) EIR do not mean that the Community legislature wished to exclude the jurisdiction of the courts of the State within the territory of which the insolvency proceedings for the type of actions concerned were opened. Those words mean, in particular, that it is for the Member States to determine the court with territorial and substantive jurisdiction, which does not necessarily have to be the court which opened the insolvency proceedings. Moreover, the Court explained that those words refer to the recognition of judgments opening insolvency proceedings, which is provided for in Article 16 EIR (point 27).

The question about the exclusivity of jurisdiction in annex proceedings has been raised in the *F-Tex* case. The referring court asked whether the jurisdiction conferred by Regulation No 1346/2000, as interpreted by the CJEU, on the courts

46 Case C-339/07 *Christopher Seagon v Deko Marty Belgium NV* [2009] 2009 I-00767, Opinion of AG Colomer.

of the Member State in which insolvency proceedings have been opened to hear and decide actions which derive directly from those proceedings and are closely connected with them constitutes exclusive jurisdiction. The question originated from the proceedings in the Lithuanian national court in which F-Tex, as creditor to whom claims of an insolvent undertaking had been assigned, launched its claim not in the courts of the Member State which opened insolvency proceedings against the debtor (Germany) but in the courts of the Member State in which the debtor of the assigned claim had its domicile (Lithuania). The question remained unanswered since the CJEU found applicability of Brussels I Regulation and not EIR to an action taken against a third party by an applicant acting on the basis of an assignment of claims which was granted by a liquidator appointed in insolvency proceedings.

The proposed Recast version of the EIR, namely Article 6(2), sets down that where an action which derives directly from the insolvency proceedings and is closely linked with them is related to an action in civil and commercial matters against the same defendant, the insolvency practitioner may bring both actions in the courts of the Member State within the territory of which the defendant is domiciled, or, where the action is brought against several defendants, in the courts of the Member State within the territory of which any of them is domiciled, provided that these courts have jurisdiction pursuant to the rules of Regulation Brussels Ia. The same shall apply to the debtor in possession, provided that he is able under national law to bring actions on behalf of the insolvency estate. Article 6(2) of the EIRa adds that for the purpose of Article 6(1), actions are deemed to be related where they are so closely connected that it is expedient to hear and determine them together to avoid the risk of irreconcilable judgments resulting from separate proceedings.

The EIRa does not give a direct answer as to whether the jurisdiction in annex proceedings *per se* is exclusive or not. Although, as it may be seen from the phrasing of Articles 6(2) and 6(3), the Regulation does not expressly exclude jurisdiction of the court which would have had competence to resolve a particular dispute in lieu of the insolvency court. Since Article 6(1) is a codification of *Deko Marty*, therefore the rationale of this judgment should apply to the interpretation of the newly included text, which would mean that jurisdiction is rather exclusive.

Additionally, the sheer fact that alternative jurisdiction is permitted in the very next articles in respect of situations where annex proceedings are closely related to ordinary civil or commercial proceedings, but not in Article 6(1), might suggest that the jurisdictional rule contained in the latter is intended to be of an exclusive nature. While Article 6(2) speaks of an action “in civil and commercial matters”, hence governed by the provisions of Brussels Ia and therefore not attractable to the insolvency proceedings, it seems rational for the insolvency practitioner to "travel" in order to pursue both actions in the same forum, thus possibly facilitating the insolvency proceedings. Obviously, the explanation by the CJEU will be welcome.

The vast array of possible annex proceedings could lead to the question whether the administrator should be granted a possibility to implement his litigation strategy by choosing a forum in each individual case based on different criteria (e.g. speed of proceedings)? Possibility to have the judgment in annex proceedings recognized and enforced could be one of the relevant criteria. While the issue of the enforcement of judgments causes no difficulties within the EU, it may become problematic to enforce a judgment in annex proceedings outside the EU if jurisdictions against a third state defendant were based on the provisions of the EIR.

2.2.2 Jurisdiction as to Annex Proceedings against Third State Defendants

Article 3(1) of the current EIR determines the jurisdiction of courts of the EU to open main insolvency proceedings. According to Article 3(1) of the EIR, the location of the centre of the debtor's main interests (COMI) is the one and only relevant criterion for determining which court is competent to open main insolvency proceedings. In addition, Recital 13 in the Preamble to EIR, in essence, precludes the possibility to apply the Insolvency Regulation to proceedings where the centre of the debtor's main interests is located outside the EU. At this stage, the distinction is crystal clear without any additional analysis being necessary. Nevertheless, real-life situations may be far more difficult, especially in cases related to parties from non-EU member states. One of the most controversial topics in this field is the possibility of application of EIR jurisdictional provisions in respect of defendants situated outside the European Union.

As already noted in scientific texts, opinions are divided on the question of whether it is possible to rely on the EIR in situations where insolvency proceedings have been opened in a Member State, but the subject against whom the avoidance action is brought is from a third country and, as Leukeman has observed, whether the Regulation's applicability *ratione loci* presupposes cross-border implications with another Member State or whether a simple connection to a third state suffices.[47]

In *Schmid v Hertel*,[48] the CJEU had to assess whether the courts of the Member State within the territory of which main insolvency proceedings have been opened have jurisdiction to decide on an *Actio Pauliana* that is brought against a

47 *Laukeman* [8], p. 102.

48 Case C-328/12 *Ralph Schmid v Lilly Hertel* [2014] ECLI:EU:C:2014:6.

person whose place of residence or registered office is outside the EU. The Court responded affirmatively and concluded that:

- Neither Article 1 of the Regulation nor Annex A limits the application of the Regulation to proceedings that involve a cross-border element other than with two or several Member States. Application of Article 3(1) of the Regulation cannot, therefore, as a general rule, depend on the existence of a cross-border link involving another Member State (Point 29);
- At the time when the request to open insolvency proceedings is lodged, the existence of any cross-border element may be unknown. However, determination of the court which has jurisdiction cannot be postponed until such time as the residence of a potential defendant to an ancillary action is known (Point 28);
- The objectives of the EIR[49] may encompass not solely relations between Member States but, by their nature and in accordance with their wording, any cross-border situation (Point 25);
- Harmonisation in the European Union of the rules governing jurisdiction over actions to set a transaction aside by virtue of insolvency contributes to the attainment of the objectives of the EIR irrespective of whether the defendant's place of residence is in a Member State or in a third country. These objectives prevail over the concern to avoid the defendant being sued in a foreign court. (Point 33).
- The fact that the courts of a third country would be under no obligation at all to recognize a result of such proceedings is not decisive (Points 36 and 37), since the judgment may be recognised and enforced in the third state on the basis of a bilateral convention or by the other Member States under Article 25 of the Regulation, in particular if part of the defendant's assets are in the territory of one of those States (Point 38).

In order to evaluate the findings in *Schmid v Hertel*, it is useful to get sight of jurisdictional rules as to third state defendants laid down in both Brussels Regulations. It would be rather fair to observe that the old Brussels I was built to accumulate jurisdiction within the Union. It was done by applying Brussels I

49 The CJEU emphasized that the relevant objectives of the EIR are: 1) to ensure the proper functioning of the internal market (Recitals 2–4); 2) to avoid *forum shopping* (Recital 4); 3) to improve the efficiency and effectiveness of insolvency proceedings having cross-border effects (Recital 8); to ensure universal scope of the main insolvency proceedings (Recital 12). The Court added that in the light of Recital 8, Article 3(1) is intended to promote foreseeability and, therefore, legal certainty as regards bankruptcy and liquidation jurisdiction (Point 27).

jurisdictional rules to non-nationals domiciled in the EU[50] by allowing Member States to apply their own rules of jurisdiction in respect of defendants from third states.[51] Furthermore, the Regulation, while expressly banning exorbitant grounds of jurisdiction[52] in respect of defendants within the EU, did encourage the application of such jurisdictional heads laid down in the procedural laws of Member States regarding third state defendants,[53] save for some exceptions.[54]

Furthermore, the old Brussels I contains different possibilities to apply the methods of resolution of jurisdictional collisions, such as *lis pendens* and *forum non-conveniens* in respect of Member States and third states.[55] While the ECJ in its (in)famous decision in *Owusu v. Jackson* held that a court cannot decline the jurisdiction conferred on it by Article 2 of that Convention on the grounds that a court of a third state would be a more appropriate forum to hear the action,[56] it is unclear whether *lis pendens* rules could be applicable in favour of third states.[57] The *Cour de Cassation*, while remaining completely silent on the implications of *Owusu v. Jackson,* suggested that this was possible.[58] The Recast Brussels Ia, however, has introduced a novelty – *lis pendens* provisions to be applied in respect of third states.[59] These, obviously, are most welcome, even though the conditions required are largely strict and it is still up to the court to decide whether to apply the new instrument in a certain case.[60]

While jurisdictional rules in Brussels Ia are generally more third-state friendly than the corresponding rules of its predecessor, it is doubtful whether the same conclusions can be made as to the EIR and the proposed EIRa when it comes to

50 OJ L 12 of 16 January 2001, Article 2.

51 OJ L 12 of 16 January 2001, Articles 3 and 4.

52 "Exorbitant" jurisdiction is jurisdiction validly exercised under the jurisdictional rules of a state, which, nevertheless, appears unreasonable to non-nationals because of the grounds used to justify jurisdiction. See: *Russell* [14], pp. 57–59 and citations.

53 OJ L 12 of 16 January 2001, Article 4.

54 OJ L 12 of 16 January 2001, Articles 22, 23 and 24.

55 Case No. 2T-28-186/2015, Decision of 2 February 2015 of the Court of Appeal of Lithuania.

56 Case C-281/02, *Andrew Owusu v. Nugent B. Jackson*, trading as "Villa Holidays Bal-Inn Villas", Mammee Bay Resorts Ltd., Mammee Bay Club Ltd., The Enchanted Garden Resorts & Spa Ltd., Consulting Services Ltd., Town & Country Resorts Ltd. [2005] ECR I-1383.

57 *Magnus/Mankowski/Magnus* [9], pp. 498–499.

58 *Cour de Cassation*, Civile, Chambre Commerciale, 19 février 2013, 11-28.846.

59 OJ L 351 of 20 December 2012, Articles 33 and 34.

60 Under the new Regulation, proceedings may be stayed provided that: 1) third state court is the court first seized; 2) an expected judgment of the foreign court must be capable of recognition and, where applicable, of enforcement by the court of the Member State; 3) the EU court must be satisfied that a stay is necessary for the proper administration of justice. In cases where the actions are related, the EU court must also be satisfied that it is expedient to hear and determine the related actions together to avoid the risk of irreconcilable judgments resulting from separate proceedings.

annex proceedings against third state defendants. *Schmid v Hertel* is a great arrival for insolvency universalism, nevertheless, possible effects of the judgment still leave some uncertainty. While the *Deco Marty* rule may be entirely reasonable for intra-EU situations, the extension of the rule into the realm of third states may not. First and foremost, it is unilateral. From the perspective of non-EU countries, this may be seen as diminution of comity and mutual trust. Therefore, a treaty may arguably be a better choice to secure the same result. Although the arguments concerning different possibilities for reaching the assets located in another states are at least partially[61] correct, they are somewhat aggressive and do not complement the establishment of an efficient and predictable legal framework in the sphere of international insolvency between EU and other countries.

These findings, therefore, seem to be aimed at protecting the interests of the EU itself rather than the interests of the parties, and thus, may be construed as justifying exorbitant grounds of jurisdiction.[62] Meanwhile, there is a notable trend to move away from exorbitant heads of jurisdiction, which are sometimes referred to as "shockingly uncivilized"[63] in private international law. As expressed by the Court of Appeal of Lithuania in considering the interplay between a rule of exorbitant jurisdiction laid down in national law and the possibilities of both parties in seeking an efficient real remedy in a cross-border situation and taking their domicile into account, nominal legal connections even though they are of paramount importance cannot supersede genuine legal connections ascending from objective reality.[64]

Article 6(1) of the EIRa governing jurisdiction in annex proceedings, however, does not make any distinction as to its applicability in respect of defendants within the EU or outside the EU. The word "any", while encompassing the widest possible array of annex proceedings, additionally gives the impression that it is applicable irrespective of the domicile of the defendant, which would be in line with *Schmid v Hertel*.

2.3 Recognition and Enforcement

Judgements are not intrinsically extraterritorial. Due to the principle of sovereign equality,[65] a judgment rendered in one state must be recognized in another so that it

61 *Laukemann* observes that Article 3 EIR itself does not guarantee that insolvency practitioner can take possession of sold or transferred assets through coercive measures, because foreign judgments on avoidance might be neither recognized nor enforced, as it is the case in Switzerland. See: *Laukemann* [8], p. 102.

62 See *Kessedjian* [5], No. 138.

63 *Clermont and Palmer* [1], p. 475.

64 Case No. 2T-58/2014, Decision of 22 December 2014 of the Court of Appeal of Lithuania.

65 *Kelsen* [6], pp. 207–220; Civil case No 2-703/2009, Ruling of 30 July 2009 in of the Court of Appeal of Lithuania.

could create legal consequences in that foreign country. According to Hartley, there are two main theories that explain the legal nature of recognition and enforcement of foreign judgements. The "comity theory"[66] states that it is done out of respect for the foreign State concerned. This theory is often regarded as requiring the application of reciprocity. It may also be considered as requiring a treaty between the two States. Under the second theory – the "obligation theory"[67] – judgments are recognized in order to do justice to the parties.

The idea is that if the proceedings were fair and if the foreign court had jurisdiction, a judgment in favour of the claimant creates an obligation in the same way as a contract.[68] There are also diverging theories as to the effect of a recognized foreign judgment. The modern "extension of power"[69] theory postulates that recognition of a judgment transfers its legal power from the country of origin to a state of recognition, whereas timeworn "assimilation" theory incorporates the foreign judgement and its legal result into the national legal system treating the foreign judgement as if it were rendered in the recognizing country, adopting its legal effect into the legal regime of the latter.

Since the European Union aims to form an integral space of freedom, security and justice, the architecture of legal instruments concerning recognition and enforcement of judgements rendered in other EU Member States is significantly different. Whilst some EU Regulations do to some extent still contain a requirement for judgements to be declared enforceable by Member States other than its country of origin before actual execution takes place,[70] so-called "Regulations of the second generation"[71] have abolished the *exequatur* requirement. The rationale behind a

66 *Hilton v Guyot* [1895], 159 U.S. 113

67 *Schibsby v Westenholz* [1870] LR 6 QB 155.

68 *Hartley* [3], pp. 319–320.

69 Case 145/86 *Horst Ludwig Martin Hoffmann v Adelheid Krieg* [1988].

70 *See:* Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (OJ L 12 of 16 January 2001); Council Regulation (EC) No 4/2009 of 18 December 2008 on jurisdiction, applicable law, recognition and enforcement of decisions and cooperation in matters relating to maintenance obligations as to judgments rendered in the Member State not bound by the 2007 Hague Protocol (OJ L 7 of 10 January 2009, pp. 1–79); Council Regulation (EC) No 2201/2003 of 27 November 2003 concerning jurisdiction and the recognition and enforcement of judgments in matrimonial matters and the matters of parental responsibility, repealing Regulation (EC) No 1347/2000 (except access and child abduction cases) (OJ L 338 of 23 December 2003, pp. 1–29).

71 *See:* Regulation (EC) No 805/2004 of the European Parliament and of the Council of 21 April 2004 creating a European Enforcement Order for Uncontested claims (OJ L 143/15 of 30 April 2004); Regulation (EC) No 1896/2006 of the European Parliament and of the Council of 12 December 2006 creating a European Order for Payment Procedure (OJ L 399 of 30 December 2006, pp. 1–32); Regulation (EC) No 861/2007 of the European Parliament and of the Council of 11 July 2007 establishing a European Small Claims Procedure and Council Regulation (EC) No 4/2009 of 18 December 2008 on jurisdiction, applicable law, recognition and enforcement of decisions and cooperation in matters relating to maintenance obligations as to judgments rendered in the Member State bound by the 2007 Hague Protocol (OJ L 199 of 31 July 2007, pp. 1–22).

simplified regime of recognition of judgements within the EU is based on the idea of free movement of judgements which is intended to improve the functioning of the internal market.

Therefore, the Brussels Ia Regulation takes a significant leap forward from its predecessor and abolishes the requirement of *exequatur* as well. The abolition of *exequatur* is sometimes regarded as the most significant change in the new Regulation.[72] By virtue of Articles 36 and 39 of the Recast Brussels I, a party seeking to enforce the judgment of another EU Member State no longer needs to request a competent court of that country to declare the judgment enforceable. Such a party may get in touch with a competent enforcement authority (e.g. bailiff, enforcement agent, etc.) directly. Provided that the service of process upon a defendant has been effected,[73] the competent authorities may carry out the actual enforcement right away. The defendant still has the possibility to request that the competent courts of the Member State where the enforcement is to take place refuse recognition or enforcement.[74]

The ones who undoubtedly will benefit from the varied legal landscape the most, surprisingly, are the courts, since the removal of all the intermediate actions preceding actual enforcement will take away a significant deal of their workload. Despite the fact that the first stage of *exequatur* used to be an *ex parte* matter of a formal nature, the procedural questions which had to be performed during the procedure (e.g. verification that procedural documents submitted by the claimant met the requirements,[75] issuance of *exequatur* itself,[76] service of documents upon the parties,[77] control over the entrance into force of the judgment[78] etc.) aggregated a significant workload, which, according to Brussels Ia, no longer belongs to the courts' competence. The functions which formed the first stage of *exequatur* have been handed over to enforcement authorities, which now have greater powers and responsibilities. This is a hugely significant reduction because, as the Heidelberg report indicates, most decisions on the declaration of enforceability are not appealed; the percentage of appeals is between 1% and 5% of all decisions.[79] Therefore, a court involvement will be needed in a tiny fraction of situations thus simplifying cross-border litigation.

72 *Nielsen* [12], p. 62.
73 OJ L 351 of 20 December 2012, Article 43.
74 OJ L 351 of 20 December 2012, Subsections 1 and 2 of Section 3.
75 OJ L 12 of 16 January 2001, Articles 40(1) and 53.
76 OJ L 12 of 16 January 2001, Article 41.
77 OJ L 12 of 16 January 2001, Article 42.
78 OJ L 12 of 16 January 2001, Articles 43 and 47(3).
79 *Hess/Pfeiffer/Schlosser* [4], p. 22.

Recognition and enforcement of foreign judgements work differently under the EIR. Firstly, Article 16 of the EIR provides that any judgment opening insolvency proceedings handed down by a court of a Member State which has jurisdiction pursuant to Article 3 of the EIR shall be recognised in all the other Member States from the time that it becomes effective in the State of the opening of proceedings. In the eyes of the Regulation, it is irrelevant whether the proceedings are main or secondary, the judgment concerning the opening of proceedings is subject to automatic recognition under Article 16 of the EIR. Article 25 (1) of the EIR governs the recognition of:

1) judgments which concern the course and closure of insolvency proceedings;
2) compositions approved by the court;
3) judgments deriving directly from insolvency proceedings and judgments which are closely linked to them; and
4) judgments relating to preservation measures taken after the request for the opening of insolvency proceedings.

Subject to the provisions of Article 25(1), these types of judgments are also recognized automatically. Such judgments are to be enforced in accordance with Articles 39 to 60 of the Brussels Ia Regulation (Articles 38 to 58 of the Brussels I Regulation), with the exception of Article 46 of the Brussels Ia Regulation (Article 45(2), of the Brussels I Regulation). Under the provisions of EIR, the recognition and enforcement of judgments other than those referred to in Article 25(1) are to be governed by the Regulation referred to in Article 25(1), provided that it is applicable. Possibilities for refusing the recognition or enforcement of a judgment are very limited under the EIR: Article 25(1) rules out any prospect of relying on the grounds of non-recognition laid down in Brussels Ia; therefore, there remain only two grounds: a judgment may be refused of recognition for reasons of public policy (Article 26, EIR) or in situations which might result in a limitation of personal freedom or postal secrecy (Article 25(3), EIR).

After the Recast Brussels I abolishing the *exequatur* requirement has entered into force, the difference between the regimes of recognition of judgments under the latter and the EIR may seem marginal. The principal change regarding the interaction of the two Regulations after the renewal of Brussels I mainly concerns actual enforcement of judgments: under the new Brussels I, there is no need to request the *exequatur* in the country of enforcement, as mentioned above, thus the successful party may advance the enforcement directly. This rule also applies when a judgement subject to enforcement has been rendered in insolvency proceedings.

Although the grounds for non-recognition remain unchanged in the Brussels I Recast as compared to the old version of the instrument, the examination of these grounds is impossible without a request from the interested party.

While Brussels Ia keeps "classic" grounds of non-recognition, the EIR and its renewed version EIRa are limited to the possibility of invoking the *orde public* ground and to assess whether the judgement does not infringe personal freedoms or postal secrecy of the party. Therefore, since the grounds of non-recognition under the EIR (as well as in the EIRa) and Brussels Ia differ, the instrument applicable to annex proceedings still bears a particular importance due to the difference in possibilities available to challenge the enforcement.

Contrary to jurisdictional rules, the provisions concerning recognition and enforcement of judgements, which establish the closest possible regime of legal cooperation, work efficiently in practice and cause no significant issues. Therefore, the proposed EIRa itself does not change the existing framework of recognition and enforcement of foreign insolvency judgements.

3 Possible Actions as Annex Proceedings

In its judgment in *Deko Marty,* the CJEU explained that insolvency related actions are subject to the *vis attractiva concursus* principle, although this important clarification did not have much impact on the ambiguity as to precisely which actions derive directly from the insolvency proceedings and are closely connected to them. Nevertheless, the silence of the EIR as to the characterization of annex proceedings has been comparatively compensated by the CJEU in its numerous judgments. According to the previous jurisprudence of the CJEU, the evaluation of an action at hand must be rendered in each and every case and it should not be formalistic, hence the main criteria allowed in labelling ancillary actions is obviously the purpose: if the core purpose of the related claim is insolvency specific, then it should be regarded as an annex proceeding. It is worth mentioning that the term "insolvency specific purpose" is far from being self-explanatory; however, according to the jurisprudence of the Court, the insolvency specificity of an action may be determined with reference to the following criteria:

- an ancillary action is based on insolvency law;
- an action is based on general rules of law, although altered by the insolvency law as to its essence;
- the potential result of an ancillary action is aimed at creating a benefit for the general body of insolvency creditors.

The essence of insolvency as a social, legal and economic phenomenon may entail numerous complex issues to be resolved. Since insolvency affects the rights and interests of various individuals in one way or another, the spectrum of possible questions arising from it is eminently extensive. As a certain right of an individual is to be implemented according to a particular set of procedural rules, it is greatly important to classify the exact methods of enjoyment of these rights. In the context of insolvency law where a collision between ordinary civil proceedings and insolvency comes into being, a choice of the correct forum is indispensable.

As we have already seen from the jurisprudence of the CJEU, some of the indistinct actions have been classified by the Court itself: insolvency law-related lawsuits on personal liability of the *de facto* manager of an entity have been found falling within the ambits of insolvency in *Gourdain*. As to avoidance actions, a delimitation line may be drawn upon the strength of the subject asserting the claim: *Actio Pauliana* filed by the liquidator is indeed an insolvency-related action both in situations where the defendant resides in the European Union[80] or elsewhere,[81] but not in cases where such a claim is pursued by an assignee.[82] In *SCT Industri*,[83] the CJEU stated that a decision, in which a court of another Member State held a transfer of shares effected in the context of insolvency proceedings to be invalid on the ground that the liquidator who made the transfer lacked the power to dispose of assets situated in that Member State, derived directly from insolvency proceedings and was closely linked with them. In *German Graphics*,[84] the CJEU found that a seller's action based on reservation of title against the insolvent purchaser of assets was not related to insolvency proceedings and ruled on the applicability of Brussels I. In *Nickel & Goeldner Spedition*,[85] the Court rejected a direct link of the action with insolvency proceedings as to the action brought by an insolvency administrator against the debtor of an insolvent company for payment in respect of services involving the international carriage of goods.

As shown by the delimitation criteria laid down in the jurisprudence of the CJEU, actions which presuppose insolvency-specific interests, such as the protection of the *paritas creditorum* principle, should be attracted to insolvency proceedings. Therefore, challenges by one creditor concerning the recognition of another

80 Case C-339/07 *Christopher Seagon v Deko Marty Belgium NV* [2009], I-00767 ECLI:EU:C:2009:83.

81 Case C-328/12 *Ralph Schmid v Lilly Hertel* [2014] ECLI:EU:C:2014:6.

82 Case C-213/10 *F-Tex v UAB Jadecloud-Vilma* [2012] ECLI:EU:C:2012:215.

83 Case C-111/08 *SCT Industri AB i likvidation v Alpenblume AB* [2009] ECR 2009 p. I-5655 ECLI:EU:C:2009:419.

84 Case C-292/08 *German Graphics Graphische Maschinen GmbH v Alice van der Schee* [2009] ECLI:EU:C:2009:544.

85 Case C-157/13 *Nickel & Goeldner Spedition* [2014] ECLI:EU:C:2014:2145.

creditor's claim in insolvency proceedings, or questions concerning the priority of claims, naturally should be attracted to insolvency proceedings. The same conclusion is to be drawn about claims concerning the approval of debt-repayment plans or discharge of the obligations of the debtor or similar actions. These types of actions are insolvency specific; secondly, resolution of this kind of dispute is the most rational and economic if it takes place before the insolvency court. The jurisdiction over actions concerning insolvency practitioners' liability for damages should also fall within the competence of an insolvency court, provided this liability is based on the wrongful carrying out of his duties during the insolvency as opposed to claims based on a general tort law, which should not be subject to *vis attractiva concursus.*

Actions which ought not to be accumulated are those which would have been possible irrespective of insolvency. This category of lawsuits includes actions to recover property in possession of the debtor, disputes between the insolvent entity and a provider of services that are necessary for the former to maintain its functions during the insolvency and disputes concerning ownership of the assets. Other actions, such as claims of preferential creditors concerning separate satisfaction of their claims, although featuring connections to insolvency, should not be subject to the *vis attractiva conscursus* principle, since the essence of the legal relationship presupposes the bypassing of insolvency law.

4 Conclusions

The Brussels Ia Regulation is the main instrument in the private EU law framework projected to cover the widest possible spectrum of issues, whereas the EIR is specifically tailored to govern the sphere of insolvency within the EU. Therefore, the scopes of the two Regulations in principle should neither cause any gaps nor overlap. However, it is not always so: systematic analysis of the two instruments and assessment of the jurisprudence of the CJEU leads to the conclusion that grey areas are present, since both the EIR and Brussels Ia fall short of clear delimitation between the spheres of coverage of those two Regulations.

As it follows from the political agreement concerning the new EIR, the Recast EIR will be broader in scope than its predecessor and is expected to include pre-insolvency proceedings and hybrid proceedings. Since these types of proceedings are in essence different from traditional insolvency proceedings, it is unclear whether the criteria laid down in existing judgements of the CJEU will be sufficient to accommodate annex proceedings related to hybrid and pre-insolvencyproceedings.

Jurisdiction to open insolvency proceedings is governed by Article 3 of the EIR. However, the Regulation is silent concerning the jurisdiction in respect of ancillary actions. The muteness of the EIR in relation to these questions led to two fundamental judgments by the CJEU establishing the general principles of delimitation between actions subject to *vis attractiva concursus* and those belonging to the rules of general jurisdiction laid down in theBrussels I Regulation. The findings in *Gourdain* led to the exclusion of annex proceedings from the scope of Brussels I while the inferences in *Deko Marty* implicitly state that these questions are subject to jurisdictional rules of Article 3 of the EIR.

The findings of the CJEU in *Deko Marty* have been codified in Article 6(1) of the EIRa. Nevertheless, there still is a great deal of ambiguity concerning what exactly constitutes an annex proceeding. Therefore, it may be assumed that the inferences in *SCT Industri*, *F-Tex*, *German Graphics* and finally in *Nickel & Goeldner Spedition* will continue to provide the basis of the determination. Under the above mentioned jurisprudence of the CJEU, the main criterion which allows a given action to be labelled as "deriving directly from the insolvency proceedings and which are closely linked to them" is the insolvency-specific purpose of the action, which is to be examined on a case-by-case basis.

Although not expressly confirmed by the CJEU, it may be construed that the jurisdiction under Article 3 of the EIR is exclusive. Under the new EIRa, jurisdiction in respect of annex proceedings *per se* seems to be exclusive as well, except for the cases when the ancillary action at hand is related to another action which is subject to jurisdictional rules laid down in Brussels Ia. In this case, there is a possibility to bring both actions before the court according to the jurisdictional rules of Brussels Ia.

The rules of recognition and enforcement of judgements under the EIR may be construed as efficient and, therefore, have remained unchanged in the Recast Insolvency Regulation. After the abolishment of *exequatur* in the Recast version of Brussels I Regulation, the regime of recognition and enforcement of judgments looks very similar under both legal instruments; however, the Brussels I Regulation provides more possibilities to challenge the enforcement than the EIR.

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Chapter 2

EU-wide Interconnection of Insolvency Registers

Pál Szirányi

1 Origins of the Idea of a Europe-wide Interconnection of Insolvency Registers*

The collective nature of insolvency proceedings speaks for their publication: everyone who has an interest in the assets or affairs of the debtor should be informed about the opening of such proceedings in sufficient time to prepare and perform any appropriate action. Openness and publication of collective insolvency proceedings is also in the interest of the insolvency debtor, since this improves the chances of a genuinely universal solution covering all persons affected directly or indirectly by the opening. National insolvency laws deal in with the issue of publication of insolvency proceedings[1] very different ways, which are familiar for and accessible to their own residents, but pose a serious challenge to interested persons from other states. This was known before the creation of the first EU Insolvency Regulation,[2] which found it necessary to reinforce the universal treatment of cross-border insolvency proceedings in the Regulation by certain uniform rules on publication and registration in Member States outside the opening of the proceedings. The relatively modest approach of these rules received criticism in the relevant literature,[3] and the system indeed proved to be problematic in practice when it came to the evaluation of the Regulation after a decade of its application.

The Report of the Commission on the application of the Regulation named on the one hand the inability of creditors to become informed about the opening of insolvency proceedings, on the other hand the risk of concurrent proceedings

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1 See Annex VI of the Impact Assessment accompanying the proposal for a Regulation amending the Insolvency Regulation, Commission staff working document, Strasbourg 12 December 2012, SWD(2012) 416 final—hereinafter as "Impact Assessment".

2 Council Regulation (EC) No 1346/2000 on insolvency proceedings, OJ L 160 of 30 June 2000, p. 1-18—hereinafter as "the Insolvency Regulation".

3 *Moss/Fletcher/Isaacs* [1], paragraph 8.298.

in different Member States relating to the same debtor as the main difficulties resulting from the failure of publication of the opening of proceedings in a public register.[4] The Impact Assessment of the Commission added to these arguments that also potential customers, employers or banks of an insolvent company or a person may be negatively affected if they are not informed about the fact that their future commercial partner is subject to an insolvency proceeding or debt-discharge scheme.[5] This diagnosis of the assessment was confirmed by the results of the public consultation carried out by the Commission in 2012, where three quarters of respondents (75%) agreed that the absence of mandatory publication of the decision opening insolvency is a problem.[6]

Against this backdrop, it is easily comprehensible that the provisions of the Regulation on publication constituted an issue for consideration when the Commission undertook the preparation of its revision proposal; it remained, nevertheless, to be decided how to improve these rules. A guidance of political nature and an incentive for action came from the European Parliament in 2011. Based on a report of *Klaus-Heiner Lehne*, former chair of the Committee on Legal Affairs, the EP adopted a resolution on insolvency proceedings with concrete recommendations to the Commission, among others on the issue of publication.[7] In this resolution the EP proposed the creation of "an EU insolvency register in the context of the European e-Justice Portal, which should contain, for every cross-border insolvency opened, at least: the relevant court orders and judgments, the appointment of the liquidator and that person's contact details, the deadlines for filing claims. Transmission of this data to the EU registry by the courts should be compulsory."

Another incentive pointing to this direction was given by the evaluation study prepared by the Consortium Heidelberg/Vienna University.[8] Although the relevant conclusion maintained the idea of a single electronic platform for on-line accessibility of information, the technique preferred was less intrusive in terms of national approaches: instead of creating a uniform EU register with obligations to courts to feed in data directly, the study suggested the interconnection of

4 Report from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the application of Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings Strasbourg, 12 December 2012 COM(2012) 743 final, p. 16.

5 Impact Assessment p. 25.

6 See Annex II of the Impact Assessment, p. 53.

7 European Parliament resolution of 15 November 2011 with recommendations to the Commission on insolvency proceedings in the context of EU company law (2011/2006(INI)), document no. P7_TA(2011)0484. The relevant recommendations can be found in Part 4 of the Annex to the resolution.

8 *Hess/Oberhammer/Pfeiffer* [2].

the national electronic registers: "the creditors' access to information could be improved by using public registers as information tools. Such an approach could build upon the infrastructure that does already exist in most Member States, i.e. the national insolvency registers (or equivalent registers) which are available online. Providing a platform that interconnects existing databases would not only avoid a duplication of the process, i.e. a consequence the adoption of a new database would entail, but also provide a quick and efficient way to spread information."[9]

The suggested approach was confirmed by the conclusions of the Impact Assessment, which demonstrated that maintaining the existing solution, even with the soon to be implemented system of interconnection of national company registers, would not bring a satisfactory solution to the problems raised. Although the system set up by the relevant EU directive[10] requires the publication of information on the opening and termination of any winding-up or insolvency proceedings of the companies registered, this would improve the situation only partially, since:

(i) in most Member States only limited liability companies are registered;

(ii) natural persons, sole traders or self-employed persons are not covered by the Directive; and

(iii) the circle of information to be published in relation to insolvency is very limited.[11]

The preferred option by the Impact Assessment, therefore, suggested that Member States publish all relevant decisions of insolvency proceedings in a national electronic register and define common categories for interconnection of national registers through the e-justice portal. According to the evaluation of the Commission, such a solution could adequately satisfy the demand for information throughout the entire life-cycle of insolvency proceedings which is highly supportable even if the implementation and maintenance of the system of interconnection would generate some extra costs for Member States.[12] It was, therefore, not a surprise that the solution aimed at improving publication of insolvency proceedings within the European Union put forward by the Commission in its legislative proposal

9 Evaluation Study pp. 382–383.

10 Directive 2012/17/EU of the European Parliament and of the Council of 13 June 2012 amending Council Directive 89/666/EEC and Directives 2005/56/EC and 2009/101/EC of the European Parliament and of the Council as regards the interconnection of central, commercial and companies registers, OJ L 156 of 16 June 2012, p. 1–9.

11 Impact Assessment p. 37.

12 See estimation with regard to costs on p. 41 of the Impact Assessment.

amending the existing Regulation[13] envisaged the Europe-wide interconnection of national electronic insolvency registers.

2 Interconnection of National Insolvency Registers in the Recast Insolvency Regulation

2.1 Key Features of the System of Interconnection

Although the system adopted by the recast Insolvency Regulation differs in certain features from the solution proposed by the Commission in 2012, one can acknowledge with satisfaction that the structure and the core elements of the regime establishing the interconnection were left unchanged by the co-legislators. This approach anticipates a system which is composed of publicly accessible electronic insolvency registers of the Member States, which will be interconnected via the European e-Justice Portal. On the one hand Member States are obliged to establish and maintain such electronic registers, on the other hand they are obliged to publish in these national registers a minimum amount of information with regard to insolvency proceedings opened in their jurisdiction, which set of information is well defined by the Regulation and labelled as "mandatory information".[14] This information will then be made accessible through the European e-Justice Portal which will serve as central public electronic access point to the national databases, and which will operate a single search service in all official languages of the European Union.

The "mandatory information" under the Regulation constitutes a minimum standard: nothing precludes Member States from publishing in their national registers documents or additional information which they consider relevant regarding insolvency proceedings.[15] The final list of mandatory information maintained, with some necessary clarification and adjustment,[16] all elements suggested by the proposal of the Commission, and added a few new ones, such as

13 Proposal of the Commission for a Regulation of the European Parliament and of the Council amending Council Regulation (EC) No 1346/2000 on insolvency proceedings, Strasbourg 12 December 2012, COM(2012) 744 final.

14 Article 24(2) of the recast Insolvency Regulation.

15 Article 24(3) of the recast Insolvency Regulation.

16 E.g. the adopted Regulation dispensed with the idea of obligatory publication of (court) decisions, such as those of opening insolvency proceedings or of appointing the liquidator, since it was held satisfactory that the legally relevant information contained in such decisions are published. Another adjustment concerned the time limits for lodging claims and challenging decisions: namely, some Member States considered it technically demanding to calculate this information on a case-by-case basis, due to the specific circumstances such calculations may be influenced by. As a compromise it was agreed that this information *may* be provided in a general way, by adding hyperlinks to the European e-Justice Portal, which links contain self-explanatory information on the criteria for calculating those time limits (see recast Insolvency Regulation recital (77)).

the information relating to the ground of jurisdiction for opening proceedings,[17] or the information with regard to the exercise of the right granted by the Regulation to challenge the opening decision.[18]

2.2 Scope of the Future System Interconnection of Insolvency Register

Defining the scope of those national insolvency proceedings which should be included in the interconnected system of national registers was one of the issues most intensively debated during the legislative procedure in the Council. The political difficulty of the question derived partly from the "data protection" sensitivity of the matter, partly from the divergence in policy lines which Member States follow in terms of accessibility of registered insolvency proceedings, in particular concerning the proceedings for natural person debtors.

With regard to the first issue, it is to be noted that even the Commission proposal paid attention to the possible impacts of the on-line accessible interconnection on the protection of personal data. The Impact Assessment underlined the importance of the obligation of Member States to comply with the currently applicable EU standards in this context, which led to an express reference in the proposal to the two legislative instruments of EU law on data protection.[19] The awareness for the principles of data protection was one of the reasons why the original legislative proposal of the Commission did not extend the scope of the interconnection to proceedings which concerned "consumer" debtors, meaning natural persons not exercising an independent business or professional activity.[20]

As it appeared, this approach was not satisfactory to all Member States. There were those, which were in their national registration more liberal and put information concerning natural person debtors without any restriction on the internet, and which consequently did not accept the idea that the system of interconnection would not provide full transparency with regard to "consumer" debtors. While another group of Member States wished to exclude from the scope of interconnection all proceedings relating to natural persons, even those concerning self-employed and independent professionals. They argued that the exclusion of non-consumer individuals from the obligation of the interconnection serves the interest of protecting their clientele.

17 In order to inform the public if the insolvency proceeding opened is a main, a secondary or a territorial one.

18 Article 5 of the recast Insolvency Regulation. In the original proposal of the Commission this piece of information should have been provided to the (known) creditors through individual notices by the court of opening; but finally this idea was rejected, since the co-legislator considered it more effective to include it in the publicly available system of interconnection.

19 See Article 46a of the 2012 Commission proposal.

20 See Article 20d of the 2012 Commission proposal, as well as point 3.1.4. of its explanatory memorandum.

The data protection aspect of the proposal gained on importance in the legislative procedure due to the fact that the European Data Protection Supervisor issued an opinion on the Commission's proposal.[21] In this opinion the supervisor also addressed the proposed system of interconnection. On the one hand, he acknowledged that the aims pursued by the Commission are legitimate, and understood that transparency regarding the opening and closing of insolvency proceedings and the need for creditors and courts involved to be well informed and to avoid the parallel opening of proceedings are important objectives.[22] On the other hand, he asked for a clearer justification in terms of necessity and proportionality of the suggested measure and recommended some additional safeguards in this context.[23]

On the basis of these recommendations, the legislator introduced more detailed provisions on data protection in compliance with Directive 95/46/EC and Regulation (EC) No 45/2001. These rules clarify the responsibilities of the Member States and of the Commission with regard to the system of interconnection. Furthermore they make it clear that no personal data relating to data subjects shall be stored in the European e-Justice Portal, and that all such data shall be stored in the national databases operated by the Member States or other bodies. Consequently, the time of accessibility of personal data via the European e-Justice Portal will correspond to the retention period of that data in the national registers under the respective national laws.[24] In addition, for the purpose of satisfying the requirement of proportionality, the Regulation establishes a regime of conditionality, which Member States may apply in terms of requests on information concerning "consumers" and non-consumer natural person debtors subject to proceedings which are not related to their economic activity (see point 2.3 below).

With regard to the second source of difficulty, which is the difference of national policies, it is to be noted that in some Member States registers containing data on insolvency proceedings for natural persons are not accessible to the public on the internet, but can be accessed only through competent authorities. Those who would like to have information from such registers may get it only on a justified request through those authorities.[25] In addition, there are Member States

21 Opinion of 27 March 2013 on the Commission proposal for a Regulation amending Council Regulation (EC) No 1346/2000 on insolvency proceedings, available at: https://secure.edps.europa.eu/EDPSWEB/webdav/site/mySite/shared/Documents/Consultation/Opinions/2013/1-03-27_Insolvency_Proceedings_EN.pdf.

22 See paragraph 21 of the opinion.

23 Paragraphs 24 and 56 of the opinion.

24 Chapter VI of the recast Insolvency Regulation.

25 Member States which have registers containing data on personal insolvencies, but these are not accessible publicly on the internet, include e.g. Finland, Belgium, Ireland.

where insolvency proceedings for natural persons are designed "profile neutral", i.e. they are available both for individuals exercising an independent business or professional activity and for "consumers".[26]

Another relevant factor discussed was that in some Member States all types of debts of the natural persons subject to insolvency proceedings are considered collectively, i.e. irrespectively of the fact if they were generated by the natural person debtor in his/her "consumer" capacity or in the course of his/her economic activity.[27] The interests of these Member States were hardly reconcilable with the interests of those Member States, where data on natural persons subject to insolvency proceedings are freely accessible on the internet.[28] The former group stressed e.g. that it would be harmful and illogical to require the launching of different sets of proceedings because the nature of the debts of the same natural person differs even though both types of debt are included among the debtor's liabilities. They also said that it would require an inappropriate extra effort in terms of technical adjustment, if they would be obliged to filter out from their single national registers for the purpose of interconnection those proceedings which relate to economically active persons. Generally they wished to exclude from the scope of interconnection proceedings relating to all natural persons, including those concerning self-employed and independent professionals, going even beyond the original proposal of the Commission, which did not extend the system to proceedings relating to consumers.

Against this backdrop, it is not surprising that the Regulation reflects a compromise solution. As a starting point, it says that all insolvency proceedings covered by the scope of the Regulation which are included in its Annex are subject to the provisions on interconnection. This includes proceedings in relation to all natural persons, should they be self-employed persons or professionals or just "consumers" in the sense of the Regulation. The Regulation acknowledges only one exception from this general rule, which applies only if three cumulative conditions are met:

(a) the information is generated in relation to a proceeding of a "consumer" debtor;

(b) there is a decision by the Member State operating the national register not to include information concerning such persons in the national register or not to make such information publicly available through the system of interconnection; and simultaneously; and

26 E.g. "debt adjustment proceedings" in Finland.

27 Such as the "collective debt settlement procedure" in Belgium.

28 E.g. United Kingdom, Slovenia.

(c) this Member State ensures in its law that foreign known creditors are individually informed in the course of such proceedings.

Those Member States which do not opt for this exemption with regard to proceedings concerning "consumer" debtors in their territory may still avail themselves of the conditionality of access to information introduced by Article 27 of the Regulation (see details under subchapter 2.3). As far as the proceedings concerning economically active natural persons are concerned, finally the principle of transparency prevailed over the right to privacy: such proceedings are treated equally to the ones relating to companies or other legal persons. Since the role and function of this circle of individuals in the single market is similar to that one of the SME's, this was a decisive factor. In the times of crisis, it is especially important that creditors are informed in a full-scale manner on the financial situation of their business partners.

Another question during the legislative procedure concerned the issue if Member States were obliged to include into their national electronic registers to be connected with the e-Justice Portal information on purely domestic insolvency proceedings, without any cross-border implications. Taking into account the legal basis of the proposal and the objectives pursued by the Regulation both in general and in the context of establishment of the interconnection, one shall answer that the obligation to include data on proceedings only relates to cases with cross-border elements. This interpretation appears to be confirmed by recital (76) of the recast Regulation, which expressly refers to "cross-border insolvency cases" in connection with the information to be published in the electronic registers.

Nevertheless, this interpretation does not pay attention to the aspect of practical feasibility, namely that in most of the cases one cannot estimate with certainty at the time of opening, if the proceeding does or does not have any international connection, since such a certainty would presuppose that information with regard to all (even possibly not known) creditors are at the disposal of the court. Once a cross-border implication is there, the Member State does not have any choice but to publish and interconnect the data relating to the proceeding. This means, therefore, that Member States which would like to prevent any unintentional infringement of the obligations imposed by the rules on interconnection of registers, have to feed in information with regard to all insolvency proceedings opened within their territory.

2.3 Conditions of Access of Information

The recast Regulation guarantees access to all "mandatory information" with regard to insolvency proceedings free of charge. This means that Member States are not entitled to charge any fee for the provision of this information through the e-Justice Portal. This approach corresponds with the one proposed by the Commission. Still it should be appreciated as a great success, since during the negotiations there were attempts going in the opposite direction. Beyond that, Member States are free to charge a reasonable fee for access to the documents or additional information which they decide to share through the system voluntarily.[29]

Member States otherwise have very limited opportunities to restrict access to information included in the national registers. The Regulation allows such a restriction only with regard to a limited circle of debtors, namely to individuals who are either "consumers" or economically active persons in their capacity as consumers.[30] Even within this circle, the acceptable ways of restriction of accessibility are clearly defined by the Regulation: Member States may either require a supplementary search criteria relating to the debtor from the users of the service of interconnection, or they may make the access of information conditional upon the verification of the existence of a legitimate interest. In order to avoid any impairment of the effectiveness of the provision, the legislator did not want to expose its conditions to the practical implementation of the Member States. Instead, there are clearly defined criteria and procedures, which a State has to comply with once it decides to use the restrictions to the data referred.

- Although the determination of the "normal" search criteria is deferred to, an implementing act to be adopted by the Commission simultaneously with the establishment of the system of interconnection, the possible supplementary search criteria at the disposal of the Member States are listed in the Regulation. Recital (79) states that the following factors may constitute such additional criteria: the debtor's personal identification number, his/her address, his/her date of birth or the district of the competent court. The supplementary nature of these criteria means that they may be required from users for getting access to the requested information *in addition* to the minimum search criteria, and in such a case (but only in such cases) at least two fields have to be filled in in the search service of the e-Justice Portal.

- If a Member State decides that it will provide information on consumer debtors upon verification of a legitimate interest from the side of the searcher, the Member State has to follow the uniform rules of the verification procedure as set out in Article 27(4) of the recast Regulation. According to these rules,

29 Paragraphs (1) and (2) of Article 27 of the recast Insolvency Regulation.

30 With the language used in Art 27(3) and 27(4) "individuals exercising an independent business or professional activity when the insolvency proceedings are not related to that activity."

Member States shall ensure that such requests are submitted to their competent authorities electronically by means of a standard form via the European e-Justice Portal. If they require written justification of the interest, they must accept electronic copies of relevant documents. Furthermore, Member States are prohibited from requiring translation of the documents justifying the request by the searcher, or charge any cost of such translation which their competent authority may incur. Finally, the decision on the request for access to document shall be delivered by the competent authority within three working days upon arrival of the request.

2.4 Technical Implementation of the Europe-wide Interconnection of Insolvency Registers

The actual establishment of the system of interconnection is entrusted to the implementing powers of the Commission, which by means of implementing acts shall adopt by 26 June 2019 all measures necessary for the deployment of the system. These measures include in addition to the technical specification defining the electronic information exchange and the measures ensuring information technology security also the minimum criteria for the search service and the minimum criteria of the presentation of the results of such searches.[31] This implies that the system of interconnection will be accessible through a uniform search mask (available in all official languages of the European Union), and that also the results will be displayed in a uniform user experience.

As a necessary preliminary measure, Member States are obliged to establish their own national electronic registers complying with the Regulation's requirements by 26 June 2018.[32] The Regulation also specifies that the costs for the establishment and maintenance of the system of interconnection of insolvency registers shall be financed by the budget of the European Union, while the costs of adjustment of national insolvency registers needed for the interoperability with the European e-Justice Portal, or the costs of the establishment of national electronic registers in those Member States where such registers do not exist shall be borne by the Member States.[33]

Although we still have to wait almost four years to enjoy the benefits of a Europe-wide interconnection of insolvency registers on the internet, we may right now experience how the future system may look like in reality. This is due to an

31 Article 25 of the recast Insolvency Regulation.

32 Article 92(2)(b) of the recast Insolvency Regulation.

33 Article 26 of the recast Insolvency Regulation.

e-Justice pilot-project developed and delivered under the umbrella of the European Union.[34] The project was implemented on the basis of and executed further to the two subsequent Multi-annual Council e-Justice Action Plans.[35] The objective of the pilot project was to establish a single access point to interconnected national insolvency registers and to provide – to the greatest extent possible – a multilingual user experience. The project was based on a voluntary interconnection of insolvency registers (or data) originating from Member State registers. The integration was completed with 7 Member States: Austria, Germany, the Netherlands, Czech Republic, Estonia, Romania and Slovenia. The technical implementation was concluded in 2012, and the project went live in July 2014.[36]

The system enables a real-time search in the national registers of the Member States involved. The search functionality currently allows for two types of searches: the "simple" search runs a parallel search on a debtor's name (legal or natural person) in all participating registers; while the "advanced" search function works with different user interfaces depending on the own designs of the involved Member States. Although one can easily realise that the interconnection established by the pilot-project has a greater sensitivity to differences of national laws than the future system to be developed by the recast Insolvency Regulation will have, it provides already an impressive demonstration of the potential benefits of such an interconnection.

3 Conclusion

The interconnection of national insolvency registers via the European e-Justice Portal constitutes a major improvement in terms of openness and publication of insolvency proceedings throughout Europe. As one of the important changes introduced by the recast Insolvency Regulation, the system of interconnection will provide with certainty an appropriate tool for achieving the objectives set by the legislator, i.e. the avoidance of concurrent insolvency proceedings and the accessibility of information by all creditors. Another advantage of the adopted system appears to be its sensitivity to different national solutions and its attention to the EU data protection regulation. It serves as a good example showing that the European Union is ready to provide genuine solutions to the challenges set by the financial crisis.

34 I would like to thank to *Alexander Ivantchev* for the valuable information given about the details of the e-justice pilot project.

35 Multiannual European e-Justice Action Plan 2009-2013, OJ C 75 of 31 March 2009, p. 1–12; Multiannual European e-Justice Action Plan 2014-2018, OJ C 182 of 14 June 2014, p. 2–13.

36 The interconnection is now available at: https://e-justice.europa.eu/content_interconnected_insolvency_registers_search-246-en.do.

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1 Moss, G., Fletcher, I.F./Isaacs, S. (eds.): The EC Regulation on Insolvency Proceedings: A Commentary and Annotated Guide, 2nd edn. Oxford University Press, Oxford (2009)

2 Hess B., Oberhammer P., Pfeiffer Th.: Study for an external evaluation of Regulation (EC) No 1346/2000 on Insolvency Proceedings 2012 ("Evaluation Study"). The study is available at the site of DG Justice under the following URL link: http://ec.europa.eu/justice/civil/document/index_en.htm

Chapter 3

Communication and Cooperation in International Insolvency: On Best Practices for Insolvency Office Holders and Cross-Border Communication between Courts

Bernard Santen

1 Introduction*

Over the past 20 years, communication, coordination and cooperation have become key concepts in international insolvency law.[1] This chapter surveys the present and coming position of these concepts in European Union hard law and soft law. It starts with a discussion in section 2 on the "communication", "coordination" and "cooperation" concepts in the European Insolvency Regulation (EIR).[2] Section 3 subsequently discusses the use of these concepts in the Regulation of the European Parliament and of the Council on insolvency proceedings (EIR Recast).[3] As section 4 will show, soft law seems the most appropriate means to operationalise the communication, coordination and cooperation-concepts in practice. This section discusses three sets of soft law which Leiden Law School prepared during 2013-2014, i.e. the draft INSOL Europe 2014 Statement of Principles and Guidelines for IOHs in Europe, the EU Cross-Border Insolvency Court-to-Court Cooperation Principles and the connected EU Cross-Border Insolvency Court-to-Court Communication Guidelines.

2 Communication, Coordination and Cooperation in the EIR

The EIR mentions communication, coordination and cooperation (further on indicated as: the three C-s concept) as one of the means to achieve the objective of

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1 See for example the 1995 European Convention on insolvency proceedings and the 1996 *Virgós/Schmit* report (L6500/96). For a complete survey, see *Wessels* [4].

2 Council Regulation (EC) No 1346/2000 of 29 May 2000 as subsequently updated until the moment of writing of this chapter.

3 As mentioned in: Position (EU) No 7/2015 of the Council at First Reading with a view to the adoption of a Regulation of the European Parliament and of the Council on insolvency proceedings (recast), 2012/0360 (COD), adopted by the Council on 12 March 2015, (2015/C 141/01); as approved by the **European Parliament legislative resolution of 20 May 2015; and as published as** Regulation (EU) 2015/848 **in** OJ L 141/19 of 5 June 2015.

the EIR, formulated in Recital 2 as "cross-border insolvency proceedings should operate efficiently and effectively". This is not a hollow phrase. When e.g. KPN-Qwest NV became insolvent in 2002, its European data-stock ring-network was sold piecemeal instead of under a central direction, which could have maintained the European ring and concluded in a much better central deal. Implementing the three C-s concept would avoid many of the pointless quarrels between insolvency office holders[4] (IOHs) and long lasting discussions before courts, often costing creditors huge amounts of money. In short, the three C-s concept was implemented in order to improve the recovery rates.

The EIR introduced these "three C-s concepts" moderately. As Table 3.1 shows, "communication" is mentioned only four times, all of these in the text; "coordination" four times only in the recitals; and "cooperation" twice in the recitals and twice in the text.

Table 3.1: Survey of Presence of Communication, Coordination and Cooperation in the EIR[5]

	EIR No 1346/2000	
	Recital	**Text**
communication	-	4 (Article 31)
coordination	4 (Recital 3, 12, 20, 21)	-
cooperation	2[6] (Recitals 2, 20)	2 (Article 31)

The main presence of cooperation and communication is found in Article 31 EIR ("Duty to cooperate and communicate information"). According to Article 31(1), the IOH in the main procedure and the IOH in the secondary procedure are duty bound to communicate information to each other which may be relevant to the other proceedings. This regards, as the text states, in particular the progress made in lodging and verifying claims and all measures aimed at terminating the proceedings. Article 31(2) EIR provides for a duty of cooperation between the main and the secondary IOH. Finally, Article 31(3) EIR requires a secondary IOH to give to the main IOH an early opportunity of submitting proposals on the liquidation or use of the assets in the secondary proceedings.

4 The abbreviation "IOH", coined by the EBRD in their 2007 report: Office Holders Principles (2007), is used throughout this chapter to indicate the liquidators mentioned in Annex C of the EIR and the insolvency practitioners of Annex B of the EIR Recast.

5 Or related verbs.

6 Found in Recital 2, referring to "judicial cooperation" as meant in Article 65 of the former Treaty. Recital 20 is elaborated in Article 31 EIR.

While communication apparently implies sharing of information as the text indicates[7], neither the recitals nor the articles provide insight into the application of "cooperation" or "coordination". Moreover it is remarkable that whilst "coordination" is found four times in the Recitals, it is found nowhere in the text. Apparently, according to the European legislator "coordination" implies either communication (and/) or cooperation. The question arises whether coordination and cooperation may be (largely) identical concepts. According to the *Virgós/ Schmit* report:[8] "the liquidators have a duty to act in concert with a view to the development of proceedings and their coordination, and to facilitate their respectivework."

In their view cooperation comes down to "act in concert". The on-line Oxford dictionaries give for coordinate: "Negotiate with others in order to work together effectively". And for cooperate: "Work jointly towards the same end". Since "act in concert" and "jointly working" imply a further stage of accommodation than "negotiation in order to work together" and "effectively" in the coordination description leaves open the presence of several aims instead of "the same end" in the cooperation description, the conclusion must be that:

(1) "cooperation" is the farthest stage of tuning between IOHs in proceedings;

(2) "coordination" is the stage where IOHs negotiate in order to work together effectively; and

(3) "communication" comes down to sharing information with each other which may be relevant to the other proceedings.

In short, it seems that in the present text of the EIR, the legislator draws the relatively far reaching "cooperation-card" albeit only between IOHs. As the next section of this chapter shows, the EIR Recast leans heavily on coordination as well.

7 The 1996 *Virgós/Schmit* report refers to "communication" in nos. 230–231. No. 230 states: "The exchange of information between the liquidators concerns in particular:
- the assets;
- the actions planned or under way in order to recover assets; actions to obtain payment or actions for set aside;
- possibilities for liquidating assets;
- claims lodged;
- verification of claims and disputes concerning them;
- the ranking of creditors;
- planned reorganisation measures;
- proposed compositions;
- plans for the allocation of dividends; and
- the progress of operations in the proceedings."

Nr. 231 adds that the duty to communicate "may be limited by national legislation on data exchange, e.g. by legislation relating to the protection of computerised personal data."

8 Nr. 232.

3 Communication, Coordination and Cooperation in the EIR Recast

Contrary to the EIR, the EIR Recast mentions the "three C-s concepts" in abundancy. Already eight Articles show "cooperation and communication" in their headings, and there are five with "cooperation" in their heading, but only as in "group coordination". Table 3.2 gives a breakdown of the presence of the "three C-s concepts" in the EIR Recast.

Table 3.2: Survey of Presence of Communication, Coordination and Cooperation in the EIR and the EIR Recast

	EIR No 1346/2000		EIR Recast	
	Recital	Text	Recital	Text
communication	-	4 (Article 31)	5 (Recitals 48, 52, 59, 61, 62)	33[9] (Articles 25, 36, 41-44, 53, 56-59; 73, 74, 79)
coordination	**4 (Recitals 3, 12, 20, 21)**	-	38[10] (Recitals 4, 6, 23, 50, 54-63)	96[11] (Articles 41-43; 56, 57, 60-74; 77, 99)
cooperation	2[12] (Recitals 2, 20)	2 (Article 31)	17[13] (Recitals 3, 48, 49, 50, 52, 61, 62)	37[14] (Articles 41-44; 56-59; 74 and 85)

The EU apparently considers these "three C-s concepts" even more important today. Instead of 12 referrals to the concepts, the EIR Recast shows 226 referrals. Essentially, the present Recital 20 will be replaced by three new ones, 48, 49 and 50, and the current Article 31 by the new Articles 41, 42 and 43. Moreover, the EIR Recast adds Chapter V Insolvency Proceedings of Members of a Group of Companies, whose section 1 begins with cooperation and communication, and proceeds with coordination in section 2. A short glance at the Articles 41, 42 and 43 EIR Recast shows that Article 41(1) requires IOHs of the main and the secondary proceedings to:

> "cooperate with each other to the extent such cooperation is not incompatible with the rules applicable to the respective proceedings. Such cooperation may take any form, including the conclusion of agreements or protocols."

9 In Article 79, "communication" refers to communication to the European Commission.

10 In Recital 4, "coordination" refers to "a need for a Union Act". Figures including "coordinator": 6x in Recitals, 39x in Articles.

11 In Article 90, "coordination" is used in the review clause.

12 In Recital 2, "cooperation" refers to Article 65 of the former Treaty establishing the European Community.

13 In Recital 3, "cooperation" refers to Article 81 of the Treaty on the Functioning of the European Union.

14 In Article 85 "cooperation" refers to Treaties having "Cooperation" in their name.

This goes beyond the present Article 31 EIR, since being duty bound to communicate (para. 1) and to cooperate (para. 2) as it is now, seems more restricted than cooperation to the extent of incompatibility with the law.[15] Article 41 EIR Recast requires ("shall") IOHs specifically:

(a) to communicate as soon as possible to each other any information which may be relevant to the other proceedings;[16]

(b) to explore the possibility of restructuring the debtor;[17] and

(c) to coordinate the administration of the realisation or use of the debtor's assets and affairs.[18]

This specification goes beyond the present Article 31(1) e.g. on restructuring and coordination. In order to facilitate coordination of insolvency proceedings Article 42 EIR Recast requires:

> "a court before which a request to open insolvency proceedings is pending, or which has opened such proceedings, (to) cooperate with any other court before which a request to open insolvency proceedings is pending, or which has opened such proceedings, to the extent that such cooperation is not incompatible with the rules applicable to each of the proceedings."

According to Article 42(3) EIR Recast cooperation may, in particular, concern:

(a) coordination in the appointment of the IOH;

(b) communication of information by any means considered appropriate by the court;

(c) coordination of the administration and supervision of the debtor's assets and affairs;

(d) coordination of the conduct of hearings; and

(e) coordination in the approval of protocols, where necessary.

15 Although Article 41(1) EIR Recast refers to "the rules applicable to the respective proceedings" it should be interpreted in the author's view as "the law".

16 The section continues: "in particular any progress made in lodging and verifying claims and all measures aimed at rescuing or restructuring the debtor, or at terminating the proceedings, provided appropriate arrangements are made to protect confidential information."

17 The section continues: "and, where such a possibility exists, coordinate the elaboration and implementation of a restructuring plan."

18 The section continues: "the insolvency practitioner in the secondary insolvency proceedings shall give the insolvency practitioner in the main insolvency proceedings an early opportunity to submit proposals on the realisation or use of the assets in the secondary insolvency proceedings."

Finally, Article 43 EIR Recast requires IOHs to communicate and cooperate with (in short) all courts related to the insolvency proceedings to the extent that such cooperation is not incompatible with the law.

Already these Articles form a huge extension of the present obligation formulated in Article 31. The new Chapter V "Insolvency Proceedings of Members of a Group of Companies" adds to this two extensive and detailed sections applicable where insolvency proceedings relate to two or more members of a group of companies. The first section, on cooperation and communication in general, requires in Article 56 EIR Recast ("shall") an IOH appointed in proceedings concerning a member of the group to cooperate with any IOH appointed in proceedings concerning another member of the same group to the extent that such cooperation is appropriate to facilitate the effective administration of those proceedings, is not incompatible with the rules applicable to such proceedings and does not entail any conflict of interest. That cooperation may take any form, including the conclusion of agreements or protocols. It continues in Article 56(2):

> "In implementing the cooperation set out in paragraph 1, IOHs shall (a) as soon as possible communicate to each other any information which may be relevant to the other proceedings, provided appropriate arrangements are made to protect confidential information; (b) consider whether possibilities exist for coordinating the administration and supervision of the affairs of the group members which are subject to insolvency proceedings, and if so, coordinate such administration and supervision; (c) consider whether possibilities exist for restructuring group members which are subject to insolvency proceedings and, if so, coordinate with regard to the proposal and negotiation of a coordinated restructuring plan."

Article 57 EIR Recast provides for a similar requirement ("shall") concerning cooperation between courts, including the same list of areas as mentioned in Article 42(3) EIR. And Article 58 EIR Recast:

(a) requires an IOH to cooperate and communicate with any court before which a request for the opening of proceedings in respect of another member of the same group of companies is pending or which has opened such proceedings; and

(b) allows an IOH to request information from that court concerning the proceedings regarding the other member of the group or request assistance concerning the proceedings in which he has been appointed; to the extent that such cooperation and communication are appropriate to facilitate the effective administration.

Essentially, these articles are similar to those in the general part of the EIR Recast (Articles 41-43). Section 2 of Chapter V provides for a very detailed procedure of coordination in these group proceedings.[19] Since the coordination and cooperation in "group of companies proceedings" is very well arranged for, the question arises how the European legislator envisages to operationalise the "three C-s concept" in situations of "main/secondary proceedings". This is the subject of the next section.

4 Operationalisation of the "Three C-s Concept" in Main and Secondary Proceedings

Contrary to the Chapter V regulation, there is no regulation at all in the articles of the EIR Recast on the operationalisation of the "three C-s concept" in the case of main and secondary proceedings. However, the Recitals show a way out. When cooperating, Recital 48 reads in the fifth sentence:

> "IOHs and courts should take into account *best practices for cooperation* in cross-border insolvency cases, as set out in *principles and guidelines* on communication and cooperation *adopted* by European and international *organisations active in the area of insolvency law,* and in particular the relevant guidelines prepared by the United Nations Commission on International Trade Law *(UNCITRAL).*"[20]

In light of such cooperation, Recital 49 continues:

> "insolvency practitioners and courts should be able to enter into *agreements and protocols* for the purpose of facilitating cross-border cooperation of multiple insolvency proceedings in different Member States concerning the same debtor or members of the same group of companies."[21]

As so often, this clarification gives rise to new questions. What are best practices, principles and guidelines? What is adoption? Which organisations are *active* in

19 Interestingly, an opt-out for each of the proceedings is foreseen in the law, Article 65(1) EIR Recast.

20 The Recital starts as follows: "Main insolvency proceedings and secondary insolvency proceedings can contribute to the efficient administration of the debtor's insolvency estate or to the effective realisation of the total assets if there is proper cooperation between the actors involved in all the concurrent proceedings. Proper cooperation implies the various insolvency practitioners and the courts involved cooperating closely, in particular by exchanging a sufficient amount of information..." Thus, the text does not refer to a group of companies' proceedings.

21 Remarkably, there is nothing on "coordination" in these recitals.

insolvency law? And what are agreements and protocols? Of these questions, only the meaning of best practices, principles and guidelines will be dealt with in this chapter.[22]

According to the text of the recital, best practices are found in principles and guidelines. What are these? In a study for INSOL Europe,[23] TRI-Leiden defined "Principles" as general standards (Kaplow 1992;[24] Davies 2010[25]) of behaviour, to be made specific in a specific situation by the IOH himself.[26] A Guideline is defined in that report in accordance with the online Merriam-Webster dictionary as "a rule or instruction that shows or tells how something should be done."[27] A best practice then, could be described as either a general standard or a rule or instruction that ought to be followed save an acceptable explanation to the contrary ("comply or explain"). Over the past two years, Leiden Law School (LLS) has designed two sets of Principles and Guidelines to be applied in accordance with (now) Recital 48 EIR Recast. This section will subsequently discuss the rules for IOHs and courts that LLS designed.

4.1 The Draft Statement of Principles and Guidelines for IOHs

Immediately after the publication of the EC evaluation report of the EIR,[28] INSOL Europe took the initiative to assign a project to LLS to formulate Principles and Guidelines for IOHs in Europe.[29] Governed by an Academic Committee and a Review and Advisory Group, LLS drafted three reports. Report I contains a framework and a model, which are subsequently applied on the analysis of regionally and globally established rules for IOHs. Report II contains an analysis based on the framework and model developed in Report I, of the rules for IOHs in a number of European countries e.g. France, Germany, Italy, Latvia, Lithuania, the Netherlands, Poland, Romania, Serbia, Spain and the UK. The comparative analysis shows the differences in approach and solution on the various issues. In

22 TRI-Leiden is currently working on a "protocols" project, see: <www.TRI-Leiden.eu>.

23 *Adriaanse/Wuisman/Santen* [1], p. 15.

24 *Kaplow* [3].

25 *Davies* [2].

26 Whether the actual behaviour of an IOH was in compliance with that Principle can be assessed only *ex post* by a judicial or supervisory body.

27 These resemble "rules" in *Davies'* [2] typology.

28 Report of 12 December 2012, see: http://ec.europa.eu/justice/civil/files/insolvency-regulation_en.pdf.

29 The initial assignment was to draft Principles and Best Practices, but after an analysis of the text of (now) Recital 48 and the meaning of the concepts, TRI-Leiden suggested to INSOL Europe to change the wording of the assignment in Principles and Guidelines.

their turn, those differences indicate the room for Principles and Best Practices. Report III contains the draft Principles and Guidelines.[30]

The Statement of Principles and Guidelines for IOHs in Europe contains 7 Principles, 33 Guidelines and 83 Comments. Although it is explicitly non-binding of character and recognises that all national law and (professional) regulations have priority, it cannot be denied that its character may evolve in a "comply or explain" nature. After all, if there is supposedly a Principle or Guideline in the Statement that would have avoided certain damage that has occurred when administering the proceedings, a judge could easily question the IOH why (s)he has not followed the best practice as described in the Statement.

The Principles contain general standards for IOHs i.e. on the role of the law, regulations and the Statement itself (Principle 1); on professional (Principle 2) and ethical (Principle 3) conduct; on the administration of the estate (Principle 4); on communication (Principle 5); on coordination and cooperation (Principle 6); and on insolvency governance (Principle 7). Guidelines, sorted by Principle, and comments complete these and make them applicable in day-to-day IOH work. As an example, Principle 3 on ethics reads:

> "An IOH performs with
>
> (a) integrity, meaning that an IOH is straightforward and honest;
>
> (b) objectivity, including impartiality and independence, meaning that an IOH does not allow bias, conflict of interests or undue influence of others to override professional or business judgments and is solely guided by the interests of the estate;
>
> (c) confidentiality, meaning that an IOH complies with the confidentiality of information acquired as a result of the appointment and avoids the abuse of confidential information."

As Comment 32 on the Statement notes, "serving as an IOH solely guided by the interests of the estate" is added since there should not be any other motive. "The interests of the estate" means primarily – but not only[31] – all that would be helpful to secure or enlarge the estate. The Statement supports – not undisputedly – that an IOH in being "solely guided by the interests of the estate" should serve the

30 All reports can be retrieved from: www.TRI-Leiden.eu.

31 See for Dutch law regarding the importance to be given to the interests of the employees: HR, 24 February 1995, NJ 1996, 472 (Sigmacon II); HR 19 April 1996, NJ 1996, 727 (*Saint Maclou*). And regarding the interests of the insolvent person: HR 16 February 2015, ECLI:NL:HR:2015:87 (*X/Van der Molen q.q.*).

benefits of the creditors as a whole and in doing so have regard to – in short – other stakeholder issues.[32] This ethical principle is made more specific in Guideline 6.2:

> "Best Practice 6.2
> When assets will be sold an IOH cooperates to the maximum extent possible with other IOHs as well as with all parties involved, in order to obtain the maximum aggregate value for the assets of the insolvent debtor as a whole, across legal entities and across national borders. If this cooperation would turn out to be detrimental to a specific estate, the concerned estate(s) will be offered full compensation for the consequences of cooperation from the other estates that are better off by the cooperation."

This Guideline 6.2 shows how the INSOL Europe (draft) IOH Statement attempts to make more abstract provisions of Article 31(3) EIR and Article 41(2.c) EIR Recast relevant and applicable in practice.

All Principles, Guidelines and Comments of the IOH Statement are focussed on improving the effectivity and efficiency of insolvency proceedings. In short, they require an IOH to behave diligently, with courtesy and consideration towards all parties involved; to behave with integrity, objectivity and confidentiality, solely guided by the interests of the estate; to coordinate their actions and to cooperate to the maximum extent possible with each other and with courts involved in the insolvency proceedings, in order to:

(a) promote the orderly, effective, efficient, and timely administration of the proceedings;

(b) provide for timesaving procedures to avoid unnecessary court proceedings or unnecessary costs; and

(c) secure and enlarge the collectivity of assets.

Up to this Statement, IOHs did not have a specific set of rules of their own.[33] The Statement was presented at the annual congress of INSOL Europe in Istanbul (Turkey) in October 2014 and was apparently well received. However, INSOL Europe did not decide to "adopt"[34] these rules as required by Recital 48 of the EIR

32 Comment 32 refers to Article 172 UK Companies Act concerning the meaning of the "have regard to" phrase.

33 See, however: European Communication and Cooperation Guidelines for Cross-border Insolvency, developed under the aegis of the Academic Wing of INSOL Europe by Professor *Bob Wessels* and Professor *Miguel Virgós* July 2007.

34 Whatever this might mean exactly.

Recast, since it felt they did lack support of their members. Another reason may have been the rather detailed and not completely parallel dealing with coordination in group of companies proceedings in the EIR Recast as published by the end of 2014. Anyway, all that remains of the project for now is the draft Statement, to be found on the website of INSOL Europe[35] as well as on that of TRI-Leiden.[36]

4.2 The EU Cross-Border Insolvency Court-to-Court Cooperation Principles

In the same development, LLS – together with Nottingham Law School – received funds to draft Principles and Guidelines for Court-to-Court Cooperation. The project was co-funded by the Civil Justice Programme of the European Union and the International Insolvency Institute (III). The project's focus was to adapt the ALI and III Report on *"Transnational insolvency: Global principles for Cooperation in international Insolvency cases"* (2012) to the European context and subsequently train European judges on the subject of judicial cooperation. The process of reworking the principles was executed by Professor Bob Wessels in collaboration with experts representing around 25 different countries, especially a Review and Advisory Group of over 40 consultees (chaired by Professor Ian Fletcher), including some 25 judges, which has been consulted five times over a period of two years, and a Members' Consultative Group, formed by III Members. The project was terminated with the publication of the Principles on the project website by the end of December 2014 and the execution of three training sessions in the last months of that year.[37]

Here again, as in the IOH-project, the Principles have the overriding objective of enabling courts and insolvency practitioners to operate effectively and efficiently in international insolvency cases with the goals of maximising the value of the debtor's global assets, preserving where appropriate the debtor's business, and furthering the just administration of the proceeding (Principle 3.1). This principle is subsequently elaborated in 26 Principles in all. Determination of the language of the proceedings is one of them (Principle 14) and during the training session[38] it appeared to be an important one since judges ascertained that knowledge of English in courts except where English is the mother tongue, is generally insufficient. Other Principles, e.g. Principle 5 (Case Management), 6 (Equality of Arms), 7 (Decision and Reasoned Explanation), 8 (Stay or Moratorium), 13 (Court Access), 16 (Communications between Courts), 18 (Notice to Creditors),

35 www.insol-europe.org/download/resource/167.
36 www.TRI-Leiden.eu.
37 http://www.tri-leiden.eu/uploads/files/EU_Cross-Border_Insolvency_Court-to-Court_Cooperation _Principles.pdf.
38 Of over 60 judges from 16 countries.

19 (Coordination), 20 (Notice to Insolvency Practitioners), 21 (Cross-border sales), all aim to contribute to this overriding objective of efficient and effective dealing in insolvency proceedings.

Importantly, Principle 16 ("Communications between Courts") attempts to have communication between courts, as it provides:

> "16.1. Courts before which insolvency cases are pending should, if necessary, communicate with each other directly or through the insolvency practitioners to promote the orderly, effective, efficient and timely administration of the cases. 16.2. Such communications should utilise modern methods of communication, including electronic communications as well as written documents delivered in traditional ways."

Moreover, Principle 13 ("Court Access") provides for the "main IOH" to have direct access to any court in any other Member State necessary for the exercise of its legal rights.

4.3 The EU Cross-Border Insolvency Court-to-Court Communication Guidelines

These Guidelines, 18 in all, are based on Principle 16.3[39] that states:

> "For such (i.e. Communications between Courts) communications the EU JudgeCo Cross-Border Insolvency Court-to-Court Communication Guidelines should be employed."

These Guidelines, to be considered as a sequel to the Principles dealt with in paragraph 4.2. of this chapter, prescribe in detail how the communication as prescribed in the Principles should be executed. According to Guideline 2 ("Consistency with Procedural Law"):

> "[e]xcept in circumstances of urgency, prior to a communication with another court, the court should be satisfied that such a communication is consistent with all applicable Rules of Procedure in its state."

In Guidelines 3.2 and 4.2 it is stated that when communicating between courts, or between a court and an IOH, a court should, in advance, obtain the consent of all parties affected by these communications before disclosing the information. Moreover, the Guidelines contain e.g. detailed Guidelines on Methods of communication (Guideline 7), on E-communication (Guideline 8 and 9) and on

39 See also Guideline 1.2.

Joint-Hearings (Guideline10), mostly inspired by USA- and Canadian practice in e.g. the Nortel Case.[40]

Both the IOH Statement, the EU JudgeCo Principles and the EU JudgeCo Guidelines reflect a non-binding statement and therefore add to the volume of "soft law" in the area of international insolvency law. Although there is no organisation yet that has adopted these principles, they will probably play a role in future cases, as the ALI Principles and Guidelines already do in common law countries.[41]

5 Conclusion

The new version of the EIR, the EIR Recast, introduces the "communication, coordination and cooperation" concepts almost 20 times more than the present EIR. This is a major change. Not only lawyers of the 27 EU members[42] have to comply with these provisions, but courts will have to cooperate from 2017[43] as well, not only amongst themselves but also with IOHs. Experience from the training sessions in the EU JudgeCo project shows that both professional groups, lawyers and judges, urgently need procedures and training on how to comply with these new rules. The Leiden Law School (LLS) projects described above, which intend to improve and clarify communication, coordination and cooperation between IOHs (the IOH-project) as well as between courts and courts and IOHs (the JudgeCo project), offer examples of sets of soft law, which will likely be of importance to actually execute the provisions of the EIR Recast.

40 For example: "On May 12, 2015, the Ontario Superior Court of Justice (Commercial List) and the United States Bankruptcy Court released consistent decisions requiring the allocation of assets from the sale of Nortel's businesses and intellectual property be based on a *pro rata* approach.(…) A joint hearing of the US and Canadian courts is scheduled for June 25, 2015 to determine some points of clarification following the decisions of the Ontario Superior Court of Justice (Commercial List) and the U.S. Bankruptcy Court dated May 12, 2015." See: http://www.kmlaw.ca/nortelnetworkscorporation. Also: blog Bob Wessels "2014-05-doc8 Nortel Network Joint hearing as a test case for EU JudgeCo Principle 10?"

41 The ALI-III Global Principles and Global Guidelines are not just non-binding soft law. A strong signal of the practical use and guidance has been given by the Supreme Court of the United Kingdom in *Conjoined Appeals in (1) Rubin & Anor v Eurofinance SA & Ors and (2) New Cap Reinsurance Corp Ltd & Anor v Grant and others* [2012] UKSC 46 (24), that supported its arguments that "the modern approach […] which is that the jurisdiction with international competence is that of the country of the centre of main interests of the debtor (an expression not without its own difficulties)" by referring to the 2012 Global Principles report. The Global Principles also contribute to the development of American law. The United States Court of Appeals for the Third Circuit (in Re ABC Learning Centres) on 23 August 2013 made references to Global Principle 1, and cites that "the overriding objective [is to] enable courts and insolvency administrators to operate effectively and efficiently in international insolvency cases with the goals of maximising the value of the debtor's global assets, preserving where appropriate the debtors' business, and furthering the just administration of the proceeding." Another part of the Global Principles report is cited too: "[t]he emphasis must be on ensuring that the insolvency administrator, appointed in that proceeding, is accorded every possible assistance to take control of all assets of the debtor that are located in other jurisdictions. Id. at cmt. to Global Principle 24." See: *Wessels/Boon/Kluwer* [5].

42 Excluding Denmark.

43 The EIR Recast comes into force on 26 June 2017 (Article 92, as published).

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Chapter 4

The Recast Insolvency Regulation and Groups of Companies

Robert van Galen

1 Introduction*

This chapter will attend to the issue of insolvent groups of companies. Many enterprises are actually structured as groups of companies. If the activities of such enterprises are limited to one jurisdiction, the companies will usually all be established under the same law and the centre of main interests ("COMI") of all companies belonging to the group will be in that jurisdiction. However, if the activities of an enterprise are deployed in more jurisdictions, there may be subsidiaries in several of them and the COMI's of these companies may also differ. This of course gives rise to questions as to how to deal with a possible insolvency of such an enterprise.

The European Insolvency Regulation of 28 May 2000[1] does not contain any provisions on groups of companies. The drafters of this regulation were aware that this was a topic that needed attention, but the 2000 Regulation already constituted a giant leap forward with respect to the intra-European development of cross border insolvency law, and including provisions on groups of companies was left to be dealt with when the Regulation had to be revised, as has been the case now.

This chapter will first make some introductory remarks on some specific aspects of groups of companies. It will then turn to possible mechanisms for dealing with insolvent groups of companies in general and to integrated approaches to restructuring such groups. Finally it will discuss the provisions on groups of companies as laid down in the recast of the European Insolvency Regulation as adapted by the European Parliament on 20 May 2015.[2]

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1 Council Regulation (EC) No 1346/2000 on insolvency proceedings, OJ L 160/1 of 30 June 2000.

2 Regulation (EU) No 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast), OJ L 141/19 of 5 June 2015.

2 Groups of Companies

The basic structure of a group of companies consists of a holding company which owns all the shares in several subsidiaries, each of the subsidiaries may own all the shares in further subsidiaries. Ownership of subsidiary shares entails control over these subsidiaries. The holding company may be owned by one, several or many shareholders, but from the holding company down there is one line of ownership and control. However, more complicated structures are used as well, involving dual holding companies, joint ventures, special control rights and so on. For that reason it is not always easy to determine which companies are included in the group. Both shareholdership and control are relevant elements, but control is not always the determining factor. Where a small company manufactures parts solely for a monopolist and the monopolist can therefore more or less dictate the terms of the contract, this does not make the small manufacturing company a group company.

One area where groups of companies play an important role is the consolidation of annual accounts. For that purpose the Directive 2013/34/EU[3] and its predecessor Directive 83/349/EC[4] contain provisions and definitions of "groups" and of the parent. For the purpose of cross-border insolvencies the question arises whether a consolidated effort to restructure the business or align the sales of a group of insolvent companies should be provided for, and if so, whether the proceedings with respect to one of the group companies should be in the lead. If that is so, the question arises which proceedings that should be.

One possibility is to have the proceedings of the holding company – if such a single holding company can be determined – in charge. However, an obvious objection against such a rule would be that this company might be a postbox company, whereas the real decisions might be taken somewhere else in the structure. Another possibility might be to have the proceedings of the company of the core activities in charge, but this may also be difficult to determine. Moreover, not all groups have the same level of integration. Sometimes there are subsidiaries with completely independent activities, conducted from separate headquarters. In other cases there are group companies which conduct activities that are for the benefit of other group companies only, and such group companies might not be able to continue their existence independently from the group or at least from some of the

3 Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC Text with EEA relevance, OJ L 182 of 29 June 2013, p. 19–76.

4 Seventh Council Directive 83/349/EEC of 13 June 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts, OJ L 193 of 18 July 1983 p. 1–7.

other companies in the group. Sometimes functions have been distributed over several group companies: one group company may own the real estate, another may serve as the financing company, a third one may conduct the trading or manufacturing activities.

The recast of the Insolvency Regulation does not contain a provision which determines which proceeding should be in the lead. So-called coordination proceedings can be opened in any of the jurisdictions where insolvency proceedings with respect to group companies have been opened. Two key themes around which the problems with respect to coordination of group proceedings revolve are "synergy" and "conflicts of interests".

There may be synergy between two or more group companies which may be lost if the assets of the companies are sold separately. The KPNQwest insolvency is a clear example of such a loss of synergy. KPNQwest owned rings of fibre cable through which data were transported. The rings ran through several countries. For example, one ring ran through Germany, France, Belgium and the Netherlands. However, the sections of the rings were owned by local KPNQwest companies. So the German part was owned by a German subsidiary, the French part by a French subsidiary and so on. Clearly, the proceeds of the sale of a ring would be much greater if sold as a whole rather than in sections, but in practice this proved to be impossible to achieve with respect to most of these rings.

Another example is a conglomerate in which several products are manufactured in different companies, but sales and distribution are combined. Preserving synergy may be important in the case of liquidation. A better price may be obtained if the business or coherent parts of the business which are dispersed over several companies are sold as a whole. However, preserving synergy may also be important in cases where reorganisation is considered. Outside insolvency proceedings synergy is preserved and interdependency is managed by the chain of command. There may be a unified management or at least instructions from the holding company which looks after the interests of the group as a whole. In some insolvency proceedings the chain of command is preserved. Often this is the case in preservation or reorganisation proceedings where there is some kind of debtor-in-possession concept. Even in liquidation proceedings this may be the case. However, if different liquidators are appointed in these companies or if creditors' committees of individual companies have substantial influence, the chain of command may effectively be broken and in such cases provisions of insolvency law might constitute the only possible means to manage synergy and dependency.

As to conflicts of interests, it should be noted that in an insolvency situation, conflicts of interests between group companies become much more pronounced than in a situation where the group companies are solvent. In the standard case with one holding company, the assumption in a solvent situation is that all creditors can be paid anyway so that there is no manifest conflict of interest between the individual group companies as far as these stakeholders are concerned, whereas all shareholders have a direct interest in the performance of the holding company only. In a situation of insolvency this becomes very different. The interests of the individual group companies are now the interests of the pools of creditors of each of them and proceeds attributed to or obtained by one group company may increase the rate of recourse of the pool of creditors of that company to the detriment of the pools of creditors of other group companies.

Since group companies are not always formed primarily to create separate pools of assets and liabilities for recourse purposes, and since creditors do not always rely on this separateness, these legal structures could conceivably be ignored in insolvency proceedings so that all assets and liabilities of the group are pooled. That would be a way of dealing both with the conflict of interests issue and with disentanglement problems. However, it seems to me that this approach would turn things upside down. The essence of a legal entity is still that it constitutes a separate 'container' of assets and liabilities and that its assets are only available to its own creditors. The prevailing view is – rightly – that this basic premise should be maintained in insolvency proceedings.

In my experience in domestic insolvency cases the conflict of interests issue between group companies is relatively often disregarded. In many cases the same liquidator is appointed in proceedings of several group companies and issues between these companies are then wallpapered over. On the one hand this practice supports an efficient liquidation or reorganisation in the insolvency proceedings. On the other hand it may insufficiently take into account the differing interests of the creditor pools. Interestingly, in international situations where different liquidators are appointed in each jurisdiction, the conflicts of interests between the insolvent companies/liquidators often prevent an efficient solution. One way of overcoming this problem has been to deem all the subsidiaries to have their COMI in the same jurisdiction and then appoint the same liquidator in all those proceedings.

3 Regimes for Dealing with Insolvent Groups of Companies

I will now turn to several solutions that have been suggested for the integrated treatment of insolvencies of international groups in relation to the European Union. In more or less ascending order of integration these are:

(1) coordination between the courts supervising the insolvency proceedings or between the liquidators on a non-hierarchical basis;

(2) designation of group main proceedings and coordinating powers for the liquidator of these group main proceedings;

(3) appointment of the same liquidator in all main proceedings;

(4) opening of all main proceedings in the Member State of the group COMI[5] (joint administration by the court); and

(5) substantive consolidation.

3.1 Coordination on a Non-Hierarchical Basis

The lightest form of coordination is coordination on a non-hierarchical basis between the courts and/or between the liquidators. Rules of coordination have been fundamental both in legislation such as the European Insolvency Regulation and in guidelines such as the IBA Cross-Border Insolvency Concordat, the ILA Guidelines and the CoCo Guidelines, as well as in protocols drafted for the purpose of individual cases. Most of these guidelines and items of legislation concern multiple insolvency proceedings with respect to a single debtor, for example where there are main and secondary proceedings. Some of the protocols in individual cases concern multiple debtors (groups of companies). Legislation and guidelines with respect to single companies could to a large extent also be used for coordinating proceedings in a group setting, but not without caution. Since situations with multiple debtors involve different sets of creditors, conflicts of interests are much more likely to occur between the estates of group companies than between the creditors in main and secondary proceedings involving the same company. Examples of protocols with respect to particular cases are the Lehman protocol and the Nortel protocol.

Communication and cooperation between liquidators is good, but saying that they must cooperate to the maximum extent possible and in good faith may be insufficient. Should they not do so anyway? In group situations each liquidator

5 Centre of main interests.

may act in good faith, but he still has to act in the interest of the creditors of his debtor. In practice, such obligations may be insufficient to resolve conflict-of-interest and synergy issues. If nobody is in charge, it must be doubted whether an obligation to cooperate is sufficient to bring about the integrated administration and liquidation of the group's assets. What is needed is some kind of centralised control or coordination.[6]

3.2 Liquidators with Coordinating Powers

Under the second regime one liquidator is designated to fulfil a role in the interest of the group as a whole and has certain powers to do so. Under the European Insolvency Regulation such rules presently exist with respect to multiple proceedings involving the same debtor. The liquidator in the main proceedings has some powers with respect to the secondary proceedings. However, most of those powers involve the intervention of the court in the Member State where secondary proceedings have been opened. For example, the liquidator of the main proceedings may ask the court which opened secondary proceedings to stay the process of liquidation in whole or in part (Article 33(1)).

If a similar regime were to be applied in the context of groups of companies there should be a rule how the group should be determined and also a rule which liquidator should have the coordinating powers. I will label the proceedings of the liquidator with coordinating powers as the group main proceedings.

3.3 Mutual Liquidator Regime

One step further than the regime in which the liquidator of the group main proceedings has:

(i) certain powers of coordination, subject to supervision by the courts of the subsidiaries; and

(ii) the power to propose a plan subject to confirmation by the courts of each of the group proceedings,

is the regime in which the same liquidator is appointed in the main proceedings of all group companies, but the proceedings themselves remain under the supervision of the local courts.[7] This solves many of the problems inherent in the former regime because under the mutual liquidator regime it is much easier to adopt one common policy. However, one major problem with the main liquidator regime is that it

6 *Mevorach* [2] p. 155.

7 Advocates of this solution are *Paulus* [3], *Mevorach* [2], p. 159 et seq. and *Tollenaar* [4].

glosses over the conflicts of interests between the group companies and between their creditors.[8]

An additional issue of the mutual liquidator regime is that the liquidator has to deal with different laws and legal cultures with respect to the group companies. Basically, this means that they have to act in an area in which they have no expertise and may be faced with court documents and proceedings in languages they have not mastered. Furthermore, courts that do not speak the language of the liquidator may not be capable of supervising his work adequately.

3.4 Joint Administration Regime

The next regime is the joint administration regime. Joint administration is very popular in the United States. There it means that all proceedings of the group companies are conducted in one and the same bankruptcy court, which joins the proceedings for procedural and administrative matters. In such proceedings a joint restructuring plan can be proposed for all the companies included in the joint administration, but it has to be accepted and confirmed for each of the companies concerned separately. There are, however, important differences between the American and European situations and some of these make joint administration less attractive in a European setting.

Joint administration in the United States may mean that a company which is actually located in San Francisco could be subject to Chapter 11 proceedings in New York. However, although this may be a different location, the insolvency proceedings will still be conducted by an American federal court and there will be virtually no change in the applicable law because bankruptcy law is federal law.[9] In Europe, of course, this is quite different. If rules were developed to allow joint administration of group companies with COMI's in different jurisdictions, there would be two possibilities. First, if Article 4 EIR were to be applied, all these proceedings would be subject to the same law. For example, if the group were to consist of a French parent company (i.e. with its COMI in France) and Belgian, Italian and Greek subsidiaries, and those companies were to be subject to joint administration by the French court, French law would apply to all these proceedings and therefore also to questions such as the ranking of creditors and the termination of contracts with respect to the Belgian, Italian and Greek companies.

8 *Eidenmüller* [1], p. 541.

9 "Virtually" because there are some issues of state law that may affect the bankruptcy, but these concern only a limited number of topics such as the assets that are not included in the bankruptcy estate.

This solution is unattractive, *inter alia*, because it would mean that the law applicable to the insolvency of a group company, and therefore too many questions which have a substantial impact on the recovery of individual creditors, would depend on where the joint administration is opened. It would entail a substantial redistributive effect. And it would also be very easy for the group to manipulate the applicable law by moving a subsidiary around inside the group or by moving it outside the group. The second possibility is that the French court would apply Belgian law to the Belgian subsidiaries, Italian law to the Italian subsidiaries and Greek law to the Greek subsidiaries, but this too is very unattractive, because the French court will not know all these laws and may not even be able to read the languages.

Another disadvantage of this kind of joint administration is that it infringes on the sovereignty of the States more than is necessary, because it relocates the proceedings of the subsidiary to another jurisdiction. Joint administration has been attempted in several cases, of which the Daisytek, Rover and Collins & Aikman cases are the best known. Joint administration could also involve the appointment of the liquidator in the main proceedings as the liquidator in the proceedings of all the subsidiaries. This is actually a combination of the joint administration and mutual liquidator regimes.

3.5 Substantive Consolidation

The highest level of integration is obtained under the substantive consolidation regime. Under this scenario all the assets of the group companies are pooled and the proceeds of that pool are distributed to all the creditors of all group companies concerned as if the whole group of insolvent companies constituted one company only. Substantive consolidation benefits the creditors of the companies that suffer a deeper insolvency to the detriment of creditors of relatively richer insolvent companies. Substantive consolidation is unavoidable where the assets or liabilities of the debtor are entangled to such an extent as to be inseparable.

4 Restructuring Scenarios

There are essentially two scenarios in which restructurings of insolvent companies take place. The first type of restructuring scenario is a restructuring or rescue plan. The essence of this kind of restructuring is that the creditors agree to relinquish or modify their claims in such a way that the company becomes solvent again. Often such rescue plans entail much more than a mere write-off of debts or postponement of repayment. The activities of the company itself need to be restructured in the sense that less profitable activities have to be sold or ceased, employees may need to be dismissed, management may need to be changed and more profitable activities may need to be developed. Rescue plans adopted in insolvency proceedings contain mechanisms by which obstructing creditors may be outvoted. In order to safeguard the interests of the disgruntled creditors some kind of court involvement is needed.

The second type of restructuring scenario is the going-concern assets sale. Under this scenario the liquidator sells off the assets which comprise the company's business (or the viable part of the business) to another legal entity. Such an entity may be external, but it may also happen that the entity is financed by creditors or shareholders of the insolvent company. From the perspective of the company's creditors, such a sale often produces the same result in economic terms as a rescue plan: the rights of recourse against the debtor's assets are replaced by a pot of money which is distributed among the creditors and reflects the value of the debtor's viable business.

Which of these two basic scenarios is chosen depends on a number of legal factors, which I will now list. I will focus on the issues under Dutch law but many of these legal factors play a role under other legal systems as well:

(1) For historical reasons rescue plan proceedings are much more complicated and require much more creditor and court involvement under Dutch law than the going-concern sale of assets.

(2) The possibilities of accomplishing a Dutch rescue plan are very limited. Only ordinary creditors can be affected by the plan in the sense that a minority can be bound by a majority voting in favour of the plan, but preferred and secured creditors are not affected at all. In many other jurisdictions preferred and secured creditors can be included in the plan.

(3) A going-concern asset sale may have negative tax consequences and it may not always be possible to transfer all contracts or licences to the buyer.

(4) Rescue plans may provide a more flexible approach than the going- concern asset sale liquidation scenario.

(5) Because rescue plans involve stronger creditor participation, creditors accepting the plan may be more willing to continue their relation with the business than would be the case if the asset sale scenario had been applied.

If several group companies are involved it may be attractive to arrange for a coordinated sale of the assets. This involves the cooperation of the liquidators in multiple proceedings. Similarly, if several group companies are involved rescue plans that are offered and adopted for the individual companies could conceivably be coordinated.

In a group situation, two scenarios can be added to the two scenarios described above. The first additional scenario concerns a consolidated sale of the assets of the viable business of group companies, not by way of coordination between the liquidators of the individual companies, but at the direction of one liquidator (i.e. a unified sale with one seller). The second additional scenario involves the adoption of one consolidated plan for the whole group or a number of group companies. Thus we can distinguish between the following scenarios for a group:

(1) coordinated asset sales by the individual group companies;

(2) coordinated rescue plans for the individual group companies;

(3) unified sale of assets; and

(4) unified plan.

In discussing these scenarios, I will disregard national groups and move on straightaway to international groups which have group companies in a large number of jurisdictions.

4.1 Coordinated Asset Sales by Individual Group Companies

Under the regime (3.2) involving a liquidator with coordinating powers, the liquidator of the group main proceedings has the right to ask the court of the proceedings of the group companies to suspend asset sales by the group company's liquidator. The purpose of this power is to allow a coordinated sale of the assets of several group companies or to include those assets in a reorganisation e.g. through a set of coordinated rescue plans. A coordinated sale of this kind could thus ensue, but would be difficult to achieve in a multi-jurisdictional case because all the courts would need to become aligned. Under the regime involving coordination on a non-hierarchal basis (a), the liquidators of the subsidiaries may need to become aligned as well.

4.2 Coordinated Rescue Plans

Under the preferred regime involving a liquidator with coordinating powers the liquidator of the group main proceedings can propose rescue plans in all subsidiary proceedings. Although in such a case the role of the liquidator of the subsidiary proceedings may be somewhat reduced, the plan still needs to be accepted in each jurisdiction under local law and each of the courts needs to confirm the plan. To my knowledge, no plan involving continuation of the business of group companies has ever been accepted in three or more jurisdictions.

4.3 Unified Asset Sale

One way of achieving a concerted sale of the business is by providing that the liquidator of the group main proceedings has the power to sell all or part of the assets of the companies in the group under the sole supervision of that liquidator's own court. To a large extent this meets with the same difficulties as administration of multiple group companies by the same liquidator, because there may be conflicts of interests with respect to such sales between the group companies and because there is no creditor influence similar to the influence involved in the adoption of a rescue plan. Such a conflict of interests may, for example, concern the question of which assets should be included in the consolidated sale, but also the question of how the purchase price should be attributed to the individual estates.

4.4 Consolidated Plan

Finally, there is the possibility of having one rescue plan for the whole group. A single plan of this kind is more appropriate for adequately resolving conflict-of-interest issues than a unified asset sale. Under U.S. bankruptcy law especially, rules on reorganisation plans have been developed to deal with conflicts of interests. Although the provisions on rescue plans under Chapter 11 concern single companies, the underlying principles can be applied in a multi-company situation as well. The U.S. system with respect to Chapter 11 rescue plans has been the basis of legislation in other countries such as Germany. INSOL Europe has developed a European Rescue Plan based on these principles.[10] The conflict of interest issue is dealt with under the plan by the idea that majorities of the classes of creditors of all the group companies are required and that in fact the rescue plan is the result of structured negotiations between the creditors of all the group companies concerned.

5 The Recast Insolvency Regulation of 20 May 2015

An important part of the revision of the European Insolvency Regulation is taken up by the addition of a chapter on "Insolvency Proceedings of Members of Group Companies" (Chapter V, Articles 56-77). The various drafts that have been circulated over the last two years show the struggle of the legislator to reach a politically acceptable solution. It seems that Member States had difficulty allowing

10 The report of INSOL Europe on the revision of the EIR can be found at: <http://www.insol-europe.org/technical-content/european-insolvency-regulation>.

courts or liquidators located in other Member States to take decisions with respect to *their* group companies. The solution enacted in the Recast is therefore not very forceful.

Article 2 contains definitions of “parent undertaking” and “group of companies”. The gist of it is that a group of companies has the same meaning as it has under Directive 2013/34/EU which deals with annual accounts and in particular with consolidated accounts. The definition is of importance because, as will be shown below, insolvency practitioners of proceedings of group companies have certain rights and obligations with respect to proceedings of other group companies. Section 1 (Articles 56-60) concerns cooperation and communication. Article 56 contains an obligation for insolvency practitioners[11] appointed in proceedings concerning a member of a group to cooperate with insolvency practitioners appointed in proceedings concerning another member of the same group. The obligation to cooperate is limited in three ways:

(1) It only applies to the extent the cooperation is appropriate to facilitate the effective administration in the receiving proceedings;

(2) It should not be incompatible with rules applicable to the proceedings; and

(3) It should not entail any conflict of interest.

These limitations considerably weaken the obligation to cooperate. As discussed above, in insolvency situations there often are conflicts of interests between group companies. It is interesting to note that Article 56-2 also provides for the possibility for the insolvency practitioners to grant additional powers to one of them and to agree an allocation of tasks.

Article 57 contains a similar provision on cooperation between courts in group proceedings, with inclusion of the same limitations. It is remarkable that there is an obligation for the courts to cooperate. The INSOL Europe Judicial wing had advised including a provision that courts “may” cooperate, rather than “shall” cooperate. According to this forum there was no need for an *obligation*. Presently the problem is that in several jurisdictions the courts are of the view that they cannot engage in cooperation, because there is no basis for such action in the domestic law. A “may” provision would cure that problem. I do not think that the “shall” provision adds very much to that. It will be difficult to force courts to cooperate with each other if they do not want to, in particularly in view of the limitations they may rely on.

11 This is the new term for liquidators.

No similar transfer provision as is included in Article 56-2 applies to courts. However, the court may appoint an independent person in order to deal with the cooperation. Article 58 provides for similar cooperation between courts and insolvency practitioners in other group proceedings. I do not know what I should envisage in respect of this obligation.

The insolvency practitioner has certain powers in proceedings concerning members of other group companies. Important ones are:

(1) The right to be heard in proceedings concerning group companies; and

(2) The right to request a stay of any measure related to the realisation of assets. Thus an insolvency practitioner in proceedings of Group Company A can request a stay of the sale of the assets of Group Company B. There are, however, limitations here. The most important ones are that a restructuring plan must have been proposed and that no coordination proceedings have been opened with respect to Companies A and B. The stay can have a maximum duration (including extension) of six months.

It should be noted that these rights are attributed to the insolvency practitioners of all group proceedings. Therefore several requests for stays can be made vis-à-vis the same entity and all insolvency practitioners have the right to be heard. If, however, Group Coordination Proceedings have been opened, insolvency practitioners of the individual group company proceedings no longer have the right to request a stay with respect to another group company included in the Group Coordination Proceedings. The stay request concerns a "stay of any measure related to the realisation of the assets in the proceedings opened with respect to any other member of the group." [12] It appears that this stay is not limited to stay of actions of the local insolvency practitioner. Based on the wording of the provision, the stay may also concern actions of secured creditors. If the provision has to be interpreted this way indeed, the provision might set aside Article 5 EIR (Article 8 of the Recast).

Section 2 concerns Group Coordination Proceedings. As Article 61-1 provides, Group Coordination Proceedings ("GCP") may be requested before any court having jurisdiction over the insolvency proceedings of a member of the group. The GCP will thus be opened by the court of first seizure (as is confirmed by Article 62). Obviously this rule can give rise to manipulation of the state of the GCP. It is even conceivable that some dormant subsidiaries are put into insolvency

12 Part of the wording of Article 60-1 Recast.

proceedings with the sole purpose of creating jurisdiction in the Member State where these proceedings are opened, for the opening of GCP. There is, however, a carve out and more importantly, it remains to be seen whether it is very important where the GCP are opened, because the powers of the Group Coordinator ("**GC**") are very limited. The request should be accompanied inter alia by a proposal for the person to be appointed as GC.

After the request for the opening of the GCP has been filed a waiting period of 30 days commences. Insolvency Practitioners appointed in respect of group companies may object to the proposed GC. An Insolvency Practitioner may also opt out of the GCP (Article 64-1(a) and 65-1), in which case the proceedings in which this insolvency practitioner is appointed shall not be included in the group coordination proceedings. Furthermore, where at least two-thirds of all insolvency practitioners appointed in insolvency proceedings of group companies have agreed that the court of another Member State having jurisdiction is the most appropriate court, that court shall have exclusive jurisdiction with respect to the GCP. The GC shall not be one of the insolvency practitioners appointed in respect of any of the group companies.

The essential tasks of the GC are to:

(1) Make recommendations for the coordinated conduct of the insolvency proceedings; and

(2) Propose a Group Coordination Plan.

The Group Coordination Plan is not a rescue plan in the classic sense that it can modify creditors rights and resolve the insolvency. It is more of a plan on how to coordinate the proceedings. Article 72-1(b) provides that it may contain proposals for:

(i) measures to be taken in order to re-establish the economic performance and the financial soundness of the group;

(ii) the settlement of intra-group disputes; and

(iii) agreements between the insolvency practitioners of the group companies.

Article 70 provides that the Insolvency Practitioners shall consider the recommendations of the Group Coordinator and the content of the Group Coordination Plan, but that they shall not be obliged to follow the recommendations or the plan. However, if the Insolvency Practitioner does not follow the recommendations or the plan he has to give reasons for that. So actually, there is a comply or explain rule here.

Important rights of the GC are:

(1) He has the right to be heard and participate in any of the proceedings with respect to included group companies.

(2) He can request information from any insolvency practitioner in respect of any member of the group that is included, where the information might be of use when identifying and outlining strategies and measures in order to coordinate proceedings. It should be noted that the limitations of such rights between insolvency practitioners under Article 56 are not repeated here.

(3) He may request a stay of proceedings opened in respect of any member of the group that is included, provided, inter alia, hat such a stay is necessary to ensure the proper implementation of the plan. As mentioned above, under Article 60 insolvency practitioners have similar rights to request a stay in other insolvency proceedings of group companies, provided neither company is included in a GCP.

Thus the idea seems to be that in the case of GCP this right transfers to the Group Coordinator. However, it seems that if a group company opts out of GCP, neither the Group Coordinator nor any insolvency practitioner of included insolvency proceedings can ask for a stay of a realisation measure, because that situation is excluded under Article 60 and not included under Article 72.

It seems to me that these rules on group proceedings may constitute a small step forward, but a small step indeed. Apart from the GCP there is no dominant proceeding and if GCP are opened the powers of the GC are very limited. There is no provision on a unified rescue plan, in the vein as proposed by INSOL Europe, nor actually on coordinated plans. The future will learn whether stronger provisions are needed, but then this part of the Recast will have to be revised within five years.

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Chapter 5

Applicable Law and Carve Outs: Cross-Border Security and Rights *in rem*

Tom Smith

1 Introduction*

In practice, when faced with an insolvency of a counterparty, the essential issues to be confronted by any creditor will typically include:

- his ability to enforce his security and to obtain payment notwithstanding the insolvency;
- his ability to withstand challenges to security under the law of the insolvency proceedings provided the security is valid as a matter of its governing law and/ or *lex situs*.

Moreover, in the cross-border context, a creditor is likely to be concerned about its ability to rely on its security given in one jurisdiction where the insolvency proceedings are taking place in another jurisdiction. Indeed, a principal concern, for example, of a bank or other lender will be its ability to enforce its security in one jurisdiction where a borrower is in insolvency proceedings in another jurisdiction.

Under the Insolvency Regulation, the basic principle in Article 7 is that the law of the place where the proceedings are opened governs (inter alia), the assets which form part of the insolvency estate; the effect of the insolvency on current contracts; the effects of the insolvency on proceedings brought by creditors; and rules relating to voidness, voidability of legal acts detrimental to the general body of creditors. Further, a judgment opening insolvency proceedings will have the same effects (without further formality) in other Member States as under law of the State of the opening of the proceedings (Article 20). So, for example, a stay on creditor action imposed under the law of the State of the opening of the proceedings will have automatic effect in all other Member States.

In the case of security rights, these basic principles are, however, subject to the carve-out in Article 8.1:

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> "The opening of insolvency proceedings shall not affect the rights in rem of creditors or third parties in respect of tangible or intangible, moveable or immoveable assets – both specific assets and collections of indefinite assets as a whole which change from time to time – belonging to the debtor which are situated within the territory of another Member State at the time of the opening of proceedings."

The underlying policy behind this carve-out is to protect trade in the Member State where the assets are located and legal certainty with regard to rights over those assets.[1] As the *Virgos-Schmit* report states: "Rights in rem have a very important function with regard to credit and the mobilization of wealth."

2 Rights *in rem*

The first question which immediately arises is as to scope of the carve out in Article 8: in particular, what is meant by "*rights in rem*" for these purposes? In the text of the Regulation, such rights are said to include in particular:[2]

- a right to dispose of assets or have them disposed of and to obtain satisfaction from the proceeds of or income from those assets, in particular by virtue of a lien or mortgage
- an exclusive right to have a claim met, in particular a right guaranteed by a lien in respect of the claim or by assignment of the claim by way of guarantee
- a right to demand assets from and/or to require restitution by anyone having possession or use of them contrary to the person entitled; and
- a right *in rem* to the beneficial use of assets.

Based on this, certain initial observations can be made. First, rights *in rem* are capable of extending to rights in respect of specific assets and collections of indefinite assets, so can include, for example, a floating charge under English law. Secondly, rights *in rem* encompass a right of a secured creditor to appoint a receiver (or similar) to dispose of assets ("*the right to dispose of assets or have them disposed of ...*"). Thirdly, rights *in rem* include both security rights but also other rights *in rem* such as the rights of a beneficiary under a trust ("*a right in rem to the beneficial use of assets*").

1 Virgos-Schmit Report on the Convention on Insolvency Proceedings, Council of the European Union, Brussels, 3 May 1996, 6500/96, para 97.

2 Article 8.2.

But, aside from this, there is no definition of a "right *in rem*". This was a deliberate decision in order to allow the law of the state where the relevant assets are located to decide.[3] Accordingly, the question of characterisation (i.e. of how a particular right held by a creditor is to be characterised) must be decided under the national law which applies under normal conflict of law rules – normally the *lex rei sitae.*

3 Location of Assets

This in turn then raises the question of how the location of an asset which is the subject of a security right is to be determined. Moreover, Article 8 applies only where the asset is situated within the territory of an MS other than the one where the insolvency proceedings are commenced. As to this, Article 2(g) of the previous version of the Regulation provided that:

- tangible property was located in the Member State where the property was situated;
- registered rights and property were located in the Member State under whose authority the register was kept; and
- claims were located in the Member State where the third party required to meet the claim has its centre of main interests (COMI).

This, however, raised a number of questions as to the position in respect of other types of assets – for example, as to shares in a company or cash in a bank account, particularly where the bank account was held with a branch located in one Member State of a bank which had its COMI in a different Member State.

The revisions to the Regulation have now addressed a number of these points. Accordingly, the new Article 2(9) introduces further definitions of where assets are located for:

- registered shares in companies (located in the Member State within the territory of which the company having issued the shares has its registered office);
- book-entry securities (located in the Member State in which the register or account in which the entries are made is maintained);
- cash held in bank accounts (the Member State indicated in the account's IBAN, or, for cash held in accounts with a credit institution which does not have an IBAN, the Member State in which the credit institution holding the

3 *Virgos-Schmit* report para. 100.

account has its central administration or, where the account is held with a branch, agency or other establishment, the Member State in which the branch, agency or other establishment is located); and

- patents, copyright and related rights (the Member State within the territory of which the owner of such rights has its habitual residence or registered office).

There are, however, some remaining issues which are unresolved. For example, are the definitions in Article 2(9) exhaustive? And what happens if an asset falls within more than one definition? To illustrate with an example: assume Company A has its COMI in England and assets including shares in and receivables owed by French and German subsidiaries. It has granted Lender B full (fixed and floating) English law security over all its assets. Company A becomes insolvent and goes into administration as main proceedings in England. Lender B wishes to enforce its security by appointing a receiver over the shares and receivables for the purposes of concluding a sale.

Lender B could enforce its security in England, but only after lifting the statutory stay on enforcement. The statutory stay would also automatically apply in France and Germany; therefore any ability to enforce would depend on Article 8 applying. In this context, the question of whether there is an Article 8 right *in rem* probably depends on the characterisation of the relevant right under law where the asset is located (*lex situs*). In the case of shares, they are located in the Member State where company which issued shares has its registered office (Article 2(9)(i)); and in the case of receivables, they are located where the third party required to meet the claim has its COMI (Article 2(9)(viii)).

Therefore, the question of whether the security confers an Article 8 right *in rem is* probably determined by French and German law. If it does, then Article 8 should allow Lender B to enforce such rights as it has under its security. The question of the nature and extent of the rights of the lender are then determined by the *lex situs*. Moreover, since the appointment of a receiver does not fall under the Regulation, its recognition in France and Germany is determined by normal rules of private international law.

A different example would be where Company A has its COMI in France and assets in France, England and New York. Lender B has security over the New York assets pursuant to New York law security and security over the English assets pursuant to English law security. Company A goes into main proceedings in France. Lender B wishes to enforce its security in New York and England. In this scenario, Article 8 will not apply to the security in New York as the Insolvency

Regulation only binds Member States. Enforcement in New York will be a matter of New York law, and may depend on whether the French insolvency is recognised there (e.g. under Chapter 15 of the Bankruptcy Code). If the French insolvency is recognised, and a stay therefore arises, Article 8 will not assist Lender B.

On the other hand, Lender B should be able to enforce his security in England provided that: the rights conferred over the assets are rights *in rem* for the purposes of Article 5 as a matter of English law as the *lex situs*; the security is valid as a matter of English law; and the proposed method of enforcement is allowed under English law. The answer would, however, obviously be different if secondary proceedings were commenced in England.

4 "Shall not affect"

A further question raised by Article 8 concerns the meaning of "*shall not affect*". In other words, what is meant when it said that the "opening of insolvency proceedings shall not affect the rights *in rem* of creditors or third parties." The expression "*shall not affect*" is not defined in the Regulation. However, it seems clear that it at least means that the ability to *enforce* a right *in rem* should not affected by an insolvency in another Member State. In addition, the basis, validity and extent of the right should normally be determined by the *lex situs*.[4] On the other hand, Article 8 will not prevent the vesting of title to asset over which security is held in the insolvency officeholder.[5] Perhaps the most difficult question is whether Article 8 also protects the underlying secured debt as well as the security right itself.

Take an example, where Company A, which is incorporated in the Netherlands, is a borrower under an English law syndicated facility agreement. The agreement is secured by English law and Luxembourg law security over assets in Luxembourg. Company A concludes a scheme of arrangement in England in respect of the facility agreement which is supported by 75% of lenders, but there are dissentient creditors. A scheme of arrangement is not an insolvency proceeding for the purposes of the Regulation, so its effect on the Luxembourg assets would be a matter of normal Luxembourg law. But what if Company A went into administration in England (as main proceedings) before concluding a scheme?

In that case, the scheme should be recognised in other Member States under the Regulation (Article 32: "*compositions approved by that court shall also be recognised with no further formality*"). What about the effect of Article 8? The

4 See Recital (25).

5 German Federal Court of Justice, 3 February 2011, V ZB 54/10.

Luxembourg security rights would *prima facie* appear to be preserved by Article 8. But the scheme may have been effective, as a matter of English law, to vary the underlying English law debt. Would Article 8 also protect the underlying debt right which is the subject of the security? This is one of a number of questions which will no doubt have to be worked out as the revised Regulation is put into practice.

PART II
THE NOTTINGHAM PAPERS

Chapter 6

Universal Effects of European Pre-Insolvency Proceedings: A Case Study

Francisco Garcimartin

I. Introduction: the XYZ SA Case

XYZ SA is a company incorporated in Spain whose Centre of Main Interests ("COMI") is also in Spain. XYZ SA is the parent company of several subsidiaries located in other Member States of the European Union and third countries. Due to the financial difficulties suffered by the group, in January 2016, XYZ SA filed for protection under Article 5 *bis* of the Spanish Insolvency Act ("IA") in order to be able to conduct negotiations with its creditors with the necessary guarantees. In April 2016, XYZ SA submitted a restructuring agreement containing an amendment of the terms and conditions of its financial obligations and a partial conversion of the debt to capital. The agreement was adopted by a qualified majority of creditors. This agreement obtained judicial approval in May 2016, in accordance with the Fourth Additional Provision of the same Act ("4AP"), and its effects were extended to dissenting creditors.

"Article 5 *bis* moratorium" and "4AP homologation" constitute the main tools of the Spanish legal framework on pre-insolvency (*rectious*, preventing-insolvency) proceedings. The former gives the debtor a "breathing space" period: it envisages the possibility of a stay of individual enforcement actions and the adjournment of insolvency proceedings for a period of four months. The latter foresees the possibility of a court sanctioning the restructuring plan in order to make it binding upon dissenting creditors and benefit from a special protection *vis-à-vis* claw-back rules. The practical application of these two provisions has given rise to many legal issues. This chapter focuses on one of them: their world-wide effects, i.e. the effectiveness of those provisions for preventing individual enforcement proceedings by dissenting creditors abroad. In practice, this is key for the success of the plan since, in our example, XYZ SA has a very significant portion of its assets outside Spain. This analysis may be useful for other EU jurisdictions that have introduced similar proceedings into their national laws as well as for a future EU instrument laying down harmonized rules on restructuring proceedings.[1]

The chapter is organized as follows. Section II offers an outline of the Spanish legal framework on pre-insolvency proceedings. Section III explains how this framework fits within the new European Insolvency Regulation[2] and the 2014 Commission's Recommendation.[3] Section IV describes the rules that govern the cross-border effectiveness of Article 5 *bis* and 4AP of the IA within the EU. Section V extends this analysis to third countries. And, finally, Section VI draws some conclusions.

II. Brief Outline of Spanish Pre-Insolvency Proceedings

The original text of the current Spanish IA was enacted in July 2003.[4] This Act did not contain special rules on pre-insolvency restructuring proceedings. All restructuring arrangements must take place either under the general rules of contract law, i.e. on a consensual basis, or within formal insolvency proceedings, i.e. by means of an insolvency composition. There was no alternative between purely contractual workouts, which require unanimous consent, and formal insolvency proceedings. However, during the last few years, Spanish legislators have amended the IA in order to provide market participants with an appropriate pre-insolvency restructuring framework.[5] This framework departs from the general rules of contract law since individual consent is replaced by collective consent, preventing hold-out strategies therefore, but without the need for opening formal insolvency proceedings. The two main elements of this new framework are contained in Article 5 *bis* and 4AP of the IA.

1. Article 5 bis of the IA: Moratorium

This provision was introduced in the Spanish Insolvency Act by Act 38/2011 of 10 October 2011 and since then it has been amended on several occasions. The main purpose of this new article is to facilitate a financially-troubled company and its

1 See Commission Recommendation of 12 March 2014 on a new approach to business and insolvency ("Recommendation").

2 Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings ("EIR Recast").

3 See above note 1.

4 Ley 22/2003 of 9 July, *O.J. (Boletin Oficial del Estado),* 10 July 2003. The Law entered into force on 1 September 2004.

5 See, in particular, Royal Decree-Law 3/2009 of 27 March 2009; Act 38/2011 of 10 October 2011; Royal Decree Law 6/2012 of 9 March 2012; Act 1/2013 of 14 May 2013; Royal Decree Law 14/2013 of 27 September 2013; Royal Decree Law 4/2014 of 7 March 2014; Royal Decree Law 11/2014 of 5 September 2014; or Royal Decree Law 1/2015 of 27 February 2015.

directors with a four-month period to negotiate a refinancing agreement with its creditors with the objective of avoiding insolvency. This goal is promoted through three main benefits:

(i) A stay of the distressed company's duty to file for insolvency (and a safe harbour for its directors);[6]

(ii) A stay applicable to all creditors prohibiting the filing of involuntary insolvency petitions; and

(iii) A stay of certain individual enforcement actions, including by secured creditors.[7]

During the moratorium period, the debtor remains in full control of the company's affairs, without any external restriction. The IA does not envisage the appointment of a supervisor or examiner. Furthermore, once the debtor has notified the court of the start of negotiations to reach a restructuring agreement, the benefits of Article 5 *bis* of the IA apply automatically, i.e. by operation of law, and the affected creditors have no right to challenge it. In principle, the court clerk shall order publication on the public insolvency register of the court's acknowledgement of the notification lodged by the debtor. However, the debtor may specifically request notification of the negotiations to be confidential, in which case the court's acknowledgement shall not be issued (see Article 5 *bis* (3) of the IA). The moratorium is effective from when the debtor files the notice (Article 5 *bis* (4) of the IA).

The moratorium obtained under Article 5 *bis* of the IA functions as a single gateway to different restructuring proceedings, in particular an advance proposal of insolvency composition or a refinancing agreement that may be sanctioned under 4AP of the IA.

2. 4AP of the IA: Homologation

4AP of the IA provides for the possibility to obtain a court's approval ("homologation") of a restructuring agreement in order to:

6 Under Spanish law, a company must file for insolvency proceedings within two months from the time that the company becomes aware of its inability to pay its debts as they come due. Otherwise, the directors can be held personally liable if the company´s insolvent position was aggravated by the delay in filing for the insolvency proceedings (see Articles 5, 164-165, IA). However, according to Article 5 *bis* (2), IA, once the debtor has notified of the start of negotiations to reach a restructuring agreement: "the duty to request voluntarily the opening of the insolvency proceedings shall not be required."

7 According to Article 5 *bis* (4), IA: "From the presentation of the communication, no judicial or extrajudicial foreclosure may be performed on assets or rights that may be necessary to continue the professional or corporate activity of the debtor…"

(i) protect this agreement *vis à vis* claw-back rules; and

(ii) if need be, to bind dissenting creditors.

According to that provision, court-sanctioned restructuring agreements must be refinancing agreements that involve, at least, a significant increase in credit or the extinction or amendment of obligations. They must also be based on a viability plan that allows the debtor to continue his activities in the short to medium term. These kinds of agreements only affect debts held by financial creditors. Creditors owed non-financial debts can sign up voluntarily (public sector creditors cannot), but their debts are not counted to determine the necessary majorities and the effects of the refinancing agreement cannot be extended to them against their will (see 4AP (1) I-V of the IA).

These agreements must be sanctioned by the court that would be competent to deal with the company's insolvency proceedings i.e. the court within the territory of which the debtor's COMI is located (4AP (5) of the IA). The main effects of the court's approval are two:

(i) the refinancing agreement is protected from insolvency actions to set aside transactions as detrimental to creditors, and

(ii) the content of such agreement is extended to non-participating or dissenting creditors (4AP (3) and (13) of the IA).

For the court to make an order sanctioning an agreement, it has to fulfil a number of formal requirements and be signed by certain majorities. These majorities have to be proved by submitting a certificate from the company's auditor together with the petition for court approval.

As per the majorities required by 4AP of the IA, for the sanctioned refinancing agreement to be protected from actions to set aside, 51% of financial creditors by value (excluding debts to specially related persons) must have signed the agreement. If it is also intended to impose the agreement on dissenting creditors, the required majorities vary depending on whether the financial debts concerned are secured or not, and on the effects that are intended to be imposed on those dissenting creditors.

If the plan includes a moratorium of up to 5 years on principal, interest or any other amount, or debt conversion to equity loans with the same term, then:

- In order to extend the effects to unsecured debts and unsecured amounts of secured debts of non-participating or dissenting creditors, it must be signed by creditors representing at least 60% of the unsecured financial liabilities; and

- In order to extend the effects to secured amounts of secured debts of non-participating or dissenting creditors, it must be signed by creditors representing at least 65% of the secured financial liabilities

If the plan lays down a moratorium of 5 to 10 years on principal, interest or any amount, write-downs, debt conversion to shares in debtor, conversion to equity loans of more than 5 years up to a maximum of 10 years, convertible bonds, subordinated loans, loans with capitalisable interest or other financial instruments of different ranking, maturity or characteristics than the original debt, or assignments of assets in payment of debts in whole or in part, then the above majorities rise to 70% and 80% respectively.

Within fifteen days following the publication of the court homologation, non-signing or dissenting creditors may challenge it, but on limited grounds: that the necessary majorities have not been achieved or that the agreement involves "disproportionate sacrifice" for them. This challenge does not stay the effects of the agreement. The challenge against the homologation must be resolved in thirty days, by the same court and without remedy of appeal.

III. New EU IR and the Commission's Recommendation

Article 5 *bis* (moratorium) and 4AP of the IA (homologation) have been included in Annex A of the EIR Recast as two different proceedings, though in practice they usually constitute two stages of the same process, as in the XYZ SA example. The debtor files a notice under the former and, if an agreement is reached, he subsequently requests its homologation.

The moratorium laid down by Article 5 *bis* of the IA meets the definition of insolvency proceedings established by Article 1(1) of the EIR Recast. It is:

(i) a collective proceeding, since it potentially include a significant part of a debtor's creditors (see Article 2(1) of the EIR Recast, defining collective proceedings as those which include all or a significant part of the debtor's creditors, and Recital 14 of the EIR Recast, making clear that proceedings which involve only financial creditors qualify as collective proceedings);

(ii) based on laws relating to insolvency; and

(iii) in which, for the purpose of rescue or reorganization, a "*temporary stay of individual enforcement proceedings is granted …by operation of law in order to allow for negotiations between the debtor and his creditors*" (see Article 1(1)(c) of the EIR Recast). Accordingly, in Annex A of the EIR Recast, Spain has included: "*Procedimientos de negociación pública para la consecución de acuerdos de refinanciación colectivos, acuerdos de refinanciación homologados y propuestas anticipadas de convenio*" (Public proceedings aimed at the negotiation of a refinancing collective agreement or an advance proposal of insolvency composition). Since Article 5 *bis* of the IA allows the debtor to keep the negotiation confidential, Annex A only refers to "public" proceedings ("*Procedimientos de negociación pública […]*"). Otherwise, i.e. when the debtor chooses to keep the negotiation confidential, the EIR Recast will not apply.

Homologation proceedings governed by 4AP of the IA are also included in Annex A EIR Recast, as a separate proceeding, different from an Article 5 *bis* of the IA moratorium. Specifically, the Annex refers to "*Procedimiento de homologación de acuerdos de refinanciación*" (Court homologation of refinancing agreements). As said, in the baseline case, Article 5 *bis* and 4AP of the IA go together: i.e. the debtor notifies the court of negotiations to reach a restructuring agreement in order to obtain a moratorium, and once the agreement has been reached, he asks for its homologation. But theoretically either proceeding may stand alone: the debtor may request the homologation of a refinancing agreement without having first obtained a moratorium and *vice versa*. The debtor therefore may cherry pick between:

(i) a mere moratorium under Article 5 *bis* of the IA;

(ii) a mere homologation under 4AP of the IA; or

(iii) a combination of both.

Note, however, that a standalone homologation would only qualify as "insolvency proceedings" under the EIR Recast if it satisfied the condition laid down by Article 1(1)(b) of the EIR Recast, i.e. that "the assets and affairs of a debtor are subject to control or supervision by a court." The 4AP homologation may be subsumed neither under Article 1(1)(a) of the EIR Recast, since the debtor is not divested of its assets, nor under Article 1(1)(c) of the EIR Recast, since in a standalone homologation there is no stay. It is true that the issue of whether a mere homologation qualifies as insolvency proceedings under Article 1(1)(b) of the EIR Recast is theoretically debatable: the court only sanctions the agreement, and the challenge is limited to the achievement of the majorities and the proportionate nature of the dissenting creditors' sacrifice. However, the conclusion of EU legislators is favourable to that characterization insofar as it has been included in Annex A of the EIR Recast: from an EU law standpoint, a court's approval of a restructuring plan in the terms explained above (i.e. a 4AP homologation) entails that "the assets and affairs of the debtor are subject to control or supervision by the court." Therefore, once they have been included in Annex A of the EIR Recast, the issue is merely academic.[8]

Furthermore, the pre-insolvency framework designed by the Spanish IA fits relatively well within the 2014 Commission Recommendation. First, as explained, it provides a four-month period stay of individual enforcement actions and the adjournment of insolvency proceedings (see Articles 10 to 14 of that Recommendation); and secondly, it envisages the possibility of a court's approval of the restructuring plan in order to bind dissenting creditors (see Articles 21-26 of the Recommendation). Note, however, that the Spanish pre-insolvency framework does not contain all the elements recommended by the Commission's document, e.g. there is no possibility of renewing the moratorium (see Article 13 of the Recommendation), or there is no reference to the liquidation value as a guarantee for creditors dragged along in the restructuring plan (see Article 22(c) of the Recommendation).

IV. Effectiveness within the EU

In the example put forward at the beginning of the chapter, XYZ SA had a significant number of its assets outside Spain; in particular, most of its subsidiaries were incorporated abroad, but also claims, securities and tangible assets were located outside Spain. Therefore, one of the key issues to guarantee the success of any restructuring plan in that case was to ensure:

(i) the cross-border effects of the stay granted under Article 5 *bis* of the IA; and

(ii) the recognition of the restructuring plan once it was sanctioned by the court under 4AP of the IA.[9]

Within the EU, the situation is in turn diverse under the original EIR[10] and the EIR Recast. The latter includes both Article 5 *bis* moratorium and 4AP homologation proceedings in Annex A and, therefore, all Member States must recognize their effects.

8 Below note 13 and associated text.

9 To analyse the difficulties raised by this issue it may be useful to make a difference between EU Member States and third countries (*infra* Section V).

10 Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings.

> Example 1. If XYZ SA has entered into negotiations with its creditors to restructure its liabilities under Article 5 *bis* of the IA, the affected creditors will be prevented from initiating individual enforcement proceedings not only in Spain but also in other Member States, and no main insolvency proceedings may be opened in other Member States while the Spanish pre-insolvency proceedings are pending.

By the same token, a judgment sanctioning a restructuring plan or debt discharge will also be recognized and produce effects in the rest of the Member States in accordance with the EIR Recast.

> Example 2. If XYZ SA has reached a refinancing agreement with its creditors to restructure its liabilities and such agreement has been sanctioned by a court, its effects must be recognized in other Member States and therefore dissenting creditors could not enforce their original claims either in Spain or in other Member States. In this case, and since the court's approval entails the "closure" of the restructuring proceedings from a judicial standpoint, main insolvency proceedings might be subsequently opened in another Member State but if – and only if – there is a shift of the debtor's COMI from Spain to that Member State.

Note, however, that a temporary moratorium granted in Spain (the debtor's COMI jurisdiction) may not affect the rights *in rem* of creditors or third parties over assets located in other Member States (see Article 8 of the EIR Recast) and may only temporarily stay the opening of secondary proceedings in accordance with Article 38(3) (for a maximum period of three months and provided that suitable measures to protect the interests of the local creditors are in place). Likewise, a restructuring plan, even if sanctioned by a court, may not affect the rights of secured creditors over assets located in other Member States.

> Example 3. Even though XYZ SA has obtained a moratorium in Spain under Article 5 *bis* IA, any secured creditor may enforce his security interest insofar as the encumbered assets are located in another Member State, e.g. a pledge over registered shares of a subsidiary incorporated in The Netherlands will not be affected by the moratorium. And even if XYZ SA has obtained a court's approval of the restructuring agreement, any secured creditor may enforce his original claim over the encumbered assets insofar as they are located in another Member State. In practice, this means that the restructuring

agreement will only affect the part of the debt which exceeds the value of the collateral.

The EIR Recast only applies to insolvency proceedings opened after 26 June 2017 (see Article 84 of the EIR Recast). The date of opening of the proceedings is defined by a reference to the time at which the decision opening such proceedings becomes effective (Article 2(8) of the EIR Recast). Therefore:

(i) with regard to an Article 5 *bis* stay, this date should be, in principle, the time when the debtor's notice is presented to the court (see Article 5 *bis* (4)) if the court's acknowledgement of that notification becomes public; and

(ii) with regard to the 4AP homologation such date shall be, in principle, when the judgment is published (4AP(8) of the IA). If those acts take place after 26 June 2017, they will benefit from the principle of mutual recognition guaranteed by the EIR Recast with the limits mentioned above.

Conversely, if the Article 5 *bis* moratorium and the 4AP homologation took place before 26 June 2017, as was the case in the original example, their cross-border effects would be governed by other EU instruments or by national rules. The question of whether hybrid or pre-insolvency proceedings fall within the scope of application of the Brussels I Regulation and/or Rome I Regulation has been discussed in depth among legal scholars, in particular with regard to the English Schemes of Arrangement.

In particular, as regards Spanish pre-insolvency proceedings, it is difficult to conclude that those EU instruments apply, since such proceedings are clearly based on a law relating to insolvency and the Spanish courts' basis of jurisdiction is the location of the debtor's COMI in Spain. In this case, it may be concluded that until the entry into force of the EIR Recast their recognition in other Member States is governed by national law, and this raises a problem equivalent to that raised by their recognition in third countries (*infra*).

V. Effectiveness in Third Countries

With regard to third countries, i.e. non EU Member States or Denmark, and where there is no bilateral agreement applicable, the recognition of Spanish pre-insolvency proceedings is determined by the internal rules of the relevant country. This therefore requires a case by case analysis, and naturally the conclusion may be favourable or not to such recognition (*infra* (1)). However, even with regard to third countries which do not recognize Spanish pre-insolvency proceedings, Spanish courts may unilaterally seek to make restructuring proceedings effective across borders (*infra* (2)).

1. EU Pre-Insolvency Proceedings and the UNCITRAL Model Law

The recognition of the effects of Spanish pre-insolvency proceedings, in particular a moratorium and/or a restructuring plan, by third countries' courts depends entirely on their internal law. In practice, this entails additional legal costs in the restructuring process: the parties involved in this process usually need to assess the risk that dissenting creditors may jeopardize the restructuring plan by enforcing their claims over the debtor's assets located in those countries. A country-by-country analysis is in many cases unavoidable.

> Example 4. If XYZ SA has assets in third countries, e.g. subsidiaries, IP rights or claims, which are essential for the continuation of the business, the restructuring plan may not succeed if a significant group of dissenting creditors enforce their claims over those assets. Therefore, in the context of the negotiations of the plan, it important to assess the likelihood that such a situation may arise, which in turn depends on whether the Spanish moratorium and the restructuring agreement will be recognized in those countries. The assessment of such risk entails a legal analysis of each individual jurisdiction.

It is true, however, that a significant number of countries outside the EU have incorporated the UNCITRAL Model Law into their internal system and, therefore, the legal framework is to a certain extent harmonized.[11] The problem that immediately arises is whether the concept of "foreign (insolvency) proceedings" that could be recognized under that instrument encompasses "pre-insolvency proceedings" like those designed by Spanish legislators. Unfortunately, the answer is not clear.

The definition of foreign (insolvency) proceedings laid down by the UNCITRAL Model Law is the following:

> "(a) "Foreign proceeding" means a collective judicial or administrative proceeding in a foreign State, including an interim proceeding, pursuant to a law relating to insolvency in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation."

11 See: http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model_status.html.

The definition of the UNCITRAL Model Law calls for the combination of five cumulative elements: they must be:

(i) collective;

(ii) opened in a foreign country;

(iii) based on a law relating to insolvency;

(iv) in which the debtor's assets and affairs are subject to control or supervision; and

(v) for the purpose of liquidation or reorganization.

Of these five elements, in the context of pre-insolvency proceedings the most questionable is the fourth, i.e. the requisite that the assets and affairs of the debtor are subject to control or supervision by a foreign court: Do a moratorium (Article 5 *bis* of the IA) and/or a court homologation (4AP of the IA) entail that the assets and affairs of the debtor are subject to control or supervision? The issue is debatable.

The Explanatory Notes accompanying the Model Law give very little information about the scope of that requirement:

> "The Model Law specifies neither the level of control or supervision required to satisfy this aspect of the definition nor the time at which that control or supervision should arise. Although it is intended that the control or supervision required under subparagraph (a) should be formal in nature, it may be potential rather than actual. As noted in paragraph 71, a proceeding in which the debtor retains some measure of control over its assets, albeit under court supervision, such as a debtor-in-possession would satisfy this requirement. Control or supervision may be exercised not only directly by the court but also by an insolvency representative where, for example, the insolvency representative is subject to control or supervision by the court…"[12]

On the one hand, under Spanish pre-insolvency proceedings, the debtor is not subject to any kind of supervision over his activities, he remains in full control of the management of the business. He continues carrying out his ordinary course of business, but he may also conclude any kind of transaction even if it goes further than that, e.g. he can carry out a non-ordinary course of business sale, pledging assets, assume new financial obligations or dismiss a group of employees. No court authorization or sanction is needed to make or implement such decisions. But, on

12 See: http://www.uncitral.org/pdf/english/texts/insolven/1997-Model-Law-Insol-2013-Guide-Enactment-e.pdf.

the other hand, the moratorium implies that the debtor's assets are shielded *vis à vis* individual actions and, in any event, the restructuring plan is subject to the court's approval. Furthermore, dissenting creditors may challenge this homologation (*supra*). The homologation only becomes effective once it has been sanctioned by the court.

It is very telling that homologation proceedings have been included in Annex A of the EIR. This means that at least with regard to the 4AP of the IA homologation, the EU has understood it implies that the assets and affairs of the debtor are subject to control or supervision since they could only be subsumed under Article 1(1)(b) of the EIR Recast.[13] Thus, from an EU standpoint, it seems reasonable to conclude that a mere moratorium does not qualify as "foreign (insolvency) proceedings" under the UNCITRAL Model Law, but a homologation does.

In any event, the issue of whether EU pre-insolvency proceedings will be recognized under the national law of third countries that have implemented the UNCITRAL Model Law will depend on their own understanding of this instrument.[14] For legal certainty reasons, it would be helpful if UNCITRAL clarified the application of its Model Law to these types of proceedings.

2. Other Remedies: Extraterritorial Leverage

Even if the Spanish pre-insolvency proceedings were not to be recognized by third countries, the IA envisages certain tools for promoting a unilateral implementation of those proceedings. In particular, Article 218(1) of the IA:

> "Article 218. 1 A creditor who, after main proceedings are opened in Spain, obtains a total or partial payment of his claim against the assets of the debtor located abroad, or by disposal or foreclosure upon these, must restore what he has obtained to the estate…"

This provision addresses the situation where main insolvency proceedings, with universal effects, have been opened in Spain and, nevertheless, an individual dissenting creditor enforces his claims against the assets of the debtor in a third country. Typically, because the third country courts do not recognize the universal reach of the Spanish proceedings. In such a case, the creditor may be obliged by

13 A standalone 4AP homologation can be subsumed neither under Article 1(1)(a) (since the debtor is not divested) nor under Article 1(1)(c) (since once the agreement is reached, the moratorium elapses), but only under letter (b) which refers to proceedings where the "assets and affairs of a debtor are subject to control or supervision by a court."

14 See, concluding that an homologation under 4AP, IA can be recognized in the US under Chapter 15 which incorporate the UNCITRAL Model Law concept of insolvency proceedings, US Bankruptcy Court for the District of Delaware, Case No 16-10754, *In re: Abengoa S.A et al*.

the Spanish courts to restitute what he has unduly obtained abroad. Furthermore, the Spanish judgment on restitution may be enforced in other Member States under the EIR Recast, since it "derives directly from the insolvency proceedings and is closely linked with them" (Article 6(1) of the EIR Recast).

Ex ante, this may work as an incentive to prevent dissenting creditors from seeking enforcement of their rights over debtors' assets located in third countries that do not recognize Spanish insolvency proceedings. The threat of being obliged to restitute what they have obtained discourages such behaviour. Additionally, Article 218 of the IA may also be the basis of an anti-suit injunction. Furthermore, as argued elsewhere,[15] this provision is based on the general principle of unjust enrichment (Articles 1895-1896 of the Spanish Civil Code) and thus also applies to pre-insolvency proceedings.

> Example 5. XYZ SA has obtained a court's approval of the restructuring agreement under 4AP of the IA. Let us imagine that a dissenting creditor (DC) seeks enforcement of his claim in Country A where XYZ SA has assets since such country does not recognize the Spanish homologation. In that case, and in accordance with Article 218 of the IA, such creditor may be obliged by the Spanish courts to restitute to the debtor the amounts he may have collected abroad. Furthermore, that judgment may be enforced in other Member States under the EIR Recast. If DC has assets in Spain or in other EU Member States, the threat of restitution may be sufficient to prevent him from enforcing his claim over the XYZ's assets located in Country A. Naturally, if DC has no assets in Europe or in other country that may recognize the Spanish judgment on restitution, the threat is futile.

If the EU eventually establishes a Directive on restructuring proceedings, the inclusion of an equivalent provision is something that may be worthy of consideration, since it will strengthen the universal effects of those proceedings. Other alternatives, such as those used in the Bank Resolution framework[16] requiring debtors to include a contractual clause that gives effects to the restructuring proceedings are impracticable.

15 See F. Garcimartin, "Alcance extraterritorial del concurso español", available at: http://almacendederecho.org/alcance-extraterritorial-del-concurso-espanol/.

16 See, e.g. Article 55, Directive 2014/59/EU of 15 May 2014, establishing a framework for the recovery and resolution of credit institutions and investment firms.

VI. Conclusion: The Need for a World-wide Instrument

By way of conclusion:

(i) EU Member States have progressively introduced national proceedings that allow debtors to restructure at an early stage with the objective of avoiding insolvency. Articles 5 *bis* and 4AP of the IA are good examples of this trend. Furthermore, EU legislators will probably establish a Directive harmonizing all EU national restructuring proceedings in the short term.

(ii) The cross-border effectiveness of the measures adopted under those proceedings, e.g. a moratorium or a restructuring agreement, may be a key element to guarantee their success when the debtor has assets abroad.

(iii) Within the EU, the EIR Recast ensures such effectiveness as regards those national restructuring proceedings that are included in Annex A of the Regulation.

(iv) With regard to third countries, the question is more uncertain since it depends on the national law of the relevant country. There is no international convention that ensures the recognition of the EU restructuring proceedings outside the EU.[17]

(v) Even in those countries that have adopted the UNCITRAL Model law on cross-border insolvency the issue is not clear, since it is debatable whether and to what extent certain EU restructuring proceedings qualify as "foreign (insolvency) proceedings" under that instrument. A clarification by UNCITRAL will be helpful.

(vi) In any event, Member States may resort to unilateral mechanisms to promote a "voluntary" acceptance by dissenting creditors of the restructuring proceedings carried out in their courts.

(vii) Article 218 of the Spanish Insolvency Act may serve as a model for those mechanisms. To reduce the risks of lack of cooperation by third countries, an equivalent provision should be incorporated in any future EU instrument on restructuring.

17 For UNCITRAL's work, see: https://documents-dds-ny.un.org/doc/UNDOC/LTD/V16/010/38/PDF/V1601038.pdf?OpenElement.

Chapter 7

Pre-Insolvency Procedures: A United Kingdom and South African Perspective

Alexandra Kastrinou and Lézelle Jacobs

Introduction

In light of the longstanding economic crisis the need for corporate rescue culture has been evolving in Europe and across the rest of the world. Great emphasis has been placed on rescue at an early stage and it appears that more and more rescue is attempted at a pre-insolvency stage, so as to enhance the likelihood of a successful reorganisation.[1] The aim of this chapter is to consider the pre-insolvency procedures available in the United Kingdom and South Africa. In particular the chapter provides an overview of the CVA procedure and the Schemes of Arrangement in the United Kingdom as well as the Business Rescue and the Compromise procedures in South Africa. In conclusion, the chapter aims to provide an overview of the approach taken in both jurisdictions towards less formal restructurings by "key players" in insolvency, such as insolvency practitioners and secured creditors as well as the courts.

The Advantages of Early-Stage Intervention

Although various formal and informal steps may be taken in order to give effect to a successful rescue, it is submitted that a traumatised company will often benefit from intervention before it gets to the stage of actual insolvency. In fact, it has been noted that most rescues are achieved through informal or less formal rescue, that is, rescue without recourse to the formal insolvency proceedings.[2] Less formal, pre-insolvency rescue mechanisms have a variety of advantages for the ailing company. From a director's and also a shareholder's perspective, engaging in less formal rescue is preferable as it prevents any adverse publicity in relation to the company's financial troubles and hence protects its goodwill and reputation.[3] It could be argued that, by pursuing less formal rescue, the company can effectively

1 See S. Frisby, *Report to the Insolvency Service: Insolvency Outcomes* (June 2006) (Insolvency Service, London).
2 Idem.
3 V. Finch, *Corporate Insolvency Law: Perspectives and Principles* (2nd ed) (2009, CUP, Cambridge), at 278.

avoid the stigma which is attached to corporate failure and that the realisable value of its assets can be protected.[4] Moreover, one could argue that less formal rescue is not as costly as formal insolvency proceedings, since the involvement of the court is very limited. In addition, since there is little court involvement in pre-insolvency rescue, one could argue that the process is more flexible.

Furthermore, as opposed to completely informal reorganisation,[5] a semi-formal reorganisation under the Company Voluntary Arrangement ("CVA") in the United Kingdom could prove more effective, as far as consent is concerned, since an approval in excess of 75% in value would suffice. Arguably the fact that there is no need to obtain the consent of all the creditors under a CVA avoids the flaws and challenges of informal rescue,[6] as obtaining consent from dissenting creditors could prove to be a time-consuming and expensive course of action.[7] In the South African context it also worth noting that regardless of who initiates the rescue proceedings, the business rescue will only continue if the creditors accepts the business rescue plan. Of course there is no need for a unanimous vote of acceptance and the Companies Act 71 of 2008 therefore provides that the plan will be accepted if it was supported by the holders of more than 75% of the creditors' voting interest,[8] and the votes in support of the plan included at least 50% of the independent creditors' voting interest that were voted.[9] The South African business rescue proceedings thus also bind a dissenting minority.

It could be argued that early intervention is a key for successful corporate rescue. Accordingly, the insolvency law regimes of both the United Kingdom and South Africa make provision for early intervention proceedings. These proceedings are being increasingly used before the technical moment of insolvency and are "colonizing" the area formerly occupied by formal insolvency procedures. For instance, in the United Kingdom procedures are in place, which are designed to encourage an early stage intervention by the existing management, such as the Scheme of Arrangement, which is one of the oldest rescue devices in the world

4 Ibid., at 251-252.

5 Where a reorganisation process is of a contractual nature, hence there is great reliance on a consensus being achieved with the creditors.

6 J. Payne, "Debt Restructuring in English Law: Lessons from the United States and the Need for Reform" (2014) 130 *Law Quarterly Review* 282, at 287.

7 It could be said that a formal procedure, such as the Company Voluntary Arrangement in the United Kingdom, could prove more effective, as far as consent is concerned, since an approval in excess of 75% in value would suffice. A Part 26, Companies Act 2006 scheme of arrangement could also be used for solvent entities, which would have the same effect.

8 Section 152(2)(a), Companies Act 71 of 2008.

9 Ibid., section 152(2)(b). An independent creditor is described in section 128(1)(g) as a person who is a creditor of the company, including an employee of the company who is a creditor in terms of section 144(2) and who is not related to the company, a director or the practitioner.

and the CVA procedure, which was introduced following the recommendations of the Cork Report.[10] In South Africa, directors are also encouraged to initiate business rescue proceedings as soon as possible; in order to assist the board of directors from allegations of abuse of process the Act widened the definition of "financial distress" by introducing a six month time period. The new mixed management displacement model in South Africa also encourages directors to initiate proceedings sooner.[11]

Pre-Insolvency Proceedings in the United Kingdom

The Development of a Corporate Rescue Culture in the United Kingdom

A financially ailing company may have resort to a range of mechanisms in the United Kingdom, such as for instance, informal workouts, a CVA, a scheme of arrangement or administration. Arguably, the presence of such a wide range of reorganisation proceedings demonstrates the significance attached to business recovery in this jurisdiction. However, it was not until relatively recently that the United Kingdom established its sophisticated corporate rescue culture.

Prior to the enactment of the Insolvency Act 1986 ("IA 86"), there were only two formal possible procedures designed to keep "alive" a traumatised business, the administrative receivership procedure or a scheme of arrangement. Nonetheless, the application of these to procedures was not without problems, as the administrative receivership procedure was conditional upon the exercise of the right of a floating charge holder to appoint an administrative receiver; in addition, the use of a scheme of arrangement as a corporate rescue tool was limited, primarily because the procedure was too:

> "procedurally cumbersome and failed to safeguard sufficient and effective protection for the company."[12]

10 Report of the Insolvency Law Review Committee, Insolvency Law and Practice (Cmnd 8558) (1982, HMSO, London) ("Cork Report").

11 Sections 137(2)(a)-(c) and 140(1)(a), Companies Act 71 of 2008. Under Business Rescue, the company's management is displaced by an independent third party known as the Business Rescue Practitioner. Even though the management is displaced the directors are not removed from office and stay on in order to assist the Practitioner in his duties, this is done under the supervision of the practitioner.

12 R. Parry, "United Kingdom: Administrative Receiverships and Administrations" in K. Gromek Broc and R. Parry, *Corporate Rescue in Europe: An Overview of Recent Developments from Selected Countries in Europe* (2004, Kluwer Law International, London), at 265.

In 1985 by means of a text, later re-enacted as the IA 86,[13] two additional procedures were introduced as alternative means for corporate rescue, namely the administration procedure and the CVA. The innovative reforms introduced by the IA 86, originally had their roots in the 1982 report of the Cork Committee,[14] which recognised the need to strengthen the United Kingdom's corporate rescue regime. The Cork Report stated that a:

> "good, modern system of insolvency law should provide a means for preserving viable commercial enterprises capable of making a useful contribution to the economic life of the country."[15]

It should be noted, however, that, although the CVA appeared to be a promising "debtor in possession" reorganisation tool, it was not fully embraced by practitioners. Later, nevertheless, the Enterprise Act 2002 together with the Insolvency Act 2000 contributed significantly to the development of a corporate rescue culture in the United Kingdom. The Insolvency Act 2000 introduced key reforms to the CVA procedure, so that the CVA now constitutes an important part of the current trend in shifting the ethos of the United Kingdom's insolvency law towards effective corporate rescue.

An Overview of the CVA Procedure

The CVA was designed primarily with the aim of promoting corporate rescue. The objective of the CVA is to facilitate the rehabilitation of a financially troubled company by enabling it to reach a contractual compromise with its creditors. The CVA may be used as a stand-alone procedure or it may be combined with another procedure, such as administration. In other words, the procedure may be initiated either by the company's directors or by an administrator. Although the CVA may be effectively used as an exit route from administration, strictly speaking, it is not a formal insolvency procedure, as it is not necessary for the company to be insolvent or show that it is unable to pay its debts in order to enter into a CVA.

Where the CVA is initiated as a freestanding procedure, the existing management of a company is able to take early action by drafting a re-organisation proposal and presenting it to the company's creditors. The directors[16] are also entrusted with the implementation of the proposal under the supervision of a licenced insolvency

13 The Insolvency Act 1985 was consolidated with the winding up provisions from the Companies Act 1985 as the Insolvency Act 1986.

14 Above note 10.

15 Finch, note 3 above, at 246.

16 It should be noted that although the CVA is described largely as a "Debtor in Possession" regime, in practice the directors heavily rely on the insolvency practitioner to both draft and execute the proposal.

practitioner, known as the "nominee" prior to approval of the proposal and as the "supervisor" after approval.[17]

The formation of the proposal is a key stage of the reorganisation process. The directors form the proposal,[18] which, *inter alia*, states the reasons why the company's directors believe that a CVA is desirable; the company's assets and their value; details of assets charged in favour of creditors; the nature and the amount of the company's liabilities; the duration of the CVA; the dates of distributions to creditors; the identity and the remuneration of the insolvency practitioner of the proposed nominee/supervisor.[19]

The steps that directors must take in forming and implementing a CVA proposal depend on whether or not the protection of a moratorium is sought.[20] Arguably, one of the most significant reforms the CVA has been subject to is the introduction of provisions enabling a moratorium to be obtained while the CVA is being proposed.[21] However, notwithstanding the introduction of a reformed CVA, it could be said that the impact of the procedure has been limited. An obvious contributing factor to the limited use of the CVA could arguably be the fact that a moratorium is only available to "small companies".[22] However, since large companies can still benefit from a moratorium (if one is necessary) by simply entering into administration proceedings, the lack of it under the CVA has not been identified as a major flaw by insolvency practitioners. In addition, it could be argued that the use of the CVA has been relatively limited, due to the fact that the procedure has been overshadowed by the streamlined administration procedure.[23]

<u>The Role of the Nominee</u>

The nominee has a very important role to serve, as he must establish whether or not the company is able to implement a CVA proposal. Accordingly, the nominee must present a report to the court stating whether in his opinion meetings of the company

17 It is important to note that the insolvency practitioner must remain independent from the outset and throughout the implementation of the CVA process. See Statement of Insolvency Practice 3, at paragraph 3.2.

18 Section 1(1), IA 1986.

19 See rule 1.3. (1)-(8), Insolvency Rules 1986.

20 Where directors intend to apply for a moratorium the procedure which must be followed is stated in section 2, IA 1986, supplemented by the Part 1 Chapter 2, Insolvency Rules 1986. Where a moratorium is not required, the procedure is outlined in Schedule A1, IA 1986.

21 R. Parry, *Corporate Rescue* (2008, Sweet & Maxwell, London), at 136, paragraph 10-09.

22 See section 382(3), Companies Act 2006, which states that a company qualifies as small in relation to a subsequent financial year, if it satisfies at least two of the following "qualifying conditions": (a) its turnover does not exceed GBP 6.5 million; (b) its balance sheet total is not more than GBP 3.26 million; (c) it has no more than 50 employees.

23 Parry, above note 21, at 136, paragraph 10-09.

and its creditors should consider the proposal.[24] In order to be able to assess the company's suitability and to prepare his report, the nominee must receive a copy of the proposal from the directors,[25] a statement of the company's affairs,[26] as well as any other information he requires.[27]

The nominee shall summon meetings of the company and its creditors[28] in order to either approve (with or without modifications)[29] or reject the proposed CVA. After the conclusion of either meeting the chairman of the meeting shall report the result of the meeting to the court, and, immediately after reporting to the court, shall give notice of the result of the meeting to such persons as may be prescribed.[30]

With regard to the approval of the proposal, it is important to note that as opposed to a scheme of arrangement, the CVA treats all creditors as one single class.[31] All creditors who receive notice of a creditors' meeting can vote on a CVA draft.[32] In order for the CVA to become effective, it needs to be approved by the requisite majority at the meeting.[33] The CVA is treated as a statutory contract,[34] which binds every person who was eligible to vote at the meeting, regardless of whether they were present or not and whether they voted in favour or not of the proposed arrangement.[35] Upon approval of the CVA, the nominee becomes the supervisor.[36]

An important disadvantage of the CVA procedure is its vulnerability to claims of unfair prejudice to the interest of a creditor or member under the approved CVA. In addition the CVA is vulnerable to challenge on grounds of material irregularities. Such claims may be initiated by any person, who would be eligible to vote at the meeting, or any person who would have been entitled to vote had they had notice of the meeting. In any case no challenge can be made after a period of 28 days:

24 Section 2(2), IA 1986.

25 Ibid., section 2(3); rule 1.4. (1)-(2), Insolvency Rules 1986.

26 Rule 1.5, Insolvency Rules 1986.

27 Ibid., rule 1.6.

28 Schedule A1, paragraph 29, IA 1986.

29 Ibid., paragraph 31.

30 Ibid., paragraph 30(3).

31 See I. Fletcher, "UK Corporate Rescue Culture: Recent Developments – Changes To Administrative Receivership, Administration and Company Voluntary Arrangements- The Insolvency Act 2000, The White Paper and The Enterprise Act 2002" (2004) 5 *European Business Organisation Law Review* 119, at 127.

32 Persons who are not entitled to vote at the meeting, ae not bound by the CVA. See section 5(2), IA 1986.

33 Rule 1.19, Insolvency Rules 1986: more than three quarters in value of the creditors voting on the resolution must vote in favour of the arrangement.

34 *Johnson* v *Davies* [1999] Ch 117, at 129H-130A.

35 Schedule A1, paragraph 37, IA 1986.

36 Ibid., paragraph 39(2).

(a) beginning with the first day on which the Chairman's report required has been made to the court; or

(b) in the case of a person who was not given notice of the creditors' meeting, after the end of the period of 28 days beginning with the day on which he became aware that the meeting had taken place.[37]

Schemes of Arrangement

A scheme of arrangement is one of the oldest restructuring procedures available in the United Kingdom.[38] However, strictly speaking a scheme is not an exclusive corporate rescue instrument, as it was primarily designed to be used by solvent companies. Accordingly, as the scheme is a creature of company law,[39] when compared to CVAs, it is not as stigmatised. Similarly to the CVA, a scheme enables a financially ailing company to reach a compromise with its creditors. However, in contrast to the CVA, the popularity of the scheme, as a rescue device has been steadily rising over the last few decades[40] and practitioners have favoured the use of schemes in a number of high profile debt restructuring cases.[41]

The scheme is a compromise between the company and its creditors, or between the company and its members. Similarly to the CVA, the company's directors remain in office and are responsible for the drafting and the execution of the restructuring plan. The process of implementing a scheme involves three distinct stages:

(a) formulation of the proposal and an application to the court;

(b) a creditors' meeting for approval of the scheme; and

(c) a "sanction hearing" before the court.

As part of stage one, the board directors shall form the restructuring plan,[42] which is then proposed on behalf of the company to its members and creditors. Once a compromise/arrangement has been proposed, the company by sending preliminary

37 Ibid., paragraph 38(3).

38 It dates back to the Joint Stock Companies (Arrangement) Act 1870.

39 The statutory regime relating to schemes is set out in Part 26, Companies Act 2006.

40 Parry, above note 21, at 233. See also Finch, above note 3, at 486, where it is argued that the revived popularity of schemes of arrangement may be due to the courts "constructive attitude, to facilitate the implementation of schemes by means of assessing junior creditors' 'real economic interests."

41 Such as Crest Nicholson plc, McCarthy & Stone plc, Wind Hellas Telecommunications SA and European Directories Group.

42 Although the appointment of a qualified insolvency practitioner is not necessary, typically directors seek the advice of restructuring experts at this early stage.

circulars[43] shall inform its creditors or members about the objectives of the scheme as well as the relevant meetings (if more than one) the company aims to call. The company must also select the classes in which the creditors or members affected by the scheme should be placed and accordingly notify them. The division of classes depends on how similar[44] the rights of the members of each class are. However, it is not necessary that their rights are exactly the same.[45] Finally, stage one involves an application being made to the court, which will have to decide whether or not to make a "meetings order".[46]

Stage two involves a meeting of creditors or members who will decide whether to approve the scheme. However, it is required that, prior to the meeting, sufficient information must be circulated so as to enable the creditors to reach an informed decision.[47] As mentioned above the approval of a scheme of arrangement involves a complex voting structure under which, for voting purposes, creditors are divided into classes and it is required that a reorganization arrangement be approved by a majority vote of all classes of creditors.[48]

In comparing the complex approval process of a scheme to the much simpler process of a CVA, it could be argued that restructuring by means of a CVA should be preferable. Nevertheless, the simplicity aspect of the CVA is outweighed by the fact that, once an arrangement becomes binding under the scheme, it binds all creditors (including dissenting creditors), whereas an agreement reached under the CVA is only binding upon creditors who were eligible to vote, or who would have been eligible to vote, if they had notice of a creditors' meeting. In addition, it is important to note that, under a scheme of arrangement, it is not necessary to consult any class of creditors who have no real economic interest in the company, hence

43 However, compliance with this requirement may be waived by the court in exceptional cases. See for instance *Marconi Corp Plc v Marconi Plc* [2003] EWHC 663.

44 The interests of creditors in each class should not be so dissimilar so as to make it impossible for them to consult together with a view to their common interest. See *Sovereign Life Assurance Co v Dodd* [1982] 2 QB 573, at 583; *Re BTR Plc* [1999] 2 BCLC 575.

45 *Re Osiris Insurance Ltd* [1999] 2 BCLC 182.

46 At the meetings hearing the court will consider whether or not the company has appropriately identified the classes, which will have to consider the scheme. See *Re Hawk Insurance Co Ltd* [2002] BCC 300.

47 See section 897, Companies Act 2006.

48 Ibid., section 899, which states: "If a majority in number representing 75% in value of the creditors or class of creditors or members or class of members (as the case may be), present and voting either in person or by proxy at the meeting summoned under section 896, agree a compromise or arrangement, the court may, on an application under this section, sanction the compromise or arrangement." However, see also C. Maunder, "Bondholder Schemes of Arrangement: Playing the Numbers Game" (2003) 16(10) *Insolvency Intelligence* 73, at 76, where it is argued that if the majority in number requirement was removed, schemes of arrangement would be more flexible and attractive restructuring tools.

their votes on the scheme may be disregarded.[49] This is a significant advantage of a scheme as it provides greater finality than a CVA, which is vulnerable to challenges on grounds on unfair prejudice.[50]

Stage three involves a "sanction hearing", where the court will consider whether or not to sanction the scheme.[51] Once the scheme has obtained the required level of approval, it must be sanctioned by the court and the court's order takes effect once a copy of it is delivered to the Registrar of Companies.[52] It should be noted that the sanctioning of the scheme is not a simple rubber-stamping exercise. Instead, the court may not sanction a scheme even where it has received the approval of creditors,[53] as it must be satisfied that the classes were fairly represented by the parties who attended the meeting,[54] and that the terms of the scheme are fair.[55] In addition, the court has discretion to refuse to sanction a scheme, unless it is convinced that all the procedural requirements have been complied with.[56] It is argued that the requirement that a scheme of arrangement has to be approved by the court is a significant advantage of the procedure, because, once the arrangement has been court-approved, it cannot be challenged by the company's creditors or its members. It could be argued that this might be one of the primary reasons why such schemes seem to be more popular than the CVA, as a CVA may be challenged on the grounds of unfair prejudice.[57]

Pre-Insolvency Proceedings in South Africa

A very large premium has been placed on retaining jobs and businesses in South Africa,[58] and as an emerging market economy an efficient rescue system is of the utmost importance. South Africa's Companies Act 71 of 2008 (the "Act") heralded a new era of corporate rescue for financially distressed corporations by replacing the largely unsuccessful Judicial Management Procedure.[59] Chapter 6 of

49 See *Re Tea Corp*. [1904] 1 Ch 12. See also *Re My Travel Group Plc* [2004] EWHC 2741; [2005] 1 WLR 2365, where the basis of valuation of entitlements caused some contention. See also Parry, above note 22, at 236; Finch, above note 3, at 486.

50 Parry, above note 21, at 233.

51 Ibid., at 236.

52 Section 899 (1), (4), Companies Act 2006.

53 Payne, above note 6, at 292.

54 Parry, above note 21, at 238.

55 Ibid., at 239-247.

56 *Alabama, New Orleans, Texas and Pacific Junction Rly Co* [1891] 1 Ch 213, at 245.

57 Parry, above note 22, at 233.

58 D. Burdette, "Some Initial Thoughts on the Development of a Modern and Effective Business Rescue Model for South Africa (Part 1)" (2004) 16 *SA Mercantile Law Journal* 241, at 241.

59 Idem. See also E. Snyman-van Deventer and L. Jacobs, "Corporate Rescue: The South African Business Rescue Plan Examined" (2014) 2 *Nottingham Insolvency and Business Law e-Journal* 103, at 103.

the Act dealing with Business Rescue and Compromises also replaces the section on compromises and arrangements contained in the previous Companies Act of 1973.[60] Thus the Act currently provides for two pre-insolvency proceedings: the Business Rescue procedure and the Compromise with creditors.

Both the mechanisms contained in Chapter 6 provide a debtor in financial distress with access to corporate reorganisation in order to try and circumvent insolvency. The Business Rescue provisions can be regarded as a more traditional type of procedure that can be likened to the Administration procedure under the English Enterprise Act.[61] Under Business Rescue, the company's management is displaced by an independent third party known as the Business Rescue Practitioner. Even though the management is displaced, the directors are not removed from office and stay on in order to assist the Practitioner in his duties, this is done under the supervision of the practitioner.[62] The Compromise provisions provide for an alternative option with less involvement from the court and practitioners, in this sense it is reminiscent of the US Chapter 11 debtor-in-possession in that the debtor is able to stay in control of its affairs, although it is a simpler provision than the Chapter 11 procedure.[63] This mechanism provides for a more flexible framework and can even be utilised by companies that are not experiencing financial distress.

Although the new corporate rescue procedures in South Africa are more informal than under the previous Act, the procedures that are currently available to distressed companies are still more formal than informal in nature since it is highly regulated by legislation. Informal creditor workouts are rarely heard of nor are they documented.[64] The Chapter 6 mechanisms are less formal since the involvement of the courts have been limited whilst the involvement of other stakeholders have been broadened. A discussion on the development of a rescue culture as well as an overview of the two reorganisation options will now follow.

The Development of a Rescue Culture in South Africa

South Africa is still struggling with a liquidation culture despite the fact that South Africa now has modern rescue provisions to aid failing debtors. The process of moving towards a rescue culture is happening very slowly. This liquidation culture

60 Companies Act 61 of 1973.

61 H. Klopper and R. Bradstreet, "Averting Liquidations with Business Rescue: Does a section 155 Compromise Place the Bar too high?" (2014) *Stellenbosch Law Review* 549, at 550.

62 Sections 137(2)(a)-(c), 140 (1)(a), Companies Act 71 of 2008.

63 Klopper and Bradstreet, above note 61, at 553.

64 N. Harvey (ed), *Turnaround Management and Corporate Renewal. A South African Perspective,* (2011, Wits University Press, Johannesburg), at 134.

emanates from South Africa's prevailing creditor-friendly approach to insolvency matters.[65] It is, however, of importance to mention that even though the shift is happening at a very slow pace, it is indeed happening. In recent years, since the inception of the Companies Act of 2008, there has been more emphasis on the protection of the interests of all the relevant stakeholders. It has even been stated by the court that Business Rescue is to be preferred to the liquidation of the company and that the old mind-set of the creditor being almost entitled to a winding-up order as of a right was inappropriate.[66]

One of the biggest hurdles to overcome in creating a rescue culture in South Africa is the larger creditors, e.g. the Banks who are to a large degree very reluctant to participate in, or even support the rescue proceedings because of the aforementioned reasoning. And although creditors still play an overwhelming role in the outcome of reorganisation procedures,[67] there seems to be a shift to a more inclusive approach to the rescue of a company albeit at a very slow pace.

Business Rescue

According to section 7 of the Act, one of the main purposes thereof is to provide for the efficient rescue and recovery of financially distressed companies, in a manner that balances the rights and interests of all relevant stakeholders.[68] The Act provides for proceedings to facilitate the rehabilitation of a company that is financially distressed by providing for: the temporary supervision of the company, and of the management of its affairs, business and property; a temporary moratorium on the rights of claimants against the company or in respect of property in its possession; and the development and implementation, if approved, of a plan to rescue the company.[69]

The first topic to discuss in this regard pertains to the concept of imminent insolvency in a South African context. When will a company be regarded as being in financial distress? It is a well-known fact that time is of the essence in corporate reorganisations. Section 128 of the Act states that a company will be deemed to be financially distressed if it appears to be reasonably unlikely that the company

65 See Burdette, above note 58, at 244; *Southern Palace Investments 265 (Pty) Ltd v Midnight Storm Investments 386 Ltd* 2012(2) SA 423 (WCC); *Oakdene Square Properties (Pty) Ltd v Farm Bothasfontein (Kyalami) (Pty) Ltd* 2012(3) SA 273 (GSJ), at 276. "By law the creditor of an ailing company had a right *ex debito justitiae* (as of right) to liquidate the company."

66 *Southern Palace Investments 265 (Pty) Ltd v Midnight Storm Investments 386 Ltd* 2012 2 SA 423 (WCC).

67 A. Loubser, "The Role of Shareholders during Corporate Rescue Proceedings: Always On the Outside Looking In?" (2008) 20 *SA Mercantile Law Journal* 372, at 379.

68 Section 7(k), Companies Act 71 of 2008.

69 Ibid., section 128(1)(b)(i)-(iii).

will be able to pay all of its debts as they become due and payable within the immediately ensuing six months,[70] or if it appears to be reasonably likely that the company will become insolvent within the immediately ensuing six months.[71] The adding of the six month time period was to encourage the early commencement of Business Rescue which in turn maximises the chance of a successful rescue. The formulation of the concept of financial distress in the Act also refers to commercial and factual insolvency at a future date implying that Business Rescue should not be utilised by companies that are already insolvent. South African courts agree with this and have at numerous occasions denied applications for the initiation of Business rescue where the companies are insolvent and not in financial distress.[72]

The initiation of the procedure can happen either voluntarily by way of a company resolution or by application to the High Court by an affected person. An affected person is defined in the Act as a shareholder or creditor of the company, any registered trade union representing employees of the company and any employees of the company not represented by a trade union.[73]

The commencement standard that applies depends on the party that initiates the rescue process, providing for different requirements for when the debtor initiates to when an affected person applies to court for an order placing the company under Business Rescue. This is a positive development,[74] as it also allows for different evidential burdens taking the circumstances and information position of the different role players into account. The new requirements for initiating Business Rescue are seen as an improvement to the requirements under the previous Companies Act of 1973. Some believe that the evidential burden imposed by the previous Act was unrealistic, outdated and excessive, and resulted in rescuable companies being denied a lifeline. Others argue that the courts wrongly

70 Ibid., section 128(1)(f)(i). Referring to the so called cash flow test for insolvency.

71 Ibid., section 128(1)(f)(ii). Referring to the so called balance sheet test for insolvency.

72 *Gormley v West City Precinct Properties (Pty) Ltd* (Unreported case). "It must either be unlikely that the debts can be repaid within 6 months or that the company will go insolvent within the ensuing 6 months. In this case the company is presently insolvent and cannot pay its debts unless a moratorium of 3-5 years is granted. The facts of this matter does not bring West City's financial situation within the definition of 'financially distressed'." See also *Wellman v Marcelle Props* 193 2012 JDR 0408 (GSJ), at 12. "In my view, Business Rescue proceedings are not for the terminally ill close corporation."; *Southern Palace Investments 265 (Pty) Ltd v Midnight Storm Investments 386 Ltd* 2012 2 SA 423 (WCC); *African Banking Corporation of Botswana v Kariba Furniture Manufacturers* (228/2014) [2015] ZASCA 69: "Suffice it to say that the company was clearly hopelessly insolvent and effectively dormant in that it had not traded for years and had no business contacts in place."

73 Section 128(1)(a)(i)-(iii), Companies Act 71 of 2008.

74 Under the 1973 Companies Act, only one set of requirements was applicable regardless of who was initiating the rescue procedure.

interpreted judicial management as an extraordinary remedy, only to be granted in exceptional circumstances.[75]

Under the Business Rescue model a company may voluntarily initiate rescue proceedings and place the company under supervision, by taking a resolution, if the board has reasonable grounds to firstly, believe that the company is financially distressed and secondly, that there appears to be a reasonable prospect of rescuing the company.[76] An affected person, on the other hand, may apply to court to make an order placing the company under supervision and commencing business rescue proceedings, if the court is satisfied that the company is financially distressed; the company has failed to make an employment-related payment arising from a regulatory or contractual obligation or if it is otherwise just and equitable to do so for financial reasons, and there is a reasonable prospect for rescuing the company.[77]

The court's involvement has therefor been limited at the commencement of the proceedings. The debtor is fully aware of its own financial situation, and would be the most appropriate judge to decide when to make use of rescue provisions.[78] A rescue mechanism that relies heavily on the involvement of the court is expensive and therefor contradictory to the aim of helping the company in dire financial straits.

The most problematic requirement for South African courts to date has been the need for a reasonable prospect of rescue to exist.[79] This is mainly due to the fact that the meaning of "successful rescue" is a contentious issue and will depend on the viewpoint from which it is regarded and also because there is no way in which to determine the viability of the debtor company. According to the Act a successful rescue could include returning the company to solvency or alternatively bringing about a better return for the company's creditors and shareholders than would result from the immediate liquidation of the company.[80]

After the commencement of the proceedings, the appointment of the Business Rescue Practitioner should take place. If the company initiates the proceedings the Practitioner will be appointed by the board of the company.[81] If, however, the procedure is initiated by an affected person the applicant to court would nominate

75 See Burdette, above note 58, at 248-249.

76 Section 129(1), Companies Act 71 of 2008.

77 Ibid., section 131(4) (a) (i)-(iii).

78 D. Burdette, "Some initial thoughts on the Development of a Modern and Effective Business Rescue Model for South Africa (Part 2)" (2004) 16 *SA Mercantile Law Journal* 409, at 410.

79 M. Pretorius, *Companies and Intellectual Property Commission (CIPC) Status Quo Report* (2015), at 5.

80 Section 128(1)(b)(iii), Companies Act 71 of 2008.

81 Ibid., section 129(3)(b).

a practitioner and the court will appoint an interim Practitioner, subject to the ratification by the creditors.[82] The Practitioner is a key role player in the rescue procedure and the duty to rescue the company falls on his shoulders. It is for this reason that the Practitioner should be suitably qualified and experienced in order to perform all that is expected of him.

According to the 2008 Companies Act, a Practitioner should be a member of the law, accounting or business management profession.[83] The regulations to the act furthermore stipulate that a practitioner should have experience in "business turnaround practice".[84] The 2008 Act places more emphasis on the experience of the business rescue practitioner than its predecessor. Practitioners are therefore divided into three categories: senior practitioners, experienced practitioners and junior practitioners. For large and state-owned companies only senior practitioners may be appointed. For medium companies senior and experienced practitioners may be appointed, but not junior practitioners; etc.[85]

This clearly indicates that the legislature wanted to make sure that only the most experienced practitioners are appointed in the larger and more difficult rescue situations in order to optimise the chances of a successful rescue of the company. Apart from being suitably qualified and experienced, the Practitioner also needs to be of good character and integrity,[86] and be independent and objective.[87] The duties of the Practitioner include taking control of the management of the debtor company, undertaking an investigation into the financial affairs of the company and the drafting and implementation, if approved, of a business rescue plan. In order to assist the Practitioner in performing these duties, the Act affords him with a wide array of powers including the power to obtain post-commencement financing and suspending certain contracts or parts thereof.[88]

The drafting, acceptance and implementation of a business rescue plan are among the most important aspects of a modern rescue model.[89] The business rescue plan is one of the greatest improvements in respect of the South African rescue model. By having to propose, accept and implement a business rescue plan, the restructuring

82 Ibid., section 131(5).
83 Ibid., section 138(1)(a).
84 Regulation 127, Regulations to the Companies Act 71 of 2008.
85 Ibid., regulation 127(2)(c)(i)-(iii).
86 Ibid., regulation 126(4)(a).
87 Section 138(1)(e), Companies Act 71 of 2008.
88 Ibid., sections 135-136.
89 P. Kloppers, "Judicial Management – A Corporate Rescue Mechanism in Need of Reform?" (1999) 10 *Stellenbosch Law Review* 417, at 427. See also Snyman-van Deventer and Jacobs, above note 59, at 103.

of the debtor could occur much sooner, with the added benefit that certainty with regard to the outcome of the rescue is created for all parties concerned.[90] The business rescue plan will be considered at a meeting of affected persons and voted upon by the company's creditors. The shareholders will only be allowed to vote if the plan alters the rights attached to their shares. At this meeting, the Rescue Practitioner must present the proposed rescue plan to the creditors and shareholders to afford them the opportunity to consider it.[91] The practitioner must also use this opportunity to inform the meeting of whether he still believes that there is a reasonable prospect of the company being rescued.[92]

The creditors and shareholders may then discuss and raise arguments about the plan, as well as cast any vote on a motion regarding the amendment of the plan or the adjournment of the meeting to afford the practitioner time to revise the plan based on their recommendations.[93] When a vote is called, the proposed business rescue plan will be approved if the plan received support from the holders of more than 75% of the creditors' voting interests that were voted,[94] and if the votes in support of the proposed plan included at least 50% of the independent creditors' voting interests, if any, that were voted.[95] A business rescue plan approved in the abovementioned ways is binding on the company, each of the creditors of the company, and each holder of company securities, whether or not that person was present at the meeting or voted in favour of the plan.[96] This means that the vote will also bind the minority of dissenting creditors.

Another important aspect to consider regarding Business Rescue pertains to the automatic "stay" or moratorium that becomes effective upon commencement of the proceedings. The moratorium on claims from creditors provides the debtor company with some breathing room in order to try and facilitate the rescue procedure.[97] For the duration of the Business Rescue proceedings, no legal proceeding against the company, or in relation to any of the company property, may be commenced or proceeded with in any forum, except with the written consent of the practitioner or with leave of the court and in accordance with any terms the court deems suitable.[98]

90 Burdette, above note 78, at 438.
91 Section 152(1)(a), Companies Act 71 of 2008.
92 Ibid., section 152(1)(b).
93 Ibid., section 152(1)(c), (d)(i)-(ii).
94 Ibid., section 152(2)(a).
95 Ibid., section 152(2)(b).
96 Ibid., section 152(4).
97 Burdette, above note 78, at 417.
98 Section 133(1)(a)-(b), Companies Act 71 of 2008.

The termination of the Business Rescue proceedings can happen in a number of ways. In terms of section 132, the proceedings will come to an end if the court sets aside the company's resolution to place the company under rescue,[99] or if the court has converted the proceedings to liquidation proceedings.[100] The Practitioner can also terminate the rescue by filing a notice of termination.[101] In the event that the business rescue plan is rejected, the proceedings will also come to an end.[102] The proceedings will also come to an end when the Practitioner files a notice of substantial implementation of the plan.[103]

The Compromise Procedure

The alternative procedure provided for in the Act is the section 155 Compromise with creditors.[104] In the case of a compromise with creditors, the debtor company will remain entirely in possession and no Practitioner will be appointed in order to assist the company. This type of procedure envisages some element of commercial give and take and accommodation on both sides. That is between the Company and its creditors. The board of a company may propose an arrangement or a compromise of its financial obligations to all of its creditors, or to all of the members of any class of its creditors, by delivering a proposal to every creditor and the Commission. The company must therefore develop their own plan for "rescue". The prescribed contents of the plan for a compromise are similar to those of the business rescue plan.[105] The proposal will then be voted upon by all the creditors or the class of creditors and will only be adopted if supported by a majority in number, representing at least 75% in value of the creditors or class, as the case may be.[106]

The section 155 Compromise or arrangement under the Companies Act of 2008 replaces the old section 311 procedure of the previous Act. Like the previous procedure, the section 155 Compromise also provides for the court to sanction a compromise that was reached between the company and the majority of its creditors.[107] The wording of the Act does, however, create uncertainty regarding the need for the court to sanction the proposal: "the company may apply to court

99 Ibid., section 132(2)(a)(i).
100 Ibid., section 132(2)(a)(ii).
101 Ibid., section 132(2)(b).
102 Ibid., section 132(2)(c)(i).
103 Ibid., section 132(2)(c)(ii).
104 Ibid., section 155.
105 Ibid., section 155(3).
106 Ibid., section 155(6).
107 Klopper and Bradstreet, above note 61, at 553.

for an order approving the proposal".[108] The wording creates the impression that it is up to the company to decide whether or not to approach the court for an order approving the proposal or not.[109] It does, however seem as though the purpose of the provision was for the company to guarantee that any dissenting creditors are in fact bound by the compromise. Where the creditors unanimously agree to the proposed plan no court sanction will be needed, since section 155(8)(c) provides that the order of court sanctioning a compromise is "final and binding" on all of the company's creditors or all of the members of the relevant class of creditors.[110]

The section 155 Compromise is therefore still heavily reliant on creditor involvement despite this procedure being primarily debtor driven. It also has certain drawbacks making the process one that is rarely used. The Compromise does not afford the debtor company or other stakeholders with the same protection, for example a moratorium against claims and proceedings against the company, as the Business Rescue Procedure does. The procedure could therefore be improved upon by incorporating some form of moratorium or stay (as is afforded under Business Rescue). It could also be an expensive procedure if the debtor has to apply to court for an order sanctioning the proposal.

Conclusion

In the United Kingdom, the first step towards the establishment of a corporate rescue culture was made following the Cork Committee's proposals by means of reforms, which led to the enactment of the Insolvency Act 1986. In addition, the Enterprise Act 2002 introduced revolutionary changes to the existing restructuring regime of the United Kingdom and importantly promoted a "second-chance culture" in a traditionally regarded "creditor-friendly" jurisdiction. Finally, it has been argued that the United Kingdom's current insolvency laws, in particular its restructuring and business rescue regime, are performing well in comparison with their international peers.

On the other hand, corporate rescue in South Africa still has a long way to go in creating a rescue system that is truly reflective of a robust rescue culture. This is despite the fact that public opinion suggests support for the Chapter 6 provisions, which are even regarded as employment-preservation mechanisms. The buy-in of the larger creditors continues to be of paramount importance in moving towards the "second chance culture" that already exists in the United Kingdom. South

108 Section 155(7)(a), Companies Act 71 of 2008.

109 Klopper and Bradstreet, above note 61, at 553-554.

110 Section 155(8)(c), Companies Act 71 of 2008.

Africa has taken remarkable strides in transforming its corporate rescue sphere and the progress that it has made is laudable.

In conclusion, it could be argued that although key differences exist between the two jurisdictions, South Africa, albeit still in its toddler steps in establishing an effective corporate rescue, could benefit from keeping a close eye on the UK corporate rescue procedures and even consider whether it would be appropriate to incorporate similar procedures in its rescue regime.

Chapter 8

Groups of Companies and the "Recast" European Insolvency Regulation

Gerard McCormack

Introduction

In its Europe 2020 strategy, the European Union refers to fostering economic recovery and sustainable growth.[1] The objective is to create a situation with economic and social systems that are adaptable, resilient and fair; with sustainable economic activity and respect for human values. The 2020 strategy involves a European Commission Recommendation (and possible Directive) on a new approach to business failure and insolvency[2] and also possible new harmonisation measures on the qualifications and conduct of insolvency practitioners and the avoidance of transactions that are antecedent to insolvency proceedings.[3] An important part also involves recasting the Insolvency Regulation.[4]

The Recast Regulation was formally adopted by the European Parliament on 20 May 2015 and was published in the Official Journal on 5 June 2015[5] with most of its provisions coming into force on 26 June 2017.[6] The President of the European Council has said:

1 See *Europe 2020 – A European Strategy for Smart, Sustainable and Inclusive Growth* (2010).

2 See Commission Recommendation of 12 March 2014 – C(2014) 1500 final; Commission Communication *A New European Approach to Business Failure and Insolvency* COM (2012) 742.

3 See generally the European Parliament report *Harmonisation of Insolvency Law at EU Level*, available at: http://www.europarl.europa.eu/meetdocs/2009_2014/documents/empl/dv/empl_study_insolvencyproceedings_/empl_study_insolvencyproceedings_en.pdf/.

4 See Press Release, *New Rules to Promote Economic Recovery* (4 December 2014), available at: www.consilium.europa.eu/uedocs/NewsWord/en/jha/146041.doc/. For the original European Commission recommendations for reform of the Regulation, see *Proposal for a new Regulation* COM (2012) 744; *Report from the Commission on the application of Council Regulation (EC) No 1346/2000* COM (2012) 743; Hess–Oberhammer–Pfeiffer External Evaluation of the Regulation commissioned by the European Commission – see JUST/2011/JCIV/PR/0049/A4.

5 Regulation (EU) 2015/848 of 5 June 2015 (OJ L 141) ("Recast Regulation").

6 Articles 84 and 92, Recast Regulation.

> "The new legislation, through the protection of creditors and the survival of business, will contribute to the preservation of employment in these challenging times."[7]

The recast does not alter the structure of the original Regulation though it does create a new set of provisions dealing with the co-ordination of insolvency proceedings affecting members of a group of companies. These set of provisions form the main focus of this chapter. First however, it will say something about the general philosophy and structure of the original Regulation which is preserved largely intact in the Recast.

General Philosophy and Structure

The Insolvency Regulation establishes uniform rules on jurisdiction and choice of law and gives the country where a debtor has its "centre of main interests", or "COMI", the exclusive authority to open main insolvency proceedings.[8] The decision to open such proceedings must be given immediate, full and unqualified recognition throughout the EU.[9] If a debtor has an "establishment" within a particular EU State, that State may open secondary insolvency proceedings in respect of the debtor.[10] The effect of these secondary proceedings is however, limited to assets within the State.

The general rule established by the Regulation is that the law of the "opening" State governs the conduct and effect of the insolvency proceedings. The law applicable to the insolvency proceedings is, in general, the law of the State where the proceedings are opened, irrespective of whether these insolvency proceedings are main or secondary proceedings.[11] Article 4 sets out a number of matters which are specifically referred to the law governing the opening of the proceedings. These matters cover both substantive and procedural issues and include the assets which form part of the estate; the powers of the liquidator; rules governing the lodging, verification and admission of claims; and the priority ranking of creditors. There

7 Press Release, above note 4.

8 Article 3(1). On COMI, see the decisions of the European Court in *Re Eurofood IFSC Ltd* C-341/04 [2006] ECR I-03813; *Interedil* Case C-396/09 ECLI:EU:C:2011:671; *Mediasucre* Case C-191/10 OJ 2012 C39/3 cases.

9 Articles 16, 17 and 25, Regulation (original text); Articles 19, 20 and 32, Recast Regulation.

10 Article 3(2), Regulation. In the *Interedil* case, the European court suggested that the term "establishment" had to be interpreted "as requiring the presence of a structure consisting of a minimum level of organisation and a degree of stability necessary for the purpose of pursuing an economic activity." See also *Re Olympic Airlines Ltd* [2015] UKSC 27.

11 For a detailed analysis of the Recast Regulation on which this chapter draws heavily, see G. McCormack, "Something old, something new – recasting the European Insolvency Regulation" (2016) 79 *Modern Law Review* 121; L. Carballo Pineiro, "Towards the Reform of the European Insolvency Regulation: Codification rather than Modification" (2014) 2 *Nederland Internationaal Privaatrecht* 207.

are however, a whole host of exceptions to the Article 4 general rule and these are enumerated in Articles 5-15. The Recast Regulation keeps the same basic framework effecting a number of changes by way of clarification, but retaining the fundamental structure. For some commentators this is a missed opportunity.[12]

The generally accepted view sees the European Insolvency Regulation as embracing a policy of "modified" universalism.[13] The universalist approach suggests that there should be a single insolvency proceeding in respect of a debtor and this proceeding should apply to all the debtor's assets on a worldwide basis and affecting the totality of the debtor's legal relationships.[14] Insofar as the Regulation embodies a universalist approach, this is tempered by the fact that secondary insolvency proceedings may be opened in respect of a debtor. These secondary proceedings are not simply mechanisms for the more convenient collection of assets and their remission to the liquidator in the principal proceedings. The secondary proceedings have their own law applying to them with independent distributional consequences.

The rival philosophy to "universalism" is "territorialism" and this suggests that separate insolvency proceedings may be opened wherever a debtor has assets and that, in general, "local" assets should be earmarked for "local" creditors.[15] While Article 4 of the Regulation can be characterised in a universalist light, the breadth of the exceptions reflected in Articles 5-15 detract from this light. In the Recast Regulation, Articles 7-18 mirror, while not exactly replicating, Articles 4-15. Article 7 in the recast mirrors Article 4 in the original.

In terms of scope, the original Regulation was limited to collective insolvency proceedings involving the partial or total disinvestment of the debtor and the appointment of a liquidator (Article 1). The language of the recast is much

12 See M. Veder, "The Future of the European Insolvency Regulation – Applicable Law, in particular Security Rights" (2011) 3 *International Insolvency Law Review* 289; J. Marshall, "The Future of the European Insolvency Regulation – Rights in rem" (2011) 3 *International Insolvency Law Review* 268.

13 See generally on the concept of "modified universalism", the decision of the UK Privy Council in *Cambridge Gas Transport Corporation v Official Committee of Unsecured Creditors (of Navigator Holdings Plc)* [2007] 1 AC 508 and the UK Supreme Court in *Re HIH Casualty and General Insurance Ltd* [2008] 1 WLR 852; G. McCormack, "Universalism in Insolvency Proceedings and the Common Law" (2012) 32 *Oxford Journal of Legal Studies* 325.

14 As the US court remarked in *In re Board of Directors of Multicanal SA* (2004) 314 BR 486, at 521, the centralisation of insolvency proceedings "will frequently provide the optimal result for a debtor and its creditors alike by preventing certain creditors from gaining an advantage over others by virtue of differing judicial systems. A single primary proceeding also minimizes the time, expense and administrative burdens of managing full cases in multiple jurisdictions."

15 For a defence of provisions that ring-fence assets for the benefit of "local" creditors, see the paper by the Singapore Chief Justice S-K. Chan, "Cross-Border Insolvency Issues affecting Singapore" (2011) 23 *Singapore Academy of Law Journal* 413, at 419.

broader. Article 1 of the Recast Regulation states that it applies to public collective proceedings, which are based on a law relating to insolvency, and in which for the purpose of rescue, adjustment of debt, reorganisation or liquidation:

(a) the debtor is totally or partially divested of its assets with an IP appointed;

(b) the debtor's assets and affairs are subject to control or supervision by a court; or

(c) there is a stay of individual enforcement proceedings against the debtor.

If proceedings are commenced where there is only a likelihood of insolvency, their purpose has to be to avoid the debtor's insolvency or the cessation of its business activities. Notwithstanding, the broad qualifying language however, the Regulation still only applies to those insolvency proceedings listed in its Annex A and it is up to individual Member States to decide which proceedings should be listed. The UK scheme of arrangement is clearly not subject to the Regulation because it is not listed in Annex A.

In the original Regulation, liquidation was considered to be the paradigmatic insolvency procedure. Secondary proceedings commenced after main insolvency proceedings had been opened, could only be liquidation proceedings and secondary proceedings initiated before main insolvency proceedings had been opened had to be converted into liquidation proceedings at the request of the liquidator in the main proceedings.[16] Now under the Recast Regulation, there is no requirement that secondary proceedings should be liquidation proceedings. The original Regulation referred to the person who took control of a debtor's affairs after main insolvency proceedings had been opened as a liquidator even though that person might have the task of preparing a restructuring plan. On the other hand, the Recast Regulation opts for more neutral terminology and uses the expression insolvency practitioner ("IP") throughout rather than liquidator.[17]

16 See Articles 3(3), 3(4) and 37, Regulation.

17 Article 2(5), Recast Regulation defines an "insolvency practitioner" ("IP") as meaning "any person or body whose function …, is to: (i) verify and admit claims submitted in insolvency proceedings; (ii) represent the collective interest of the creditors; (iii) administer, either in full or in part, assets of which the debtor has been divested; (iv) liquidate the assets referred to in point (iii); or (v) supervise the administration of the debtor's affairs." These persons or bodies are listed in Annex B of the Recast Regulation.

Groups of Companies

In the original Regulation, the focus was much very on the particular individual company and not on its possible status as a member of a group of companies.[18] In one sense, this focus was understandable for the Regulation is more a conflict-of-laws instrument than a substantive law instrument. Provisions, for example, for the pooling of assets of related companies would trench on the fundamental principle of substantive company law, reaffirmed by the UK Supreme Court,[19] that a company is a legal entity, separate and distinct from its controlling shareholders.[20] Nevertheless, the Regulation might have contained procedurally oriented provisions enabling the same IP to be appointed to different companies within the same corporate group and for proceedings involving related group companies to be administered from the same State.

The jurisprudence from the European court has also been generally unsympathetic to the notion of procedural consolidation of insolvency proceedings. In the *Eurofood* case,[21] it was held that:

> "where a company carries on its business in the territory of the Member State where its registered office is situated, the mere fact that its economic choices are or can be controlled by a parent company in another Member State is not enough to rebut the presumption laid down by the Regulation."

In other words, the presumption applied that the COMI was the place of the registered office of the subsidiary. Moreover, in *Mediasucre*,[22] the court rejected the proposition that a single COMI could automatically be inferred from the intermixing of the property of two related companies. The court said that this could be organised from two management and supervision centres in two different Member States.

The case law in some EU States has however embraced the concept of procedural consolidation more warmly. A French Court has said that:

18 See generally I. Mevorach, "The 'Home Country' of a Multinational Enterprise Group Facing Insolvency" (2008) 57 *International and Comparative Law Quarterly* 427; "Centralising Insolvencies of Pan-European Corporate Groups: a Creditor's Dream or Nightmare?" [2006] *Journal of Business Law* 468.

19 *Prest v Petrodel Resources Ltd* [2012] 2 AC 415; *VTB Capital plc v Nutritek International Corp* [2013] 2 AC 237.

20 See however, *Re BCCI (No 2)* [1992] BCC 715, where it was held that pursuant to section 167, Insolvency Act 1986, the court could approve a "pooling" agreement if the assets of insolvent companies were so confused that it was impossible to define the assets of each company.

21 Case C-341/04 [2006] ECR 1-03813.

22 Case C-191/10 [2012] All ER (EC) 239.

> "the analysis of the case law of the various Member States shows that courts adopt a pragmatic approach tending to allow streamlining of strongly integrated groups of companies."[23]

In cases like *Re Daisytek-ISA Ltd*,[24] this approach was effectively adopted in the UK with the court holding that all the members of a group of companies had a common UK COMI despite the fact that the companies had been incorporated in different countries.

The Recast Regulation does not preclude the possibility of procedural consolidation in appropriate cases. The European Commission in its initial proposals reaffirms:

> "the existing practice in relation to highly integrated groups of companies to determine that the centre of main interests of all members of the group is located in one and the same place and, consequently, to open proceedings only in a single jurisdiction."[25]

The main thrust however, of the Recast Regulation in relation to groups is to extend the principles of cooperation that apply in the context of main and secondary proceedings to insolvency proceedings that involve different companies within the same group. IPs and courts are obliged to cooperate and the cooperation may take different forms depending on the circumstances of the case. IPs should exchange relevant information and cooperation by way of protocols is explicitly mentioned.[26] This reference acknowledges the practical importance of these instruments as well as further promotes their use. Courts can cooperate by the exchange of information; by coordinating the administration and supervision of the assets and affairs of the group companies as well as coordinating the conduct of hearings and the approval of protocols.[27]

The Recast gives an IP standing in relation to insolvency proceedings affecting another member of the same group with rights to be heard and to request a stay provided that a restructuring plan for some or all of the insolvent group members has been proposed and presents a reasonable chance of success.[28] In the original Commission proposals, it was suggested that the IP with the biggest interest in a successful group restructuring could submit a coordinated restructuring plan even

23 *Re MPOTEC Gmbh* [2006] BCC 681, at 687.

24 [2003] BCC 562.

25 See explanatory memorandum attached to the Commission proposals COM (2012) 744 final, at paragraph 3.1.5.

26 Articles 41(1) (main and secondary proceedings) and Article 56(1) (groups), Recast Regulation.

27 Ibid., Article 57. Co-operation however, must be appropriate to facilitate the effective administration of the proceedings; not be incompatible with the rules applicable to the respective courts nor entail any conflict of interest.

28 Ibid., Article 60(1).

if the plan did not meet with the approval of the IPs of other group members.[29] But this gave rise to the possibility of procedural chaos with different IPs putting forward different restructuring plans. This possibility appears to have eliminated in the text that finally emerged. It is provided that IPs:

> "should consider whether possibilities exist for restructuring group members which are subject to insolvency proceedings and, if so, coordinate with regard to the proposal and negotiation of a coordinated restructuring plan."[30]

Nevertheless, working relationships between IPs will have to be good to ensure that the potentially valuable procedural tools provided by the Recast do not become instruments for conflict and increased transaction costs.

The same hope and prayer extends with added force to the second aspect of the provisions for groups of companies.[31] These provisions were added to the original Commission proposals by the European Parliament[32] and involve the possibility of opening group co-ordination proceedings that would sit alongside the separate insolvency proceedings opened in respect of individual companies within the group. The co-ordination proceedings would allow for the appointment of a co-ordinator who would partially act as a sort of "super-mediator" between the different IPs.[33] The coordinator also has the task of proposing:

> "a group coordination plan that identifies, describes and recommends a comprehensive set of measures appropriate to an integrated approach"

to resolving the insolvency of group members. The plan may contain proposals for the settlement of intra-group disputes or, more ambitiously, to re-establish the economic performance and financial soundness of the group or any part of it.[34]

The amicable settlement of intra-group disputes and disputes between IPs is undoubtedly beneficial and so too is restoring the financial soundness of a group of companies but it is questionable whether the new provisions will contribute in particular to the achievement of the latter end. They may in fact lead to further costs and delay.

29 COM (2012) 744 final, at paragraph 3.1.5.

30 Article 56(2(c), Recast Regulation.

31 Ibid., Chapter V Section 2.

32 See the Report from the European Parliament's Committee on Legal Affairs on the proposed new Regulation (A7-0481/2013, 20.12.2013 – the "Lehne 2 report"), at 39-43 and 47-48.

33 Article 72(2)(b), Recast Regulation.

34 Ibid., Article 72(1)(b)(ii).

Firstly, group co-ordination proceedings may be commenced in any State that is administering an insolvency in respect of a group member but where there are different co-ordination proceedings instituted in different States, other courts are required to decline jurisdiction in favour of the courts of the State that is first seised of the matter.[35] This rule is however subject to Article 66 which allows for an agreement between at least two-thirds of IPs conferring exclusive jurisdiction on a particular court. Such exclusive jurisdiction agreements must be recognised and enforced.

Secondly, the IPs of individual companies within the group are not obliged to join the group proceedings. They may simply opt-out at the commencement stage.[36] Thirdly, the group co-ordination plan is not binding on individual IPs, even on those who had opted-in, though the latter have a duty to consider the plan recommendations and to explain deviations from the plan to the coordinator.[37] Fourthly, to ensure proper implementation of the plan, there is a stay for up to 6 months on separate insolvency proceedings affecting a group member[38] and it has been suggested this this stay may act as a real deterrent for supporting any group restructuring proposal:

> "Individual group companies could choose not to opt in, simply to avoid the stay applying, as the stay is expressed not to apply to those companies who have not agreed to support the group coordination proceedings." [39]

Finally, the costs regime in respect of group coordination proceedings may give rise to difficulties. These costs are to be met by participating companies but are only to be paid for at the end of the proceedings.[40] This leads to the possibility that individual companies or IPs may dispute or delay payment when they have effectively opted out of the coordination proceedings after having opted in at the commencement stage.

Group coordination proceedings are laudable in intention.[41] Nobody is obliged to participate and a would-be participant can even effectively opt out at a later stage. Moreover, before opening such proceedings a court needs to be satisfied that

35 Ibid., Articles 61(1) and 62.

36 Ibid., Articles 64 and 65.

37 Ibid., Article 70.

38 Ibid., Article 72(2)(e).

39 See Clifford Chance briefing note, *Final Text for the Amended EU Regulation on Insolvency Proceedings* (December 2014) ,at 3.

40 On costs see Article 77, Recast Regulation.

41 For discussion of the cross-border insolvency of multinational enterprise groups at UNCITRAL level, see the Working Paper A/CN.9/WG.V/WP.128, available at: www.uncitral.org/.

the proceedings are appropriate and that none of the creditors of the participating companies are financially disadvantaged. The voluntary nature of the regime however may mean however that they are unlikely to be much used in practice but they may have a use in the "big ticket" cases where there is a high degree of coordination among IPs at the outset.

Conclusion

The European Commission has said that:

> "Europe is facing a severe economic and social crisis, the European Union is taking action to promote economic recovery, boost investment and safeguard employment. It is a high political priority to take measures to create sustainable growth and prosperity."[42]

The Commission has also highlighted the importance of insolvency rules in supporting economic activity and recasting the Insolvency Regulation is part of a multi-pronged strategy in this regard. The Recast Regulation, or at least the rhetoric surrounding it, puts the emphasis very much on business restructuring rather than on liquidation but the Recast is not unduly presciptive. It extends recognition to a greater range of "pre-insolvency" procedures promoting the rescue of economically viable but distressed businesses but ultimately it is up to individual Member states to decide what should be included. There is no scope for second guessing the decision of individual States about what to include; either by the Commission or by other States.

The Recast Regulation retains the same basic structure as the original including the concepts of main and secondary insolvency proceedings with the secondary proceedings applying to local assets and qualifying the universality of the main proceedings. The Recast makes a number of changes to improve the practical operation of the Regulation and the coordination between main and secondary proceedings. A significant innovation is the new mechanism for coordination proceedings involving members of a group of companies. Nevertheless, individual members within a group of companies are not obliged to take part in the coordination proceedings and may opt out subsequently if the proposals emanating from the group coordinator are not to their liking. In the circumstances, it is questionable whether the new mechanism will be widely used in practice though it may have a role, for instance, in high value, high profile cases.

42 Communication, *A new European approach to business failure and insolvency* COM (2012) 742, at 2 citing President Barroso's letter to EP President in the framework of the State of Union address on 12 September 2012.

Chapter 9

Corporate Restructuring: The European Recommendation and the Spanish Model

Juana Pulgar Ezquerra

I. The Evolution of European Law towards Distressed Corporate Restructuring

For some time now, and to a large extent in relation to the widespread economic crisis suffered by European and North American markets since 2007, we have been witnessing a paradigm change in the continental European framework as regards the handling of corporate economic crises. A progressive move towards the model of the Anglo-American countries is occurring, particularly towards Chapter 11 of the United States Bankruptcy Code, which has traditionally revolved around two basic ideas with effective practical results: firstly, restructuring as opposed to company liquidation, and secondly, fresh start mechanisms based on the North American concept of a second chance, which enables individual "honest" debtors to be relieved of unsettled liabilities within the framework of insolvency proceedings.[1]

That is probably why these are precisely the two concepts the Recommendation of the European Commission of 12 March 2014 and the European Insolvency Regulation ("EIR")[2] regarding a new approach to insolvency and company failure is based on, which could constitute a first step towards the construction of

1 Until now and although the position may change as a result of the European Commission's initiatives, insolvency law and policy within the EU remains fundamentally a matter for each state. As a result, insolvency proceedings that are entirely domestic are governed purely by national law. EU law is engaged only in cases with a cross-border element.

2 Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015, available at: http://eur-lex.europa.eu/legal-content/DE/TXT/?uri-OJ%3AJOL_2015_141_R_0002.

harmonized European Law in the area of restructuring companies,[3] and to which, for the above-mentioned purpose, the member countries "should" adapt (soft law).[4]

When focussing on the regulation of business restructuring mechanisms, a progressive move can be observed from traditional Insolvency Law, where the priority is the creditor settlement, to restructuring Law for companies in crisis. As well as looking out for the interests of the creditors as regards settling their claims, this framework aims to protect other "interested parties" traditionally described as stakeholders (workers, investors), which is in some ways connected to the framework for corporate social liability, particularly in the case of large companies. In this framework corporate governance and restructuring are intertwined, since one of the key elements for successful restructuring is an effective policy framework that balances the interests of all stakeholders including shareholders, debtors, creditors, clients, workers and the government.

However, the idea of restructuring companies in crisis is not completely new in continental European regulation, since it has evolved from the generic idea of company conservation in large companies in crisis present in European reforms of the 1980s (French prevention from 1984, German co-management…) towards restructuring, which despite being most suited to application in large companies, can also be applied to small and medium sized enterprises.[5]

A distinction must be made between business conservation and restructuring although restructuring generally involves conservation, in a genus (conservation)/species (restructuring) relationship. Indeed, in a first instance to conserve means not to liquidate, where the conservation, considered in isolation, does not involve a selective judgement of the companies that have to be conserved. This led to the traditional debate last century on economic judgements about conserving or liquidating distressed companies (illiquidity versus insolvency). However, this selective judgement is conceptually resolved in "business restructuring", because only viable companies from a structural and operational viewpoint can be restructured, despite the existence of financial difficulties (high indebtedness, and financial leveraging).

3 See: http://ec.europa.eu/justice/civil/commercial/insolvency/index_eu.htm. See also The Summary of Restructuring Insolvency Reforms in World Bank, "Business Reforms for Resolving Insolvency" 2014, available at: http://www.doingbusiness.org/reforms/overview/topic/resolving-insolvency.

4 See Cork Committee, *Report of the Review Committee on Insolvency Law and Practice* (1982); London Approach to the Resolution of Financial Distress; INSOL International Statement of Principles for a Global Approach to Multi-Creditor Workouts (October 2000). See J. Armour and S. Deakin, "Norms in Private Insolvency Procedures: The London Approach to the Resolution of Financial Distress" (2001) 1 *Journal of Corporate Law Studies* 21.

5 See J. Pulgar Ezquerra, *La reforma del Derecho Concursal español y comparado* (1999, Civitas, Madrid).

Nevertheless, it must be pointed out that viability cannot always be identified with an absence of insolvency. A company could well be insolvent and not be in a position to meet its obligations, but could recover this capacity if it were to reduce its financial expenditure, which could be achieved by means of a viability plan which, subsequent to a "standstill" agreement, would firstly, involve the **restructuring of the debt** (relaxing credit and/or deadline conditions), in addition to a disinvestment plan for activities that are not part of the "core" business, or are, and require costly maintenance. And secondly, would involve the financing of essential liquidity for business activity, and lastly, a reduction in company costs.[6]

In short, restructuring companies in distress may involve splitting a company, mergers, acquisitions or the reorganization of businesses within a company, but taking advantage of the goodwill, the intangible value of the company (the French *fond du commerce* or Italian *avviamento*) and above all, adapting the business organization to company needs, which change in the event of economic difficulties because of company transformations, mergers, splits, segregations or debt-to-equity swaps, all while ensuring jobs are maintained. That is why organisations must restructure with an appropriate governance plan in place to meet the challenges and benefit from the opportunities presented by an ever-changing environment. This once again demonstrates that corporate governance and restructuring are intertwined in this framework. Improving governance is viewed as one of the most important elements of a restructuring plan.

Even if they could be inserted into the framework of judicial insolvency proceedings (a good example of this is the 2011 German reform of the InsO, by virtue of the *Gesetzes Zur Weiteren Erleichterung Der Sanierung Von Unternehmen* or "ESUG"). These business restructuring processes are more effective if they are tackled at an early stage and extra-judicially by means of restructuring workouts between debtors and creditors given autonomy of will to prevent the costs in terms of time, money and reputations involved in judicial insolvency proceedings, as expressed in the above-mentioned European Recommendation of 12 March 2014. In fact, the fear of failure and the stigma attached to insolvency may tend to hinder entrepreneurs and also corporations entering into new businesses and markets, as they may see the financial and social costs of failure as outweighing the benefits of success.

An analysis will be made below of the factors leading to the success of "restructuring workouts".

6 See J. Pulgar Ezquerra, *Preconcursalidad y reestructuración de empresas* (2nd ed) (2016, La Ley, Madrid).

II. Key Factors in "Restructuring Workouts"

Restructuring is a long process requiring an appropriate governance plan in place on the one hand, and a supportive legal, regulatory and accounting environment, necessary for successful corporate restructuring, on the other. The success of any new restructuring regime will depend above all on the drafting of suitable laws and reforms, and also on the institutional and professional capacity to implement the legislation. In this framework:

- "Restructuring workouts" cannot be achieved if general categories of Private Law in the framework of the Law of Obligations and Contracts cannot be 'relaxed' or 'overcome', in which obligations that are subsequently not met or could be breached originate, making restructuring necessary; where this enables a renegotiation of the conditions initially outlined in the contract (overcoming unanimity to achieve workouts and superseding the principle of privity of contracts).

- "Restructuring workouts" cannot be achieved if measures affecting the nature of the company are not adopted (company transformations, mergers, splits, debt-to-equity swaps), where it is necessary to configure a new framework for Insolvency Law/Company Law relations. This on occasions gives rise to or reopens debates on the framework of corporate governance as regards the function of the share capital, as well as the traditional sovereign role of the general meeting and the framework for shareholder-company relations, particularly the extent to which shareholders have to be involved in solving the economic problems of the company, and in this framework, on their potential duty of loyalty to the company, and limits to the distribution of profits to shareholders and the protection of creditors.

- It is necessary to introduce rules for the resolution of potential conflicts that could arise between minority and majority shareholders, and between the creditors, in order to resolve economic difficulties, in the framework of what has become known in economic terminology as "agency problems" between "corporate insiders" such as controlling shareholders and top managers, and 'outsiders' such as minority shareholders or creditors.[7] In this Framework it is important to ensure that all major stakeholders in the restructuring process feel engaged. It is even necessary to involve creditors holding *in rem* securities in the restructuring process, either voluntarily or through legal mechanisms

7 See J. Armour *et al.*, "Agency Problems and Legal Strategies" in R Kraakman *et al.* (eds),"The Anatomy of Corporate Law: A Comparative and Functional Approach" (2nd ed) (2009, OUP, Oxford), at 35-53; J. Armour *et al.*, "Transactions with Creditors" in Kraakman *et al*. (eds), idem, at 115-151.

to limit the potential of their privileged position enabling them to prevent restructuring, which could ensure the company and jobs are saved.

1. Superseding Traditional Categories in Private Law: Majorities, Relativity of Contracts and Potential Majority/Minority Abuses

In order to promote "restructuring workouts", traditional requirements of unanimity, typical of extrajudicial agreements, must be superseded by majority rules, where the contents of the agreement can also be extended to dissident or non-participating creditors ("cramdown"). This may at first appear questionable given the contractual nature of the "workouts", despite French doctrine accepting the introduction of majority rules in contracts some time ago.[8] However, it entails a need to supersede the principle of privity of contracts.

Privity of contract (*pacta sunt servanda*) is a fundamental principle in the general theory of obligations and contracts, it means that contracts bind only the parties to them (*res inter alios acta*) and not third parties. They neither benefit nor prejudice third parties (*nec prodest nec nocet*). This makes it very difficult to overcome a key problem when negotiating a consensual solution to the debtor's economic crisis, namely hold-out strategies, whereby certain creditors do not participate in the negotiations, in some instances due to disagreement as to how the value of the assets can be maximised, either through insolvency proceedings or a consensual negotiation, or even instances where a dissenting creditor tries to use their leverage to obtain an advantage.[9]

The problem of holdouts results from the information asymmetries that characterise consensual negotiations, where creditors who do not have access to enough information are unable to clearly assess whether the debtor's offer is the best outcome, in terms of their own interests. This asymmetry is minimised in insolvency proceedings through the disclosure duties imposed on the parties ("fish bowl effect"). In circumstances where blocking by minority creditors amounts to an abuse and an antisocial use of law against good faith, legal sanctions exist under the various legal systems penalising such abuses (e.g. in Spanish law ex Article 7 of the Spanish Civil Code, indemnification or damages, adoption of precautionary measures to curtail such abuses). However, invoking these remedies requires the debtor or another party to satisfy the court that the conduct is in fact abusive, resulting in delay, costs and uncertainty.

8 See E-E. Thaller, *Des faillites en droit comparé* (1887, A. Rousseau, Paris).

9 See ROE, MJ (2996).

This shows why it is more effective to introduce a legal exception to the application of the principle of privity of contract. In this regard, legal systems in for example, the United Kingdom, Italy and Spain, have promoted consensual solutions to insolvency by acknowledging the right of the majority to modify contracts.[10] Thus, if a workout has been reached between the debtor and a specified percentage of the creditors, the agreement will take effect and be binding for the creditors not in agreement, and this even affects secured creditors in some jurisdictions (e.g. schemes of arrangement in the United Kingdom).

Overcoming the principle of privity of contract requires, on one hand, sufficient notice to be provided in relation to all agreements so the non-participating or dissenting parties in the negotiations can challenge the agreement by means of the appropriate procedures. On the other hand, it is necessary to be able to neutralize potential creditor majority abuses against the dissenting or non-participating minority, by enabling those the agreement is imposed upon to contest it as a means of defence.

2. Moratorium and Automatic Stay of Execution

In order to achieve "restructuring workouts", it is necessary to stop or suspend the initiation of execution, including *in rem* securities, against the assets of the debtor, at least as regards those required to continue business activities, during the negotiation of the agreement and during execution. The reason is to prevent debtors from liquidating their assets individually. To this end, the "standstill" negotiated between those involved in the agreement is not enough, since it only binds and obliges those involved, when it is necessary to employ a "legal automatic stay" during the negotiation and execution of the "restructuring workout", which does not depend on the will of the creditors.

3. A New Framework for the Relationship between Insolvency Law and Company Law

<u>3.1 Promoting Business Restructuring Measures in Pre-Insolvency and Insolvency Proceedings</u>

A company in economic distress cannot be restructured if company restructuring measures are not undertaken (transformation, merger… capital increase and/or decrease, debt-to-equity swaps). The starting point has traditionally entailed a

10 I have discussed these topics previously in J. Pulgar Ezquerra, "A Contractual Approach to Over-Indebtedness: *rebus sic stantibus* instead of Bankruptcy" in L. Nogler and U. Reifner (eds), *Life Time Contracts: Social Long-Term Contracts in Labour, Tenancy and Consumer Credit Law* (2014, Eleven International Publishing, The Hague), at 531-550.

radical separation of insolvency law and company law. Therefore, on the one hand, company measures were taken by the shareholders at general meetings, which on occasions led to potential conflicts of interest between majority shareholders, who were able to reach restructuring agreements at general meetings, and minority shareholders, whose goal could be to maximise their investment in the company. This made majority and minority abuses possible. On the other hand, Insolvency Law was traditionally restricted to the exclusive adoption of liability plans, devised to satisfy the creditors (discounts, moratoriums on settling claims).

New approaches to restructuring law for companies in distress are more company oriented, with the exception of classical paradigms of Company Law, which on the one hand, have an effect on the sovereign will of general meetings to adopt restructuring agreements, where questions are sometimes raised as to whether the management capacity of the company really should remain in the hands of this body or be transferred to the administrative body, and on the other hand affect a new framework of duties and liabilities of the company directors *vis-à-vis* the creditors. In this context, in some of the latest European reforms, the possibility of "promoting" or sometimes "forcing" the adoption of company restructuring measures has been introduced in the framework for "restructuring workouts" or "insolvency proceedings", where non-compliance is "penalized" by excluding the shareholder from the company.

In my opinion, the paradigmatic example in this area is constituted by German Law, in the latest reform of the InsO in 2011, by virtue of the ESUG, in which, first shareholders are legally prohibited from obstructing the restructuring (Article 245 of the InsO), and second in certain legal conditions the will of the shareholders at a general meeting is replaced by a judicial decision to agree on a company restructuring measure, albeit in a framework for insolvency proceedings.

3.2 The Introduction of Solvency Rules as a Limit to the Distribution of Profits

Moreover, there is one area above all others which can have a decisive impact on the possibility of successfully achieving restructuring workouts, in which conflicts of interest between shareholder majorities and minorities may arise, as well as between the right of creditors to settle their claims and the right of shareholders to participate in company profits. This area is the distribution of company profits and company revenue in the broadest sense (dividends and other similar operations, such as the purchase of own shares, financial assistance).

The interests of majority shareholders in restructuring the company, manifest in a decision to not distribute profits and to voluntarily provide reserves to ensure the solvency of the company, may therefore contrast with the interests of minority shareholders who are likely to pursue their slice of earnings, as a consequence of not feeling "involved" in the restructuring.[11] A distribution of profits may give rise to the decapitalization of the own funds of the company to the detriment of the creditors, and could make the company insolvent in the widest sense of illiquidity, or asset imbalance, thereby thwarting the possibilities of restructuring to the detriment of the creditors, along with illiquidity (cash-flow test) and imbalance (balance sheet test).

The right of shareholders to participate in the profits of the exploitation of the corporate purpose, can on occasions contrast with the right of creditors to settle their claims. In this framework, the question one must ask is: Should the interests of creditors in settling their claims be taken into consideration in an area such as the distribution of profits, which is connected to the right of shareholders to participate in company earnings, in light of the fact that the above-mentioned distribution could impact on the solvency of the company?

The move towards law for restructuring distressed companies has therefore reopened the debate on the rules for and limits on the distribution of profits among shareholders in the widest sense in companies. This is to a large extent linked to the questioning of the functions traditionally assigned to share capital, in international forums such as the Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe (2002) ("de Winter Report"), from the viewpoint of protecting creditors in terms of the figures for liabilities on the balance sheet of the company and the "principle of minimum correspondence" with the contributions of the shareholders, around which European Union directives in the field of Company Law are structured, particularly the Second Directive (consolidated text of EU Directive 2012/30 of the European Parliament and Council of 25 October 2012).

A contrast can therefore made between "**systems governed by capital principles**", which have been traditional in continental Europe (Germany, Spain), and aim to prevent the distribution of profits from eating away at the capital, by placing limits on the distribution of this capital, essentially by taking into account the current economic situation of the company, and the traditional Anglo-American systems based on "solvency rules" or "solvency tests", in which the economic situation of the company is not only considered at the present moment in time but also in the future, with a more efficient protection of the creditors, so the solvency of the

11 See B. Cheffins, "Dividends as a Substitute for Corporate Law: The Separation of Ownership and Control in the United Kingdom" (2006) 63 *Washington and Lee Law Review* 1273.

company is adopted as the limit on company distributions, where distributions cannot be made that place the company at risk of insolvency in the broadest sense at the present moment in time or in the near future, and therefore, not only identified as a potential imbalance (liabilities lower than assets), but also with illiquidity that prevents the company meeting its obligations on maturity.[12]

To be effective, these criteria for and limits on the distribution of dividends must be combined with a framework for the duties and liabilities of the company directors, not only *vis-à-vis* the shareholders, but also as regards the creditors, in which the latter take on the liability of the oversight of liquidity as an essential element in the execution of the distribution, as will be analysed below. This does not necessarily involve changes made to the distribution of company powers, between the general meeting and the company directors in for example the Spanish model; the general meeting remains the highest body of the company with decision-making power and charged with the management and representation of the company before the company directors, but rather that company directors just have to take on liability for the oversight of insolvency.

This is precisely the model employed in the European Union directive proposal on European single-member companies (*Societas Unius Personae* or "SUP") of 9 April 2014, which includes the "solvency test" and the corresponding liability regime for company directors as regards distributions made in situations of insolvency, or which may lead to insolvency.

3.3 The Appropriateness of Regulating a Framework for the Liability of Company Directors *vis-à-vis* the Creditors

Directors of companies in financial distress need to understand their duties in the corporate decision making process and how this may change. Directors must also know the extent of oversight they need to maintain over the management in such situations. The company therefore needs to review its existing corporate governance frameworks and practices. Traditionally, in the framework of North American and European Comparative Law, two models can be distinguished for defining the duties of the directors of companies in a present or imminent situation of company insolvency, and for the resulting framework for directors' liability in situations of business crisis.

12 B. Pellens and T. Sellhorn, "Improving Creditor Protection through IFRS Reporting and Solvency Tests" in M. Lutter (ed), *Legal Capital in Europe* (2006, De Gruyter, Berlin); B. Manning, *A Concise Textbook on Legal Capital* (2nd ed) (1981, Foundation Press, New York).

Firstly, the Anglo-American model, which sets up a trustee framework for the duties of company directors relative to the creditors when the company is insolvent, or close to becoming insolvent, depending on the particular regulatory framework, without the formal obligation to apply for the declaration of insolvency proceedings, and not accompanied by a legal duty for the company to apply for the declaration of insolvency proceedings in situations of insolvency.[13]

The establishment of these duties, which in this model have not been set up with the priority of maximizing the interests of the creditors, but rather as duties to ensure they can settle their claims, and are treated equally, and which involves the inclusion of other interests of "stakeholders" in the concept of company interest, over and above those of the shareholders, and particularly, the interest of creditors in settling their claims, is grounded in a jurisprudential area (North American model, based to a large extent on the so-called "trust fund doctrine", i.e. during insolvency, company assets constitute a fund for creditors, as well as on the "insolvency exception"), and sometimes also in a legal reasoning ("wrongful trading", regulated in section 214 of the English Insolvency Act).[14]

The underlying idea behind this is that, in any present or imminent insolvency situation (concepts that vary in accordance with different regulatory frameworks), it is the creditors and not the shareholders who are in reality taking on the risk of the continuation of the business activity, where it is understood that they are the ones who hold the "ultimate financial interest in the company". The non-compliance of the company directors with these trustee duties gives rise to a liability that is not legally articulated, causing the exercise of a range of actions jurisprudentially ("derivate action" by the creditors; "direct action" by third parties).

This Anglo-American trustee model has the advantage of being flexible and providing creditors with a broad margin of protection, but entails an undesirable lack of legal security, because the duties are not configured legally. The moment in which the duties come into being is not specified, and the actions creditors could initiate in response to the activities of company directors are not regulated legally.

13 A. Brown, "Fiduciary Duties of Directors of Financially Troubled Companies: When and how do the Rules change?" in *Corporate Law and Practice Course Handbook* (April 1991), at 1-2; R. Hartman, "Situation-Specific Fiduciary Duties of Corporate Directors: Enforceable Obligations or Toothless Ideals?" (1993) 50 *Washington and Lee Law Review* 1761.

14 See I. Fletcher, "La recuperación de empresas en crisis en el Reino Unido" in J. Pulgar Ezquerra (ed), *Company Insolvency in European Law* (Monograph Number 1) (2004, Revista de Derecho Concursal y Paraconcursal, Madrid); "Cuatro décadas de reforma del derecho de la insolvencia. La experiencia inglesa" (2008) 15 *Revista de Derecho Concursal y Paraconcursal* 49; *The Law of Insolvency* (2009, Sweet and Maxwell, London).

In contrast, the model of continental Europe is characterised by the establishment of legal duties to apply for insolvency proceedings in situations of insolvency, which fall to the company director, and in relation to this, a precise legal framework for liability in company law and insolvency proceedings, connected to a large extent to the non-compliance of this legal duty, but not only to this. It is also connected to a broader framework related to the duty of care required of the company directors when carrying out their functions, which in the final analysis, connects with the "company interest", a concept which could conceivably, while recognizing the differences, allow for the potential consideration of "trustee duties", similar to those taken into account in the Anglo-American model, in these continental European Models.

In this framework the progressive introduction of a framework of company directors' duties *vis-à-vis* the creditors is advisable in situations of present or imminent insolvency, as can be observed in a range of reforms undertaken in the European domain.

4. Incentivizing Fresh Money

Another aspect the European Commission Recommendation insists on as a key element for the promotion of "restructuring workouts" is the need to incentivize the financing of companies undergoing restructuring processes; commonly referred to as "fresh money". Since the injection of this fresh money involves an increase in the credit risk derived from the fact that the company is immersed in a "restructuring workout", which could have begun in a present or imminent situation of insolvency, the financing must be incentivized in three basic ways. Firstly, it must be easy for financiers to recover their credit in the event that insolvency proceedings are declared, if in the end, the "restructuring workout" is a failure.

To this end, it is advisable that on the one hand, the concept of fresh money not being subject to claw-back is re-established, and on the other, that the credit is declared an estate claim (pre-deductible), where its settlement is prioritized, and not therefore subject to classification in relation to the other creditors of the debt. Lastly, the pre-deductible nature of the estate claim must be maintained even in the event of internal financing, when the financing comes from shareholders as a loan, or in the event of intra-group financing.

III. The Inclusion of these Elements in the Spanish Model

The Spanish Insolvency Law 22/2003 of 9 July has been amended several times. The latest reform was undertaken by virtue of Law 25/2015. The latest reforms of the Spanish insolvency act have promoted a contractual approach to insolvency, through out-of-court workouts as a first step or even as an alternative to bankruptcy (workouts instead of filing bankruptcy petitions which are still compulsory) (protected workouts) in order to preserve going-concern value.

In a first instance, the Spanish model was inspired by the Italian model of "*Accordi di ristrutturazione*". However, subsequent to the latest insolvency reforms, workouts in the Spanish model have been inspired by the United Kingdom model (schemes of arrangement), towards which some of the most important refinancing agreements in Spain had "fled" (La Seda, Metrovacesa), as had also occurred with other companies (for example, Telecom, Rodenstock, Apcoa Parking Holdings, DTEK Finance etc.) (Germany until now has not had a legal framework for refinancing workouts in bankrupt businesses).

Subsequent to the Law being passed, the Spanish "refinancing agreement" model regulations can be said to contain some of the main elements the EC Recommendation of 12 March 2014 points to as necessary for the success of the workouts. The "unfinished business" of Spanish Law however, is still the establishment of effective exoneration mechanisms for unsettled liabilities for individual debtors.

1. Over-Indebtedness of Individuals

In the context of the current economic crisis, debtors who are natural persons have certain particularities in the Spanish model due to the specific origins and causes of their over-indebtedness. While in other jurisdictions the over-indebtedness of individuals is mostly related to illness or divorce, in Spain it is primarily caused by an over-commitment in home mortgages (beginning around 2007 with the real estate "credit boom"). Unexpected problems from lower incomes and higher expenditures are less important because the social welfare safety net in Spain is quite high.

That is why the principal focus for the government in Spain was at the beginning to protect home owners rather than consumers in a more general sense, as this is regulated for instance, in the French model. In this context the Spanish government using the leeway of the European Supreme Court Decision of 14 March 2013 (**affaire** Aziz) have adopted legislative reforms which result in high costs especially for mortgage creditors (e.g. Royal Decree Law 6/2012; Act 1/2013 concerning measures to further debt restructuring in mortgage loans and the rents of tenants). Afterwards, the law on enterprises and internationalisation of September 2013 (Law 14/2013 of 27 September) has for the first time in Spain introduced a discharge for natural persons.

As a result, exoneration mechanisms do exist in a formal sense, but in contrast to the criteria recommended by the EU, which concern strict subjective access limits to these mechanisms and the maximum spectrum of debts exonerated, in the Spanish model, the access requirements are not overly strict (it is just necessary for the insolvency to be deemed wrongful, with no judgements concerning good faith) and the exonerated debts are very restricted (public credits, security claims, etc. are not exonerated…). The latest Spanish insolvency reform passed on 27 February 2015 (Royal Decree Law 1/2015) continues in the same vein. It does, however, add judgements concerning debtor good faith as a requirement to benefit from discharge.

2. Refinancing Workouts in the Spanish Model: Legal Incentives

Refinancing agreements that have been used in the biggest enterprise insolvencies or pre-insolvencies in Spain (Martinsa Fadesa, Panrico, FCC, Construcciones y Contratas) constitute a pre-insolvency solution to crises of a contractual nature, centred on renegotiating conditions in which a contract was originally agreed. In the Spanish model, they are characterized by the particularity of not having been proceduralized, as has occurred traditionally with the French *prevention* since 1984 (*prévention et redressement judiciaire des entreprises en difficultés*), the latest reform by virtue of *Ordonnance 2014/326 of 12 March 2014 (portant réforme de la prévention des difficultés des entreprises et des procédures collectives*), and of not having been judicialized.

Indeed, despite debtor and creditors being able to apply to the commercial court judge who would be competent in the event of the declaration of insolvency, for the judicial approval of the agreement, which enables the basic principles of Contractual Law to be overcome, for example in regard to the relativity of contracts, where the content of the agreement can be extended not only to those in acceptance, but also to dissident financial creditors or non-participants, including the holders of *in rem* securities with particular majorities and conditions, that does not mean these agreements are turned into procedures or judicialized, since the judge is undertaking an act of "voluntary jurisdiction" (DA 4ª LC 22/2003 updated by Law 17/2014).[15]

15 Pulgar Ezquerra, above note 6.

However, the restructuring of company debt has not only been sought in pre-insolvency proceedings, but also subsequent to the declaration of *concurso de acreedores*, in pursuit of fostering conservational solutions through agreement in this domain, and also translational settlements that enable the transmission of operational productive units. The Law 17/2014 about "Restructuring and refinancing commercial debts" (*Ley de reestructuración y refinanciación de deuda empresarial*) introduces legal incentives for protected refinancing workouts:

- Article 5 *bis* of the insolvency law protects directors of companies under debt renegotiations by extending their statutory time frame for filing bankruptcy. Thus protecting debt renegotiations even from enforcement actions as regards assets necessary for the continuance of business activity carried out by non-participating creditors (automatic stay), which represents a similar protection as in the US Bankruptcy Code (Chapter 11).
- Claw-back protection.
- A privilege for fresh money (new credit for insolvent entities): new money provided under a protected refinancing workout within two years from the enactment of Royal Decree 4/2014, will be regarded as an estate claim in therefore having priority over all other claims except secured claims and the privilege is also enjoyed by fresh money injected by specially related persons, to the extent it is not made by means of a capital increase.

Alongside this change in the function of pre-insolvency workouts and insolvency proceedings, in recent insolvency reforms occurring in Spanish Law, shareholder-creditor relationships and the duties of company directors as regards managing the economic crisis also appear to be evolving, especially when the dilemma faced by the company centres on whether to restructure or liquidate.

3. Incentivizing "Debt-to-Equity Swaps": The Duties of Directors vis-à-vis Creditors and Shareholder Liability

In this context, the radical separation between Company Law, in which traditionally measures have been taken in Spanish Law related to restructuring, and Insolvency Law, aimed at satisfying the settlement claims of the creditors, seems to be on the wane given that company measures can also be adopted in pre-insolvency and insolvency proceedings. A restructuring measure typical of company law is therefore being fostered in pre-insolvency proceedings, which is the debt-to-equity swap, for which the board of directors is fully authorized to negotiate. Depending on the conditions, and above all, the type of swap agreed, this measure can weaken the position of the shareholders to the benefit of the creditors, thereby inverting the traditional pre-eminence of the former over the latter in the adoption of company restructuring measures.

The reform included in Spanish Law in the *Ley Concursal* 22/2003 by virtue of Law 17/2014 makes it possible to somehow "impose" this debt-to-equity swap on the shareholders, when specific majorities are reached during the adoption of the judicially approved agreement, where they are sanctioned if they have refused this, with insolvency possibly deemed wrongful (negative incentive), rather than the replacement of the agreement of the meeting with a decision of the judge who approves the agreement. This declaration, as regulated by Article 172.*bis*.1 LC, would be forthcoming if there were no reasonable cause justifying the refusal, assuming the debt-to-equity swap has a legally reasonable cause when this has been stated in an independent expert's report, and in these cases, establishing preferential subscription rights for former shareholders.

This *calificación culpable* (insolvency deemed wrongful) could entail the shareholders in question incurring in insolvency liabilities for the coverage of the net worth deficit, in other words, in relation to what the creditors do not settle, and equivalent to the insolvency liability that could be held by the directors, as regulated in Article 172.*bis* LC. Moreover, in relation to this debt-to-equity swap, the company directors are exonerated of liability when they recommend a debt-to-equity swap based on a reasonable cause, in accordance with the contents of the independent expert's report, even if it is subsequently rejected by the shareholders.

On the one hand, this has the effect of transferring some of the risk corresponding to the company director for the management activities of the company to the shareholders, and on the other, it has a questionable impact on constitutionally recognized principles such as private property and the freedom of business initiatives.

In my opinion, this appears to introduce the beginnings of pre-insolvency duties for the directors, not only relative to shareholders, but also relative to creditors in present or imminent situations of insolvency, since refinancing agreements can be reached in both economic situations. Indeed, "recommendations" made by the company director to the shareholders as regards the debt-to-equity swaps mentioned above, could weaken their position, but would however provide the creditors with "a way out"; a way of settling their claims which would not otherwise be available.

Spanish Law does therefore seem to be evolving in regard to the duties of the directors, from an initial model typical of Continental Europe, centred on the legal duty to apply for insolvency as the means by which it appeared adequate protection was understood to be given to creditors, which provided a great deal of legal security but perhaps left little margin for the protection of creditors, to a model that is beginning to resemble Anglo-American models, centred on the pre-insolvency duties of the directors relative to the creditors with the emphasis on the proposal of certain company law measures, and especially, debt-to-equity swaps.

However, the Spanish model, which regulates an insolvency liability of the company directors related to non-compliance with the duty of applying for insolvency, but does not include a "wrongful trading" rule, and which is also based on the introduction of negative incentives in order to make the shareholders opt for restructuring through debt-to-equity swaps, with no consideration of replacing the desires of shareholders at the general meeting with a judicial decision, seems to be less effective than other models such as German one.

Indeed, a rule equivalent to "wrongful trading" is regulated in German Law in the framework of the duties of company directors during the management of crises, which is based on the United Kingdom model. This means that legally, when the company director learns of or should have learnt of the fact that there are no reasonable prospects for the company to avoid insolvency, an application must have been made for the declaration of insolvency, and what is more, there is also an obligation to have taken:

> "every step to minimize the potential loss to the company's creditors which he ought to have taken."

Moreover, following the passing of the reform of the German InsO by virtue of the ESUG Reform in 2012, as part of the insolvency proceedings there is a provision for the replacement of the will of the shareholders at a general meeting with a judicial decision, in order to adopt company agreements such as debt-to-equity swaps, on which the company restructuring depends. This model enables agreements to be reached, and therefore, company restructuring, and neutralizes possible minority or majority abuses during votes and other company matters.

In contrast, the "threat" of *calificación culpable* (insolvency deemed wrongful) in the Spanish model, which could well not be carried through in the end, and by the same means, the possible liability of shareholders who unjustifiably refuse the debt-to-equity swap, prevents the agreement from being adopted, and results in insolvency proceedings being declared, making it difficult (or impossible) to restructure the company.

4. The Inexistence of "Solvency Rules" as a Limit to Dividend Distribution in the Spanish Model

Moreover, as regards limits on the distribution of profits, particularly as dividends, the Spanish model can be classified within the so-called and aforementioned "capital system". Therefore in Article 273 of the Spanish Capital Company Law of 2 July 2010, subsequently reformed on successive occasions ("LSC"), the limit on the distribution of profits is set, based on the traditional minimum correspondence principle between share capital *versus* assets. The distribution is therefore accepted whenever the value of the net assets is not, or as a result of the distribution does not fall, below the share capital, where profits posted directly to net assets cannot be distributed, and profits must be allocated to the compensation of losses that could potentially exist from previous financial years, which were the cause of the net assets value being lower than the figure for the share capital.

In the Spanish model, by virtue of Article 348 *bis* introduced in the LSC by Law 25/2011, in order to avoid potential shareholder majority abuses of minorities as regards an unjustified and repeated refusal to distribute dividends to shareholders, these legal limits on the distribution of dividends are also accompanied by an obligation of the general meeting to agree, regarding unlisted companies, the distribution as a dividend of at least a third of the own profits resulting from the exploitation of the corporate purpose, which can legally be distributed; in other words, within the limits of Article 273 of the LSC, where in addition a right to individualized separation is conferred on shareholders who may have voted in favour of the above-mentioned distribution. However, this rule setting a legal minimum and obligatory distribution of profits, as one can imagine, has received harsh doctrinal criticisms in reference to the intertwining of company management policies and the principle of free business initiative. For this reason, and because of the current economic crisis, the application of this rule has been suspended until 31 December 2016.

All of which could negatively affect the solvency of companies to the detriment of the creditors. Indeed, "solvency rules" or "solvency tests" are not envisaged in the Spanish model, which means legal dividend distributions could be made based on the share capital *versus* assets ratio included in Article 273 of the LSC, which could set the company on course for insolvency, since it is just necessary to reduce capital to set it alongside assets, in order to be able to distribute dividends while clearly leaving creditors unprotected, since there would be less capital for the payment of their credits.

Precisely for this reason, although "solvency rules" or "solvency tests" are not legally included, the jurisprudence of the Spanish Supreme Court is progressively introducing these in relation to potential claw-back of the dividend distributions carried out during the two years prior to the insolvency declaration of the creditors, following the failure of a "workout". Here, the Supreme Court makes a distinction between a "legal distribution" and a "dividend distribution, which despite being legal, is unjustifiable", if it places the company, at the present time or in the imminent future, in a situation of insolvency, where this is understood to be illiquidity or imbalance, which makes it impossible for creditors to be satisfied, because during insolvency proceedings it is detrimental to the estate, and, in consequence, subject to claw-back if the distribution is carried out during the two years prior to the insolvency declaration (the time factor for claw-back in the Spanish model).[16]

5. The Transitory Regime for "Fresh Money"

The introduction of the privilege of "fresh money" in the Spanish model by Law 38/2011 was not easy, especially because of the need to reconcile this with the protection of the employees, because in relation to a portion of their credits, these are also considered estate claims (pre-deductible). However, subsequent to the reform introduced by Law 17/2014, the legal regime varies in two different time periods:

- Up until 2016 → 100% of the new financing is pre-deductible including contributions made as loans from shareholders, where the administrators of the insolvency are granted powers to change the order of the payments of estate claims (pre-deductible).

- After 2016 → 50% of the new financing would be pre-deductible as estate claims, to prevent 100% exhausting the estate claims (pre-deductible), which also includes the credits of the employees, and 50% would be granted special privilege, which on many occasions would mean the financier would receive nothing, having already guaranteed (e.g. with *in rem* securities) their financing.

During this second period, contributions made as loans from shareholders and people related to the debtor are excluded. In addition to not enjoying the "fresh money" privilege, they would be considered subordinated credits (Article 92 of the LC 22/2003). The subordination of credits would operate by way of a penalty

16 As in STS 24 July 2014 and 1 November 2014. Previously, outside the insolvency framework, STS 26 May 2005 (nº 418/2005, Civil Courts, Section 1), where the refusal to distribute dividends was unjustified, because the illiquidity of the company could not be proven.

because of the questionable presumption that, in cases in which shareholders have to provide the company with loans, it is because the business in under-capitalized. The subordination of the credit in insolvency proceedings, would involve the postponement of collection, loss of voting rights, and the elimination of *in rem* securities.

These two time periods have probably been introduced in order to promote "injections of new money" in the current context of economic crisis. However, the lack of a stable and lasting "fresh money" regime, and the harsh "punishment" of shareholder financiers in contrast to the situations in other models of Comparative Law, for example in France and Italy, do not provide financiers with the stable regulatory framework they require, and introduce an undesirable element of "forum shopping" in the regulation, which is a disincentive for financiers in the framework of the Spanish model.

Furthermore, the new financing in the Spanish model would be protected from a potential claw-back, in the framework of protection granted by Article 71 *bis* LC to the refinancing agreement and the acts involved in its execution. In short, in the area of "restructuring workouts", Spanish Law follows the recommendations of the European Commission.

Chapter 10

Crossroads in EU Harmonization on Restructuring and Insolvency: Towards a Market-based System or One where "The Senior takes it all"?

Adrian Thery

I Why Harmonize?

The Recast European Insolvency Regulation of 2015 ("Recast EIR") has meant new progress in relation to restructuring and insolvency. However, the Recast EIR is also reaching the limit of what it could regulate bearing in mind that its provisions are limited to international jurisdiction, applicable law, recognition and coordination of insolvency proceedings. In addition, it must accommodate systems that have a different conception of insolvency.

In fact, the Recast EIR is faced with two models that are difficult to reconcile, since they are based on practically opposing approaches. On the one hand lies the English model, in which restructuring is almost only possible in the framework of the pre-insolvency scenario (with its Scheme of Arrangement and its Company Voluntary Arrangement), and in which the formal insolvency proceedings are not debtor in possession and tend towards liquidation.[1] On the other hand, we find the German model, in which the pre-insolvency is, at least conceptually, of relative importance, and within whose formal insolvency proceedings both liquidation and financial and operational restructuring are possible, more similarly to the US model, expressly providing for a cram-down in the strict sense. There is a wide array of different national systems between both models.

This duality of models that the EIR must encompass has led the Recast EIR to the minimum common denominator, to the limit it could cope without opting for either of them. This is shown in some points of the Recast EIR that might look somehow antithetical, although might end up being valuable in practice: such as the

1 According to the 2008 Report of the UK Insolvency Service (Enterprise Act 2002 – Corporate Insolvency Provisions: Evaluation Report), only 2.4% of Administration procedures achieved a corporate rescue during the period 2001-2005.

relaxation of secondary proceedings as liquidation proceedings; or the possibility that a sole insolvency practitioner may be appointed for insolvencies of several companies of the same group (although they may have opposing interests); or the institution of a coordinator of the insolvency proceedings of several companies of the same group, which must not have a conflict of interests (although there might be differing opinions at different levels of the group regarding whether to reorganize or to liquidate); or the possibility that the coordinator of the insolvency proceedings of group companies requests the stay of any of them (likely when it tends towards a piecemeal liquidation of the group which may be detrimental to a viable reorganization of the whole or to a package sale).

These new features may be partly due to the fact that, sometimes, formal insolvency proceedings such as English law proceedings, eminently creditor-friendly, may tend directly towards liquidation, without taking into account other interests in play, solely for the benefit of the most senior secured creditors. Be that as it may, it does not seem that the current European regulation can evolve much more now, unless by embarking on the harmonization of the substantive legislation of the Member States.

II. The Will to Harmonize

The EU seems to be aware now of the need for a greater degree of harmonization, which will be probably not achieved only by the regulatory competition derived from the current EIR, but through a substantive harmonization of domestic legislation. It was the European Parliament, which, back in 2012,[2] after having received the baton from INSOL Europe in 2010,[3] asked the European Commission to analyse the possible harmonization of certain aspects of the domestic regulation of restructuring and insolvency. Following a first study in 2012,[4] in which the Commission saw merits in harmonization, the Commission issued non-binding legislation focused on pre-insolvency (the "2014 Recommendation").[5]

2 European Parliament Committee on Legal Affairs, Report with recommendations to the Commission on insolvency proceedings in the context of EU company law (A7-0355/2011, 17 October 2011), and related resolution of the European Parliament of 15 November 2011 (2011/2006(INI)).

3 INSOL Europe (2010), Harmonization of Insolvency Law at EU level, European Parliament, Directorate General for Internal Policies, Policy Department C: Citizens' Rights and Constitutional Affairs, Legal Affairs, PE 419.633.

4 European Commission, Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee: A new European approach to business failure and insolvency (COM(2012) 724, 12 December 2012).

5 European Commission, Recommendation of 12 March 2014 on a new approach to business failure and insolvency, C(2014) 1500 final.

The 2014 Recommendation has meant progress. But beyond serving as a certain inspiration for some States, it has not been followed by many others. The regulatory competition derived from the EIR has already borne some fruit, but it hinders genuinely satisfactory solutions given the discrepancies between domestic legislation that still exist (and will continue to exist) in the absence of harmonization. The 2014 Recommendation already envisaged the commencement in September 2015 of an evaluation of the degree of observance of its content by the Member States, and:

> "whether additional measures to consolidate and strengthen the approach reflected in this Recommendation should be proposed."

Since then, the Commission seems to be aware of the priority need for harmonization in relation to restructuring and insolvency, especially due to the Green Paper "Building a Capital Markets Union" ("CMU") of 2015 and the Feedback Statement containing the result of public consultation. The latter shows that stakeholders with such varied interests such as banks, pension funds, business associations, labour unions or research institutes supported substantive harmonization on restructuring and insolvency, and not only cross-border provisions. In summer 2015, the Commission commenced the selection of the group of experts who must assist it in the preparation of a potential legislative proposal containing the minimum standards for a harmonized restructuring and insolvency law in the EU.

III. Which Areas may be Harmonized?

In its 2010 Report, INSOL Europe already detected a series of areas in which it considered that harmonization could be desirable and feasible. These were mainly the following: a possible common test of insolvency as a requirement of a formal insolvency process; the formal aspects of lodging and dealing with claims in a formal insolvency; certain aspects of the manner in which reorganization plans are adopted and their contents; the rules regarding so-called detrimental acts and the interrelationship between contractual rights of termination and insolvency; and finally directors' responsibilities. The 2014 Recommendation of the Commission has focused on the pre-insolvency (which is inextricably linked to insolvency).[6]

6 In the words of H. Eidenmüller and K. van Zwieten: "the Commission essentially approaches restructuring law in isolation – in stark contrast to the harmonization agenda sketched out by INSOL Europe and the European Parliament in 2010-2012, which encompassed various aspects of insolvency and restructuring law." (H. Eidenmüller and K. van Zwieten, "Restructuring the European Business Enterprise: The EU Commission Recommendation on a New Approach to Business Failure and Insolvency", September 2015, ECGI Working Paper Series in Law, Working Paper #301/2015).

Hopefully, harmonization will ultimately go beyond the above areas. The Commission seems to be aware of this. When convening the above-mentioned Group of Experts, the Commission named such subjects merely by way of example. Thus, areas such as the following might also be envisaged for harmonization: the degree of debtor in possession or divestment of the debtor; the possible stay and its duration; the treatment of executory contracts and *ipso facto* clauses; and, especially, the features of the reorganization plan and, above all, the cram-down feature, whose mere existence and intensity may give rise to important differences when facilitating the restructuring of a debtor depending on the State where it is located, and consequently the discrimination between nationals of different States and their terms of access to credit.

IV. Restructuring and Insolvency Harmonization and Company Law Harmonization

Already in its 2010 Report, INSOL Europe warned that even the areas the harmonization of which it advocated:

> "are affected by non-insolvency law considerations. Therefore, any further consideration of reform in an insolvency law context will have to take into account other important areas that are or may be the subject of European law amendment and reform such as general company law."

Just like restructuring law cannot be viewed in isolation from insolvency law, restructuring and insolvency law cannot be viewed separately from general company law either.[7] This is so especially when, as we will see, an important part of the new European reorganization process would have to focus on the "permeability of the capital structure": the possibility of operating a cram-down in relation to junior stakeholders and, specifically, in relation to equity[8] (provided that it is out-of-the-money and this has been resolved by a court with full guarantees on valuation). This is also so since the possibility exists that the new capital structure of a certain company (i.e. shareholder cram-down) might have to be approved, not by a court of the state in which that company was incorporated, but rather by a

7 As has been denounced, for instance in Spain, by J. Pulgar Ezquerra, "Reestructuración empresarial y potenciación de los acuerdos homologados de refinanciación" (2015) 22 *Revista de Derecho Concursal y Paraconcursal* 67, the need exists to "overcome the traditional and radical divorce between insolvency law and company law."

8 Furthermore, as has been rightly pointed out by T. Richter, "Reconciling the European Registered Capital Regime with Modern Corporate Reorganization Law: Experience from the Czech Insolvency Law Reform" (2009) 6 *European Company and Financial Law Review* 358, the possibility of reorganizing the capital structure of a company through a plan crammed down on the existing shareholders is compatible with the Second Company Law Directive.

court of the state of its Centre of Main Interests (or "COMI"), which does not need to coincide with the state of incorporation.

Those connections between restructuring and insolvency law and, namely, company law, make harmonization complex, but also justify why the principle of subsidiarity kicks in (there needs to be a homogeneous treatment of equity cram-down in order to allow any EU court to cram-down shareholders of a debtor company incorporated in different states). The impetus towards a Capital Markets Union and the necessity to deleverage private debt in the Eurozone also point to harmonization in this matter.[9]

V. Choice of Model for Harmonization: Restructuring Valuation and Capital Markets Union

Focus will now be put on the first dilemma (in which policy and technical issues are intimately linked) faced by substantial harmonization: which model to opt for, the English model or the German-US model? There are weighty reasons to seriously consider the German-US model as a reference, like the 2014 Recommendation of the Commission already did in several aspects (stay/moratorium, debtor in possession, cram-down, super-priority financing).

Dichotomy of the English Model

The English model is based on the following dichotomy: the formal insolvency proceeding is conceived, and is in practice, eminently geared towards liquidation; in order to carry out a reorganization (financial, since such legislation does not provide major tools for operational restructuring) it is necessary to achieve it in the course of a pre-insolvency procedure. This dichotomy (reorganization=pre-insolvency/insolvency=liquidation) only works for very specific times of financial crisis, or it only works in countries with an eminently financial economy, i.e. an economy formed by holding companies that receive financing and in turn own foreign subsidiaries that are operationally restructured in their respective

9 F. Bornhorst and M. Ruiz Arranz, "The Perils of Private Sector Deleveraging in the Eurozone" (2013), available at: http://voxeu.org/article/private-deleveraging-eurozone, who state: "The perils of private-sector deleveraging in the Eurozone,: "In the Eurozone, an accelerated clean-up of private and financial sector balance sheets can help avoid a protracted period of stagnation (see IMF, 2013). But delays and resistance to work out nonperforming loans in the banking system, and lengthy procedures for personal and corporate bankruptcies, increase uncertainty over the extent of the problem, and put further downward pressure on asset prices and firm performance. At the aggregate level, such feedback loops can trigger debt deflation dynamics. Therefore, in addition to providing a supportive macroeconomic environment, targeted policies to support the debt workout should be strengthened (see e.g., Laryea 2010 and Laeven and Lareya 2009)."

countries.[10] This explains why the scheme of arrangement is a close reference in this financial crisis, but also why the model in which it is inserted is insufficient in order to create a system in countries with different problems than those of the City.

It would appear that the scheme of arrangement is a sort of pilot project of the theory of "privatization of bankruptcy": when coupled with pre-pack administration, the scheme is tantamount to share pledge enforcement. But this is so even in cases where such share pledge does not exist (if the debtor has never granted a pledge on his business, it is difficult to accept that it can be taken away from him and the rest of stakeholders on a forced sale basis, especially with relation to non-sophisticated co-creditors). The connected valuation problem is further analysed below. Deregulation was at the origin of the current financial crisis and now threatens to propagate downstream into restructuring and insolvency; this is an additional justification for harmonization at EU level.

Similarity of the German Model

The German model is more similar to that of the majority of the rest of continental legislation. Crisis and regulatory competition through COMI have brought about the importation of scheme-like instruments by some systems, but they have been stopgap solutions born of the current crisis: the architecture of most continental systems does not follow the English Law dichotomy.

Financial and Operational Restructurings

A long-term stable regulation should serve, not only for financial restructuring, but also for operational restructuring. A model that does not provide the necessary legal tools to carry out operational restructuring at least at the same time (i.e. by virtue of a stay and adequate treatment of executory contracts) as the financial restructuring is a model that is particularly detrimental to equity, especially in order for companies to re-adapt to sudden market changes. In fact, it prevents shareholders from fully participating in the redistribution of post-restructuring value: if the operational restructuring is undertaken after the financial restructuring, the greater rents derived from the operational restructuring will only accrue to those who are still stakeholders after the financial restructuring (it being likely

10 In an attempt to confine their scope to holding companies, UK Schemes of Arrangement usually also feature the so-called "release of third parties". Those imply that the UK Court purports to release guarantees granted in favor of creditors by other group companies (usually foreign operating companies) different from the scheme holding company. Such a release entails that the scheme would extend its effects over companies that are not a party to the scheme process, and may also infringe legal principles present in many Member States (i.e. that the restructuring of the debt of a specific company cannot impair guarantees granted by a third party, unless the latter is included in the perimeter of the restructuring proceeding). For this and other reasons, schemes may face serious problems to be recognized and enforced both in Europe as well as in US Chapter 15 proceedings.

that by then the pre-existing equity might have been wiped out). Focus and efforts are nowadays on financial restructuring, leaving operational restructuring under-used, but that should not drive to understate its importance.[11] Fresh money legal incentives would also contribute to finance and develop operational restructuring.

Balancing Interests within the System

An excessively creditor-friendly system, which does not maintain a certain balance between the rights of creditors and of the equity (like the "level playing field" under the US Chapter 11), will facilitate credit but will not induce investments and entrepreneurship.[12] Entrepreneurs might look for more benevolent jurisdictions, especially in times in which the blend of debt and equity is increasingly more balanced, and in which R+D investments will make a difference.

The Importance of the Stay

The facet of the stay is important in order to provide the debtor with a breathing space to tackle restructuring. This is recognized by the 2014 Recommendation. The moratorium in the application of *ipso facto* clauses in relation to critical suppliers is also important, for the same purposes. Both are facets which are protected in Chapter 11, but these and similar concepts are nevertheless very restricted in the English Law model: the scheme of arrangement, main corporate rescue instrument in practice in the UK, lacks such a stay. The lack of a stay is also one of the reasons that lead UK to a system where "the Senior takes it all".

Perhaps rather than allowing enforcement in case of debtor's difficulties by creditors (whose business, in the case of banks, should be more focused in granting loans rather than recovering distressed claims, which in fact are usually sold at a discount), it might be more important to enable banks to get out of such distressed situations obtaining the highest possible price for their claims. Hedge funds are the natural purchasers of distressed claims of banks on the secondary market. Hedge funds are nowadays displacing banks in insolvency situations: where traditionally insolvency has been in Europe a place where banks were struggling to minimize

11 T. Laryea, "Approaches to Corporate Debt Restructuring in the Wake of the Financial Crisis" International Monetary Fund Staff Discussion Note 10/02 (2010, IMF, Washington DC): "To be successful in securing the longer term viability of corporates, debt restructuring will often be accompanied by operational restructuring addressing the structure and efficiency of the firm's business through closures and reorganization of productive capacity."

12 S-H. Lee *et al.*, "How do Bankruptcy Laws affect Entrepreneurship Development around the World?" (2011) 26 *Journal of Business Venturing* 505: "we find that the less the downside risk involved in filing bankruptcy, the more new firms are founded. For policymakers, we suggest that making bankruptcy laws more entrepreneur-friendly will positively affect entrepreneurship development by lowering exit barriers and entry barriers."

loss, now insolvency is becoming a "no banks land" where hedge funds are working to create value and maximize benefits.

This is not necessarily something negative. Hedge funds have naturally become nimble players in rescuing corporations.[13] Because they are ultimately interested in the equity, they are also prone in deleveraging, keeping the business alive and appointing an efficient management.[14] The greater the visibility of a hedge fund in relation to the convertibility of a claim into the debtor's equity, the more a hedge fund will be willing to pay the bank for its distressed claim.[15] Hence it is critical, as we will see later, to provide for the ability to carry out equity cram-down in reorganization frameworks (provided equity is effectively out-of-the-money).

Going back to the stay, ideally banks should not lend looking at the collateral and its enforceability, but rather considering their debtor's efficiency and underlying business. Otherwise, when the banks are more focused on accepting a certain collateral rather than anything else, this creates the so-called "lazy banks" phenomenon,[16] not accustomed to rely on the analysis of the underlying business of their debtors, nor therefore carrying out their function of efficiently assigning credit, i.e. distinguishing who deserves a loan in the light of the greater efficiency of his services, and not merely due to the effectiveness of his security (which may be unrelated to the merits of a certain enterprise, and also stimulate real estate business over all others). Still, of course, the fact that secured creditors may be affected by an optional stay or by a certain plan does not mean that secured creditors shall not be granted adequate protection.

One of the priorities of the 2015 Green Paper is to develop the bonds market in Europe. As is well known, the bonds market is much more developed in the

13 In contrast, Banks recently have become heavily influenced in their decisions by financial and regulatory policy to push their distressed borrowers to sell assets rather than reorganize (see S. Woo, "Regulatory Bankruptcy: How Bank Regulation causes Fire Sales" (2011) 99 *Georgetown Law Journal* 1615). When dealing with debtors that are "too big to fail", banks' reluctance to reorganize by equitizing their claims naturally drives to banks keeping debtors overleveraged (the only alternative to equitizing, i.e. a plain write off, being even worse for the banks).

14 E. Hotchkiss and R. Mooradian, "Vulture Investors and the Market for Control of Distressed Firms" (1997) 43 *Journal of Financial Economics* 401, show that the improvement in the debtor's post-restructuring operating performance is greater when hedge funds take control of the restructured firm or sit on the board, suggesting that these investors contribute valuable governance to the debtor.

15 The visibility by managers concerning the possibility that creditors may be converted into new equity-holders in the event of a reorganization entails that the managers themselves avoid power struggles over control rights and manage the company refraining from siding with anything other than the business' interests. In other words, visibility by the managers concerning the possibility of an equity cram-down may improve corporate governance. There is a direct relationship between the flourishing of the bonds market and the perception that corporate governance works properly: P. Coombes and M. Watson, "Three Surveys of Corporate Governance" (2000) 4 *McKinsey Quarterly* (Special Edition) 74.

16 M. Manove *et al.*, "Collateral versus Project Screening: A Model of Lazy Banks" (2001) 32(4) *RAND Journal of Economics* 726.

US than in the UK, which is due, among other factors, to the US regulation of insolvency compared with that of the UK. Some sectors (like the European High Yield Association ("EHYA")[17] have been recommending to English authorities since 2008 the introduction of US model features in England. But English industry, firmly rooted in a bank-based model, has blocked those proposals. However, UK seems to begin to understand the merits of, and to coincide with, the US model (as recently shown by the introduction of a moratorium *vis-à-vis* the so-called "essential suppliers", which reminds us of the US "critical vendors", in the case of administration or company voluntary arrangement).[18]

Taking the UK as a reference for restructuring and insolvency might not be the best option when the UK itself is starting to look at the US for such purpose. UK law has in this field many great characteristics to learn from, although probably is suboptimal as holistic system for restructuring and insolvency: as seen, administration most frequently ends up in liquidation, pre-packs are severely

17 Since 2009, the EHYA has been integrated into the Association for Financial Markets in Europe ("AFME").

18 See the Insolvency (Protection of Essential Supplies) Order 2015.

criticized,[19] while the most efficient restructuring instrument in the UK is a company law institution. By contrast, the US Bankruptcy Code does not need major surgery and constitutes a consistent system, simply needing isolated tweaks every four decades.[20]

The Cram-down

As regards financial restructuring, the permeability of the capital structure, and consequently, the ability to cram-down equity is essential in most major

19 Prepacks in UK have been severely criticized for not being transparent and competitive and due to the so-called "sweet-heart deals" between management and senior creditors. According to the "Pre-pack Empirical Review" previous to the "Graham Review" (based on sample analysis), approximately 63% of pre-packs took place with connected parties to the Oldco. In turn, the Sixth Report of the House of Commons Business and Enterprise Select Committee (HC198) suggests that only 1% of unsecured debt is paid in pre-packs. As laid out in this Report: "25. Public confidence in the insolvency regime is being and will be further damaged. Prompt, robust and effective action is needed to ensure that pre-pack administrations are transparent and free from abuse. Unsecured creditors tend to be kept in the dark and recover even less than they would in a normal administration. This causes particular outrage where the existing management buy back the business and continue to trade clear of the original debts. Pre-packs of this kind fuel understandable concerns about illegitimate, self-serving alliances between directors and insolvency practitioners. The interests of unsecured trade creditors must take a higher priority, especially in "phoenix" pre-pack administrations." Criticism on UK pre-packs gave rise to the so-called "2014 Graham Review" and subsequently to a new draft of the Statement of Insolvency Practice 16 ("SIP 16"), which has been received with skepticism. In fact, the Small Business, Enterprise and Employment Act 2015 has created a reserve power for the Government to make regulations in the future to prohibit pre-packs in case the voluntary measures arising from the Graham Report prove unsuccessful. One can doubt whether, for instance, the NRJ Nabisco transaction would have been closed for USD 25 billion if the management's initial USD 17 billion "sweet-heart LBO" had been substantiated as an English pre-pack. At the end of the day, a distressed business sale protection of junior creditors resembles that of minority shareholders in takeovers (if minority shareholders protection takes place ex ante in a takeover, one wonders why it should take place ex post in a restructuring –and only if some impaired junior stakeholder, with asymmetrical information, takes the risk to file a challenge). It is questionable that a distressed business sale shall be carried with no open doors and real market contrast, unless such business is inevitably a "melting ice cube": however, with certain exceptions, the "melting ice cube" may sometimes be a convenient excuse to carry out certain transactions or may be the result of inefficient management (see M. Harner, "The Melting Cube Fallacy", available at: www.creditslip.org). Otherwise, the value preservation of the distressed business can be simply achieved through insolvency regulations on *ipso facto* clauses and executory contracts (so as to allow the business to maintain the critical contracts in force during a competitive sale process) and new money (so as to allow the business to resort to fresh financing should it need working capital during such competitive process). Once stabilization of distressed businesses is possible through such regulations, sale of distressed businesses would be normalized, and clients and suppliers would not perceive any particular risk or stigma. This would allow for usual M&A (as opposed to truncated) processes to take place, maximizing price and creditors recovery. In an article called "For some, Britain's insolvency laws add to pain" (*Reuters*, 11 February 2009), Nick O'Reilly, then president of R3, stated that: "It's because the company is failing, or has failed, that creditors lose money -- not because the business was pre-packed and sold on. In fact, a pre-pack is often the only option available to save a business and jobs and avoid liquidation." Nevertheless, when a business is economically viable on a standalone basis, it is difficult to appreciate why it would melt if regulation provides with the necessary toolkit to stabilize such business. In fact, the trend as regards section 363 sales in US points precisely in the direction of restricting to only properly justified cases the application of the "melting ice cube" theory, according to the Final Report and Recommendations released on 8 December 2014 by the American Bankruptcy Institute Commission to Study the Reform of Chapter 11.

20 See the Final Report and Recommendations released on 8 December 2014 by the American Bankruptcy Institute Commission to Study the Reform of Chapter 11: "For more than 35 years, the US Bankruptcy Code has served these purposes, and its innovative debtor in possession chapter 11 process, which allows a company to manage and direct its reorganization efforts, is emulated around the globe. As with any law or regulation, however, periodic review of US bankruptcy laws is necessary to ensure their continued efficacy and relevance."

reorganizations. Otherwise, holdouts may jeopardize the entire reorganization, due to the veto power of a stakeholder without economic interest. Does it make sense for restructuring law to be evolving in the direction of removing veto rights of individual stakeholders, while allowing the most junior creditors (equity) to maintain such veto rights in relation with debt for equity swaps? It is already commonplace[21] and we will not dwell on it.[22]

For the equity to be impaired by a reorganization plan, it must be eligible to be included as a class,[23] just like any other creditor who is in an unsteady situation like distress, which can easily slip into liquidation or upsetting the rights of preferential creditors. However, it is important to point out that the equitization of claims, given the probable dilution of the pre-existing equity, must be carried out with guarantees in order not to violate the right of ownership and not be expropriatory. Thus, equity wipe out shall comply with the rights to a fair trial and to effective remedy. In other words, it should be carried out with full Court supervision, not in proceedings with minimal judicial intervention and a mere sanction, incompatible with a serious valuation of the enterprise value (as has been criticized, for instance, in the UK pre-pack schemes).[24]

21 See R. de Weijs, "Harmonization of European Insolvency Law and the Need to tackle Two Common Problems: Common Pool and Anticommons", Center for the Study of European Contract Law, Working Paper Series #2011-16. As explained by the AFME, when responding to the consultation of the Commission in relation to the 2014 Recommendation: "In recent times, parties have realized that making a restructuring dependent upon consents from stakeholders with no economic interest in an enterprise, properly valued, is not conducive to an efficient restructuring. However, practice has differed in the resolution of this issue. Our view is that the question of whether shareholder or junior creditor consents should be conditions to restructurings (which, if not met, would lead to formal insolvency proceedings) will become increasingly important as more complex capital structures predominate. The present position is that practice varies. This ad hoc approach leads to greater uncertainty concerning stakeholders' rights and, ultimately, makes restructurings outside administration more difficult. This issue is too important to be left subject to the vagaries of each individual case. As a policy matter, we do not consider that creditors or shareholders with (on a proper valuation basis) no economic interest in the enterprise should be in a position where their "veto" forces full insolvency proceedings or delays otherwise viable restructurings. In other words, a judicially supervised process is required to allow a restructuring to proceed without the necessity of extracting consent from a class of creditors or shareholders with no economic interest."

22 For instance, in Spain, the attempt to obtain an effect equivalent to the equity cram-down by other alternative legal means has been unsatisfactory. The introduction of a legal threat of potential liability for shareholders and directors in the case of unjustified rejection of a lender-led plan has proved insufficient to tackle the problem of hold-out of the equity that is out-of-the-money. By way of example, in the Pescanova case (with a debt exceeding EUR 3 billion and an ebitda of barely EUR 50 million), the shareholders assembled at a shareholders' meeting (held after the approval of the reorganization plan by the bankruptcy court) agreed to modify the distribution of capital among stakeholders contained in the previously approved reorganization plan.

23 Impaired shareholders do compose a class under US Chapter 11, and also in Germany since the 2011 reform of the InsolvenzOrdnung ("InsO") through the "Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen" ("ESUG"), which introduced important measures addressed at preventing shareholders to block restructurings of a debtor's capital structure. On the contrary, in a "pre-pack scheme" in the UK, Oldco equity-holders to be crammed-down would not even be entitled to integrate in a class.

24 J. Taylor and N. Stewart, "UK: Cram-down of Junior Creditors using Schemes of Arrangement", Chapter 18 in H. Gibbon and Q. Carruthers (eds.), *Corporate Restructuring: The Breaking Wave* (2009, Thomson Reuters, London), at 103-106.

An example of this is that the adequate framework for discussing in depth valuation and the appropriateness of such a serious measure as is the disenfranchisement of equity exists in the US (the country that wrote the book) within a fully-fledged process like the Chapter 11 proceedings. The approach of the 2014 Recommendation on this point has been shown to be delicate. In the words of Eidenmüller and van Zwieten:

> "A third crucial deficit of the Commission's RR lies in its minimalist approach to the role of the court in the restructuring process. The RR would like to have it all: a flexible and quick procedure with only minimal involvement of the competent court (see RR No. 7) and at the same time permit potentially massive curtailments of the claims of dissenting creditors with a minority protection standard that is not very clearly articulated (RR No. 22 (a) and (c)). This does not work: curtailments of creditor rights can only be justified if the legal standards for these curtailments are clearly defined and full court supervision and control are assured." [25]

Therefore, the so-called "hybrid procedures" do not ensure sufficient guarantees so as to be able to adopt drastic measures in relation to creditor rights, and less still in relation to the formal owners of the company. However, that does not hinder the possibility of judicial intervention being minimized on other aspects, if the use of any of the features available (for example, the stay or the new financing) is not required. Process features should work as modules, so that process complexity should not be fix, but variable depending on the specific features requested by the restructuring at hand (for instance, stay should not be automatic but optional, so that the process does not necessarily trigger *ipso facto* cross-default clauses, for instance, in other group companies).

One could think that success in out-of-court workouts may depend on the pre-insolvency regulations themselves. However, pre-insolvency regulations will hardly provide for efficient cram-down mechanisms, since those should involve more than light court involvement. On the contrary, success in out-of-court workouts depends on the fall-back position that each of the constituencies would find itself in lack of acceptance of the restructuring proposal. Stakeholders are aware of being bargaining in the shadow of insolvency regulations. Pre-insolvency workouts do not necessarily require pre-insolvency instruments, but simply

25 H. Eidenmüller and K. van Zwieten, "Restructuring the European Business Enterprise: The EU Commission Recommendation on a New Approach to Business Failure and Insolvency", September 2015, ECGI Working Paper Series in Law, Working Paper #301/2015.

visibility on all stakeholders' relative positions in case of hold-out, and subsequent opening of collective proceedings like Chapter 11.[26] Ignoring this will lead in the long run to transform current pre-insolvency instruments into fully fledged proceedings, when attempting to incorporate in the former the necessary cram-down and operational restructuring features. It might therefore be more sensible to directly improve a Chapter 11-like instrument and, in particular, the ability for Courts to rapidly confirm pre-packaged and pre-negotiated reorganization plans.[27]

Reorganization Plans

Apart from the purely consensual extrajudicial workouts, a model should provide for two types of reorganization plan, in which the majority principle would apply (both "intra-class" or horizontally between claims of the same class, and "inter-class" or vertically between the majority of impaired classes or at least one of them, as in the US, with absolute priority rule assuring the fairness of the plan):[28]

a) That reorganization plan to be approved by the Judge with the support of the relevant majority of each and every class of creditors: it is the perfect scenario, since it makes it unnecessary to consider valuation problems and also renders unnecessary the application of the absolute priority rule.

26 Y. Liu and C. Rosenberg, "Dealing with Private Debt Distress in the Wake of the European Financial Crisis: A Review of the Economics and Legal Toolbox" International Monetary Fund Working Paper 13/44 (2013, IMF, Washington DC): "Fast track court approval procedures refer to those under which the court expeditiously approves a debt restructuring plan negotiated between the debtor and its creditors in a consensual manner before the initiation of an insolvency proceeding. This technique draws upon the most significant advantage of a court-approved restructuring plan—the ability to make the plan binding on dissenting creditors or cram down—while leveraging speedy out-of-court negotiation process. (…) Achieving effective out of court restructuring requires, however, a robust insolvency regime and adequate incentives for creditors and debtors to participate in the restructuring. As out of court restructuring takes place in the shadow of the formal insolvency regime, it is critical to have in place an effective insolvency law, which provides clear benchmarks to incentivize debtors and creditors to reach a restructuring agreement. In addition, a regulatory framework requiring financial institutions to write down the value of distressed debt should be put in place, tax disincentives for debt write-downs or transfer of a distressed loan to a third party should be removed."

27 US prepackaged reorganization plans and UK pre-packs (or prepackaged administrations) are completely different animals. While US prepackaged plans are reorganization plans negotiated with creditors before Chapter 11 and confirmed by court swiftly after the opening of the Chapter 11 proceedings, UK prepacks are business sales organized by an insolvency practitioner ("IP") before the opening of the administration proceedings and executed by the IP upon his appointment immediately after the administration opening. UK prepack sales are typically made to connected parties of the debtor and with no creditors intervention whatsoever. UK pre-packs evoke bringing one's son to hospital and finding out some hours later that all his organs have been donated with no consent from the parents, without doctors even attempting to operate surgery on him.

28 For a plan to be deemed «fair and equitable» it must abide with the «absolute priority rule», contained in 11 USC §1129(b)(2)(B)(ii) and 11 USC §1129(b)(2)(C)(ii). According to the absolute priority rule, a junior stakeholder that is subordinated to a senior stakeholder cannot receive any value under the Plan unless such senior stakeholder is also obtaining under the Plan nothing less –and nothing more– than the value of his allowed claims (relative subordination agreements are recognized within Chapter 11: 11 USC §510(a)). Absolute priority rule can be visualized like a series of piled champagne glasses, requiring that the glasses of the senior stakeholders that are on top get filled completely before allowing any value to cascade down to the glasses of lower-ranking stakeholders.

b) That reorganization plan to be approved by the Judge although it does not have the support of the majority of each and every class (cram-down in the strict sense): applying the absolute priority rule in order to provide the backbone of the reorganization plan and guarantee that it is "fair and equitable" for a possible dissenting class, and thus ensure, not only that each receives at least what he would receive in a liquidation (the so-called "best interest of creditors" test,[29] which plays out in an absolute or objective level taking as a reference the liquidation value), but even more: that no junior creditor receives anything until the senior creditors are not fully satisfied and, as a corollary, that no senior creditor receives anything more than the amount of its claims either (absolute priority rule hence plays out in a relative or subjective level taking as a reference the future enterprise value as a going-concern). It is important to note the different valuations that serve as a reference for the purpose of the best interest of creditors test (liquidation value) and for the purpose of the absolute priority rule or fairness test (future value). This second valuation shall determine which stakeholders are in-the-money and thus have a say on the reorganization plan: by challenging a possible breach of the corollary to the absolute priority rule (i.e. when a junior stakeholder considers that more senior creditors are getting a higher recovery than their allowed claims, because the equity being received by the latter would supposedly have a higher value than such claims). Valuation thus orders the post-emergence capital structure in case of cram-down. No major reorganization can be accomplished without cram-down features, and no cram-down can in turn be achieved without rules on valuation.[30]

The absence of rules on cram-down, valuation and absolute priority lead to unsatisfactory situations, like in the model of UK and other countries, in which:

(i) The disenfranchisement of equity is not carried out by virtue of an ad hoc proceeding, but rather by means of an artificial combination of a scheme of arrangement (addressed at rescuing a debtor) and a pre-pack administration

29 The "best interest of creditors" test recalls the EU Bank Recovery and Resolution Directive ("BRRD") "no creditor worse off" principle. Equity wipe out is thus not a stranger to European law. In fact, importation of certain concepts from the BRRD could be analyzed, such as the general rule of non-suspensive effects of appeals (unless a bond is posted) and/or the limitation of remedies to loss compensation.

30 France and Italy have recently introduced certain instruments in order to wipe out equity but, paradoxically, with no regulation or guidance whatsoever in relation with valuation, with the risk of being deemed expropiatory. See S. Vermeille *et al.*, "A Constitutional Review of the Draft Macron Law introducing Shareholder Eviction under French Law: The Revolution that didn't happen" (March 2015), available at: revue-banque.fr.

(addressed at liquidating a debtor):[31] the so-called pre-pack scheme or transfer scheme. In other words, it consists of a liquidation of the debtor and a subsequent transfer of its assets and restructured debts to a Newco usually owned by the senior creditors, leaving the rest of the creditors and the shareholders behind. It is a traumatic solution, only valid for holding companies (or simple companies), which can transfer the enterprise as a whole without legal or operational obstacles.

(ii) The lack of cram-down in the UK gives rise to it being potentially disguised in practice through an artificial class formation (by including possible dissenters as a minority in a broader and sole class altogether with a majority of supporting creditors).[32] The concept of "class of creditors" is a generic concept that English courts do not seem to manage to refine.[33] This is perhaps why it is common to hear in the UK that "class formation is an art, not a science". However, risk of gerrymandering is likely to constitute a serious disincentive for non-senior financiers.[34]

31 Although the City of London Law Society considers pre-pack, quite tellingly, as a cram-down mechanism, rather than a liquidation proceeding, in its 18 October 2010 response to the Insolvency Service consultation: "In relation to the restructuring proposals themselves, the Insolvency Service may wish to consider the existing cram-down mechanisms (such as a pre-packaged administration, the company voluntary arrangement or the scheme of arrangement) for binding dissenting creditors" (at paragraph 14).

32 One of the arguments used by UK courts to justify one sole class being formed consists in contending that the backdrop of insolvency and the prospect of non-recovery shall unite all the relevant creditors in one sole class. This is shown for instance in the recent judgment that sanctioned the Apcoa scheme (*Apcoa* [2014] EWHC 3849 (Ch)): "Lastly, in considering the composition of classes, I have sought to stand back and assess more generally whether, in the round, and even if I am wrong in my judgment that on analysis there is no difference in the relevant rights so as to require application of the second limb of the test, there was sufficiently more to unite than divide all creditors within a single class so as to make further classes unnecessary (and see *Telewest (No 1)* at [40]). (…) It seemed and seems to me that the advantage of avoiding insolvency and being able to share in a larger cake would sufficiently outweigh the wish to have a larger share than others in a much smaller cake. (…) Accordingly, whilst I accept that the risk of imminent insolvency is not to be used as a solvent for all class differences, in this case in my judgment it would have caused reasonable Existing SFA Creditors to unite in a common cause."

33 According to the classic UK definition, a "class of creditors" is to be formed by "those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest": *Sovereign Life Assurance Company v Dodd* [1982] 2 QB 573.

34 For instance, three out of five schemes of arrangement related with Spanish companies in the last few years featured one sole class of creditors (and, to date, two out of those five scheme companies did already end up in bankruptcy proceedings in Spain soon thereafter).

(iii) No procedure, nor rules, relating to valuation[35] exist in order to ascertain where the value breaks and who is in or out of the money,[36] with the resulting uncertainties and potential for unfairness as a result of wrong class formation. Few existing precedents in UK[37] seem to show that English Courts would stick to liquidation value for such purposes. And even if they were to admit going-concern value, they would be reluctant to admit valuation of enterprise value for a higher value than the so-called "value today" (or liquidation or fire-sale value), which is a depressed value – thus allowing a model where we could say that "the senior takes it all" (i.e. the equity post-restructuring is not taken over by the fulcrum,[38] but by the senior class).[39] Senior taking it all implies that absolute priority rule (and its corollary) is not respected, and that valuation is meaningless. It also implies confusion between the best interest of creditors test (conceived to protect creditors against abusive plans that would entail lower recoveries than liquidation itself) and the absolute priority rule or the fairness test (conceived to rightly allocate enterprise value amongst

35 Taylor and Stewart, above note 24, at 23.

36 The AFME explained in its letter to the Commission of 25 March 2014 in relation to the 2014 Recommendation: "Dramatically different allocations of value arise if a liquidation basis of valuation is used as opposed to various alternative "going concern" bases. There is currently no consistent method or platform for resolving stakeholders' disputes as to the basis of valuation, short of a company entering formal insolvency proceeding. Hence, somewhat crudely, the dynamic that emerges is that often stakeholders are in effect given a choice – accept a particular basis of valuation (and it may be a liquidation valuation, which ignores going concern surplus arising from a successful restructuring) or see the enterprise go into an administration or liquidation proceeding. Ideally, a consistent and harmonized framework should be created for fast judicial resolution of valuation disputes in restructurings."

37 See the *Re Tea Corporation* [1904] 1 Ch 12; *My Travel* [2004] EWHC 2741 (Ch); [2004] EWCA Civ 1734; *IMO Car Wash* [2009] EWHC 2114 (Ch).

38 Unless a different agreement is reached through the Plan, the stakeholders who should naturally be entitled to equitize their claims are the so-called "fulcrum security" in the US: i.e., only the most senior class of creditors that are not fully repaid according to the Plan – in other words, the most senior class in which "the value breaks" (not necessarily, nor usually, the most senior class at the top of the waterfall in absolute terms), because such class is only partially covered by enterprise value. The logic of not allocating the new equity in a different manner than to the fulcrum security (unless an agreement exists amongst the creditor's classes) resides in the fact that the best candidates to efficiently manage the debtor company are not the creditors whose recovery is assured (senior creditors already repaid in full), nor creditors whose recovery expectations are close to nil due to them being "out-of-the-money": on the contrary, those who would best manage the company are those creditors that still have a certain probability that enterprise value overflows in their benefit, but only if the company is efficiently managed.

39 Hence losing the opportunity to have a really incentivized fulcrum very efficiently managing corporations post-restructuring as the only alternative to maximize value of the main consideration obtained through the reorganization: the equity (as opposed to the UK scenario in which it is the senior class –and not the class where the value breaks- who gets the equity).

stakeholders following absolute priority rule).[40] This scenario is opposed to the US, where absolute priority rule applies and where reasonable fair-market value or "future value" would be considered, in benefit of more junior stakeholders and richer financing structures. Valuation guidance provides a reference to distressed investors as to the level of the fulcrum security in order to buy into the debt, but also provides certainty to entrepreneurs as to their possible entitlements in case of distress. Proper valuation is also a guarantee for pre-existing lenders against their post-restructuring interests being diluted in excess by new money providers.

40 This in turn justifies why valuation for both tests (best interest and fairness) shall be a different valuation. Indeed, if the main purpose of the reorganization plan is to make a company viable and prevent the loss of value derived from liquidation, then: why should the value to be reallocated amongst stakeholders (through the plan and the absolute priority rule) be liquidation value and not future value? In other words: does it make sense that the greater value derived from avoiding liquidation (going concern surplus) shall solely benefit senior creditors, just because those would be the only ones to be covered by liquidation value in a no longer existing case of liquidation? As explained by M. Crystal and R. Mokal, "The Valuation of Distressed Companies: A Conceptual Framework" (in two parts) (2006) 3 *International Corporate Rescue* 63 and 123: "The primary question is: what is the current value of the company's assets? If the company in question is promulgating a scheme of arrangement which amounts to a restructuring of its liabilities, it follows, as explained in Section II of this article, that it considers that the value of its business contains a going concern surplus, but that a simple market sale would not capture the entirety of this surplus. The value of the company's assets and undertaking would therefore be maximised by, in effect, 'selling' them to its existing investors in consideration for a restructuring of the company's liabilities to them. This is what the scheme of arrangement is meant to accomplish. It follows that in order to determine which of the company's current investors retain a real economic interest in the company as things currently stand, the value to be determined is the existing going concern value of the company's business, which, after all, is the value the proposed scheme is intended to both preserve and apportion. Assuming that the alternative to the proposed reorganisation would be a liquidation, it is difficult to see the rationale of determining the rights of any of the parties by assuming the very outcome that the scheme of arrangement is intended to avoid, namely, a liquidation of the business and resulting dissipation of the going concern surplus."

In other words, the UK has somehow opted for a "Forced Sale" or "Texas Shootout" model,[41] as opposed to the US' "Appraisal" model.[42] The less information is offered to stakeholders before plan voting, the closer their position will be to the Texas Shootout model.

The prejudice to junior stakeholders derived from not using a future going-concern valuation is escalated by the fact of hybrid-proceedings (such as scheme of arrangement) can be initiated (and the plan shall be proposed) only by the debtor. This increases the risk of majority senior creditors teaming up with the debtor/ equity (due to its exclusive locus), in detriment of junior creditors and absolute priority rule. This is one reason for certain continental companies' restructuring tourism to London.

The UK scheme of arrangement lacks regulation not only on valuation, but also on two features such as "third party releases" and –when coupled with a pre-pack– cram-down *stricto sensu*. UK scheme seems thus to be embarked in a "race to the bottom", with the resulting uncertainties for stakeholders and especially for non-bank financiers that EU is in parallel seeking to attract. Only the extraordinary

41 D. Baird and D. Bernstein, "Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain" (2005) 115 *Yale Law Journal* 1930; (2006) U Chicago Law & Economics, Olin Working Paper No. 259: "The junior investor would have the option to buy out the senior investor for the amount of the senior investor's claim. If the junior investor thought the business worth less than what the senior investor was owed, it would not exercise the option, and the senior investor would end up with the entire business as the absolute priority rule requires. If the junior investor believed the business worth more than what the senior creditor was owed, it would have to pay the secured creditor in full, again vindicating the absolute priority rule. (…) Whether such a mechanism best serves the interests of the parties, however, is not clear. It relies on the junior investor possessing sufficient capital. The junior investor may find it impossible to borrow the full amount from a third party because the third party does not know as much about the business and will therefore lend only a fraction of the business's value. The private information problem that makes a sale of the business unattractive also makes it difficult for the junior investor to borrow the funds needed to buy out the senior investor. (…) In short, there are likely to be practical difficulties in the corporate reorganization context with requiring junior investors to buy out senior investors, and a more practical valuation mechanism is needed." This "Texas Shootout" approach was actually verbalized in the *IMO Car Wash* judgment, which sanctioned a scheme that had to argue why the mezzanine was out of the money (*IMO Car Wash* [2009] EWHC 2114 (Ch)): "The Mezzanine Lenders have a safeguard in the form of clause 12 of the Intercreditor Agreement. If they really thought that the debts were being sold at an undervalue, or at a price which gave the Senior Lenders a good prospect of a benefit in the future which was unfair to the Mezzanine Lenders (because it deprived them of that benefit) then they could buy out the Senior Lenders and do the restructuring themselves, with the benefits which they claim to flow from the restructuring to the Senior Lenders. They have chosen not to do so. They do not seem to want to run the risk."

42 Idem: "Modern Chapter 11 is the equivalent of a provision in a joint venture agreement that calls for the appointment of an appraiser and uses the number that the appraiser sets (or is expected to set) as the baseline against which to measure the rights of the parties. Sophisticated parties often bargain to adopt such mechanisms. A "put" mechanism based on an appraisal is particularly useful when a partner wants to terminate a joint venture, but does not have the liquidity to buy the other partner out, the sine qua non of the dissolution mechanism that uses the I-pick-you-choose "Texas Shootout" approach. Like any other valuation mechanism, however, an appraisal mechanism comes with its own costs. In particular, in the reorganization context, any valuation mechanism that does not involve a transaction that monetizes the senior investor's position (through a sale of the business or a buyout of the position) creates option value in the position of the junior investor. This will be priced into any deal the parties strike, which avoids the need to complete the valuation."

quality of UK judges seems to be preventing the UK model to create more negative effects on junior financing.

Credit rationing these days does not appear to be due to an absence of liquidity in the age of quantitative easing, but rather to the lack of entrepreneurs and of worthy projects for lenders. Sophisticated entrepreneurs are likely to choose in the future the region where they invest taking into account what would be the valuation of their business in case of distress, especially if high R&D investments are expected and markets keep turning upside-down overnight, as seems to be the new normal.

Permeability of the Capital Structure

Finally, the permeability of the capital structure, which is implied by the possibility of operating equity cram-down, also has other important collateral advantages. Indeed, the risk of dilution of the equity operates as a check and balance so that debtors will not commence abusive reorganization processes (i.e. for the purpose of obtaining illegitimate transfers of value at the expense of other stakeholders, who could turn the situation around).[43] In fact, if in the absence of consensus the equity runs the risk of being diluted in the reorganization process itself, the debtor will think twice before commencing a frivolous process that is not strictly necessary in order to restructure the company. This is especially true in the EU, where separation between equity and management is less clean-cut than in the US.

Such risk of dilution also allows indirectly for three important objectives to be achieved. First, it saves the complexities and costs arising from excessive judicial control (direct or delegated) over the debtor in order to rule out the possibility that the commencement of the reorganization process may have had an abusive purpose: in a scenario in which the process may involve the wipe-out of the equity, that type of abuses is not to be expected. Secondly, for the same reason, it relaxes the need for –and the difficulties inherent in– defining the eligibility prerequisite in order to have the reorganization process commenced: it is not necessary to demand a situation of insolvency, nor even financial difficulties with a likelihood of insolvency – so that one manages to thereby get rid of the stigma otherwise associated with the commencement of the process, and also induces debtors resorting to it at early stages. Thirdly, the fact that the debtor has commenced the reorganization process, risking the possibility of the equity being displaced

43 If the valuation is low, the equity could be displaced and thus end up being cut out of the reorganization process commenced by it. If, on the other hand, the valuation turns out to be high, the protection provided by the absolute priority rule should prevent the imposition of a Reorganization Plan that is too onerous for the stakeholders.

as a result of it, shows the reasonableness of maintaining a system of debtor in possession, or with minimal intervention.[44]

The Problem of SMEs

A sophisticated model for reorganization plans with the cram-down feature might only make sense for large and complex corporations, where liquidation entails a considerable loss of value due to the inefficiencies associated with the transfer of their business as a going-concern: operational, contractual, tax, administrative difficulties, etc.[45] Reorganization can both allow to avoid formal liquidation of the corporate structure and the possible inherent loss of value, as well as prevent the sale of the business to a third party at the bottom of the market. Otherwise, for SME's, a simpler process more geared towards an efficient plain vanilla liquidation through business transfers might be contemplated: where the small entrepreneur really adds a particular personal value or knowledge to the business, he would get higher credit than other bidders and outbid them at the auction, recuperate the business free and clear,[46] and enhance creditors' recovery.

Where creditors are able to participate at the auction (as opposed to in the UK pre-pack) the phoenix phenomenon is far from being censurable, but rather a legitimate deleveraging mechanism. Besides, the manageable size of SMEs avoids in the SME scenario the problem posed by the "Texas Shootout". Finally, in case the entrepreneur is not the winner at the auction of his business, where the entrepreneur really adds value to the business he is likely to be offered equity in (or other market consideration by) the acquirer Newco for maintaining the entrepreneur's services. This system allows for the entrepreneur to be offered the equity his services deserve on a case-by-case market basis (otherwise he might as well team up with any other financier), instead of allocating a fix and rigid "prescribed part" to the entrepreneur that might not fit nor be fair in every given situation.

44 Especially if the debtor's period of exclusivity to propose a Reorganization Plan is limited or can be terminated for cause.

45 For this reason, the "going concern surplus" can be understood, not only as including the difference in value between piecemeal liquidation and going concern, but also as including the possible additional difference in value between the business kept as a going concern through a sale and the business kept as a going concern within the same original debtor entity.

46 The insolvency regulation of some States, like Spain, prevents entrepreneurs to bid for their own businesses at the auction in case of liquidation, in detriment of such entrepreneurs (whom are excluded from the market) and of creditors themselves (whose auction is deprived of the bidder most likely to offer the higher price for the business, thus prejudicing creditors' recovery).

Valuation

Cram-down is a powerful and necessary restructuring tool. However, it must come along, on one hand, proper valuation guarantees so as to determine which classes are in or out-of-the-money – and, for fairness tests purposes, valuation should be performed on a future going-concern basis. On the other hand, features like stay/moratorium (on enforcements, involuntary insolvency and/or *ipso facto* clauses), DIP financing and adequate regulation on executory contracts are not only crucial parts of the restructuring toolkit by their own right: these features also play an important role as checks and balances of cram-down of junior stakeholders. Indeed, where these features do not exist, businesses cannot be stabilized and seemingly justified outcomes are therefore seen as lesser evils: hasty pre-packs and schemes of arrangement based on forced sales valuations. But, of course, if businesses can be stabilized in the first place there is no need to resort to hasty procedures and valuations.

However, as advanced before, there is also a lesson to be learned from the UK swiftness in restructuring. While swiftness cannot be a policy on its own, court intervention can be more efficient if it is made variable depending on the necessary toolkit necessary for each case at hand. Therefore, for instance:

a) Stay/moratorium is optional for the debtor, i.e. it can be coupled with the proceedings depending on the needs of the restructuring, but does not kick-in automatically with the opening of the proceedings if not requested by the debtor.

b) DIP financing regime is available but also optional.

c) Appointment of an insolvency practitioner only takes place when the following circumstances concur:

    (i) The reorganization plan is to impair creditors other than financial creditors (lenders and/or bondholders);

    (i) In-depth operational restructuring is envisaged, i.e. rejection of executory contracts (in which case special eligibility requirements for the opening of the proceedings may apply, such as financial difficulties or qualified losses foreseen) or labour measures;

    (iii) The debtor's business produces operational losses; and/or

    (iv) Section 363-type sales of relevant parts of the business are envisioned.

Finally, reorganization and liquidation paths should not be irrevocable: a sale of the business as a going concern should be revocable so as to allow a reorganization plan route to be implemented in case the price of the sale is not deemed fair by creditors. Besides, a real market test being driven in parallel to a plan would also assist to obtain a more accurate valuation reorganization-wise. Also, if the bidders at the business auction know that the creditors can at any given moment rescue the asset through a reorganization plan, that would incentivize bidders not to skimp on their offers. In other words, ability for creditors to recapture a business from an auction and rescue it through a reorganization plan would convey to the third party bidders the impression that, even if the business has arrived to an auction stage, it is not necessarily a "lemon".

VI. Concluding Remarks

The degree and tools of harmonization might depend on the response to the question consisting of which of the two current predominant models to opt for. The option for a model similar to US or Germany allows for it to be an objective element (enterprise valuation), which puts each stakeholder in his place. If equity is out-of-the-money, creditors are allowed to take control of the company, deleverage and rescue it, avoiding its liquidation when viable, and maximizing value and recovery. In exchange, entrepreneurs are comfortable that, in distress, they will kept as debtors in possession and have an opportunity to undertake an operational restructuring before or simultaneously the financial restructuring, optimizing valuation and also their position in the capital structure – which is not possible in a model of summary judicial intervention based on restructurings restricted to pre-insolvency and limited to balance sheet.

Alternative non-banking sources of financing would be propitiated by giving comfort to junior financiers (typically bonds) that, should the debtor face distress, enterprise valuation will not be a depressed value-today valuation, and that, as a result, it would not be only senior lenders who would capture all of the value. Finally, in case the difficulties are mainly financial, the collective proceedings would allow that, in lack of an arrangement between creditors and shareholders, valuation is the basis on which to recompose the capital structure – without affecting workers, clients nor suppliers, with which (unless operational restructuring is also necessary) business as usual could be maintained as counterparties of critical executory contracts, thus minimizing the proceedings' stigma.

In short, cram-down and valuation are not only a relevant matter insolvency and restructuring-wise. In order to promote a capital markets union so as to overcome the risks and flaws of the current EU bank-based system, it might be wise not to embrace a model where, in case of distress, "the senior takes it all".

Chapter 11

Pre-Insolvency Arrangements: The Belgian Experience

Melissa Vanmeenen

I Introduction

Pre-insolvency arrangements come in different shapes and colours and the rescue approach varies widely between jurisdictions. However all these mechanism have in common that they strive to save the business from failure. During the last decade the attention for pre-insolvency mechanisms is intensively growing both on the national and the European level. Remarkably the business rescue culture has recently taken another turn towards European harmonisation. The European Parliament kicked off the harmonisation trend with its Resolution of 15 November 2011 with recommendations to the Commission on insolvency proceedings in the context of EU company law.[1] The Commission answered this call and outlined the importance of efficient business rescue mechanisms for the European market on several occasions.

A new landmark in the harmonisation development was the Commission's Recommendation on a new approach to business failure and insolvency (2014).[2] The (non-binding) EC Recommendation 2014 encouraged the Member States to implement efficient reorganisation procedures based on the same common features. One of the objectives of the EC Recommendation 2014 is to ensure that viable enterprises in financial difficulties, wherever they are located in the Union, have access to national insolvency frameworks which enable them to restructure

1 European Parliament Resolution of 15 November 2011 with recommendations to the Commission on insolvency proceedings in the context of EU company law (OJ 2013, C153E/01). This resolution builds upon previous studies on harmonization: "Harmonisation of Insolvency Law at EU level" (April 2010), available at: http://www.europarl.europa.eu/committees/en/supporting-analyses-search.html#studies and the following in-depth analyses building upon this report.

2 Commission Recommendation of 12 March 2014 on a new approach to business failure and insolvency, 2014/135/EU (OJ 2014, L74/65) ("EC Recommendation 2014"). See for commentary on the Recommendation: K. van Zwieten, "Restructuring law: Recommendations form the European Commission" (2014) *EBRD Law in Transition* 2; S. Madaus, "The EU Recommendation on Business Rescue – Only Another Statement or a Cause for Legislative Action Across Europe?" (2014) 27(6) *Insolvency Intelligence* 81; H. Eidenmüller and K. van Zwieten, "Restructuring the European Business Enterprise: The EU Commission Recommendation on a New Approach to Business Failure and Insolvency", ECGI Law Working Paper No 301/2015 – Oxford Legal Studies Research Paper No 52/2015, available at: ssrn.com.

at an early stage with a view to preventing their insolvency.[3] In other words the implementation of pre-insolvency restructuring tools is a must.

The Member States were invited to implement these principles by 14 March 2015. Six months later the Commission published an evaluation report concluding that the main elements of the EC Recommendation 2014 are implemented in different ways in the Member States.[4] Several Member States considered that they already largely complied with the EC Recommendation 2014.[5] Moreover a significant number of Member States, who did not comply, cherry picked from the EC Recommendation 2014 or stayed inert. The EC Recommendation 2014 did not succeed in having the desired impact to facilitate the rescue of businesses in financial difficulty. However the Commission is determined to enhance the business rescue tools in the EU.[6] To obtain this goal, the Commission announced a new legislative proposal on insolvency by the end of 2016.[7] One can anticipate that this new initiative will be of a more binding nature. No doubt this new instrument will be a new milestone in the harmonisation movement.

Harmonisation of business rescue mechanisms requires a good insight in the existing tools to determine the most effective way forward. This chapter intends to contribute to this exercise by discussing three topics. The first part will examine the concept of pre-insolvency arrangements. Secondly the Belgian pre-insolvency arrangements will be briefly discussed. The chapter will conclude with some thoughts on the effectiveness of business rescue tools in Belgium. To avoid any misunderstanding, it is important to clarify that this chapter only considers corporate rescue mechanisms. In Belgium, corporate rescue tools apply both to companies and individual entrepreneurs (natural persons).

3 The Recommendation also aims at giving honest bankrupt entrepreneurs a second chance across the Union. This objective will not be discussed in this chapter.

4 Evaluation of the implementation of the Commission Recommendation of 12.3.2014 on a new approach to business failure and insolvency (30 September 2015), available at: http://ec.europa.eu/justice/civil/files/evaluation_recommendation_final.pdf.

5 For a detailed analysis of the compatibility of the Belgian legislation, see M. Vanmeenen, "In de ban van continuïteit" (2015) 6 *Tijdschrift voor Belgisch Handelsrecht* 526.

6 See e.g. "Action Plan on Building a Capital Markets Union" COM (2015) 468 final (30 September 2015) (Insolvency at 24-25); Commission's Communication "Upgrading the Single Market: more opportunities for people and business" COM (2015) 550 final (28 October 2015) (Insolvency at 6); Commission Communication "Towards the completion of the Banking Union" COM (2015) 587 final (24 November 2015) (Insolvency at 10).

7 In order to prepare this new legislation, the Commission sought feedback through different channels. In December 2015, the Commission set up an Expert Group consisting of 22 independent (non-governmental) experts, who will assist the Commission in the preparation of a legislative proposal. The Commission also sought input from the broadest public possible though its "Public consultation on an effective insolvency framework within the EU", available at: https://ec.europa.eu/eusurvey/runner/InsolvencyJUSTA1 (closed 14 June 2016). The Commission will also take into account the result of the new "Study on a new approach to business failure and insolvency. Comparative legal analysis of the Member States' relevant provisions and practices", prepared by the Leeds University, (Tender No. JUST/2014/JCOO/PR/CIVI/0075) (not yet published).

II The Concept of Pre-Insolvency Arrangements

To define the concept of pre-insolvency arrangements is a difficult exercise. Before one can tackle this question, a clear understanding of the notion "insolvency" is prerequisite. However insolvency is an ambiguous notion with different interpretations. Insolvency goes back to the Latin verb "*in-solvere*", which means "not able to pay". To simplify the delineation, a distinction between insolvency *sensu stricto* and insolvency *sensu latu* is helpful.

Insolvency sensu stricto addresses the state of being insolvent entailing the compulsory opening a collective procedure during which the assets of the debtor are sold off and his creditors are paid out of the proceeds of the assets The opening of such a collective insolvency procedure traditionally requires an "insolvency test". Various insolvency tests exist in different countries. Some of these insolvency test focus primarily on illiquidity (e.g. the cessation of payment test or the cash flow test), other insolvency tests compare the value of the debtor's liabilities to the value of his assets (e.g. balance sheet test; over-indebtness test). Sometimes different approached are combined to determine the insolvency. *Insolvency sensu latu* regards a situation of (financial) difficulties bringing about a potential risk of insolvency for the debtor. Pre-insolvency arrangements undoubtedly fit this last category, such arrangements are initiated in view to avoid a formal insolvency *sensu stricto*.

The same view is taken in the INSOL Study on a new approach to business failure and insolvency,[8] published in May 2014. This study identifies a number of problems to formulate a uniform and/or shared definition of "pre-insolvency proceedings" due to the differences and divergences in the domestic laws of the Member States. However the following general description is proposed:

> "Pre-insolvency proceedings are proceedings opened because the debtor is in financial difficulties but without any prior insolvency test, they involve the applicability of special rules of insolvency law."

The comparative study distinguishes between confidential and public pre-insolvency proceedings. Pre-insolvency proceedings differ from full insolvency proceedings, which are opened after the insolvency test has been carried out and the court has determined that the debtor is insolvent. At the European (regulatory) level, the concept of insolvency is often used but deliberately never defined.[9]

8 Study on a new approach to business failure and insolvency – Comparative legal analysis of the Member States' relevant provisions and practices (Tender No. JUST/2012/JCIV/CT/0194/A4), available at: http://ec.europa.eu/justice/civil/files/insol_europe_report_2014_en.pdf.

9 The need for such a common definition of insolvency at EU level is questioned in the recent Public consultation of the Commission, above note 6, in questions 2.7 and 2.7.1.

The first instrument to be examined is the European Insolvency Regulation ("EIR"). Neither the Original EIR[10] nor the Recast EIR[11] include a definition of insolvency. Depending on the context, insolvency refers to insolvency *sensu stricto* or insolvency *sensu latu*. However the importance and the impact of the insolvency concept increases in the Recast EIR due to its broader scope of application. The new Article 1 of the Recast EIR explicitly encompasses hybrid and pre-insolvency proceedings striving *to avoid the debtor's insolvency or the cessation of the debtor's business activities*.

While the Original EIR focusses mainly on traditional insolvency proceedings (so called full insolvency proceedings), the Recast EIR considers the widest possible spectrum of insolvency proceedings.[12] Nevertheless the question whether a debtor is insolvent, is always left to the national level. Member States decide exclusively whether a national procedure should be considered as an insolvency proceeding in the context of the EIR. These proceedings are listed in the Annex to the EIR. Both type of insolvency (proceedings) *sensu stricto* and *sensu latu* are included in the Annex. The second example is the previous mentioned Recommendation. Again no definition of the notion of insolvency in this instrument, but the term is popping up regularly. A key element within the Recommendation is the prevention of insolvency (*sensu stricto*). A debtor should be viable but a likelihood of insolvency (in the strict sense) is required. The objectives of the EIR obviously relate to insolvency *sensu latu*, but the notion of insolvency *sensu stricto* plays an important role to determine its scope of application.

Defining insolvency on a European level remains a hazardous mission, because it touches upon the heart of national insolvency laws. Which insolvency test should be considered the best one to determine a state of insolvency *sensu stricto*? Is there actually a way to determine the best insolvency test? Which moment in time could be considered as an acceptable starting point to turn to pre-insolvency mechanisms (insolvency *sensu latu*)? Under which conditions a potential pre-insolvency mechanism should be turned into full insolvency proceedings? These questions are hard to resolve and at present the answers are to be found at national level only. This brings us to the Belgian level. Belgian corporate insolvency legislation is twofold: the Bankruptcy Act of 8 August 1997[13] and the Business Continuity Act

10 Regulation (EC) No. 1346/2000 of 29 May 2000 (OJ 2000 L160/1) ("Original EIR").

11 Regulation (EU) No. 2015/848 of 20 May 2015 (OJ 2015 L141/19) ("Recast EIR").

12 Please note the fact that it is prerequisite for the application of the Recast EIR that a proceeding is based on laws relating to insolvency (in a broad sense).

13 Loi sur faillites – Faillissementswet (*Belgian State Gazette*, 28 October 1997), entered into force on 1 January 1998, 23 amended versions, updated official text available in Dutch, French and German at: http://www.ejustice.just.fgov.be/wet/wet.htm.

of 31 January 2009 ("BCA").[14] These acts do not include a definition of the general concept of insolvency. Again we note the use of 'insolvency' in various situations.

An insolvent debtor (*sensu stricto*) is an enterprise (natural person or legal person) who is not able to pay his outstanding debts ("cessation of payment") AND does not get credit from his bank and/or suppliers anymore ('lack of credit'). Such a debtor is considered to be in a "state of bankruptcy". Upon fulfilment of both conditions, bankruptcy proceedings should be opened. Bankruptcy proceedings are initiated either by the debtor, by a creditor or by the public prosecutor.[15] Debtors are obliged to apply for bankruptcy proceedings within 30 days after cessation of payment[16] or else they might be penalised. Bankruptcy proceedings consist of a traditional piecemeal liquidation under the supervision of an insolvency practitioner.

Parallel to the bankruptcy proceedings, Belgian legislation offers other corporate insolvency proceedings. These proceedings focus on reorganisation of businesses in distress and consequently classify as insolvency instruments *sensu latu*. These reorganisation mechanisms will be further discussed in the next chapter. In view of our research on the concept of insolvency, it is interesting to focus on and compare the entry criteria. Belgian reorganisation mechanisms can be divided in two categories: informal and formal reorganisation mechanisms. Only for the second group entry criteria apply. A formal judicial reorganisation proceeding can be opened if the debtor faces an imminent or potential continuity threat.[17] Not the potential insolvency (*sensu stricto*), but the continuation of the business is the key threshold to access this procedure. Moreover this procedure is also explicitly accessible to debtors who fulfil the above mentioned bankruptcy criteria.[18]

In other words, debtors who are insolvent (*sensu stricto*) can opt for a reorganisation procedure instead of a bankruptcy procedure. This approach illustrates the determination of the Belgian legislator to save as much businesses as possible by introducing a legal preponderance of the pre-insolvency arrangements over the bankruptcy proceedings. This brings us to a striking conclusion: the concept of insolvency is at first glance irrelevant for Belgian reorganisation mechanisms. The principle objective is the continuity of the business activity. More over the reorganisation mechanisms are also available for insolvent debtors. Of course

14 Loi rélative à la continuité des enterprises/Wet betreffende de continuïteit van de ondernemingen (*Belgian State Gazette*, 9 February 2009), entered into force on 1 April 2009, 6 amended versions, updated official text available in Dutch, French and German from the same website mentioned above note 13.

15 Article 6, Bankruptcy Act.

16 Ibid., Article 9.

17 Article 16, BCA.

18 Ibid., Article 23.

in the end prevention of insolvency will be the ultimate result, when the debtor succeeds to rescue his business (activity) by way of a reorganisation mechanism.

The preceding brief observations do not reveal a clear answer to the delineation question regarding pre-insolvency arrangements. The pre-insolvency period is vague, depends on the angle taken and is determined by national parameters. To solve this issue and to confine potential misunderstanding of this paper, the following working hypothesis is put forward. Pre-insolvency arrangements should be understood as all mechanisms available to the debtor to prevent a (potential) piecemeal liquidation procedure.[19]

III Pre-Insolvency Arrangements in Belgium

The table below offers a bird eye view of the corporate insolvency proceedings available in Belgium. The first two columns encompass reorganisation tools, while the third column considers the traditional liquidation procedure. Taking into account the working hypothesis explained above, the latter will not be further discussed in this chapter. This part focusses on the Belgian reorganisation tools which could be considered as pre-insolvency arrangements. As stated above, two different tracks of reorganisation mechanisms are distinguished: the informal reorganisation (first column) and the formal reorganisation (second column). Both ways of reorganisation are handled exclusively by the Commercial Courts.

Table 9.1. Map of Belgian Procedures

<table>
<tr><th colspan="4">PRE-INSOLVENCY ARRANGEMENTS</th><th>LIQUIDATION</th></tr>
<tr><td>Informal reorganisation/ Out-of-court

No procedure
No stay</td><td colspan="3">Formal reorganisation
Judicial reorganisation procedure

Court supervised procedure
Moratorium period – general stay for all creditors
Debtor in possession</td><td>Bankruptcy

Court supervised procedure
Liquidator</td></tr>
<tr><td>Amicable agreement
Art 15, BCA</td><td rowspan="2">Amicable agreement
Art 43, BCA</td><td rowspan="2">Collective agreement
Arts 44-58, BCA
Reorganisation plan
Simple vote by creditors
Court confirmation</td><td rowspan="2">Transfer of business under court supervision (going concern)
Arts 59-70/1, BCA</td><td rowspan="2">Bankruptcy procedure
Bankruptcy Act</td></tr>
<tr><td>Business mediator
Art 13, BCA</td></tr>
<tr><td></td><td>Annex A, EIR</td><td>Annex A, EIR EC Recommendation 2014</td><td>Annex A, EIR</td><td>Annex A, EIR</td></tr>
</table>

19 Companies or natural persons with a commercial business activity.

Informal Reorganisation Track

The *informal reorganisation track* offers different possibilities depending on the situation of the debtor: the appointment of a business mediator,[20] the appointment of an interim administrator[21] and the informal amicable settlement.[22] All of the mechanisms are confidential and low cost recue tools.

The informal amicable agreement is the principal reorganisation mechanism and is mainly governed by contract law. A debtor can negotiate an amicable agreement with at least two creditors. The settlement only involves creditors who take part in the negotiations and voluntarily agree to be bound by the settlement. The parties to this amicable agreement are free to determine its content. There is no strict legal framework that should be taken into account. It is possible to file the settlement at the commercial court. In that case the amicable agreement will not be reviewed or approved by the court, the agreement remains strictly confidential. There is no obligation to file the amicable agreement, however such filing offers a considerable advantage: payments executed in good faith under the settlement will be protected against avoidance actions[23] in future bankruptcy proceedings. It is important to note the difference between an *informal* amicable settlement (Article 15 of the BCA) and a *formal* amicable settlement in the BCA (Article 43 of the BCA). The basic features are the same, but the first option:

(1) does not entail a moratorium for the creditors;

(2) is not a formal and public procedure involving court supervision; and

(3) remains confidential at all times.

A business mediator is appointed by the Commercial Court at the sole request of the debtor.[24] No other parties may request such an appointment. The main task of a business mediator is to facilitate the reorganisation of the business. A business mediator will analyse the problems of the debtor and will suggest solutions to rescue the business. Commonly the mediator will assist the debtor with the negotiation of an informal amicable agreement. It is important to know that a business mediator is not an administrator, the debtor remains in full control of his business.

20 Article 13, BCA.
21 Ibid., Article 14.
22 Ibid., Article 15.
23 Payments, which are envisaged in Articles 17, 2° and 18, Bankruptcy Act.
24 Article 13; BCA.

Before the opening of a formal judicial reorganisation proceeding, an interim administrator may by appointed by the president of the Commercial Court at the request of any interested party in accordance with Article 14 of the BCA. This appointment serves as a protective measure in case of gross mismanagement of the debtor or its corporate bodies threatening the continuity of the business. The tasks and powers of an interim administrator are determined by the court taking into account the specific facts of the case.

All three of the informal mechanisms discussed above should be considered as pre-insolvency arrangements. These mechanisms can be used by the debtor to avoid a formal bankruptcy procedure. However none of these mechanisms are included in the EIR, neither do they correspond with the basic features proposed by the EC Recommendation 2014. This situation could be partially explained by the informal and therefore confidential nature of the mechanisms.

To conclude this brief overview of informal reorganisation tools in Belgium, a concise observation on a specific court-driven prevention tool, the so-called commercial investigation procedure,[25] is indispensable. This technique consists of Commercial Court judges monitoring the financial situation of troubled businesses and inviting them to appear in court if their difficulties appear to be heading towards bankruptcy. By doing so, the court seeks to prevent undertakings from becoming insolvent by encouraging reorganisation at early signs of trouble. Although this mechanism's purpose is bankruptcy prevention, we hesitate to classify the commercial investigation procedure as a pre-insolvency arrangement. These court activities should rather be considered as a supporting measure to promote the actual pre-insolvency arrangements discussed above. For the same reason the commercial investigation procedure is left out in the table above.

Formal Reorganisation Track

The judicial reorganisation procedure constitutes the *formal reorganisation track* under the BCA. As a rule this public procedure is initiated at the request of the debtor.[26] The judicial reorganisation entails a general moratorium granted by the court to protect the debtor from his creditors by suspending their rights.[27] The

25 Enquête commerciale – Handelsonderzoek, see Articles 5-12, BCA. For a detailed analysis, please refer to M. Vanmeenen, "Corporate Rescue in Belgium", in M. Veder and P. Omar (eds), *Teaching and Research in International Insolvency Law: Challenges and Opportunities* (2015, INSOL Europe Academic Forum and NACIIL, Nottingham), at 84-87.

26 Article 59, BCA, stating that, exceptionally, the procedure can be introduced by a creditor or the public prosecutor.

27 Ibid., Articles 30-34. The stay of individual enforcement actions is also binding upon secured and preferential creditors, see Recommendation 10, EC Recommendation 2014. The need for such a general moratorium is questioned in the recent Public consultation of the Commission, above note 6, in questions 2.9-2.9.2.

moratorium is granted for a maximum initial period of 6 months,[28] with unlimited possibilities for renewal up to 12 months.[29] Commonly the debtor remains in possession and is trusted to conduct his business without any court intervention. Exceptionally, in fraudulent cases, the debtor or its directors can be divested and replaced by an administrator.[30] This debtor-in-possession regime fits both the EC Recommendation 2014[31] and the Recast EIR.[32]

During the moratorium period the debtor will start a reorganisation exercise. The judicial reorganisation procedure offers three restructuring options: an amicable agreement, a collective agreement or a transfer of business under court supervision. An amicable agreement[33] consists of a (contractual) settlement between the debtor and at least two creditors. These creditors need to agree with the proposed restructuring measures, e.g. deferral of payments, debt reductions, etc. The debtor determines which measures he considers to be appropriate and to whom he will propose them. However a creditor will only be bound by these measures, if he accepts them explicitly. Exceptionally the court can impose a payment deferral without the consent of the creditor. Once agreed upon, the amicable agreement will be presented to and acknowledged by the court[34] and the judicial reorganisation procedure will end.

The second option, the collective agreement,[35] is by far the most popular reorganisation tool. The debtor will prepare a reorganisation plan which is submitted to a vote of all creditors involved in the plan. The reorganisation plan can propose restructuring measures such as instalment periods, debt reductions (principal claim and interest), debt-equity conversion, a restricted right to set off claims, transfer of business, etc. The time limit of all proposed measures is set at five years maximum. As a rule all creditors should recover at least 15% of

28 Ibid., Article 24. Please note that the moratorium granted by the court, may vary from case to case.

29 Ibid., Article 38. In exceptional circumstances the moratorium can be extended up to 18 or 24 months (see Articles 38 and 60, BCA).

30 Ibid., Article 28.

31 See Recital (17) and Recommendation 6(b), EC Recommendation 2014.

32 See Article 1, Recast EIR.

33 Article 43, BCA. Please note the difference between the formal amicable settlement with moratorium and the previously discussed informal settlement without moratorium (Article 15, BCA).

34 The settlement should not be approved by the court. However the judicial acknowledgment does offer an advantage: payments conducted in the course of the amicable settlement will be protected against claw back actions in subsequent bankruptcy proceedings.

35 Articles 44-58, BCA.

their claim.[36] The reorganisation plan will be binding on all creditors,[37] when it is approved by a majority[38] of creditors and ratified by the court.[39]

The transfer of business under court supervision[40] is the third reorganisation option. In such a case the court will order the transfer of all or part of the business activity, either with or without the debtors' consent. Once the court decides to initiate the transfer, the debtor is no longer in charge of the reorganisation process. The transfer is prepared and effectuated by the court representative, who will search the relevant market for the best offers. Once a reasonable offer for the business activities has been selected, the court will hear the various stakeholders, including the creditors, and will approve, where appropriate subject to conditions, or reject the sale. Following the completion of the sale of the business, the proceeds of the sale are distributed by the court representative among the creditors taking into account any existing security interests. This distribution process is very similar to a distribution in a bankruptcy.

The transfer of business under the BCA is therefore perceived as an alternative to bankruptcy. Preserving (going concern) value and employment are considered to be the main (expected) benefits of the transfer procedure *vis-à-vis* a traditional bankruptcy procedure. It should be emphasized that the transfer of business under court supervision is different from a prepack regime: the transfer is initiated by a court decision, the implementation is supervised by the court and finally the court decides if, by whom and at which price the business activity is transferred.

Finally the qualification of the formal judicial reorganisation procedure as a pre-insolvency arrangement requires some concluding observations. The interaction between the application criteria of the judicial reorganisation procedure and the working hypothesis stated above instigates a potential paradox. The judicial reorganisation procedure should be considered as a pre-insolvency arrangement because it is accessible to businesses that suffer an imminent or potential continuity threat. However the fact that this procedure is also available for insolvent debtors

36 Ibid., Article 49/1. The minimum recovery rate of 15% was only recently introduced by the Act of 27 May 2013, which aims to reduce abuses by debtors. Compare to Recital (19) and Recommendation 22(c), EC Recommendation 2014.

37 Ibid., Article 57. This is in line with Recommendations 25-26, EC Recommendation 2014.

38 Ibid., Article 54. The reorganisation plan is accepted, when it is approved by more than half of the creditors present at the vote, together representing more than half of the principal amount of the claims involved Please note that claims of creditors who are not present or represented at the vote, are not taken into account for the calculation of the majority.

39 Ibid., Article 55. The court can only reject a reorganisation plan if the debtor did not respect the formal requirements of the BCA or if the plan violates rules of public order.

40 Ibid., Articles 59-70/1.

(being in a state of bankruptcy), might bring some doubts with regard to the PRE-insolvency requirement.[41] Nevertheless the Belgian approach strives to preserve business activity and therefore still dovetails with the main objective to prevent a piece meal liquidation. Consequently the qualification of a pre-insolvency arrangement should be endorsed.

The judicial reorganisation procedure also fits in with the new European business rescue model. The three restructuring options provided for in the judicial reorganisation procedure are all included in the Annex A of the Recast EIR.[42] This brings about a European wide recognition of these three restructuring options. As regards the scope of the EC Recommendation 2014, only the collective agreement option corresponds more or less to the framework proposed.[43] On the contrary the amicable agreement and the transfer of business are not addressed in the EC Recommendation 2014.

IV Effective Business Rescue in Belgium?

The previous part attested the comprehensive legal framework to rescue businesses in Belgium. However does this framework also bring about effective business rescue? As regards the informal reorganisation mechanisms the question remains unsure. There are no statistics available due to the confidential character of these mechanisms. However several judges state that to their knowledge the informal tools are not regularly used. In contrast elaborated statistic evidence is available to evaluate the success of the formal judicial reorganisation.[44]

41 Recitals (1) and (16) and Recommendations 1, 6(a) and 11(b), EC Recommendation 2014 require firmly that restructuring mechanisms should only be available for viable debtors. For a critical evaluation and some alternatives, see Eidenmüller and van Zwieten, above note 2, at 29-30.

42 Please note that the Original EIR was not applicable to the amicable agreement within a judicial reorganisation procedure because this option was not included in Annex A.

43 See Recital (19) and Recommendations 6(d) and 15-26, EC Recommendation 2014. For a detailed analysis of the compatibility of the BCA with the EC Recommendation 2014, please refer to Vanmeenen, above note 24, at 77-91.

44 Yearly statistics and a detailed analysis are available at: www.graydon.be. The most recent analysis can be found in "Gezondheidsbarometer van de Belgische ondernemingen – Baromètre de la santé des entreprises belges, 31/21/2015" (28 June 2016).

Table 9.2. Statistics of Procedures

	BANKRUPTCY	JUDICIAL REORGANISATION (BCA)			
	Total Number	Total Number	Amicable Agreement	Collective Agreement	Transfer of Business
2009	9,504	633 (from 1 Apr)	82	341	15
2010	9,939	1,253	249	688	40
2011	10,519	1,389	281	847	68
2012	11,062	1,438	304	1,029	94
2013	12,306	1,460	216	1,073	109
2014	11,294	1,117	135	814	125
2015	10,601	877	101	658	100

Source: Graydon Belgium

These statistic data demonstrate a number of trends. First finding is the large discrepancy between the yearly number of bankruptcies and the yearly number of judicial reorganisation procedures. Although the Belgian legislator strongly focusses on reorganisation, bankruptcy proceedings significantly outweigh reorganisation proceedings. Second trend is the decrease of the number of judicial reorganisation proceedings in the last two years. This evolution is caused by an amendment of the BCA in 2013,[45] which tightened certain procedural aspects, making it far more difficult for a debtor to file for a judicial reorganisation procedure.[46]

Thirdly, a clear shift from the amicable agreement to the transfer of business under court supervision becomes gradually visible over the years. As discussed above, the transfer of business is considered as an alternative to bankruptcy proceedings. Finally, a fourth finding should be added to the figures shown in the table. Statistic data demonstrate that after a six year period, 75 to 80% of all BCA-undertakings end up in bankruptcy anyway. This leads to the conclusion that, at least for now, the bankruptcy prevention ratio of the BCA is significantly low.

Hence do we need different procedures or legislation to enhance business rescue? I am not convinced we do. Currently the Belgian legislator is working on a codification of the insolvency legislation.[47] The first results of this initiative will presumably be published in the beginning of 2017. It is anticipated that the new legislation will not bring about fundamental changes for the business rescue regime. In my opinion, fine tuning legislation might be useful, but if we

45 Act of 27 May 2013 (*Belgian State Gazette*, 22 July 2013), entered into force on 1 August 2013.

46 For example a higher filing fee (from EUR 60 to 1,000); compulsory filing of financial documents prepared with the assistance of an external accountant or auditor to ensure that the data provided are reliable. For a comment on the impact of the 2013 amendment, refer to Vanmeenen, above note 24, at 87-91.

47 The Bankruptcy Act and the BCA will be inserted in the new Economic Law Code.

want to enhance business rescue, we should be working on a change of mindset of businessmen rather than changing the legislation. Only expedient and early recourse to reorganisation tools will do the trick. Such a change of mindset is a major challenge in the whole of Europe.

However, and this is just as important as changing the mindset, in many (minor) cases a timely and swift liquidation is still the best way forward. So paradoxical re-imagining rescue is also pushing businesses into liquidation as soon as possible before debts have increased tremendously. A responsible liquidation policy of course needs to be accompanied with flanking measures on second change. After a swift liquidation remaining debts should be discharged within a reasonable period of time to offer honest businessmen an effective fresh start. In this respect the EC Recommendation 2014 upholds a maximum period of three years.[48] As regards the Belgian situation, there are some changes to be made. Potentially the Belgian legislator could look into this issue while preparing his new code.

48 See Recommendations 30-33, EC Recommendation 2014.

Chapter 12

Reimagining Rescue: The View from the United States

G. Ray Warner

Keynote Address

I am very honored to be here. I would like to thank Professor David Burdette and Professor Michael Veder for inviting me to Nottingham. I also would like to thank INSOL Europe for hosting this event. I look forward to a stimulating and informative conference. My non-bankruptcy colleagues at St. John's University in New York think that Nottingham is the perfect place for an insolvency conference. You should see the emails. The Robin Hood statue that really made me feel at home. Just like us, he helped the poor address the problem of insolvency. And, he had a rather novel approach to the problem. So this is not the first time that a group has gathered in Nottingham to reimagine rescue.

It is an exciting time to be involved in insolvency law in Europe. Things are changing here, and they are evolving very quickly. Less than 4 years ago in 2011, the European Parliament adopted its Resolution on Insolvency Proceedings in the Context of EU Company Law. Four months later, the European Commission issued its Communication to the European Parliament on the Single Market Act II, with business rescue as its Key Action Item 7. Then the European Commission's Recommendation on a New Approach to Business Failure and Insolvency was issued in final form only a little more than a year ago. And then, only a month ago on 20 May, the final version of the revised EU Regulation on Insolvency Proceedings was issued and the final printed version became available only two weeks before this conference.

David asked me to start us off with a few thoughts about the EU Insolvency Project from the United States' perspective. My first thought is that we are jealous. You are having all of the fun. There is almost no legislative insolvency action going on in the US. Indeed considering the current dysfunctional state of our Congress, you probably do not want it to look at our insolvency laws. As academics, we are left to study, then study, then study some more.

So what is the US view of what is happening in Europe? While I can't speak for everyone in the United States, I think I can sum up our main view in a word. That word is "competition". For a long time we were the only option if you wanted to reorganize a global business. Chapter 11 was the option – and frankly it was a pretty good process. It was open and transparent. It provided a very flexible process that could be adapted to almost any situation. It gave everyone a voice. Even the disorganized general creditors were given a committee that could assert their interests. That committee could employ lawyers, accountants and investment bankers to level the playing field. And, the fees for their services were paid out of the bankruptcy estate with no direct cost to the creditors.

Chapter 11 allowed the business to continue operating with existing management and with little disruption as it shifted into the formal bankruptcy process. It provided a nice set of tools designed to preserve the going concern value of the business. There was a comprehensive moratorium, forced contract assumption, and rescue financing. These tools helped to preserve the business' going concern value, and sometimes even increased it. Chapter 11 provided an environment where the stakeholders could negotiate a workout, and it included some pretty strong incentives to reach a compromise. It included valuation and auction tools that largely ensured that the enterprise value was received by the estate in either a reorganization or a sale. It included an active judge on call to reign in dishonest or stupid management. It included an expedited dispute resolution process that could promptly address almost any legal issue facing the enterprise.

- It saved businesses;
- It saved jobs;
- It helped preserve communities; and
- It preserved value for stakeholders.

It also became a reasonably effective cross border restructuring tool. Three main factors account for that. The first was that our bankruptcy law applies extraterritorially. But that's not very strange since most nations' insolvency laws apply to the worldwide assets and affairs of entities subject to a proceeding. However, unlike most nations, we had a very low threshold for asserting jurisdiction over an entity. Basically, if any property, even a tiny amount, was located in the United States, then the US courts could take jurisdiction of the case. This was true even if the asset was moved to the US solely for the purpose of creating bankruptcy jurisdiction. While this principle has been criticized, I believe that if you look at the cases where the US courts retained jurisdiction you will see that they did so because a US Chapter 11 was necessary to preserve the enterprise's value. These two factors would only be interesting academic points if it weren't for the third factor. The US had the world's most important economy so virtually every major creditor or counterparty of a global enterprise had interests in the US that required it to obey the orders of the US courts.

What has changed? Well, we have added a number of special interest provisions and exceptions to Chapter 11 that make it less useful as a tool to save businesses. At the same time, we have allowed the costs to balloon to the point that it may no longer be an attractive restructuring option for many enterprises. But the other issue is competition. It started when the English embraced the rescue culture. Changes in its insolvency laws and innovative uses of pre-packs and schemes of arrangement provided a quicker and cheaper way to restructure the finances of an enterprise without interrupting its operations. Then, taking a page from our play book, the English courts interpreted their jurisdiction so broadly that virtually any enterprise from any nation could come to London to reorganize.

The English competition did not just take cases away from the US courts; it also took away cases from other EU courts. For the United States, London has mostly taken away some of the global enterprise cases we used to get. And many of those arguably had no business being in the US courts anyway. We really haven't seen our local enterprises or global enterprises that we think of as American flock to London for their restructurings, although I suspect we may eventually see that too. However, that is not the cases for other EU countries. There London's liberal rescue tools have been used by many enterprises that other EU member states view as local enterprises. I suspect that is why we are here today.

The European Commission recommendations merely invite all EU nations to join in the competition for restructuring cases. That invitation may have arrived a little late. Based on the 2014 INSOL report produced by Professor Stefania Bariatti and Robert van Galen, most of the EU member states already had laws incorporating major features of rescue before the Recommendation was formally issued. The competition to create a local rescue scheme that could lure German companies back to Germany, Spanish companies back to Spain and Dutch companies back to the Netherlands already was well underway.

Competition can be a good thing. Competition can drive us to excel, with each nation trying to build a better rescue process that will make the world a better place. It can also be a bad thing. We may become so afraid that our nation will lose its place in the insolvency world, and of depriving our insolvency professionals of lucrative fees, that we design our laws to attract insolvency business rather than to achieve the best insolvency results. Features in our laws that protect creditors or make the process more open and harder to control may discourage the case placers from choosing our courts and our professionals. Competition puts pressure on us to remove or dilute those protective features of our laws.

So are we in a race to the top – or a race to the bottom? I fear that it is a race to the bottom. Unlike most competitive marketplaces, the insolvency market is not one where the buyers want the best product they can get for the best price. Instead the buyers are the managers or owners of the failing enterprises, or maybe their principal financiers. They are not looking for the best rescue system and do not care how other creditors, employees, contract counterparties or society are treated by the law they choose. They cannot be trusted to make a valid cost benefit analysis for society of the different available rescue options. Instead, they are engaged in a game of regulatory arbitrage, picking the system with the fewest limitations on their ability to achieve their goals. Then, using the EU treaties and regulations and cross-border tools like the UNCITRAL Model Law on Cross-Border Insolvency, they seek to impose that result elsewhere.

My second serious thought is hope. I have hope that you might lead the rest of the world to a new understanding of what rescue means, new theories about what recue can or should be used to achieve, and maybe even some novel ideas about how best to achieve the goals of business rescue. The title of this conference is "Reimaging Rescue." I really hope that you can.

So how does the current EU insolvency project look to me coming, as I do, from the United States? I am not sure what I can say that will be useful to you. My deep understanding of the US system may allow me to provide you with a few helpful insights. But I am feeling very unworthy of the honor of speaking to you today. I know that I lack a full understanding of the EU context. And, due to the limited number of current sources available to me in the United States, I cannot know the full range of national insolvency reform projects currently underway in England and Europe. Thus, please forgive me if some of my observations are naïve or miss the mark.

So what do I think? Honestly, I am a little bit bored with rescue. Almost forty years ago, the United States innovated with Chapter 11. That was pretty imaginative and pretty interesting -- when I was a MUCH YOUNGER MAN. A few years ago, the English innovated a little bit by adapting their scheme of arrangement to rescue situations. But that was basically just a Chapter 11 class cram down without the rest of the case. It is interesting that the English continue to act like their scheme is not an insolvency process. Does that mean that I can't really even count it as an innovation in this field?

I gather that most of the other European rescue schemes are variations on the same old composition and arrangement idea, with the addition of feature that permits the majority to bind a dissenting minority. It is interesting and important that the Commission Recommendation expands upon that idea and adds in an inter-class cram down so that an entire dissenting class can be bound by the plan. The English pre-pack isn't much more imaginative. One of the really interesting things about it from a US perspective is that it proves the old saying that the United States and UK are two nations divided by a common language.

What we call a "pre-pack" looks more like an English scheme of arrangement. In our pre-pack, we propose an exchange offer and solicit acceptances outside of bankruptcy and then flip it into a Chapter 11 to get court confirmation and bind the dissenting class members. It was used just a few years ago in the MGM case. MGM was rescued by a pre-pack and was in and out of Chapter 11 in only 47 days. Most importantly, the bankruptcy did not interrupt the on-going filming of The Hobbit, which proves my point about the importance of Chapter 11. It saves Hobbits. And if you saw the Lord of the Rings, you know that is no small feat!

The English pre-pack does not seem that imaginative to us. It is basically a section 363 sale. Only it is usually a sale to insiders, without the protection of competitive bidding, or any serious scrutiny by a court, or any real opportunity for challenge by affected parties. Sure, there is a licensed Insolvency Practitioner overseeing the process. But after a host of accounting scandals, Americans tend not to believe in the integrity of licensed professionals, especially when they are selected by parties with financial incentives that may conflict with the interests they are charged with protecting. Of course, Americans tend not to believe in climate change either, so maybe our views on this are not worth much.

But back to my point – I'm bored. I read about legislation in other countries and attend lectures on new developments globally and, to stick with my movie theme, I feel like I do when I see the most recent summer movie sequel. Take your pick, *Jurassic World*, *Mad Max Fury Road*, *Avengers: Age of Ultron* . . . you get the idea. My thoughts are:

> "I think I've seen most of this before. I wish that someone would come up with a truly new idea instead of just some variation on the same old theme."

Please re-imagine rescue! If anyone can do it, you can. Here is where the innovations are coming from now.

The US is stuck in legislative gridlock so there is almost no chance of any serious legislative innovation. The US academics are either focused on very broad theories that are very interesting but have little practical application, or they are focused inward, mostly on minor tinkering rather than bold new concepts. For example, although I think the recent ABI Commission study is wonderful, it is mostly minor tinkering with the details of our law and not an attempt to radically re-imagine it. There is much to be learned from that Report. At a minimum, you can learn from the mistakes we have made and be forewarned about the issues we are now struggling with a quarter of a century further down the rescue path.

As an American I wonder whether I am seeing such familiar rescue models in Europe because Chapter 11 was the first modern legislative rescue scheme that worked reasonably well. Your best insolvency professionals have become familiar with our law, so it is natural that you might borrow ideas from it. Alternatively, I may keep seeing the same models because we already have discovered the principal rescue tools, so there is not much left to imagine. I hope that is not true.

But, it seems to me that this is the assumption behind the European Council Recommendation. It is not an invitation to be creative and design completely new recue models. Instead, the Recommendation includes a list of traditional rescue tools and directs Member States to align their laws to those traditional rescue models. This is a document designed to advance conformity and to limit creativity; not one to encourage new innovation. So maybe we will not be reimagining rescue after all.

While I would love to see some real innovation, I think this is the right approach for the EU. Frankly it doesn't go far enough. My US perspective is that you need a single EU-wide law for EU-wide enterprises. Harmonized laws, or even inconsistent laws, might be OK for businesses operating in only a single nation. I suspect that, except for small entrepreneurs, strictly local businesses are becoming very rare in the EU. They will become even rarer as you move closer to the goal of a single market.

Two hundred years ago, when the founders of the United States created our common market among our states, they recognized the bankruptcy laws had to be uniform. That idea is enshrined in our Constitution. With our adoption of the UNCITRAL Model Law and the growth of cross-border cases, we have had to accept some non-uniformity in insolvency outcomes for global businesses operating in our market.

But under the Model Law, we have discretion to reject those outcomes if they are too divergent from our own law. The EU Insolvency Regulation does not give your member states that option.

I understand that there are serious political problems with implementing an EU-wide insolvency law at this point in the EU's development. The harmonization that the Recommendation advances may be the best that can be expected as a practical matter. But that is not what the Recommendation and commentary about it says. I read that one justification for mere harmonization is that it would not be proper to impose an EU-wide law because the local insolvency laws reflect the deeply held cultural views of each member state. But, the most cursory look at the current state of affairs in the EU cast doubt on that rationale.

It appears to me that, as a practical matter, every EU country currently is subject to the English insolvency laws. Companies and individuals can freely and fairly easily shift their COMI. Or, companies can change the governing law of their debt instruments in order to use the English restructuring tools. And it seems to me that the recent revisions to the EU Insolvency Regulation will institutionalize that practice, not eliminate it. So why should Germany be subject to English insolvency law or be forced by competition to adopt a local law that does not reflect German values in order to woo cases back home?

I understand that the Principle of Subsidiarity in Article 5 of the Treaty of the European Union pushes you away from a uniform approach. That principle requires that action be taken at the E.U. level only if that is more effective to the goals of the Union than action taken at the national level. But this is such a case. The goal is a single market, and a single market needs a single bankruptcy system. While there will be important local concerns, it seems that the better approach would be one that provides a uniform set of restructuring options, with accommodations, carve outs, and choice of law rules that protect important areas of local interest. The EU Insolvency Regulation already reflects this approach.

Having said that, I do recognize that international co-operation involves more process than product. Viewed as a process, the European Commission's Recommendation is a major step toward a uniform European insolvency law. The Commission's evaluation in October may confirm that the laws already are largely harmonized. And, the process of review will no doubt nudge member states to reconsider those laws that are not. As the laws become more similar, there will be less resistance to a single uniform law. But there also will be less need for it.

Reimagining rescue. Maybe we need to define the project better. What are we trying to rescue? And what are we trying to rescue it from?

Here, I feel like we are ships passing in the night. As Europe and much of the rest of the world race to copy us and adopt rescue regimes, we have moved to a quick sale model. We file Chapter 11, but rather than use the restructuring tools it provides, we instead use our section 363 to sell the viable parts of the business as a going concern. Your Commission Recommendation does not address this type of business recue. It should. Section 363 not only permits a sale, but more importantly, it permits a sale free and clear of liabilities that might otherwise follow the business. This can be an effective tool for cleansing a business that has legacy costs that otherwise would make it unattractive to any buyer.

The Commission Recommendation speaks of the need to preserve jobs and focuses on the impact of rescue on society. This is another place where we are traveling in opposite directions. As you try to add these goals to your insolvency systems, we have been removing them from ours. Our academics are enamored of the law & economics movement and its approach to law. They have pushed our thinking to focus solely on maximizing value. That is not bad goal, but the only value that gets into the equation is measurable dollar value and even then only the dollar value return to the parties with a debt or equity stake in the enterprise. No soft values like the impact of failure on the workers and communities, or our national industrial policy count.

It may surprise you that the text of Chapter 11 gives no official recognition to the interests of employees, communities or society. We used to believe it was part of our law, but the major modern proponent of that theory, Professor Elizabeth Warren of Harvard Law School, decided to become a senator, and she apparently is one of the few Americans not running for President. Does this mean that I think Chapter 11 is a failure? No, and I have several thoughts about that.

First, what is hard to measure when we talk about the success of our system is the shadow effect. Once the law becomes clear, deals get done without using it. Why would rational parties incur the expense and risk of a Chapter 11 when they can lock in comparable results through an agreement? Chapter 11 casts a very long shadow. But actual cases are filed only when something goes wrong, like when one party is not realistic, or has an ulterior motive or when the problem involves too many players or too rapid a collapse for a workout. When you look at the cost of Chapter 11 and the situations where it fails, keep in mind that your sample is already filtered to include only problem cases.

We also don't have that many Chapter 11's anymore. Part of the reason is that it is no longer as needed. We used to need Chapter 11 to force a creditor to acknowledge that its USD 100 debt was only worth USD 40. Bank lenders in particular were unwilling to acknowledge that and take a write down without a fight. Also our banks could not voluntarily accept a debt-for-equity swap even if that made economic sense. Chapter 11 was an important tool to overcome thoseproblems.

What has changed? First, our lending markets have changed. The new lenders are not banks and are much more focused on reality and maximizing their economic returns. Also we have a very active distressed debt market. In fact there is not enough distressed debt to meet the demand. You may have seen some of our players come to Europe looking to acquire distressed debt and distressed assets. Many times we do not need to use bankruptcy to write down debt since the holder bought it at a deep discount and has expectations that match the debtor's ability to pay.

These players also can make rescue much harder. They are not the traditional creditor we think about who is looking to salvage what they can from a bad lending decision and who may have an on-going relationship with the debtor. They often buy into the debt with an ulterior motive beyond making a reasonable return on their investment. Maybe they want to acquire the enterprise. Maybe they plan to acquire a blocking position and extort value from other stakeholders. Maybe they bought into the debt planning to engage in scorched earth litigation tactics. Think of Argentina and you get the idea. These are not going to be easy rescue cases and the "let's get together and work things out" theory that most restructuring laws are based on will not work. Our Chapter 11 is simply not robust enough to deal with this change cheaply or effectively.

Next, you need to get over insolvency. Insolvency is not a former lover whose memory should distort your current thinking. The European Commission Recommendations focus on creating pre-insolvency systems, but even there the view is that insolvency must be imminent and that the pre-insolvency system must prevent it. Why is insolvency even relevant? Is this merely a vestige of your earlier punitive systems that viewed failure and insolvency as a wrongful act committed by a business?

If you move away from a fault-based model of failure and focus instead on a solution-based model, you may see rescue as merely part of a single continuum of tools for addressing problems that a business might encounter. The English scheme of arrangement is a good model for this. Mostly it is used to address financial restructuring problems faced by businesses that are successful. But, it can also address a financial restructuring that is needed because the business is in distress.

Insolvency and burdensome debt loads may be the most pressing current problem that the business is facing, but insolvency usually is not the type of thing that "happens" to a business like a fire or other calamity. Instead, the insolvency problem is usually nothing more than the result of some other business problem that was not addressed in a timely fashion. If you recognize that, you might envision your rescue regime as merely part of a broader set of tools for addressing business problems. You also might decide that the rescue tool should be available long before the underlying business problem has metastasized into an insolvency problem.

The Commission Recommendation fails to recognize that bankruptcy and secured debt go together. I do not envy your problem. One goal of the Recommendation is to help create a single credit market that flows freely across borders. But if you want a single credit market you don't just need a uniform or harmonized insolvency law, you also need uniform or harmonized secured credit laws, at least for movable and intangible property. Secured debt is another reason our Chapter 11 is not working well. When Chapter 11 was adopted, one famous scholar declared that it was the "death of secured credit". Our history has been a running battle between secured debt and bankruptcy. In our 1978 Bankruptcy Code, the public policy of business reorganization trumped secured credit. It took a while, but in 2001 our states revised their secured credit laws, our UCC Article 9, to greatly enhance the security rights of creditors. I've criticized those changes in an article that called that revision the "Anti-Bankruptcy Act".

Now a secured creditor can effectively opt out of the reorganization process or co-op it for its own purposes because it controls the bankruptcy case. Make no mistake, secured credit cares only about its own recovery. It is not concerned about worker rights, society or national industrial policy. Other opt out strategies have also gained traction in the United States. Why do you think asset securitization structures that shift an operating company's income stream into a bankruptcy remote special purpose entity are so popular?

Take the case of LTV, a major steel manufacturer. In that case a large amount of going concern value could be preserved by continuing the business operations for a short period of time after the bankruptcy filing. But there was no free cash because all of the accounts receivable had been securitized and sold to a bankruptcy remote special purpose vehicle. The bankruptcy judge used procedural arguments to temporarily override the purported ownership rights of the securitization parties so the going concern value could be realized.

Lenders similarly use complex corporate structures to keep essential assets out of the shared pool. During the recent financial crisis the credit markets froze forcing General Growth Properties, one of our largest shopping mall operators, to file Chapter 11. For lending purposes, each shopping mall property had been placed in a different legal entity and the lenders refused to upstream the cash from rental income that was necessary to rescue the enterprise. In an opinion that has been criticized by commentators, the bankruptcy judge overrode those limitations. The end result was not merely the avoidance of a wave of value destroying liquidations of shopping malls around the country, but a successful restructuring plan that even returned billions of dollars in value to shareholders.

And we wonder why Chapter 11 is so costly and no longer so effective. We don't just do our reorganizing in Chapter 11 plans anymore. No buyer wants to acquire a business if it comes with potential massive successor liability risk. We use our section 363, which provides for a sale of the business free and clear of obligations, to continue business operations free of old debt. As I mentioned, the Commission Recommendation does not address this tool.

Can you do a section 363 sale to an entity created solely for the purpose of continuing the business without the liabilities? That is exactly what was done in the General Motors bankruptcy case, and the Chrysler case was not much different. Again, our bankruptcy judges permitted these sales even though most observers think they pushed beyond the limits of our statute. But does anyone in this room doubt that both General Motors and Chrysler would be gone if that had not been done? And, with GM and Chrysler gone, most of the US based automotive supplier chain would have failed. Without that local supply network, our third major automotive company, Ford, could not have maintained its manufacturing presence in Detroit.

So our restructuring tools do not merely save Hobbits; they saved the American automotive industry. American industrial policy was well served, but over the strenuous objection of the economic stakeholders with secured bonds. Did this happen because Chapter 11 is such a wonderful law? No, frankly Chapter 11 has not kept up with the times. It is too weak to deal with the modern challenges to rescue. Fortunately our bankruptcy judges have been willing to push the envelope to do what a true rescue regime should do. But they will only do that in exceptional cases.

While the lack of a rescue process inhibits rescue, the real threats to business rescue are that the tools we are using are not up to the task. The European Commission Recommendation pushes the idea of creating a framework for a negotiated workout. That is an important goal. But the Recommendation is deficient in not providing the essential tools to preserve a viable but distressed business.

Where are the tools to block "opt out" strategies? Where is the override of bankruptcy termination clauses in contracts? Where are the standards for addressing legacy obligations? Where are the standards for super-priority rescue financing? Over-indebtedness is a problem that threatens the survival of the business. But most likely it is merely the symptom of deeper problems. If you want to re-imagine rescue, then identify those problems and design a system that addresses them.

Just like our half century old Chapter 11, the rescue systems advanced by the Commission Recommendation are simply too weak to address even the existing opt out strategies. I hope you can design more robust rescue systems that balance the interests of stakeholders with those of society. But, unless it is an EU-wide system or the jurisdiction rules limit forum shopping, the case placers will simply avoid it.

I look forward to hearing many new ideas today and tomorrow as we re-imagine rescue. As your American competitor, I hope you can come up with some ideas that we can copy.

Thank you.