Harmonisation of European Insolvency Law

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Editor

INSOL Europe
Nottingham • Paris

Published by
INSOL-Europe
PO Box 7149
Clifton
Nottingham NG11 6WD
England

INSOL-Europe website:
http://www.insol-europe.org

ISBN 978-0-993-1897-5-3

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Editorial Preface

Since 2010 and the publication by the European Parliament of the "Harmonisation of Insolvency Law at EU Level" policy document, harmonisation of insolvency law has continued to gain in importance as considered in practice and by academics. Only a decade prior to the publication of that document, the harmonisation of insolvency law in Europe seemed an impossible, and perhaps, unwanted task. As Professor Fletcher noted in the second edition of his text in 2005, *Insolvency in Private International Law: National and International Approaches*, "National attitudes toward the phenomenon of insolvency are extremely variable, as are the social and legal consequences for the debtors concerned." However, given the continued aspects of globalisation, multinational enterprises, and the concomitant need for a robust framework for cross-border insolvency coordination, not only have we seen the introduction of the European Insolvency Regulation to help coordinate cross-border insolvency in the EU in 2002, but 15 years later this regulation has been recast in Regulation 2015/848 to clarify and codify existing practice and case law. While it does not aim to harmonise, it does recognise the need for greater efficiency in cross-border coordination of insolvency procedures.

Seven years ago, it was recognised in the report on "Harmonisation of Insolvency Law at EU Level" that in order to build a crisis management framework for the internal market and for structural measures to be efficient at an EU level, it was equally important to establish the extent to which insolvency laws throughout the EU may be required. While harmonisation may only be desirable and achievable in limited circumstances, it was acknowledged that harmonisation should be sought where possible. Among the circumstances identified were: a common test of insolvency; the formal aspects of lodging and dealing with claims in formal insolvency; the manner in which reorganisation plans are adopted; rules regarding detrimental acts; the inter-relationship between contractual rights of termination and insolvency; and directors' responsibilities. There have been a number of developments in these areas in since the publication of that document, which merit discussion.

The purpose of this text, which consists of papers delivered at the INSOL Europe Academics Forum annual conference entitled "Harmonisation of European Insolvency Law" held in Cascais, Portugal on 21 and 22 September 2016, is to showcase a number of perspectives on the current state of harmonisation in various aspects of European insolvency law. The particular focus of the conference was on challenges of harmonised insolvency proceedings, including opening requirements, filing, and verification of claims; substantive harmonisation and aspects of avoidance actions and directors' liability; creditor ranking in insolvency and possible approaches and obstacles to harmonisation;

and challenges for preventive restructuring frameworks, in particular regarding new finance and treatment of executory contracts.

Contributions range from comparative analyses of various aspects of potentially harmonised or harmonizable areas of insolvency law, to inter-disciplinary perspectives, and investigations of other legal areas that intersect insolvency and the potential impact of harmonisation upon them. Contributors range from early career academics and PhD students, to eminent judges and professors, offering a colourful perspective on the nature of harmonisation in European insolvency law today.

The papers contained herein are therefore truly innovative and will increase the awareness of the impact of insolvency law and its harmonisation throughout Europe and the potential impact this may have in domestic, regional, and even global contexts. Submissions for this collection have come from prominent academics, doctoral students and other researchers, practitioners, and policy makers in the field, representing numerous jurisdictions including common law, civil law, and mixed systems within Europe and even beyond. As such, the contents of the research and analyses are of extremely high quality and offer thought-provoking and at times innovative insights into the subject matter at hand. It is hoped that this will render the contributions here, as well as the further references that they contain, of great value for researchers in the field of insolvency law.

In summary, I would like to express my appreciation to every contributor who has given their time and intellectual skills to making this project a rich and diverse treatise on the issue of harmonisation of insolvency law in Europe. I must also give my profound thanks to the administrative staff members of INSOL Europe, particularly Caroline Taylor and Wendy Cooper, together with the technical officers Myriam Mailly and Emmanuelle Inacio, and Paul Newson for his brilliant design and publishing expertise. If not otherwise noted by the contributors, the law is as stated as at 10 July 2017.

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Introduction to INSOL Europe 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), Berlin and Lisbon (2016) as well as Trier and Warsaw (2017). A number of smaller events, including University seminars and colloquia, are also co-hosted by the Academic Forum with institutions across Europe.

At Lisbon, Professor Michael Veder (Radboud University, the Netherlands) was elected Chair of the Academic Forum for a three-year term. Anthon Verweij (Sdu Publishers, the Netherlands) serves as Secretary to the Board, while Florian Bruder (DLA Piper Munich, 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) and Rolef de Weijs (Amsterdam University, the Netherlands) are ordinary members of the Board. Jennifer Gant (Nottingham Trent University, the United Kingdom) is the Editor of the Conference Proceedings series. 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), Professor Axel Flessner (Humboldt University Berlin, Germany) and His Honour Judge Ignacio Sancho (Spanish Supreme Court).

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 Warsaw, Poland on 4-5 October 2017, with future conferences likely to see Academic Forum members visit Athens (2018), Copenhagen (2019) and Sorrento (2020). Details of academic conferences will be posted on this website (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.

PART I
SUBSTANTIVE HARMONISATION

Chapter 1

Stakeholders and their Influence on Harmonisation of Insolvency Laws in Europe

Gert-Jan Boon*

1 Introduction

Since the 2011 call of the European Parliament for legislative measures with regard to insolvency proceedings in the context of EU company law,[1] reform of insolvency regimes has been prominent on academic and legislative agendas.[2] Undoubtedly, the interest in insolvency, and more specifically rescue of distressed businesses, has been driven by the economic downturn that the EU (and its Member States) experienced since 2008.[3] These developments have proven pivotal in the Commission's legislative efforts that followed.[4] In these efforts, the Commission acts in a largely untapped area of European law, namely the harmonisation of substantive insolvency law. A field of law characterised by diverse stakeholders with strongly opposing interests, including, among others, the debtor, the debtor's management, shareholders, employees, financiers, secured and unsecured creditors, and tax authorities. The Commission has not ignored the great challenges its legislative initiatives have brought as its approach is characterised by the active involvement of all these stakeholders.

In this paper I will discuss the – what I call – integrated stakeholder approach that the Commission pursues in harmonising European insolvency regimes. Both in

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1 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)).

2 Ian F. Fletcher and Bob Wessels, Harmonisation of Insolvency Law in Europe, Reports presented to the Nederlandse Vereniging voor Burgerlijk Recht (Netherlands Association of Civil Law) (2012, Kluwer, Deventer).

3 See e.g. 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 of 12.12.2012, COM(2012) 742 final, at 1. Here, the Commission highlights the effects that the economic crisis has on people, jobs and businesses, including some 200.000 companies that were declared insolvent annually in the EU between 2009 and 2011 and with the loss of 1.7 million jobs annually too.

4 *Idem*, see e.g. also Commission Recommendation of 12.3.2014 on a new approach to business failure and insolvency, C(2014) 1500 final, at (6).

its revision of the European Insolvency Regulation[5] (EIR) and the proposal for a directive on preventive restructuring frameworks; second chance and measures to increase the efficiency of restructuring; and insolvency and discharge procedures ('Restructuring Directive'),[6] the role and direct influence of stakeholders is noteworthy.

This interesting development may have several outcomes. Concerns are raised regularly regarding undesired involvement of stakeholders, in particular commercial market players, in legislative processes. But at the same time, stakeholders may contribute to prioritising potential themes for harmonisation based on perceived needs in practice, a focused treatment of the scope and details of those needs, and a higher level of involvement in law making and its execution. As a result, involvement of stakeholders may lead to better founded legislation. The question is, however, what a relevant 'stakeholder' is, why the Commission is involving them, and whether – and under which conditions – it is justified to involve stakeholders in designing and execution of EU insolvency legislation.

This chapter is organised as follows. Section 2 will elaborate on some theories regarding stakeholders and will propose a technique to distinguish and rank different types of stakeholders based on their salience. Subsequently, in section 3, this will be applied to define what stakeholders are in the field of insolvency legislation. Then, in section 4, the approach of the European Commission towards harmonising substantive insolvency and stakeholders will be discussed. Section 5 will turn to the sentiments of different stakeholders on harmonisation. This will be followed by some recommendations to pursue, with the involvement of stakeholders, the Commissions' aim of harmonising certain aspects of national insolvency regimes (section 6). Finally, section 7 draws some conclusions.

2 Theorising the Stakeholder

The relevance of stakeholder involvement in the field of insolvency was advocated by EU Commissioner Věra Jourová. The EU Commissioner for Justice, Consumers and Gender Equality touched upon this in her speech of 16 June 2016 held at the occasion of the 5th European insolvency and restructuring congress where she spoke on the harmonisation process of European insolvency law. She

5 Council Regulation (EC) no 1346/2000 of 29 may 2000 on insolvency proceedings, which will be revised in June 2017 when Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast) comes into force.

6 European Commission, Proposal for a Directive of the European Union and the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU of 22 November 2016, COM(2016) 723 final.

emphasised the important role of practitioners and judges to bring legislation alive and bring forward the benefits of legislation to the whole of the internal market. But their involvement is also required in designing new legislation. In particular, in drafting the new legislative instrument on substantive insolvency law, the EU Commissioner stated:

> "It will build on the 2014 Recommendation and designed based on the input receive[d] from all concerned stakeholders, including you the practitioners, and from other Member States experts. We'll duly consider such input also in order to assess the state of play on consumer insolvency and whether action is needed in this regard." [7]

More recently the EU Commissioner said:

> "In our preparatory work, we paid attention to the opinions of all stakeholders, including national parliaments."[8]

These quotes show the great importance the Commission has attached to involve all stakeholders. At the same time, it is left open what these 'stakeholders' are. Though the Commissioner refers to, among others, insolvency practitioners, national parliaments and Member State experts, this seems a non-exhaustive list of stakeholders and leaves much room for interpretation. But also, what role do these stakeholders fulfil; are they a sounding board for the Commission's policies or even a strategic partner in developing and executing new legislation?

2.1 EU Perspectives on the Role of Stakeholders

In the field of business administration and corporate governance, research has been conducted on what stakeholders are, how different stakeholders can be distinguished, and how the interests of different stakeholder should be prioritised. My line of approach is built, in particular, around the well-known divide between

7 Speech by Commissioner Jourová at 5th European insolvency and restructuring Congress, Brussels (16 June 2016). The full text is available at: http://ec.europa.eu/commission/2014-2019/jourova/announcements/speech-commissioner-jourova-5th-european-insolvency-and-restructuring-congress_en.

8 Speech by Commissioner Jourová to the Legal Affairs Committee and EU Affairs Committee in the Bundestag: Anti-Money Laundering, European Public Prosecutor's Office, Digital Contracts, and Insolvency (26 September 2016), SPEECH/16/3189. The full text is available at: http://www.europa.eu/rapid/press-release_SPEECH-16-3189_en.htm.

the shareholder primacy (corresponding to the agency theory[9]) and the non-shareholder stakeholder perspective.[10]

In 2014 the Commission published a proposal to revise two directives on encouraging long-term shareholder engagement and corporate governance.[11] Here, the Commission promotes the involvement of shareholders and other stakeholders in a company. The European Parliament, in response, took this a step further and suggested to include the position of all stakeholders of the company ('EP Amendment').[12] Regarding shareholders, the text should explicitly state (underlining added):

> "(2) Although they do not own corporations, which are separate legal entities beyond their full control, shareholders play a relevant role in the governance of those corporations.
>
> […] (2a) Greater involvement of shareholders in companies' corporate governance is one of the levers that can help improve the financial and non-financial performance of those companies. Nevertheless, since shareholder rights are not the only long-term factor which needs to be taken into consideration in corporate governance, they should be accompanied by additional measures to ensure a greater involvement of all stakeholders, in particular employees, local authorities and civil society."[13]

9 Michael C. Jensen & William H. Meckling, "Theory of the firm: Managerial behavior, agency costs, and ownership structure", (1976) 3(4) Journal of Financial Economics, pp. 305-360.

10 See David Millon, "Radical Shareholder Primacy", (2013) 12(4) University of St. Thomas Law Journal, pp. 1013-1044, also published in Washington & Lee Legal Studies Paper No. 2014-17. Available at SSRN: http://ssrn.com/abstract=2473189. Millon describes two types of shareholder primacy, (i) the radical shareholder primacy where directors are fully focused on serving the shareholders' interests and (ii) the traditional shareholder primacy, where directors consider interests of shareholders and (where appropriate) that of non-shareholders. Vasudev and Watson refer to this divide as the 'Great Debate', see P.M. Vasudev and S. Watson (eds.), Corporate Governance after the Financial Crisis (2012, Edward Elgar, Cheltenham), p. 6. Available at SSRN: http://ssrn.com/abstract=2009076. See also Jonathon Strom, "The Rebirth of Heroic Managerialism", (2015-2016) 3 Bus. & Bankr. L.J. 67, p. 69 et seq.

11 European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement, 9 April 2014, 2014/0121 (COD). Both the directives themselves and this proposal hardly touch upon the position of stakeholders other than shareholders.

12 European Parliament, Amendments adopted by the European Parliament on 8 July 2015 on the proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement (COM(2014)0213 – C7-0147/2014 –2014/0121(COD)) (Ordinary legislative procedure: first reading), P8_TA (2015)0257.

13 *Idem*, at (2), subsequent to adopting these proposed amendments, it was decided to proceed with informal discussions by the Commission, Council and the Parliament. See also Jean Jacques Du Plessis, "Corporate Governance, Corporate Responsibility and Law: Shareholder Primacy and Other Stakeholder Interests" (2016) 34(8) Company and Securities Law Journal, pp. 238-242, available at SSRN: http://ssrn.com/abstract=2777832.

With this proposal the European Parliament declines, more explicitly than the Commission did, the shareholder primacy perspective, as shareholders are not regarded as owners of companies. Shareholders are recognised for their important contribution to the company, but, with regard to the corporate governance of the company, involvement of all stakeholders is required.

2.2 Defining Stakeholders

The European Parliament's Amendment provides a useful definition of stakeholders. Interestingly, the European Parliament proposes a definition of a company's stakeholders (in particular those of employees, local authorities, and civil society),[14] which reads as follows:

> "any individual, group, organisation or local community that is affected by or otherwise has an interest in the operation and performance of a company."[15]

Various other definitions of stakeholder can be found in academic literature.[16] Parliament's definition seems in line with Freeman's perspective of stakeholders of 1984, although he takes a stronger emphasis on the companies' strategy and purpose:

> "A stakeholder in an organization is (by definition) all of those groups and individuals, that can affect, or are affected by, the accomplishment of organizational purpose."[17]

A more invasive perspective on stakeholders is proposed by Savage, Nix, Whitehead and Blair (1991), as they define stakeholders as follows:

14 For civil society no definition is provided by the European Parliament in this proposal, nor who will represent these interests (to the company). The United Nations regards 'civil society' as the third sector, besides the government and business, comprising the whole of non-governmental and not-for-profit organisations, see United Nations, Civil Society (2016), available at: www.un.org/en/sections/resources/civil-society. The World Bank defines civil society as follows: "the wide array of non-governmental and not-for-profit organizations that have a presence in public life, expressing the interests and values of their members or others, based on ethical, cultural, political, scientific, religious or philanthropic considerations. Civil Society Organizations (CSOs) therefore refer to a wide of array of organizations: community groups, non-governmental organizations (NGOs), labor unions, indigenous groups, charitable organizations, faith-based organizations, professional associations, and foundations" (World Bank, Defining Civil Society (2016), available at: http://go.worldbank.org/4CE7W046K0).

15 *Idem*, Article 1(2)(jb).

16 Some prime definitions of stakeholder have been provided in this chapter, however, as has been rightly observed by Samantha Miles, there are numerous definitions and consensus on the concept of 'Stakeholder'. She even concludes that we could speak of stakeholder as an essentially contested concept, see Samantha Miles, "Stakeholder: Essentially Contested or Just Confused?", (2012) 108(3) Journal of Business Ethics*,* pp. 285-298. For an overview of some 27 definitions of 'stakeholder', see Ronald K. Mitchell, Bradley R. Agle, & Donna J. Wood, "Toward a theory of stakeholder identification and salience: Defining the principle of who and what really counts", (1997) 22(4) Academy of Management Review, p. 858.

17 R. Edward Freeman, "Strategic Management: A stakeholder Approach" (1984, Pitman, Boston), p. 25.

> "Stakeholders include those individuals, groups, and other organizations who have an interest in the actions of an organization and who have the ability to influence it."[18]

According to Savage et al., stakeholders need to have both (i) an interest in the actions of an organisation, which I argue is present when an organisation's actions affect these interests, and (ii) be able to influence the organisation. This is a more stringent definition compared to the definitions of the European Parliament and Freeman, where either (i) or (ii) would suffice to qualify as stakeholder.

In light of the above, there would in general be two (not mutually exclusive) types of stakeholders from the perspective of the legislative 'business' of the European Commission: (i) all those individuals and groups that can affect the drafting process of a legislative measure on insolvency law, in particular the Council, the Parliament and the Member States, and (ii) all those individuals and groups that are affected by a legislative measure on insolvency. This could include, among others, companies, employees, insolvency practitioners, judges, etc. From a strict legal perspective, only the first group would qualify as stakeholders, as the latter group has no formal foundation upon which they can affect legislation. In its current insolvency endeavour, the Commission provides these latter stakeholders with an informal influence on the legislative process, that therefore fall within the scope of stakeholders as defined by Savage et al. (1991).

2.3 Distinguishing and Ranking of Stakeholders

With a broad perspective on stakeholders, the inequality of interests makes it hard to compare the various stakeholders involved in insolvency. To distinguish 'who and what really counts', Mitchell, Agle & Wood (1997) have developed an approach based on salience. They propose that those interests that have the highest salience are the interests that should be given most priority. Salience should be evaluated on three attributes, namely (i) power, (ii) legitimacy, and (iii) urgency:[19]

i. <u>Power</u> relates to the possibility that someone can impose his will in a relationship upon (an) other(s). There can be a legal foundation to this power.[20]

18 Grant T. Savage, Timothy W. Nix, Carlton J. Whitehead, and John. D. Blair, "Strategies for assessing and managing organizational stakeholders", (1991) 5(2) Academy of Management Executive, p. 61. They further distinguish between (i) primary stakeholders as the ones that have a direct and necessary economic impact on the organization, and (ii) secondary stakeholders as the ones that are only indirectly part of the companies' business, but that can influence the company. To review the different stakeholders two dimensions are proposed: (i) the potential threat they represent and (ii) the potential to cooperate with these stakeholders.

19 Mitchell et al., above note 16, pp. 853-854.

20 *Idem*, pp. 1 and 865-866.

ii. Legitimacy relates to the (social) desirability of the interest (and accompanying behaviour) of a stakeholder as shared by others.[21]

iii. Urgency relates to whether or not 'time is of the essence' for the interests at hand and whether compelling action is required.[22]

The combination of these three attributes results in eight different types of stakeholders (see figure 1).

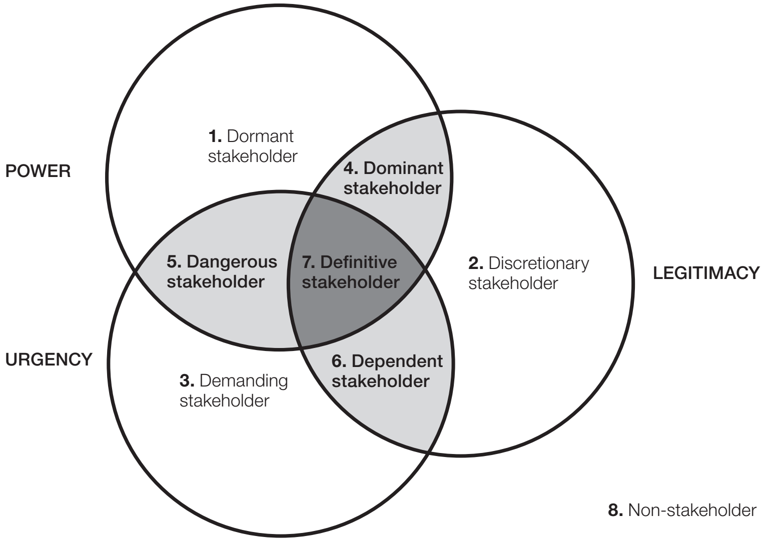

Figure 1: Qualitative Classes of Stakeholders[23]

Mitchell, Agle and Wood propose the following typology of stakeholders:

1. Dormant stakeholder
2. Discretionary stakeholder
3. Demanding stakeholder
4. Dominant stakeholder
5. Dangerous stakeholder
6. Dependent stakeholder
7. Definitive stakeholder
8. The non-stakeholder

21 *Idem*, p. 866-867.
22 *Idem*, p. 867-868.
23 *Idem*, p. 872.

The more attributes a stakeholder possesses, the more priority should be given to a stakeholder. Besides 8 (the non-stakeholder), 1-3 (dormant, discretionary and demanding stakeholders) would receive the least attention, 4-6 (dominant, dangerous and dependent stakeholders) much more and 7 (definitive stakeholders) most attention. Applying this framework will be useful in distinguishing between various interests.[24]

2.4 Conclusion

The above has shown the interrelatedness between a governance model and the involvement of stakeholders. Where it concerns corporate governance, the Commission and in particular the European Parliament have expressed support for the stakeholder approach (in contrast to shareholder primacy). This requires the involvement of all concerned stakeholders in the governance of companies.

Various definitions of stakeholders have been developed, in this section the definition of Savage et al. (1991) was adopted, which requires stakeholders to have an interest in the organisations' action and be able to influence its actions:

> "Stakeholders include those individuals, groups, and other organizations who have an interest in the actions of an organization and who have the ability to influence it."[25]

These perspectives on corporate governance can also be used to analyse the governance of a legislative process. The EU Commissioner pointed out the importance of involving all stakeholders in its current endeavour on insolvency, thereby advocating a stakeholder perspective on legislative governance. It remains, however, undecided who these stakeholders are and what their role should be in this legislative process. The above framework provides a qualitative tool for the evaluation of who possible stakeholders are and what their position is compared to other stakeholders. Where, following the Commission's approach, besides legislative parties (such as the European Parliament, Council, and Member States) other parties are also recognised as stakeholders (for example employees and civil society), an approach based on salience of interests may be effective in prioritising the different stakeholders. This differentiation can be based on three attributes: (i)

24 *Idem*, p. 856. This framework also leaves some room for subjectivity, for example, on whether or not a broad or narrow view is applied in recognising power, legitimacy, and/or urgency of specific interests of stakeholders.

25 Savage *et al*., above note 18, p. 61. They further distinguish between (i) primary stakeholders as the ones that have a direct and necessary economic impact on the organisation, and (ii) secondary stakeholders as the ones that are only indirectly part of the companies' business, but hat can influence the company. To review the different stakeholders two dimensions are proposed: (i) the potential threat they represent and (ii) the potential to cooperate with these stakeholders.

power, (ii) legitimacy, and (iii) urgency. The more attributes a stakeholder possesses, the more important its interests are. This forms a starting point in distinguishing between the many conflicting interests involved in legislative processes.

3 Stakeholders in Insolvency and Restructuring

As mentioned before, governance plays a key role where it concerns the extent to which internal and external stakeholders are involved in a legislative process, to which I refer as 'legislative governance'. Where it concerns the legislative efforts of the Commission on harmonising insolvency and restructuring laws, stakeholders can be defined, based on the definitions of, in particular, Savage et al., as follows:

> "Stakeholders are all those individuals, groups and other organisations that have an interest in the EU legislative process of harmonising insolvency and restructuring law and which have the ability to influence the choices and decisions the Commission has to make."

The ability to influence the legislative process will be presumed present for all individuals, groups and other organisations that have taken (actively) part in any of the activities that the Commission has employed, as will be elaborated in section 5, and represent interests that are affected by insolvency and restructuring proceedings. For legislative governance, in particular 'power' and 'legitimacy' are important attributes for stakeholders to affect legislation. For 'urgency' this is different, as urgency will in the course of a legislative process not be an attribute likely present with stakeholders in general. Taking the Commission's perspective with a focus on insolvency and restructuring proceedings, a distinction can be made between three types of stakeholders which provides the following non-exhaustive overview of stakeholders:

3.1 Dominant Stakeholders (Attributes: Power and Legitimacy)

Stakeholders for whom power is based on a statutory provision includes:

- European Parliament
- European Council
- Member States

Power can also be based on the direct involvement and central role played by certain stakeholders in realising a successful restructuring:

- Banks and other institutional investors
- Non-institutional investors
- Secured creditors

3.2 Discretionary Stakeholder (Attribute: Legitimacy)

Legitimacy for various stakeholders is based on their direct involvement in insolvency and restructuring proceedings, as is the case for:

- Debtors*
- Shareholders*
- Trade creditors
- Employees
- Tax authorities*
- Judiciary*
- Practitioners (insolvency practitioners,* mediators, supervisors, CROs, turnaround professionals)

* While these stakeholders have no statutory power to draft legislation, they can, based on different grounds, have some informal power due to their direct involvement on insolvency and restructuring proceedings.

For other stakeholders, legitimacy is based on the indirect involvement in insolvency and restructuring proceedings, as their involvement is professional or based on representation of interests:

- Accountants
- Lawyers (including barristers, solicitors, attorneys-at-law, etc.)
- Labour Unions
- Business Associations
- Trade Unions

3.3 Dormant Stakeholders (Attribute: Power)

Informal power based on independent expertise applies to these stakeholders:

- The Commission's Group of experts on restructuring and insolvency law[26]
- Academics
- International Monetary Fund (IMF)
- United Nations Commission on International Trade Law (UNCITRAL)
- World Bank

The above overview shows in part a divide between the formal legislative stakeholders versus the 'other stakeholders'. Though some of these other

26 This group has been initiated by the European Commission, with the aim of assisting the Commission in its work on a legislative proposal on substantive insolvency law. See http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetail&groupID=3362.

stakeholders may have a powerful informal position, from a strict legal perspective this is of secondary importance to that of the legislator. However, as Věra Jourová stated, these other stakeholders are the ones "to apply the new rules as well as help deliver the benefits to the Single Market"[27]

3.4 Conclusion

With regard to the legislative governance of the European Commission concerning the involvement of stakeholders in its legislative endeavour on substantive insolvency law, stakeholders can be defined as:

> "Stakeholders are all those individuals, groups and other organisations that have an interest in the EU legislative process of harmonising insolvency and restructuring law and which have the ability to influence the choices and decisions the Commission has to make."

In the field of legislation, ranking of diverse interests of stakeholders can be based on two out of the three attributes defined by Mitchell et al. Stakeholders can be characterised by their 'power' and/or 'legitimacy', but in general not with 'urgency'. Different groups of stakeholders can be distinguished. The formal legislative stakeholders (e.g. the Parliament, Council or Member States) are referred to as dominant stakeholders with power and legitimacy of their interests. Other stakeholders can have direct (e.g. debtor, shareholders or employees) or indirect (e.g. insolvency practitioners or accountants) legitimacy of their interests (the so-called discretionary stakeholders). Dormant stakeholders are characterised by the power of their interests (e.g. academia). Whereas this approach shows the strength of certain interests, it gives no substantive judgement on the value of specific interests.

4 Towards Harmonisation of EU Insolvency and Restructuring Laws

Where various developments argue in favour of stakeholder involvement, this was not yet the approach when, in 2011, the European Parliament adopted a resolution by which it requested the Commission to submit proposals for legislative measures with regard to insolvency proceedings in the context of EU company law (Resolution).[28] This Resolution was the so-called 'kick-off' for a series of new initiatives in which active stakeholder involvement developed over time.

27 Speech by Commissioner Jourová at 5th European insolvency and restructuring Congress, Brussels, 16 June 2016. For the full text see http://ec.europa.eu/commission/2014-2019/jourova/announcements/speech-commissioner-jourova-5th-european-insolvency-and-restructuring-congress_en.

28 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)).

4.1 The Road towards Harmonisation

The 2011 Resolution of the European Parliament clearly expressed its aim with regard to insolvency law:

> "insolvency law should be a tool for the rescue of companies at Union level", and also, that "a legal framework should be established that better suits cases of companies which are temporarily insolvent."[29]

The Commission subsequently employed many activities, this included the Resolution at the end of 2012 with a 'Communication on a new European approach to business failure and insolvency' (Communication),[30] but also the Commission's proposal to revise the EIR.[31] With regard to the latter, two extensive studies were conducted to review the working of the EIR.[32]An expert group was formed to assist the Commission in the drafting process,[33] a public consultation was held and two meetings took place with national experts. This contributed to the adoption of the European Insolvency Regulation (recast) ('EIR (recast)') on 20 May 2015.[34]

Another landmark was the publication of the Commission's Recommendation on a New approach to business failure and insolvency (Recommendation) in 2014.[35] In the preparation of the Recommendation, the Commission commissioned a study to INSOL Europe on national insolvency regimes.[36] The Recommendation lays down six key topics for Member States to reform national preventive restructuring

29 *Idem*, page 3.

30 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, 12.12.2012, COM(2012) 742 final, p. 3, 5-8.

31 European Commission, Proposal for a Regulation of the European Parliament and of the Council amending Council Regulation (EC) No 1346/2000 on insolvency proceedings, COM(2012) 744 final, Explanatory Memorandum, p. 4 and 5.

32 Report from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the application of the Council Regulation (EC) No. 1346/2000 of 29 May 2000 on insolvency proceedings, COM(2012) 743 final, available at: http://ec.europa.eu/justice/civil/files/insolvency-report_en.pdf. For the comparative legal study see Burkhard Hess, Paul Oberhammer, and Thomas Pfeiffer, "European Insolvency Law, The Heidelberg-Luxemburg-Vienna Report on the Application of Regulation (EC) No. 1346/2000/EC on Insolvency Proceedings (External Evaluation JUST/2011/JCIV/PR/0049/A4)" (2013), available at: http://ec.europa.eu/justice/civil/files/evaluation_insolvency_en.pdf. Separately published as: Burkhard Hess, Paul Oberhammer and Thomas Pfeiffer, "European Insolvency Law, The Heidelberg-Luxembourg-Vienna Report"(2014, C.H. Beck – Hart – Nomos, Baden-Baden).

33 European Commission, Expert group on cross-border insolvency (E02772), 2013, http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetail&groupID=2772.

34 Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast).

35 Commission Recommendation on a new approach to business failure and insolvency, 12 March 2014, C(2014) 1500 final.

36 European Commission, Study on a new approach to business failure and insolvency – Comparative legal analysis of the Member States' relevant provisions and practices (submitted by INSOL Europe), 2014.

frameworks, in order to provide for: (1) restructuring at an early stage, when there is a likelihood of insolvency; (2) keeping control over the day-to-day activities of the distressed business (debtor-in-possession); (3) requesting a temporary stay of individual enforcement actions; (4) adopting a restructuring plan that is binding also on dissenting creditors; (5) accepting new finance for the implementation of a restructuring plan; and (6) resolving financial distress by employing out-of-court procedures.[37]

Eighteen months after the issuance of the March 2014 Recommendation,[38] the Commission presented an evaluation of the implementation of the Recommendation. The Commission concluded that "a few Member States have undertaken reforms which, in some cases, resulted in legislation implementing the Commission's Recommendation," though in some Member States legislative proposals are still pending. This has lead the Commission to conclude that the Recommendation did not have the desired impact.[39]

In September 2015 a new initiative was announced with a public consultation on a European Capital Markets Union (CMU), with the aim to promote diversification of and access to the funding needs of businesses.[40] In the subsequent Action Plan the Commission considered, out of twenty key actions, 'insolvency' as one of the key actions for a CMU. It was stated that the Commission:

> "will propose a legislative initiative on business insolvency, including early restructuring and second chance, drawing on the experience of the Recommendation. The initiative will seek to address the most important barriers to the free flow of capital, building on national regimes that work well."[41]

In preparation of this proposal for a Restructuring Directive the Commission undertook various activities, directed in particular at involving a wide variety

37 Kristin van Zwieten, "Restructuring law: recommendations from the European Commission", (2014) Law in Transition, pp. 1-9.

38 Articles 35 and 36 of the Recommendation.

39 European Commission, Directorate-General Justice & Consumers of the European Commission, 'Evaluation of the implementation of the Commission Recommendation of 12.3.2014 on a new approach to business failure and insolvency', 30 September 2015, at 2 and 5. See also: European Commission, Directorate-General Justice (A1), 2016/JUST/025 – Insolvency II, Inception Impact Assessment, 2 March 2016, p. 7.

40 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Action Plan on Building a Capital Markets Union, 30.09.2015, COM(2015) 468 final, p. 3.

41 *Idem*, at p. 26 and 30. This was reiterated in: European Commission, Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, "Towards the completion of the Banking Union", 24 November 2015, COM(2015) 587 final, p. 10.

of stakeholders. Besides some ad-hoc substantive harmonisation of insolvency law, on a European level this is the first structural initiative in this regard. Often for good reasons, substantive harmonisation of insolvency laws was considered impractical and unfeasible.[42] Still, since 2012 the Commission has shown its dedication to promote the rescue of distressed businesses, although in particular the widely diverging national insolvency regimes and the embeddedness of insolvency law have been mentioned as a hindrance to harmonisation.[43]

4.2 The Commission's Involvement of Stakeholders

With the foregoing in mind, any legislative proposal to substantively harmonise insolvency law will have a significant impact on national insolvency regimes. Involvement and support for any legislative proposal from such a broad group of stakeholders may be compelling for EU Member States too to fine-tune its efforts on the Proposal for a Restructuring Directive. It is what could be called a horizontal approach where extensive consultation takes place to involve stakeholders (already) in preparation of a legislative proposal, contrary to the traditional vertical approach where stakeholder involvement relates mostly to consultation on a published legislative proposal.

So far, the Commission has employed various activities in which stakeholders are involved, this includes among others:[44]

- Discussions with a group of experts on restructuring and insolvency law.[45] This group, established in 2015 and expected to continue until 2018, consists of some 22 individual experts and 4 institutional observers. The individual experts are practitioners, academics, and judges from mostly western European countries and are appointed based on their personal capacity. The observers

42 See e.g. 'The H-word is out!' observed by Bob Wessels, "Harmonization of Insolvency Law in Europe" (2011) 8(1) European Company Law, at 27 et seq. See also Björn Laukemann, "Structural Aspects of Harmonization in European Insolvency Law", in: Jean François Vandrooghenbroeck, "Hommage au Professeur Gilberte Closset-Marchal" (2013, Louvain-la-Neuve), at 347 et seq, and Christoph Paulus, "Europeanisation of the Member States' Insolvency Laws", (2015) 3 Nottingham Insolvency and Business Law e-Journal, at 301 et seq.

43 Gert-Jan Boon & Stephan Madaus, "Toward a European Business Rescue Culture", in: Jan Adriaanse en Jean-Pierre van der Rest (eds), 'Turnaround Management and Bankruptcy" (2017, New York: Routledge).

44 See the Commission's webpage on insolvency: http://ec.europa.eu/justice/civil/commercial/insolvency/index_en.htm.

45 European Commission, Group of experts on restructuring and insolvency law (E03362), 2015, http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetail&groupID=3362. Reports of the expert group's meetings are published at this website. The group consists of 22 experts (comprising academics, judges and practitioners) and two international organisations. With regard to the functioning of expert groups they are guided, since 2010 by a Communication from the President to the Commission, Framework for Commission Expert Groups: Horizontal Rules and Public Register, C(2010) 7649 final which was revised in 2016 with the Commission Decision of 30.05.2010 establishing horizontal rules on the creation and operation of Commission expert groups, C(2016) 3301 final.

are public entities, mostly international organisations. The experts assist the Commission directly in drafting a legislative proposal.[46] These groups in the field of insolvency (a previous group on cross-border insolvency was initiated to assist on the revision of the EIR)[47] are established only for specific matters and usually operate on a temporary basis. With the increasing involvement of the Commission in insolvency law, they may consider establishing a permanent expert group on insolvency law.[48]

- Stakeholder meetings. In the course of 2016 the Commission organised several meetings with diverse stakeholders to discuss the possibilities for a legislative proposal. Three informal stakeholder meetings took place in April, May, and July, which functioned as a sounding board for the Commission.[49] In addition, on 12 July 2016 a conference, hosted by the Commission and under the auspices of the Slovak Presidency of the Council, was held on convergence of insolvency frameworks within the European Union. This conference was attended by some 250 representatives of national governments, national parliaments, European Commission, European Parliament, courts, insolvency practitioners, business associations, consumer associations, academia, lawyers, banks, trade unions and labour unions.[50]

- Public consultations on an effective insolvency law within the EU. The Commission conducted two public consultations where harmonisation of insolvency laws was considered. Firstly, in 2015, with regard to the Capital Markets Union, a public consultation was conducted in which one question touched upon harmonisation of insolvency. Secondly, in 2016, after it was announced that a legislative proposal would be prepared, an in-depth consultation on harmonisation of insolvency law was conducted. These public consultations will be discussed more extensively in section 5.

The above examples of stakeholder involvement took place in 2015 and 2016, in the phase where the Commission was preparing its proposal for a Restructuring

46 Commission Decision of 30.05.2010 establishing horizontal rules on the creation and operation of Commission expert groups, C(2016) 3301 final, Article 3(1)(c).

47 European Commission, Expert group on cross-border insolvency (E02772), 2013, http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetail&groupID=2772.

48 In contrast to, for example, company law (Group E01456), there is no permanent expert group on insolvency law.

49 These meetings took place on 7 April 2016, 27 May 2016 and 18 July 2016. The minutes of the meeting of the informal stakeholder group are available at: http://ec.europa.eu/justice/civil/commercial/insolvency/index_en.htm. Participants of these meetings included: BusinessEurope, AFME, EBF, ACCA, UEAPME, ESBA, Independent Retail Europe, EuroChambers, ETUC, EFIN, FEE, INSOL Europe, FDC, The Council of Bars and Law Societies of Europe, and the European Law Institute.

50 For more information on this event see http://ec.europa.eu/justice/newsroom/civil/events/160712_en.htm. A video-recording of the conference is available at: http://ec.europa.eu/justice/newsroom/civil/events/160712_en.htm.

Directive, and where no draft texts were publicly available. It is not certain whether stakeholders will be involved now that the proposal has been published. In October 2016, the Commissioner stated in this regard: "[i]n our preparatory work, we paid attention to the opinions of all stakeholders, including national parliaments."[51] Besides the group of experts, which is expected to continue until 2018,[52] no further details have been announced whether and to what extent the Commission will continue to involve stakeholders in the legislative process.

4.3 Conclusion

Since the 2011 Resolution of the European Parliament, the Commission has been dedicated to promote the rescue of financially distressed but economically viable businesses. This has resulted, in particular, in a Communication (2012), a Recommendation (2014) and a legislative proposal in (2016). Also the EIR (recast), adopted on 20 May 2015, extends its scope with regard to specific restructuring proceedings. Until 2015, the involvement of stakeholders has been limited. Besides some studies and an expert group, stakeholders in general were hardly involved. At the same time, studies on national regimes, but also analyses of the Commission and the European Parliament pointed out that any legislative effort in this regard would be complex. This is, in particular, due to (i) the widely differing national insolvency regimes, and (ii) the great extent to which insolvency law is embedded in other fields of law. Harmonisation efforts will therefore touch upon the interests of the many affected stakeholders. This is also why the involvement of stakeholders by means of expert groups, stakeholder meetings and public consultations, comes as no surprise. This involvement took off especially after the preparation of a legislative proposal was announced. Interestingly, the Commission has not made comments yet on how stakeholders will be involved now the proposal for a Restructuring Directive has been published, except for the group of experts that will continue to assist the Commission until 2018.

5 Stakeholder Sentiments: the Public Consultations on CMU and on an Effective European Insolvency Framework

The involvement of stakeholders has already shed light on their sentiments towards harmonising insolvency law. To gain an overview, the Commission's

51 Speech by Commissioner Jourová to the Legal Affairs Committee and EU Affairs Committee in the Bundestag: Anti-money Laundering, European Public Prosecutor's Office, Digital Contracts, and Insolvency (26 September 2016), SPEECH/16/3189. For the full text see http://www.europa.eu/rapid/press-release_SPEECH-16-3189_en.htm.

52 See the Call for a Group of Experts on insolvency and restructuring, available at: http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetail&groupID=3362.

public consultations that touched upon matters of insolvency are useful. They show what the targeted audience is, what topics they are requested to respond too, what types of respondents are involved, and what their positions are. First of all, in 2015 a consultation was held with regard to the initiative on a Capital Markets Union (CMU),[53] in which the Commission also surveyed on the need and possible topics for harmonisation of insolvency laws.[54] Subsequently, in 2016 a public consultation was conducted more specifically on the feasibility and scope of possible EU legislative measures regarding insolvency frameworks.[55] I will briefly describe both consultations.

5.1 Public Consultation on Building a Capital Markets Union

In 2015 the Commission surveyed on harmonising insolvency laws in Europe with the public consultation on the CMU, and asked respondents: "What specific aspects of insolvency laws would need to be harmonised in order to support the emergence of a pan-European capital market?"[56] From the responses the Commission concluded that a lack of harmonised insolvency law is regarded as one of the main barriers to bank and non-bank direct lending to companies, and that indeed harmonisation of certain aspects of insolvency law is recommended.[57] The stakeholders that took part in this public consultation, however, took varying positions on harmonisation. The Commission summarised their positions as follows:[58]

- Banks favour reform of certain aspects of national insolvency regimes at the EU level.

53 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Action Plan on Building a Capital Markets Union, 30.09.2015, COM(2015) 468 final.

54 Public Consultation: Building a Capital Markets Union, from 18 February 2015-13 May 2015, see http://ec.europa.eu/finance/consultations/2015/capital-markets-union/index_en.htm.

55 Consultation on an effective insolvency framework within the EU, from 23 March 2016-14 June 2016, see http://ec.europa.eu/justice/newsroom/civil/opinion/160321_en.htm.

56 This public consultation ran from 18 February 2015 to 13 May 2015 and was based on the Commission's Green Paper 'Building a Capital Markets Union, 19.02.2015'. The responses to the questionnaire were made available at: https://ec.europa.eu/eusurvey/publication/capital-markets-union-2015?surveylanguage=en. A summary of the responses is provided in Commission Staff Working Document, Feedback Statement on the Green Paper "Building a Capital Markets Union" Accompanying the document Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Action Plan on Building a Capital Markets Union of 30.9.2015, SWD(2015) 184 final, see http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/summary-of-responses_en.pdf.

57 Commission Staff Working Document, Feedback Statement on the Green Paper "Building a Capital Markets Union" Accompanying the document Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Action Plan on Building a Capital Markets Union of 30.9.2015, SWD(2015) 184 final, at 2.6 and in the accompanying Annex at Q 5.6, Q15.1, Q16.1, Q19.1, Q24, Q27.1, Q27.2, and Q29.

58 *Idem*, at Q29.3.

- Pension funds and other financial intermediaries noted that the diverging national insolvency laws should be reformed, but this is a long-term project.
- Member States and Ministries of Finance were hesitant about harmonisation. They might consider a step-by-step approach in increasing approximation of national insolvency laws, possibly accompanied by measures to strengthen national insolvency frameworks.
- Central Banks showed support for a more comprehensive reform of the diverging national insolvency regimes
- Capital Market Regulators similarly expressed support for a reform of insolvency regimes, as the current differences create barriers to cross-border investments.
- Business Associations showed diverse responses on the harmonisation of insolvency laws.
- SME Representatives expressed that efficiency and effectiveness of insolvency practitioners and courts could be improved with harmonisation.
- Labour Unions support a wide ranging harmonisation of insolvency frameworks.
- Research Institutes favour harmonisation to realise better re-allocation of capital and bring more economic growth.

Most respondents emphasised the differences between national insolvency regimes as a prime reason for reform or harmonisation of national insolvency laws. However, the Commission noticed that, in particular, Member States and Ministries of Finance seemed more cautious (see figure 2). Out of the twelve substantive responses from Governments and Ministries,[59] five showed some interest to further study possibilities for partial harmonisation, including Austria, the Czech Republic, Germany, the Netherlands and Sweden.[60]

59 Responses to the public consultation were received from several Governments/Ministries, those from Austria, Czech Republic, Estonia, Finland, France, Germany, States of Guernsey, Hungary, Ireland, Isle of Man, Italy, Jersey, Lithuania, Netherlands, Norway, Slovakia, Sweden and the United Kingdom were published. Only twelve of these responses touched upon the issue of harmonisation of insolvency law, six responses provided no answer.

60 Commission Staff Working Document, Feedback Statement on the Green Paper "Building a Capital Markets Union" Accompanying the document Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Action Plan on Building a Capital Markets Union of 30.9.2015, SWD(2015) 184 final, see the Annex at Q29, see http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/summary-of-responses_en.pdf.

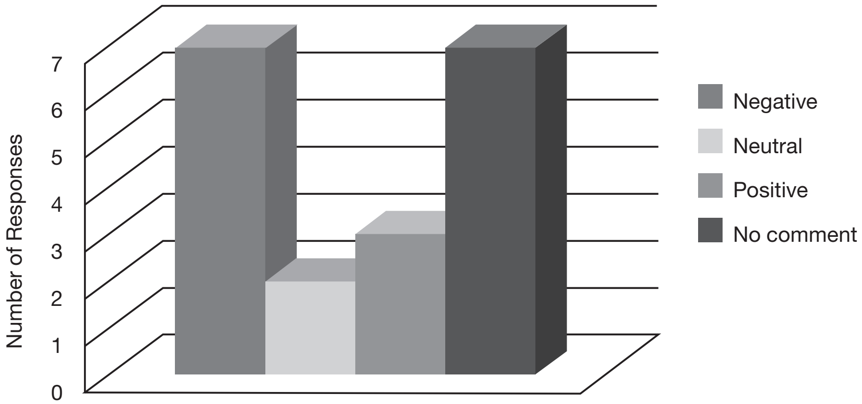

Figure 2: Sentiments of Member States and Ministries of Finance towards harmonisation

Other responses stated that harmonisation would not be desirable or that current measures would suffice. However, out of all responses to the consultation, there appears to be significantly more support for substantive harmonisation (to some extent), compared to those favouring no substantive harmonisation.[61]

The respondents to the public consultation made various suggestions for specific topics which would be ready for harmonisation:

- Common definitions of e.g. default, avoidance actions, restructuring of companies, stay on individual creditor claims, discharge period, and close-out-netting;
- Preventive restructuring proceedings, out-of-court, and hybrid restructuring proceedings;
- Communications on the opening of insolvency proceedings and measures to be taken upon commencement;
- Requirements for opening insolvency proceedings;
- Ring-fencing of a client's securities (for insolvent financial intermediaries);
- Ranking of creditor's claims;

61 From the 346 public responses, about 25% of the responses showed support (to some degree) for substantive harmonisation, against less than 10% of the respondents stating substantive harmonisation would not be desirable or possible (considering the great divergences among countries). Most of the remaining respondents did not answer Q29 on harmonisation of insolvency law.

- Qualifications, tasks and rights of insolvency practitioners;
- Liability of directors and shadow directors;
- Time cap on insolvency proceedings;
- Establishment of EU register with information on insolvencies;
- Single form for petition of claims;
- Second chance for entrepreneurs; and
- Personal insolvency.

The consultation, which was open to all citizens and organisations, resulted in some 422 responses from a wide variety of stakeholders.[62]

From the responses the Commission derived that insolvency proceedings are considered a key barrier to a Capital Markets Union, especially as inefficiency and the great diversity of national insolvency regimes inhibit the possibility to assess the risks associated with making cross-border investments. It was often commented that harmonisation is not only complex, in particular due to its embeddedness in other fields of law, but also a long-term rather than short-term endeavour.

5.2 Public Consultation on Effective Insolvency Frameworks

For a period of twelve weeks (23 March 2016 to 14 June 2016), the Commission also held a public consultation directed at distinguishing the barriers to effective insolvency frameworks within the EU.[63] It relates especially to the:

> "efficient organisation of debt restructuring procedures" and "the rationale and the process for debt discharge for entrepreneurs (and its possible extension to consumers)."[64]

62 In total some 422 respondents from across the 27 Member States and beyond submitted a response on the 32 questions of this consultation (346 responses were made public). This includes (representatives of) Member States and Ministries (of Finance), non-governmental organisations, international or European organisations, industry/business associations, trade unions, companies, SME's, micro-enterprises, sole traders, private individuals, banks, pension funds, central banks, capital market regulators and supervisors, consumer organisations, think tanks and research institutes.

63 The Commission reported on this public consultation in its proposal for a Restructuring Directive. There were over 260 respondents, from the 27 Member States. At the time of finalizing this chapter, the responses to the public consultation itself were not yet published.

64 European Commission, Webpage on the Consultation on an effective insolvency framework within the EU, see http://ec.europa.eu/justice/newsroom/civil/opinion/160321_en.htm. See also the introduction to the questionnaire of the public consultation itself.

Against the backdrop that the absence of a harmonised approach to insolvency is preventing the proper functioning and development of capital markets, the Commission stated as its aim:

> "[i]it seeks views with regard to common principles and standards which could ensure that national insolvency frameworks work well, especially in a cross-border context."[65]

The consultation has predominantly an explorative character, as the results would be used to devise relevant topics for the Commission's legislative proposal. As a consequence, the scope of this survey is broad, it includes basically all key aspects of insolvency.[66]

The consultation is based, in particular, on the 2014 Commission Recommendation which is also reflected in the above mentioned topics. In this consultation the Commission was open to the "views and input from the broadest public possible." This envisaged audience reflects diverse groups of possible stakeholders, including:

> "citizens, companies (including SMEs and entrepreneurs), business associations, public authorities, consumer organisations, as well as insolvency practitioners, researchers and think tanks, courts and public administrative bodies at international, EU-wide, national, regional and/or local levels".[67]

The results of this public consultation shows that Member States take different positions to the other stakeholders. This is in line with the public consultation on the CMU. The Member States, in general, preferred a principle based approach, as the embeddedness of insolvency laws prevents more substantive harmonisation at this point. The other stakeholders, however, were in favour of a framework with

65 *Idem*.

66 The topics include among others: effect of differences between the laws of the Member States, in particularly at newly established companies and saving distressed but viable companies; involvement of courts in restructuring procedures; publicity for restructuring procedures; assessment of the viability of a distressed debtor; debtor-in-possession; stay; adoption of restructuring plan and cram-down; protection of rescue finance; directors' liability; second chance for over-indebted honest debtors (entrepreneurs and consumers); recovery of debts, including ranking of claims and avoidance actions; professional standards for insolvency practitioners; and disqualification of debtors. See also: Questionnaire for the public consultation on an effective insolvency framework within the EU. Responses to the consultation could also be submitted by (e-)mail to the DG Justice, Unit A1 – Civil Justice Policy.

67 European Commission, Webpage on the Consultation on an effective insolvency framework within the EU, see http://ec.europa.eu/justice/newsroom/civil/opinion/160321_en.htm.

minimum rules on early recourse for distressed businesses and a second chance for honest bankrupt entrepreneurs.[68]

5.3 Conclusion

From the public consultations in 2015 and 2016 on insolvency I observe that, in general, there is support for furthering the adoption of a European insolvency framework. The major divergences between the regimes of Member States create a barrier for harmonisation, as well as the embeddedness of insolvency law. At the same time, it necessitates action from the Commission in order to promote the free flow of capital across the EU as well as the assessment of investment risks. This support is given by a variety of stakeholders, including banks, central banks, capital market regulators, business associations, labour unions and research institutes, which are mostly the so-called dormant and discretionary stakeholders.

Most notably, the Member States and the Ministries of Finance (they can be classified as dominant stakeholders), seem to lack ambition and support for substantive harmonisation. They appeared reluctant or sometimes even dismissive in considering any further substantive harmonisation. Perhaps, this could have been derived already from the mild adoption of the Commission's Recommendation but also national political considerations can play a role here. The results of the Commission's public consultations provide further insight in the position of Member States, and show that Member States are more reluctant than other stakeholders to pursue a significant attempt toward substantive harmonisation.

6 The Way Forward with Stakeholders

The previous conclusion leads to the (for some not so surprising) observation that expectations for a legislative instrument on harmonising EU insolvency and restructuring law should not be too farfetched. In principle, one could regard this as a situation where most of the dormant and discretionary stakeholders take a different position to that of the dominant stakeholders. The support of other stakeholders, especially from practice, may promote the Commission's initiative with, for example, Member States. Where a standstill in the legislation might be risked, the Commission could draw on experiences from other fields by introducing 'semi-legislation', based on self-regulation. This would be in line with the 'open method of coordination', as suggested by Ian Fletcher and Bob Wessels, where

68 European Commission, Proposal for a Directive of the European Union and the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU of 22 November 2016, COM(2016) 723 final, Explanatory Memorandum, p. 17.

traditional hierarchical legislation is supported by soft-law instruments.[69] With Recital 48 EIR (Recast) I will try to illustrate how semi-legislation can assist in the insolvency endeavour.

6.1 Inspiration from Recital 48 EIR (Recast)

In the EIR (recast) the obligations for cooperation and communication have been extended significantly. Not only insolvency practitioners, but also courts must cooperate and communicate closely with each other in cross-border insolvency cases.[70] The EIR (recast) has left room to further specify how this cooperation and communication should actually take place, as is stated in Recital 48 EIR (recast):

> "[…] When cooperating, insolvency practitioners 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)."

The EU legislator has given explicit room to groups of European or international stakeholders to develop further guidance on communication and cooperation by insolvency practitioners and courts. This novelty (in the field of European insolvency law) can be an effective approach to allow for a sort of harmonisation based on self-regulation by means of principles and guidelines, but within the scope of an EU legislative instrument.[71]

Formulating such provisions should receive considerable attention. Recital 48 of the EIR (recast), for example, states that in particular the guidelines prepared by UNICTRAL are relevant. Remarkably, UNCITRAL has provided no 'guidelines' with regard to communication and cooperation. It is therefore not clear what the EU legislator is referring to. Perhaps it is the UNICTRAL Model Law on Cross-Border Insolvency (1997) with Guide to Enactment and Interpretation (revised in 2013) where Articles 25-27 relate to cooperation and communication in cross-border

69 Fletcher and Wessels, above note 2, paragraphs 146 and 216. See also http://eur-lex.europa.eu/summary/glossary/open_method_coordination.html.

70 Articles 41-44 EIR (recast), for group-proceedings comparable obligations have been provided for insolvency practitioners and courts, see Articles 56-59 EIR (recast).

71 Another example where the importance of self-regulation and soft law was emphasized concerns the review of the EU Mediation Directive in 2016, see: Report from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the application of Directive 2008/52/EC of the European Parliament and of the Council on certain aspects of mediation in civil and commercial matters, 26 August 2016, COM(2016) 542 final.

insolvency cases.[72] At the same time, the EIR (recast) may refer to the UNCITRAL Practice Guide on Cross-Border Insolvency Cooperation (2009) which provides, for example, insights on cooperation and sample clauses for insolvency agreements (also known as protocols).[73] Alternatively it could refer to the UNCITRAL Model Law on Cross-Border Insolvency: The Judicial Perspective (2013) which provides also some guidance to courts on cooperation and communication. Therefore, the EU legislator should provide stakeholders with clear directions on the scope, status and adoption of principles and guidelines.[74]

6.2 Conclusion

Where support from the Member States (dominant stakeholders) may be lacking for substantive harmonisation of insolvency law, despite the support from dormant and discretionary stakeholders, we could draw from experiences in other fields. Here, examples with regard to 'semi-legislation', based on self-regulation, show how the EU legislator can involve stakeholders also in executing EU law by creating room for non-binding principles and guidelines on matters where EU legislation is absent.

The EIR (recast), leaves room for self-regulation in Recital 18. It states – in brief – that insolvency practitioners and courts should take into account principles and guidelines on communication and cooperation in cross-border insolvency cases adopted by European and international organisations. Within the scope of an EU instrument, and within certain conditions, stakeholders are permitted to develop principle and best practices.

It illustrates an alternative for the EU legislator when support for (specific parts of) harmonisation is lacking. Stakeholders, in particular from practice and academia, could function as the place where such principles and best practices could be jointly developed to further specific elements of an effective restructuring framework for distressed businesses in Europe.

72 UNCITRAL Model Law on Cross-Border Insolvency Law, 1997, with Guide to Enactment and Interpretation, 2013, available at: http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency.html. See also Bob Wessels and Gert-Jan Boon, "Cross-Border Insolvency Law: International Instruments and Commentary, second edition" (2015, Kluwer Law International, Alphen aan den Rijn), paragraph 8.

73 UNCITRAL Practice Guide on Cross-Border Insolvency Cooperation, 2009, available at: http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency.html. See also Bob Wessels and Gert-Jan Boon, "Cross-Border Insolvency Law: International Instruments and Commentary, second edition" (2015, Kluwer Law International, Alphen aan den Rijn), paragraph 11.

74 UNCITRAL Model Law: the Judicial Perspective, 2011, available at: http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency.html. See also Bob Wessels and Gert-Jan Boon, "Cross-Border Insolvency Law: International Instruments and Commentary, second edition" (2015, Kluwer Law International, Alphen aan den Rijn), paragraph 14.

7 Conclusion

In this section I will summarise the findings and present conclusions.

In its preparatory work for a legislative proposal on substantive harmonisation of insolvency laws in Europe, the European Commission has given stakeholders a prominent role. However, it remains undecided who these stakeholders are, why the Commission is involving them, but also whether and to what extent it is justifiable to involve them in a legislative process.

In sections 2 and 3 I elaborated on what stakeholders are, in particular regarding the Commission's legislative governance, and how different stakeholders can be distinguished. Following the definition of Savage et al., stakeholders need (i) to have an interest in the actions of an organisation, which I argue is present when an organisation's actions affect these interests, and (ii) be able to influence the organisation. The Commission does not apply a formal approach to these dimensions of stakeholders, as also non-legislative parties are involved in its activities and considered a stakeholder. Concerning the legislative governance of the Commission, stakeholders can be defined as:

> "all those individuals, groups and other organisations that have an interest in the EU legislative process of harmonising insolvency and restructuring law and which have the ability to influence the choices and decisions the Commission has to make."

With the Commission's broad perspective on stakeholders, differentiation of stakeholders is even more complex. Interests can be distinguished on the basis of the salience of interests. Salience consists of the attributes (i) power, (ii) legitimacy and (iii) urgency. Urgency will, in general, not be an attribute likely present for stakeholders in a legislative process. Prioritising of interests, without prejudice to specific interests, can be based on the number of attributes they possess. This leads to three types of stakeholders in the legislative governance of the Commission:

(1) Dominant stakeholders: they possess both power and legitimacy. This includes foremost the formal legislative bodies, such as the Council and the European Parliament.

(2) Discretionary stakeholders: they possess legitimacy. It relates to direct and indirect parties involved in insolvency proceedings, such as debtors, creditors and employees, but also insolvency practitioners and trade unions.

(3) Dormant stakeholders: they possess power. This group includes for example academics, the Commission's expert group, but also international organisations such as the IMF, UNCITRAL and the World Bank.

In section 4, it is argued that stakeholder involvement developed only over time. The debates on harmonising substantive insolvency law started with a resolution of the European Parliament in 2011. A subsequent milestone was the publication of the 2014 Commission's Recommendation on a new approach to business failure and insolvency. Input for this Recommendation was, in particular, the study on national insolvency regimes that was conducted by INSOL Europe. The evaluation in 2015 on the adoption of the Recommendation showed, however, that it had limited effect on national regimes. The Commission, at the time, also worked on the EIR (recast), which was adopted on 20 May 2015. In these efforts, the Commission was supported not only by extensive studies on the EIR, but also a temporary group of experts and meetings with national experts.

In 2015, subsequent to the evaluation of the Recommendation, the Commission published the Action Plan on a Capital Markets Union and announced a legislative proposal on harmonising insolvency law. From here on stakeholders were more actively involved by the Commission. The Commission initiated a new (temporary) group of experts to assist in the preparations for the legislative proposal. From April till July 2016, multiple meetings were organised for extensive debate with a broad variety of stakeholders on the possibilities for harmonisation. Also, public consultations were conducted to gather insights from the wider public. These efforts have led to ample response from stakeholders.

It was shown in section 5 that Member States showed some reluctance to substantively harmonise insolvency laws, but that general principles are welcomed. At the same time other stakeholders, including central banks, pension funds, Member States, business associations, SME representatives, labour unions, and research institutes, are supportive of a minimum framework to rescue distressed businesses and provide a second chance to honest bankrupt entrepreneurs.

Finally, in section 6, I propose that the current sentiment of all stakeholders does not prevent the Commission from furthering approximation of insolvency frameworks. Before, the Commission experienced similar situations with differing perspectives of stakeholders, and where different approaches based on semi-legislation were adopted. Inspiration could be drawn from the EIR (recast). In this regulation, Recital 48 allows explicitly for European or international organisations to adopt principles and guidelines to further cross-border insolvency cooperation and communication. These examples illustrate how promoting effective European restructuring frameworks for distressed business may be given shape by means of semi-legislation, even where stakeholder perspectives are diverging. With guidance from the EU legislator, there could be room in legislative measures for contributions from stakeholders.

From all this it can be concluded that stakeholders are becoming increasingly important for the EU legislator in designing and executing EU legislation. Traditionally, stakeholders have been involved, for example, in providing comments on a legislative proposal (this could be called a vertical approach). This provides the legislator with the information on how stakeholders perceive the proposal. The Commission has, in developing a proposal for a Restructuring Directive, decided to involve stakeholders right from the start and in multiple ways. They have been given a prominent role in discussing what a feasible and desirable direction is for a draft legislative proposal (this could be called a horizontal approach). This would not only help the Commission to better adapt its proposal to the insights derived from these stakeholders, but has provided the Commission also with a new partner in its efforts so far.

Chapter 2

The Role of Judiciary for a Greater Convergence of European Insolvency Law

Nicoleta Mirela Nastasie

1 Introduction

In the new environment of globalization, national laws develop an increasingly internationalized orientation. Differences in insolvency regimes and their impact on EU investments in the Internal Market, unification, approximation or harmonization of Insolvency EU Law and structures are burning issues within the European Union not only for law-makers, but also for the judiciary.

In the doctrine some terms have been used to define the process of obtaining a "higher degree of similarity": unification, convergence, harmonisation, approximation. Harmonisation has been characterised as a process "in which diverse elements of legal system are combined or adapted to each other in aim to create a coherent body of rules or principles". It is a legislative activity, different from convergence, seen as a "global phenomenon that transcends different legal orders."[1]

It is interesting the use of terms as "interaction, synchronisation, adjustment, unity, coherence" to describe this complex and coordinated process, able to create and improve "a world-class European insolvency law and regulatory framework."[2] Harmonisation was also considered as a "standardization regarding issues implicating core insolvency concern."[3] In the academic world of insolvency law, it is not questionable anymore that modern reality necessitates a modified universalism. In addition, if harmonisation is an essential tool for modified

1 I. Fletcher and B. Wessels, "Perspectives on Harmonisation of Insolvency Law in Europe", in *Harmonization of Insolvency Law in Europe*, *Report* (2012, Kluwer, Deventer) pp. 107-135.

2 B. Wessels, "Amending the EU Insolvency Regulation: Shaken or Stirred?", in R. Parry (ed), *The Reform of International Insolvency Rules at European and National Leve* (2011, INSOL Europe, Nottingham, Paris) pp. 125 – 135.

3 I. Mevorach, "The Prospect of Standardization of Insolvency Laws in Europe- Learning from UNCITRAL's Work on Enterprise Groups and Directors' Duties" in *Substantive Harmonisation and Convergence of Laws in Europe* (2012, INSOL Europe, Nottingham) at 18.

universalism, it is important to find out the proper methods and mechanisms for its most efficient form.

The Treaty on the Functioning of the European Union (TFEU) does not provide explicit legal basis “to the approximation of insolvency law”, but Article 114 TFEU (measures for the approximation of the provisions laid down by the law) and Article 81 TFEU (cross-border judicial cooperation) “may serve as legal basis for harmonization.” [4]

However, is legislative intervention sufficient and strong enough to reach this scope in a short time, or is concentrated action of the judiciary, professionals, and other actors involved in international insolvency necessary to develop an efficient process?

The judiciary is the key institution in the insolvency system. Consequently one fundamental question is to establish how the judiciary could participate to the European process of harmonization of insolvency law.

2 Methods for the Judiciary to Metamorphose into a more Coherent System

The progress of institutional capacity could increase the role of judges in supervision of insolvency procedures. But we should not forget that promoting the fundamental values of a judicial system, such as procedural fairness, efficiency, accessibility, and confidence, the insolvency domain is able to transform the system itself.

2.1 Judicial Institutional Capacity in the EU – a Comparative Perspective

2.1.1 A Common Definition of “Court”

There is no common definition of “court” or a harmonised professional status of judges involved in insolvency cases. The term needs some clarification to make it less confused and more comprehensible. From the Insolvency Regulation perspective, the concept of a “court” includes a broad meaning of the judicial body or any other competent body of a Member State, empowered to open insolvency proceedings or to take decisions in the course of such proceedings.[5] According to the European Court of Justice’s jurisprudence, a functional criterion, not the

4 I. Fletcher and B. Wessels, above note 1.

5 Article 2(d) and Recital (10), Council Regulation (EC) No. 1346/2000 on insolvency proceedings of 29 May 2000 (OJ 2000, L 160/1).

national definition, has relevance to establish whether an authority represents a "court".[6]

The nature, history, influence, and authority of a court are factors in determining significant variations of judicial identity. In the doctrine were described four major problems affecting the judiciary system: judicial selection and discipline, additional duties and non-judicial functions, the freedom of speech and the need for an environment of trust and confidence.[7]

2.1.2 Institutional Differences

The Report on the judicial system 2014, CEPEJ[8] emphasizes the diversity of the persons defined as "judges" by the status and functions, through the categories identified across Europe: professional judges; those who have been trained and who are paid as such; professional judges practicing on an occasional basis; non-professional judges; and volunteers who give decisions in courts.[9] It was observed that the number of professional judges sitting in courts varies considerably between countries and judicial systems, higher in Central and Eastern Europe. Some systems, such as Portugal and Romania, rely completely on professional judges. In other systems, such as in Norway, Denmark, Sweden, Germany or the UK-England and Wales, lay judges have a significant role. The UK has a low number of professional judges (less than 4 per 100.000 inhabitants). The justice system uses lay judges in more than 90 % of cases. According to conclusions of the reports,[10] from the analysis of the judicial data between 2004 and 2014, the European judicial landscape has evolved in key areas. Among others, this includes "the protection of the independence of judges and of the principles of a fair trial within a reasonable time, the promotion and protection of access to justice, efficient and effective court organisation, adequate judicial proceedings and public service".[11]

6 *HSB Wohnbau*, Case C-86/00, ECJ 10 July 2001.

7 For details and explanations see H P Lee (ed) "Judiciaries in Comparative Perspective" (2011, CUP, Cambridge).

8 The European Commission for the Efficiency of Justice (CEPEJ) is an unique body for all European States, made up of qualified experts from the 47 Council of Europe member states, to assess the efficiency of judicial systems and propose practical tools and measures for working towards an increasingly efficient service for the public, for details see http://www.coe.int/T/dghl/cooperation/cepej/default_en.asp (last viewed 14 October 2016).

9 "Report on "European Judicial Systems – Edition 2014 (2012 data): Efficiency and Quality of Justice, The European Commission for the Efficiency of Justice (CEPEJ) available from: http://www.coe.int/t/dghl/cooperation/cepej/evaluation/2014/Rapport_2014_en.pdf (last viewed 14 October 2016) pp. 155- 159 and Report on "European judicial systems – Edition 2016 (2014 data): efficiency and quality of justice, The European Commission for the Efficiency of Justice (CEPEJ), available from http://www.coe.int/T/dghl/cooperation/cepej/evaluation/2016/publication/CEPEJ%20Study%2023%20report%20EN%20web.pdf (last viewed 14 October 2016) p. 81.

10 *Ibid*, pp.264, pp. 199.

11 *Ibid*, p.264.

After an analysis of the courts' role in 12 Member States, provided by the Judicial Wing of INSOL Europe in 2013, it was observed that in some states courts are not involved in grounding solutions in insolvency cases, they have a passive and supervisory role, in contrast to insolvency administrators.[12] But even in these systems, based on the traditional role of the courts, a judge's competence in insolvency problems, such as debtors' reorganisations or rescues, is paramount.

As Professor Westbrook observed in 2015, an important issue to determine is whether insolvency proceedings will be private (contractual bankruptcy) or public. The protection of the public interest indicates the importance of public control in proceedings, an actual issue and a problem for the future of the international insolvency domain. There are two options described in EU legal systems. The first is the United Kingdom and many common law countries' orientation to a private insolvency system. The second model in most civil systems is orientated to the public and third parties' interest. They are different from the United States' system, where "the bankruptcy law has exerted strong control over the exercise of the secured party's rights."[13] It is interesting to surmise whether there will be some harmonisation in this matter and the effects it may have on the judicial institutional system.

An important problem is the courts' specialisation. It is recognised that in some civil law countries, such as the Czech Republic, Estonia, and Germany, there are not specialised judges for insolvency cases. Other issues, such as differences between financial institutional budgets, discrepancies between the professional judges status, are seen as major obstacles towards harmonization.[14]

The court's infrastructure, poor available means, and the career judicial system in which judges are moved from one court to another, or to one specialized domain to another on a regular basis, make it difficult for judges to specialise in the field of insolvency. The principle of specialisation has to find an equitable balance with the coherence of the national legal systems. Harmonisation of EU insolvency law through judges' activity dealing with insolvency cases may be easier than for those judges faced with public enforcement or civil cases.

12 H. Vallender "The Role of the Judge in the Restructuring of Companies Within Insolvency" in *The Role of the Judge in Nomination, Supervision and Removal of the Insolvency Representative*: Judicial Wing INSOL Europe (2013, INSOL Europe, Nottingham).

13 J. L. Westbrook, "The Present and Future of Multinational Insolvency, in P Omar and Rebecca Parry (eds) *International Insolvency Law: Future Perspectives* (2015, INSOL Europe, Nottingham) p. 9.

14 Bob Wessels, "On the Future of European Insolvency Law, in INSOL Europe Academic Forum's 5th Edwin Coe lecture, Leiden Law School Brussels, 2012 available from: https://www.iiiglobal.org/sites/default/files/futureofeuropeaninsolvencylaw.pdf, (last viewed 14 October 2016).

The institutional organisation has been studied by CEPEJ. According to the CEPEJ 2014 Report, European states experience the greatest difficulties in managing insolvency cases. In most of the EU states, courts cannot cope with the larger volume of cases, which leads to delays and increasing durations, with more than 2,500 days in Italy and more than 1,000 days in Spain, partially because of the economic crisis, together with "the specificity of the procedures that varies according to the national systems".[15] The data for 2014 confirms the results. 60% of the states were able to solve fewer cases than those received and these cases would require more than two and a half years to be solved. The reported duration of case proceedings in 2014 was particularly long in France, Italy, and Turkey.[16]

In some systems, such as Romania, judges have to participate in an excessive number of cases and in procedures based on hearings for almost all petitions and stages, which encumber the courts.

2.1.3 Education and Training

There are many issues affecting the judicial efficiency in dealing with insolvency cases in civil courts and common law courts: insufficient commercial expertise, differences in continuing education, and insufficient experience in complex cases.

It was observed that in some Member States, the knowledge of the Insolvency Regulation is insufficiently developed. Judges have no proper experience in international insolvency cases and most do not know a second language.[17] A large number of judges do not speak another language than the national one. Especially in cross-border insolvency cases in Europe many courts agree "that it is for the administrators to smoothly and effectively run their proceedings", but local language in proceedings is mandatory and translations are constantly requested for all documents transmitted to the court.[18] That is usually a matter of domestic law, but maybe an expression of the passive attitude of the judiciary.

It is a fact that in some jurisdictions judges are more active in the process, being involved as a supervisory, directing, giving instructions, and controlling most of proceedings, not just the opening and adjudication of litigation. When judicial power in economic and business resolutions or the viability of a reorganisation plan

15 Above note 9, CEPEJ, p.264.

16 *Ibid*, pp. 199 & 264.

17 A. Sadler, "Practice Obstacles in Cross-border Litigation and Communication between (EU) Courts" (2012) 5(3) Erasmus Law Review 151-168.

18 *EU Cross-Border Insolvency, Court-to-Court Cooperation Principles, Final Public Draft* (extended version) June 2014, pp. 58, available from http://www.tri-leiden.eu/uploads/files/Final_Public_Draft_-_EU_JudgeCo_Principles.pdf, (last viewed 14 October 2016).

is increased, this situation necessitates superior economic expertise and abilities. Of course, not all judicial systems offer the opportunity to attain such expertise for all judges involved in insolvency procedures. What is the proper solution for a predictable and efficient institutional insolvency system; to reduce the powers and judicial involvement to the minimum possible,[19] or to search financial and structural resources to increase judicial skills and knowledge, aptitudes to operate as an active player in the process? The question is still in need of an answer.

The efforts of EU training institutes or national judicial formation providers for education on economic aspects related to insolvency law are not great. When the number of judges who could potentially be involved in insolvency cases is relatively large, it means that in reality a small number of them actually deal with such cases or with cross-border insolvency.

There are few opportunities for judges to meet their colleagues from other States who are involved in international insolvency law, or to participate in distance-learning courses or programs. Regarding judicial training, the CEPEJ's last Report established that the financial effort is limited to less than 1% of the budget of the courts on average, less than 0,1 % in Albania, Bulgaria, the Czech Republic, Italy, Malta, Republic of Moldova, Romania, and the UK-England and Wales, although judicial training should be a higher priority for the European states.[20]

2.2 Relation to Other State Powers and Legal Orders

The relation to other state powers and legal orders is another subject for reflection in the process of searching the best solutions for a more coherent EU insolvency system, keeping in mind the connections with other states authorities and also the relationships between legal systems.

]Scholars exploring the field are talking about internationalisation of the judiciary or the development of a transnational law. The theory of judicial interests expresses the idea that the judiciary is not "an epistemic community" but rather a bureaucracy, with significant differences, and that European law could also support or threaten judges "independence, influence and authority vis-à-vis other courts and political bodies". The process depends on how a judge understands his or her role in the political process.[21]

19 Forum for Asian Insolvency Reform, "Insolvency Reforms in Asia: An Assessment of the Implementation Process and the Role of Judiciary" Bali, Indonesia, 7-8 February 2001, Synthesis Note 1.

20 Above note 9, pp. 43 & 479.

21 K. J. Alter, *Establishing the Supremacy of European Law: The Making of an International Rule of Law in Europe* (2001, OUP, Oxford) pp. 39.

From another perspective, it is important to search for coherence in the definition of concept of judicial independence and to find the right balance between judicial independence and public responsibility of judges. Fairness is particularly important in a collective process. It therefore requires supervision by a credible and impartial institution, which has independence as key word.

When examining judicial developments, we have to analyse the relationship to other systems, such as the legislature, government, and international legal orders, but also internal factors affecting connections between courts and judges. Recent legal and social transformations of insolvency domain, especially cross-border insolvency, have influenced not only the size of judicial systems as institutions, and the structure of the legal field, but also the authority, power, jurisdiction, economic, and sociological role of the judiciary.

When describing the contrasting trends that can lead to the increase or limitation of the judicial area and influences, in doctrine the idea was emphasised that "long-term developments are so complex that the effects cannot be individualized and are, in a number of ways, dependent on the judge's role in society and in the legal order".[22] In this context, it has to be determined if the harmonisation of insolvency law will push back the judiciary in relation to the administration authorities and international courts, or, by the contrary, will increase its powers and control.

It is not clear if the actual EU tendencies lead to a growing demand for the judiciary, or to the promotion of out-of-court settlements, as an expected alternative. It is obvious that international and EU legal orders have exerted an increasing pressure of supranational legal power on national legislation and the judiciary, a superposition of jurisdictions between the national and European courts, territorial and functional, and the formation of a global law through the harmonization or unification of law between different countries.

The transformations in the EU legal order could determine in time also a judicial restraint, with national judges giving away part of their jurisdiction to European judges, but also judicial progress, through the functions and application of EU insolvency law and principles.

2.3 Solutions to Bring into Harmony Different Judicial Systems in Europe.

A method to a more convergent EU system could be the judicial structure with specialized courts or specialized chambers for insolvency proceedings, with a

22 M. Loth & E. Mak, "The Judicial Domain in View, Figures, Trends and Perspectives (2007) 3(1) Utrecht Law Review pp. 82-85.

number of judges with high level of expertise in the commercial field, able to deal with complex cross- border insolvency cases. This system would permit a rapid evaluation of organization, schemes, and judges' education necessary at an EU level and could increase the possibilities for the development of frameworks or structures different from ordinary courts. Judges could meet and communicate easier, contributing to more coherent practices and predictable interpretation of concepts, to the creation of unified substantial EU insolvency law. Another direction is to modernise and simplify judicial insolvency proceedings in order to reduce the involvement of the courts in many administrative steps of the process. Developing simplified procedures could be a way toward harmonisation of the EU insolvency law.

What is the role of judicial training to achieve a higher degree of similarity in insolvency proceedings in Europe?

It is actually impossible to train all judges acting in general jurisdictions, potentially called to decide in an insolvency case, to the same extent as specialised judges from a court with exclusive jurisdiction. But for judges having regular contact with international insolvency law, or as part of specialized courts, continuous training programmes and language training are necessary.

What are the possibilities to increase technical assistance at EU level in order to develop judicial competence, expertise, and cooperation? What is the appropriate way to bring the judiciary "up to standards"?

I imagine a complex European program beginning with an assessment report in order to conduct a general analysis of actual judicial procedures, powers and practice, the role of judiciary, and difficulties and issues in the existing national insolvency legal systems. The next step is to develop a teaching methodology applicable in Member States by national authorities or institutions, such as the National Institute of Magistracy in Romania. It could be useful as an e-learning system of teaching created by an European institution/organisation for judges or a permanent EU judicial training program, a common internship training at European level with judges from each European country.

The combination of regional, social, and cultural characteristics can certainly affect the point of view and activity of judges involved in insolvency cases. It would be helpful to consider the creation of an EU organisation or institution (European Insolvency Institute), including scholars, judges, lawyers, and other insolvency specialists as an important step to increase judicial cooperation and "structured education on European basis" in the field. A very interesting expectation was also expressed in 2012: the creation of an organisation comparable to the National Conference of Bankruptcy Judges existing since 1926 in the USA.[23]

3 How can the Judiciary Participate in the European Process of Harmonisation of Insolvency Law through its Main Prerogatives?

3.1 Judicial Attributions

Dealing with concrete cases as a main competence, the judiciary has to offer a sufficient degree of legal certainty and keep the balance between the interests of all parties. When judges decide what law is applicable to a particular situation, they become interpreters and enforcers of the law.

One way to achieve EU insolvency law harmonization can be a judicial metamorphosis in the process of interpretation. National courts dealing with non-harmonized rules of domestic insolvency law may and should reduce the inflexibility or incoherency between such rules, through the interpretation by analogy to general principles or regulations of EU insolvency law.

However, insolvency is a complex domain that challenges different problems both in national circumstances and international cases. More important than any of the other objectives that judges have to keep in mind are the main purposes of maximising the value of the debtor's assets, providing chances for reorganisation of a debtor's business, and ensuring that all creditors are to be treated equally.

One debatable issue is the concept of equal treatment of creditors in an international context. In national systems, creditors have procedural rights, such as the right to be informed, to claim, and to be heard, but what are the limits of non-discrimination among the same class of creditors in the absence of harmonised concepts at EU level? Which are the proper methods for a local judge to ensure that the demand for good faith and integrity are respected by the creditors, the debtor, their representatives, and other parties interested in the insolvency procedures? It is not yet established.

In another regard, the concrete judicial activity in the field of insolvency law is influenced by different factors, such as the knowledge of the applicable law, how often the judge has to apply the law in insolvency cases, and other domains of law in which the judge is involved in his daily activity. It is difficult to evaluate if a judge assigned to solve a case has the knowledge and skills to interpret and apply the insolvency law in accordance with international general principles, complex

23 Above note 2, p.133; B. Wessels, above note 14.

socio-economic conditions, and processes existing in the contemporary world. In addition, the details of European Insolvency law and the role and responsibility of national judges as specified by Regulation No.1346/2000 and No.848/2015 are not easily grounded in the absence of concrete jurisprudence, practice, or coordination in the national courts.

It is not yet determined if standardizing legal judgments it could bring about convergence in the EU and how to realise this process. International enforcement of insolvency judgements and automatic enforcement generate numerous issues, given the fact that national courts and legislation have different approaches. Consequently, the need for harmonisation is real in some matters, such as how to equilibrate the "wide judgment" in common simple cases with "deep" complex judgments; and how to find proper instruments for a coherent enforcement of judicial decisions, for a standardization of legal judgments, and for the development of fundamental principles in substantial insolvency law.

3.2 Law-Making Attributes

The need for approximation in the field of international insolvency is expressed through a modern orientation of approach between the major systems of law, the Romano-Germanic system and common-law system, but also through an increasing role of jurisprudence as a source of law.

The European legal system is very powerful and the European Court of Justice helps the continuous changing and improvement of its framework. The relationship between judges dealing with insolvency cases and the ECJ on law-making influence is already a reality. Local judges apply the law in domestic cases and European litigation according to their competences and to principles of procedural autonomy, using the framework of the national procedural and remedial laws. When national procedural rules make it impossible or unreasonably difficult to protect rights derived from EU law, the principles of equivalence and effectiveness require national judges to remove those rules. Moreover, national judges analyse and apply the rights, obligations, and principle related to the insolvency domain, provided by a plurality of legal regimes, with an increased possibility of conflicts between legal systems.

In their search for solutions, scholars have identified as EU tools:

> "consistent interpretation of national law with EU law; the power/duty to make a reference for a preliminary ruling; proportionality within the margin of deference afforded by the CJEU; mutual recognition of foreign judgments; comparative reasoning with national legislation

and jurisprudence from another Member State; disapplication of national law for violation of EU norms."

The use of consistent interpretation as a "judicial interaction technique,"[24] would lead to changes of the domestic judges and legislative interference.

Judges can use the preliminary ruling mechanism to the European Court of Justice, which has the authority not only to explain the EU law, but also to ensure its uniform application in all Member States. In this matter, national courts and the ECJ act together to enforce the rule of law in Europe and to increase the influence of courts in the political process of European integration.[25]

In order to gain a further insight, it would be interesting to follow the experience of this process for private law in Europe. It is analysed in a recent study, made under the umbrella of European Parliamentary Research Service,[26] the proposal for a European Civil Code, providing general principles on the basis of a Code as a directive. Compared to the European Convention on Human Rights, the directive is described as an important measure for the internal market process, but also for the creation of a "transnational civil society in Europe," for the positive integration in the "pan-European civil society."[27] Is it desirable and attainable for a directive aimed at the substantive harmonization of some important issues in insolvency domain, as an effect of EU legislative activity but also as a result of judicial dialogue between national courts and the CJEU?

Participating in the process of European integration, each member of judiciary can and may have some influence. When laws are equivocal, doubtful, or in conflict, the role of the judiciary is essential because of its ability to act as a law-maker. The judicial system in this sense should align to the process of continuous reassessment and renovation of the insolvency law, and through that to the "normative structure of society," more than any other institution.[28]

24 Final Handbook, Judicial Interaction Techniques- Their Potential and Use in European Fundamental Rights Adjudication, project funded by the European Commission Fundamental Rights & Citizenship Programme (JUST/2012/FRAC/AG/2755) Project Coordinator: European University Institute, pp.39 available from http://www.eui.eu/Projects/CentreForJudicialCooperation/Documents/JUDCOOPdeliverables/FinalHandbookUseofJudicialInteractionTechniquesinthefieldofEFRs.pdf, (last viewed 14 October 2016).

25 K. J. Alter, "An Analysis of the European Legal System Transformation," in *The Making of an International Rule of Law in Europe*, (2010, Oxford Scholarship Online) available from http://www.oxfordscholarship.com/view/10.1093/acprof:oso/9780199260997.001.0001/acprof-9780199260997, (last viewed 14 October 2016).

26 R. Mańko, "EU Competence in Private Law - The Treaty Framework for a European Private Law and Challenges for Coherence," European Parliamentary Research Service, January 2015 — PE 545.711, available from http://www.europarl.europa.eu/RegData/etudes/IDAN/2015/545711/EPRS_IDA(2015)545711_REV1_EN.pdf.

27 H. Collins, "Why Europe Needs a Civil Code" (2013) 21(4) European Review of Private Law 907-922.

28 Loth & Mak, above note 22, pp. 98-100.

Although harmonisation refers to a legislative activity, the judiciary could express a more flexible way to deal with cross-border insolvency cases, helping significant changes in the existing legal framework and ensuring the equitable treatment of different proceedings and creditors. Therefore, the justice system in each Member State must be adjusted to the EU standard. The judicial body could contribute to the establishment of minimum standards for different legal traditions or methods.

3.3 Social Role of the Judiciary

Solutions to find and keep the balance in the relationship between the judicial system and the parties in the insolvency proceedings are necessary. Referring to the judicial system trends and perspectives, a distinction is made between two visions. First, the judicial system is seen as having a subsidiary role, rather than instrumental, to solve conflicts between disputing parties, "in the service of the citizen's freedom." [29] In the second opinion, called the public life conception, the judicial system has a resolving function but also an important forming function, promoting the public values through its main purpose: to be the strong arm of the law. There is also recognised the mediating function "not only between the disputing parties, but also between the parties and the community, and also between a diversity of interests, roles, and values that typifies a plural society."[30] I believe that this second viewpoint is approaching closely to the real meaning of a judicial system for the insolvency domain and its development.

The social role of the judiciary is directly connected to citizens, not just as recipients of judicial activity. The central idea in this matter is the confidence in the judicial system as a fundament of the relationship between the judicial system and participants in insolvency procedures. The decreasing confidence could reduce the demand addressed to the judicial system and its procedures, with an effect on the size of the judiciary as an institution. But the development of the insolvency domain in society and the global economy leads rather to an increase in the judges' activity, and to the strengthening of the judicial structure, in order to realize its social role.

In the doctrine the connection between the influence of the judge and the impact of his decisions was analysed, especially under the criteria of judicial activism. It was observed that an activist judge makes "wide judgements", being attentive to the social context of his work, as a:

29 *Ibid.*
30 *Ibid.*

> "social engineer or case load manager, with an increasing responsiveness on his work. Instead, minimalist judges avoid precedent on principle grounds and for pragmatic reasons."[31]

However, in the context of international developments of insolvency law, what can be the proper approach of judicial activity in the connection to the democratization of judicial structures and consequences for the social role of the judiciary?

3.4 Judicial Cooperation

3.4.1 Consultation Power

The judiciary may and should develop research to encourage remedies for problems of inconsistency with the Insolvency Regulation, and a comparative analysis on the functioning of courts managing international insolvency cases.

3.4.2 Legal Cooperation

As part of general trends in the judicial domain, the evolution to a functional jurisdiction can be observed even in insolvency field. The main criterion is not based on territoriality anymore. The important aspects at institutional level are the specialisation of judges, the rapidity and correctness of judgements, and how a fair and predictable application of both substantive and procedural law can be obtained.

In this actual system the role and impact of national Supreme Courts on the lower courts is also significant. Academics use different terms to describe the phenomenon of judicial interaction, such as "conversation" or "transnational dialogue of judges" in the sense that the highest national courts often consult the case law of the highest courts in other countries to see how a solution was found to a certain case, especially for a comparative objective.[32]

In the increasing interest for a set of rules and practices in the process of efficient judicial communication and cooperation, some issues need answers. Firstly, how to determine concretely when the direct judicial cross-border communication is absolutely necessary and what are the best solutions in insolvency procedures? How to establish if this kind of cooperation offers sufficient procedural safeguards for all parties, when national procedural laws do not regulate such matters? Beyond general principles and guidelines emphasized recently in the doctrine, we have to

31 *Ibid*.

32 M. Bobek, *Comparative Reasoning in European Supreme Courts,* (2013, OUP, Oxford); A. Slaughter*, A New World Order,* (2009, Princeton University Press, Princeton); M. Claes, M de Visser, P. Popelier and C van de Heyning, "Introduction: On Constitutional Conversations," in Koen Lemmens, Maartje De Visser (eds), *Constitutional Conversations in Europe, Actors, Topics and Procedures,*(2012, Intersentia, Cambridge) pp. 1-8.

find the fastest, most practical and least costly methods to be used currently and without losing time.

In recent years it was emphasized that appointing one or more intermediaries in procedures, viewed as impartial specialists, with proper skills and experience, able to identify possible conflicts or problems and to find practical solutions to them enhances efficiency.[33] However, if the judge needs a general opinion or advice on cross-border problems related to a problem or practice, would it be possible that this intermediary could be a judge from other national system? Could judges specialized in insolvency be integrated in a group of possible EU "advisors" in cross-border insolvency issues for their colleagues? Is this form of communication and cooperation prohibited by general principles of a judicial system? Would it be possible to create a powerful group of EU judges dealing with international insolvency cases through a combination of statute, conventions, judicial restrictions, while also ensuring their independence?

Because the training priorities of judges and resources available are different from court to court and state to state, and that this is difficult to harmonize, maybe a coordinator designated from judges in each court or at a regional level, advanced and academically trained, whom his colleague judges can consult, especially in complex issues involving cross-border insolvency law, would be easier to attain.

3.4.3 Judicial Cooperation with Professional Associations, Practitioners, and Non-Insolvency Specialists.

The International Bar Association, with a membership of more than 80,000 individual lawyers and 190 bar society members from 160 countries, has conducted an informal survey as to the desirability and feasibility of an international insolvency convention. This was presented to the UNCITRAL Working Group V in May 2016. Very interesting resolutions related to judicial cooperation appear in this survey. Between 74% and 84% of respondents indicate that an international insolvency convention should deal with issues of cross-border judicial cooperation and communication based on harmonious principles of insolvency law developed at the national level. The convention would promote harmonization in cooperation, coordination, and recognition in insolvency law, taking into consideration that "judicial cross-border cooperation and communication can co-exist effectively

33 B. Wessels "The Role of Courts in Solving Cross-Border Insolvency Cases," (2011) 24(5) Insolv. Int 65-73.

with national sovereignty and public policy priorities in a treaty regime."[34] The idea of an international bankruptcy court created by a convention or treaty, whose judgments are enforced by domestic courts of individual countries, is described as a model for cross-border insolvency law.[35]

This study and the UNCITRAL recent activity develop the real interest in fair and effective regulation of international insolvency law and judicial cooperation at global level, not just within EU. Direct and indirect communication is developed as form of judicial globalisation. In reality, EU Member States have adopted (e.g. Greece, Croatia, Poland, Rumania, Slovenia, and the UK) (or are considering adopting) the UNCITRAL Model Law on Cross-Border Insolvency 1997, with regard to, among other principles, the idea expressed by Article 27, cooperation through communication between courts and office-holders.

It should also be noted that a significant role that the judiciary may accomplish is in removing or reducing obstacles to communication and cooperation in cross-border insolvency proceedings. Regarding such communication, it is at judicial discretion to establish which method of communication to use in the process. Is it feasible that a modern method, such as telephone, teleconference, or electronic mail could be used instead of traditional ways of transmitting written documents? What is the real freedom of judge to decide the method and the language of communication? How might it be possible to solve the problem of differences between national procedural rules in these matters?

At the same time it is important to support judicial activity for the identification and development of soft law techniques, best practices, or guidelines in the international insolvency field. Determining best practices for the cooperation in international insolvency is a continuous activity of specialists. One project was developed between 2005 and 2012 for the American Law Institute and the International Insolvency Institute to determine Principles and Guidelines for

34 For more details, see UNCITRAL Working Group V, "Note by the International Bar Association Observer Delegation: International Insolvency Convention, Issues, Options and Feasibility Considerations", 49th Session, May 2016, "Report to the IBA RE May 2016 UNCITRAL Working Group V 49th Session and Meeting of the HOC Convention Study Group, available from http://www.ibanet.org/LPD/Insolvency_Section/Insolvency_Section/Projects.aspx (last viewed 14 October 2016).

35 UNCITRAL Working Group V "Note by the International Bar Association Observer Delegation*:* International Insolvency Convention, Issues, Options and Feasibility Considerations," 49th Session,May 2016, available from file:///C:/Users/User/Downloads/IBA%20Submission%20UNCITRAL%20re%20Insolvency%20Convention%20May%202016%20(1).pdf and "Report to the IBA RE May 2016, UNCITRAL Working Group V 49th Session and Meeting of the HOC Convention Study Group, available from file:///C:/Users/User/Downloads/Report%20IBA%20re%20UNCITRAL%20May%202016%20(3).pdf, (last viewed 14 October 2016).

Cooperation in International Insolvency Cases, a form of soft law aimed at helping judges, legislators, and practitioners in their work.[36]

Judges have to keep in mind that in cross-border litigation the principle of cooperation represents a central problem and perhaps solution for many issues related to the procedures. The application of this principle and the search for practical solutions could conduct the practitioners and courts to develop Guidelines to increase the efficiency and effectiveness of procedural rules in international insolvency cases and maybe a uniform interpretation the law in its substance.[37]

In early 2011, Romania adopted rules concerning communication and cooperation in cross-border cases. At present, regulation of private international law in insolvency is made in Romania by the EU Insolvency Regulation and the Insolvency Code, Title III "Cross-Border Insolvency," which contains provisions on the coordination of insolvency proceedings. It recognizes the principle of cooperation, and establishes forms and means of cooperation and their limits. In addition to such a new and revolutionary legislation, several manifestations lead to a changing role of Romanian insolvency judges as a professional body interested in developing ways for international communication.

4 New Trends and Practices for an Increasing EU Insolvency Law Coherence

4.1 The Need for an EU Database of Court Orders and Judgments

The need for an EU database of court orders and judgments and a central source of information relating to national insolvency law frameworks, an open-book improved and updated with the help of the national authorities and courts, including a description of some key-aspects and changes of national legislation in Member States is evident. The lack of EU database of court judgements is an significant obstacle to obtaining common rules on insolvency matters.

The 2010 INSOL Europe Study[38] emphasised the necessity of a centralised e-database containing significant court orders and decisions, to help individuals and practitioners to have direct access to information in their language about national

36 I. Fletcher and B. Wessels (reporters), "Transnational Insolvency: Global Principles for Cooperation in International Insolvency Cases" (2012, The American Law Institute and the International Insolvency Institute, Philadelphia) available from https://www.iiiglobal.org/sites/default/files/alireportmarch_0.pdf, (last viewed 14 October 2016).

37 Above note 1, pp. 166

38 European Parliament, Directorate –General for Internal Policies, G. Cherubini, et al, (eds) "Harmonisation of insolvency law at EU level"(2010, INSOL EUROPE), pp.24, available from http://www.europarl.europa.eu/meetdocs/2009_2014/documents/empl/dv/empl_study_insolvencyproceedings_/empl_study_insolvencyproceedings_en.pdf (last viewed 14 October 2016).

insolvency procedures.[39] The European Judicial Network in civil and commercial matters is by purpose and organization such a tool. Building best practices in a number of Member States, the purpose of the Network is to ensure interaction and the availability of knowledge and information, to provide substantial support for efficient judicial cooperation between Member States, and stronger integration of judges and other judicial authorities, as well as legal professionals. To facilitate the access to justice, the Network's core function is to set up an online information system for the public on EU instruments, national measures for their implementation in national law, international instruments, and on relevant case-law by the Court of Justice.[40]

The European Commission launched in 2014 an EU interconnection of national insolvency registers, with a database of seven Member States: the Czech Republic, Germany, Estonia, Netherlands, Austria, Romania, and Slovenia, including real time access to insolvency information, in the languages of EU, clear explanations on the insolvency terminology and national systems.[41] In July 2014 the European e-Justice Portal was made available which interconnected insolvency registers as an important source of insolvency-related information.[42]

An important element is the adopted revision of the EU Insolvency Regulation (Regulation EU 2015/848) which rules the establishment of the EU-wide interconnection of national electronic insolvency registers.[43] In this international context, would it be possible, through the efforts of judges and local judicial authorities as Network members, to provide information on national decisions on insolvency related cases to improve and enlarge the EU e-databases in the future? It is a question not just for European Commission but also for national judiciaries.

39 Directorate General for Internal Policies, "Harmonisation of Insolvency Law at EU Level" (2010, European Parliament, Brussels) available from http://www.europarl.europa.eu/meetdocs/2009_2014/documents/empl/dv/empl_study_insolvencyproceedings_/empl_study_insolvencyproceedings_en.pdf (last viewed 14 October 2016) p 84.

40 Report from the Commission to the European Parliament, the Council and The European Economic and Social Committee on the Activities of the European Judicial Network in Civil and Commercial Matters, Brussels, 10.3.2016, COM(2016) 129 final; The Multiannual European e-Justice Action Plan 2014-2018 of the Council, OJ C 182, 14.6.2014, p. 2.

41 European Commission Press Release, "Modern Insolvency Rules: European Commission kicks off EU-wide interconnection of insolvency registers," (Brussels, 7 July 2014) available from http://europa.eu/rapid/press-release_IP-14-774_en.htm.

42 For details, see European e-Justice Portal – Insolvency registers, e-justice.europa.eu.

43 EU-wide interconnection of insolvency registers, Pál Szirányi, P. ERA Forum (2015); Regulation (Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast)—hereinafter as "the Recast Insolvency Regulation", OJ L 141 of 5 June 2015, p. 19.

4.2 Increasing Consistency of Insolvency Law Across the European Union through Recent Soft-Law Instruments.

There have been efforts to develop soft law mechanisms, principles and recommendations, possible to be used both in civil-law as well as common law jurisdictions, to increase convergence of insolvency law across the European Union. In this context, EU Cross-Border Insolvency Court-to-Court Cooperation Principles and Guidelines produced by a team of scholars of Leiden Law School and Nottingham Law School (2013-2014) in collaboration with some fifty experts, including 25 judges representing several EU countries, finalised in February 2015, with a set of 26 EU Cross-Border Insolvency Court-to-Court Cooperation Principles (EU JudgeCo Principles) and 18 EU Cross-Border Insolvency Court-to-Court Communications Guidelines (EU JudgeCo Guidelines), represents an important step to making national legal systems "work together" without unifying or approximating them, nevertheless obtaining a "limited harmonisation" of insolvency law.[44]

The JudgeCo Project, promoted as a comparative research activity followed by a training programme for insolvency judges from all EU states, is a valuable experience. The JudgeCo Project is a result of complex analysis of practice and theoretical expertise about the process in which judges and other practitioners can be directly involved. The project is innovative for the development of certain rules, encouraging them to achieve greater convergence to the main EU goals.[45]

The project's results may be a well prepared step for certain measures to be taken by the European Commission as recommendations or they may be used for the approximation of civil, procedural or insolvency laws, within the meaning of art 288 TFEU.

As an individual practitioner involved in this training program, I can say that its aim was at least partially accomplished, considering the fact that it was an important reason in my decision to specialize in the field of international insolvency law and cross-border judicial cooperation.

44 EU Cross-Border Insolvency Court-to-Court Cooperation Principles, Final Public Draft, 2014, at 27, for details of project see http://www.tri-leiden.eu/project/categories/eu-judgeco (last viewed 14 October 2016).

45 The project is initiated and co-funded funded by the European Union and the International Insolvency Institute (III). It is a part of a larger EU initiative called "European Cross-border Insolvency: Promoting Judicial Cooperation". The Project Team consisted of Bob Wessels, Professor International Insolvency Law, Leiden University (principle drafter); Jan Adriaanse, Professor of Turnaround Management, Leiden University; Paul Omar, Professor of International and Comparative Insolvency Law, Nottingham Law School; Dr. Jean-Pierre van der Rest; Dr. Bernard Santen; Gert-Jan Boon LL.M MSc; Frédérique Vos LL.M; Rumana Abdur; and Leiden Law School master students. For more details, see http://www.tri-leiden.eu/projects.

In should be also noted the important role played by international organisations such as a forum for judges in this field. It is uncontestably the significant place of INSOL Europe and also INSOL International for increasing connections between IP's, judges, regulators, and academics in the process of judicial communication and cooperation, for development of "mutual trust," common ideals, and scopes in insolvency domain.

5 Conclusion

Full harmonisation of insolvency law, presented as an option for the reform of EU legislation, does not look like a real possibility for the time being. Such unity of vision is yet to be achieved across the 28 Member States, and it may take some time, much patience and effort before a consensus can emerge. Consequently, it is essential to establish which areas demand harmonisation and what levels of approximation are required.

The sustained effort made for removing or reducing the existing disparities in the European Union is appreciable, as is the respect for insolvency legislation and cross-border proceedings.

I strongly believe that the contribution and involvement of the judiciary in the process of harmonization of international insolvency law and procedures is a problem and a necessity for the present and the near future, which requires concrete and viable measures to be taken both at national and European level.

Chapter 3

Constitutions and Crises: Balancing Insolvency and Social Policy through the Lens of Comparative Legal History

Jennifer L. L. Gant*

1 Introduction

The economic and financial crises of the last decade have led to massive changes in economic, social, banking, and employment policies throughout the world. However, both the United States and the United Kingdom have generally maintained more static in relation to their overall status quo regarding insolvency and social policy, in stark contrast to the reactions of most continental European nations. Taken together with the sovereign debt crisis that plagued many continental European nations beginning in 2010, it may be somewhat surprising that the United Kingdom has not adjusted its policies to any greater degree than it has. Rather, it is continental Europe that has moved more or less *en masse* toward the lower common denominator of the United Kingdom, at least in terms of social and employment protection. In addition, many peripheral or less economically developed European nations have achieved some inadvertent legal benefits from the crises of the last decade in the reform or creation of more robust insolvency and corporate rescue systems.

The purpose of this paper is to explore the historical and constitutional underpinnings of the US and the UK, within the context of the European Union when required, in order to identify important differences in legal development and divergence from a common legal ancestry in approaches to insolvency, in particular corporate rescue procedures such as Chapter 11 and administration under the Insolvency Act 1986, and the social policy issues related to it. By identifying points of divergence situated within the historical context in which it arose, a more detailed, path dependent observation may reveal deeply seated differences that can explain why the US and the UK have often relied upon different foundational philosophies in the development of legal systems in insolvency and social policy. While the UK

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and the US are often compared in a positive light, as being more closely aligned than other European nations and the UK, their differesnces continue to persist, despite EU influence, and indeed, at times, in spite of it.

2 Comparative History of Insolvency and Corporate Rescue in UK and USA

Insolvency law draws together a number of different legal areas that interact in a complex balancing act, one that has sometimes been skewed due to constitutional restrictions and other legal and policy related roadblocks. The complex intermingling of insolvency law with, in particular, the law of contract, with what one might normally view as the defining parameters of the American Constitution, contrasted with the decisions of individual state courts, illustrates how this area has been problematic. The United Kingdom has not faced similar obstacles for a number of centuries, which, while reducing the competing factors that might be encountered by legislators in this area, has not prevented a slow evolution of insolvency systems, as opposed to the more rapid and holistic changes that has historically characterised insolvency in the US.

2.1 Divergence from a Common Past

The Statute of Anne that was in place in the American colonies at the time of the American Revolution, exporting the stigma that remains attached to indebtedness today in the UK given the fact that one was "liable" to bankruptcy, rather than benefitting from it.[1] This law is often portrayed as the beginning of a modern, enlightened bankruptcy practice because it introduced the possibility of being discharged from debt, though exceedingly difficult and restricted only to traders.[2] Even prior to the passing of the Statute of Anne various states of America had created their own ways of dealing with bankruptcy, with Maryland formulating the first true bankruptcy law on the American continent in 1638, though it tracked existing English law at the time. Pennsylvania, New York, and Massachusetts followed suit with their own versions, all of which varied in description, scope, and purpose. Between 1755 and 1770 New York expanded a system for the release of impoverished debtors from prison to include the ability to bind holdout creditors to a workout agreed by a majority of creditors. Thus, the US began to diverge from the norms of British bankruptcy law even prior to the Revolution, developing a number of procedures that were often labelled as something else and private bills that eventually came together to provide an early system of bankruptcy relief.

1 S.J. Lubben, "A New Understanding of the Bankruptcy Clause", (2013) 64(2) Case Western Reserve Law Review 319, pp. 337.

2 *Ibid.*, pp. 336-337.

While it relied heavily on English practice in the earliest days, the tendency of the colonial law makers were to concentrate on the plight of imprisoned debtors rather than the punishment of them.[3]

In the early 1770s, the US continued to attempt to provide better and greater relief via bankruptcy provisions. One of the major issues encountered by colonial legislators was the requirement that any commercial legislation must obtain approval of Britain's Privy Council. In 1771, New York attempted to further expand their system relating to the release of imprisoned debtors to also protect the debtor's property acquired following release from prison, but Britain refused to approve it.[4] Thus not only did the Revolution successfully separate the American nation from the patriarchy of English rule, it freed their ability to legislate to create systems suited to the social, cultural, and economic circumstances that characterised the pioneering spirit of the new American nation. Following the American Revolution, the first constitutional document, the Articles of Confederation, failed to provide for a national bankruptcy law, thus the states had to continue to legislate in this area without any continuity that might have been possible with some federal coordination.[5]

The US Constitution provided the framework for the power relationship between the States and the Federal Government. Due to competing views on what level of power the federal government should wield over the states, the Federal Government was given enumerated powers that limited its competences to govern the states.[6] These enumerated powers included a Bankruptcy Clause, which gave the federal government the apparent power to enact "uniform laws on the subject of bankruptcies throughout the United States."[7] This should have heralded the commencement of a senatorial drafting of a unifying bankruptcy act that would have consolidated and simplified bankruptcy throughout the entire nation. However, such was not to be for nearly two centuries due to fundamental differences in governance philosophies between Federalists and Republicans, the competing political parties of the day.[8] Thus, the states remained free to enact the insolvency laws they deemed appropriate and the Federal Government was acquiescent, leaving individual states responsible for providing the means to resolve financial

3 *Ibid.*, pp. 338-339.

4 *Ibid.,* p. 339.

5 *Ibid.,* p. 340.

6 M.H. Redish, "Doing it with Mirror: *New York v United States* and Constitutional Limitations of Federal Power to Require State Legislation", (1993-1994) 21 Hastings Const LQ 593, pp. 594-596.

7 US Constitution, article I paragraph 8 clause 4.

8 R. Sylla, R.E. Wright and D.J. Cowen, "Alexander Hamilton, Central Banker: Crisis Management during the US Financial Panic of 1792", (2009) 83 Business History Review, pp. 62-63.

distress despite the apparent constitutional power of the Bankruptcy Clause,[9] with only a few largely failed interventions by the Federal Government.[10]

In 1874, a predecessor of the debtor in possession provision of Chapter 11 was introduced in a composition procedure that formed a part of massive reforms made to the Bankruptcy Act of 1867.[11] The composition provision allowed a debtor to remain in possession of his property if a sufficient number of creditors accepted the composition proposal, which would then be binding on all unsecured creditors, while those creditors who dissented were paid according to a "best interests" test based on liquidation outcomes. While this law lasted longer than those attempts made previously by the federal government, the economic problems encountered by the South following the Civil War led to the repeal of the federal bankruptcy legislation.[12]

2.2 British Insolvency: Slow Escape from the Debt Stigmata

During period between the passing of the Statute of Anne and the commencement of hostilities with the American colonies, Britain also had developments in its bankruptcy system, but in a fashion that focussed on maximising the returns to creditors rather than alleviating the burden of debtors to any significant degree. In 1732, a consolidating act[13] was passed that became the statutory basis for bankruptcy law for the rest of the eighteenth century. As the eighteenth century progressed, the number of insolvencies increased, revealing weaknesses in the system illuminated by the burden placed upon it.[14]

Throughout the nineteenth century, insolvency law in the UK evolved in order to avoid fraudulent activities common in the earlier regimes. While *laissez-faire* economics was the preferred approach during this period, government intervention[15] was justified due to the growing influence of the business community,[16] particularly following the introduction of the joint-stock companies.[17] While an

9 Lubben, above note 1, 341-342.

10 The Bankruptcy Act of 1800, Act of Apr 4, 1800, ch 19, 2 Stat 19 (repealed 1803); The Bankruptcy Act of 1841, Act of Aug 19, 1841, ch 5 Stat 440 (repealed 1843); The Bankruptcy Act of 1867, Act of Mar 2, 1867, ch 176, 14 Stat 517 (repealed 1878).

11 Act of Jun 22, 1874, ch 390, 18 Stat 178 (amending and supplementing an act entitled "an act to establish a uniform system of bankruptcy throughout the United States).

12 Lubben, above note 1, 377.

13 An Act Preventing the Committing of Frauds by Bankrupts 1732 (5 Geo 2 c 30).

14 V.M. Lester, *Victorian Insolvency* (1995, Oxford University Press, Oxford), pp. 18-21.

15 Bankruptcy Court (England) Act 1831 (1 & 2 Will 4 c 56).

16 Lester, above note 14, pp. 40-48.

17 Joint Stock Companies Act 1844 (7&8 Vict c 110); a winding-up was introduced at the same time in the Act Facilitating the Winding Up of Affairs of Joint Stock Companies Unable to Meet Their Pecuniary Engagements 1844 (7&8 Vict c111).

early composition procedure was also available,[18] the stigma associated with debt and bankruptcy remained resilient, as well as the focus on creditors.[19] The focus on fault and creditor satisfaction indicates a close tie to the prevailing moral perception of bankrupts and the Victorian values of thrift, self-help, and individual effort.[20]

A number of Acts[21] introduced and reinforced modern concepts of insolvency, such as the statutory regime for preferential debts; the *pari passu* principle; separate judicial and administrative functions; and the public examination of those at fault for creditor losses.[22] Some of these were influenced by the recognition that some species of public good was both desirable and could be achieved by providing a means of collective action in the liquidation and distribution of bankrupt estates.[23] However, the quantity of bankruptcy reforms during the nineteenth and early twentieth century resulted in layers of law that were difficult to operate and prone to manipulation and would attract the attention of reformers in the 1970s,[24] but it would not be until the Insolvency Act of 1986 that a true species of corporate rescue would be legislated,[25] partly due to the desire of the UK to join the European Community.[26]

The Cork Report preceded the passage of the Insolvency Act 1986.[27] An entirely new approach and perception of the aims of insolvency law in the UK was adopted, including a truly social message that was recommended to be incorporated in the imminent reforms.[28] The Cork Report recognised and formulated the concept of a rescue culture, stating that given that the failure of commercial enterprises has wide repercussions for a variety of stakeholders, including but not limited to creditors, shareholders, employees, suppliers, and others who would be adversely affected by business failure. A legitimate aim of insolvency laws should be to have concern for the livelihood and well-being of those dependent upon an

18 Bankrupts (England) Act 1825 (6 Geo 4 c16).

19 Lester, above note 14, 21-37 & 53-64.

20 R. Bellamy, *Victorian Liberalism: Nineteenth Century Political Thought and Practice* (1988, Routledge, London), p. 7.

21 The Joint Stock Companies Winding-Up Act 1844 (7&8 Vict c111); Bankruptcy Act 1883 (46&47 Vict c52); Bankruptcy Act 1914 (4&5 Geo 5 c59); and The Companies Act (25 & 26 Vict c89).

22 R. Goode, *Principles of Corporate Insolvency Law,* Student edn, (2005, Sweet and Maxwell, London) 6-9 and Lester, above note 14, p. 227.

23 Lester, above note 14, pp. 293-294.

24 V. Finch, *Corporate Insolvency Law: Perspectives and Principles,* 2nd edn (2009, CUP, Cambridge), pp. 12-13.

25 1986 c 45 (hereafter referred to as the IA1986); M. Hunter, "The Nature and Functions of the Rescue Culture" (1999) November JBL 426, p. 455.

26 Hereafter referred to as the "EC".

27 Hunter, above note 25.

28 K. Cork, Sir (Chairman), *Insolvency Law and Practice: Report of the Review Committee* (Cmnd 8558 1982) ch 4 para 203-204.

enterprise.[29] In the view of Cork Committee, the rescue culture would manifest itself in policies directed at the more benevolent treatment of insolvent legal entities as well as the more draconian treatment of the unscrupulous abusers of the system. It would also mean the steady removal of the stigmatising effect of bankruptcy.[30] Though beneficent in their view of what the future should hold for insolvency, the Cork Committee's more socially oriented recommendations would not find immediate implementation, however, more recent reforms[31] as well as the influence of the EU have seen many of the social objectives of insolvency law incorporated into the British insolvency system, including a preference for rescue over simple liquidation.[32]

The changes made to insolvency law in the last fifteen years demonstrate that the policy of corporate rescue is now being given precedence over traditional creditor wealth maximisation and debt recovery.[33] Rescue strategies supported by the current legislation are based upon a utilitarian approach, predicated on the premise that the interests of the few are outweighed by the needs of the many. The interests represented now also include the wider community, as well as social and political objectives of full employment. These interests can often be better served though the rescue of a business than asset realisations followed by *pari passu* distributions of what remains after secured creditors and liquidators are paid their share.[34]

2.3 The American Way: A Constitutional Conundrum

The presence of the Bankruptcy Clause in the American Constitution crossed with the existence of a myriad of State authored bankruptcy laws caused a number of problems for state courts. Some held insolvency codes to be unconstitutional, on the interpretation of the Bankruptcy Clause as having left Congress with the sole power to legislate in this area. Focused on the existence of the discharge, it was held that

> "a law discharging a debtor from his debts, without payment, if not a bankrupt law, is a law impairing the law of contracts, the power of making which is, by the said Constitution, expressly forbidden to individual states."[35]

29 *Ibid*.

30 Hunter, above note 25, p. 26.

31 The Enterprise Act 2002 c 40 (hereafter referred to as the "EA").

32 See the Insolvency Act 1986 sch B1 para 3.

33 D. Milman, "Moratoria on Enforcement Rights: Revisiting Corporate Rescue" (2004) March/April *Conveyancer and Property Law Journal* 89, p. 104.

34 *Ibid*.

35 *Olden v Hallet* 4 NLJ 466, 469 (NJ 1819).

Thus it was not only the Bankruptcy Clause, the ignoring of which was beginning to create uncertainty, but also implicated the Contracts Clause, given the effect on contracts that a discharge post-bankruptcy would have. By allowing a discharge, bankruptcy law was viewed as interfering with the integrity of contracts by facilitating a breach in discharging the obligation to pay the full consideration agreed by the contracting parties.[36]

The constitutionality of state authored bankruptcy law was assessed in *Sturges v Crownshield*[37] in 1819. Crownshield sought relief by way of bankruptcy and discharge under the New York statute. It was argued by his creditor that the Bankruptcy Clause prevented states from legislating in this area and that, therefore, the New York statue and the discharge it afforded was unconstitutional. The Supreme Court failed to state definitively the position of state insolvency law with regard to the Bankruptcy Clause; rather, the Court inferred a broader reading of the Clause, ruling that the states had the power to legislate in this area in the absence of Congressional action, and that such laws would be constitutional as long as they were not applied to contracts arising prior to the promulgation of the law.[38] By not weighing in definitively on what likely should have been the federal nature of bankruptcy under the Bankruptcy Clause of the US Constitution, the Supreme Court allowed the States to take the ambiguous judgment in *Crownshield* and apply it to their own bankruptcy cases with an extraordinarily diverse effect, creating a great deal of uncertainty in relation to the applicability and effectiveness of bankruptcy laws among the states, as well as the validity of any discharges that were given.[39]

State insolvency laws met their end in the final years of the nineteenth century with the passing of the Bankruptcy Act of 1898.[40] The Act was a clear break from the English inspired, creditor controlled systems that were tried earlier in the century, providing discharge post liquidation and the option of compositions with creditors. When challenged in the Supreme Court, the Bankruptcy Clause finally left dormancy as bankruptcy became the province of the federal government.[41] Its boundaries were tested in the 1930s and corporate reorganisations were federalised in the Chandler Act. Following the Act, a group of specialised bankruptcy

36 Lubben, above note 1, 349-350.

37 *Sturges v Crownshield* 17 US (4 Wheat) 122 (1819).

38 Lubben, above note 1, 352-353.

39 Joshua M. Van Cott, "A General Bankrupt Law" (1841) 4 Merchant's Magazine and Commercial Review 22.

40 Act of July 1, 1898, Ch 541 30 Stat 544 (repealed 1978); SJ Lubben, "A New Understanding of the Bankruptcy Clause" (2013) 64(2) Case Western Reserve Law Review 319, 383-384.

41 Lubben, above note 1, 388-389.

professionals developed, who would be important characters for the procedures introduced in the 1978 Act when the referees under the previous act became bankruptcy judges.[42]

3 Aims of Insolvency: An Anglo-American Rift

American Bankruptcy Law evolved following the Revolution in a piecemeal fashion among individual states with a focus on how to provide relief for debtors while also treating creditors as fairly as possible under the circumstances. A Maryland bankruptcy statue encapsulates the concept of discharge:

> "The great principle upon which it is founded, is, that the debtor shall surrender *all* his property for the common benefit of *all* his creditors. He can only obtain his discharge on complying with this requisite, and some others of an inferior nature. When he *has* complied, then he is entitled to his discharge."[43]

The idea of a "fresh start" attracted dozens of bankrupts to apply to the court in Baltimore. Further, the concept of a fresh start is a fundamental characteristic of the modern American bankruptcy system. It was recognised that it was important for the entrepreneurial spirit of the country that relief should be made available to honest but unfortunate debtors.[44] Thus the purpose of bankruptcy in the American system has evolved with the foundational principle of aiding the unfortunate but honest debtor.[45]

English bankruptcy was quite different due to the historic relationship with debt which characterised debtors as anti-social and immoral by causing difficulty for one's creditors and failing to adhere to bargains struck. While the unforgiving nature of English bankruptcy law has changed over time to a degree, financial failure is still considered a character weakness and business failure is generally an embarrassment.[46] The opposing character of American bankruptcy law could be attributed to the draconian treatment of debtors in the English legal system. A large proportion of settlers in the eighteenth century were convicts who had been imprisoned for debt, so it is not surprising that the American approach to bankruptcy would be potentially quite different from the old country. In addition,

42 *Cent Va Cmty Coll v Katz,* 546 US 356, 373 (2006).

43 *In Re Stewart,* 2 Am LJ 184, 186 (Md Ch 1809).

44 *In Re Brown*, 1 Mart (os) 158, 159 (Orleans 1810).

45 *Stellwagen v Clum*, 245 US 605, 617 (1918).

46 N. Martin, "Common-Law Bankruptcy Systems: Similarities and Differences" (2003) 11 Am Bankr Inst L Rev 367, pp. 371-374.

the nature of economic growth in America had to be rapid in order to cope with competing industrialising nations in Europe; as such, early bankruptcy laws had the flavour of promoting commerce, which meant encouraging entrepreneurialism and the risk taking that was inherently associated with it.[47] Debt forgiveness was therefore critical to a strong American economy.[48]

There is also a cultural aspect of the American people that helps to explain the focus on debt forgiveness and reorganisation over liquidation and punishment. Money and consumerism are particularly strong forces in American society. Losing money equates to losing independence and independence is a fundamental facet of the American psyche.[49] In addition, business failure is often viewed as a product of misfortune rather than wrong doing. Given the pioneering character of the US historically, risk-taking is expected and respected, while creditors are at times perceived as being greedy.[50]

The Chapter 11 procedure today continues to adhere to aims of rescue and reorganisation over liquidation with the debtor-friendly aspect of early bankruptcy laws evident in the "debtor in possession" nature of the procedure. Reorganisation has been prioritised because it was viewed that allowing assets to be utilised as intended with the benefit of preserving jobs was preferred over the destruction of valuable firm specific assets.[51] Thus not only is the old focus on discharge still present, which places the plight of the honest debtor ideologically above the position of creditors, but the focus on rescue over liquidation is clear in the preference that managers often have for the former given the presumption favouring the continued control of management. The structure of the procedure provides an incentive for managers given the latitude corporate debtors have regarding the treatment of creditors and the fact that the managers can control what is done with that freedom.[52] The underpinning philosophy is to balance the desires of creditor and debtor groups while promoting commerce, which was not aligned with the English system's unforgiving and highly administrative bankruptcy process.[53] It did not take long to shed the stigma of the more punitive English system.

47 *Ibid*, p 370.

48 *Ibid.*, p. 403.

49 G. McCormack, "Control and Corporate Rescue – an Anglo-American Evaluation" (2007) 56(3) International and Comparative Law Quarterly 515, p. 525.

50 G. Moss, "Comparative Bankruptcy Cultures: Rescue or Liquidations? Comparisons of Trends in National Law—England" (1997) 23 Brooklyn Journal of International Law 115.

51 M. Bradley and M. Rosenwig, "The Untenable Case for Chapter 11" (1992) 101(5) The Yale Law Journal 1043, pp. 1043-1044.

52 *Ibid.*, 1045

53 Martin, above note 46, pp. 367-368.

Prior to the introduction of the concept of corporate rescue in the United Kingdom, the purpose of insolvency was based primarily on a collective regime aimed at achieving the best possible outcome for creditors.[54] The purpose of insolvency law was predicated on the assumption that if a company encounters financial difficulty, it is probably due to the failure of management. Thus, unlike the American system, it is viewed as contrary to the aims of insolvency to allow the management to retain control.[55] Further, the British system tends to favour financiers as bankers seem to have acquired respectability while entrepreneurs who take business risks have not.[56] The English judiciary also tend to be inclined to be sympathetic to insolvency practitioners rather than debtors as practitioners are professionals known to the court, whereas the debtor's fall into insolvency tends to be treated as a basis for suspicion.[57]

Although insolvency law has traditionally aimed to satisfy more economic interests in the UK, issues of fairness have now been accepted as necessary considerations in the UK insolvency system. Among these considerations are the ranking of wages as preferential debts, access to social security for repayment of arrears, rules dealing with continuity of employment, and laws stipulating the mandatory transfer of contracts on the transfer of a business as a going concern.[58] In this area, the UK has expanded beyond the social considerations taken in relation to corporate rescue than has the US, which is again influenced by the constitutional and legal history of both jurisdictions, as well as the approach to social policy that each country takes. It is to the concept of social policy as it relates to insolvency that this paper now turns.

4 Employees in Insolvency: Issues of Job Security and Social Policy

From its peak following the New Deal era,[59] much of the welfare state programmes have been retrenched in the US with policy changes that either cut social expenditure, restructure welfare state programs to conform more closely to the residual welfare state model, or alter the political environment in ways that enhance the probability of such outcomes in the future.[60] In addition, social policy retrenchment is highly path dependent, thus social policy choices tend to create

54 Goode, above note 22, p. 5.

55 McCormack, above note 49, p. 522.

56 Moss, above note 50.

57 McCormack, above note 49, p. 525.

58 Finch, above note 24, p.15.

59 The New Deal was a series of federal programs, public works projects, and financial reforms and regulations enacted in the United States during the 1930s in response to the Great Depression.

60 P. Pierson, *Dismantling the Welfare State* (1995,CUP, Cambridge), p. 17.

strong vested interests and expectations, which are difficult to dislodge. As the risks have risen due to increased income inequality, growing instability of income over time, increased employment in less structured services and part time roles, and increased structural unemployment, social protections have been eroded rather than enhanced.[61] The US has an uneasy partnership with welfare state ideals. The purpose of welfare considerations undermines that central theme of independence and the individual responsibility that is connected to it. This approach to matching reforms to social changes is also evident in the American approach to employment issues arising out of corporate rescue.

While the UK tends toward a modest liberal market ideology, its welfare state model tends to be far more progressive than the US model. Among most welfare states apart from the US, core programmes are broadly cherished, rather than regarded with suspicion.[62] However, the financial crisis and sovereign debt crisis precipitated a review of such programmes throughout the world's welfare states, including the UK. A number of social protections have been undermined, including employment protection and job security, despite public outcry and resistance. In fact, public support for the welfare state has increased following the crises, despite mounting financial constraints that have limited the extent to which governments can meet such demands. The UK, however, has scaled back far more welfare support than has its European counterparts,[63] though the nature of social policy remains far more central and important in the UK than the position it occupies in the US.

4.1 Social Policy and Insolvency in the United States: A Dire WARNing

Until World War I, State law was the primary source of employment law, but these regulatory frameworks were heavily tempered by the concept of individual liberty. State laws generally tended to uphold rights to freely enter contracts for the hiring of services.[64] The American employment system is thus characterised by the concept of "at-will" employment in which employers possessed the legal authority to determine unilaterally the terms and conditions of an employment relationship.[65] This rule gained the ultimate authority in 1908 when the Supreme Court provided a

61 J.S. Hacker, "Privatizing Risk without Privatizing the Welfare State: The Hidden Politics of Social Policy Retrenchment in the United States" (2004) 98(2) The American Political Science Review 243, pp. 245-249.

62 B. Vis, K. van Kersbergen and T. Hylands, "To What Extent Did the Financial Crisis Intensify the Pressure to Reform the Welfare State" (2011) 45(4) Social Policy & Administration 338, p. 341.

63 *Ibid.*, 342.

64 C.A. Scott, "Money Talks: The Influence of Economic Power on the Employment Laws and Policies in the United States and France" (2006) 7 San Diego Int'l LJ 341, pp. 350-351.

65 S.F. Befort, "Labour and Employment Law at the Millennium: a Historical Review and Critical Assessment" (2001) 43 B C L Rev 460, pp. 355-375.

constitutional basis for the doctrine.[66] Essentially the doctrine means that both the employer and employee are engaged in a relationship that is at the will of either of them, thus the employee can leave at any time and the employer can dismiss him, unless there is a contractual provision in place to the contrary.[67] The at will doctrine is universally accepted in the US, having been described as the "very foundation of the free enterprise system."[68] Some states have enacted legislation placing limitations on the at-will doctrine; however, broadly speaking it is still in place.[69] The lack of employment protection for American workers is not helped by the lack of federal power to control social policy in this area in any fundamental way due to the fact that contract law, of which employment law is a subset, is governed by individual state legal systems.

While the Bankruptcy Clause provides the US Federal Government with the power to legislate in relation to insolvency and corporate rescue,[70] the same does not apply to contract law and other domestic state concerns. Certain rights are now guaranteed for employees in the US, but these rights do not derive from any specific constitutional article or amendment implementing social policy objectives on a federal level. Rather, they derive from various articles and amendments to the Constitution that have been used to justify their existence. Notably, employee rights such as minimum wage, working hours, health and safety, equal pay, and even civil rights issues such as affirmative action[71] have been justified as being covered by the Commerce Clause,[72] which allows the federal government to regulate business conducted across state lines. There is also a "necessary and proper" clause providing Congress with a significant degree of flexibility in the invocation of its enumerated powers, though this flexibility has been continuously mitigated by a focus on the limitations on the federal government set out with some specificity in the Constitution.[73] The context of US social policy thus differs significantly from EU social policy, which figures quite prominently in most

66 *Adair v United States,* 208 US 161 (1908).

67 Scott, above note 64, 351.

68 D.B. Shine, "An Analysis of the Terms and Level of Implementation of the European Union's Collective Dismissal Directive and the United States WARN ACT. Another Example for the European Union on the Relative Merits of Political Federation over Confederation" (1998) 12 Fla J Int'l L 183, p. 185.

69 Known as "whistle-blowing" in the UK which as a reason for discharge is now prohibited in a number of American states; see Befort, above note 65, 385-393.

70 Article 1 Section 8 Clause 4 states that Congresses enumerated powers include the power to establish a uniform rule of naturalisation and uniform laws on the subject of bankruptcies throughout the US.

71 Although the groundwork for these were laid by the 13th amendment abolishing slavery, the 14th amendment prohibiting discrimination in the right to vote based on race and the 15th amendment giving women the right to vote laid the groundwork for these laws.

72 Article 1 Section 8 of the Preamble to the US Constitution

73 Redish, above note 6, p. 604.

Member States through the implementation of social policy directives having legal basis set out in the Social Chapter of the EU Treaty.

Although there are certain employee rights available under Chapter 11, these do not always adequately protect employees who might be subject to drastic reductions in the workforce, pensions and other employee benefits. As these are not protected in any way by statute, and in the absence of any protection from collective agreements, employees may get notification of redundancies but will essentially just have to suffer the loss of their jobs and associated benefits. These drastic reductions often occur at the beginning of a reorganisation process, which is then sometimes followed by the payment of massive retention bonuses to upper management in order to keep them "on the job."[74] Thus, there is often a great divide between the treatment of managers as opposed to workers and employees in the context of Chapter 11 restructurings.[75] In addition, collective agreements and employment contracts can be summarily terminated under the Bankruptcy Code.[76] The persistence of the "at will" doctrine means that employees in these situations will have recourse to legal protection in only limited circumstances.

Employee claims occurring prior to the petition for Chapter 11 rank fourth in priority under the US Bankruptcy Code and are limited in time and amount.[77] While such claims carry priority, this is only after administrative expenses and secured claims have been paid.[78] Following the petition for bankruptcy, those employees that have been assumed by the debtor are assured of being paid for services rendered during the reorganisation. These rank as an administrative expense and are given first priority, though it is rare that such a claim will arise as a debtor will be sure to continue to pay such administrative debts as they fall due or risk not completing reorganisation.[79] In any event, while priority exists, it falls short of the priority given to employees in similar situations in EU countries

74 See for example *Re Eastman Kodak Co. et al*, Voluntary Petition for Chapter 11 Bankruptcy, Case No 12-10202, So, Dist. NY (2012) available from http://bankrupt.com/misc/Kodak_StipSpectra073013.pdf accessed 30 October 2014.

75 J. Berry, "Different Playing Fields: What Affect Does Chapter 11 Bankruptcy Have on Employees of the Debtor and Why do, These Affects Drive Companies to Bankruptcy?" (2012) Social Sciences Research Network http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2139062 accessed 30 October 2014.

76 P.A. Susser, A.M. Weber and S.J. Friedman, "Employment and Employee Benefits in the US: Overview" (2014) Practical Law Multi-Jurisdictional Guide on Employment and Employee Benefits http://global.practicallaw.com/1-503-3486 accessed 28 October 2014.

77 Pensions refers only to retirement income while welfare benefits refer to medical, health, accident, disability or death benefits, severance pay, training, apprenticeship programmes, day care and prepaid legal services.

78 P.M. Secunda, "An Analysis of the Treatment of Employee Pension and Wage Claims in Insolvency and Under Guarantee Schemes in OECD Countries: Comparative Law Lessons for Detroit and the US" (2014) XLI Fordham Urban Law Journal 867, 898 and D R Korobkin, "Employee Interests in Bankruptcy" (1996) 4 Am Bankr Inst L Rev 5, pp. 8-9.

79 Korobkin, above note 78, pp. 14-15.

as employees with pre-petition claims essentially rank equally with unsecured creditors and are limited in time and amount claimable.

In terms of the employment protection regulation available to employees during the insolvency of their employer, the "at-will" doctrine continues to apply in the United States. An employee does not have the right to be transferred with a business to which he is associated and if he is, there is no continuity of employment between the previous employer and the new one. Essentially, this relies on basic laws of contract that once governed the whole of employment law in the UK, though this is now mitigated by employment protection regulation aimed at correcting the power imbalance in the employment relationship. There are no statutory notice periods, requirements for severance, or redundancy pay, or procedural requirements for dismissal. For any of these to apply, they would have to be included in a collective agreement or perhaps an employee handbook. Employers can lay-off employees for any reason that does not violate anti-discrimination statutes or that constitute an act of bad faith.[80]

There are some limited protections available to employees affected by an employer's insolvency. The Worker Adjustment and Retraining Notification Act,[81] a statute requiring advance notice if collective redundancies were envisaged, was passed to mitigate some of the issues surrounding large scale bankruptcies.[82] If the WARN Act is engaged, the employer must provide written notice to representatives and employees affected by the action. The WARN Act applies to business enterprises of a certain size and composition in the event of a mass layoff,[83] however, the threshold for a mass layoff is relatively high compared to the Collective Redundancies Directive. The WARN Act does not require consultation, merely 60 days advance notice in employers having over 100 employees, though it excludes several categories of workers, including those engaging in collective action at the time of the notice.[84] There is also no provision for transferring employment contracts. Employees will only transfer if the transferee formally offers them employment and continuity of employment is not guaranteed.[85] Compared with the protections available to employees affected by the insolvency of their employer in the UK and other EU countries, the WARN

80 Susser, Weber and Friedman, above note 76.

81 An Act to require advance notification of plant closings and mass layoffs, and for other purposes (the "WARN" Act) enacted by the 100th United States Congress, Pub. L. 100-379 102 Stat 890.

82 Susser, Weber and Friedman, above note 76.

83 Scott, above note 64, pp. 373-374.

84 Council Directive 98/59/EC of 20 July 1998 on the approximation of the laws of the Member States relating to collective redundancies.

85 Scott, above note 76, p. 377.

Act merely recognises that employees are affected, but offers very little in terms of real security or protection. This is where the protections provided to American employees in the event of an insolvency ends.

4.2 Social Policy and Insolvency in the United Kingdom: An EU Imperative

The British employment relationship is based on a 'master and servant' model connected to the early legal form of social relations, which was a statutory and hierarchical paradigm rather than contractual and common law. The master and servant form of employment relationship relied upon a command relation with an open ended duty of obedience imposed on the worker, reserving far-reaching disciplinary powers to the employer.[86] Even once the employment relationship had been given contractual status, imposing certain civil obligations, the hierarchical characteristic of the traditional master and servant model has been carried over into the modern contractual employment relationship to some extent.[87] Legal terminology and the old assumptions of unmediated control continued to be applied by the courts as they developed the common law of employment. The advent of the welfare state and the extension of collective bargaining caused employment law to change direction, but the traditional hierarchy of employer and employee remained difficult to dislodge from the British legal psyche.[88] While this has been tempered since the 1940s and given legal status following the introduction of the Employment Rights Act of 1996, as well as other more progressive employment oriented legislation, the master and servant approach is still evident in Britain's regulatory approach to employment law.[89] This has been displaced to some extent by the application of EU law through a number of social policy directives.

After decades of slow but progressive changes to employment rights and protections within the EU, all Member States are now bound by the EU Charter of Fundamental Rights[90] and the Social Chapter of the EU Treaty,[91] with some narrow derogative options.[92] However, EU social policy remains within the domain of Member States to determine, requiring unanimous decision making in

86 S. Deakin and W. Njoya, "The Legal Framework of Employment Relations" (2007) Centre for Business Research, University of Cambridge, Working Paper no. 349, p 7.

87 Lord Wedderburn of Charlton, "The Social Charter in Britain: Labour Law and Labour Courts?" (1991) 54(1) MLR 35*,* p. 6.

88 Deakin and Njoya, above note 86*,* p. 7.

89 Lord Wedderburn of Charlton, above note 87, p. 6.

90 Charter of Fundamental Rights of the European Union OJ 2000/C 364/1 of 18 December 2000.

91 The Treaty on European Union OJ C/191/01of 29 July 1992 (the Maastricht Treaty).

92 The Treaty of Amsterdam incorporated the provisions of the Social Chapter directly in 1997.

legislative proposals falling under its definition.[93] As social institutions are deeply embedded in each country's larger societal framework and history, they cannot be easily aligned[94] as can be seen by the diverse ways in which social policy related directives are implemented in Member States.

The approach to social policy differs significantly from the more closely coordinated action taken by the EU in matters of insolvency. The cooperation of European countries in matters of insolvency has a long history. The project has been in progress for over 40 years within the EU, evolving in complexity and increasing in cooperation as the EU has expanded and changed.[95] The culmination of this cooperation was the EU Insolvency Regulation.[96] While this does not implement an EU wide insolvency system, the aims and outcomes of corporate rescue mechanisms throughout the EU do not have the same variance that social policy regulation does. This could be explained by the fact that insolvency, as a corporate law matter, has a more international influence given the globalised marketplace in which most businesses now exist. A closer alignment of insolvency mechanisms is logical, therefore, as it makes cross-border business less complicated. This may also explain the EU approach to a cross-border insolvency regulation, rather than trying to implement an EU wide insolvency system. There is perhaps a more natural tendency to align systems that are forced to interact regularly in the common and international markets.[97]

This same idea can explain to a certain extent why it is that Member State employment regulations have not seen the same kind of convergence or direct regulation by the EU. Workers are generally less mobile with the consequence that differences in preferences can lead to differences in employment law systems. Also, the political context of business versus labour is specifically a domestic concern; as such, the conflicting pressure may steer different countries in different directions.[98] This also offers justification for legislating in this area with directives, which are binding only as to the result to be achieved. There are a number of EU directives

93 N. Esenturk, "EU Social Policy: Progressive Development in Legal and Governance Aspects" (2010) UK Social Policy Association http://www.social-policy.org.uk/lincoln/Esenturk.pdf accessed 17 November 2012, 2-3.

94 P. Kettunen and C. Wolff, "Europeanisation through the Back Door: EU Social Policy and the Member States" (2010) 47(5) Politicka misao 146, p.148.

95 P. Omar, *European Insolvency Law* (Ashgate 2004), p. 49.

96 Council Regulation (EC) No. 1346/2000 of 29 May 2000 on Insolvency Proceedings (OJ 2000/L160/1) (hereafter referred to as the "EIR").

97 See M. Siems, "Shareholder, Creditor and Worker Protection: Time Series Evidence about the Differences between French, German, Indian, UK and US Law" (2012) Centre for Business Research, University of Cambridge, Working Paper No 381 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1329997 accessed September 2013.

98 *Ibid.*, 20-21.

that serve to further preserve employment and workers' rights in insolvency situations in relation to collective redundancies,[99] transfers of undertakings[100] and state guarantee funds for employee wages and other compensation.[101] Member States have taken varied approaches to the implementation of these directives[102] as derogations are available that have been implemented differently among the Member States owing to the endogenous factors of culture, legal tradition and domestic social policy.[103] While social policy directives and their implementation among Member States provide a minimum level of protection for employees affected by their employer's insolvency, the position following the financial crisis has seen a retrenchment of social policy issues throughout the EU.

In the UK there are a number of protections in place for employees affected by the insolvency of their employer. While employees are still generally considered unsecured creditors of the employer with the usual rights of a normal contracting party,[104] their position is protected in relation to up to four months wages occurring prior to the insolvency, ranking as a preferential debt subject to a maximum amount of £800, an amount set in 1986[105] and, to date, unchanged. Employee claims beyond the preferred portion rank equally to that of other unsecured creditors. An employee also has the right to claim some amounts due from the Secretary of State, which is paid out of the National Insurance Fund.[106] In the event the business continues, an insolvency practitioner steps into the role of the employer and must deal with the adopted employment contracts appropriately. Where the business is sold, provisions apply that will transfer employment contracts to the purchaser.[107] This was a huge change for the UK system, which relied on a fundamental value of

99 Council Directive 98/59/EC of 20 July 1998 on the approximation of the laws of the Member States relating to collective redundancies, OJ L 255 provides standards to be used when an employer is contemplating collective dismissals which must be applied in a situation that involves dismissing 20 employees over a period of 90 days or the lesser of 10% or 30 employees over 30 days.

100 Council Directive 2001/23/EC of 12 March 2001 on the approximation of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses, OJ L 82 - provides for specific protections for employees subject to business transfers requiring the transfer of their employment contracts with continuity of employment, but allows for specific derogations in insolvency situations.

101 Council Directive 80/987/EEC of 20 Octover 1980 on the approximation of the laws of hte Member States relating to the protection of employees in the event of the insolvency of their employer, OJ L 283.

102 Ius Laboris, Collective Redundancy Guide (2009). http://www.iuslaboris.com/files/documents/Public%20Files/Publications/2009_Publications/collective-redundancies-guide.pdf first accessed 2013.

103 Ius Laboris, Guide on Transfer of Undertakings, available from http://www.iuslaboris.com/files/documents/Public%20Files/Publications/2008_Publications/transfers-of-undertaking.pdf first accessed 2012.

104 D. Pollard, *Corporate Insolvency: Employment and Pension Rights*, 4th edn, (2009, Bloomsbury Professional Limited, Haywards Heath), p. 1.

105 SI 1986 No. 1996 The Insolvency Proceedings (Monetary Limits) Order 1986 para 4.

106 D. Baker and I. Smith, *Smith & Woods Employment Law*, 10th edn, (2010, OUP, Oxford), pp. 202-203.

107 Pollard, above note 104, p. 1.

freedom of contract. The first UK legislation conferring continuity of employment on a business transfer[108] only applied if the employees were voluntarily retained by the purchasing firm. There was no concept of automatic transfer as this would conflict with the fundamental freedom of contract.[109]

In terms of dismissals associated with corporate rescue procedures, there are a number of protections in place. Unfair dismissal legislation[110] generally will protect employees from dismissals that have not been justified if an employee has worked at an establishment for at least two years. Redundancy[111] is also regulated, which is the most likely method of dismissal to occur in the event of an employer's insolvency. Like unfair dismissal, an employee must also have two years of continuous employment. If eligible, then employees may also be due a statutory redundancy payment[112] calculated according to the length of time an employee has worked for the employer. In the event of collective redundancies, the Collective Redundancies Directive[113] may apply, which requires consultation and information obligations provided to employees by the employer. Thus there are a number of provisions available to employees affected by the insolvency of their employer, unlike the limited protections available under the US system.

5 Constitutional Matters: Bankruptcy and Social Policy – a Question of Federalism?

The UK and US have developed insolvency and social policy regulation in a fairly opposing manner. Despite the fact that parallels are often drawn between the UK and the US due to their generally shared views of a neo-liberal economy, the underpinning philosophies that inform regulatory choices are diametrically opposing. This can be attributed to the staid and steady UK culture and history juxtaposed against the fast growing, risk taking, and pioneering spirit that formed the backbone of the US. The American spirit of entrepreneurialism and independence continues today and is evident in its approach to both insolvency and social policy. The independence factor tends to both impede progress in the area of social policy due to the suspicion with which any paternalistic activism is viewed, while the same independence has imbued itself in the US insolvency system by making it possible for debtors to be freed from the shackles of debt without the

108 Contracts of Employment Act 1963.

109 Baker and Smith, above note 106, p. 541.

110 S98 Employment Rights Act 1996 c 18 (hereafter referred to as the "ERA").

111 S139 ERA.

112 S162 ERA.

113 S188 Trade Union and Labour Relations (Consolidation) Act 1992 c 52.

same stigma that often accompanies debt discharge in the UK. Seeking to balance the earnest businessman's need to take risks to capture economic progress with the need to satisfy the obligations owed to creditors under contract law, the US created a system that allowed for bankruptcy discharge and an emphasis on rescue and restructuring. These aspects of the American culture are deeply imbedded in its history, colouring much of the policies still held today.

Applying in a shallow manner the theory of path dependence to the social policy of the US, it is clear that given the American emphasis on individuality and independence, and the restrictions that it has created in relation to offering more robust protections to individuals who find themselves in difficulty due to their employers' insolvency or other aspect of the lack of job security that is generally characteristic of the American employment market, it is clear that without some kind of "revolutionary" change, incremental changes are unlikely to achieve any significant shifts in relation to the protections available in such circumstances. While progressive ideas have recently found their way into common discourse, particularly in light of the current political debate, it remains uncertain whether the current system of governance is equipped to deal with such fundamental changes. The path dependent obstacles standing in the way of change in this area may require a federal approach that is potentially unachievable given the lack of firm constitutional basis to make unilateral change in the area of social policy. A similar structure can be observed in the way that social policy matters tend to be left to the prevue of the Member States of the EU, however, despite this fact, it appears that the EU has been able to influence individual states in a far more significant manner than the US has for the States. However, it is questionable whether such intervention is something that is within the ideological capacity of the American system in any event.

While the power of the US Federal Government to legislate with regard to bankruptcy law forms a part of the very first Article of the Constitution, any federal intervention in labour or employment have had to find their justification in clauses and amendments that may or may not provide enough muster to pass Supreme Court analysis. This seems directly opposed to the way in which insolvency and social policy are regulated within the EU. The European Insolvency Regulation only goes so far as to regulate in matters of cross-border insolvencies, leaving member state procedures autonomous, while the social chapter has given the EU wide powers to legislate in matters of employment and labour regulation. While true that there the EU Commission has issued a recommendation introducing a new approach to business failure and insolvency that shifts the focus from liquidation to encouraging the early restructuring of viable businesses,[114] this is merely exhortation and an invitation to reform, non-binding on the Member States. However, in areas of social policy, EU influence is far more heavily felt, despite the fact that legislation is only in the form of Directives, which are binding only to the achievement of the intended results. The constitutional framework of the EU also seems far more flexible than the US, having directly interfered with Member State sovereignty in the area of social policy through a number of directives requiring implementation.

What, then, is the final analysis that provides a rationale for the foregoing investigation? Despite the fact that the US and the UK are in theory aligned in economic and social policy to a significantly high degree compared to the rest of the EU, their underpinning values vary due to historical influences that have created very different contexts of legal development. It has been said that the US and the UK are two countries divided by a common language, but it seems that in terms of the philosophical foundations of both insolvency and social policy, in spite of an apparent cohesiveness, the truth of the matter is that the underpinning values vary to such an extent that they may not be reconcilable. This helps to explain why a debtor in possession model has not been tried in any meaningful way in the UK as it is contrary to the fault-based ideology underpinning insolvency theory. It explains why the at-will doctrine continues to find favour in the US among individuals, companies, and governmental organisations alike due to the focus on independence and freedom to contract. While in reality such freedom does not exist due to the imbalance in bargaining power in the employment relationship, the belief in freedom and independence is such that applying paternalistic employment policies, such as those present in the UK and throughout the EU, which provide basic job security and employee protection, would be unacceptable to many Americans.

Even the more progressive nature of the Democratic party today tends to be tempered by some adherence to American values of independence and freedom, although the current climate is introducing extraordinary innovation that tempers those values with some social democratic ideas. The 2016 presidential election had the potential to break new ground that has the potential to dislodge some of the path dependent ideals that continue to inform both social policy and bankruptcy policy decisions, and the first year of the current presidency has seen significant attempts to “buck the trend” of progress. In a similar vein, the upcoming spectre of Brexit is raising serious questions about the direction that the UK will take in the future. The direction taken will inevitably influence the path of the law.

114 See the Commission Recommendation of 12.03.2014 on a new approach to business failure and insolvency.

Chapter 4

Harmonization and Avoidance Disputes Against the Background of the European Insolvency Regulation[1]

Antonio Leandro

1 Introductory Remarks on the Treatment of Detrimental Acts within the European Insolvency Regulation: the Role of *Lex Concursus* and *Vis Attractiva*

Regulation 2015/848 on insolvency proceedings 'EIR' provides that the validity and efficacy of acts reducing the debtor's assets are subject to the *lex concursus*, i.e. the law of the Member State in which the proceedings have been opened or before whose courts the request of opening has been submitted. In this regard, the EIR coincides with Regulation no. 1346/2000. Therefore, even though the EIR will be applicable from June 2017, references in this paper are to its provisions.

Lex concursus applies according to Article 7(2)(m), which refers to the "rules relating to the voidness, voidability and unenforceability of legal acts detrimental to the general body of creditors", irrespective of whether the detrimental act yields rights that are not affected by the opening of the insolvency proceedings, such as rights *in rem*, the right to set-off and the rights based on a reservation of title. Articles 8(4), 9(2) and 10(3) ensure the *lex concursus* applicability while safeguarding those rights and claims when being governed by a different law.

The strong interconnection between proceedings' purposes and avoidance actions/rules explains why the latter are in principle governed by the lex concursus. Such interconnection also underpins the *vis attractiva* principle whereby the courts of the State in which the proceedings have been opened rule on cross-border avoidance actions as well.

The *vis attractiva* principle has been codified in Article 6. However, while no provisions of the Regulation no. 1346/2000 expressly govern the jurisdiction over the so-called 'ancillary actions', it is well known that the CJEU has filled in this

1 The content of this paper is up to date as at 3rd May 2017.

gap with the aim to avoid loopholes between the Regulation no. 1346/2000 and the Brussels I Regulation (and the Brussels I Regulation (recast)),[2] which does not apply to "bankruptcy, proceedings relating to the winding-up of insolvent companies or other legal persons, judicial arrangements, compositions and analogous proceedings".

Following a CJEU's well-established case law, this exception covers only actions and decisions which derive directly from the bankruptcy or winding-up and are closely connected with the proceedings.[3]

In *Deko Marty* particularly, the CJEU stated that even though Regulation no. 1346/2000 lacks grounds of jurisdiction for actions directly stemming from and closely linked to the insolvency proceedings, it should nevertheless govern cases excluded from the Brussels I Regulation whenever a jurisdictional issue in matters of insolvency arises. To this end, the Court acknowledged a *vis attractiva* in favour of the courts of the Member State where insolvency proceedings have been opened, thereby allowing them to rule on the ancillary actions as well. Indeed, *vis attractiva* strengthens the *effet utile* of the Regulation, as it centralizes all ancillary actions in the court of the insolvency proceedings in such a way as to enhance the proceedings' effectiveness and efficiency. Moreover, *vis attractiva* appears to be consistent with the scheme of interconnection between jurisdiction, recognition and enforcement framed by Articles 3 and 25 of the Regulation no. 1346/2000. Thus, actions that qualify as ancillary to insolvency proceedings are excluded from the Brussels I Regulation and fall within the Insolvency Regulation.[4] This means that actions lacking such characterization are covered by the first Regulation as it "is intended to apply to all civil and commercial matters apart from certain well-defined matters".[5]

2 Regulation (EC) no. 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, replaced by the Brussels I Regulation (recast) (Regulation (EU) No 1215/2012 of 12 December).

3 *Henri Gourdain v Franz Nadler* Case C-133/78 [1979] ECR I-733; *Christopher Seagon v Deko Marty Belgium NV* Case C-339/07 [2009] ECR I-767; *SCT Industri AB (in liquidation) v AlpenblumeAB* Case C-111/08 [2009] ECR I-5655; *German Graphics Graphische Maschinen GmbH v Alice van der Schee* Case C-292/08 [2009] ECR I-8421; *F-Tex SIA v Lietuvos-Anglijos UAB 'Jadecloud-Vilma'* Case C-213/10 [2015] ECLI:EU:C:2012:215; *Nickel & Goeldner Spedition GmbH v «Kintra» UAB* Case C-157/13 [2014] ECLI:EU:C:2014:2145 and *Comité d'entreprise de Nortel Networks SA and others v Cosme Rogeau* Case C-649/13 [2015] ECLI:EU:C:2015:384.

4 See *H v HK* Case C-295/13 [2014] ECLI:EU:C:2014:2410, para 31 et seq, also for references to the 2007 Lugano Convention (Lugano Convention of 30 October 2007 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, [2007] OJ L 339/3).

5 *F -Tex SIA*, above note 2, para 29.

Moreover, having regard to the scope of the Brussels I Regulation, that of the Regulation no. 1346/2000 "must not be interpreted broadly".[6] In this regard, the CJEU pays attention to the legal basis of the claim rather than to the procedural context of which the action is part. In other words, *vis attractiva* depends more on the action's basis in insolvency law than on its connection with insolvencyproceedings.[7]

In case *H v HK*, the CJEU seems to clarify that actions based on insolvency which, according to national law, "could theoretically be brought even if there were no insolvency proceedings", may fall within the Brussels I Regulation when brought outside – and in the absence of – insolvency proceedings.[8]

Finally, *vis attractiva* applies both to main and secondary proceedings[9] and irrespective of whether the defendant's seat (or habitual residence) lies inside or outside the EU: when dealing with an action to set aside brought in the COMI's court against a person whose place of residence was located outside the EU, the CJEU decided that the universal effect of main proceedings and the need to ensure certainty and uniformity to the jurisdiction criteria imply that the *vis attractiva* principle is not limited to ancillary disputes involving defendants domiciled or resident in a Member State.[10] The Court emphasised that the Regulation does not only address cross-border situations within the EU, and that the determination of jurisdiction cannot be postponed until the time when the location of various aspects of the proceedings in addition to the COMI, such as the residence of a potential defendant to an ancillary action, are known. The CJEU stated that "to wait for knowledge of these matters would frustrate the objectives of improving the efficiency and effectiveness" of cross-border insolvency proceedings.[11]

2 The Interplay between *Lex Concursus* and Law Governing the Detrimental Acts

In a nutshell, 'avoidance rules' (and related proceedings) amount to both substantive and procedural devices serving the insolvency proceedings objectives,

6 *Nickel & Goeldner Spedition*, above note 1, paras 22-23; *Comité d'entreprise de Nortel Networks SA*, above note 2, para 27.

7 See extensively *F -Tex SIA*, above note 2; *Nickel & Goeldner Spedition*, above note 2; *H v HK*, above note 3; *Comité d'entreprise de Nortel Networks SA*, above note 2.

8 Above note 3, paras 20-25.

9 *Comité d'entreprise de Nortel Networks SA*, above note 2, para 32.

10 *Ralph Schmid (liquidator of the assets of Aletta Zimmermann) v Lilly Hertel* Case C-328/12 [2014] ECLI:EU:C:2014:6; *H v HK*, above note 2.

11 *Ralph Schmid*, above note 9, para 28.

particularly the creditor satisfaction and the *pari passu* principle, by means of measures preserving the debtor's assets.

National legal systems provide for the so-called suspect period with respect to pre-insolvency transactions and establish in different ways the substantive and procedural conditions under which a detrimental act can be avoided in order to return assets to the insolvent estate.[12]

While remitting avoidance matters to the *lex concursus*, the EIR sets forth two exceptional provisions. The first subjects 'avoidance actions' concerning payments and financial markets transactions to the law governing the system or the market concerned (Article 12(2)). The second one, enshrined in Article 16, excludes the application of Article 7(2)(m) whenever the person who benefited from an act detrimental to all the creditors provides evidence that both the act is governed by the law of a Member State other than that of the proceedings, and that law "does not allow any means of challenging that act in the relevant case".

The specific rule concerning payment and financial markets transactions is self-evident owing to the specificity of the system in which the detrimental effect arises. Article 16 amounts instead to a general exception to the *lex concursus* applicability.[13]

Article 16 aims, in fact, to preserve the legitimate expectations of third parties who had dealings with the debtor in Member States (and under laws) other than those in which the proceedings have subsequently been opened, to rely on the validity and efficacy of the act according to its applicable law (*lex causae*).[14]

The EIR does not determine such law, as its scope is confined to insolvency issues. Instead, it provides third parties with a means to demonstrate that the act detrimental to collective creditors was, and still is valid and effective according to its *lex causae*, even though their counterparty has been declared insolvent under the *lex concursus*. Accordingly, Article 16 does not establish a special conflict-of-law rule that replaces the general one of Article 7, but rather a rule providing an

12 See the INSOL Europe Report, "Harmonization of Insolvency Law at EU Level", April 2010, p. 10 ff., available at http://www.europarl.europa.eu/meetdocs/2009_2014/documents/empl/dv/empl_study_insolvencyproceedings_/empl_study_insolvencyproceedings_en.pdf last viewed 8 December 2016; and G. McCormack, A. Keay, S. Brown, J. Dahlgreen, "Study on a New Approach to Business Failure and Insolvency", January 2016, p. 137 ff., available at http://ec.europa.eu/justice/civil/files/insolvency/insolvency_study_2016_final_en.pdf last viewed 8 December 2016.

13 For a deeper analysis see A. Leandro, "Il ruolo della lex concursus nel regolamento comunitario sulle procedure di insolvenza" (2008, Cacucci, Bari).

14 Recital 67.

exception to the application of the *lex concursus* if that law were to adversely affect the acts protected by the *lex causae*.[15]

3 The Assessments of the Court of Justice

Since it goes without saying that third parties bear the burden of establishing the content of the *lex causae* 'in the relevant case', it has been disputed whether third parties may invoke only the provisions on insolvency of the *lex causae* to prevent the insolvency practitioner from challenging the act or have to provide evidence that the act is unchallengeable according to the entire *lex causae*.

The CJEU uphold the latter view in *Nike European Operations* judgment, stating that

> "a person benefiting from a detrimental act must prove that the act at issue cannot be challenged either on the basis of the insolvency provisions of the *lex causae* or on the basis of the *lex causae*, taken as a whole."[16]

Moreover, the CJEU seems to enlarge the concept of 'rules concerning the unenforceability of legal acts detrimental to all creditors' in order to include provisions such as § 64 (2) GmbHG, which compels managing directors to reimburse the payments they make after the company's insolvency or after it has been established that the company is over-indebted.[17] This view comes from the judgment on the *Kornhaas v. Dithmar* case, where the Court ruled in the perspective of Article 4 Regulation no. 1346/2000.

Following a previous judgment,[18] the Court considered § 64 GmbHG as a provision "covered by insolvency law" so as to be attracted into the *lex concursus* for the purposes of Article 4.[19] In particular, § 64 (1) would serve the purposes of identifying the persons obliged to open the proceedings (and penalizing the managing director who fails to request the opening within three month from the insolvency),[20] while § 64 (2) "appears at least similar to a rule laying down 'the

15 *Hermann Lutz v Elke Bäuerle* (Case C-557/13) [2015] ECLI:EU:C:2015:227, para. 31.

16 *Nike European Operations Netherlands BV v. Sportland Oy* (Case C-310/14) [2015] ECLI:EU:C:2015:690, para. 34.

17 *Kornhaas v. Dithmar* (Case C-594/14) [2015] ECLI:EU:C:2015:806, para. 20.

18 *H v HK*, above note 3.

19 Above note 16, para. 17.

20 *Ibid*, para. 19.

unenforceability of legal acts detrimental to all creditors' which ... comes within the *lex fori concursus*" for the purposes of Article 4 (2) (m).[21]

Finally, with the aim to safeguard the uniform application of the Regulation no. 1346/2000, the Court holds that Article 13 (Article 16 EIR) also covers limitation periods or other time-bars as well as both substantive and procedural requirements for the exercise of an action to set a transaction aside.[22]

In reality, the Court's views are somewhat arguable. Generally speaking, the Court seems to underestimate that the EIR sets up the mechanism of Article 16 with respect to 'the relevant case', which leads to keeping the dispute on the existence of means to challenge the act confined into the grounds of avoidance invoked by the insolvency practitioner.[23]

As for the *Kornhaas* judgment, the characterization of § 64 (2) GmbHG as a rule "at least similar to a rule laying down 'the unenforceability of legal acts detrimental to all creditors'" is also arguable because § 64 (2) only compels the managing director to reimburse the payments they made after the company became insolvent or after it was established that the company was over-indebted.

However, since the Court qualified the provision as an insolvency one with respect to an action brought within an insolvency proceeding and for the purposes thereof, it is debatable whether the Court would have reached the same result if the action had been brought in absence of proceedings. As a matter of fact, if the action were to be brought out of the proceedings, it would not be 'covered' by insolvency law, instead falling under company law.

4 Safeguarding the Alleged Detrimental Act at the Heart of the Choice of the Law Applicable to the Transaction

Be that as it may, the Court makes it clear that the evidence on being the act valid and effective – by proving in negative the existence of circumstances to challenge the act – as well as the success of the avoidance action itself, depend on the contents of the entire *lex causae*. The need to take into account the entire

21 *Ibid*, para. 20.

22 *Lutz*, above note 14, paras 44-49.

23 On the other hand, the Court has been recently requested to rule on whether it would suffices for the third party, should the *lex causae* theoretically allow a detrimental act to be challenged, to show that the conditions for such challenge have not been fulfilled in the relevant case (see request for a preliminary ruling from the Tribunale ordinario di Venezia lodged on 29 January 2016, *Vinyls Italia S.p.A., in liquidazione* v. *Mediterranea di Navigazione S.p.A.* (Case C-54/16), still pending). Advocate General Szpunar delivered his conclusions on 2 March 2017 answering in the affirmative (see paras 66, 73, 74).

lex cause raises peculiar concerns because of the lack of a EU harmonization in matter of avoidance actions (apart from the uniform rule – stressed by the CJEU – whereby the defendant in disputes under Article 16 bears the burden of proof). Such concerns stem from the uncertain legal framework in which the interplay between *lex concursus* and *lex causae* shapes .[24]

The remainder of this paper aims to demonstrate how the pattern of Article 16 – clearly tailored to cross-border transactions governed by a private international law mechanisms –, along with other private international law provisions applicable to detrimental transactions, such as the Rome I Regulation on the law applicable to contractual obligations, allow parties to legitimately opt for a law even to *avoid the avoidance effects* and, therefore, to somewhat foster the aforementioned uncertainty that, in reality, only a process of harmonization may reduce.

Initially, it should be borne in mind that EIR does not provide for the harmonization of substantive and procedural rules in matters of avoidance actions. Moreover, the resulting differences between national legal systems do not, *per se*, engender problems, even in terms of public policy, that might prevent the judgments from being recognized or enforced out of the State whose courts have opened the proceedings (and ruled on the avoidance dispute).

In other words, having regard to the *Lutz* case, it does not matter in terms of public policy that German law requires the insolvency practitioner to commence the avoidance action within three years from the opening of the proceedings, while Austrian law requires it within in one year. In the same vein, having regard this time to the *Nike Operation* case, it does not matter that Finnish law requires that for the avoidance to be granted, payments must be made by unusual means or prematurely or in a large amounts, while Dutch law 'only' requires that the payment be made in the recipient's awareness that the application to open the insolvency proceedings have been already submitted or with an agreement entered into by the debtor and creditor to alter the *pari passu* principle within the proceedings.

As for other avoidance rules, such as the 'preference' test, it does not matter that German law requires to consider the creditor/third parties' intention, while English law the debtor's one. What might have importance is instead that parties, against

24 See A. Leandro above note 12, and Id., "*La legge applicabile alla revocatoria fallimentare nel regolamento*" (CE) n° 1346/2000", (2009) 1(1) Cuadernos de derecho transnacional, pp. 102-111; more recently, *inter alia*, G. McCormack, "Conflicts, avoidance and international insolvency 20 years on: a triple cocktail", [2013] Journal of Business Law 141, 156-157; A. Keay, "Security rights, the European Insolvency Regulation and Concerns about the Non-application of Avoidance Rules", (2016) 41 European Law Review, pp. 72-90; J. Briggs, G. Corno, "Cross-border Insolvency – the Treatment of Legal Acts Detrimental to Creditors in English and Italian Law and under the European Insolvency Regulation", (2016) 29 Insolvency Intelligence, pp. 49-57.

the background of different provisions with respect to the same matter, may prefer one rather another of the aforementioned laws to be applied as *lex causae* for the sake of the transaction.

Broadly speaking, the more national legal systems are different as to the rules governing the avoidance actions, the more they get competitive with one another when parties are about to choose the law applicable to the transaction (be it '*lex causae* or *lex contractus*' referred to). As a result, the 'proper' law of the transaction ends up being chosen as the 'best *anti-avoidance* law', in the perspective of parties' insolvency, rather than the 'best contractual law' in the perspective of the substantive contractual right and obligations.

What is being described is a scenario not raising *per se* alarms because it corresponds to the usual competitive position that national legal systems keep with each other to be as attractive as possible to the contracting parties. Nor does it reveal abusive tactics aiming to escape from the *lex concursus* because parties generally prefer choosing a law under which the contract is enforceable without regard to the risk of insolvency of one of them. Nor, finally, should this strategy be deemed limited to debarring the effects of the opening of an insolvency proceeding on the contract's enforcement, given that parties may prefer a law just for its contents concerning the ordinary *actio pauliana*. In other words, parties may legitimately choose a law also for seeking to protect under the *lex causae* their expectation concerning the stability of a contract.

The same scenario, however, raises concerns whenever the choice of the law ignores considerations about the connection between the contract and *lex contractus*. As it is well known, according to Article 3 Rome I Regulation the law applicable to the contract may be selected irrespective of being connected with the contract. Here again, the freedom of the parties (i.e. the *dogma* of the parties' autonomy) is undisputable. However, as parties may not evade the imperative provisions of the law that is entirely connected with the contract (Article 3 (3)), one may wonder if they are also debarred when the provisions at stake govern the avoidance actions.

For instance, it may be that two companies with a seat in Member State X enter into a contract to be performed in the same State, but designate the law of Member State Y as the *lex contractus*. As a result, the avoidance rules of the State X may not be applicable neither in the ordinary course of the contractual relationship nor – under the conditions of Article 16 EIR – in case of insolvency proceedings subsequently opened therein. Recently the CJEU has been requested by the *Tribunale ordinario* *di Venezia* to rule, among other things, on whether Article 13 Regulation no. 1346/2000 should be applicable in cases such as that just described.[25]

In more detail, the point is whether the rules protecting the creditors against a detrimental act amount or not to mandatory rules to which derogation is not possible according to Rome I Regulation, whose Article 3 (3) states:

> "[w]here all other elements relevant to the situation at the time of the choice are located in a country other than the country whose law has been chosen, the choice of the parties shall not prejudice the application of provisions of the law of that other country which cannot be derogated from by agreement."

Accordingly, the Italian Tribunal referred a question to the CJEU as to whether Article 3 (3) Rome I Regulation prevails in such circumstance over Article 13 Regulation no. 1346/2000 (*i.e.*, Article 16 EIR).

Waiting for the Court's answer, three premises may be considered to handle the issues at stake:

(a) both Article 3 (3) Rome I Regulation and Article 16 EIR are exceptions to general rules (respectively that of the Rome I Regulation allowing parties to put the contract under the provisions of the designated law – even when all the other elements relevant to the situation are located in a different State – and the rule of EIR whereby the avoidance disputes are governed by the *lex concursus* in case of insolvency);

(b) the derogation of Article 16 comes up only in case of insolvency, thereby being almost irrelevant as to the application of the avoidance rules outside of an insolvency proceeding; and

(c) following the CJEU's reasoning, there are no differences between provisions pertaining and those not pertaining to the insolvency for the functioning of Article 16 EIR.

The first premise leads to a restrictive interpretation of the exceptional rules.[26] The second premise leads to a recognition of an interplay between the Rome I Regulation and the EIR only in case of party's insolvency and, particularly,

25 See *Vinyls Italia S.p.A., in liquidazione* v. *Mediterranea di Navigazione S.p.A.*, above note 22. Advocate General Szpunar questionably held in his conclusions that no *lex cause* clashes with the *lex concursus* – and, accordingly, no problem arises as to the coordination between the EIR and the Rome Regulation – due to the absence of a choice of law in cases falling under Article 3 (3) Rome Regulation (paras 160-170).

26 It was in *Lutz*, above note 14, para. 34, that CJEU remarked in general that Article 16 must be 'interpreted strictly'.

of insolvency avoidance disputes. However, the third one makes the need of a difference between insolvency provisions and not-insolvency provisions for the functioning of Article 3 (3) Rome I Regulation questionable.

Even assuming, in fact, that the avoidance rules of a State amount to imperative rules for their purpose to protect the creditors, they hardly may be conceived of at the moment of the choice of law as mandatory rules of the contract absent an insolvency proceeding, or (overriding) mandatory rules in case of insolvency opened in that State if they may be derogated through Article 16 EIR all the same. In other words, the point is not whether Article 3 Rome I Regulation may derogate to Article 16 EIR, but whether, under Article 3 generally, parties may choose – to target the favourite *avoidance rules* – a law different to that would-be applicable on the basis of all the elements of the contract.

Actually, the applicability of the insolvency avoidance rules is unlikely to be affected by the freedom of choice governed by the Rome I Regulation (and *vice versa*) due to the substantive scope of the Rome I Regulation itself, which is devoted to contractual obligations. The fact that *lex contractus* and *lex concursus* may concur for the functioning of Article 16 EIR has no importance because – as earlier noted – Article 16 assumes that a different law from that of the State of the proceedings exists and neither establishes how that law is to be designated nor evidently may extend the scope of Rome I Regulation to insolvency matters.

As a consequence, the scope of the Rome I Regulation restricts the reasoning to *contractual/ordinary* avoidance rules. But, lacking the harmonization, the mandatory nature thereof depends on the value such rules have according to each Member State. Article 3 (3) leaves the existence of mandatory rules and the margin of derogation thereof to the law of the State in which 'all other elements relevant to the situation at the time of the choice are located'.

The mandatory nature of the ordinary avoidance rules (if ascertained under the national legal system at stake) comes further into evidence when parties, availing themselves of the so-called *dépeçage*[27], choose for the avoidance disputes a law different from that applicable to the rest of the contract. The case differs from those concerning Article 3 (3) of the Rome I Regulation. In that case the relevant standpoint necessarily is that of the law governing the rest of the contract: whether parties are debarred from designating for the ordinary avoidance disputes a different law will depend on the mandatory nature of the same rules under the *lex contractus*.

27 Generally speaking, *dépeçage* is a private international law technique which splits an issue into two or more parts and subjects them to different laws.

From the foregoing description it follows that the Rome I Regulation does not debar parties from choosing a specific law, even when they seek the sole purpose to safeguard the contract from avoidance challenges.

5 More Laws, More Avoidance Rules ... More Uncertainty

Should different laws govern the transaction, the lack of harmonization among avoidance rules may engender inconsistency in the whole treatment of the avoidance disputes, thereby infringing the legal certainty, *i.e.* just the objective Article 16 aims to.

One can imagine a *dépeçage* provided by the parties under Rome I Regulation or a contract covered by a partial choice of law to be compensated with the law designated by the court under Article 4. Unlike the case described above in which the *dépeçage* aims to put the avoidance issue under a specific law, this would only divide the contract into multiple fractions under different laws.

The fragmentation either of the contract or of the rules governing the contract may lead to the fragmentation in the treatment of the related avoidance disputes. The case would be more interesting if one of such laws became *lex concursus* afterwards. As for the insolvency rules, it is apparent that if they were to be harmonized the fragmentation could not engender problems under Article 16 EIR in terms of incongruous treatment of the same contract before the court of the proceedings.

6 Concluding Remarks

After having emphasized how the CJEU encourages an accounting for the entire *lex causae* when applying Article 16 and the problems of uncertainty that the interplay between the Rome I Regulation and the EIR cause, the reasons why harmonization among national avoidance rules by way of EU legislation is pressing are further evident.[28]

However, it should not be overlooked that the success of the harmonization (especially in case of a maximum one) would somewhat affect the *rationale* of Article 16 as a private international law device which assumes – in the light of the legitimate expectations of the parties – a difference between the avoidance rules managed by the court of the proceedings. But we have been talking about harmonization not unification...

28 See the 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)) at recital C and point 1.3.

Chapter 5

"Wrongful Trading" in England and Hungary: A Comparative Study

Zoltán Fabók[1*]

1 Introduction

At the time of writing, it is still unknown how, if at all, the EU Commission's legislative proposal due to be published in the framework if the "insolvency initiative"[2] in autumn 2016 addresses the harmonisation of the laws of Member States on some aspects of directors' liability. Given the long history of harmonisation attempts in this area, raising the idea of harmonisation again would not really be surprising.

In this paper, it is not intended to argue for or against a potential European legislation on the personal liability of directors. Its purposes are more limited. It aims to present a specific example of legal transfer[3] that took place in 2006 when Hungary imported the English concept of the liability for "wrongful trading".[4] The result of this legal transplant, it is believed, may be instructive for future incentives for harmonisation in the field of directors' liability.

In the second part of this paper, the initiatives of harmonisation of the directors' liability in the history of the European Communities is summarised. In the third part, the function of wrongful trading concept is shortly discussed. In the fourth part, a comparative analysis of the main features of the liability for wrongful trading both in England and Hungary is presented. Subsequently, the diverging

1* Zoltán Fabók, Fellow of INSOL International, is a counsel in DLA Piper, Budapest and a PhD candidate at Nottingham Trent University. The Shakespeare Martineau travel grant is gratefully acknowledged.

2 European Commission, Insolvency Proceedings, available at http://ec.europa.eu/justice/civil/commercial/insolvency/index_en.htm (last viewed 25 April 2017). In the meantime, the Commission published its Proposal for a Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures, available at http://ec.europa.eu/information_society/newsroom/image/document/2016-48/proposal_40046.pdf (last viewed 8 May 2017). Article 18 of the draft Directive limits itself to determining some duties of the directors in the vicinity of insolvency.

3 *"Legal transfer"* or *"legal transplant"* means unilateral adoption of legal norms from other jurisdictions. See N. Garoupa and A. Ogus, "A Strategic Interpretation of Legal Transplants", (2006) 35 Journal of Legal Studies, p. 341.

4 On the legal transfer of the English provisions on wrongful trading see T. Cseh, "Új hitelezővédelmi jogintézmény a magyar társasági törvényben (wrongful trading) [New Legal Institution of Creditor's Protection in the Hungarian Companies Act (Wrongful Trading)]", (2006) 14 Gazdaság és Jog, pp. 9 ff.

tendencies in case law is discussed. In the sixth part, an indication of some possible reasons why wrongful trading provisions play a more prominent (and different) role in Hungary than they do in England is given. As a conclusion, it will be attempted to answer the following questions: (i) Do the Hungarian provisions on liability for wrongful trading qualify as a "legal transplant"? (ii) Has the adoption of the English concept of wrongful trading resulted in "harmonised" or "unified" rules[5] on directors' liability for wrongful trading in England and Hungary?

2 Harmonisation Initiatives

The concept of uniform rules in the field of director's liability throughout the Member States emerged early in the history of the European Communities. The 1970 Preliminary Draft Convention[6] envisaged a number of territories where the contracting states would have been required to harmonize their substantive laws. The personal liability of directors was one of these areas. However, the idea did not survive the Preliminary Draft Convention: no similar provision can be found in the latter versions of what eventually became the 2000 Insolvency Regulation.[7] The thought emerged again in 2003. The Commission, reflecting to the initiative of the "High Level Group"[8] proposed[9] introducing a wrongful trading rule similar to that found in England. However, on the basis of the responses that the Commission received,[10] the idea was abandoned.[11] In 2010 the idea of harmonisation turned up again. This time, INSOL Europe, commissioned by the European Parliament,

5 *"Legal harmonization"* is a cooperative approach of approximation of laws through setting of objectives and targets and let each nation amend their internal law to fulfil the chosen objectives. *"Legal unification"* is an extreme version of harmonization replacing national rules and adopting a unified set of rules chosen at the interstate level. See E. Carbonara and F. Parisi, "The Paradox of Legal Harmonization", (2007) 132 Public Choice, p. 368; N. Garoupa and A. Ogus, *ibid*., p. 343. The dichotomy of harmonisation and unification is mirrored at the level of the legislative acts of the EU. „With the use of »directives« member states of the EU harmonize their national legal systems by setting common goals and standards. With »regulations« EU countries instead agree to replace their respective national laws with a common rule which becomes directly applicable in the national systems of all member states."; see E. Carbonara and F. Parisi, *ibid*., p. 368.

6 Preliminary Draft of a Convention on Bankruptcy, Winding-Up, Arrangements, Compositions and Similar Proceedings. Translation of Commission Document 3.327/1/XIV/70, 4 June 1973. [EU Commission - Working Document]' (1973), Annex 1 Article 1.

7 Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings [2000] OJ L160/1.

8 J. Winter et. al., "Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe" (2002), available from http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf (last viewed 27 July 2016).

9 Communication from the Commission to the Council and the European Parliament Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward COM (2003) 284 Final.

10 Synthesis of the Responses to the Communication of the Commission to the Council and the European Parliament "Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward" – COM (2003) 284 Final of 21 May 2003.

11 P. J. Wright, "Challenges to the Harmonization of Business Law: Domestic and Cross-Border Insolvency" (2015) SSRN Electronic Journal, available at: http://papers.ssrn.com/abstract=2658230 (last viewed 1 August 2016), pp. 15 ff.

conducted a report[12] identifying some areas of insolvency law where harmonisation at EU level seemed to be worthwhile and achievable. The report of INSOL Europe concluded that, among other things, directors' liability could have been subject of harmonisation. At a later stage of the legislative process, this aspect of the initiative seemed to have evaporated.[13] Recently, however, following a communication[14] on a new European approach to business failure and insolvency, the Commission adopted a recommendation[15] in March 2014. This 2014 Recommendation aims at establishing minimum standards for: (i) preventive restructuring procedures enabling debtors in financial difficulty to restructure at an early stage with the objective of averting insolvency, and (ii) debt discharge, within prescribed periods, for honest bankrupt entrepreneurs as one of the steps necessary to provide them with a second chance. Neither in these texts nor in the evaluation[16] of the 2014 Recommendation by the Directorate-General Justice & Consumers of the European Commission is any direct referral to the intended harmonization of the rules on the personal liability of the directors. Notwithstanding, the idea seems to keep entertaining the European legislator.[17] By the time of the publication of this paper it will be known to what extent and how, if at all, the legislative proposals of the Commission addresses the issue of directors' liability.

3 The Function of the Provisions on Wrongful Trading

The principle underlying the wrongful trading concept is the protection of creditors in the period of time when the debtor company still operates, but is in a state of imminent insolvency. Diverging incentives can be detected in this period of time.[18] The director, acting in the interest of the company, may want to trade the company out from the difficult situation, but to do so he needs time, and possibly more credit and new obligations. The unsecured creditors may be concerned that the assets of the debtor, which are the only coverage for their claims, are melting away and that

12 INSOL Europe, *Harmonisation of Insolvency Law at EU Level*, (2010) https://www.insol-europe.org/technical-content/european-insolvency-regulation (last viewed 1 September 2016).

13 See Report with Recommendations to the Commission on Insolvency Proceedings in the Context of EU Company Law (2011/2006(INI) (2011); European Parliament Resolution of 15 November 2011 with recommendations to the Commission on insolvency proceedings in the context of EU company law, P7_TA (2011) 0484 2011.

14 A New European Approach to Business Failure and Insolvency COM(2012) 742 Final.

15 Commission Recommendation of 12.3.2014 on a New Approach to Business Failure and Insolvency C(2014) 1500 final.

16 Evaluation of the Implementation of the Commission Recommendation of 12.3.2015 on a New Approach to Business Failure and Insolvency (2015), available at http://ec.europa.eu/justice/civil/files/insolvency/02_evaluation_insolvency_recommendation_en.pdf (last viewed 8 May 2017).

17 See e. g. the reports of the Group of experts on restructuring and insolvency law at http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetail&groupID=3362 (last viewed 8 May 2017).

18 On the incentive structures see G. Spindler, "Trading in the Vicinity of Insolvency", (2006) 7(1) EBOR, pp. 340. ff.

they will end up in a position worse than it would have been if formal insolvency proceedings had started earlier in time. As Professor Keay put it,

> "[i]f the risk-taking [by the director] pays off, then the shareholders will see their wealth maximised, but if it does not, then they have lost nothing more; it is the creditors who will bear the cost."[19]

Beyond this, the interest of the employees and the wider public is, generally, to save the company or at least the business as going concern. The secured creditors normally want their security interests to retain their value, etc.

Directors are among the key players in the situation when the company is on the verge of insolvency. They may just throw in the towel, stop trading and file an application for winding up (insolvent liquidation). They may file for formal insolvency proceedings designed for reorganisation of the company or rescuing the business. Alternatively, they may continue operations and try to trade the company out of its difficulties. Should the latter option be chosen, there is little to protect the interests of the creditors of the struggling company.

Two main strategies appear to exist in Europe when dealing with the protection of creditors' interests in the vicinity of insolvency: the "duty to file" strategy and the "wrongful trading" strategy. The reports drafted by the London School of Economics[20] and more recently by the team of University of Leeds[21] give a detailed account on these strategies.

The duty to file strategy is more common in Europe. The majority of the member states[22] of the EU expect the directors to file for insolvency within a certain period of time after the insolvency (on cash-flow or balance sheet basis) occurs. Should the director fail to comply with that rules then he may be liable for the damage caused to the creditors while delaying the insolvency. Apparently, this concept puts the emphasis on the formal insolvency proceedings and leaves less room for either a potential "trade out" by the debtor company or informal rescue strategies.

19 A. Keay, "Wrongful Trading and the Liability of Company Directors: A Theoretical Perspective", (2005) 25 Legal Studies 434.

20 C. Gerner-Beuerle *et. al*., "Study on Directors' Duties and Liability", (the "London Report"), (2013, London), pp. xiv, 208 ff.

21 Gerard McCormack *et. al*., "Study on a New Approach to Business Failure and Insolvency – Comparative Legal Analysis of the Member States' Relevant Provisions and Practices" (the "Leeds Report"), (2016), 48 ff.

22 E.g. Germany, France, Austria, Belgium, Poland, Spain, Portugal etc. For more details, see the London and Leeds Reports, above notes 19 and 20.

A minority group of the member states[23] incentivise directors to respect the interest of the creditors by imposing special – and personal – liability for diminution of assets in the period of the approaching insolvency. Following the English example, this can be called the "wrongful trading" strategy. As we are going to see below, the basis of the liability in the English law is that the director continues operating the company whilst he knows or should know that there is no reasonable prospect of avoiding an insolvent winding-up. The wrongful trading strategy indicates a more flexible approach where there is much more room to try to trade out of the difficulties by continuing operations or attempting to rescue the company through informal agreements with (some of) the creditors. However, because the apparent victims of failed behind-the-door rescue attempts are creditors, their interests are protected by special rules making directors liable for losses suffered by the debtor in the vicinity of insolvency.

4 Wrongful Trading in England and Hungary

4.1 The Legal Transplant to Hungary

In England the liability for wrongful trading was introduced[24] in the 1986 Insolvency Act (IA) *in addition* to other existing civil remedies, first of all the provisions on fraudulent trading and misfeasance.[25] By contrast, virtually no civil law protection was available in Hungary for creditors *vis-à-vis* the directors of the insolvent company prior to 2006.[26] As long as the company was not formally insolvent (no insolvency proceedings were opened) in most cases directors were free to operate the debtor company without any relevant restrictions. Even if the management activity of the director resulted in the increase of the net deficiency of

23 E.g. the U.K., Ireland, Malta, Cyprus, Hungary. For more details, the London and Leeds Reports, above notes 19 and 20. Of course, the two strategies may be combined: e.g. under certain circumstances Hungarian companies are required to file for insolvency, see § 3:189 and § 3:270, Act V of 2013 on the Civil Code (the "Civil Code").

24 On the background, aims, rationale of the liability for wrongful trading in comparative context see A. Keay, *Company Directors' Responsibilities to Creditors* (2007, Routledge-Cavendish, London), pp. 73-80.

25 Fraudulent trading is a cause of action which arises if, in the course of winding-up a company, it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or has been carried on for any fraudulent purpose, see section 213, IA. *Misfeasance* is a cause of action which arises if, in the course of winding-up a company, it appears that a person has misapplied or retained, or become accountable for, any money or other property of the company, or has been guilty of any wrongdoing or breached their duties of trust (for example, duty to hold something in trust) in relation to the company, see section 212, IA. On the number of the cases in England and Wales classified according to the different types of actions see P. Walton, "Insolvency Litigation and the Jackson Reforms – An Update" (the "Walton Report") (2016), available at https://www.r3.org.uk/media/documents/policy/research_reports/bus_distress_index/Insolvency_Litigation_and_the_Jackson_Reforms_-_An_Update_April_2016_FINAL.pdf (last viewed 18 April 2017), pp. 18-19.

26 See 2006. évi VI. törvény indokolása a csődeljárásról, a felszámolási eljárásról és a végelszámolásról szóló 1991. évi XLIX. törvény módosításáról [Explanatory note on the Act VI of 2006 amending of the Hungarian Insolvency Act].

the debtor, that did not typically provoked the personal liability of the executives *vis-à-vis* creditors.[27]

What is equally relevant is that even before the import of the wrongful trading provisions from England, no efficient "duty to file" rule existed in Hungary. This means that Hungary applied none of the main strategies designed for protection of the creditor's interests in the vicinity of the insolvency. In other words, there were no efficient rules forcing the directors or shareholders to start formal insolvency proceedings within a certain period of time after the company became insolvent, virtually nothing prevented directors from continuing to operate long-insolvent companies and accumulate further losses to the creditors of the dying company.

Quite often, legal transplants occur because a legal institution another nation has is deemed superior.[28] If that is true, the transfer of the liability for wrongful trading from the English law to the Hungarian legal system was more than justified. The wrongful trading concept had at least two features which were new and superior as compared to the Hungarian law. First, the newly adopted provisions established the legal basis of the liability of corporate directors directly vis-à-vis the creditors of the debtor company. Second, the new concept created an obligation on the side of the company directors to take into consideration the interests of the creditors in the period of *imminent* insolvency, i.e. *prior* to the factual insolvency.[29]

4.2 The Key Ingredients of Wrongful Trading in English and Hungarian Law

The basic elements of the liability for wrongful trading pursuant to the IA[30] and the Hungarian Insolvency Act (HIA)[31] are, somewhat generalised, as follows:

27 In fact, a kind of statutory derivative action for compensation and some judge-made remedies were available; see below under heading *6 Possible reasons for the diverging case law.*

28 M. Graziadei, "Comparative law as the study of transplants and receptions", Chapter 13 in M. Reimann and R. Zimmermann (eds.), *The Oxford Handbook of Comparative Law* (2006, OUP, Oxford), pp. 457 ff.

29 In theory at least, wrongful trading rules impose duties on directors already *prior* to the onset of material insolvency. However, as Bachner demonstrated, this is not necessarily the case. In fact, English courts tend to establish the starting point of the critical period (thus the beginning of the special duties) at a later stage of the agony, when the company is already (cash-flow or balance sheet) insolvent. See Th. Bachner, "Wrongful Trading - a New European Model for Creditor Protection ?", (2004) 5(2) European Business Organization Law Review, pp. 296 ff. Similarly, A. Campbell, "Wrongful Trading and Company Rescue Andrew", (1994) 25 Cambrian L. Rev., p. 74.

30 Section 214, IA.

31 § 33/A, Act XLIX of 1991 on Reorganisation Proceedings and Liquidation Proceedings. Note that, to some extent, "culpable trading" as a sub-category of the criminal offence "fraudulent insolvency", § 404(1), Act C of 2012 on the Hungarian Criminal Code, can be interpreted as a criminal law counterpart of the wrongful trading; for an analysis of the interplay between the two remedies see M. Tihanyi, "A vezetői felelősséggel kapcsolatos megállapítási per (wrongful trading) lehetséges hatásai a vétkes gazdálkodással elkövetett csődbűncselekmény miatt indult büntetőeljárásokra [The possible effects of the declaratory action regarding the liability of the directors (wrongful trading) on the criminal proceedings due to fraudulent insolvency committed through culpable trading]", working paper, http://www.mabie.hu/node/2491 last viewed 17 October 2016.

- Formal insolvency proceedings[32] have been opened against the debtor company. If the debtor is able to avoid opening formal insolvency proceedings the director will not be liable for wrongful trading.
- The director knew or should have concluded before the commencement of the formal insolvency proceedings that the company would be unable to avoid going into insolvent liquidation or administration (in England) or that the company is in the state of imminent insolvency (in Hungary).
- The person affected was, in a wide sense, a director of the company during the critical period.
- The director fails to prove that he took every step he ought to have taken to minimise the loss to creditors.
- The continued operation caused loss to the creditors.

Under the subsequent headings a comparative analysis of these ingredients will be provided.

4.3 Similarities between English and Hungarian Wrongful Trading Provisions

4.3.1 The Debtor Goes into Insolvent Liquidation

Both in England and Hungary, precondition to the liability for wrongful trading is that insolvent liquidation proceedings[33] have been opened against the debtor company. This form of liability is *per definitionem* retrospective. The liability is not an end in itself: should the continued trading or rescue turn out to be successful and, as a consequence, the company regains solvency, there is no point to penalise the director for the – eventually successful – decision to continue business activity even in a seemingly hopeless situation.

4.3.2 The Addressees of the Norm are Directors in a Wide Sense

Section 214 of the IA requires the persons targeted to be directors. First of all, this category includes *de jure* directors, i.e. those who occupy the position of director, by whatever name called.[34] Also *de facto* directors are included.[35] A *de facto* director is a person who assumes to act as a director. He is held out as a director

32 In England: winding up or insolvent administration where the insolvency is to be determined on the basis of the balance sheet test, see Section 214, IA; Section 246ZB, IA; in Hungary: *felszámolási eljárás* (liquidation proceedings), see § 33/A, HIA.

33 *Ibid.*

34 Section 251, IA.

35 See Hydrodan (Corby) Ltd (In Liquidation), Re [1994] BCC 161.

by the company, and claims and purports to be a director, although never actually or validly appointed as such.[36] Finally, the statute itself provides that the category of director includes also shadow directors, too.[37] Shadow director, in relation to a company, means a person in accordance with whose directions or instructions the directors of the company are accustomed to act.[38] Millett J. characterised a shadow director as someone who:

> "[…] does not claim or purport to act as a director. On the contrary, he claims not to be a director. He lurks in the shadows, sheltering behind others who, he claims, are the only directors of the company to the exclusion of himself."[39]

In Hungary, the concept of director refers first of all to *de jure* directors.[40] Beyond that, the statute provides that any person who has in fact exercised dominant influence on the decision-making mechanisms of the debtor company shall also be considered an executive, i.e. subject to liability.[41] This category is generally mentioned as "shadow directors" in judgements and the literature but the definition appears to cover both shadow and *de facto* directors. By contrast to the English statute, the HIA limits the application of the wrongful trading provisions to those directors who have been in this position in the period of three years prior to the opening of the insolvency proceedings.[42]

4.3.3 Exculpation of Directors

The defence to wrongful trading actions is addressed by both the IA and the HIA in a rather similar way. Should the director as defendant in the wrongful trading litigation be able to prove that he took every step with a view to minimising the potential loss to creditors he ought to have taken (in Hungary: that is to be expected from persons in such position), then no liability is incurred.[43] This is a defence to the wrongful trading action thus the burden of proof, principally, lies on the director.

36 R. Goode, Principles of Corporate Insolvency Law (2011, Sweet & Maxwell, London), pp. 641-643.

37 Section 214(7), IA.

38 Section 251, IA.

39 *Hydrodan (Corby) Ltd (In Liquidation), Re* [1994] BCC 161, at 163.

40 § 3(1)(d), HIA.

41 § 33/A(1), HIA.

42 *Ibid*.

43 Section 214(3), IA; § 33/A(3), HIA. The HIA adds that the it is expected from the director to prompt the supreme body of the debtor company to take action.

In Hungary, however, there appears to be some ambiguity regarding the burden of proof. On the one hand, the wording of the statute suggests that the claimant is expected to prove that the director, when continuing trading, disregarded the interests of the creditors.[44] On the other hand, the HIA provides that the director as defendant who is able to prove to have taken all reasonable measures expected from persons in such positions, upon the occurrence of the imminent insolvency so as to prevent and mitigate the losses of creditors, and to prompt the supreme body of the debtor's economic operator to take action, shall not be held responsible. Thus, it is not completely clear on the basis of the wording of the statute, which party is expected to establish that the director reasonably tried to protect the interests of the creditors. The position of the Curia (Highest Court of Hungary) is not completely straightforward, either. In one judgement, the judicial body ruled that the occurrence and the date of the imminent insolvency, the fact and the extent of the increase of the net deficiency and the causal relation between the behaviour of the director and the increase of the net deficiency were to be proved by the claimant. On the other hand, the defendant director needs to prove that he has taken all reasonable measures expected from persons in such positions to prevent and mitigate the losses of creditors.[45] However, another decision suggests that the claimant is required to establish also that the director acted in a way contrary to the interests of the creditors during the critical period.[46]

4.3.4 Losses during Continued Trading

Section 214 of the IA does not expressly require any loss suffered by the creditors, but it is well-established in case law that the continued trading should make the company's position worse, so that it has less money available to pay creditors, rather than to leaving the company's position at the same level.[47] Importantly,

44 Before 15 March 2014 the statute expected to establish that the director failed to act on the basis of the priority of the creditors' interests. Since, the statute has expected directors to take into consideration the interests of the creditors, thus there is no clear priority order. However, the changing in the wording of the statute may have no effect on the case law, see A. Csőke, "A vezető tisztségviselő felelőssége fizetésképtelenség és felszámolás esetén [Liability of executives in the context of insolvency and liquidation]", in Z. Csehi and M. Szabó (eds), A vezető tisztségviselő felelőssége [Liability of the executives] (2015, Wolters Kluwer, Budapest) p. 142.

45 Legfelsőbb Bíróság Gfv.X.30.047/2011/3. cf. A Kúria Polgári Kollégiuma Joggyakorlat-elemző Csoport [Civil Department of the Curia, Expert Group Analysing the Case Law], "A vezető tisztségviselők hitelezőkkel szembeni felelőssége« tárgykörben felállított joggyakorlat-elemző csoport összefoglaló véleménye (A Kúria Polgári Kollégiuma által 2017. február 6-án elfogadott összefoglaló vélemény) [Summary Opinion of the Expert Group on the Subject of »the Liability of the Executives vis-à-vis the Creditors" (Summary Opinion approved by the Civil Department of the Curia on 6 February 2017] [2016.El.II.JGY.G.2.] (the "Summary Opinion"), available at http://lb.hu/sites/default/files/joggyak/osszefoglalo_velemeny_6.pdf (last viewed 12 February 2017); the Summary Opinion appears to share this view, pp. 25-27, 31-32.

46 Kúria Gfv.VII.30.303/2013/6.

47 *Re Continental Assurance plc* [2001] BPIR 733 at paragraph 9 of Annex B; *Ralls Builders* [2016] EWHC 243 (Ch) at paragraph 241.

English provisions on wrongful trading seem to focus merely on the general body of the creditors: form the point of view of the wrongful trading prohibition, it is not relevant if some creditors are paid fully during the period of continued trading while others end up receiving nothing due to payments made to other creditors.[48] What matters is the overall debt position of the company: as long as the overall position does not worsen during the critical period, no loss of assets occurs for the purposes of wrongful trading.

The HIA expressly provides[49] that some kind of loss is required to activate wrongful trading liability: either the debtor's assets have diminished, or the director obstructed full satisfaction for the creditors' claims, or has neglected to carry out the cleaning up of environmental damages. However, in order to trigger this type of liability the director must disregard the creditors' interests in consequence of which the losses occur. In other words, even if the asset pool diminishes during the critical period that does not automatically result in the liability of the director. Some additional element, typically a fraudulent or grossly negligent act of the director, is required.[50]

Note that case law appears to be rather divided as to whether payments to selected creditors diminishing the asset pool of the company and decreasing the shares to be paid to the remaining creditors is contrary to the prohibition of wrongful trading. This question will be analysed below.[51]

4.3.5 The Quantitative Limit of the Compensation

The IA simply provides that the court may declare that the director is to be liable to make such contribution (if any) to the company's assets as the court thinks proper.[52] These are very wide words of discretion and, as Knox J. stated, it would be undesirable to seek to spell out limits on that discretion.[53] Still, the principle is that the contribution to the assets in which the company's creditors will share in the liquidation should reflect (and compensate for) the loss which has been caused to those creditors by the carrying on of the business when the insolvent liquidation could not be avoided.[54]

48 *Re Continental Assurance plc* [2001] BPIR 733 at paragraph 8 of Annex B; *Ralls Builders* [2016] EWHC 243 (Ch) at paragraphs 239-240.

49 § 33/A(1), HIA.

50 BDT2016 3499 (Debreceni Ítélőtábla Gf. IV. 30 369/2015/6).

51 See below under the heading *4.5.2 Which creditors can be lawfully paid off during the critical period?*

52 Section 214(1), IA.

53 *Produce Marketing Consortium (In Liquidation) Ltd, Re (No2)* [1989] 5 BCC 569, at 597-598.

54 *Morphitis v Bernasconi* [2003] EWCA Civ 289, at paragraph 55 (in relation to fraudulent trading).

In Hungary, the established principle is that the upper limit of the liability for wrongful trading is the amount by which the assets of the debtor have diminished during the critical period, as long as this is attributable to the director.[55]

4.4 The Differences

4.4.1 What should the Director Foresee?

Pursuant to the English statute, what the director knew or ought to have concluded is that there was no reasonable prospect of avoiding insolvent liquidation or insolvent administration.[56] Once the director first gains this "deemed knowledge"[57], the critical period begins. For the purposes of this provision, insolvent liquidation or administration means that the assets are insufficient for the payment of debts and other liabilities and the expenses of the winding up or those of administration (balance-sheet test).[58] The statute provides for both objective and subjective tests regarding the directors. The focus of the objective test is what should be known or concluded by a reasonably diligent person having the general knowledge, skill, and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company. Then, the subjective test focuses on the what should be known or concluded by this reasonably diligent person with the general knowledge, skill, and experience that the director in question (i.e. the defendant of the wrongful trading litigation) has.

It is crucial to emphasise that the focus is not on insolvent trading but on the question of whether there is a reasonable prospect of avoiding insolvent liquidation. Insolvent trading in itself does not give rise to wrongful trading.[59] As Snowden J. put it,

> "[i]t is important to note that the fact that a company is insolvent (on a balance sheet or cash-flow basis) and carries on trading does not mean that a director – even one with knowledge of that fact — will be liable for wrongful trading if the company fails to survive. Many companies show a balance-sheet deficit from time to time, but nevertheless have every real prospect of trading out of that position or otherwise recovering from the deficiency and thereby avoiding an insolvent liquidation […]. Likewise, trading companies often suffer

55 Legfelsőbb Bíróság Gfv.X.30.047/2011/3.; Debreceni Ítélőtábla Gf.III.30.387/2012/5.; Summary Opinion, above note 44, p. 23.

56 Section 214(2)(b), IA and Section 246ZB(2)(b), IA.

57 Goode, above note 35, p. 670.

58 Section 214(6), IA and Section 246ZB(6), IA.

59 See *Brooks v Armstrong* [2015] EWHC 2289 (Ch).

> cashflow difficulties and fail to pay their creditors on time, but are able to overcome that cash-flow insolvency by (for example) selling an asset or raising external finance on the security of their assets."[60]

What triggers the liability is not the factual insolvency of the debtor but rather "the type of situation […] where the director has been held to have had no rational basis for believing that the event that they hoped would save the company would come about."[61] To sum up, the critical period does not begin just because the debtors is insolvent: as long as there is reasonable prospect to trade the company out of the difficulties, the threat of wrongful trading does not emerge, even if the director knows about the insolvency and even if the continued trading in the period of insolvency results in loss to the creditors. English courts tend not to place undue emphasis on hindsight and avoid the danger of assuming that what has in fact happened was always bound to happen and was apparent.[62] As Lewison J expressed in so graphic terms,

> "[o]f course, it is easy with hindsight to conclude that mistakes were made. An insolvent liquidation will almost always result from one or more mistakes. But picking over the bones of a dead company in a courtroom is not always fair to those who struggled to keep going in the reasonable (but ultimately misplaced) hope that things would get better."[63]

In Hungary, the critical period begins with the occurrence of imminent insolvency. Pursuant to the legal definition, imminent insolvency starts when the directors were or should have been reasonably able to foresee that the debtor company would not be able to satisfy its liabilities when due[64] (cash-flow test). In other words, as long as the director knows or should foresee that the debtor is cash-flow insolvent he is exposed to the liability for wrongful trading if further elements of the liability are present. The Curia found that

> "[r]egarding the occurrence of the imminent insolvency the relevant question is whether the debtor is able to settle its debts when due. If the debtor is unable to do so because it has neither liquid assets nor

60 *Ralls Builders* [2016] EWHC 243 (Ch) at paragraph 168.

61 *Ibid.* at paragraph 174.

62 *Sherborne Associates Ltd, Re* [1995] BCC 40 at 54; *Brian D Pierson (Contractors) Ltd, Re* [1999] BCC 26 at 50; *Hawkes Hill Publishing Co Ltd (In Liquidation), Re* [2007] BCC 937 at paragraph 47; *Ralls Builders* [2016] EWHC 243 (Ch) at paragraph 173.

63 *Hawkes Hill Publishing Co Ltd (In Liquidation), Re* [2007] BCC 937 at paragraph 47.

64 § 33/A(1), HIA. Further, see Summary Opinion, above note 44, pp. 20-21; A. Csőke, "A fizetésképtelenséggel fenyegető helyzet [The imminent insolvency]", (2016) (Annex No 2 to the Summary Opinion), pp. 66-70.

> credit to settle its debts and it is unable to agree with its creditors on a different kind of performance or adjustment of the due date then the imminent insolvency occurs even if the other assets of the debtor […] exceeds the amount of debts."[65]

When applying the rather rigid cash-flow test, it appears that the hope in realising some uncertain incomes in the future is insufficient to be shielded from imminent insolvency.[66] László Juhász, a Hungarian senior judge noted, regarding the rather rigid notion of imminent insolvency, that:

> "[h]owever difficult it is to say, it is a fact that a significant number of enterprises operating in Hungary need to face with the fact on a daily basis that they will not be able to pay off their debts when due if they are unable to collect their receivables. The executives should realise that in such situations they are acting in the state of imminent insolvency even if [the debtor] has significant assets […]."[67]

In several cases, Hungarian courts apply the current ratio test or even the quick ratio test to determine the cash-flow situation of the company.[68] The current ratio is a basic indicator calculated by dividing total current assets by total current liabilities; the quick ratio, by contrast, takes into account the most liquid current assets: it is calculated by adding cash and equivalents, marketable investments, and accounts receivables, and dividing that sum by current liabilities. Although the wording of the HIA ("were or should have been reasonably able to foresee") seems to suggest that, similar to the English provisions, both an objective and subjective test applies, the Curia ruled that

> "[t]he occurrence of the imminent insolvency is to be examined from the point of view of the knowledge of the director, i.e. of those circumstances he has been able to recognise."[69]

To sum up, the difference between the English and Hungarian approach is of paramount importance: While an English director is safe from wrongful trading liability as long as there is reasonable prospect to avoid insolvent liquidation, his

65 BH2014. 188. (Kúria Gfv. VII. 30.247/2013.); Kúria Gfv.VII.30.265/2015/4.

66 Fővárosi Ítélőtábla 15.Gf.40.043/2015/5/II.

67 L. Juhász, A Magyar fizetésképtelenségi jog kézikönyve [Textbook on the Hungarian insolvency law] (2014, Novotni Kiadó, Miskolc) [electronic edition] p. 484.

68 Fővárosi Ítélőtábla 12.Gf.40.469/2013/5.; Fővárosi Ítélőtábla 12.Gf.40.679/2015/5-II.; Fővárosi Ítélőtábla 12.Gf.40.013/2015/6-II. See also Csőke, above note 63, pp. 67-69. For an analysis of the methods of examination of the imminent insolvency see S. Fónagy, "A Fizetésképtelenséggel fenyegető helyzet megítélése [Assessment of the imminent insolvency", (2015) 23 Gazdaság és Jog, pp. 16 ff.

69 BH2014. 188. (Kúria Gfv. VII. 30.247/2013).

Hungarian counterpart is exposed to personal liability once and as long as the debtor company is cash-flow insolvent. Most probably this provision radically increases the number of the potential defendants in Hungary.[70]

4.4.2 Who initiates the wrongful trading litigation and benefits from it?

The IA reserves the power for liquidators and administrators to claim against directors for wrongful trading.[71] Should the court approve the claim the director is declared to be liable to make a contribution to the company's assets. The contribution serves the purpose of making a distribution to the unsecured creditors, and is therefore not available for a charge holder.[72]

In Hungary, the legislator followed a different path. For some reasons, the legislator designed the rules so that the court cannot oblige the director to contribute to the asset pool of the debtor company. Instead, a peculiar two-level litigation has been introduced. In the first phase, after the opening but before the closing of the insolvency proceedings, a declaratory action should be brought against the former director. This claim is available for both the liquidator and any creditors. The litigation is declaratory in nature. It is aimed at establishing the liability and the amount of the diminution of assets caused by the continuation of the business activity during the critical period of imminent insolvency.[73] No performance may be sought in this proceeding. Then, in a second step, after the closing of the insolvency proceedings, assuming that the assets of the debtor do not or only partly cover the creditors' claims (so in virtually all cases), the creditors, but not the liquidator anymore, may bring an action for performance.[74] In this second phase of the litigation the court, if approving the claim, orders the former director to compensate those creditors on *pro rata* basis who initiated this second litigation. The maximum of the compensation to be shared among those creditors amounts to the net deficiency accumulated during the critical period as established by the court in the first phase of the litigation. One of the inexplicable peculiarities of the rules is that the second litigation may be initiated by any creditors, i.e. also by those who did not even participate in the first litigation. The root of the problem is that – for an unknown reason – the statute does not require the defendant director to contribute

70 See below under the heading *6 Possible reasons for the diverging case law.*

71 Section 214(1), IA and 246ZB(1), IA.

72 *Re Oasis Merchandising Services Limited* [1998] Ch 170; *Ralls Builders* [2016] EWHC 243 (Ch) at paragraph 235.

73 1/2013. (II. 28.) Polgári jogegységi határozat. See A. Csőke, "A vezető tisztségviselő felelőssége [Liability of the executive]", in A. Csőke, E. Lettner and Cs. Juhász, Nagykommentár a csődeljárásról és a felszámolási eljárásról szóló 1991. évi XLIX. törvényhez [Comprehensive Commentary on the Insolvency Act] (2015, Wolters Kluwer, Budapest) [electronic edition], at § 33/A.

74 § 33/A(6), HIA. See also 1/2013. (II. 28.) Polgári jogegységi határozat [Civil uniformity decision].

to the assets of the debtor company.[75] Instead, the claimants are free to enforce their claims on a quasi-individual basis in the second stage of the litigation. This appears to be contradictory to the principle of collective insolvency proceedings. Note that the legislator has recently eased the strict separation of the two stages of litigation by enabling the claimants to request performance during the insolvency proceedings if, according to the interim financial statement, the debtor's assets are insufficient to cover the creditors' claims.[76]

4.4.3 Statutory Presumption

In Hungary, a statutory presumption assists the claimant in several cases.[77] The violation of the interests of the creditors is presumed if the director, failing to comply with the law, did not deposit and publish the debtor's annual accounts prior to the opening of liquidation proceedings and/or breached his obligation to cooperate with the liquidator by providing him with the relevant information and documentation. There are some questions regarding this provision. *First*, the rule apparently fails to determine the length of the period before the opening of the liquidation proceedings concerning which the failure to deposit and publish the annual accounts is taken into consideration. *Secondly* and more importantly, there is some uncertainty in the case law regarding the scope of the presumption. The position of the Curia is that, if the claimant proved the occurrence and beginning of the imminent insolvency and the increasing of the net deficiency in the critical period then, should the statutory presumption be applied, it is presumed that the director neglected the interests of the creditors and this is in causal relation with the losses to the creditors.[78] Others suggest that the scope of the presumption is much wider and extends to the occurrence of the imminent insolvency and the increase of the net deficiency during the critical period.[79]

The statutory presumption does not operate regarding shadow directors.[80]

4.4.4 Majority Shareholder as *ex lege* Guarantor

The concept of lifting the corporate veil, i.e. ignoring the separate legal personality of the company thereby imposing personal liability on shareholders, is recognised,

75 Csőke, above note 72, at § 33/A.

76 § 33/A(7), HIA.

77 § 33/A(3), HIA. cf Summary Opinion, above note 44, pp 22-25; P. Lakatos, "A vezető tisztségviselő felelőssége vélelmének fennállásával kapcsolatos kérdések [Questions regarding the Statutory Presumption of the Liability of the Executives]" (undated) (Annex No 5 to the Summary Opinion), pp. 80-84.

78 Kúria Gfv.VII.30.024/2015/4; Kúria Gfv.VII.30.059/2015/5.

79 M. Dzsula, "A vezető tisztségviselő felelősségével kapcsolatos jogalkalmazási problémák II. [Issues regarding application of law relating to the liability of executives II.]" (2013) 23(7) Céghírnök, p. 9.

80 ÍH 2012.91. (Fővárosi Ítélőtábla 14.Gf.40.493/2011/4)

although it plays a minor role, in England.[81] In Hungary, this concept enjoys a wider recognition and shareholders need to consider a number of statutory provisions making them personally liable vis-à-vis the creditors of the insolvent company.[82] What is common in these actions is that they focus on the shareholders of the debtor company.

By contrast, the liability for wrongful trading is generally reserved for directors of the debtor company, even if the term "director" is to be construed in a wide sense: beyond *de jure* directors, it includes *de facto* and shadow directors. Actually, the term "shadow director" is so widely drafted both in the English and the Hungarian statutes that it may cover also controlling shareholders – assuming, of course, that they interfere in the management of the company in a way that verifies this qualification.[83]

One of the peculiar characteristic of the Hungarian legislation is that, in an indirect but unambiguous way, it puts the majority shareholder of the debtor company to the position of a "statutory surety" (guarantor) of the director regarding the liability for wrongful trading even if that majority shareholder does not fall within the category of shadow director. The essence of the provision[84] is that the claimants of the declaratory action, i.e. the first litigation,[85] may request the court to order the director as defendant to provide financial security for the case if – typically later, in the second litigation (action for performance)[86] – the court finds the director liable for wrongful trading and obliges him to pay compensation to the creditors on pro rata basis. Should the judgement ordering the former director to pay compensation to the creditors turn out to be unenforceable, e.g. because the director is impecunious, then the creditors as claimants will be able to recover their claims approved by the court from the financial security. Up to this point the system is consistent, if not really efficient. However, the statute goes further. The majority shareholder of the debtor company shall be deemed, by force of law, as a guarantor regarding the financial security if the latter cannot be recovered from the director. Practically, by this provision the legislator expanded the liability for wrongful trading, originally targeting the managers of the company, to the majority shareholders. Thereby, beyond providing an apparent benefit to the creditors, the

81 P. L. Davies, S. Worthington and E. Micheler, Principles of Modern Company Law (2016, Sweet & Maxwell, London) pp. 191-206.

82 See § 3:2(2) and § 3:324. § (3, Civil Code; § 63(2) and § 63/, HIA; § 118/A, Act V of 2006 on Public Company Information, Company Registration and Solvent Winding-up Proceedings.

83 Regarding the IA see Goode, above note 35, p. 668.

84 § 33/A(2), HIA.

85 See above under the heading *4.4.2 Who initiates the wrongful trading litigation and benefits from it?*

86 *Ibid*.

legislator virtually eliminated the, otherwise very real, conflict of interests between directors and the majority shareholders arising from the threat of liability for wrongful trading.

4.4.5 Professional Advisers are not Statutorily Exempted from the Category of Shadow Director

The IA provides that a person is not deemed a shadow director by reason only that the directors act on advice given by that person in a professional capacity.[87] Of course, if they cross the line and move from advising to instructing this exemption will not protect them.[88]

No similar exemption exists in the Hungarian statute. The widely drafted definition[89] of shadow director may, in theory, include those who advised the debtor company in a professional capacity (e.g. solicitor or accountant). However, there are no apparent cases in which Hungarian courts established the liability of a professional adviser as shadow director.

Another aspect of the involvement of professional advisers is whether that has any effect on the liability of the director. In England, courts have been prepared to place weight upon the evidence as to whether the directors took professional advice, and if so, what that advice was.[90] It appears that asking for and following the advice of an informed professional is a strong defence against wrongful trading claims.[91] No similar case law appears to exist in Hungary.

4.5 Some further Critical Questions

4.5.1 The Question of "New Creditors"

One of the crucial, partially ethical, question emerging when a company operates on the verge of insolvency is the treatment of "new creditors". When a company continues operating after the critical date,[92] normally new debts incur. This is because, in order to generate revenues and performing its obligations *vis-à-vis*

87 Section 251, IA.

88 L. Doyle and A. Keay (eds.), Insolvency Legislation: Annotations and Commentary (2016, Jordan Publishing, Bristol) p. 380.

89 § 33/A(1), HIA.

90 *Hawkes Hill Publishing Co Ltd (In Liquidation), Re* [2007] BCC 937 az paragraph 43; *Continental Assurance Company of London plc* [2007] 2 BCLC 287 at paragraph 108; *Ralls Builders* [2016] EWHC 243 (Ch) at paragraph 176-177, 206.

91 F. Oditah, "Wrongful trading" (1990) Lloyd's Maritime and Commercial Law, p. 208.

92 In England when they know or should conclude that there no reasonable prospect to avoid insolvent liquidation and in Hungary when the director foresees or should reasonably foresee that the debtor company will not be able to satisfy its liabilities when due. See above under the heading *4.4.1 What should the director foresee?*

their partners, the debtor company more often than not needs to purchase material, order services, involve sub-contractors, accept new orders, etc. In principle, this is not contrary to the obligation of the director to take every step with a view to minimising the potential loss to the company's creditors in the critical period.[93] After all, if the trade out is successful and the company regains its solvency then no creditor's claims remain unpaid. However, in the event of a failure of rescue the new creditors, i.e. those whose debts arose during the critical period, find themselves in the situation as if they were, typically involuntarily, used to finance the attempt to rescue the debtor company at their own risk. Moreover, in several cases they have to face the fact that some of the "old creditors" (i.e. those whose claim arose prior to the critical period) were simply paid off from the money coming from the new creditors.

Some legal systems, e.g. the German, handles this question differently. When applying the German "counterpart" of wrongful trading provisions, the so-called *"Insolvenzverschleppungshaftung"* (liability for delaying insolvency), German courts distinguish between old and new creditors. While the former ones receive *"Quotenschaden"* (i.e. the diminution after comparing the hypothetical dividend that would have been payable to the creditors at the time when the company should have filed for insolvency and the actual dividend expressed as a percentage of the nominal claims), the new creditors generally retrieve their total losses which are not to be claimed by the liquidator.[94] In other words, when considering the damage has been caused by the delay in the commencement of the insolvency, German law focuses on the position of the creditors rather than the position of the company.[95]

By contrast, section 214 of the IA apparently looks at the loss suffered by the company, and consequently, by the general body of creditors, rather than the individual creditors. As Snowden J explained:

> "Standing back, whatever other criticisms can be made of the manner in which the Directors conducted the business of the Company [in the critical period], I think it is entirely plausible that such continued activity did not cause loss *to the Company overall or worsen the position of the creditors as a whole* [emphasis added]. The real sin of the Directors, so far as the unsecured creditors left in the liquidation are concerned, is the manner in which the continued trading facilitated the repayment of the Bank and some existing creditors whilst leaving

93 Section 214(3), IA; § 33/A(3), HIA.

94 Bachner, above note 28, 311 ff; Spindler, above note 17, p. 47.

95 *Ibid*, p. 311.

> new creditors unpaid. I have already indicated my view that this is not something that the Directors ought to have permitted to occur, but for the reasons I have explained, I cannot see that it justifies a contribution to be made to the assets of the Company under section 214(1). That may be thought to be a shortcoming in the structure of section 214 [the provision on wrongful trading], but I do not think it is one that I can remedy: any such change would be for Parliament."[96]

Having said that, this does not mean that the directors should irresponsibly use the new creditor's means to help the company survive or pay off some other due debts. Namely, such behaviour may trigger liability for fraudulent trading pursuant to section 213 IA.[97] In general, fraudulent trading is committed if the company obtains new credit, knowing it will be unable to repay it when due in order to pay off existing creditors.[98] The threshold of proof, of course, is higher as compared to that of wrongful trading. Namely, in order that the liability for fraudulent trading be established it is necessary to prove that the business has been carried out with intent to defraud creditors, that the defendant participated in carrying on the business, and that the defendant did so with knowledge about the fraudulent intention.

As with the English provisions, the Hungarian subspecies of wrongful trading also focuses on the interest of the general body of the creditors. The monetary limit of the compensation is the decrease of the asset pool of the debtor company in the period of the imminent insolvency.[99] Consequently, if there is no loss, there is no liability. Apparently, the current provisions of the liability for wrongful trading, like the English statute, are not designed to differentiate between "old" and "new" creditors.

But again, as with the English provisions, there is some protection for those creditors whose claims arose when there was virtually no chance that the debtor would be able to pay them off. Although there is no statutory rule in Hungary corresponding to English civil remedy of fraudulent trading, fraud as a general criminal offence appears to cover this kind of behaviour.[100]

96 *Ralls Builders* [2016] EWHC 243 (Ch) at paragraph 279.

97 Regarding the criminal liability for fraudulent trading see Section 993, Companies Act.

98 *R v Grantham* [1984] QB 675; Goode, above note 35, p. 661-662.

99 See above under the heading *4.3.5 The quantitative limit of the compensation*.

100 BH2011. 58. (Legf. Bír. Bfv. II. 1040/2009.)

4.5.2 Which Creditors can be Lawfully Paid off During the Critical Period?

We have seen before that section 214 of the IA is basically neutral regarding payment to selected creditors. What matters is the overall position of the company rather than the position of singular creditors. Similarly, fraudulent trading pursuant to section 213 of the IA is generally not implicated by payment of preferences. The mere fact of preferring one creditor will not in itself qualify as fraudulent trading.[101] Of course, other legal grounds for liability like the provisions on preferences[102] and misfeasance[103] may come into play.

In Hungary, there is a degree of uncertainty as to what constitutes the diminution of assets and which payments by the debtor, diminishing the asset pool, are deemed lawful. In several judgements, the question of the increase of the deficiency (i.e. the worsening of the position of the general body of creditors) on the one hand and that of the lawfulness of such increase on the other hand are not handled as separate questions. The following main directions can be distilled from case law.

The majority opinion, confirmed by the Curia suggests that wrongful trading provisions are designed to protect the assets of the debtor company.[104] Consequently, if the asset pool diminishes in the critical period, even if through paying off some legitimate debts to the creditors, this amounts to the diminution of assets for the purposes of the wrongful trading provisions. However, this does not necessarily mean that such diminution is unlawful, as we are going to see below.

A minority of the decisions concluded that in the event both the assets and the liabilities decreases, e.g. by paying off one or more legitimate creditors with due claims, this is not a diminution of assets for the purposes of wrongful trading.[105]

As to the question asking which creditors may lawfully be paid off in the critical period, even if at the price of diminishing the asset pool, diverging answers can be found in the case law. At the one end of the scale there are a few judgements concluding that no payment is allowed which diminishes the assets of the debtor company.[106] At the other end of the scale are those decisions ruling that payments

101 *Sarflax Ltd, Re* [1979] Ch 592.

102 Section 239, IA.

103 Section 212, IA; *Liquidator of West Mercia Safetywear Ltd v Dodd* [1988] 4 B.C.C. 30; Goode, above note 35, 652 f.

104 Kúria Gfv.VII.30.024/2015/4., Kúria Gfv.VII.30.265/2015/4., BH2016. 179. (Kúria Gfv. VII. 30.254/2015.), ÍH 2013.37. (Szegedi Ítélőtábla Gf. I. 30.344/2011.), Fővárosi Ítélőtábla 12.Gf.40.343/2012/7., Fővárosi Ítélőtábla 15.Gf.40.043/2015/5/II.

105 E.g. Debreceni Ítélőtábla Gf.III.30.387/2012/5; Pécsi Ítélőtábla Gf.IV.40.022/2015/4; Szegedi Ítélőtábla Gf.IV.30.105/2013/5.

106 Kúria Gfv.VII.30.265/2015/4; Legfelsőbb Bíróság Gfv.IX.30.432/2010/4.

to legitimate creditors, including shareholders, do not violate the prohibition of wrongful trading,[107] as long as both the assets and liabilities diminish in equivalent proportions.[108]

What appears to be the majority opinion is that payments to related persons (first of all to the shareholders of the debtor company) are not acceptable.[109] A number of judgements agree that from the point of view of the liability for wrongful trading a distinction must be made between outsider creditors on the one hand and the shareholders of the company. The repayment of the shareholder's loan may not frustrate the settlement of claims belonging to outsider third party creditors. Some judgements and authors have emphasised that a director, when deciding about payments to be performed during the critical period, should make sure that the specific payment serves the restoring of the solvency, the enabling of the continued operation, thus the interests of the general body of the creditors.[110]

Hungarian courts appear to accept that payments to those secured creditors whose claim would be covered by the assets anyway in a hypothetical insolvent liquidation scenario does not trigger liability for wrongful trading.[111]

As with the English law, the fact that some payments to selected creditors do not constitute wrongful trading liability does not mean that the payment in question would not be targeted by provisions on preferences.[112]

4.5.3 "Pull the Plug" Scenario

Sometimes a decision whether to continue the operation or to shut down the business can be difficult indeed. This is the situation if the company is insolvent or is in the state of imminent insolvency, the survival is rather questionable and the chances are that, if the attempt to trade out of insolvency turns out to be unsuccessful, then the general body of creditors finds itself in a situation worse than it would have been if the debtor had filed for insolvency earlier. What are directors expected to do in such situation?

107 But it may well be incompatible with the rules on preferences, see § 40, HIA.

108 Fővárosi Ítélőtábla 12.Gf.40.469/2013/5; Pécsi Ítélőtábla Gf.IV.30.117/2013/8; Pécsi Ítélőtábla Gf.IV.40.022/2015/4.

109 Kúria Gfv.VII.30.193/2013/8; Debreceni Ítélőtábla Gf.IV.30.008/2015/5; Szegedi Ítélőtábla Gf.III.30.401/2014/2; BDT2014. 3241 (Szegedi Ítélőtábla Gf. I. 30 509/2012); Győri Ítélőtábla Gf.II.20.117/2015/3; BDT2013. 2881 (Szegedi Ítélőtábla Gf. I. 30 276/2011.). Similarly, Csőke, above note 43, p. 132.

110 BDT2014. 3241 (Szegedi Ítélőtábla Gf. I. 30 509/2012); Győri Ítélőtábla Gf.II.20.117/2015/3; Debreceni Ítélőtábla Gf.IV.30.008/2015/5. Similarly, Csőke, above note 43, p. 132.

111 Kúria Gfv.VII.30.040/2012/3; ÍH 2013.37. (Szegedi Ítélőtábla Gf. I. 30.344/2011).

112 See § 40, HIA; BH2016. 179 (Kúria Gfv. VII. 30.254/2015); ÍH 2013.37 (Szegedi Ítélőtábla Gf. I. 30.344/2011); Pécsi Ítélőtábla Gf.IV.30.117/2013/8; Szegedi Ítélőtábla Gf.IV.30.105/2013/5.

The emblematic sentences of Park J., which sum up the diverging incentives influencing the decision of the managers, are worth citing in this regard:

> "An overall point which needs to be kept in mind throughout is that, whenever a company is in financial trouble and the directors have a difficult decision to make whether to close down and go into liquidation, or whether instead to trade on and hope to turn the corner, they can be in a real and unenviable dilemma. On the other hand, if they decide to trade on but things do not work out and the company, later rather sooner, goes into liquidation, they may find themselves in the situation of the respondents in this case—being sued for wrongful trading. On the other hand, if the directors decide to close down immediately and cause the company to go into an early liquidation, although they are not at risk of being sued for wrongful trading, they are at risk of being criticised on other grounds. A decision to close down will almost certainly mean that the ensuing liquidation will be an insolvent one. Apart from anything else liquidations are expensive operations, and in addition debtors are commonly obstructive about paying their debts to a company which is in liquidation. Many creditors of the company from a time before the liquidation are likely to find that their debts do not get paid in full. They will complain bitterly that the directors shut down too soon; they will say that the directors ought to have had more courage and kept going. If they had done, so the complaining creditors will say, the company probably would have survived and all of its debts would have been paid. Ceasing to trade and liquidating too soon can be stigmatised as the cowards' way out."[113]

What appears to be certain in the context of the English law is that there is, of course, no obligation to cease operating once the company becomes insolvent, even if the situation is so hopeless that there is no prospect of saving the company. In this case, the continuation of operations may still diminish the net deficiency so that the general body of creditors is better off than it would have been in the event of an early filing.[114] Even if the continued trading happened to increase the net deficiency, the director who tried to save the business may still have some chance to rely on the statutory defence by proving that he took every step with a

113 *Re Continental Assurance plc* [2001] BPIR 733 at paragraph 281.

114 *Ralls Builders* [2016] EWHC 243 (Ch) at paragraphs 185, 268-270.

view to minimising the potential loss to the creditors, assuming it was designed appropriately so as to minimise the risk of loss to individual creditors.[115]

The risks connected to the opposite situation, i.e. when the manager decides to stop trading and file for insolvency even though there was still reasonable prospect to avoid going into insolvent liquidation, is less clear. As we have seen above, Park J. seems to suggest that in this case directors are not at risk of being sued for wrongful trading.[116] This appears to be logical. Wrongful trading liability is attached to the continuation of trading in the critical period, i.e. when the director knew or ought to have concluded that insolvent liquidation cannot reasonably be avoided. If there is no such critical period or it is very short simply because the director filed for insolvency once the situation started to become critical, there appears to be no basis for the application of section 214 of the IA.

In Hungary, the "pull the plug" scenario is sometimes regarded as a safe harbour by advisers and directors striving to avoid personal liability for wrongful trading. Indeed, while on the one hand wrongful trading provisions do not seem to restrain directors from attempting to save debtor companies through continuing operation as long as the operation and the associated payments are not contrary to the interests of the general body of creditors, on the other hand, those provisions do not prohibit or penalise early filing, either. Having said that, directors may be liable *vis-à-vis* the company (thus indirectly to the shareholders and the creditors) on a legal basis different[117] from wrongful trading if they let the company go into insolvent liquidation despite the opportunity to dissolve the company through solvent liquidation proceedings.[118]

5 The Diverging Case Law

Despite the visibility of the wrongful trading concept both in England and abroad, section 214 of the IA has not been often used. There have only been a small number of reported cases.[119] What generally can be said about the case law is that courts do not appear prepared to impose liability on directors, and this is particularly so if the directors have sought and obtained advice from professionals. Accordingly,

115 *Ibid,* at paragraph 245.

116 Goode, above note 35, pp. 667, 673-674 is of the opposite view.

117 E.g. a derivative claim for compensation brought by the liquidator on behalf of the insolvent debtor company, § 3:24(1), Civil Code; or a shareholder's claim for compensation *vis-a-vis* the director, § 3:117(3), Civil Code.

118 BDT2012. 2782. (Szegedi Ítélőtábla Gf. I. 30 346/2011.)

119 A. Keay and P. Walton, Insolvency Law, Corporate and Personal (2012, Jordan Publishing, Bristol), p. 659.

in most cases where directors have been found liable they have been found to have acted *irresponsibly*.[120] As Park J. summarised:

> "Typically they have been cases [where directors have been held to be liable] in which the directors closed their eyes to the reality of the company's position, and carried on trading long after it should have been obvious to them that the company was insolvent and that there was no way out for it. In those cases the directors had been irresponsible, and had not made any genuine attempt to grapple with the company's real position."[121]

In *Produce Marketing,*[122] the directors ignored the warning of the auditors and continued trading. Beyond, the affairs of the debtor were conducted in a way which reduced the indebtedness to the bank, to which one of the directors had given a guarantee, at the expense of trade creditors. In *Re Purpoint,*[123] the director failed to ensure that proper records were kept and that proper cash flow calculations and net worth calculations were made, therefore it was impossible to ascertain the extent to which the net liabilities were increased by the continuance of the company's trading. In *Re Bangla Television,*[124] instead of causing the company to cease trading, the directors caused the company to deal or purportedly trade with its assets so that the company parted with £250,000 worth of them for no consideration.

By contrast, there have been a relatively high number of cases reported in Hungary in the recent years. It appears that more than 300 cases reached the courts of appeal, most of them after 2010. Taking into consideration the difference in size of the two countries, we can say that wrongful trading litigation is much more widespread in Hungary than it is in England. Based on the review of the cases, it can be said that in Hungary, a successful wrongful trading litigation presupposes an element of fraud in a wide sense, the term including preferential payments to affiliated entities as well.

Among other things,[125] Hungarian courts held directors liable who had repaid shareholders' loans in the critical period while no assets were available for

120 Morris v Bank of India [2005] EWCA Civ 693 at paragraph 103; *ibid*, p. 659.; A. Keay, above note 23, p. 130.; Doyle and Keay (eds.), above note 87, p. 298.

121 *Re Continental Assurance plc* [2001] BPIR 733 at paragraph 106.

122 *Produce Marketing Consortium (In Liquidation) Ltd, Re (No.2)* [1989] 5 BCC 569.

123 *Purpoint Ltd, Re* [1991] BCC 121.

124 *Bangla Television Ltd (In Liquidation), Re* [2009] EWHC 1632 (Ch).

125 On the behaviours of executives normally giving rise to personal liability see Summary Opinion, above note 44, pp. 21-23.

unsecured creditors.[126] Also, providing loans to affiliated companies and/or (asset-less) third parties without any security interests, thereby diminishing the asset pool available to the creditors, amounted to wrongful trading.[127] Similarly, directing payments originally due to the debtor company to another (affiliated) entity in the vicinity of insolvency may trigger the director's personal liability.[128] Entering into notional contracts in order to dissipate the debtor's assets[129] or a fraudulent transfer of real estate for no real consideration to another (affiliated) company[130] qualified as wrongful trading. Should the director be unable to give an account of the assets indicated in the annual accounts he has to be prepared to be subject to wrongful trading litigation, too.[131]

6 Possible Reasons For Diverging Case Law

As has been shown, there are significant differences in the case law between England and Hungary, both in terms of the number and the substance of the cases.

As to the low number of reported cases in England, the findings of the Leeds Report[132] are instructive. The Report identified a number of obstacles to enforcement vis-à-vis directors who breached their insolvency-related duties.[133] In relation to the United Kingdom, these obstacles seem to be: impecunious directors, cost of litigation, lack of evidence, burden of proof, and lack of funding. The problem of funding and the litigation costs as important obstacles are highlighted by other authors, as well. Because only office holders (liquidators and administrators) have the right to initiate the litigation and no public funding is available, they are rather cautious of risking the debtor's already inadequate assets on litigation unless there is a very strong chance of success.[134] Possibly, the reforms of 2015 giving office

126 BH2016. 179 (Kúria Gfv. VII. 30.254/2015); BDT2013. 2881 (Szegedi Ítélőtábla Gf. I. 30 276/2011); Debreceni Ítélőtábla Gf.IV.30.008/2015/5; Szegedi Ítélőtábla Gf.III.30.401/2014/2.

127 EBH2011. 2326 (Legf. Bír. Gfv. IX. 30.249/2010); Kúria Gfv.VII.30.253/2014/6; ÍH 2013.76 (Fővárosi Ítélőtábla 13. Gf. 40.002/2012/15); BDT2010. 2282 (Pécsi Ítélőtábla Gf. II. 30 266/2009/7); BDT2016. 3499. (Debreceni Ítélőtábla Gf. IV. 30 369/2015/6).

128 BH2014. 188 (Kúria Gfv. VII. 30.247/2013).

129 BH2012. 101 (Legf. Bír. Gfv. X. 30.361/2010); BH2013. 222 (Kúria Gfv. VII. 30 036/2013).

130 Fővárosi Ítélőtábla 12.Gf.40.013/2015/6-II.

131 Legfelsőbb Bíróság Gfv.IX.30.432/2010/4; BDT2008. 1767 (Szegedi Ítélőtábla: Gf. I. 30.099/2006).

132 Above note 20.

133 *Ibid*, pp. 62 ff.

134 Davies, Worthington and Micheler, above note 80, pp. 217-218; Keay and Walton, above note 118, pp. 659-660. The abolition of the "Jackson exemption" for insolvency in April 2016 is expected to have a negative impact on the insolvency litigation in the UK, see Walton Report, above note 24, p. 11. By contrast, the new section 15A of the Company Directors Disqualification Act 1986 creates a new alternative way of director's liability by giving the court a new power to make a compensatory award against a director at the time it makes a disqualification order.

holders the statutory right to assign wrongful trading claims or the proceeds of such action[135] will somewhat improve the situation.

In relation to Hungary, the Leeds Report mentioned all the obstacles identified in relation to England plus a time factor. Without calling into question that all of these factors may play some role in the initiation of wrongful trading litigation, it must be noted that the high number of cases in Hungary seem to suggest the relative insignificance of such obstacles. The huge gap in terms of the number of cases heard in England and Hungary necessitates some explanation, however.

First of all, the Hungarian wrongful trading litigation is not reserved for office holders. By contrast, both the liquidator and any creditor have the right to bring actions for a declaration of liability for wrongful trading.[136] In reality, a significant percentage of the reported cases were commenced by creditors, not infrequently by the tax authority.[137] The fact that the pool of the claimants is bigger may increase the number of cases by itself. Beyond this, in some cases the wide pool of the potential claimants, particularly those with "deep pockets" like the tax authority, contributes to overcoming obstacles like the lack of funding and the costs of litigation. Also, the relatively modest cost of the litigation may be a factor contributing to the popularity of this remedy in Hungary.[138]

Beyond these above points of a somewhat "technical" nature, there are also some substantive differences that may potentially explain the high number of cases. In this regard two main factors should be referred to. First, as we have seen above, the level of knowledge "expected" from directors, i.e. what they could or should have been able to foresee, is rather different in Hungary from the English model. While in England, in order to activate liability for wrongful trading, it is necessary that the director knew or ought to have concluded that there was no reasonable prospect to avoid going into insolvent liquidation or administration (on balance sheet basis), while in Hungary a much lower level of knowledge suffices: the period of imminent insolvency begins when the directors were or should have been reasonably able to foresee that the debtor company would not be able to satisfy its liabilities when due (on cash-flow basis). As a consequence, this element of the wrongful trading materialises frequently. Second, the statutory presumption in Hungary, according

135 Section 246ZD, IA; Davies, Worthington and Micheler, above note 80, pp. 218.

136 § 33/A(1), HIA.

137 Summary Opinion, above note 44, p. 16; R. Muzsalyi, "A joggyakorlat-elemző csoport által vizsgált ítéletek alapján levonható statisztikai következtetések [Statistical Conclusions from the Judgements Analysed by the Expert Group]" (2016) (Annex No 9 to the Summary Opinion), pp. 99-104.

138 The stamp duty to be paid for the first instance declaratory action is approx. GBP 100. See §§ 39 and 42, Act XCIII of 1990 on Duties; 1/2013. (II. 28.) Polgári jogegységi határozat [Civil uniformity decision].

to which the violation of the interests of the creditors is presumed if the director has not deposited and published the debtor's annual accounts prior to the opening of liquidation proceedings or breached his obligation to cooperate with the liquidator and to provide him with the relevant information and documentation, plays an important role in a not insignificant number of wrongful trading litigations.[139]

Looking at the substances of the cases it can be observed that most (if not all) of the cases where the courts have established the personal liability for wrongful trading involved an element of fraudulence by the director. However, this element of fraudulence is to be understood widely: cases in which the defendant prioritised affiliated entities or shareholders over outsider creditors seem to suffice to trigger the liability for wrongful trading, assuming the further ingredients are also present.[140]

It appears that the implementation of the wrongful trading provisions in Hungary making possible to sue former directors for compensation of the damage caused to the creditors of the company during the period of imminent insolvency opened an invisible door for lawsuits against directors. This is most probably because prior to the implementation of the rules on wrongful trading there were no efficient civil law remedies protecting the interests of the creditors in the vicinity of the insolvency.[141] Undoubtedly, liquidators had been (and still are) free to initiate a kind of derivative claim for compensation in the right of the insolvent company.[142] However, the scope of those derivative actions are somewhat different from the wrongful trading actions. The prohibition of wrongful trading is designed to protect the interests

139 E.g. BH2012. 101 (Legf. Bír. Gfv. X. 30.361/2010); Kúria Gfv.VII.30.059/2015/5; Kúria Gfv.VII.30.024/2015/4; ÍH 2013.37 (Szegedi Ítélőtábla Gf. I. 30.344/2011); ÍH 2013.76 (Fővárosi Ítélőtábla 13. Gf. 40.002/2012/15); BDT2012. 2619. (Szegedi Ítélőtábla Pf. I. 20.498/2010); Fővárosi Ítélőtábla 12.Gf.40.013/2015/6-II; Fővárosi Ítélőtábla 15.Gf.40.043/2015/5/II. In around 36% of the cases the statutory presumption applies, see Lakatos, above note 76, p. 82.

140 See above under the heading *5 The diverging case law*.

141 2006. évi VI. törvény indokolása a csődeljárásról, a felszámolási eljárásról és a végelszámolásról szóló 1991. évi XLIX. törvény módosításáról [Statement of reasons given for the Act VI of 2006 amending the HIA]. Having said that, in some cases courts have decided to lift the corporate veil on the basis of the general civil law declaring that the defendant-directors abused the shield of limited liability. See Szegedi Ítélőtábla Polgári Kollégium 2/2008 (XII. 4) számú kollégiumi véleményével módosított, egységes szerkezetbe foglalt 1/2005. (VI. 17) számú kollégiumi véleménye a jogi személy elkülönült felelősségéről és a felelősség „áttöréséről" [1/2005 (VI. 17) opinion of the Regional Court of Appeal Szeged (Civil Division) about the separate liability and the "lifting of the corporate veil" as amended and consolidated by 2/2008 (XII. 4) opinion of the same court]; BDT2002. 631 (Csongrád Megyei Bíróság 1. Gf. 40 298/1999/3); BDT2012. 2707 (Szegedi Ítélőtábla Gf. I. 30 146/2011). Some authors argue that this case law is *contra legem*, see Sz. Patai and S. É. Szabó, "A működő jogi személy elkülönült felelősségének áttörése az EDB 2014.11.G3. ítélet tükrében [Lifting of the corporate veil of an operative (i.e. non-insolvent) company in the light of decision EDB 2014.11.G3]", (2016) (3) Polgári Jog [electronic journal]. After the entering into force of the new Civil Code this case law appears to be unsustainable, see P. Gárdos and L. Vékás (eds), Kommentár a Polgári Törvénykönyvről Szóló 2013. évi V. törvényhez [Commentary on the Civil Code] (2014, Wolters Kluwer, Budapest) [electronic edition], Chapter LXIX.

142 § 3:24(1), Civil Code.

of the creditors by making directors liable for the diminution of the asset pool, thus for losses suffered, indirectly, by the unsecured creditors in the period of imminent insolvency. By contrast, the derivative action initiated by the liquidator on behalf of the company is designed to make the directors liable for losses caused to the company itself. In the latter case the fact that the directors disregarded the interests of the creditors is irrelevant. Consequently, it is more than questionable whether a director following the instructions of the majority shareholder or acting in compliance with the resolutions of the shareholder's meeting could be held liable, without the special rules on wrongful trading, for losses suffered by the company. E.g. paying off due and lawful shareholder's loans prior to outsider commercial creditors, while this is apparently a violation of the wrongful trading rules, it seems to be out of the scope of the derivative compensatory action.[143]

7 Some Conclusions

Should the Hungarian legislation on wrongful trading therefore be regarded as a legal transplant of its English counterpart? The answer is yes, with some reservations. It was the apparent decision of the Hungarian legislature to create special rules on director's liability *vis-à-vis* creditors in the context of insolvency. Both the wording and certain basic ingredients of the Hungarian provisions suggest that the Hungarian rules were inspired by the English example. Both provisions are intended to protect creditors' interests in the vicinity of insolvency, the basis of the liability is the loss caused to the creditors in the critical period, the starting point of the liability, at least in theory, precedes the factual insolvency etc. On the other hand, on at least at one crucial point, the Hungarian legislator deviated from the English template. In England, the insolvent trading in itself does not trigger personal liability. Should the director reasonably believe that the company can trade out of difficulties, so that balance sheet insolvency is avoidable, there is no liability. By contrast, in Hungary the mere knowledge or anticipated knowledge about an, even temporary, cash-flow insolvency is enough for directors to enter into the danger zone.

The differences in the case law, first of all in terms of the quantity of cases in Hungary appears to be attributable, principally, to the broader pool of the potential defendants stemming from the widely formulated statutory provisions regarding the critical period, the broader pool of the claimants arising from the legal standing

143 By contrast, there appear to be misconducts which may trigger either types of liability; see BDT2013. 2897 (Debreceni Ítélőtábla Gf. III. 30 617/2012/6); BDT2008. 1767 (Szegedi Ítélőtábla: Gf. I. 30.099/2006); EBH2011. 2417 (Legf. Bír. Pfv. X. 21.462/2011).

of creditors, the statutory presumption supporting the claimants' case and the modest litigation costs.

However, if we have a look at the substantially different nature of the case law, it becomes apparent that this may not follow from the differences of the statutory provisions. As we have seen, while English directors are normally found liable where they have acted irresponsibly, in Hungary courts tend to hold directors personally liable when an element of fraudulence in a wide sense can be detected. At the first sight, it may seem a paradox that the caseload is more substantial in Hungary despite the higher threshold of misconduct (fraudulence instead of irresponsibility). However, the real reason behind this phenomenon is probably different. It appears, that the provisions on the personal liability of directors for wrongful trading, imported by Hungary back in 2006 with no ancestors in the Hungarian law, have found their place in the Hungarian legal system covering a wider circle of misconduct and incorporating actions which would fall within the scope of other actions in England, first of all that of the fraudulent trading or misfeasance.[144] This demonstrates that the transfer of certain legal institutions from one country to another without having regard to the wider context of the legal systems, however successful they are, does not necessarily result in legal harmonisation. Perhaps the term "legal naturalisation" may be more appropriate to describe the story of the liability for wrongful trading in Hungary.

144 See above note 24.

Chapter 6

Directors in the Twilight Zone - *Kornhaas* and "Beyond" – some Observations from a Dutch Perspective

Loes Lennarts

1 Introduction

In its judgment in the *Kornhaas*[1] case the Court of Justice of the European Union (CJEU) ruled that the liability of company directors under German company law for making payments after the "moment of truth" falls within the scope of Art. 4 of the European Insolvency Regulation.[2] This means that when insolvency proceedings are opened against a company in Germany, the German provisions on director liability for making payments after "the moment of truth" apply as part of the *lex concursus*. The fact that these provisions are part of German company law (par. 64 of the German Act on Private Limited Liability Companies (GmbHG))[3] is not considered decisive for their qualification under the regime of the EIR. In this contribution, I will analyse the implications of this judgment from a Dutch perspective and I will link these implications to the perspectives for European harmonization of insolvency-related directors liability rules.

I will start with a brief outline of the *Kornhaas* case (section 2). Then I will make some observations on the phenomenon of 'insolvencification', relabeling or characterising provisions of company law as insolvency law provisions, so they can be applied to foreign-incorporated companies subjected to domestic insolvency proceedings (section 3). I will explore what this judgment means for claims brought against directors of insolvent companies under Dutch law. To this end, I will discuss the liability risks that may arise for directors in the twilight zone under Dutch law. I will show that they may be faced with a fairly broad range of potential director liability claims, based on provisions of company law and tort law

1 *Simona Kornhaas v Thomas Dithmar als Insolvenzverwalter über das Vermögen der Kornhaas Montage und Dienstleistung Ltd* (C-594/14) [10 December 2015] CJEU (*Kornhaas*).

2 Council regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings (OJ L 160) (Hereafter referred to as the EIR).

3 *Gesetz betreffend die Gesellschaften mit beschränkter Haftung* (hereafter referred to as the "GmbHG").

(section 4). Particular attention will be paid to claims against directors for making (or allowing) preferential payments. I will show that the *Kornhaas* judgment does not answer the question which law applies to director liability claims for making preferential payments based on Dutch law (section 5). I will then sketch a few scenarios to illustrate the uncertainties that may arise in cross-border corporate insolvencies in respect of the law applicable to insolvency-related director liability claims (section 6). In the final part of this essay I will look "beyond" *Kornhaas* by discussing the perspectives for harmonisation of insolvency-related director liability (section 7).

2 CJEU *Kornhaas*

The facts of the *Kornhaas* case are straightforward. Ms. Kornhaas was the director of Kornhaas Montage und Dienstleistung Ltd (KMD). This company was incorporated under English law but it was mainly active in Germany, where a branch of KMD had been entered into the companies register. Main insolvency proceedings were opened in Germany in respect of KMD and Mr. Dithmar was appointed as the trustee ('Insolvenzverwalter'). Mr. Dithmar brought a directors' liability claim against Ms. Kornhaas, stating that Ms. Kornhaas had - in her capacity as director - made payments on behalf of KMD to the amount of €110,151.66 during a period before the opening of insolvency proceedings when the company was already insolvent. This claim was based on Par. 64 of the GmbHG, which prohibits directors from making payments after the 'moment of truth': cash flow or balance sheet insolvency. It should be noted that when the litigious payments in the *Kornhaas* case were made, Par. 64 GmbHG still consisted of two sections, the first of which contained an obligations for company director to file for the opening of insolvency proceedings within 21 days from cash flow or balance sheet insolvency. This section was transferred to Par. 15a of the German Insolvency Statute in 2008.[4] The former second section was retained in Par. 64 GmbHG and reads as follows:

> "The directors shall be obligated to compensate the company for payments made after the company has become illiquid or after it is deemed to be over-indebted. This shall not apply to payments which, after this point in time, are compatible with the due diligence of a prudent businessman. The same obligation shall affect the directors in regard to payments to shareholders if these led to the company

4 The text of the German Insolvency Statute is available in English at http://www.gesetze-im-internet.de/englisch_inso/.

becoming illiquid, unless this was not recognisable whilst observing the due diligence referred to in the second sentence. [...]"[5]

Mr. Dithmar's claim against Ms. Kornhaas was successful in first instance. On appeal, this judgment was confirmed by the Higher Regional Court of Jena, which gave permission to have the case reviewed by the German Federal Court of Justice on a point of law.

The German Federal Court of Justice referred the case to the CJEU for a preliminary ruling on the following questions:

(1) Does an action against the director of an English private limited company that is subject to insolvency proceedings opened in Germany fall within the scope of Art. 4 EIR, having regard to the fact that the action is brought by the trustee of the insolvent company and that the trustee seeks reimbursement of payments made by the director before the opening of the insolvency proceedings but after the date on which the insolvency of the company was established?

(2) Does an action as referred to above infringe the freedom of establishment under articles 49 and 54 TFEU[6]?

2.1 The First Question

In answering the first question, the CJEU refers to its decision in the case *H. v H.K.*[7] relating to jurisdiction in respect of claims based on par. 64 GmbHG. In its judgment in that case, the CJEU held that the courts of the Member State in the territory of which main insolvency proceedings regarding a company's assets have been opened also have jurisdiction on the basis of Art. 3(1) EIR to hear and determine an action based on par. 64 GmbHG brought by the trustee against the managing director of the insolvent company. That decision was based on the view that par. 64 GmbHG derogates from the common rules of civil and commercial law and that an action brought on this provision, brought in the context of insolvency proceedings, is an action deriving directly from and closely connected with insolvency proceedings. In addition to this, the CJEU stresses the link between the (then) two sections of par. 64 GmbHG, the first of which contains a duty to file for the opening of proceedings. Art. 4(2) EIR provides that the lex fori concursus determines the conditions for the opening of the insolvency proceedings. This means, according to the CJEU, that rules designating the persons who are obliged

5 The text of the German Limited Liability Companies Act is available in English at http://www.gesetze-im-internet.de/englisch_gmbhg/englisch_gmbhg.html#p0408.

6 Treaty on the Functioning of the European Union (OJ C 326).

7 *H v HK* (C295/13) [4 December 2014] CJEU.

to file and the consequences of an infringement of such an obligation fall within the scope of Art. 4(2) EIR. Secondly, the CJEU stresses the link between (then) section 2 of pa. 64 GmbHG and provisions allowing for the avoidance of pre-insolvency transactions. According to the CJEU, par. 64(2) GmbHG appears at least similar to a rule laying down the "unenforceability of legal acts detrimental to all the creditors" which, under Art. 4 (2) (m) falls within the scope of the *lex concursus*.

The arguments mentioned above bring the CJEU to the conclusion that the claim for reimbursement brought by Mr. Dithmar against Ms. Kornhaas is governed by the *lex concursus*: German law. This means that directors of English limiteds with their centre of main interests in Germany should in the event of insolvency have due regard to the duty laid down in par. 64 GmbHG. The *Kornhaas* judgment has shed some light on the question to what extent director liability provisions connected to insolvency fall within the scope of Art. 4 EIR/7 EIR (Recast). Uncertainty will remain, however, because the *Kornhaas* judgment is quite fact-specific. Member States' company statutes will contain insolvency-related director liability provisions that are very different from par. 64 GmbHG. In respect of those provisions, the question may still arise whether they are governed by the *lex concursus* or the *lex societatis*. What if, for example, a particular director liability claim arises only upon insolvency of the company but both the trustee and creditors have standing to bring the claim?

2.2 The Second Question

In respect of the second question, the CJEU ruled that the application of par. 64 GmbHG to a company incorporated under the law of another member state does not affect the freedom of establishment because it:

> "in no way concerns the formation of a company abroad or its subsequent establishment in another Member State, to the extent that that provision of national law is applicable only after that company has been formed, in connection with its business, and more specifically, either from the time when it must be considered, pursuant to the national law applicable under Article 4 of regulation 1346/2000, to be insolvent or from the time when its over-indebtedness is recognised in accordance with that national law."

This decision was met with criticism. Ringe commented that the distinction the CJEU makes between rules affecting the formation or establishment in another country and those relating to the conduct of the company's business is not appropriate because Art. 49 TFEU applies to the right to take up *and pursue* activities and to set up *and manage* undertakings.[8] As to the fact that the CJEU seems to 'carve out' measures that operate only when the company is insolvent: this can be seen as an open invitation to Member States seeking to apply certain creditor-protecting provisions to companies incorporated in other Member States to 'insolvencify' these provisions.

3 Insolvencification

Member States can use and have[9] used the technique of 'insolvencification'[10] to facilitate domestic liability provisions to directors of foreign companies in the event that they are subjected to domestic insolvency proceedings. This trend was triggered by case-law[11] of the CJEU on freedom of establishment of companies that virtually outlaws attempts of member states to apply domestic provisions of company law to companies incorporated under the law of another member state to situations.[12] Attempts to apply domestic provisions of company[13] law to companies incorporated in other Member states must pass scrutiny under the so-called *Gebhard*[14]-test. This means that the provisions must be applied in a non-discriminatory manner, they must be justified by imperative requirements in the public interest and they must be suitable and necessary for achieving the envisaged purpose.

Where the CJEU case-law means that founders of companies within the EU are free to choose the law that will apply to their company, this is different for the law

8 Wolf-Georg Ringe, "*Kornhaas* and the Limits of Corporate Establishment", (25 May 2016) Oxford Business Law Blog, available at https://www.law.ox.ac.uk/business-law-blog.

9 An example was mentioned above: the transfer in 2008 of the duty for German company directors to file for the opening of insolvency proceedings from the company statute to the insolvency statute (clearly motivated by the desire to be able to apply this provision to English limiteds that were used to do business in Germany). I note that the Belgian legislator is contemplating a shift from the real seat doctrine to the incorporation theory. This shift may involve the insolvencification of certain liability provisions, in order to enable the application of these provisions to foreign-incorporated companies subjected to insolvency proceedings in Belgium. See Marc van de Looverbosch, "Real Seat Theory v Incorporation Theory: the Belgian Case for Reform", (2017) I.C.C.L.R., at 6.

10 The term *insolvencification* was coined by L. Enriques and M. Gelter in "Regulatory Competition in European Company Law and Creditor Protection", (2006) 7 EBOR, at 450.

11 *Centros Ltd v Erhvervs- og Selskabsstyrelsen* (Case C-212/97) [9 March 1999] CJEU (*Centros*); *Überseering BV v Nordic Construction Company Baumanagement GmbH (NCC)* (Case C-208/00) [5 November 2002] CJEU (*Überseering*); CJEU 30 September 2003, *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd* (Case C-167/01) [30 September 2003] CJEU (*Inspire Art*).

12 See Loes Lennarts, "The Review of the EU Insolvency Regulation - Time to Recognize the Ties that Bind Company Law and Insolvency law?" in M. L. Lennarts & F. Garcimartin (eds), *The Review of the EU Insolvency Regulation: some Proposals for Amendment*, (2012, Report NACIIL), p. 75, available at http://www.naciil.org.

13 It can be argued that domestic insolvency law provisions must also pass the Gebhard-test if they are applied to a company incorporated under the law of another Member State. See Enriques and Gelter, above note 10, p. 450 and W.-G. Ringe, "Forum Shopping under the European Insolvency regulation", (2008) 9(4) EBOR 579-620, at 609.

14 *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* (Case C-55/94) [November 1995] CJEU (*Gebhard*).

that will apply in the event of insolvency of the company. This law is linked to the Member State where insolvency proceedings will be opened in respect of the company. Under the regime of the EIR, main proceedings in respect of a company can be opened by the court of the Member State in which the company has its centre of main interests (COMI), being the place where the debtor conducts the administration of its interests on a regular basis and which is ascertainable to third parties (Art. 3 (1) EIR (Recast))[15]. This is presumed to be the Member State where the company has its registered office, but rebuttal of the presumption is possible. This means - for example - that a UK private limited company may be subjected to insolvency proceedings in Germany if facts are provided that place the COMI in Germany. In this event, according to Art. 4 EIR/7 EIR (Recast), German law will apply to the insolvency proceedings and their effects. The fact that Art. 4 EIR/7 EIR (Recast) does not contain an exhaustive list of matters that are governed by the *lex concursus* creates an incentive for Member States to argue that certain director liability provisions should be characterised as insolvency law. They may try to strengthen this argument by relabeling provisions, by moving them from a company law statute to an insolvency law statute. As was predicted some years ago, the fight against abuse of legal personality has shifted from company law to insolvency law.[16]

The trend of insolvencification is not unproblematic. First, it can be argued that simply characterising or relabeling provisions cannot be a way of avoiding the consequences of Art. 49/54 TFEU. No matter whether a provision is characterised as company law or insolvency law, if it represents a significant impediment to the establishment of a company in another member state, the application of such a provision to a company incorporated under the law of another member state may infringe the freedom of establishment enshrined in the TFEU. It has been submitted by several authors that the *Gebhard*-test applies not only to provisions of company law, but also to other provisions that may have the effect of obstructing the freedom of establishment.[17] It is not the aim of this essay to further explore the freedom of establishment aspects of the *Kornhaas* judgment. In the remainder of this paper the focus will be on a second problem attached to the application of domestic provisions of insolvency law to companies incorporated in another Member State: the inefficiencies caused by the misalignment of director liability provisions in the various domestic laws of Member States.

15 Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (OJ L 141).

16 Sandra van den Braak, "Creditor Protection at the Crossroads of Company law and Insolvency Law: The Dutch Example", (2008) 5 *European Company Law* 229-236, at 236.

17 See Enriques and Gelter, above note 10, p. 450 and Ringe, above note 13,p. 609.

4 Director Liability in the Twilight Zone under Dutch Law

4.1 The Twilight Zone and Risks for Company Creditors

In the so-called 'twilight zone' or 'vicinity of insolvency' there is an incentive for shareholders to engage in opportunistic behaviour. This incentive can be explained by the fact that in the event of insolvency of the company, the shareholders will lose the contributions they have made to the company. They are 'residual claimants', who will only receive payment after all of the company's creditors have been paid. There are two main types of opportunistic behaviour of shareholders in the twilight zone that may create risks for company creditors.

The first risk is that shareholders will try to have assets of the company shifted to them.[18] Legal systems typically try to regulate this behaviour by imposing restrictions on asset shifting. Common forms of such restrictions are transaction avoidance rules in insolvency law and company law rules imposing limits on distributions to shareholders. Because the cooperation of company directors may be necessary to effectuate a transfer of assets to shareholders, legal systems may also impose personal liability on directors who are implicated in asset transfers to shareholders that harm the company's creditors. Typically, asset shifting to shareholders occurs in closely held companies, where the shareholders are directors or can control the board.

The second risk of opportunistic behaviour is wrongful trading, i.e. continuing to trade when there is no reasonable prospect of avoiding insolvent liquidation, thus increasing the deficit of the company. This behaviour can be described as 'gambling with the creditors' money'. Given that trading decisions belong to the power of the company's directors, legal measures aimed at preventing wrongful trading are typically targeted at company directors.[19]

There are two common techniques the legal systems deploy to counter wrongful trading. The first is a duty for company directors to file for the opening of insolvency proceedings after the 'moment of truth', which can be defined in different ways. This method, strengthened by directors' personal liability in case of violation of the duty, suits systems that have a strong preference for court-supervised insolvency proceedings. The underlying presumption is that filing for

18 See L. Lin, "Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors", (1993) 46 Vand. L. Rev. 1485, at 1494. See Paul Davies, "Directors Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of insolvency", (2006) 7(1) EBOR 301-337, at 306.

19 Sometimes the scope of the measures is extended to so-called 'shadow' directors. Shareholders that pull the strings behind the scenes may qualify as such.

court-supervised insolvency proceedings is the best way to serve the interests of the creditors.[20]

The second technique, a duty to refrain from wrongful trading, is less prescriptive. A good example is Section 214 of the UK Insolvency Act.[21] This does not prescribe that directors file for the opening of insolvency proceedings when it is (cash flow or balance sheet) insolvent. Instead, it requires directors who (should) have concluded that there is no prospect of avoiding insolvent liquidation "to take every step with a view to minimising the potential loss to the company's creditors". This means that they can decide that it is in the best interests of the company's creditors to petition the court to order the company's winding up, but they can also take another course of action as long as this is in the interest of the company's creditors. This approach fits a system that takes a more favourable view to out-of-court solutions and court-sanctioned schemes of arrangement, that are not regulated in insolvency law.

Aside from the two risks described above - asset shifting and wrongful trading - there is the risk of mismanagement of the company that may *cause* the company's insolvency. Some Member States have director liability provisions aiming to prevent company directors from taking irresponsible decisions that lead to the company's insolvency.[22] These provisions are interesting from the perspective of the *Kornhaas* decision because they are linked to general director liability for violation of the duty of care owed to the company. Liability for violation of the duty of care owed to the company belongs to the domain of company law. On the basis of case-law of the CJEU it can be submitted that mismanagement claims that can only be brought by the liquidator in insolvency and the proceeds of which must be paid into the estate belong to the realm of insolvency law.[23]

4.2 Overview of Claims against Directors of an Insolvent Dutch Private Limited Company that May Arise under Dutch Law[24]

20 See Alexander Schall, "The Forthcoming ECJ Decision of the *Kornhaas* Case (C-594/14) - The Final Chapter of the European Traveller's Tales?", (2015) 12(2) ECFR 280-298, at 288.

21 1986 c. 45.

22 Examples are the Netherlands (Art. 2:138/248 DCC), Belgium (Art. 530 Belgian Company Code) and France (Art. L. 651-2 French Commercial Code).

23 *Henri Gourdain v Franz Nadler* (Case C-133/78) [22 February 1979] CJEU (*Gourdain/Nadler)*; *Christopher Seagon v Deko Marty Belgium NV* (C-339/07) [12 February 2009] CJEU (*Deko Marty)*; *H. v H.K.; Kornhaas*.

24 For a more elaborate description of directors' liability rules in the Netherlands see: Yvette Borrius, "Directors' Liability: The Netherlands", (2011) 8(6) *European Company Law,* 246-252 and the country report on Directors' Duties and Liability in the Netherlands prepared for the 2013 LSE study on Directors' Duties and Liability commissioned by the European Commission DG Markt, available at http://ec.europa.eu/justice/civil/company-law/corporate-governance/index_en.htm. I note that the country report is limited to Dutch public limited companies and therefore does not discuss the directors' liability in case of unlawful distributions to shareholders that since 2012 applies to private limited companies.

4.2.1 Liability Claims Targeted at Preventing Unlawful Asset Transfers to Shareholders

First of all, directors who approve a distribution to shareholders when they know or should have known that the company will not be able to continue to pay its debts as they fall due may be held liable for the damage caused to the company's creditors. According to the text of the relevant provision, Art. 216 (3) of Book 2 of the Dutch Civil Code (DCC), this is a liability towards the company. In the event of insolvency of the company, it is the liquidator who has standing to bring the claim on behalf of the company. Although claims on the basis of this provision will typically be brought in insolvency, it is submitted that such claims do not fall within the scope of Art. 4 EIR/7 EIR (Recast). The only argument that can be made in favour of an insolvency law qualification is that there is an analogy between Art. 2:216 (3) DCC and transaction avoidance provisions. However, there is no mention of this analogy, or any link with insolvency law, in the parliamentary history of Art. 2:216 DCC. Therefore, it can be concluded that this provision belongs to the *lex societatis*. Consequently, it only applies to private limited companies incorporated under Dutch law.

Next to being held liable for allowing distributions infringing Art. 2:216 DCC, a director may be sued on the basis of tort law for involvement in transactions (with shareholders or others) that harm the company's creditors. The tort of negligence is regulated in Art. 162 of Book 6 of the DCC. For a successful claim the plaintiff needs to show that in engaging in the allegedly detrimental transactions, the directors violated a duty of care owed to the company's creditors. Furthermore, the plaintiff needs to show for each defendant that he or she can be seriously blamed for violating this duty of care. Detrimental transactions can take the form of transactions at an undervalue or preferences. In the event that the loss caused by the tortious behaviour has been suffered by the creditors collectively, the liquidator has the right to bring a claim against the tortfeasor(s).[25] The Dutch Supreme Court has ruled that this is not an exclusive right, but that, in the event of a competing claim by one or more individual shareholders, the court may decide to hear the liquidator's claim first.[26] If the liquidator brings such a claim, the proceeds will be paid into the estate and distributed in accordance with the rules on ranking of creditors.

25 Dutch Supreme Court, 14 January 1983, *Nederlandse Jurisprudentie* 1983, 597 (*Peeters/Gatzen*).

26 Dutch Supreme Court, 21 December 2011, *Nederlandse Jurisprudentie* 2005, 95 (*Lunderstädt/De Kok*).

4.2.2 Director Liability for Continuing to Trade after the 'Moment of Truth'

Dutch law does not require directors to file for the opening of insolvency proceedings when the company is cash flow or balance sheet insolvent. Neither does Dutch law contain a specific provision aimed at preventing wrongful trading. This does *not* mean, however, that Dutch law does not contain any instruments aimed at preventing directors from allowing companies to trade at the expense of its creditors. On the contrary: in the event that directors have engaged in wrongful trading, two types of claims can be brought, which are both based on tort law (Art. 6:162 DCC).

The first option, tried and tested in Dutch practice, is for individual creditors to bring a negligence claim for 'reliance loss'. This has become known as the *Beklamel*[27]-claim. For such a claim to succeed, the plaintiff needs to show that the director knew or should have known that the company would not be able to perform (and would not offer recourse) when he allowed the company to incur an obligation. If the plaintiff succeeds in proving this, it means that the director can be seriously blamed for violating a duty of care owed to the creditor who never received payment. Dutch practice shows that the *Beklamel* line of case-law poses a real threat to directors and is a strong incentive for directors to file for bankruptcy or seek advice on the possibility of restructuring.[28] Therefore, the conclusion in a recent study that the Netherlands is a Member State lacking sanctions for wrongful trading is misleading.[29]

The second option, which is less frequently used, is for the liquidator to bring a negligence claim against the directors for 'rate reduction loss'[30] caused to the joint creditors. The proceeds of such a claim are paid into the estate and distributed by the liquidator.

Opinions are divided on how to qualify director liability claims based on tort law in Dutch private international law. Where it concerns a tort claim against a director that is brought by an individual creditor, such as a *Beklamel*-claim, the prevailing opinion is that such a claim falls within the scope of Art. 4 of the

27 Dutch Supreme Court, 6 October 1989, Nederlandse Jurisprudentie 1990, 286 (*Beklamel*).

28 Borrius, above note 24, at. 251: "this type of liability urges management to take action to avoid the risk of liability if fundamental cash flow problems are foreseen".

29 *Study on a New Approach to Business Failure and Insolvency - Comparative Legal Analysis of the Member State's Relevant Provisions and Practices*, University of Leeds, 2016, available at http://bookshop.europa.eu/en/home, table 2.1. at 60. This example shows that conclusions in comparative studies should not be taken at face value.

30 This means that the liquidator has to calculate - for each creditor - the difference between the rate received in the insolvency proceedings and the rate the creditor would have received in case of timely filing. This corresponds with the damage the German trustee can claim in case of a violation of the duty to file laid down in Par. 15a Insolvency Statute (the so-called *'Quotenschaden'* (lit.: 'percentage damage').

Rome II-Regulation.[31] [32] In respect of tort claims brought against directors by the liquidator for loss suffered by the creditors collectively, opinions are divided on the question as to whether such a claim falls within the scope of Art. 4 EIR or the aforementioned articles of the Rome II-Regulation.[33]

4.2.3 Director Liability for Mismanagement of the Company

In case of mismanagement of the company, directors can be held jointly and severally liable on the basis of Art. Art. 2:9 DCC. The claim belongs to the company but in case of insolvency it will be brought by the liquidator. The liquidator needs to show that there has been improper management (‘*onbehoorlijk bestuur*’), which can be attributed to the directors because they can be ‘seriously blamed’ (‘*ernstig verwijt*’). The requirement of serious blame is meant to ensure that directors are not held liable for every mistake they make in managing the company. The liquidator further needs to establish causation between the improper management and the loss he claims to have been suffered by the company. There is no dispute as to the nature of this provision: it belongs to company law. According to Dutch private international law application will be determined by the *lex societatis*[34].

In the event that the company is subject to bankruptcy proceedings, the liquidator can also bring a mismanagement claim based on Art. 248 of Book 2 of the DCC, provided that certain requirements are met. This claim was introduced as part of a series of laws targeting abuse of legal persons. If the liquidator succeeds in proving that these requirement are met, he can claim the full deficit. First of all, the liquidator needs to show that there has been manifestly improper management (‘*kennelijk onbehoorlijk bestuur*’) within a time frame of three years prior to the opening of the bankruptcy proceedings. Proof that the manifestly improper management was an important cause of the bankruptcy is required, unless the liquidator shows that the annual accounts have been published too late or the bookkeeping duties have been neglected. If the liquidator succeeds in showing that one (or both) of these duties have been neglected, manifestly improper management is established and it is presumed that this was an important cause of the bankruptcy. Directors may still escape by proving that another circumstance that cannot be attributed to improper management was an important cause of the bankruptcy. If the directors’ defence does not succeed, they are jointly and severally liable for the full deficit. Individual directors may try to exculpate themselves but this is difficult. As a last

31 Regulation 864/2007 of 11 July 2007 on the law applicable to non-contractual obligations, (OJ L 199/40).

32 See the country report in above note 24, at 635.

33 *Ibid*, at 636.

34 See Art. 10:119 DCC. See also the country report in above note 24, at 635.

resort, directors can ask the court to mitigate the amount of compensation to be paid to the estate.

When Art. 2:248 DCC was introduced, the legislator seemed to hold the view that this provision belongs to the *lex societatis*, meaning that it only applies to companies incorporated under Dutch law. Therefore it was deemed necessary to introduce a special provision enabling application of this special form of director liability to companies incorporated outside the Netherlands in the event that they are subjected to Dutch bankruptcy proceedings.[35] The relevance of this provision can be called into question because strong arguments plead in favour of qualifying a claim on the basis of Art. 2:248 DCC as a matter belonging to the *lex concursus*[36]:

- the claim only exists when the debtor company is subject to bankruptcy proceedings;
- only the liquidator can bring the claim;
- the liquidator cannot assign the claim to a third party;
- the proceeds of the claim must be paid into the estate.

This overview of director liability claims shows that, under Dutch law, directors may be faced with a variety of claims in the event of insolvency of the company. The grounds for these claims can be found in two distinct parts of the DCC, book 2 (law of legal persons) and Book 6 (law of obligations). None of the claims is founded on a provision of the Dutch Insolvency Act. Claims against directors for involvement in transactions detrimental to creditors as well as claims for engaging in wrongful trading are primarily founded in tort law. In the light of the above, it was surprising to see that the authors of the 2013 LSE Study on Directors' Duties and Liabilities conclude that the Netherlands belong to the Member States where the rules aimed at restricting or regulating near-insolvent trading can be primarily classified as *company law* (for the purpose of private international law). These are the white Member States in the figure opposite.

35 This special provision was Art. 5 of the Act on Conflicts of Laws in respect of Corporations. In 2012, when Dutch private international law was codified in Book 10 of the DCC, this provision was transferred to Art. 10:121 DCC

36 S.M. Van den Braak, above note 16, at 234.

[Source: LSE Study on Directors Duties and Liability, 2013, p. 235]

It is submitted that the Netherlands do not belong to the white group (taking the company law approach) nor to the medium grey group (taking the insolvency law approach). The Netherlands belong to the dark grey Member States, where the approach to regulating near-insolvent trading is mixed or disputed. This is an important conclusion because it means that from a Dutch substantive and conflicts law perspective, insolvency-related director liability is an area that is not at all straightforward to harmonise. Lawmakers in Brussels should have due regard for this.

Looking at Dutch practice, the following are the liability claims that are typically brought against directors of insolvent companies:

- Claims for the full deficit brought by the liquidator, typically based on a number of provisions simultaneously (2:9, 2:138/248 and 6:162 DCC), the essence of the claim being that the company has been mismanaged;
- *Beklamel*-claims brought by so-called 'new' creditors (those creditors with whom the company entered into agreements after the 'moment of truth');
- Tort claims brought by the liquidator or by an individual creditor against directors for making 'selective' payments on behalf of the company.

Legal advisors involved in the Dutch restructuring and insolvency practice frequently have to advise clients on the latter two forms of personal liability. These are the key director liability issues arising in restructuring attempts as well as in (pre-packaged) going concern asset sales. When the company is on the brink of insolvency, directors want assurance that they can enter into new obligations on behalf of the company and they want to know to what extent they can selectively pay creditors without running the risk of being held personally liable.

5 Director Liability for Payments Made after 'the Moment of Truth'

A form of director liability that is much discussed in the Netherlands is the tort liability of company directors for engaging in 'selective' (preferential) payments. The rationale for this liability is that the pari passu principle must be upheld after 'moment of truth'. In this sense there is a link with avoidance law. Art. 47 of the Dutch Insolvency Act only allows for the avoidance of due payments if a) the creditor knew that the debtor had already filed for bankruptcy when the payment was made or b) creditor and debtor conspired to give a preference. This begs the question whether a company director can be held personally liable for allowing preferential payments when the director knows that the company is on the brink of bankruptcy, in the absence of any conspiracy with the creditor. The Dutch Supreme Court has ruled that directors may be held liable on the basis of tort law if the allow selective payments to related parties if there are serious reasons to expect a deficit. It has been argued that selective payments to unrelated parties can lead to liability if there is no reasonable prospect of avoiding insolvent liquidation. The latter implies that preferential payments may be justified by showing that the payments were part of a feasible turnaround plan. It is important to note that a liquidator bringing a claim against directors for allowing preferential payments can claim the losses suffered by the joint creditors as a consequence of the preferential payment. This means that the amount to be paid by the director cannot be more than the amount needed to make up for the difference in recovery rate caused by the preferential payment. A simplified example: company X has assets worth 200 and 4 creditors to whom it owes 100 each. The recovery rate is thus 50% for each of the creditors. If company X makes a preferential payment of 100 to one of the creditors, this leaves 100 for the remaining 3 creditors to share. Their recovery rate drops from 50% to 33.3%. To make up for this, the liquidator can claim what is necessary to restore the recovery rate to the original 50%, which is (150-100=) 50.

It is interesting to compare the Dutch tort-based director liability for 'selective' payments to the German director liability for making payments after the moment of truth at issue in the *Kornhaas* case. Under Par. 64 GmbHG, the duty to refrain from further payments is triggered by balance sheet or cash flow insolvency. The rationale of this duty is to preserve the assets of an insolvent company ('save what can be saved'). The duty is a complement to the duty to file for the opening of insolvency proceedings (Par. 15a German Insolvency Statute). Until fairly recently, the liability was quite harsh because directors could be made liable for payments infringing Par. 64 GmbHG, regardless of any consideration that was received by the company in return for the payment. This was much criticized in doctrine and in 2014, the German Federal Court of Justice held that there should be no liability if the company received direct and fair consideration at the time the payment was made.[37] Directors can also escape liability under Par. 64 GmbHG by showing that any prudent business man would have made the payment. This is interesting from a Dutch perspective, because it seems to be similar to the possibility under Dutch law to justify 'selective' payments made as part of a feasible turnaround plan.

6 Hypothetical Scenarios

6.1 Case I

A Dutch private limited company has its COMI in Germany. It does not have an establishment in the Netherlands. The sole director of the company is domiciled in the Netherlands. The director makes a payment to one of the company's creditors when there is no reasonable prospect of avoiding bankruptcy. No direct and fair consideration is received by the company in return for the payment. The director cannot justify the payment by showing that it is part of a feasible turnaround plan. Main insolvency proceedings are opened in Germany. The German liquidator can bring a Par. 64 GmbHG-claim against the company's director before a German court according to the judgments of the CJEU in the cases *Kornhaas* and *H. v H.K.*. One or more creditors in the Netherlands may under certain circumstances bring

37 Federal Court of Justice 18 November 2014 (BGH II ZR 231/13).

claims against the director in a Dutch court (Art. 4(1) Brussels Ibis) for allowing selective payments based on Dutch tort law (Art. 4 Rome II[38]).

The result is a possible accumulation of claims against the director handled by courts in different Member States.

6.2 Case II

A German private limited company has its COMI in the Netherlands. It has an establishment in Germany. The sole director of the company is domiciled in Germany. The director pays a dividend to shareholder knowing that company will not be able to pay its debts as they fall due. Main insolvency proceedings are opened in the Netherlands.

Can the Dutch liquidator bring a claim against the director based on Art. 2:216 (3) DCC? The answer is 'no' if Art. 2:216 (3) DCC only applies as part of the lex societatis. Can the liquidator try to convince the Dutch court to apply a similar German provision instead? Par. 64 GmbHG specifically prohibits payments to shareholders leading to insolvency (illiquidity) of the GmbH (this is the German solvency test for distributions), but this does not apply either as it only applies as part of the *lex concursus*. A further question: can the Dutch liquidator solve the conundrum by requesting the opening of secondary proceedings in Germany? Other options may also be available. The liquidator may try to sue the director who has engaged in a transaction detrimental to the joint creditors before a Dutch court on basis of Dutch tort law (Art. 7(2) Brussels Ibis and Art. 4 Rome II[39]) or try to claw back the distribution from the shareholder using Dutch transaction avoidance law.

These were just two hypothetical scenarios, limited to selective payments and to just two Member States. Many more scenarios can be designed and analysed. Some work has already been done[40], but it is not enough. I believe that any attempt at harmonisation of director liability provisions should be based on a thorough analysis of the problems that lawyers working on cross-border insolvency and restructuring cases across the EU actually encounter in practice. Which problems related to director liability are really pressing in practice? Are clashes between

38 Unless this claim should be regarded as falling outside the scope of the Rome II Regulation, see Art. 1(2)(d) Rome II.

39 *Ibid*.

40 *Study on a New Approach to Business Failure and Insolvency - Comparative Legal Analysis of the Member State's Relevant Provisions and Practices*, University of Leeds, 2016, available at http://bookshop.europa.eu/en/home and Carsten Gerner-Beuerle, Philipp Paech and Edmund Philipp Schuster, *Study on Directors' Duties and Liability*, LSE, London, April 2013, available at http://ec.europa.eu/justice/civil/company-law/corporate-governance/index_en.htm.

systems causing problems? Are certain domestic director's duties (such as a duty to file for the opening of insolvency proceedings) causing problems because they make it risky for directors to undertake a restructuring attempt? This is what the focus of the Commission should be on before putting forward any proposal to harmonise directors' liability.

7 Beyond *Kornhaas*: Perspectives for Harmonization?

Looking at the problems and inefficiencies that may be caused by clashes of systems, the question rises what can be done to 'streamline' insolvency-related director liability claims. It seems that there are three options.

7.1 'Synchronizing' the Connecting Factors for Company Law and Insolvency Law

A first option would be to 'synchronise' the connecting factors for company law and insolvency law. There are - theoretically - two ways of doing this. The first way is to maintain the current concept of COMI as the connecting factor for insolvency law but switch to the real seat as the connecting factor for company law. It needs no explanation that this is not a viable option, in the light of the CJEU's interpretation of Art. 49/54 of the TFEU. The second option is to tie the COMI to the registered office. This has been suggested by a number of authors[41] but it should also be regarded as a mere theoretical option, given the choice that was only recently made by the lawmakers in Brussels to retain the possibility to rebut the presumption that a legal person's COMI is at the place of its registered office. I note that even if any of the two options just discussed *were* feasible, this would not solve all problems. For example: clashes might still occur between applicable company/insolvency law and tort law (see the hypothetical cases discussed above).

7.2 Adopt a Specific Conflict Rule in the EIR

It could be considered to expressly include in Art. 7 EIR (Recast) director liability claims that *derive directly from and are closely connected with insolvency proceedings*. I am quite sceptical about this option because it would mean that the lawmakers in Brussels need to pick up what the CJEU (understandably) refrained from doing in its *Kornhaas* judgment: to *clearly* define what the passage in italics means. Must (de facto) insolvency be a precondition for claim to arise? Must only liquidator have standing? Must the proceeds of the claim go to the

41 I suggested it myself in my report "The Review of the EU Insolvency Regulation - Time to Recognize the Ties that Bind Company Law and Insolvency law?" in: *The Review of the EU Insolvency Regulation: some Proposals for Amendment*, at 57, available at http://www.naciil.org.

estate? If the lawmakers in Brussels would bring certain director liability claims within the scope of Art. 7 EIR, should there be a possibility for directors to defend themselves against a claim by showing that they would not be liable under the applicable company law, similar to the defence available under Art. 13 EIR/16 EIR (Recast)?[42] I refrain from answering these questions. I merely present them to illustrate that it is unlikely that a specific conflict rule covering insolvency-related directors' liability will be introduced in the EIR in the near future.

This leaves the third option:

7.3 Substantive Harmonization

Let me start by saying that full harmonisation of all 'insolvency-related' director liability claims seems not feasible. What the Commission could do is to harmonise certain core duties of directors of near-insolvent companies. A first choice that the Commission would need to make is whether to opt for specific rules aimed at preventing specific behaviour or broad standards. Should there be an EU-wide duty to file within a specific period of time after the 'moment of truth' has arrived or should directors be under a duty 'to take every reasonable step' to protect the creditors from harm? Should there be a duty to refrain from making (preferential) payments or a duty 'to act in best interest of creditors'? The problem with prescribing more or less clear-cut rules is that it seems hard to formulate clear rules on which all 28 (or 27) Member States can agree. The problem with standards is that they give much discretion to courts and do not give clear guidance to directors.

In my view, meaningful harmonisation requires further study. What is needed in particular is an in-depth analysis of the risks for directors when they are involved in restructuring attempts and reorganisation through (pre-packaged) going concern sales. The study should not be limited to the duty to file and the wrongful trading rule as it exist in the UK, it should be broader. It should also include the risks involved in allowing payments when the company is close to insolvency. Not only civil liability should be studied: serious risks may also exist under director disqualification rules and under criminal law. The study should include the possibility for directors (or their companies) to insure the risk of insolvency-related director liability.

The common denominators found through in-depth scenario analysis should be used to draft rules that give guidance to directors of companies in distress. I give a (simplified) example. Scenario analysis may show that uncertainty for directors

42 See Schall, above note 20, p. 297.

as to the liability risks they run when making preferential payments is a problem in the insolvency and restructuring practices of a large number of Member States. In this case, any attempt at harmonisation should at least clarify:

- the point in time when the duty to have regard to the *pari passu* rule kicks in;
- whether it is possible for directors to justify a preferential payment because it was made on the basis of a feasible restructuring plan;
- which conditions a restructuring plan used as a justification for making preferential payments must meet.

In November 2016, several months after the INSOL Europe conference where this paper was presented, the Commission published its Proposal for a Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU.[43] To my surprise, this Proposal also aims to harmonise the duties of directors in connection with negotiations on a preventive restructuring plan. Art. 18 of the proposed directive provides the following:

> "Member States shall lay down rules to ensure that, where there is a likelihood of insolvency, directors have the following obligations:

a) to take immediate steps to minimise the loss for creditors, workers, shareholders and other stakeholders;

b) to have due regard to the interests of creditors and other stakeholders;

c) to take reasonable steps to avoid insolvency;

d) to avoid deliberate or grossly negligent conduct that threatens the viability of the business."

I believe that directors will not find much guidance in this provision. It does not offer them assurance on the two key issues identified above: wrongful trading and 'selective' payments. Instead, it will only confuse and it may even scare them. I looked for guidance in the preamble but did not find it there either. I quote from recital 36:

> "Where the debtor is in the vicinity of insolvency, it is also important to protect the legitimate interests of creditors from management decisions that may have an impact on the constitution of the debtor's

43 COM(2016) 723 final.

> estate, in particular where those decisions may have the effect of further diminishing the value of the estate available for restructuring efforts or for distribution to creditors. It is therefore necessary that in such circumstances directors avoid any deliberate or grossly negligent actions that result in personal gain at the expense of stakeholders, agreeing to transactions at under value, or taking actions leading to unfair preference of one or more stakeholders over others."

In practice, directors nor their advisors will be able to rely on this. I therefore suggest that Article 18 be removed from the proposed Directive and that the Commission refrain from isolated and vague attempts at regulating directors' duties in the vicinity of insolvency.

PART II
CREDITOR RANKING IN INSOLVENCY: POSSIBLE APPROACHES AND OBSTACLES TO HARMONISATION

Chapter 7

Reflections on a European Proposal for a Pre-Insolvency Restructuring Directive Based on the Experience out of the Banking Industry in Germany and Italy in the Period 2007-2017

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1 Introduction

As Europe faces the next round of changes, which will involve the attempts for a deeper integration of the member-countries at every level, the European Commission is trying to push the countries to a unification of the steps and tools that form part of the process that we identify as “debt restructuring”, and specifically during a so called “pre-insolvency phase”. As it can be noticed already in the initial stage of the definition of the process to be adressed, the main challenges faced by the European Commission derive from the most basic elements of this ensemble of countries that is called European Union: the differences in the culture and languages. The simple translation of the word “restructuring” is difficult as it is transferred down in the national legal frameworks. To these cultural and philological differences, a further deeper one needs to be added: the different economical and financial situation in which the single countries live, after the global financial crisis started, in its more evident stage, in 2008.

Documenting the difficulties of the challenges faced by the Commission, this work would like to offer some reflections deriving from the ten years (incidentally started in the years of the Lehman driven crisis) experience in the debt restructuring. Among the countries in which such experience was collected, Germany and Italy were chosen for the numbers of managed cases, but even more so because of the currently contrasting economic situation of the two countries; the different culture facing the notion of “debt” within their own legal cultures and traditions; and in the ways and steps that the two countries decided to take to find a solution to the forecasted huge wave of insolvency in the corporate environment, which has and continues to happen in Italy.

Further, looking at individual European Union countries regarding the need for the introduction of a regulation of a “pre-insolvency” restructuring process, Germany and Italy could be considered as being at a different stages as well: while, for example, in England we can find the scheme of arrangement and in France the "*mandat-ad-hoc*", in Germany we can find no specific regulation for such a phase (though the *Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen* (EsUG) is available within the remit of insolvency law). In Italy art.67 and 182bis of the Italian Insolvency Law show the different tools legally regulated within a process that ends with *concordato in bianco*.

2 Targets and Assumptions of the European Commission for the Proposal[1]

In the introductory chapter of the Proposal, the reasons for the directive are explained and the major drivers could be identified and summarized as follows:

(1) A huge amount of unpaid debt is leveraging the financials of the industrial and real estate of European companies. Difficulties in finding agreements among the stakeholders, and especially among the debt holders, result in forcing many "unguilty" debtors into declaring insolvency, causing the disappearance of industrial realities in a phase of the already huge unemployment situation throughout Europe. This would take place without giving a "last chance" to the debtor, especially in the small and medium-sized enterprises (SMEs) segment, to find a solution.

(2) The "restructuring within insolvency" is considered mostly as a negative aspect as it is viewed in the entrepreneurial environment as "stigmatic" and the "declaration of insolvency" opens in the majority of the cases the worst possible scenario, leading to the liquidation with losses borne by customers and suppliers and other stakeholders.

(3) The current national legal environments do not allow a fair competition among the individual countries, as the investors will look for the most certain and easier to understand or faster to implement process in their investment decision in relation to distressed companies as well in their decision in relation to the financial liabilities structure to be given to the industrial companies.

(4) Companies operating in the European Union are mostly financed through bank debt. A declaration of the insolvency of a big portion of the debtors would not only destroy decades of experience and knowledge in industry, but would weaken further the balance sheets of the banking world. In order to

1 COM2016/723 Proposal for a Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU

avoid the recurrance of such a situation, the European Commission considers it reasonable to increase the role of the capital market (ie. financing through bonds and investment funds, either as private equities or debt funds) as a sourcing player in the future of financing of the industrial environment.

(5) One of major hurdles to the implementation of an efficient process in the capital market is represented by the assumed inefficiency present due to the lack of rules; of cramming down dissenting voteson the restructuring proposal; of financial lenders, single or in class, which enables "free-riders" with minor stakeholders able to endanger the process of the "debt-restructuring".

In the next sections we will offer some reflections of the above mentioned arguments.

3 Situation of Distressed Companies and the Economic Environment

The global financial and economic crisis, initiated following the "Lehman crisis", caused an abrupt destruction throughout the corporate world in the European countries. While it struck with an unseen (in peacetime) force in companies with a healthy business model and no strategic crisis before 2008, no doubt was left that, as a result of the liquidity and credit crisis, it hit the weaknesses that economic systems had been able to survive in the previous years.

The German economy is characterized by its structurally export oriented industries, of much bigger dimension in the Mid Caps Segment (Mittelstand) than the Italian competitors, was hit at first in the banking industry, where players like Hypo Real Estate and some major Landesbanken were relying on ample liquidity and availability in the credit markets for investing in assets of different durations and terms. Other players were found in the middle of transformation without a clear business model (like Dresdner Bank merged with Commerzbank requiring the support of the German State, or WestLB). This happens in a phase in which the Italian Banks, whose assets were more based on lending to domestic companies of small dimensions and therefore with portfolios more similar to the ones present in the German savings banks, were considered as safer.

After the crisis developed from the international markets mostly drying up the inter-banking money market, some big industrially operative companies in the leveraged buy-out (LBO) market went into a distressed situation, as their owners could not find in the LBOs funds market any partner willing to or financially strong enough to enter into a new acquisition that would have ensured, as co-product of a new debt structuring, new working capital financing.

The German legal environment at that point, aside from not yet foreseeing any regulations for debt/equity swaps (usually the most relevant collateral in a LBO financing are the shares of the holding and operative companies in the structure, that in a distressed situation requires a strong haircut from the lenders to counterbalance the now unsustainable goodwill originated by the exacerbated "take and pass" model in the balance sheet of the debtors), was still based on an old Insolvency Law, that principally foresaw an asset deal ("*Uebertragende Sanierung*") as a restructuring in the insolvency: the alternative being liquidation during the insolvency.

Aside of the LBO financed companies, which in Germany because of their dimension were seen as more interesting assets for the LBOs funds in comparison to the relatively smaller dimension of the Italian industrial realities (see below), some Germany based multinational industrial groups found themselves wrongly positioned in the middle of acquisitions (or speculation), financed almost totally through debt. Groups like Schaeffler and Merkle, with a huge numbers of employees, were on the verge of collapse.

The reduction of liquidity and credit in other countries reduced dramatically the orders for the whole industrial German automotive and machine tooling mid sized companies, whose working capital financing was structurally too high relying on the planning of the multinational German exporting masters.

Germany reacted in a very short time and in a very decisive way with the following measures:

(1) The Government recognised the immediate danger in the banking sector, by reassuring the savers about the healthiness of the banks, but contemporaneously developed guidelines that enabled debt for equity swaps in banks enabling the takeover of shareholding by the German State in banks such as HRE and Commerzbank, as well as Lone Star into IKB, and moved fast in setting up bad banks such as FSM or Portigon for the parking of portfolios to be run off. For other Landesbanken, such as BLB and HSH, the danger was considered limited to a structurally regional problem or a short term phase in a long term cycle (and hoping for a market rebound in the shipping financing).

(2) The insolvency of some LBO financed structures, when no agreement was reachable because of too high a request from free-riders, was taken into account, with the insolvency administrators showing their ability in finding solutions via asset deals and repositioning the operative companies where possible

(3) Through the rapidly implemented Restructuring Refinancing Programme via the KFW companies that were identified, on clear parameters, as worthy of restructuring, many companies in the SME segment were saved. The old lenders, mostly existing banks, had to accept constraints in the ranking of their financing (KFW financing was granted a supersenior position) and limitations to a future sale of their existing financing (KFW was granted a no objection right to a sale of the receivables of the other banks). The concept of overindebtness (*Ueberschuldung*) was diluted.

(4) The German banks recognized that to stop the crisis, where legally allowed, would require supporting the major industrial groups.

(5) The industrial companies dramatically reduced their capacity, resorting to tools that enabled the flexibilisation of the worked hours (tools already foreseen during the crisis of the reunification years), while capital infusions or *thésaurisation* of the profit strengthened the equity base as much as possible. Investment cycles were postponed.

(6) The reduction of investment in government bonds in other countries in the bank balance sheets enabled the banks to free up resources for the financing of industry.

(7) A new insolvency law, protecting the rights of the creditors in first place, but enabling new tools as a shield for the creditors (*Schutzschirmverfahren*) and debtor in possession (*Eigenverwaltung*), within the insolvency legal framework (EsUG) was issued. The opposing stakeholders within the insolvency would have their interestes protected through the consideration in alternative scenarios, mostly based on liquidation, or practical evaluation of the equity value of an insolvent company (shareholders rights).

Because of the help from the Central Banks worldwide, sustaining the demand in the export markets, and in Europe where the European Central Bank shielded the German financing houses from the exposure to the risks represented by the southern European countries, the capital flows to Germany did not stop. The LBOs were replaced by the interest in the very small SMEs, which quickly issued corporate bonds, and later through strategic investors looking for industrial operative companies owning the Made in Germany Brand.

As a result, in 2016 Germany had the lowest level of insolvency declarations in the last 20 years and the exit from the crisis was evident after 3 years deep crisis a “V” shaped recovery. Even though it cannot be excluded that in future crisis (shipping financing is just entering the final chapter of its drama, with workout scenarios) the solutions adopted in Germany could have similar positive results, especially in a prolonged crisis hitting firstly and principally SMEs. The first argument of the European Commission is not felt as strongly as in Italy. Nevertheless the positive approach of the banking world, within a system that had a coordinated view, was able to find solutions without endangering a culture that had the protection of the rights of the single creditor to find solutions to that crisis and without questioning the discipline resulting from the principle that "*pacta sunt servanda*".

In Italy, as shortly described, the local banks, coming from a traditionally more commercial banking oriented lending approach and within dimensions more similar to those of local saving banks rather than a more volatile and sophisticated investment banking approach, were seen as a proof of a (wrongly assumed) solidity of the economic system facing the effects of a crisis caused from the volatility of badly managed investment banking institutions. Consequently, the Italian authorities did not concentrate on developing solutions for endangered banks (the Italian Government in some way declared their surprise in the "sudden implementation" of the European CRR Directive[2] in 2016!), while they were still facing the growing difficulties of finding investors for Italian government bonds, especially after the Greek crisis. The Italian Banks were therefore, as in the 70s, required to increase their exposure in the refinancing of a state lending, contemporaneously with a moment in which Italy itself was asked to contribute substantially to the restructuring of the Greek Government. Until that point their exposure was almost inexistent in comparison to the levels in the books of German and French Institutions.

The effects of increasing spreads towards the German Bund, combined with the almost disappearing of USD funding possibilities, increased the feeling in the financial markets that Italian banks, whose equity was disappearing like snow at the sun, were, after the Spanish saving banks, the next weakest link of the chain. This reduced further the lending capabilities of the local banks towards the Italian industries.

In the meantime, Italian SMEs, whose dimensions are much smaller than the German ones, were affected by the same reduction of orders as in Germany. Unfortunately, the Italian SMEs are far more reliant on domestic demand, which principally disappeared because of the uncertainty about the risk of insolvency of the Italian State, considering what happened in Greece and the Government crisis in Italy. The family based Italian capitalism was used to uncertainty in the financial

2 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, *OJ L 173, 12.6.2014, p. 190–348*.

environment, due to the periodical devaluation of the Lira, and tended to increase the leverage of the operating company to extreme levels, and because of stability of the Euro and availability of banking debt, increased the leverage even further. Facing the dramatic drop in orders, most of the companies, instead to resorting to capital increases, asked more financing from the banks. The banks agreed, hoping that the crisis would have finished in a short period. The banks, within their regional relevant financing role, refinanced on their own balance sheets the maturing debt, asking for further collateral or advising to transfer the existing assets to leasing companies with a further increase of the value in the transfer.

While in Germany the LBOs restulted in medium sized companies bought and sold, increasing the goodwill in their balance sheet due to the appetite of the investment funds, in Italy the increase of leverage and further model of investment banking were used for small sized companies, in order to compensate with fees the business risks of already high leveraged companies with exposure of their turnover to the national demand. This consequently influenced the value of goodwill and fixed assets. Not rarely the lending from local banks to the SMEs was "linked" to the purchasing of other risky products, such as banking tier 2 bonds, derivatives and sometimes even shares of the lending bank itself. This kind of "refinancing" in this phase was usually based on pure reframing of documentation with the lenders, while the SME was increasing the term of payment towards the suppliers and postponing the payment of taxes.

With the continuing, and worsening, of the crisis, as the banks started to feel uncomfortable with the overall failure to realise the assumptions based on their business plans, multiple changes of the insolvency and commercial code took place. This made a number of new tools available, such as debt restructuring under Art.67 (without publicity of the plan and agreement out of court) and further debt restructuring under Art.182bis (which is usually referred to when over the 12-24 months earlier an approved Art.67 restructuring has failed), in which a court publicly approves the restructuring plan, ensuring the position of the participating lenders from delay of insolvency processes. Debt/equity swaps were mostly unused in Italy due to the possibility of issuing shares and equity-like instruments of different classes and rights ("*strumenti participativi di capitale*"), without obliging the owner of the company to leave the company.

Finally, in an economic environment in which the Italian State was more and more under the examination of the European Commission for its debt levels and its incapability to pay its debt towards the tax credits of Italian companies in a structural way, a new reform of the Insolvency Law gave a final opportunity to the debtors for finding a restructuring solution. This included postponing a distressed liquidation, creating the institute of *Concordato Aziendale*, of which the form *concordato in bianco* foresees up to 9 months of a moratorium of any enforcing actions from the lenders, granting time for the generation of a "new" restructuring plan. In such an environment, after 9 years, it is no surprise that the non-performing loan situation in the books of the banks degenerated up to a point that the banks themselves are now a distressed case and that the assets in the books of companies in distress are of a difficult realisation and therefore of a significantly reduced value.

While it is difficult to understand the argument of the Proposal in looking for granting a "final chance" to the debtor, it is certain that Italian SMEs are facing final liquidation in a pre-workout scenario. The identification of "guilt" is difficult in a financial environment, but it is clear that banks have not represented any model of financial discipline in the recent past in Italy. On the other side, the dimensions of the involved companies and the proved concerting of all the stakeholders and the shareholders (in some but not all cases), show that all attempts for out of court pre-insolvency restructuring have already been tried and what remains now is the implementation of haircut in the debt level. Whether for such steps a new European Directive is required or could just be left to the local states eventually within the insolvency framework, our view would prefer the discipline of the insolvency framework, as this would after many years remind the shareholders the risk of business and that "*pacta sunt servanda*".

4 The Stigma of Restructuring within Insolvency

Even underlying the importance of not repaying debt in Germany, a country in which the language itself uses the same word for identifying debt as for guilt, ("*schuld*"), our experience did not allow a difference in the Italian and German environment among the entrepreneurs facing the distress situation. For most of the businessmen to communicate the phase difficulty of the company is surely a very relevant factor and seen as a personal failure.

This surely postpones the reference to the relevant instruments and tools provided in both the national insolvency laws.

On the other side, different considerations could be included in the analysis:

(1) While Germany did not reform their legislation to the extent Italy did with Art.67, the impacts on the customers' and suppliers' relationships start already with the slowing down of payment and investment and not only with the declaration of insolvency. The company is easily recognized as in distress in

the region in which it is based. As a matter of fact many Italian debtors did not approve the request of the Art.67 from the banks, initially arguing that it would be too public. Would a “pre-insolvency” restructuring really change the situation? When does the stigma start to taek effect?

(2) Is the downside of a “insolvency stigma” not intrinsically linked to the business risk undertaken by any enterprenuer?

(3) In order to reduce the stigma for the shareholders, even for the ones that are struggling for the last 9 years, not strongly diminishing the effect of the other stakeholders, typically the banks in a banking financed environment, to convince the shareholders, and increasing the responsibility of the management in such a delicate moment, to agree to a proposed restructuring of the debtor company?

(4) Instead of identifying the means that could reduce the stigma for the shareholders and management in asking in a timely fashion for restructuring within insolvency, would it not make sense to increase the discipline on the lending side? In other words, rely on banking and funds and suppliers (we do not dare to think about the employees and their representative) to identify the crisis in a timely fashion, with stringent banking and lending regulations, and proposing alternative restructuring within insolvency? Considering how many insolvencies were required by the banks in the two countries, it looks like that the lenders almost fear the reactions of asking a restructuring within insolvency.

(5) The stigma will remain until it is possible to convince the public that restructuring within is not a negative action for the operative company, but that it can show positive future, while it can have adverse impact on the shareholders of the same company.

Based on these reflections, our experience does not consider the argument of the Proposal as a relevant one, on the balance of pros and cons, and we believe the problem will remain, endangering the rights of other stakeholders.

5 Competition among Countries in the Choice of Investors

During the crisis, and even today, some debt restructuring was transferred to other locations, mostly London, in order to obtain an easier debt restructuring, or at least it was planned as such.

The city of London with its the scheme of arrangement has always been perceived as a better location for many cases.

The reason for such perception are in our opinion different from the existence or less of a regulated pre-insolvency restructuring process:

- Most of the investors in the debt were already London based at the time of entering into the distress, and not always at the moment of underwriting the debt at the moment of issue. This can be derived from London being the base for a Credit Distressed Trading Desk, an activity typical of investment banking. For such desks, trading distressed debt is the same that trading other assets. To follow such desks would mean to follow future insolvency legislation to the USA or Asia as the investors could be concentrated there.
- The restructuring of debt always requires a very long considerable time, and London offers the concentration of lawyers, insolvency practitioners, external consultants, etc that can support the investors in their need and even more everything is English language based.
- Especially for corporate bonds, LBOs and high yield bonds, the liquidity of the instrument is derived from the dimensions and from the transferability of the title on a certain almost standardized documentation.
- The liquidity of the debt instruments tends to enable a quick exchange of positions, near to exchange of favour among dealers. This is very important in the evaluation of the net present value of the fund, looking for market-to-market prices instead of keeping the receivables on bank books for the long term.

As a result the London based investors do not have the feeling of "games behind the scenes" typical of bank driven restructuring, especially in different local languages and national legislation.

On the other side, as some products are till now typically (still) offered by the banks only, such as ancillary business (performance bonds, guarantee letters, etc) as well as derivatives, it was not easy, just by transferring the centre of main interests (COMI) to London, to make the investments into a country more attractive.

As seen in the Italian experience, a regulated pre-insolvency debt restructuring package can be introduced, but the investors are not, till now, looking at Italy as place where to allocate their money with high priority. What is for them more important, are factors like government stability, technology and business model of the debtor, financial health of the banking sector, and even for very volatile activity such as the credit distressed debt, the formation of transparent price, which is the derivate of a shortly implementable insolvency and certainty about the flows deriving from the liquidation. This needs to happen through specialized concentrated and unified courts and related practitioners of a sufficient capacity and capability.

Considering the differences in the current legal frameworks in commercial, banking, tax and insolvency law among the European countries, it is more than understandable that the Commission was obliged to compromise and to leave great space for implementation to the different local legislative powers. But just how such a compromise will avoid influencing their investors in their decision is still to be clarified.

For this aspect there are no differences between the German and Italian realities, with the exception of the sizes of the possible targets of the investors. Few Italian companies could represent a liquid asset for such investors, much fewer than in Germany. Further, the few cases are quite relevant for the national politics that identify in Commissariamento through Legge Marzano a further phase in the reorganization of a company before declaring insolvency, depending on the dimension (workforce etc).

6 Increasing the Financing through Capital Markets and Reducing the Relevance of the Banking Debt

The phase after 2010 saw even in Germany, while the banks were repositioning themselves in an uncertain situation, an increase of issuing corporate bonds from midsize companies that either found insufficient banks ready to increase their financing in a riskier environment or the need to refinance equity-like instruments such as the mezzanine debt that were issued in the years 2004-2007. In Italy as above described the banks were keen to refinance the debts of the midsize companies, even if with dimension not comparable with the German ones, through the issuance of high yield debt.

As a result of these and similar aspects, many companies were given access to capital markets without always having the capability in reporting and consequently the transparency for managing the phase of a debt restructuring. The increase in the complexities deriving from a multilayered structure of financing, where banks, bondsholders, factoring and leasing companies, were financing different subsidiaries of a industrial group linked eventually by a cash pooling or intercompany financing scheme, is challenging the traditional praxis of the debt restructuring. The decision of reducing the financing through banks, aiming at similar situations as in USA, could eventually protect the banks' balance sheet from national or international financial crisis that can transmute into economic crisis, but at the same time reduces the turnover of the banks and their capability to sustain the company in a distressed situation. Even more, assuming that the banks are, like mostly in the USA, reducing their lending to the industrial partners to the financing of working capital lines, it will be very difficult to have a future debt restructuring that will be driven by the banks. Their exposure will either be correctly collateralized and therefore with less downside risk, or will be part of a class in which their amount will not be so significant to manage the process of the restructuring.

With the introduction of the International Financial Reporting Standard 9, the banks will be more and more interested in handling the loans and receivables exposures like a market instruments, as they will have to face a very volatile market-to-market evaluation, even worse in the case of the debt being restructured, with de-recognition and rebooking of the remaining debt.

This has been already seen in case such IVG in Germany, where at the end no bank was left but only investment funds, either distressed or commercial real estate. In such an environment, it is clear the need of a regulated pre-insolvency debt restructuring process, as such investors are mostly interested in a pure financial debt restructuring, in which clean and fast haircuts of the existing debt, enables the remaining stakeholders to re-launch the company, or to book their profit or loss in a speedy way, with a lower debt.

Some reflections could be considerable though:

(1) How such situation could currently help SMEs, which because of their dimension cannot reach the capital market dimension of the Proposal, not univocally identifying what is meant by financial lender, will cause the banks to reduce their efforts in forcing a industrial restructuring of the companies *en bloc*?

(2) Further, it has to be hoped that the haircuts that are needed will find sufficient solidity in the balance sheet of the banks, as they will reduce the provision fund and impact their capital ratios and evaluation of migration of portfolios, of the vintage before the introduction of the directive.

(3) Certainly, in a situation in which the banks have already decided to abandon their role as a driver in the debt restructuring, the Proposal is filling an empty space within the unification plan in Europe and at a moment in which the banks have difficulty in identifying their future business model and role.

7 Cramming Down and Qualified Majority

As a logical consequence for the haircuts, needed because of the extensive leverage with complex liabilities structures and of the request of the investors in the issued capital market instruments, the regulations for the cramming down of disturbing factors is totally correct and logical. Considering the difficulties in identifying the holders of the debt in the months during an exercise such as debt restructuring, the search for a unanimously accepted agreement is sometime similar to the search for the Holy Graal. Having said that, and without entering the discussion whether the majority should be represented by 75% or 90%, the challenges that the implementation of the directive will face will be major.

First of all, in a country like Germany, the protection of the rights of the creditors is a absolute fundament of the local legislation. Until now, the solution was found either through other stakeholders buying out the dissenting ones, even against any financial logic, or menacing and finally implementing an insolvency procedure, with the possibilities of using the restructuring within the insolvency. The losses due to not being able to reach an agreement were accepted in view of the defense of the importance of the protection of right of each single creditor. This is in a mostly coordinated national environment, in which the restructuring and financing are banks driven make senses, having the investment funds learned that a long term relationship with the national system was the top priorities for being recognized as long term investors. In the last years, nevertheless, the cases of free-riders, unwilling to consider the arguments of the more traditional players (almost lobby), are showing an increase at the same time during which the number of banks is reducing on the German stage.

In Italy, the original agreement among the banks disappeared with the worsening of the crisis while the cases of declaration of insolvency let the “open bills” among the lenders add up. Currently the *concordato* enables the qualification of the majority among lenders and classes of lenders (75%). The point in the praxis is anyway more challenging than can be be solved through amounts and percentages. In many cases an industrial restructuring at the base of a debt restructuring has to include strategic customers and other business factors (employees). Their exposure, being much more difficult to quantify, is often of even a bigger strategic importance than the one of the financial lenders, assumed to be defined as existing banks and bonds investors. The situation of original equipment manufacturers (OEM) in the automotive business, having given advance payment for future investment tools, the credit insurers for the existing suppliers and whose “virtual” receivables become due in an insolvency, or the communitiess having to grant the permission of developing the ground for the future investment cycle in a real estate company within a urban development plan require clear definition of how these stakeholders need to be considered, if dissenting from the plan approved by the financial lenders.

A final question regards the way of identification of the class of creditors to be crammed down: in some cases the collateral linked to the financing is of different nature among the secured creditors (because of cash flow and of the rank of importance of such collateral in enabling a further existence of the debtor); therefore to set up a single class for all secured creditors can be misleading. The creditor with a better collateral should be allowed to get his rights recognized in a different class reducing the possibility to be watered down in a cramming process. In Italy such arguments have, thanks to the correct interpretation of specific courts, allowed new jurisprudence limiting the rights of cramming down. If the difference is to be made through jurisprudence by, yet to become specialized, single national courts, the introduction of cramming down and qualified majorities will not represent a unifying factor among Europe but a divisive one (as is already happening in Italy).

In summary, the European Proposal for a Directive on preventative restructuring frameworks will surely change dramatically the tradition and praxis of debt restructuring in the EU, but it can be doubted that it will reach the proposed targets in their completeness. The risk of endangering the current role of the banks as a driving force in the restructuring, possibly enabling a further delay in the declaration of insolvency. Some of the targets could be reached better eventually through enhancements in the current frameworks within the insolvency laws. In both ways a much deeper specialization of the courts that will be asked to decide on the matter of the debt restructuring, as well as an increase of their capacity, will be unavoidable and necessary.

PART III
SHAKESPEARE MARTINEAU PRESENTATION INSOLVENCY HOLDERS’ QUALIFICATION, REGULATION, AND REMUNERATION IN THE UK

Chapter 8

Insolvency Office Holders' Qualification, Regulation, and Remuneration in the UK

Christina Fitzgerald and Tania Clench*

1 Becoming a Licensed Insolvency Practitioner ("IP") in the UK

Since 1986 all IPs have been required to be licensed by a recognised professional body ("RPB") or the Department for Business, Innovation and Skills ("DBIS") in England and Wales, or the Department of Enterprise Trade and Investment ("DETI") in Northern Ireland. An individual's licence can be revoked if the holder ceases to be a fit and proper person to act as an IP. Only Licensed IPs are authorised to take appointments as administrative receivers, Scottish receivers, administrators, liquidators, trustees in bankruptcy or sequestration, supervisors of voluntary arrangements, and trustees under deeds of arrangement and trustee deeds.

There are seven RPBs who can license IPs as well as DBIS in England and Wales and DETI in Northern Ireland. Licensing, discipline and ethics are the responsibilities of these bodies. The commitments made by the RPBs are set down in a "Memorandum of Understanding" which records the agreement between the RBPs and the Secretary of State.

Licence holders have considerable responsibilities. Cases are always taken in the name of the individual IP. They are then personally responsible for all the cases taken in their name and for the actions of everyone working on those cases.

Before applying for a licence, you must pass the Joint Insolvency Examination Board ("JIEB") examination and satisfy either one of the RPBs, DBIS or the DETI that you have the necessary practical experience.

The JIEB Exams are held once a year, usually in November.

* Of Shakespeare Martineau LLP.

There are 3 papers:

(1) Liquidations;

(2) Administrations, Company Voluntary Arrangements (CVAs) and Receiverships; and

(3) Personal Insolvency.

To pass JIEB you have to pass all 3 papers, though you do not have to sit them all at once. Candidates who have not passed any of the papers may opt to sit one, two or three papers in one sitting. Candidates who have passed a single paper at any sitting of the exam from 2007 onwards will be allowed to carry forward that pass, but must pass the remaining two papers at the same sitting. They will have five years in which to pass the other two papers.

Candidates who have passed two papers at a single sitting will be allowed five years in which to pass the third. The JIEB exam is notoriously difficult and the average age at which the exam is passed is 33 years old. It is recommended that candidates have at least 3 years' practical experience in all areas examined.

There are four compulsory questions to each paper and Questions 1 & 2 carry 20 marks each and questions 3 & 4 carry 30 marks each. The overall emphasis of the papers is practical and numerical and Candidates must demonstrate the ability to prepare balance sheets, cash flow forecasts, and profit and loss accounts. The pass mark in each paper is 50%.

IPs must also amass a certain number of hours experience in insolvency work and the amount varies according to the body issuing the licence. For example, the Insolvency Practitioners Association requires not less than 600 hours of experience in the 3 years preceding the application for a licence. IPs must have a "bond" in place, a form of insurance against which a claim could be made if the IP acts fraudulently or dishonestly. All IPs are subject to regular monitoring visits, at least once every 6 months, by their RPB and the Insolvency Service visits each RPB and has the power to revoke the RPB's status.

Change may be coming to the UK sector. The new section 390A of the Insolvency Act 1986 allowed the granting of new partial authorisation. This was aimed to encourage those who only practice personal insolvency or Individual Voluntary Arrangements (IVAs) to qualify into the profession. The exam diet in 2016 will remain the same format as recent years. This is because the JIEB is conscious that the administration of either a personal insolvency or a corporate insolvency requires an awareness and understanding of the ethical environment in which any appointment takes place and of all forms of formal and non-formal insolvency procedures. This will remain under review for 2017 and onwards.

In addition to their responsibilities for the administration of the cases, licence holders are responsible for getting the best possible outcome in each case whether it is a small liquidation, a large group administration, an IVA or a complicated bankruptcy. In every case, their ultimate responsibility is to the creditors, but there are also legal, ethical and moral obligations to employees, directors and other stakeholders to consider. Typically IPs are very proud of their work and thrive on the challenges that they face in their chosen profession - most of them would not wish to do anything else!

2 Regulation

Insolvency in the UK is a very highly regulated profession. There are over 120 pieces of legislation extending to some 2000 pages which govern insolvency practice. In addition, IPs are required to comply with Statements of Insolvency Practice ("SIP"s), a series of documents setting out standards of professional conduct with which IPs are required to comply. If IPs depart from the standards, they can face disciplinary action from their regulator. As discussed above, there are 7 RBPs together with DBIS and DETI who regulate IPs. The Insolvency Service is also the "regulator of regulators". The Joint Insolvency Committee ("JIC"), which comprises of representatives from each of the regulatory bodies, and the Insolvency Service meet on a quarterly basis to discuss matters of mutual interest and concern.

IP regulation in the UK is a complex and sometimes contentious area and the regulatory regimes efficacy and potential reform represent a key challenge for policy makers, regulators and members of the profession over the coming years. The Office of Fair Trading's ("OFT") recent study into the corporate insolvency market recommends certain changes to insolvency regulation and it is likely that the Government, through DBIS, will explore options for reform during the current Parliament.

In the UK there are currently concerns over consistency of approach from one regulator to the next and that the regulatory structure can be confusing to anyone who is not familiar with it.

We would welcome effective reform and rationalisation of the regulatory system, with the possibility of reducing the number of regulators and/or introducing a single regulatory framework, under which anyone advising on and acting in insolvency cases would operate. We certainly believe that the vast majority of IPs undertake their statutory functions diligently and professionally but as with all industries, it is important that the regulatory regime is capable of strong enforcement to deal with misconduct in order to protect the integrity of the profession.

3 Remuneration of IPs in the UK

IPs act as office-holders in insolvency procedures and are given extensive powers by legislation. They take decisions that can have a significant impact on the funds available to creditors; their fees are paid out of the assets in cases.

The statutory provisions relating to the remuneration of IPs are set out in the Insolvency Rules 2016. Rules 18.15 to 18.38 of the Insolvency Rules 2016 deals with remuneration principles, fixing of remuneration, challenges by creditors and applications to Court by officeholders in relation to their remuneration. SIP 9 was one of a series of guidance notes produced to maintain standards by setting out agreed best practice. Concerns have been expressed about the level of IP charges and the consequential impact on unsecured creditors.

The Office of Fair Trading ("OFT") launched a market study into corporate IPs in 2009. A review was undertaken and the Report of Professor Kempson was published in July 2013 supporting the OFT's findings.[1] The Report concluded that, where there was insufficient creditor control of fees, the fees tended to be higher. Professor Kempson also noted that reports to creditors were typically formulaic, which discouraged meaningful engagement.

The outcome of the Report is reflected in a new SIP 9 and the Insolvency Amendment Rules 2015[2] which came into effect on 1 October 2015.

Under the new rules IPs are required to provide a summary of estimated costs, the work to be undertaken and, where an hourly rate is proposed, an estimate of the expected time. These estimates act as a cap on fees as, once agreed, they can only be changed by agreement between the IPs and the creditors. The new Rules apply to:

- Administration;
- Creditors' voluntary liquidation;

1 Professor Elaine Kempson, "Review of Insolvency Practitioner Fees" (July 2013, Report to the Insolvency Service) available from http://www.bristol.ac.uk/media-library/sites/geography/migrated/documents/pfrc1316.pdf.

2 The Insolvency (Amendment) Rules 2015, SI 2015/443.

- Compulsory liquidation (unless the Official Receiver acts as liquidator); and
- Bankruptcy (unless the Official Receiver acts as trustee in bankruptcy).

In addition to accommodating these legislative changes, the new SIP 9 provides a significant shift in emphasis towards the importance of the narrative explanations provided to creditors. This largely reflects what creditors have said they wish to receive, namely, less formulaic reporting, with meaningful explanations of:

- What has or will be done by the office holder;
- What the office holder has achieved or expects to achieve; and
- What the office holder expects the costs will be.

In keeping with the prevailing theme of transparency, the SIP contains a new provision:

> "Where it is practical to do so, the office holder should provide an indication of the likely return to creditors when seeking approval for the basis of their remuneration."

This reflects what creditors groups have reported namely, that this is the key piece of information from their perspective.

The provision of an indication of the likely return to creditors is perhaps the most significant addition to the consultation draft, and reflects the wishes of creditors to be told at an early stage whether there is any significant prospect of a distribution to them.

The SIP has been written in such a way as to guide practitioners as to the qualitative nature of what is required. In that sense, it is perhaps less onerous than it could have been, as it does not specify a format or a detailed list of matters to be covered (as does SIP 16, for example). It seeks to encourage practitioners to take a meaningful approach to their compliance with the Insolvency (Amendment) Rules 2015. One size will most definitely not fit all in this context.

The added challenge relates to the need to submit fees and expenses estimates before the determination of basis upon which the IP's fees are to be calculated, thereby requiring accurate estimates early on. As stated above, too low an estimate will place a cap on fees and will require further recourse to creditors for approval at a later stage.

It is often difficult to estimate fees at a very early stage when the precise work an insolvency job may produce is unknown and where there is limited (or incorrect) information. Questions to be asked will include *'Is litigation likely to be needed? Will the directors comply or prove hostile? Will there be difficult creditors to deal with?'* It is not clear whether it will be possible to caveat or qualify estimates in order to allow the increases in the estimated amount without the need to refer back to creditors.

While there has been some disquiet in the profession about the absence of a template or suggested format for fee estimates, this is fully intended to reflect the fact that a fee estimate in a simple case might be little more than a few lines of text, while such a brief explanation will almost certainly be inadequate in more complex scenarios. Explanations cannot be scripted in advance and the level of detail required will vary from case to case. Another situation where one size will not fit all.

PART IV
YOUNGER ACADEMICS NETWORK OF INSOLVENCY LAW (YANIL)

Chapter 9

Ranking of Creditors in Insolvency: An Empirical Debate on Optimal Harmonization Practices

Eugenio Vaccari

1 Introduction

The European Commission and Parliament have long advocated for substantive and substantial changes in national insolvency[1] practices, on the premises that disparities between national systems create obstacles to the functioning of an efficient internal market, hinder economic growth (or recovery), and impact the availability and cost of investments.[2] Furthermore, there is a general understanding that integration of capital markets is seriously jeopardized by lack of sufficient harmonization in insolvency law.[3]

These calls have triggered some changes to insolvency law within Member States. However, unsatisfactory and uneven progress has been achieved, with the subject of creditors' ranking proving one of the most resistant to harmonization.

With reference to ranking of creditors, the academic community seems to support the proposal of "whitewashing" existing statutory privileges, with very few notable exceptions.[4] Priorities recognized by the law should be reduced to a minimum,

1 Depending on the jurisdiction, there are different understandings of the meaning of 'insolvency law'. This paper adopts the English version of the notion. Therefore, the term 'insolvency law' is used to refer to corporate practice, while the term 'bankruptcy law' is relegated to cases dealing to individuals. Occasionally, in direct quotations from other authors, this distinction may not be respected.

2 EC Communication "Towards the Completion of the Banking Union" Com (2015) 587.

3 "Five Presidents' Report" on "Completing Europe's Economic and Monetary Union", 22 June 2015.

4 See, among others: Alan Schwartz, 'Security Interests and Bankruptcy Priorities: A Review of Current Theories' (Jan. 1981), 10(1) The Journal of Legal Studies 1; Jacob S. Ziegel, 'Preferences and Priorities in Insolvency Law: Is There a Solution?' (1994-1995) 39 St. Louis University Law Journal 793; Vanessa Finch, 'Security, Insolvency and Risk: Who Pays the Price?' (Sept. 1999) 62(5) The Modern Law Review 633.

or should not be recognized at all, a position mildly supported by international organizations, more cautious in their recommendations.[5]

This paper looks at Italian treatment of statutory priorities in insolvency law. It focuses on the priority ranking granted to a particular category of small entrepreneurs, collectively defined as 'artisans' (section I). While not questioning the validity of the proposed harmonization process, and the recommendation for getting rid of statutory priorities, it evidences the hurdles that have to be overcome in the process of repealing these mechanisms from Italian law (sections II and III). Accordingly, it proves that, if European institutions adopt a soft, as opposed to a hard harmonization approach, the Italian legislator may more easily achieve the market integration goal, without disposing of domestic distinctiveness (sections IV and V).

2 Italian Insolvency Law

Under the existing Italian insolvency legislation, there are roughly 114 statutory exceptions to the principle of rateable distribution among unsecured creditors. This is without considering rights *in rem* and the preferential treatment of the expenses accrued during the insolvency procedure.[6]

Commentators have tried to determine the reasons that push some legislation to single out so many claimants from the wider category of unsecured creditors, and from the rateable principle that should guide the distribution of proceeds among them. It has been rightly observed that in some countries, priority claims "perform the function undertaken by security credits in other systems".[7] Nevertheless, in my opinion such an exorbitant and striking deviation from equality in distribution can be satisfactorily explained only as the by-product of ongoing political and economic pressures, a point of view shared in other contexts and documents.[8]

5 In reality, this conclusion is fully supported by the UNCITRAL, which in its Legislative Guide on Insolvency Law, Parts One and Two, states that "[m]aintaining a number of different priority positions for many types of claim has the potential to complicate the basic goals of insolvency and to make efficient and effective proceedings difficult to achieve". More recent documents from the World Bank - namely the 'Principles for Effective Insolvency and Creditor/Debtor Regimes' (2016) and the 'Revised Principles for Effective Creditor Rights and Insolvency Regimes' (2011) - adopt a more cautious approach, and simply advocate for the establishment of clear rules for the ranking of creditors, including prioritized ones.

6 Available at http://fallimento.it/redazione/Privilegi/index.htm (last viewed 21 July 2016).

7 José M. Garrido, 'The Distributional Question in Insolvency: Comparative Aspects' (1995) 4 *International Insolvency Review*, 25, p. 41.

8 UNCITRAL, 'Legislative Guide on Insolvency Law - Parts One and Two' (2004), where it is written that "priority rights, which are often based upon social, and sometimes political, considerations, militate against the principle of pari passu distribution and generally operate to the detriment of ordinary unsecured creditors by reducing the value of the assets available for distribution to them" (270).

Irrespective of the majority position against the recognition of priority claims in the law,[9] Italian legislation recognizes a priority ranking to certain Micro, Small, or Medium Enterprise (MSME) claimants, should one of their debtors enter into an insolvency procedure. An *ex ante* approach aimed at protecting companies considered at high risk of insolvency.

According to article 2751 *bis* (5) of the Civil Code,

> "[a] general privilege on movable property is granted to claims relating to […] claims of an artisan enterprise [as defined according to the enforceable law] and of cooperative societies or institutions for production and work, for the compensation of services rendered and the sale of manufactured products".[10]

This article was introduced by means of law no. 426/1975, to grant additional protection to certain creditors (including artisan entrepreneurs) who were considered "worthy" of special consideration by the Italian Constitution.[11]

This rule represents a serious obstacle to the European Commission's call for closer approximation in substantive insolvency practice. While it is undeniable that rules can change, whenever they are the expression of established principles and values they prove more resilient to modification. The next sections demonstrate the issues that had to be taken into consideration in reforming the priority treatment of artisan entrepreneurs.

3 Artisans - Peculiarities

The profession of 'artisan' has always been associated with the making of art (it. "*artefatto*", lat. *arte + factu*, made in an artistic fashion) and hand works (it. "*manufatto*", lat. *manu + factu*, made by hand). The Italian legislature developed the legal notion of 'artisan' against this background. Therefore, it comes as no surprise that the first legal understanding of 'artisan' was closely related to the commonly accepted belief of this labourer as a craftsman, who primarily made his living in a workshop, relying mainly on manual work.

9 For a summary see (among others): Ziegel, above note 4; Garrido, above note 7; José M. Garrido, 'No Two Snowflakes the Same: The Distributional Question in International Bankruptcies' (2011) 46 Texas International Law Journal 459.

10 Susanna Beltramo, *The Italian Civil Code and Complementary Legislation* (West/Thomson Reuters, 2012), at 699. The words in brackets were added by law no. 35/2012, and were translated into English from Italian by the author of this note. The term "cooperative societies" should be translated as "cooperative companies".

11 Article 35(1) of the Italian Constitution lays down that "The Republic protects work in all its forms and practices", while article 45(2) specifies that it is up to the law to "safeguard and promote artisanal work". These are the translations in English of the Italian text made by the author of the present note.

This is the position adopted by the first "modern"[12] statute that mentioned this group of workers. Pursuant to law no. 830/1925, the notion of 'artisan' was to be used only with reference of those self-employed people, who exercised their craft in an artistic workshop, alone or with the exceptional assistance of a salaried apprentice, and with the occasional use of 'mechanical means'.[13]

Neither the Civil Code (enacted in 1942) nor the Constitution (enacted in 1948) provide a specific definition of 'artisans'. Only article 2083 of the Civil Code lays down that the category of 'small entrepreneurs' is formed by

> "farmers who personally cultivate the land, artisans, small tradesmen and those who engage professionally in an activity organized mainly with their own work and that of the members of their families"[14] (emphasis added).

It would seem, therefore, that artisans have been treated similarly to several other categories of entrepreneurs. In reality, this conclusion would be fallacious, for the following reasons.

Firstly, later amendments in the law prove that their corporations have constantly lobbied for (and succeeded in) obtaining particular consideration by the government. They have efficaciously conveyed the message that artisans are substantially similar to salaried workers, thus achieving significant fiscal, administrative and legal advantages for their members.[15]

As part of this process, law no. 426/1975 recognized the priority treatment in insolvency for these entrepreneurs, by means of an amendment of Civil Code rules. Quite unsurprisingly, the ranking of priority recognized to these entrepreneurs is substantially similar to the ranking of salaried workers.

Secondly, they campaigned for, and managed to amend the legislative definition of their category, to include as many self-employed entrepreneurs as possible. Even the original definition of 'artisan', while narrow for contemporary standards,

12 'Modern' refers to legislation enacted after the unification of the different states that formed the Italian peninsula, and the settlement of a central government in Rome (17 March 1861).

13 For an analysis of the preliminary evolution of the legislation on artisans, see F. Cavazzuti, 'Le Piccole Imprese' in F. Galgano (eds), *Trattato di Diritto Commerciale e di Diritto Pubblico dell'Economia* (1978, Cedam, Padova).

14 Beltramo, above note 10, p. 441.

15 These advantages originally included the exemption from keeping accounting entries, the registration in a special section of the Companies' House register, and the exemption from insolvency procedures.

was less so if we contextualize it within the economic and social situation that the country experienced in the first half of the 20th century.[16]

The 1956 amendments[17] allowed artisans to avert the risk of losing legislative protection and financial benefits. The new law recognized the industrialization of the artisan practice,[18] and provided a definition of artisan entrepreneur valid "*for any purpose of the law*".[19] This trend has also been reinstated in following reforms. Law no. 443/1985 further extended the notion of 'artisans', and anchored it to quantitative rather than qualitative criteria (even though the definition was no longer valid for any purpose of the law). Later on, laws no. 133/1997 and 57/2001 conceded that artisans could incorporate their workshops and activities in the form of limited liability companies, even with more than one shareholder.

More recently, partly in reaction to the dissatisfaction of the business community (namely: the artisan lobbies), and partly out of a need to provide a higher degree of certainty in the judicial interpretation of legal standards, law no. 35/2012 - which amended art. 2751 *bis* (5) of the Civil Code - specified that there is only one definition of 'artisan', and that is the definition set out in the special law ("as defined according to the enforceable law").[20] In other words, the most recent legislator opened the floodgates to the recognition of a wide category of beneficiaries of the priority status in insolvency. This is despite the opposing call for reforms from the European Union and UNCITRAL, but partially in accordance with the guidelines provided by the World Bank.

16 Mechanical instruments were expensive, people tended to live in small villages in the county, and Italy was still in the early stages of industrialization. It is therefore safe to assume that a relevant part of autonomous, self-employed workers fit in the definitions of 'artisan' and 'small entrepreneur'.

17 Law no. 860/1956.

18 Entrepreneurs could subsequently still be qualified as 'artisans' despite: incorporating themselves in some of the existing corporate forms; employing a limited number of salaried workers; and making use of more sophisticated mechanic tools to produce goods *and* services.

19 This specification appears tautological, but in reality is extremely important. Law no. 860/1956 was mainly enacted to determine the criteria that certain self-employed entrepreneurs should respect in order to benefit from tax rebates and other preferential treatments. The specification that the definition is valid 'at any effect of the law' means that, in the legislator's view, the judiciary should have looked *only* at the statutory criteria set out in the 1956 law to determine if an artisan is a small entrepreneur according to art. 2083 of the Civil Code. Another proof of the effective lobbying activities of this corporation.

20 This is the translation in English of the Italian text made by the author of the present note.

Law	Content
Law no. 830/1925	Notion of ‘artisan’ as self-employed craftsman; little mechanical help.
Civil Code (royal decree no. 262/1942)	Art. 2083: ‘artisans’ are small entrepreneurs, if personal work prevails over the work of the members of their families and over capital.
Constitution (1947/1948)	No definition of ‘artisan’.
Law no. 860/1956	‘Artisan’ defined for any purpose of the law as a self-employed entrepreneur or a company, which may produce goods *and* provide service while employing salaried workers and making use of mechanical tools.
Law no. 426/1975	Introduction of art. 2751 bis in the Civil Code. ‘Artisans’ (as defined by art. 2083 c.c.) are recognized a priority ranking among unsecured creditors in insolvency proceedings.
Law no. 443/1985	‘Artisans’ no longer defined for any purpose of the law, but definition is anchored to loose quantitative criteria and procedural requirements.
Laws no. 133/1997 and no. 57/2001	‘Artisans’ could enjoy the benefits of limited liability.
Law no. 35/2012	Amendment to art. 2751 *bis* (5) of the Civil Code: to identify artisans, it is necessary and sufficient to look at the criteria set out in the special legislation (e.g. law no. 443/1985 as subsequently amended).

Thirdly, artisans have successfully campaigned for a change in the judicial understanding of the notion. This is not yet the position of the Supreme Court which, back in 2000,[21] held that

> “the qualification of an individual entrepreneur as an artisan […] requires the prominence of the contribution of labour over invested capital, and of personal or even manual work, from the owner of the enterprise”.[22]

Additionally, back in 1998,[23] the Supreme Court clarified that

> “law no. 860/1956 […] shall be considered as a natural integration, specification and clarification of article 2083- both under a qualitative

21 Eraldo c. Fall. soc. Ocn - PPI, C. Cass. no. 15785/2000, in *Giust. Civ, Mass*. 2000, 2598.

22 This is the translation in English of the Italian text made by the author of the present note.

23 Ditta Allibardi Salotti c. Fall. Gherardi, C. Cass. no. 456/1998, in Giust. Civ. Mass. 1998, 105.

> and […] a quantitative perspective. However, an enterprise cannot be defined as 'artisanal', merely because it matches the quantitative requirements set out in articles 1 and 2 of law no. 860/1956"[24] (emphasis added).

The Supreme Court[25] and the majority of lower courts[26] have been consistent in ruling that *only* those 'artisan enterprises', which possess both the qualitative criteria set out in the Civil Code (article 2083) and the quantitative criteria set out in the special legislation (law no. 443/1985), are entitled to the priority ranking.[27]

Despite that, some courts[28] (backed by some commentators[29]) seem to favour the opposite solution, according to which only the definition provided in the special law is relevant to determine the beneficiaries of priority treatment in insolvency. It appears that the 2012 amendments would result in a change of the consolidated jurisprudence, in favour of the adoption of this understanding of the notion of artisan for insolvency law purposes.

4 Further Obstacles to Repealing Priority of Artisans in Insolvency Law

The previous section has shown that artisans successfully campaigned for obtaining specific consideration from both the law and the judiciary. Irrespective

24 This is the translation in English of the Italian text made by the author of the present note.

25 See among others F.lli Zanchetta S.n.c. c. S.V., C. Cass. no. 7116/2015, in *Diritto & Giustizia*, 10 April 2015; Soc. Battocchia Termo c. Fall. soc. Edil 200, C. Cass. SS.UU. no. 5685/2015, in Giust. Civ. Mass. 2015; Annapiù Tricot di Carrer Anna Maria & C. S.n.c. c. Fallimento Harold S.r.l., C. Cass. no. 11024/2013 (unreported). Similar conclusions were reached in older judgments, such as Fall. Deiani e altro c. Leonesio, C. Cass. no. 11963/1990, in Giur It., 1991, I(1), 1014; and Soc. De Benedetti c. Fall. soc. Rossi, C. Cass. no. 7366/1998, in Giust. Civ. Mass. 1998, 1603. Unfortunately, all these judgments refer to the law applicable before the 2012 amendments. In fact, despite some of them being given after the enforcement of the modifications, the Supreme Court clarified that the new version of art. 2751 *bis* (5) does not apply to insolvency procedures filed before 2012 (see Cass. SS.UU. no. 5685/2015, cited above in this note). As such, the Supreme Court has not yet had the opportunity to clarify whether the 2012 amendments modified the commonly accepted criteria for determining whether a company is an 'artisan' or not.

26 Among others, see Trib. Udine, 11 June 1982 and 22 August 1983, in Giur. Comm., 1984, II, 49; and Trib. Genova, 4 August 1982, *Banca Borsa Titoli di Credito*, 1983, II, 567.

27 In other words, the prevailing opinion in the judiciary is that – for the purposes of art. 2751 *bis* (5) of the Civil Code - 'artisans' should be small entrepreneurs whose work (and that of the members of their family) prevails over the work of any other employee and on the assets (as per art. 2083 of the Civil Code). Additionally, their company should meet the criteria set out in law no. 443/1985. But this understanding is likely to be revised for post-2012 cases.

28 Decreto Tribunale Milano 14 June 2013, Eredi di Frigerio Angelo di Leonardo Frigerio & C. S.n.c. c. Fall. Immobiliare Costruzioni IM.CO. S.p.a. (unreported), available at: http://www.ilcaso.it/giurisprudenza/archivio/9874.pdf [last viewed: June 14, 2016]; App. Torino, 30 April 1986, in *Fall.*, 1987, 817; Eraldo c. Fall. soc. Ocn - PPl, C. Cass. no. 15785/2000 in *Giust. Civ. Mass.*, 2000, 2598; and Ditta Allibardi Salotti c. Fall. Gherardi, C. Cass. no. 456/1998, in *Fall.*, 1986, 915.

29 G. Bozza and G. Schiavon, *L'Accertamento dei Crediti nel Fallimento e le Cause di Prelazione* (1992, Giuffré, Milano), at 928.

of the power of their lobby, this section illustrates other, tangible obstacles that may hinder repealing this statutory priority from the law.

The first aspect is the relation between statutory laws enacted by the Parliament and Italy's fundamental law, the Constitution. While the priority ranking in insolvency for artisans was introduced only by means of law no. 426/1975, the Italian Constitution mentions artisans in two different articles (even if in one case only indirectly). These references are particularly surprising given it is a relatively short piece of legislation with only 139 articles, which are very broad in scope.

Article 35(1) of the Constitution clarifies that "The Republic protects work in all its forms and practices". Artisanal practice is included in this notion of "work", as clarified by the case law[30]. Furthermore, pursuant to article 45(2) "<u>The Law</u> safeguards and promotes artisanal work" (emphasis added).[31]

These articles are not sufficient to claim that the statutory priority for artisan entrepreneurs enjoys a "constitutional" protection. Nevertheless, it is undeniable that the legislation, which has introduced this mechanism into the Civil Code, has aimed to transplant a mandate specified in the Constitution.

Furthermore, the choice to introduce this priority ranking by means of an amendment to the existing Civil Code should not be underestimated. The Civil Code, despite its lack of hierarchical prominence over other statutes, is remarkably more prestigious than any other legislative instrument.

Finally, the Constitutional Court has proven very resilient in allowing the legislator to amend the "rights" of Italian citizens. For instance, it took the government three attempts[32] to establish a "solidarity contribution" on retirement benefits exceeding the threshold of €90,000 per year. If the Constitutional Court considered that the priority ranking of artisan entrepreneurs aims to safeguard and promote artisanal work, its repeal might prove problematic. In truth, this is a remote and unlikely

30 Adriano Patti, *I Privilegi* (2003, Giuffré, Milano), at 201. The belief that priority treatments granted by means of art. 2751 *bis* of the Civil Code represent the enforcement of the constitutional principle according to which 'work in every forms and practices' needs to be protected, is supported by the prevailing jurisprudence (see the judgment no. 1/2000 rendered by the Constitutional Court).

31 This is the translation in English of the Italian text made by the author of the present note. Article 45 in particular entrusts the legislator to define the statutory measures to not only protect, but also promote the development of artisanal work. This attention to this typology of enterprise has, for some authors, resulted in "*iper-regulation*" – P.F. Lotito, 'Commentary to Art. 35 of the Italian Constitution' in R. Bifulco et al (eds), *La Costituzione Italiana* (2007, Strenna Utet, Milano) at 927.

32 The first attempt (law no. 111/2011) was quashed by the ruling no. 116/2013 in the case B.G. et al c. Inps et al. (*Giurisprudenza Costituzionale*, 2013, 3, 1886). The second attempt (art. 1(1), law no. 214/2011) was successfully challenged in C.G. et al c. Pres. Cons., C. Cost, no. 70/2015, in Foro Amministrativo 2015, 4, 1004.

hypothesis, but there are precedents, and a legal basis for it being advocated in a courtroom.

The second aspect to be taken into account is the relevant role that micro-enterprises and, in particular, artisan enterprises play in the current economy. In the case of artisans, there are also political considerations closely linked to sustaining the economic relevance of this category of entrepreneur.

According to the most recent available data[33] (that refer to the situation as at 31 December 2013), micro-enterprises (with less than 10 people employed) represent 95.3% of active enterprises, 47.45% of number of persons employed, and constitute 25.85% of total turnover generated by companies in the country. Among these micro-enterprises, there are 2.4 million employing only one person, which contributes a third of the global turnover generated by this class.

Small and medium enterprises (10-249 people employed) provide work to 32.88% of the total labour force and account for 43.18% to turnover, while larger enterprises (250+ employees) grant a workplace to 19.7% of the workforce, and account for almost 31.0% of the global turnover.

Size Classes	**No. of Enterprises**	**%**	**No. of Persons Employed**	**%**	**Turnover (ml €)**	**%**
0-9	4,094,444	95.27	7,518,178	47.45	762,497	25.85
10-19	127,998	2.97	1,679,039	10.6	316,186	10.72
20-49	50,760	1.19	1,510,447	9.53	343,315	11.64
Total (1)	**4,273,202**	**99.43**	**10,707,664**	**67.58**	**1,421,998**	**48.21**
50-249	20,897	0.49	2,021,059	12.75	614,279	20.82
250+	3,383	0.08	3,116,677	19.67	913,555	30.97
Total (1+2)	**4,297,482**	**100**	**15,845,400**	**100**	**2,949,832**	**100**

In summation, companies with up to 49 employees, which are, for the largest part, potentially eligible under current legislation to be classified as “artisan enterprises”, represent 99.43% of Italian companies, despite employing “only” 67.58% of the workforce and contributing less than half of global business turnover.

33 ISTAT, Report on the Structure and Competitiveness of the Industrial and Services Enterprises, available at: http://www.istat.it/en/archive/175960 (last viewed 20 July 2016).

These represent quite remarkable numbers, although not dissimilar to those experienced in other jurisdictions.[34] Nevertheless, it is the role that these companies play in the society (section III) and their constitutional prominence (first half of section IV), which push the Italian legislator to continue to recognize their priority within insolvency law.

5 Perspectives of Reform

The political influence, statutory protection, and economic relevance that artisan enterprises have been able to obtain in Italy have also affected the scope and content of recent reforms in the field of insolvency law.

Italian authorities have undertaken successive reforms in recent years[35]. What has always been lacking is a "global view". More recently, however, on February 10, 2016 the Cabinet adopted a draft statutory instrument ('the bill'[36]) to reform the Italian insolvency framework from the grounds-up.[37]

To be enforced, this bill shall be approved by the Parliament, and published on the *Official Gazette* ('the act'). At that point, the Government will have the authority (and twelve months) to amend the current legislation by means of one or more law decrees ('the decrees'), which have to conform to the requirements and directions set out in the act. It is the enactment of these decrees that will determine a change in the applicable law. If enacted, the act will be binding only with reference to the content of the reform. The Government will not be forced to issue the decrees, and the delegation may expire without any amendment to the law being introduced.

34 According to the Department for Business, Innovation & Skills' study on *Business Population Estimates for the UK and Regions 2015*, small businesses accounted for 99.3% of all private sector businesses at the start of 2015, and 99.9% were small or medium sized (MSMEs). Department of Business, Innovation & Skills, Business Population Estimates for the UK and Regions 2015, available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/467443/bpe_2015_statistical_release.pdf (last viewed 20 July 2016). Similar data were collected by EUROSTAT with reference to other countries within the European Union - available at: http://ec.europa.eu/eurostat/web/structural-business-statistics/structural-business-statistics/sme (last viewed 20 July 2016).

35 For a summary, see José Garrido, IMF Working Paper on Insolvency and Enforcement Reforms in Italy, WP/16/134, at 7 - available at: https://www.imf.org/external/pubs/ft/wp/2016/wp16134.pdf (last viewed 29 July 2016). The Author notes that "[t]he frequent and sudden modifications of the law have, however, come at a cost of undermining legal certainty", p. 8.

36 More precisely, it is a 'proposal for delegated legislation'.

37 The bill has already been interested by significant amendments. At the moment, debate is taking place over two proposals: (i) C-3671 *bis* - available at: http://www.camera.it/_dati/leg17/lavori/stampati/pdf/17PDL0041360.pdf (last viewed 26 July 2016) which deals with the main body of the reform; (ii) C-3671 *ter* - available at: http://www.camera.it/_dati/leg17/lavori/stampati/pdf/17PDL0041370.pdf (last viewed 26 July 2016) which reforms the discipline of a rescue procedure for large corporations only.

This call for reform has been justified not only by "conventional" reasons, such as the need to reduce inconsistencies between old and more recent provisions; to ease administrative burdens; or to streamline judicial practice. In the explanatory documents attached to the bill, the Italian Ministry of Justice has urged for implementing a system of best practices and recommendations that have emerged at the international and regional/European level.

It is not surprising, therefore, to read that one of the purposes of the act should be to repeal or reduce statutory priorities.[38] However, it is interesting to observe that the subject of statutory priorities has hardly been mentioned in the hearings in front of the Parliamentary Commission in charge of drafting the bill. It is highly questionable, therefore, if the final act will contain any reference (apart from general ones) to this subject.

Furthermore, even if that was the case, the government would have to be able to overcome the fierce opposition of artisan lobbies to enact a reform, which cancelled their priority status, or reduced their economic and administrative privileges in general law. This in a period, which is likely to be close to the next general elections.

6 Conclusion

This paper speculated why artisans' ranking in Italian insolvency law has proven so incredibly resilient to reform. It investigated the social and legal obstacles that have prevented in the past, and still prevent at present, the enactment of a law, which repealed their priority status in insolvency.

It appears from the reasons highlighted in the main body of the article that any such proposal is unlikely to be enforced in the short term, since it would cause much havoc in the economic community, and it would trigger extensive litigation in courts.

A less troublesome alternative, however, may be possible.

38 Introductory explanation to the V Commission of the House of Parliament ("*Camera dei Deputati*") of the purposes and scope of the proposal for delegated legislation rendered by the Ministry of Justice, Leoluca Orlando - Camera dei Deputati, Atti Parlamentari XVII Legislatura n. 3671, available at: file:///C:/Users/Vale/Downloads/17pdl0039820.pdf (last viewed 22 October 2016). The section dedicated to priority rankings in insolvency is no. 13 out of 15. It seems that matters were organized in order of importance/urgency.

If the Italian legislator wanted to restrict the priority treatment to those small[39] artisans, who find themselves in a situation substantially similar to that of unskilled salaried workers, it could rephrase art. 2751 *bis* (5) of the Civil Code[40] as follows:

> *"Hanno privilegio generale sui mobili i crediti riguardanti: [...] (5) i crediti dell'artigiano (...) che esercita un'attività professionale con il lavoro proprio e dei componenti della famiglia, per i corrispettivi dei servizi prestati e della vendita dei manufatti".*
>
> "A general privilege on movable property is granted to credits relating to […] claims of an artisan (…) who engages professionally in an activity organized mainly with his/her own work and that of the members of their families, for the compensation of services rendered and the sale of manufactured products".

Laws should be sufficiently flexible to allow both judiciary and practitioners to exercise adequate discretion in their implementation. As a result, the Italian legislator may explore the opportunity of introducing in its insolvency framework a provision similar to 11 U.S. Code §.105(a), like the one that follows:

> *"L'autorità giudiziaria competente può adottare ogni ordinanza, decreto o sentenza che appaia necessario o appropriato per implementare le disposizioni [della presente legge]".*[41]
>
> "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions [of this law]".

This proposal for reform is unlikely to be rejected *a priori* from the associations and corporations, which defend the interests of artisans. Even if that was the case, the government may argue that it is simply working to introduce new rules designed to better achieve the general purposes of the law, and to recognize a more effective protection to artisan entrepreneurs. This would significantly reduce the risk of lengthy litigations in courts.

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This paper has therefore illustrated the merits of adopting a soft law harmonization approach on the subject of creditor priorities in insolvency law. While the alternative solution (a single law for all European Member States) would be harder

39 According to the European standards set out in the EU Recommendation 2003/361.

40 The Rordorf Commission advocated for grouping the insolvency discipline in a single piece of legislation, outside the Civil Code. Nevertheless, this provision can easily be accommodated within this yet-to-be-drafted bill.

41 This is the translation in Italian of the English text made by the author of the present note.

to negotiate, and could lead to non-uniform interpretations at national level, this soft law harmonization approach may yield results in a shorter timeframe, without unduly repressing domestic peculiarities. Furthermore, its implementation would prove less troublesome at national level.

Chapter 10

Time to Renew the Debate on Cross-Border Insolvency Law: Out with Theoretical Ideals, in with Pragmatism

Emilie Ghio*

1 Introduction

The difficulties caused by cross-border insolvency cases and the search for a viable solution are not new. The effective handling of insolvencies involving multinational companies operating in various countries is an unresolved problem of international insolvency law. As far back as 1888, John Lowell wrote:

> "It is obvious that … it would be better in nine cases out of ten that all settlements of insolvent debtors with their creditors should be made in a single proceeding, and generally at a single place."[2]

Over the last couple of decades, academics have vigorously debated which approach to cross-border insolvency is best. The debate usually centres on questions of predictability, certainty, national sovereignty, fairness, and efficiency. In this academic discourse over the most appropriate design for an international insolvency system, two theoretical approaches have traditionally been identified: universalism and territorialism. Universalism means that one jurisdiction should administer the insolvency proceedings and the debtor's assets should be dealt with on a worldwide basis. Since universalism requires a single law to be applied, it goes hand in hand with harmonisation of insolvency law, both procedural and substantive. The most eloquent[3] and effective proponent of universalism in the last decade has been Professor Jay Westbrook. Territorialism on the other hand means that any State in which the debtor's assets are located has jurisdiction to open insolvency proceedings, applying its own domestic insolvency law to distribute the assets for the benefit of local creditors. In the most recent past

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2 J. Lowell, "Conflict of Laws as Applied to Assignments of Creditors" (1888) 1 Harvard Law Review 259-264, p. 264.

3 See J.A.E. Pottow, "The Myth (and Realities) of Forum Shopping in Transnational Insolvency" (2007) 32 Brooklyn Journal of International Law 785-818, p. 785.

Professor Lynn LoPucki has traditionally been the main advocate for a territorialist insolvency system.

Even though it has widely been accepted in academic literature that universalism is preferable, the reality of the international insolvency scene is quite different.

The substantive differences in domestic insolvency laws have precluded the development of a uniform approach to multinational default:

> "[t]he ensuing diversity of [insolvency laws] has been unusually intense, even by the standards of private international law, with the result that the quest for unifying principles has so far proved to be elusive."[4]

As a matter of fact, if universalism has been advocated as the ideal solution to the issue of cross-border insolvencies, it is now also accepted that it is an unreasonable objective in the foreseeable future. Recent international developments, such as the European Insolvency Regulation[5] in particular, show that it has largely been discarded and replaced by a more reasonable, grounded approach, trying to achieve solutions which, although more modest than the initial goal of universalism, are also more achievable in the present circumstances.

2 The Theoretical Debate

The debate on universalism versus territorialism has been, in the end, quite heated in the United States.[6] If we look at the different approaches proposed by scholars, they all come from the United States: Professor Westbrook – from the University of Texas at Austin - is the main proponent of universalism, Professor LoPucki – from UCLA - the main advocate for a territorialist system, Professor Rasmussen – from the university of Southern California - proposed a system based on a contractual

4 I. Fletcher, *Insolvency in Private International Law* (1999, Clarendon Press, Oxford), p.10.

5 Council Regulation (EC) No. 1346/2000 of 29 May 2000 (OJ 2000 L160/1) (hereafter referred to as the "EIR").

6 See e.g. L.A. Bebchuk & A.T. Guzman, "An Economic Analysis of Transnational Bankruptcies" (1999) 42 Journal of Law & Economic s 775; A.T. Guzman, "International Bankruptcy: In Defense of Universalism" (2000) 98 Michigan Law Review 2177; L. LoPucki, "Cooperation in International Bankruptcy: A Post-Universalist Approach" (1999) 84 Cornell Law Review 696; L. LoPucki, "The Case for Cooperative Territoriality in International Bankruptcy" (2000) 98 Michigan Law Review 2216; J.A.E. Pottow, "Procedural Incrementalism: A Model for International Bankruptcy" (2005) 45 Virginia Journal of International Law 935; J.A.E. Pottow, "Greed and Pride in International Bankruptcy: The Problems of and Proposed Solutions to 'Local Interests'" (2006) 104 Michigan Law Review 1899; R.K. Rasmussen, "A New Approach to Transnational Insolvencies" (1997) 19 Michigan Journal of International Law 1; R. K. Rasmussen, "Resolving Transnational Insolvencies through Private Ordering" (2000) 98 Michigan Law Review 2252; J.L. Westbrook, "A Global Solution to Multinational Defaults" (2000) 98 Michigan Law Review 2276; J.L. Westbrook, "International Judicial Negotiation" (2003) 38 Texas International Law Journal 567; J.L. Westbrook, "Multinational Enterprises in General Default: Chapter 15, The ALI Principles, and the EU Insolvency Regulation" (2002) 76 American Bankruptcy Law Journal 696.

approach to cross-border insolvencies and Professor Janger – from Brooklyn Law School - envisioned a regime of procedural universalism. Other American authors have also put forward ideas such as the use of protocols and the concept of procedural consolidation of insolvency proceedings. However, in the EU, the debate has been quieter and the embrace of one side or another more restrained.[7]

2.1 Universalism

Universalism in its purest form promotes an idealistic world in which each legal system and their courts are compelled to enforce the orders of the court which manages the case. That is why

> "most proponents of universalism do not advocate the pure form of the model, because of the practical recognition of the enduring differences among political and economic systems, legal regimes, and court systems…"[8]

As a result, pure universalism is a model confined to the theoretical realm, since it would require States to surrender their sovereignty, agreeing *ex ante* that only one jurisdiction can handle the insolvency proceeding and all other domestic courts would merely assist in the collection of assets. That is why the more usual form of universalism advocated

> "refers to a […] system where a single court, that of the debtor's home country has jurisdiction over a debtor's assets, wherever located in the world, and distributes them in according with the law of that country."[9]

7 European academics who have written on the topic include: G. McCormack, see "Universalism in Insolvency Proceedings and the Common Law" (2012) 32 Oxford Journal of Legal Studies 325; "Jurisdictional Competition and Forum Shopping in Insolvency Proceedings" (2009) 68 Cambridge Law Journal 169; "Reforming the European Insolvency Regulation: A Legal and Policy Perspective" (2014) 10 Journal of Private International Law 41; P. Omar, see "The Landscape of International Insolvency Law" (2002) 11 International Insolvency Review 173; "New Initiatives on cross-border insolvency in Europe" (2000) 5 Insolvency Lawyer 211; "The New European Legal Order in Insolvency: Fundamental Legal Bases and Harmonisation Initiatives" (2004) 17 Insolvency Intelligence 17; "The European Insolvency Regulation 2000: A Paradigm of International Insolvency Cooperation" (2003) 15 Bond Law Review 214; B. Wessels, see "Contracting Out of Secondary Insolvency Proceedings: The Main Liquidator's Undertaking in the Meaning of Article 18 in the Proposal to Amend the EU Insolvency Regulation" (2015) 9 Brooklyn Journal of Corporate Finance and Commercial Law 236; "Amending the EU Insolvency Regulation: Shaken or Stirred?" in R. Parry (ed.), *The Reform of International Insolvency Rules at European and National Level* (Nottingham: INSOL Europe, 2011) 125; "The Changing Landscape of Cross-Border Insolvency Law in Europe" (2007), available at http://www.juridicainternational.eu/the-changing-landscape-of-cross-border-insolvency-law-in-europe.

8 E. Adams and J. Fincke, "Coordinating Cross-Border Bankruptcy: How Territorialism Saves Universalism" (2008) 15 Columbia Journal of European Law 43-88, p. 48. See also J.L. Westbrook, "Universal Priorities" (1998) 33 Texas International Law Journal 27-46, p. 28.

9 E. Adams and J. Fincke, *ibid.*, p. 48.

Professor Jay Westbrook is the most eloquent proponent of a universalist model for cross-border insolvency, which he described as "the administration of multinational insolvencies by a leading court applying a single bankruptcy law."[10] In a nutshell, the

> "case for universalism relies on efficiency grounds: clear rules decrease lending costs and do not skew investment choices, and a single forum provides a number of administrative savings."[11]

2.2 Territorialism

The idea that universalism was the best approach to cross-border insolvency law was hardly contested until Professor LoPucki did so in his March 1999 article in the Cornell Law Review. He advocated that territorialism was actually the best approach to solve cross-border insolvency issues. According to LoPucki, assets located in different countries should be administered by local courts, for the benefit of local creditors. This is based on the idea that local creditors will not receive their fair shares of the assets in a foreign insolvency and as a result, a local court must provide for them and distribute the assets within the jurisdiction in which they are situated.[12]

LoPucki claims that the advantages of such a system are:

(1) it offers greater *ex ante* predictability for lenders and investors since they would only need to know the countries in which their debtor has assets and the distributional priorities in these countries

(2) the costs of proceedings are not high since courts would deal with assets located in their jurisdiction only

(3) it allows creditors to litigate in a closer and more convenient forum.

Universalism and territorialism are not the only two approaches proposed by academics to solve the issues arising from cross-border insolvency cases. They are merely the two ends of the theoretical spectrum.

10 J.L. Westbrook, "A Global Solution to Multinational Default" (2000) 98 Michigan Law Review 2276-2328, p. 2277.

11 R.K. Rasmussen, "A New Approach to Transnational Insolvencies" (1997) 19 Michigan Journal of International Law 1-36, p. 27.

12 L. Perkins, "A Defense of Pure Universalism in Cross-Border Corporate Insolvencies" (2000) 32 New York University Journal of International Law & Politics 787-828, p. 813. See L.M. LoPucki, "Cooperation in International Bankruptcy: A Post-Universalist Approach" (1999) 84 Cornell Law Review 696-762.

2.3 Corporate Charter Contractualism

In 1997, Professor Rasmussen put forward a new approach to cross-border insolvency issues, which was quite a shift compared to the growing movement favouring universalism. Basically, he stated that companies should be given the right to decide which insolvency system should apply to its potential insolvency. He is of the view that companies are better positioned than governments to select the insolvency laws that will maximise firm value. The claimed advantages of this contract approach is that it focuses on efficiency, which in turn results in higher likelihood of success for rescues, decreased strategic removal of assets and an overall race to the top.

2.4 Procedural Universalism

Professor Edward Janger put forward another approach to cross-border insolvency, based on the idea that the uniform lawmaking process should:

- limit its aspiration to seeking procedural and transactional efficiencies;
- promote legislation based only on broad-based consensus; and
- shy away from legal questions with important distributional consequences.[13]

He seeks a middle ground between territorialism and universalism in international insolvency cases by placing administration of the case in one main proceeding while dividing the debtor's assets into local pools, each governed by local priority rules.

Janger claims that his model will bring several advantages, notably those attached to universalism, since the insolvency case would be centralised. This would result in a decrease in costs, increased likelihood of success for rescues and a maximisation of assets value. It would also reduce forum shopping and make international cooperative instruments more attractive for policymakers.[14]

2.5 Conclusion

The academic debate has generally focused on the respective strengths and weaknesses of each system. The analytical framework for evaluating transnational insolvency is traditionally analysed in terms of their conformity with the two ends of a theoretical spectrum: universalism and territorialism. My point is not to determine which approach is best but rather to show, by looking at recent

13 E.J. Janger, "Predicting When the Uniform Process Will Fail: Article 9, Capture, and the Race to the Bottom" (1998) 83 Iowa Law Review 569-632, pp. 630-31.

14 See generally E.J. Janger, "Virtual Territoriality" (2010) 48 Columbia Journal of Transnational Law 401-441, p. 432.

developments such as the European Insolvency Regulation and the current European reforms, how complex and unsolved the debate is. To sum up, in the 1990s, an idealistic concept emerged which sparked a (re)newed theoretical debate on cross-border insolvency. It was followed by criticisms in the late 1990s, and alternative approaches were proposed up to the mid-2000s. However, since then, no new approach has been put forward.

I am also of the view that more discussion is taking place at the academic level than in international practice. Even though the European Insolvency Regulation endorses a modified version of universalism, in practice, territorialism remains vibrant as a matter of domestic policy in many countries. Whatever convergence may be emerging in the academic community, no such international consensus has been reached at the legal policymaking level so far.

3 The Future of the Theoretical Debate in the European Union

As can be seen from the previous debate, the difficulties caused by cross-border insolvency cases and the search for a viable solution are not new, and the best approach to effectively handle the insolvency of multinational companies is an unresolved problem. Even if it appears that universalism has been deemed to be preferable in the academic literature, it is now also internationally accepted that it is an unreasonable objective in the foreseeable future.

Additionally, since the 2008 global economic and financial crisis, cross-border insolvency filings have been on the rise, reviving the debate as to the best approach to create an efficient international insolvency regime. The recent crisis shows that the theoretical debate has largely been discarded and replaced by a more reasonable, grounded approach, which has tried to achieve solutions which, although characterised as more modest in their scope, are also more attainable in the present circumstances. In fact, these developments were necessary and address immediate problems. International developments show that international institutions have recognised the limits beyond which the sovereign States are not willing to go at the present stage. The debate has therefore shifted, especially within the European Union, from the traditional universal versus territorialism divide to a more feasible approach to cross-border insolvency: pragmatism and cooperation.

The debate on the divide between universalism and territorialism is not new and will likely not be settled anytime soon. Nations are stubborn regarding their regulatory sovereignty and policy-makers are cautious. However, different points can be made regarding this theoretical debate.

First, it is worth noting that there is a significant difference in the debate between the United States and the EU. Even though nowadays there are many similarities between the EU and the US in the field of insolvency law, since companies have more and more multinational and cross-continent dimensions, a shift seems to have happened: the US theoretical debate on the universalism/territorialism divide seems to be more prominent and is still very much alive, whereas the EU seems to have a much more pragmatic outlook on how to settle the issues stemming from cross-border insolvency cases.[15] This could be due to the main difference that remains between the EU and the US in terms of insolvency law. In this field, the latter is a true federal state, whereas the EU is a *sui generis*, sometimes qualified as a "quasi-federal" supranational entity. In the US, bankruptcy law is federalised, whereas in the EU, insolvency law remains a competence of the Member States and their domestic courts.

Additionally, since there is no EU Constitution, like there is in the US, the European institutions need to compromise to a larger extent to get Member States' approval. That is why the European institutions have long understood the need to look beyond theory to focus on pragmatic solutions to cross-border insolvency cases. This is the reason why they decreased the scope of the reform instruments and adopted an incrementalist approach, since they considered that the most important, at the end of the day, was to promote and reach co-operation of Member States and national courts, greatly needed in cross-border insolvency cases. Therefore, even though the debate around the universalism/territorialism divide has been historically more prominent in the US compared with the EU, this can be explained by the constitutional differences between the two entities: insolvency law in the EU remains a competence of the Member States and that can explain why in the end, the EU institutions have not grasped the debate like American academics have.

This leads to the second point. On this side of the Atlantic, the theoretical debate has been much more cautious from the start, as is evidenced by the small amount of contribution on the subject. Additionally, recent publications on the topic of European/international insolvency law seem to have skipped the debate altogether.

15 Legal pragmatism is not anti-theoretical and has been considered by some academics as being a theory in itself. Perhaps instead of opposing pragmatism to theory, it should be understood as "experience". See *e.g.* P.S. Atiyah, *Pragmatism and Theory in English Law* (1987, Sweet & Maxwell, London). See also J.L. Coleman, *The Practice of Principle: In Defense of a Pragmatist Approach to Legal Theory* (2001, OUP, New York); B.Z. Tamanaha, *Realistic Socio-Legal Theory: Pragmatism and a Social Theory of Law* (1997, Clarendon Press, Oxford); R.A. Posner, "What Has Pragmatism to Offer Law?" (1990) 63 Southern California Law Review 1653; D. Lind, "The Mismeasurement of Legal Pragmatism" (2012) 4 Washington University Jurisprudence Review 213; S.D. Smith, "The Pursuit of Pragmatism" (1990) 100 The Yale Law Journal 409.

Therefore, the point made by many academics, both in the EU and in the US, that the theoretical debate regarding universalism and territorialism is ongoing[16] can be contested. The debate started in the 1990s in the US and the majority of the contributions happened in that decade. In fact, Professors Westbrook's and LoPucki's main contributions were published between 1990 and 2003. Other American academics, such as Anderson, Adams and Fincke, Guzman, Janger, Pottow and Rasmussen, for example, have kept the debate alive for a little bit longer. However, since the mid-2000s, the theoretical debate in the US seemed to have died slowly, and it is interesting to note that no new major publication on the controversy has been issued. Therefore, it appears that the theoretical debate regarding universalism and territorialism in cross-border insolvency cases is not ongoing anymore, but rather buried, especially in the EU.

Third, as a consequence of this abandonment by academics, especially on this side of the Atlantic, it is not surprising that no mention of it is made by the European institutions in their efforts to reform the EIR. Indeed, an examination of the Recast Regulation,[17] of the Restructuring Recommendation,[18] and of other preparatory documents drafted by the European institutions[19] reveal that the debate has been pretty much ignored. One of the only mentions made in relation to the debate is when the European Commission acknowledged the "difficulty to strike a balance between the universality of the debtor's insolvency and the territoriality of proceedings" in its Consultation on the Future of European Insolvency Law.[20] However, even when the European institutions deal with the concepts of universalism and territorialism, they appear not to do so in a purely

16 J.A.E. Pottow, "Procedural Incrementalism: A Model for International Bankruptcy" (2005) 45 Virginia Journal of International Law 935-1016, p. 937; F. Tung, "Is International Bankruptcy Possible?" (2001) 23 Michigan Journal of International Law 31-102, p. 90.

17 Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast), OJ L141/19.

18 European Commission, Recommendation on a New Approach to Business Failure and Insolvency, 12 March 2014, C(2014) 1500 final.

19 See e.g. 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) and related resolution of the European Parliament of 15 November 2011 (2011/2006(INI)); European Commission, *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,* COM(2012) 743 final (12 December 2012); European Commission, *Proposal for a Regulation of the European Parliament and of the Council ame4nding Council Regulation (EC) No 1346/2000 on insolvency proceedings,* CON(2012) 744 final (12 December 2012); European Commission, *Impact Assessment accompanying the document Revision of Regulation (EC) No 1346/2000 on insolvency proceedings* (Commission Staff Working Document), SWD(2012) 416 final; Communication from the European Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, "Action Plan on Building a Capital Markets Union", COM(2015) 468(final), 30 September 2015.

20 European Commission, *Consultation on the Future of European Insolvency Law*, 30 March – 21 June 2012, at p.1, available at http://ec.europa.eu/justice/newsroom/files/insolvency_en.pdf (last viewed 5 September 2016).

theoretical manner but from a pragmatic and realistic standpoint. In the Executive Summary accompanying the Revision of the EIR, the European Commission put forward two policy options: updating the existing Regulation while maintaining the current balance between creditors and debtors; or changing the basic premises of the Regulation and requiring some approximation or convergence of national insolvency laws and proceedings. The Commission acknowledged that even though the latter was potentially more effective than the former in achieving the objectives and providing economic and social benefits for the single market, the former was also a more proportionate option at this stage of European integration.[21]

The Commission has a realistic outlook on the current political circumstances across the EU and that explains why the European documents, since the passing of the EIR in 2000, reveal some element of frustration with the lack of success in achieving any of the two ends of the theoretical spectrum, as well as pragmatic acceptance that these theories are theories only: they do not work in practice and are not symmetrical to current developments. Indeed, the theoretical debate that emerged from the US is grandiose and idealistic but the worldwide focus is now on rescue and cooperation and the debate is clearly outdated and counterproductive. "The debate on the cross-border insolvency theories essentially reflects issues that have been raised in the past."[22] That is why the fact that no mention of the various theoretical approaches is made by the European institutions, neither in their various preparatory documents, nor in the EIR and its Recast version, does not seem to decrease the regulatory quality of such legal agreements. The theoretical approaches do not seem essential at this stage to solve issues in cross-border insolvency law.

Fourth, it can be acknowledged, however, that the theoretical debate provides an additional tool to assess the significance of the European institutions', in particular the Commission's role in the EU regulatory landscape, and their position towards academia. It appears that academia's influence on this European policy-making body is potentially not particularly strong. Academics may not be as prominent in shaping the future of EU regulation as one may think. European institutions do value legal professionals' and academics' point of view but they seem to do

21 European Commission, *Commission Staff Working Document, Executive Summary on the Impact Assessment Accompanying the Document Revision of Regulation (EC) No 1346/2000 on insolvency proceedings*, SWD(2012) 416 final, at 8, 12 and 13.

22 B.S. Masoud, "Theoretical Aspects of the Cross-Border Insolvency Landscape: Issues and Perspectives for Sub-Saharan Africa", (2010) Submission for the III Prize in International Insolvency Studies, available at https://www.iiiglobal.org/sites/default/files/theoreticalaspectsofthecrossborderinsolvencylandscapeissuesandperspectivesofsubsaharaafrica.pdf, p. 11 (last viewed 5 September 2016).

so in very specific settings, such as organised EU conferences, consultations or other funded studies. However, the European Commission seems less interested in pure theoretical debate such as the universalism and territorialism one, and more focused on particular issues arising from practice.

The best approach to adopt to solve the issues of cross-border insolvencies has been a matter of debate among academics for a long time. However, as stated above, it has not really been grasped by legal professionals and the European institutions. It is undeniable that there are pros and cons to each respective approach. However, they are idealistic theories. Even though the world is more and more interconnected, political differences remain stark, rendering universalism impossible considering the continuous protectionist position of States, and territorialism quite obsolete at this advanced stage of globalisation. Universalism and territorialism are quite naïve approaches to cross-border insolvency law since these extremes do not reflect an adequate picture of the real world. Therefore, they should not be used as tools or aims for regulatory decision-making.

To conclude, the debate surrounding the universalism and territorialism divide is not new and will likely not be settled anytime soon. It is however, a tired debate, which fails to tackle the real current issues of insolvency cases, *i.e.* problems due to the lack of cooperation among courts and insolvency professionals, the lack of focus on rescue proceedings or the lack of efficient mechanisms dealing with groups of companies. The current status quo would be unsustainable over a very long period of time and the need for harmonisation in the field is certain. However, "[i]t seems unrealistic to think that universalism will be accepted absent roughly similar laws."[23] This is why EU policy-makers are remedying the situation by basing the reform of the EIR on an incrementalist approach and focusing on procedural harmonisation of European cross-border insolvency law. The persistent disinterest with cross-border theories, notably from the European institutions, should be perceived as a welcome invitation to close the old theoretical debate and focus on new theories and realistic developments.

4 Conclusion

It was not my purpose in this article either to pick a side, or to elaborate a new approach to cross-border insolvency cases, but rather to point out the state of the debate. The argument presented here is that even though the theoretical debate has been ongoing for decades now, it has not really moved forward for years. No fresh

23 J.L. Westbrook, "Theory and Pragmatism in Global Insolvencies: Choice of Law and Choice of Forum" (1991) 65 *American Bankruptcy Journal* 457-490, at 485.

approach or arguments have been put forward for a long time and the theoretical debate has been unable to generate international consensus. That could explain the caution of European academics and more importantly, the lack of engagement with the debate by the European institutions, who have only acknowledged that the Regulation follows modified universalism, but who have not mentioned the theoretical divide. The conclusion reached may be that the academic debate described the characteristics of the various regimes but did not offer any practical solution for settling the issues stemming from cross-border cases.

Maybe, it is the European compromising approach, more anchored in pragmatism than principle, which should be taken as a sign of the end of the debate. Looking at it from an optimistic perspective, we should gladly welcome this move from the old fashioned debate and embrace pragmatism, which represents "a triumph of the 'art of the possible' in the delicate field of international treaty negotiation…"[24] Therefore, the efforts made notably by the EU with the Restructuring Recommendation and the Recast EIR should not be reprimanded for their modest contribution, but on the contrary, should be applauded for abandoning a theoretical position which was not moving forward and for taking an extra step, a practical step. It is time to look at the European Insolvency Regulation and other initiatives for what they are: attempts – however cautious – at making the cross-border insolvency scene better, instead of always measuring them against the yardstick of universalism, which has long been established as unrealisable in the current stage of European integration.

The development of European insolvency law is an ongoing process. Looking at the history of the EU, we can see that crises are often followed by increased integration. However, this is not always the case. In addition, the 2008 global economic and financial crisis will not lead to any positive aftermath without some political resolve. The EU is at a crossroads: it can either follow the path of the 1980s, when following the post-war challenges, the European institutions and national politicians came up with numerous successful policy innovations, such as the creation of the single market or the progresses made in the field of consumer law; it could also follow the path of political and economic stagnation, such as the empty chair crisis which impeded reforms for a long time in the 1960s and the energy crisis in the 1970s. The European institutions seem to hope that modest reforms in insolvency law will appease sovereign mistrust, but they could also eventually stall.

24 I. Fletcher, "European Convention on Insolvency Proceedings: Choice-of-Law Provisions", (1998) 33 Texas International Law Journal 119-140, p. 124.

PART V

CHALLENGES FOR PREVENTIVE RESTRUCTURING FRAMEWORKS

Chapter 11

Back to Basics – The Role of the Core Principles of Law in the Clarification and Harmonisation of Preventive Restructuring Frameworks

Catarina Serra

1 Foreword

It is submitted that, in the field of preventive restructuring frameworks, a certain degree of harmonisation or convergence is recommendable, given the fact that legal systems are used by increasingly global entities and the differences cause disincentives for business and cross-border investments.[1]

One possible way to achieve this harmonisation / convergence would be the design of a principle-based framework, with rules supported by the core principles of Law which are common to European jurisdictions.[2]

A framework of this kind would imply putting in place a clear system of duties and liability likely to induce subjects to act in accordance with the core principles of law and developing expedients aimed at removing the obstacles to restructuring that may be considered unjustified in light of the core principles of law, and, conversely, admitting to the contrary in the remaining cases. A principle-based framework could have the further use of serving to clarify the doubts and fill the gaps of domestic frameworks.

1 For the (economic) reasons that justify uniformity in pre-insolvency frameworks see, among others, M. C. Carcea / D. Ciriaci / C. C. Caballero / D. Lorenzani / P. Pontuch, "The Economic Impact of Rescue and Recovery Frameworks", (2015) European Commission Directorate-General for Economic and Financial Affairs, European Commission Discussion Paper 004, available at: http://ec.europa.eu/economy_finance/publications/eedp/dp004_en.htm (last viewed 13 October 2016).

2 The text should reflect the common elements "which exist, to a surprising degree, in European systems". See W. W. McBryde, "The Principles of European Insolvency Law: An Exercise in Drafting", (2004) 8 Edinburgh Law Review, p. 111.

2 The Contractually-Based Instruments as an Ancillary Solution to Distress: a Brief Reference to the Roman *cessio bonorum* to Illustrate it

In ancient times, when a sole trader was insolvent or on the verge of insolvency he gathered all his creditors (around a solid oak table, I like to picture it) in order to reach an understanding. The trader could either try a plain moratorium or a general reduction of his liabilities or, if this proposal was not accepted, the negotiation of a contract whereby he disposed of his assets in favour of the creditors. The contract implied the voluntary transfer of all of the debtor's property to the creditors in trust, so that they would sell the assets and apply the money received to the payment of the debts, returning any surplus to the debtor. Until such sale, the debtor remained the sole proprietor of the assets and had the possibility to regain possession (if he managed to pay his debts through alternative means).

The origins of this contract are easily traced back to Roman Law. The *cessio bonorum* (literally meaning, disposal of the assets) appeared then, as some say, for humanitarian reasons[3] and, consequently, for social reasons, since it led to a general stay in enforcement actions, therefore allowing the debtor to avoid the painful effects of an insolvency situation (eventual imprisonment and personal infamy).[4]

Later on, *cessio bonorum* was recreated and inspired the Italian and the Portuguese legislators to accommodate contracts of the kind in the respective Civil Codes.[5] The contract calls upon values that seem long dissolved due to the pace of economic development, from which stand out dignity, integrity, and honesty.[6] The attempt to negotiate with the creditors showed that the debtor was honest[7] (the "*ehrlicher*

3 See M. Leitão, "A cessão de bens aos credores", (1987, Associação Académica de Lisboa, Lisboa), p. 22.

4 One must keep in mind that, in this period, enforcement of creditors' rights involved the person of the debtor and not yet exclusively his patrimony. Depending on the seriousness of the default and the degree of his guilt, the debtor could be subjected to corporal punishments, imprisoned, made slave, expelled from the city of Rome or sentenced to death.

5 Regretfully, the contract was never very popular in Portugal, for reasons beyond the direct utility of the instrument and strictly concerning the *contours* of the legal framework.

6 Still, in the majority of European insolvency laws, honesty is valued: discharge is still reserved to deserving debtors – to the "honest but unfortunate debtor". What is more, the Commission Recommendation of 12 March 2014 on a new approach to business failure and insolvency sets out rules to be applied to honest entrepreneurs. The reference to honest debtors maybe traced back to the French *Code Civil*, where the *cessio bonorum* was exclusive of the "*débiteur malheureux et de bonne foi*". See A. Bénabent, "La Question de la Bonne Foi dans les Procédures Collectives", (2003) 57-58 Gazette du Palais, p. 37. It was later embraced by the Anglo-American systems. See, for instance, B. Rothschild, "The Illogic of No Limits on Bankruptcy", (2007) 2 Emory Bankruptcy Developments Journal, pp. 483 and 502.

7 As some recall, the honest tradesman is (should be) the first to seek a remedy for his situation, disclosing his difficulties to the creditors so that they may guarantee their rights and, all together, find the least harmful solution. See P. S. Macedo, *Manual de Direito das Falências*, vol. I (1964, Almedina, Coimbra) p. 317.

Kaufmann" of whom Kant spoke[8]) or, to be realistic, that the debtor treasured his reputation (for its economic value). The acceptance of the contract by the creditors, on the other hand, was a sign that they sympathised with the debtor, that they were willing to let him have a dignified way out and probably give continuity to the business relation. In sum, there was trust (*fiducia*) and cooperation on both sides, which is crucial for the development of all contractual relations and, in particular, business relations.[9]

At this point, it may be asked: how is this related to preventive restructuring frameworks? *Cessio bonorum* seems to work as an alternative to a court-ordered asset liquidation and not as a rescue tool.[10] The interesting thing is that there are references to a similar contract, commonly known as "ABC" (Assignment for the Benefit of Creditors), being used in some American states (e.g. Florida) to sell the business as a going concern, thus as a means of rescue.[11] The instruments share, in addition, a couple of features. They have a contractual basis and they rise from, and give rise to, certain fiduciary duties between the parties.[12] Considering the pre-existing relation, both parties (debtor and creditors) must be available to negotiate, to cooperate, and to enter a reasonable compromise, one that balances the fundamental interests at stake and does not entail the disproportionate sacrifice of any party's interests.

Bearing in mind *cessio bonorum*, it is possible to say that when it comes to modern workouts, namely out-of-court and even hybrid proceedings, nothing was actually

8 According to Kant, the merchant should act honestly by conviction and not with the intention to withdraw any benefits from it: if the merchant does not fool his clients just because he fears he will lose them, his behaviour has no moral value for it is driven by an egoistic aim; if instead the merchant acts honestly because he believes he has the duty to act honestly, then his behaviour has indeed moral value. See I. Kant, *Grundlegung zur Mataphysik der Sitten* (1785), available at: https://korpora.zim.uni-duisburg-essen.de/kant/aa04/385.html (last viewed 13 October 2016).

9 Although in its origins the contract was available to debtors of any kind, it soon developed into a resource exclusive of merchants / tradesmen. See A. Castana, La cessione dei beni ai creditori nelle diverse fattispecie (1957, Giuffrè, Milano) at 44.

10 A couple of other features distinguish *cessio bonorum* from typical rescue tools: *cession bonorum* is not restricted to pre-insolvency situations and, whereas preventive restructuring instruments are usually characterised by the persistence of the debtor in possession of his patrimony (DIP) involves the disposal of the debtors' assets

11 According to A. Dawson, although the conventional wisdom is that these procedures provide an alternative to liquidate the business, debtors are, in fact, using these procedures not to liquidate a business but to sell the business as a going concern, free and clear of creditors' interests in their assets. These going concern sales, particularly when they involve insiders of the debtor, are actually more like corporate reorganisation than liquidation. See A. Dawson, "Better than Bankruptcy?" (2017) Rutgers Law Review (forthcoming), University of Miami Legal Studies Research Paper No. 16-24, available at: https://ssrn.com/abstract=2778282 (last viewed 13 October 2016).

12 An additional aspect – one that should not be undermined – is the fact that, pursuant to the contract, the creditors (who are parties in the contract and who come afterwards) are prevented from bringing enforcement actions against the debtor. Under the Portuguese law (and unlike under Italian law), creditors may still bring enforcement actions involving assets other than those that are object of the contract. This represents a significant distancing from the historical function assigned to the institute and explains why it is not very appealing to the debtor and was never very successful in Portugal. See M. Leitão, above note 3, pp. 97-98.

invented. Very early on, there was a quest for alternative means to deal with the risk of default – alternative to individual enforcement and ultimately to the dramatic insolvency proceedings.[13] The answer has been a variety of instruments built upon consensus, notwithstanding further developed and enhanced by Law. For better and for worse, preventive restructuring instruments are bound by "the logic and limits"[14] of private law.[15]

3 The Case for Convergence through a Principle-Based Framework

3.1. Putting in Place a System of Duties and Liability Adjusted to Preventive Restructuring Instruments

The advantages of contractually-based instruments do not need to be enumerated.[16] The debate is instead centred on their limits. How are these instruments supposed to allow debt restructuring and lead to business rescue if each creditor may act freely?

Despite what some may think, contract law is not all about freedom of contract. Every contractual relation entails a multiplicity of duties, most of which derive from the core principles of law. The parties are expected not merely to fulfil the main obligations arising from the contract but are also expected to adopt the appropriate behaviour, that is, the behaviour that, in view of normative values like proportionality, equality, fairness and, above all, good faith, are appropriate to the case. If they do not act accordingly, there may be a breach of contract, thus giving the injured party a cause for legal action – a liability action.

Considering the present sophistication of credit relations, it is legitimate to ask: is such an action viable in court? The time of atomistic relations (strictly creditor-to-debtor) is long gone. Sole traders were definitely replaced by companies, or even worse, groups of companies, as a result of wonderful as well as wicked expedients

13 For obvious reasons, the availability of such means is particularly important when a business is at stake (to avoid the loss of value).

14 This is a clear reference to T. H. Jackson and his famous work entitled, *The Logic and Limits of Bankruptcy Law* (2001, BeardBooks, Washington DC).

15 See C. Serra, "A Contratualização da Insolvência: Hybrid Proceedings e Pre-Packs (A Insolvência entre a Lei e a Autonomia Privada)", in AAVV, II Congresso – Direito das Sociedades em Revista (2012, Coimbra, Almedina), pp. 265 ff.

16 Talking about the "privatization of bankruptcy", Prof. Eidenmüller takes the view that it "promises flexible, tailor-made and fast solutions that come with significantly reduced bankruptcy costs". See H. Eidenmüller, "Comparative Corporate Insolvency Law", European Corporate Governance Institute (ECGI) – Law Working Paper No. 319/2016, available at https://ssrn.com/abstract=2799863 (last viewed 13 October 2016).

like legal personality, limited liability and so on, making it rather difficult to identify the players, let alone hold them liable.[17]

On the other hand, legal principles tend to be vague, to lack determination. Are principle-based rules likely to be effective?

To tackle these difficulties, the principles have indeed to be translated into standards of conduct adapted to the preventing restructuring scenario. In particular, the general duty to act in good faith should develop, in what regards the debtor, into the duties to disclose and to report all relevant information, to foster the participation of the creditors in the negotiations, to cooperate with the creditors in the quest for the most suitable solution and to treat the creditors equally throughout the process.[18] It should develop, in what regards the creditors, into the duties to engage in the negotiations, to cooperate with the debtor in the quest for the most suitable solution (considering seriously the proposals presented by the debtor and voting them conscientiously) and to accept all necessary restrictions to their rights as long as they are fair and proportionate (e.g. stay of enforcement actions).[19]

It is well-acknowledged that, both at international and European level, there is a significant number of documents[20] corresponding to this paradigm, standing out

17 See C. Serra, above note 15. Professor Eidenmüller talks about the changing of debt structures and financing techniques (bond financing also for SMEs, debt trading, activist investors, credit default swaps, etc. See H. Eidenmüller, above note 16. On this topic see also B. Wessels, "Business Rescue in Insolvency Law – Setting the Scene" (2014, European Law Institute Projects Conference, Croatia), available at https://www.europeanlawinstitute.eu/fileadmin/user_upload/p_eli/General_Assembly/2014/Business_Rescue_in_Insolvency_Law___Setting_the_Scene.pdf (last viewed 13 October 2016).

18 Prof. Wessels (also) regrets the absence of some of these principles in the Commission Recommendation:
"(…) there is no clear principle that the debtor should not take any action which might adversely affect the prospective return to relevant creditors (either collectively or individually) as compared to a certain reference date or that the debtor should provide, and a principle that would allow relevant creditors and/or their professional advisers reasonable and timely access to all relevant information relating to its assets, liabilities, business and prospects, in order to enable proper evaluation to be made of its financial position and any proposals to be made to relevant creditors".
See B. Wessels, above note 17.

19 On the principle of good faith and the duties that arise from it, in particular the duty to renegotiate see A. M. Cordeiro, "O Princípio da Boa-Fé e o Dever de Renegociação em Contextos de 'Situação Económica Difícil'", in C. Serra (ed*), II Congresso de Direito da Insolvência* (2014, Almedina, Coimbra), p. 11 ff.

20 Standing out from the initiatives undertaken by international organisations, although in the broader field of insolvency, there is the Model Law on Cross-Border Insolvency, forwarded in 1997 by the United Nations Commission on International Trade Law (UNCITRAL), a soft law instrument which provides for a worldly standard for cooperation in cross-border insolvency.

the Statement of Principles for a Global Approach to Multi-Creditor Workouts,[21] issued early on (in 2000), by INSOL International.[22]

From a strictly scientific perspective, if no other, the Statement of Principles (the INSOL Principles) is a remarkable contribution to the increase of transparency and accountability in restructuring workouts. It lays down eight principles that, together, consubstantiate the desirable behavior on the part of debtor and creditors.[23] Notwithstanding the soft law nature of this document, the fact is that the subjects generally act accordingly.

There may be a variety of explanations.

Firstly, any standards that are evidently based in principles form what might be considered a self-enforcing system. Principles are largely intuitive, which makes principle-based standards easy to understand, thus more likely to be accepted by the general public.

Then, there is the issue of reputation. The entities / persons normally involved in business restructuring are eager to have opportunities to profit. Any deviation to the standard conduct / good practice is regarded as poor behaviour. The "dissident" will most likely be excluded from future projects by the others. This is to say that some instruments acquire normative force, not as a consequence of classic

21 The Statement of Principles was allegedly modelled after the London Approach. The London Approach is a set of non-binding principles that worked as guidelines for out-of-court restructurings. They were initially conceived by the Bank of England in the 70's, amended in the 90's and used mainly in the Easter Asian countries (Thailand, Indonesia, Malaysia, South Chorea and Hong Kong, the Filipines, Singapore and Taiwan), where, during the "Asian crisis" (1997), there were no rules applying to insolvency.

22 Strictly at the European level, again on the broader area of insolvency, there are important documents such as the Principles of European Insolvency Law, issued, in 2003, by the International Working Group on European Insolvency Law, with B. Wessels as the contributing editor. The International Working Group on European Insolvency Law spelled out fourteen principles which deal with the fourteen following topics: insolvency proceeding; institutions and participants; effects of the opening of the proceeding, management of the assets; obligations incurred by, and fees of, the administrator; treatment of contracts; position of employees; reversal of juridical acts; security rights and set-off; submission and admission of insolvency claims; reorganization; liquidation; closure of the proceeding; and debtor in possession. Still worth mentioning are two main studies recently conducted: the INSOL Europe Study on a new approach to business failure and insolvency – Comparative legal analysis of the Member States' relevant provisions and practices, issued in 2014, and the Study on a new approach to business failure and insolvency – Comparative legal analysis of the Member States' relevant provisions and practices, issued in 2016, and written, among others, by Gerry McCormack and Andrew Keay. These and other documents surely represent extremely valuable contributions to the consolidation of standards and practices in the field of insolvency Law. If nothing else, they have the merit of clearing the way.

23 Broadly speaking, the principles concern the creditors' duty to cooperate with the debtor (first principle), the creditors' duty to refrain from enforcement actions (second principle), the debtors' duty to refrain from actions that might affect return to creditors (third principle), the creditors' duty to act coordinately (fourth principle), the debtor's duty to disclose and report to creditors (fifth principle), the duty to act in accordance with the law (sixth principle), the creditors' duty to treat, in principle, all information disclosed by the debtor as confidential (seventh principle) and, finally, the recommendation that funding during negotiations be given priority status (eight principle).

sanctions, but, using the words of Professors Armour and Deakin, as a result of "'mutual aid' games in which co-operation is enforced by the threat of exclusion from future business".[24]

In any case, and in order to avoid any doubts as to the binding effect of the duties, any framework on preventive restructuring should contain strong liability rules.

3.2 Clarifying the Scope of Preventive Restructuring Instruments

A two-folded system of duties and liability would certainly reduce the risks of poor behaviour but would not exclude them entirely. It would still be possible for one or more creditors to oppose the restructuring plan and, given their position, put the restructuring at risk.

The usual solution (i.e., the solution set out by the majority of Member States providing norms on these matters) has been the creation of a specific instrument allowing the restructuring plan to be sanctioned by the court and, thereby, to become binding on all subjects.

Cram down, in itself, appears as a reasonable solution. It is presumed that the restructuring plan accepted by the majority – because it was accepted by the majority – is in the best interests of every subject. It is arguably not fair / proportionate to allow a single creditor / a single group of creditors to obstruct the whole plan.

This presumption is, however, not unconditionally valid, leaving room for minority protection.

If we take the German or the Portuguese laws roughly as models, the court sanctioning of the restructuring plan should be refused at the request of any interested party, at least, in two situations: when he / she shows to the satisfaction of the court that he / she is likely to be placed at a disadvantage by the restructuring plan compared with his situation without it[25] and when he / she shows to the satisfaction of the court that, under the plan, another creditor is likely to receive what might be considered excessive payment.[26]

24 See J. Armour and S. Deakin, "Norms in Private Insolvency: The 'London Approach' to the Resolution of Financial Distress" (2001) 21 Journal of Corporate Law Studies, p. 22.

25 See Section 251 (1) of the German Insolvency Act and Article 216, 1, a), of the Portuguese Insolvency Act.

26 See Article 216, 1, b), of the Portuguese Insolvency Act.

In the end, the principles that justify the presumption that the plan accepted by the majority is in the best interests of every subject are the principles that set out the presumption's limits.

In the situations above mentioned, but others are conceivable, the restructuring plan should be rejected because there would be a lack of conformity with the principle of proportionality and with the principle of equality or, to use Chapter 11's terminology, the restructuring plan would not be "fair and equitable". In the first situation, the plan would lead to an undesirably onerous burden. In the second, it would lead to a payment without reasonable justification.

At this point, several questions arise. Which should be the majority required for the approval of the plan? Would simple majority be sufficient or should there be additional requirements? Should creditors be divided into different voting groups in order to allow cross-class cram down?[27] And what about the facts that hinder the sanctioning of the plan? If the concepts of "undesirably onerous burden" and "payment without reasonable justification", and concepts of the kind, deserve to be given any relevance, they should be stated and developed. In short, a principle-based framework should determine the conditions under which a restructuring plan might be imposed upon the subjects despite their lack of consent and the conditions under which the court should abstain from sanctioning. Concepts like fair, equitable, reasonable, proportional, justified (and, of course, their antonyms) would provide the necessary support.

27 Cross-class cram down consists of a majority of classes binding the rest. This corresponds to the solution adopted in Chapter 11 of the US Bankruptcy Code. Under Section 1129(a)(8), the acceptance of the plan by each class is required in order for the plan to be confirmed under Section 1129(a). However, Section 1129(b)(1) provides that a plan that satisfies all of the other applicable provisions of Section 1129(a) may be confirmed despite the rejection of the plan by a class or classes. In order for such a plan to be confirmed under Section 1129(b), the plan must meet two criteria: The plan (1) must not unfairly discriminate and (2) must be fair and equitable. These tests only apply to a class as a whole and not to individual creditors. Thus, the court need not consider whether the plan discriminates unfairly against a class or is not fair and equitable with respect to a class if such class accepts the plan, even if an individual creditor or interest holder within the class rejects the plan. A plan unfairly discriminates against a class if another class of equal rank in priority will receive greater value under the plan than the non-accepting class without reasonable justification. The requirement that a plan be "fair and equitable" involves two concepts: (1) the absolute priority rule and (2) no payment in excess of the allowed claim. The absolute priority rule provides that a non-accepting class of creditors or interest holders cannot be compelled to accept less than full compensation while a more junior creditor or equity holder receives anything or retains its interest in the debtor under the plan. This rule is intended to ensure that the priority rules set forth in Section 507 are followed. The second concept (no payment in excess) was included in the requirement of fair and equitable by bankruptcy courts. It comes down to a prohibition against paying the holders in a senior class more than the full value of their claims or interests while cramming the plan down on a more junior class. A similar solution is accommodated in the German Insolvency Act (see Section 244 and, under the title "Prohibition to Obstruct", Section 245).

3.3 Serving as Guidelines to Remedy the Shortcomings of National Frameworks

A principle-based approach would have still one further use: to serve as guidance, helping to clarify the doubts and fill the loopholes of national frameworks. This can be illustrated through the example of existing principle-based documents: the INSOL Principles (already mentioned) and the Portuguese Guiding Principles of Out-of-Court Restructuring,[28] allegedly designed after the former.[29]

One of the many topics concerning the preventive restructuring framework in Portugal, as elsewhere, is the regime of new financing. It is, for instance, debated whether pre-existing creditors should be given a pre-emptive right to provide new financing. The question is pertinent (whomever provides new finance is usually given a priority right and additional protection over the other creditors). Yet, the law is absolutely silent in this regard.

Based on the INSOL Principles or the Portuguese Guiding Principles, it is possible to come up with an answer. According to the second, the third and the sixth INSOL Principles, all relevant creditors are entitled to expect that their position relative to other creditors and each other will not be prejudiced.[30] The sixth and the ninth Guiding Principles state basically the same. In other words, both point to the conclusion that such a pre-emptive right should be admitted. Pre-existing creditors may, therefore, encounter support in these principles to impose such a right.

4 The Assessment of the Commission Recommendation of 12 March 2014 in Light of a Principle-Based Approach

One final reference is due to the Commission Recommendation on a New Approach to Business Failure and Insolvency of 12 March 2014. To some extent,

28 The document took the form of a Resolution of the Council of Ministers. Under the Portuguese constitutional system, resolutions are deprived of normative force. Yet, as there are legal norms referring to them, the Guiding Principles are enforceable in some circumstances, that is, in the context of the Portuguese out-of-court and hybrid proceedings.

29 The Portuguese Guiding Principles develop the duty to cooperate, the duties to disclose and to report and the duties of loyalty. See N. M. P. Oliveira, "Entre o Código da Insolvência e 'Princípios Orientadores – Um Dever de Renegociação", (2012) II / III Revista da Ordem dos Advogados, pp. 677 ff., and "Responsabilidade pela Perda de uma Chance de Revitalização?", in C. Serra (ed), *II Congresso de Direito da Insolvência* (2014, Almedina, Coimbra), p. 153 ff.

30 According, furthermore, to the Commentary to the Eighth Principle, it could be argued that "[t]he provision of New Money (…) can impact upon the position of relevant creditors. This is because its priority treatment may affect the prospects of other non-prioritised debt being repaid. Ideally, where appropriate, all relevant creditors participating in the process should be given the opportunity to participate in the provision of, and should accept the risks associated with, the provision of New Money on a proportionate basis (i.e., proportionally to the perceived exposures which each of them has to the debtor as at the Standstill Commencement Date)".

the Recommendation[31] seems to correspond to the model above described, a principle-based document or a document guided by principles. It admittedly aims at establishing a common framework and, unlike other documents, has normative – a sort of normative – value.[32] In spite of this, it was not implemented, not even partially, in all member States.[33] As duly noticed by Professor Madaus, "none of the Member States fully complies with the Recommendation".

The resistance it encountered should not be surprising, especially on the part of large (self-confident) Member States like France, Italy, Germany and the United Kingdom.[34] The official explanation, for example in Germany, is that the German Insolvency Act is working well as it is.[35] In the German government's view, it is satisfactory to have a pre-insolvency solution within the insolvency proceedings.[36] Coming to think of it, why should a stand-alone pre-insolvency framework be mandatory? It is generally believed that the insolvency order compromises the

31 Unlike other kind of documents (regulations and directives), recommendations from the Commission are not binding on member States. Still, in this particular case, the Commission Recommendation invited member States to enact appropriate measures within one year (by March 2015) and announced that the Commission would assess the situation eighteen months after adoption of the Recommendation (by September 2015), based on the reports from member States.

32 According to M. Thierhoff and R. Müller, when the Commission started the project in 2013, its original intention was to introduce a directive and make it compulsory for member States to implement the rules within a certain timeframe. The decision to refrain from a directive and to use instead a recommendation was driven by the view that some member States were in the process of implementing reforms to their insolvency regimes and that a directive could delay the national reforms. See M. Thierhoff and R. Müller, "A New Approach to Business Failure and Restructuring: Pre-Insolvency Restructuring vs. Early Filing in Germany", Practical Law Restructuring and Insolvency Multi-Jurisdictional Guide 2014/15, available at www.http://uk.practicallaw.com/1-573-5547 (last viewed 13 October 2016).

33 In September 2015, the Directorate-General Justice & Consumers of the European Commission issued, as announced, a report disclosing the results of the evaluation of the implementation of the Commission Recommendation. The report shows that only partial implementation has taken place. Some member States have launched reforms and tried to accommodate the requirements set out whilst in some other the Recommendation was unable to trigger any changes to the current insolvency laws.

34 In the United Kingdom several have manifested against the Commission Recommendation. The scheme of arrangement falls short on a number of requirements (for instance, it does not trigger a stay on individual creditor enforcement action) but the general feeling is that the instrument should remain unchanged. See A. Wilkinson, K. Ewer, and K. Stephenson, "What's next for insolvency law reform in Europe: a pan-European insolvency law?", (2015) Butterworths Journal of International Banking and Financial Law, p. 435 ff., available at www. http://eurorestructuring.weil.com/wp-content/uploads/2015/07/Whats-next-for-insolvency-law-reform-in-Europe-JIBFL-Aug-2015.pdf (last viewed 13 October 2016). In contrast, recent reforms carried out in Spain ensure the compatibility of Spanish law with the Recommendation. See J. P. Ezquerra, "El Nuevo Paradigma Concursal Europeo y su Incorporación al Derecho Español", in *Estudios Sobre el Futuro Código Mercantil: Libro Homenaje al Profesor Rafael Illescas Ortiz*. (2015, Universidad Carlos III de Madrid, Getafe) p. 253 ff., available at www. http://hdl.handle.net/10016/21082 (last viewed 13 October 2016).

35 Some argue that "the [German] Protective Shield Proceeding has managed to escape the insolvency stigma and, despite being a proper insolvency process, is viewed by the larger public and even the media as an informal restructuring process" See M. Thierhoff and R. Müller, above note 32.

36 The insolvency proceedings provide an instrument for early restructuring (Protective Shield Proceeding). See M. Thierhoff and R. Müller, above note 32.

chances of a successful restructuring but we may have to admit it might not always be the case.[37]

First of all, although it is often said that the Commission Recommendation sets out common principles[38] (see, for example, Professor van Zwieten's brilliant analysis[39]), what it sets out is, in reality, a variety of standards or prescriptions, some of which with a considerable degree of detail.[40]

In spite of this, the Commission Recommendation may be considered an inspiring first step towards a minimum harmonisation or convergence.[41]

37 Under the (more generous) Portuguese Law, not only one but two stand-alone pre-insolvency proceedings are legally provided. Following the classification forwarded by Prof. Madaus, one is modelled after the English scheme of arrangement (but without the classes of creditors) and the other is modelled after the "expedited (pre-voted) insolvency" (but without the insolvency order). The latter was recommended by UNCITRAL in the Legislative Guide on Insolvency Law. See S. Madaus, "The EU Recommendation on Business Rescue – Only Another Statement or a Cause for Legislative Action Across Europe?", (2014) 27(6) Insolvency Intelligence, p. 81 ff.

38 Not by chance the German Minister of Justice argued that the Commission Recommendation contained too many details. See M. Thierhoff and R. Müller, above note 32.

39 According to K. van Zwieten there are six core principles emphasised in the Commission's recommendations: early recourse; minimised court involvement; debtor-in-possession; court-ordered stay; ability to bind dissenting creditors to a restructuring plan; and protection for new finance. See K. van Zwieten, "Restructuring Law; Recommendations from the European Commission", (2015) Law in transition online (EBDR publication), p. 1 ff., available at www.http://www.ebrd.com/downloads/research/law/lit114e.pdf (last viewed 13 October 2016). It should be said that van Zwieten's approach is illuminating, achieving the reduction of the Commission Recommendation – the multiplicity of recommendations thereby presented – to its essentials. In any case, it is plain to see, the six elements thereby encountered correspond to core rules rather than legal principles.

40 The distinction between "standards" and "rules" is usually considered analogous to the distinction between "principles" and "rules", which is more common among European scholars. On this analogy see, for example, D. Kaplow, "Rules versus Standards: An Economic Analysis", (1992) 42 Duke Law Journal, p. 557 ff., and V. Fon / F. Parisi, "On the Optimal Specificity of Legal Rules", (2007) 3(2) Journal of Institutional Economics, p. 147 ff. In this case, however, the term "standards" is used to designate something in between principles and rules, based on the conviction that the recommendations laid down in the Commission Recommendation do have a higher degree of specificity when compared to principles. This does not mean that the standards laid down in the Recommendation are not based on principles. As a matter of fact, it is not difficult to unveil the principles underlying some of the standards. Just for one example, according to recommendation 13, the duration of the stay should strike a *fair* balance between the interests of the debtor and of creditors, and in particular secured creditors. It is fairly clear that such as standard calls upon the principles of fairness, proportionality and equality.

41 "Hence, a case can be made for 'minimum harmonization' with respect to jurisdictions' provisions of pre-insolvency restructuring regimes. […] By and large, the substantive insolvency regimes of the Member States would be left intact, potentially reducing the political resistance that is to be expected". See H. Eidenmüller, above note 16. In this respect, some talk about the "modesty" of the initiative. See, among others, B. Wessels, above note 17, and S. Madaus, above note 37. See also H. Eidenmüller and K. van Zwieten, "Restructuring the European Business Enterprise: The EU Commission Recommendation on a New Approach to Business Failure and Insolvency", European Corporate Governance Institute (ECGI) – Law Working Paper No. 301/2015; Oxford Legal Studies Research Paper No. 52/2015, available at https://ssrn.com/abstract=2662213 (last viewed 13 October 2016). Quite surprisingly, the last pair of authors criticise the scope of the harmonisation proposal of the Recommendation, arguing that "sketchy minimum harmonisation of restructuring rules leaves huge potential for residual diversity in Member States' restructuring laws". According to them, "regulatory competition is not a sensible regulatory alternative in this area". Yet, in a more recent article, Professor Eidenmüller not only emphasises the benefits of regulatory competition in the field of corporate insolvency Law but also seems to take the view that harmonisation with respect to pre-insolvency frameworks is best kept to a minimum, at the risk of a "stifling effect on regulatory competition between the Member States and on the benefits that could bring ('laboratory for the best solutions')". See H. Eidenmüller, above note 16.

Certainly, the underlying principles would benefit from being more explicit and taken a few steps further (extended and deepened). The principles could easily support a wider range of rules: on the impact of the stay on individual enforcement actions; the contents of the restructuring plan; the extent to which shareholders could be bound by the restructuring plan; the criterion for the composition of creditors and shareholders in classes; the conditions under which the restructuring plan could be approved and sanctioned; and the treatment of new finance, just to name some.

In short, a principle-based framework could or should have more rules and rules more clearly based on the existing common principles of law. Still remaining an "opened" framework, that is, allowing the determination of the law's content and substance *ex post*, it would be more likely to generate consensus.[42]

It is quite obvious that providing a framework guided by principles may prove to be an extremely challenging task. Handling principles (setting them out and developing them for the purpose of drafting rules) is, to adopt and adapt Professor McBryde's wording,[43] a real "exercise in drafting".[44] Nevertheless, it should be feasible.

As to the effect of future initiatives (hard law or soft law), there are good arguments on both sides. Against diversity, it could be argued that, as long as it persists, debtors "in different Member States have different opportunities to access efficient restructuring proceedings".[45]

It should be clear, once and for all, that efficiency is not a self-sufficient concept. Its meaning depends, among other factors, invariably on the policy objectives set down.[46] And, as Professor Paulus rightly pointed out, not all insolvency laws are premised on the same policy objectives.[47] What might be considered efficient in a legal system that aims to achieve the best possible satisfaction of the creditors

42 From a law and economics' perspective, the degree of specificity of rules implies variable costs. Standards are, in principle, less costly for the legislator because, unlike rules, they are given a specific content only afterwards. See V. Fon and F. Parisi, above note 40.

43 See W. W. McBryde, above note 2.

44 The rule to just keep it simple could prove to be useful. See W. W. McBryde, above note 2, p. 114.

45 See H. Eidenmüller / K. van Zwieten, above note 41.

46 "A system is shaped not only by the rationality itself, but also by the particular economic framework which is composed of historical, cultural, political and legal systems. So, the efficiency of the system is relative". See X. Zheng, "Could the Different Countries' Corporate Governance Regimes be Harmonised?", (2009) 3(2) Management Science and Engineering, p. 32.

47 See C. Paulus, "Group Insolvencies – Some Thoughts About New Approaches" (2007) 42(3) Texas International Law Journal, p. 821.

might not work well nor be the most efficient solution in a system primarily focused on giving the debtor a fresh start or on fostering entrepreneurship.[48]

In view of all this, I would say that until the most efficient restructuring framework is found, the most "efficient" for all member States, it is recommendable that some space be left to member States, so that they may search for the solution that most suits them.[49]

48 In the words of Prof. Eidenmüller, "[i]f anything, the absence of empirical evidence for dysfunctional regulatory diversity cautions against too much zeal in pursuing harmonization projects in the field of corporate insolvency law. Regulatory competition with respect to corporate insolvency law systems has certain benefits of its own, and what appears 'dysfunctional' may be an expression of completely different (but legitimate) insolvency philosophies". See H. Eidenmüller, above note 16.

49 In any case, as Prof. Wessels recently demonstrated, even in the absence of binding measures, legislation in a considerable number of member States is actually converging to the same kind of solutions – the kind that is being fostered in the Commission Recommendation. See B. Wessels, above note 17.

Chapter 12

Restructuring Reform with Pre-Insolvency Proceedings – Where is the EU Heading?

Stephan Madaus* and Bob Wessels**

1 Shifting Centuries - Shifting Focus

In Europe, during the last two decades of the last century, liquidation of a business (of a corporate debtor) was nearly the only option for financially distressed companies in many EU Member States. The goal of liquidation is not survival of the business, as under such a liquidation or winding-up regime the related assets are sold piece-meal. The liquidity (money) received is distributed to creditors according to the ranking of their claims. This one-sided approach to corporate distress is clearly reflected in the EU Insolvency Regulation of 2002, which, for instance, allows the opening of secondary proceedings, which must be winding-up proceedings. The one-sidedness of the aforementioned approach is also indicated by the chosen name for the responsible insolvency office holder in either main or secondary insolvency proceedings: "liquidator". In 2005, a non-EU academic scholar, still observed: "Compared to U.S. bankruptcy laws, many countries' laws read like penal codes".[3]

In the first decade of the 21st century, however, many European countries have come to understand that the existing legal framework does not meet the challenge:

> "… to achieve economic results that are potentially better than those that might be achieved under liquidation, by preserving and potentially improving the company's business through rationalization."[4]

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3 See Natalie Martin, "The Role of History and Culture in Developing Bankruptcy and Insolvency Systems: The Perils of Legal Transplantation", (2005) 28(1) Boston College International & Comparative Law Review 1-78, p. 46.

4 Rebecca Parry, "Introduction", in Katarzyna Gromek Broc and Rebecca Parry (eds.), *Corporate Rescue: An Overview of Recent Developments from Selected Countries in Europe*, (2004, Kluwer Law International, The Hague / London / New York), p. 2.

Substantial revisions have taken place in countries like Germany (1999 and 2012)), England (Enterprise Act 2002), Poland and Romania in 2003 (and 2006), Spain in 2004 (and 2013), France in 2006 (and 2014), Belgium in 2010 (and 2013) and quite recently in countries such as Denmark, Portugal, Italy, Greece and Spain, whilst in some countries legislative changes are underway (the Netherlands, since 2011).[5] Although even more recent insolvency laws in several European countries continue to show substantial differences in underlying policy considerations, in structure and in content of these new enacted laws, in most of these jurisdictions there is an openess towards corporate rescue procedures, as an alternative to liquidation procedures. We will get back to this observation later.

Furthermore, in many of these countries the USA's Chapter 11 procedure has served as a model for legislators. Generally, these laws are based on the principle of a composition or an arrangement concluded between the insolvent debtor and his creditors, which is binding upon a given percentage on a dissenting minority of creditors, sometimes referred to as "cram-down". A characteristic feature of these types of proceedings, aiming at reorganization of the debtor's business, is the fact that attempts to restructure or reorganise enterprises can only be initiated by the debtor himself, or at least not against his will. The traditional "post-mortem autopsy" approach (liquidation; winding-up), slowly, is supplemented by instruments which allow for "real time action" and domestic laws nowadays contain several proceedings which reflect different goals of a company in a rescue. Quite rightly it has recently been observed that in most Member States insolvency laws have been modernised:

> "… to fit with the new economic context: beside traditional collective insolvency proceedings decided by the court on the basis of the debtor's insolvency, new schemes applicable to a group of main creditors (for example banks, public bodies) at a pre-insolvency stage are regarded as being more efficient for the purposes of business continuation and preservation of jobs."[6]

5 See e.g. Otto E. Fonseca Lobo (ed.), *World Insolvency Systems: A Comparative Study*, (2009, Sweet & Maxwell); Christopher Mallon (ed.), *The Restructuring Review*, 3rd edition (2013, Law Business Research, London).

6 See page 1 of the Terms of Reference for the EU Group of Experts on Cross-border Insolvency (http://ec.europa.eu/justice/newsroom/contracts/files/2012_expert-group-insolvency/terms_of_reference_group_insolvency_en.pdf). See in this respect also Bob Wessels, "Europe Deserves A New Approach To Insolvency Proceedings", in A. Bruyneel et al., *Bicentenaire du Code de Commerce – Tweehonderd jaar Wetboek van Koophandel*, uitg. (2007, Larcier, Brussel), 267ff; Cornelia J. Doliwa, *Die geplante Insolvenz. Unternemenssanierung mittels Prepackaged Plan und Eigenverwaltung*, Diss. (2011, Nomos, Berlin).

2 Chapter 11 U.S. Bankruptcy Code under the Magnifying Glass

Most remarkably, the USA Chapter 11 proceeding is being criticised more and more since some three years. There is a consensus, on the other side of the Atlantic Ocean, that the time has come to study whether Chapter 11 is in need of reform. The basic model of Chapter 11 has been introduced in 1978. Since the U.S. Bankruptcy Code's enactment, however, there has been a marked increase in the use of secured credit, placing secured debt at all levels of the capital structure. Chapter 11 assumes the presence of asset value above the secured debt, but asset value is often not present in many of today's Chapter 11 cases. The debt and capital structures of most debtor companies are more complex, with multiple levels of secured and unsecured debt, often governed by equally complex inter-creditor agreements. Also, the market in the USA has changed. It is acknowledged that the growth of distressed debt markets and claims trading introduced another factor, which was absent when the 1978 Code was enacted.

The nature of businesses has changed: Chapter 11 was developed in an era when the biggest employers were manufacturers with domestic operations. Today, many of the biggest employers are service companies. Many of the remaining American manufacturers are less dependent on hard assets, and more dependent on contracts and intellectual property as principal assets. The U.S. Bankruptcy Code does not clearly provide for the treatment of such assets and affected counterparties. And of course, debtors are much more often multinational companies than 30+ years ago, with the means of production and other operations offshore, constituting international law and choice of law implications. Today's "debtor" is likely to be a group of related, often interdependent, corporate entities. For instance, in Chrysler, the "debtor" was a group of some 25 companies. And finally, the original intention of Chapter 11, being the rehabilitation of businesses, and the preservation of jobs and tax bases at the state, local and federal level, is eroded. Presently, the emphasis is "maximization of value" as an equal, sometimes competing or even exclusive goal, e.g. by using "fire sales" in the meaning of Section 365 of the U.S. Bankruptcy Code.

All these developments have called in the USA for a fresh assessment of the purposes and goals of a U.S. restructuring regime, which is undertaken by a special

Commission of the American Bankruptcy Institute (ABI).[7] The ambitions of the Commission are anything but small:

> "… the study of the need for comprehensive chapter 11 reform, by which we mean consideration of starting from scratch and re-inventing the statute."

By looking at the substantive topics identified, one gets a good sense of the topics that are under further study and discussion:

(1) Financing Chapter 11;

(2) Governance and Supervision of Chapter 11 Cases and Companies;

(3) Multiple Enterprise Cases/Issues;

(4) Financial Contracts, Derivatives and safe Harbours;

(5) Executory Contracts and Leases;

(6) Administrative Claim Expansion, Critical Vendors and Other Pressures on Liquidity; Creation and / or Preservation of Reorganization Capital;

(7) Labor and Benefit Issues;

(8) Avoidance Powers;

(9) Sales of Substantially All of the Debtor's Assets, Including Going-Concern Sales;

(10) Plan Issues: Procedure and Structure;

(11) Plan Issues: Distributional Issues;

(12) Bankruptcy Remote Entities, Bankruptcy-Proofing and Public Policy;

(13) The Role of Valuation in Chapter 11.

In 2013 the ABI Commission has established a Working Group on Comparative Law with the task to address questions raised by the Commission and the other Advisory Committees regarding how particular issues are addressed in several countries, where the country's approach may be relevant to the Chapter 11 model.

7 ABI is the organisation of choice to undertake such an effort. It has some 13,000 members coming from all parts of the legal world. The ABI Commission itself is composed of some twenty members. It is co-chaired by Bob Keach and Albert Togut, whilst prof. Michelle Harner (University of Maryland) serves as the primary investigator.

The countries identified include e.g. Australia, Canada, China and Japan. The participating European countries are Austria, Belgium, France, Germany, Italy, the Netherlands and Spain.[8]

3 European Union: Rapidly Changing Political Landscape

In Europe, the start of the second decennium of this century has shown a dramatic increase of political attention for matters of insolvency. We are referring to the following.

3.1 Revision EU Insolvency Regulation

On 12 December 2012, the European Commission published its proposal for a Regulation amending the EU Insolvency Regulation (COM(2012)744). This Regulation was enacted 10 years earlier, in 2002. The Commission has detected five main shortcomings of the Insolvency Regulation in the current economic climate, the first one being the "scope" of the Insolvency Regulation. The Regulation should, in future, have a wider application:

> "The proposal extends the scope of the Regulation by revising the definition of insolvency proceedings to include hybrid and pre-insolvency proceedings as well as debt discharge proceedings and other insolvency proceedings for natural persons that currently do not fit the definition."[9]

In the Explanatory Memorandum, the European Commission notes as its view that the Insolvency Regulation is generally considered to operate successfully in facilitating cross-border insolvency proceedings within the European Union, but that the consultation of stakeholders and legal and empirical studies commissioned by the Commission revealed a range of problems in the application of the Regulation in practice. Moreover:

> "… the Regulation does not sufficiently reflect current EU priorities and national practices in insolvency law, in particular in promoting the rescue of enterprises in difficulties."

8 The Working Group on Comparative Law has been coordinated by Dr. Rolef de Weijs (University of Amsterdam) and myself as Chair. See Bob Wessels and Rolef de Weijs (eds.), *International Contributions to the Reform of Chapter 11 U.S. Bankruptcy Code*, Volume to in the *European and International Insolvency Law Studies*, (2015, Eleven International Publishing, The Hague).

9 In addition to "Scope", the other improvements relate to Jurisdiction, Secondary proceedings, Publicity of proceedings and lodgments of claims, and, Groups of companies. See http://ec.europa.eu/justice/civil/commercial/insolvency/index_en.htm.

Therefore, in addition to the overall objective of the revision of the Insolvency Regulation to improve the efficiency of the European framework for resolving cross-border insolvency cases, the presented improvements are set in a policy context: amending the Insolvency Regulation:

> "… in view of ensuring a smooth functioning of the internal market and its resilience in economic crises. This objective links in with the EU's current political priorities to promote economic recovery and sustainable growth, a higher investment rate and the preservation of employment, as set out in the Europe 2020 strategy. The revision of the Regulation will contribute to ensuring a smooth development and the survival of businesses, as stated in the Small Business Act [COM2008)394]."

After a relativly short, but intensive review proces, the final text of the new Insolvency Regulation entered into force on 26 June 2017.[10]

3.2 Renewed Policy: Enable Financially Distressed Enterprises to Survive

The revision is also one of the key actions listed in the Single Market Act II[11], within which Key action 7 ("Modernise EU insolvency rules to facilitate the survival of businesses and present a second chance for entrepreneurs"), includes the following text:

> "Businesses operating in Europe benefit from an overall positive business environment, which the EU is further improving through its better regulation agenda. But more can be done. Europe needs modern insolvency laws that help basically sound companies to survive, encourage entrepreneurs to take reasonable risks and permit creditors to lend on more favourable terms. A modern insolvency law allows entrepreneurs to get a second chance and ensures speedy procedures of high quality in the interest of both debtors and creditors. We thus need to establish conditions for the EU-wide recognition of national insolvency and debt-discharge schemes, which enable financially distressed enterprises to become again competitive participants in the economy. We need to ensure simple and efficient insolvency proceedings, whenever there are assets or debts in several Member States. … However, we need to go further. At present, there is in

10 See Regulation (EU) 2015/848 of the European Parliament and the Council of 20 May 2015 on insolvency proceedings (recast) (EIR Recast or EIR 2015), [2015] OJ L 141/19.

11 Available from http://ec.europa.eu/internal_market/smact/index_en.htm.

> many Member States little tolerance for failure and current rules do not allow honest innovators to fail 'quickly and cheaply'. We need to set up the route towards measures and incentives for Member States to take away the stigma of failure associated with insolvency and to reduce overly long debt discharge periods. We also need to consider how the efficiency of national insolvency laws can be further improved with a view to creating a level playing field for companies, entrepreneurs and private persons within the internal market."[12]

We will return to this subject shortly below.

4 In Europe: Rescue On The Rise

4.1 Differences in National Insolvency Laws

The Insolvency Regulation is an instrument of a private international law. It tries to overcome the huge differences in the national laws of the Member States. Recital 11 in the present text of the Regulation provides:

> "(11) This Regulation acknowledges the fact that as a result of widely differing substantive laws it is not practical to introduce insolvency proceedings with universal scope in the entire Community. The application without exception of the law of the State of opening of proceedings would, against this background, frequently lead to difficulties. This applies, for example, to the widely differing laws on security interests to be found in the Community. Furthermore, the preferential rights enjoyed by some creditors in the insolvency proceedings are, in some cases, completely different …"

On a global level, it has been recognised that with all national insolvency systems having so many differences, these

> "… hamper the rescue of financially troubled businesses, are not conducive to a fair and efficient administration of cross-border insolvencies, impede the protection of the assets of the insolvent debtor against dissipation and hinder maximization of the value of those assets. Moreover, the absence of predictability in the handling

12 Available from http://ec.europa.eu/internal_market/smact/docs/single-market-act2_en.pdf. See Communication, dated 12 December 2012, re "A new approach to business failure and insolvency" [COM(2012) 743]: http://ec.europa.eu/justice/civil/commercial/insolvency/index_en.htm.

> of cross-border insolvency cases impedes capital flow and is a disincentive to cross-border investment …"

This view forms the foundation for the creation of the UNCITRAL Model Law on Cross-border Insolvency.[13] This Model Law, presently, is applied in over twenty countries, including Japan, Australia, USA, and in Europe: UK, Poland, Romania and Greece.

Since 2011 the book of rules for European insolvency law turns to a next page: harmonisation of insolvency law. Harmonisation by the way has been a term that until then was carefully avoided in insolvency circles.[14]

4.2. Growing towards an Aligned Approach to Business Rescue

On 15 November 2011 the European Parliament (EP) approved a "Motion for a European Parliament resolution with recommendations to the Commission on insolvency proceedings in the context of EU company law". In its motion the EP requests the Commission to submit to Parliament one or more legislative proposals:

> "… relating to an EU corporate insolvency framework, following the detailed recommendations set out in the Annex hereto, in order to ensure a level playing field, based on a profound analysis of all viable alternatives."[15]

These harmonisation-proposals have been the object of a different study.[16] Although "harmonisation" sounded new, actually many EU countries' national laws share several tendencies in renewing their national rescue legislations. And "…[t]he pace of insolvency law reform has been fast and even, at times, relentless."[17]

In a 2012 study, University of Heidelberg professor Andreas Pieckenbrock compares insolvency laws of England, Italy, France, Belgium, Germany and

13 See its Guide to Enactment (1997), nr. 13.

14 "The H-word is out!", see Bob Wessels, "Harmonization of Insolvency Law in Europe", (2011) 8(1) European Company Law, 27ff.

15 See Motion for a European Parliament resolution with recommendations to the Commission on insolvency proceedings in the context of EU company law (2011/2006(INI). See http://www.europarl.europa.eu/sides/getDoc.do?type=REPORT&reference=A7-2011-0355&format=XML&language=EN.

16 See Ian F. Fletcher and Bob Wessels, "Harmonisation of Insolvency Law in Europe", Reports presented to the *Nederlandse Vereniging voor Burgerlijk Recht* (Netherlands Association of Civil Law), (2012, Kluwer, Deventer). Summarised findings and presented conclusions are separately published, see http://bobwessels.nl/wordpress/?attachment_id=2409.

17 See Catherine Bridge, "Insolvency – a second chance? Why modern insolvency laws seek to promote business rescue", in *Law in Transition* 2013, 28ff., mentioning (non-EU) changes in insolvency laws over the last five years in Albania, Kazakhstan, Moldova, Russia, Serbia and Ukraine.

Austria. He concludes that there are several common tendencies in these rescue proceedings:

(1) Early recourse: sometimes there is an earlier moment of starting a rescue process, for instance in the French *sauvegarde*: the debtor must encounter problems that he can not solve, which is earlier than the traditional moment that the debtor can not pay its financial obligations when they are due;

(2) Debtor in possession: the board is not fully replaced by the insolvency administrator - n certain proceedings the board stays in control of the business, what we call "debtor-in-possession";

(3) Stay: in these countries one finds a moratorium or a stay either automatic like in the *sauvegarde* or at request (for instance the *concordato preventivo* or *réorganisation judiciare*);

(4) Protecting fresh money: there are special provisions to protect fresh money available for the company while trying to work itself out of its misery;

(5) Debt for equity swap: the possibility of a debt for equity swap, i.e. the conversion of a creditors' claim into shares in the capital of the company;

(6) Binding disapproving creditors: generally, as Pieckenbrock explains, such a rescue is based on the principle of a composition or an arrangement concluded between the insolvent debtor and his creditors. Such a rescue plan is binding for those creditors who voted in favour of the plan, but is also binding – as indicated earlier – upon a (given percentage) of a dissenting minority of creditors or a watering down ("bail-in") for *altgesellschafter* (ie. existing shareholders).[18]

In April 2014, INSOL Europe published a study on a new approach to business failure and insolvency. The reporters (University of Milan professor Stefania Bariatti and Robert van Galen) have studied 28 EU Member States. It is interesting

18 Andreas Pieckenbrock, *Das ESUG – fit für Europa?*, NZI 22/2012, 906ff. By the same author the theme has been presented in a broader context with focus on Germany, as a continuous work in progress, see Andreas Pieckenbrock, *Das Insolvenzrecht zu Beginn des 21. Jahrhunderts: ein Dauerbaustelle*, in Werner Ebke, Christopher Seagon, Michael Blatz (eds.), *Solvenz – Insolvenz – Resolvenz*, (2013, Nomos, Baden-Baden), 79ff.

to note that generally professor Piekenbrock's characteristics are available in new or renewed recovery proceedings in nearly all member states.[19]

4.3 EU's Response: A New Approach to Business Failure and Insolvency

On 12 December 2012, the European Commission responded to the harmonisation-challenge of the European Parliament and stated a new policy, named "A new European approach to business failure and insolvency". Via a public consultation, opened in July 2013, the European Commission seeks to identify the issues on which the new European approach to business failure and insolvency should focus "… so as to develop a rescue and recovery culture across the Member States". It is stated that many European restructuring frameworks "… are still inflexible, costly and value destructive".[20]

Using the outcomes of this public consultation the European Commission presented on 12 March 2014 its Recommendation on a new approach to business failure and insolvency. The Recommendation has 20 recitals and 36 recommendations.[21]

5 Recommendation of 12 March 2014 on a New Approach to Business Failure and Insolvency

5.1 Major Objects

Let"s look at the Recommendation more closely. It has two major objects. First of all 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 at an early stage with a view to preventing their insolvency, and therefore maximise the

19 For instance, debtor in possession proceedings (in certain cases supervised by an insolvency practitioner appointed by the court), a rescue plan in which creditors, sometimes even secured creditors, can be crammed down provided a certain qualified majority is reached, the ability to order a stay of the enforcement of claims, the possibility of attracting new loans, although these reporters have generally found that no super-priority was granted to new financing. The study is available via www.insol-europe.org. For an eyewitness account of the machinations behind tendering for and successfully delivering a report to the European Commission: Michael Tierhoff, "Love me tender: How a project rocked INSOL Europe", (2014) spring, eurofenix, 16ff. Harmonising continental European insolvency law therefore seems much less illusory as some 10 years ago, observes Eric Dirix, *Het insolventierecht anno 2014,* in H. Braekmans, E. Dirix, M.E. Storme, B. Tilleman, and M. Vanmeenen (eds.), *Curatoren en vereffenaars: actuele ontwikkelingen III, Antwerpe*, (2014, Intersentia, Cambridge), 3ff, at 7.

20 See Impact Assessment ("Impact Assessment 2014" or "IA 2014") accompanying the document Commission Recommendation on a New Approach to Business Failure and Insolvency", 12.3.2014, SWD(2014) 61 final, at 2.

21 For the text, see http://ec.europa.eu/justice/newsroom/civil/news/140312_en.htm. For an overview, see Stephan Madaus, "The EU Recommendation on Business Rescue – Only Another Statement or a Cause for Legislative Action Across Europe?", (2014) 27(6) Insolvency Intelligence, 81ff.

> total value to creditors, employees, owners and the economy as a whole. The Recommendation also aims at giving honest bankrupt entrepreneurs a second chance across the Union.” (recital (1))

In order to achieve these aims, the Commission deemed it necessary to:

> “… encourage greater coherence between the national insolvency frameworks in order to reduce divergences and inefficiencies which hamper the early restructuring of viable companies in financial difficulties and the possibility of a second chance for honest entrepreneurs, and thereby lower the cost of restructuring for both debtors and creditors. Greater coherence and increased efficiency in those national insolvency rules would maximise the returns to all types of creditors and investors and encourage cross-border investment. Greater coherence would also facilitate the restructuring of groups of companies irrespective of where the members of the group are located in the Union.” (recital (11))

5.2 Introducing Minimum Standards on Preventative Restructuring Frameworks

The Recommendation seeks to reach these goals by encouraging Member States to put in place

> “… a framework that enables the efficient restructuring of viable enterprises in financial difficulty and give honest entrepreneurs a second chance” (R1).[22]

The Recommendation provides for “minimum standards” on “preventative restructuring frameworks” (R3(a)) to be implemented in all Member States.

Through promoting adherence to these standards throughout the Union, the Commission”s hopes are three of a kind:

- for national insolvency systems: to improve the existing means for resolving distress in viable enterprises (R5) and encourage coherence in initiatives or reviews of “corporate rescue framework” in all Member States (R10);
- for businesses (debtors): to improve access to credit (R4), encourage investment (R8) and to smoothe “… the adjustment for over-indebted firms, minimizing the economic and social costs involved in their deleveraging process” (R12); and

22 Recommendations 30-33 relate to a second chance for honest entrepreneurs. These are not discussed here. “R” stands for Recommendation.

- for creditors: to improve mechanisms for resolving financial distress efficiently, with reduced delays and costs and limited court formalities ("… to where they are necessary and proportionate in order to safeguard the interests of creditors and other interested parties likely to be affected") (R17).

5.3 Six Core Principles

Oxford associate professor Kristin van Zwieten has analysed the Recommendation in greater detail with as a result that she concludes that there are six core principles on which the minimum standards of the Commission's recommendations for a preventative restructuring framework are based.[23] I will follow her analysis below. These principles apply to any debtor ("… any natural or legal person in financial difficulties when there is a likelihood of insolvency"; R5(a)), excluding financial institutions.[24] The scope of these core principles is "restructuring", which means

> "… changing the composition, conditions, or structure of assets and liabilities of debtors, or a combination of those elements, with the objective of enabling the continuation, in whole or in part, of the debtors' activity" (R5(b)).

5.3.1 Early Recourse

A debtor should be able to have recourse to the restructuring framework at an early stage (R6(a)). The framework only is open to a debtor that is already in "financial difficulties" (R1), such that there is a "… likelihood of insolvency"(R6(a)).

5.3.2 Minimised Court Involvement

A debtor should have recourse to the restructuring framework without the need to formally open court proceedings (R8). More generally, a restructuring procedure should not be lengthy and costly and court involvement should be limited to circumstances where necessary and proportionate to safeguard the rights of creditors and others affected by a proposed restructuring plan (R7). On the other hand, involvement of a court in some other circumstances may be necessary, including the granting of a stay.

23 Kristin van Zwieten, "Restructuring Law: Recommendations from the European Commission", in *Law in Transition* (2015, EBRD publication).

24 Recital 15: "It is appropriate to exclude from the scope of this Recommendation insurance undertakings, credit institutions, investment firms and collective investment undertakings, central counter parties, central securities depositories and other financial institutions which are subject to special recovery and resolution frameworks where national supervisory authorities have wide-ranging powers of intervention …". See: Matthias Haentjens & Bob Wessels (eds.), *Bank Recovery and Resolution – A Conference Book, The Hague,* (2014, Eleven International Publishing, The Hague); Matthias Haentjens & Bob Wessels (eds.), *Research Handbook on Crisis Management in the Banking Sector* (2015, Edward Elgar, London).

5.3.3 Debtor in Possession

A debtor "… should keep control over the day-to-day operation of its business" while the restructuring framework is used (R6(b)).[25] This principle provides an incentive for a debtor to use the procedure early and ensures minimum disruption to the operations of the debtor and allows him to carry on his day-to-day operations.[26] Restructuring is a management tool, rather then a signal of failure.[27]

5.3.4 Court-Ordered Stay

A debtor should have the power to seek a temporary stay of individual creditor enforcement actions (including those by secured and preferential creditors), by application to a court (R6(b) and R10). From a debtor's perspective a stay is designed to enable the assets of the business to be kept together, preventing their piecemeal dismemberment by creditors. A stay improves the chances of negotiations for a restructuring plan by the debtor, but it should be balanced by the need to adequately protect secured creditors" interests, by allowing them to request a relief from the stay under certain specified conditions. The Recommendation recommends a set of safeguards, including timelimits (initial stay of up to four months, subject to renewal up to a maximum duration of 12 months; R13), and an obligation to lift the stay when it is not longer necessary to facilitate the adoption of a restructuring plan (R14). In Member States which make the granting of the stay subject to certain conditions, a debtor should be able to be granted a stay in all circumstances where: (a) creditors representing a "significant amount" of the claims likely to be affected by the restructuring plan support the negotiations on the adoption of a restructuring plan; and (b) a restructuring plan has a reasonable prospect of being implemented and preventing the insolvency of the debtor (R11).

5.3.5 Ability to Bind Dissenting Creditors to a Restructuring Plan

A Member States' preventive restructuring framework should provide for a plan to be negotiated between debtor and creditors (secured and unsecured), and – where approved by the requisite majority as described by national law of creditors in affected classes – sanctioned by a court, with the effect that dissenting creditors are bound by it (R6(d), 16, 20, 21, 26). Secured creditors are to be treated as a seperate class to unsecured creditors (R17). When a restructuring plan is adopted unanimously by affected creditors it should be binding on "all those affected

25 The Recommendation does however contemplate (not compulsory, but on a case by case basis) the appointment by a court of a "supervisor" to oversee debtor activity and safeguard creditor interests: R9(b).

26 IA 2104, 10.

27 See Madaus, above note 19, at 82.

creditors", which seems to provide support for a fully out-of-court contractual restructuring, also for those creditors that did not participate in the adoption process itself.

A framework should also allow for the sanctioning of a plan approved by some classes but not others, with the result that it would be possible for a majority of classes to bind dissenting classes (i.e. for those classes to be "crammed down"). The conditions under which a restructuring plan can be confirmed by a court should be clearly specified and should include at least that the restructuring plan (a) has been adopted in conditions which ensure the protection of the legitimate interests of creditors, (b) has been notified to all creditors likely to be affected by it, and (c) does not reduce the rights of dissenting creditors below what they would reasonably be expected to receive in the absence of the restructuring, if the debtor's business was liquidated or sold as a going concern, as the case may be (the HLR-test, the hypothesis liquidation result-test). In addition (d) any new financing foreseen in the restructuring plan is necessary to implement the plan and does not unfairly prejudice the interests of dissenting creditors (R22). Procedural requirements should safeguard rights of creditors to ensure creditors are notified of the plan, can object to it, and can appeal against it, except that an appeal should "… not in principle suspend the implementation of the restructuring plan" (R24).

5.3.6 Protection for New Finance

Those parties who provide new finance to a debtor in accordance with the terms of a court-sanctioned restructuring plan should be shielded from the operation of avoidance provisions, paulian actions etc. in national insolvency law (R6(e) and 27), as well as from "civil and criminal liability relating to the restructuring process" (R28) except in the case of fraud (R29).

5.4 Relation to the Insolvency Regulation

The Recommendation is supposed to dovetail with the (amendments to the) European Insolvency Regulation. As explained, one of the proposed amendments to the European Insolvency Regulation is the widening of its scope, to include certain debtor-in-possession and pre-insolvency procedures. If this amendment is made, the "preventive restructuring framework", drafted in national insolvency systems in line with the Commission's Recommendation, could potentially come within the scope of the (new) European Insolvency Regulation. The system of the Regulation governing jurisdiction to open proceedings, and the effect of proceedings once opened could therefore apply to these restructuring procedures.

6 Turning a Recommendation into a Directive

The Recommendation, formally, reflected a rather soft approach. It invited Member States to take or continue legislative action. Within twelve months (so before April 2015) EU Member States were invited to implement the Recommendation's "principles" (R34). In September 2015 it became clear, after a study by the Commission, that the Recommendation of March 2014 has not succeeded in having the desired impact in facilitating the rescue of businesses in financial difficulty. The Commission seems nevertheless determined to harmonise certain aspects of insolvency law. It has launched a public consultation in June 2016 and with regard to the scope of the harmonisation of insolvency laws its present views are that it could deal with:

(1) preventive restructuring procedures and a discharge of debt (second chance) for entrepreneurs as provided for by the Insolvency Recommendation, and

(2) key areas of insolvency beyond the scope of the Insolvency Recommendation such as (related to corporate insolvency):

   (a) common minimum rules for directors' duties and liabilities in anticipation of insolvency, as well as their disqualification due to breach of those duties;

   (b) common minimum rules for the ranking of claims in insolvency and avoidance actions, with a view to bringing more legal certainty in cross-border flow of capital;

   (c) a simplified approach to SMEs insolvency, for example by providing standard forms for filing claims and putting in place electronic means to reduce costs;

   (d) common minimum rules for insolvency practitioners with the aim of allowing both easier exercise of this profession in different Member States and set standards ensuring proper conduct of these professionals; and

   (e) protection of investors' rights by ring-fencing securities from the insolvency regimes of intermediaries with whom investors deposited their securities.[28]

Recently, the European Commission announced a new legislative instrument to be published by the end of October 2016. While details of this instrument are

28 See for related documents http://bobwessels.nl/2016/03/2016-03-doc8-rescue-recommendation-after-2-years/, and http://ec.europa.eu/justice/civil/commercial/insolvency/index_en.htm

still unknown, it should cover the topics of the Recommendation. There will be a framework for pre-insolvency restructurings as well as an approach to facilitate a second chance for entrepreneurs. It remains to be seen whether additional topics mentioned in the consultation of June 2016 find their way into a legislative proposal as well.

7 ELI Project on Business Rescue in Insolvency

In the lingering economic crisis in many Member States, legal instruments are required that allow viable businesses to restructure of a strangeling debt burden efficiently in order to begin investing, hiring and flourishing again. Along the developments in Brussels, the European Law Institute (ELI) initiated a research project that aims at identifying the best practices and worst hinderances when trying to rescue a struggling business across Europe. Here, Professor Bob Wessels, Professor Stephan Madaus, and Associate Professor Kristin van Zwieten act as Reporters.

The ultimate aim of the project is to present a set of recommendations to European and national lawmakers as well as involved private institutions that will push for the further development of coherent and functional rules for business rescue in Europe. These recommendations will include certain statutory procedures that could better enable parties to negotiate solutions where a business becomes financially distressed. The project will also determine in which procedures and under which conditions an enforceable solution can be imposed upon creditors and other stakeholders despite their lack of consent. The research done in the project has a broad scope. It extends to consider frameworks that can be used by (non-financial) businesses out of court, and in a pre-insolvency context.

The project produces two major outcomes that will be published in 2017/18 by Oxford University Press. First major outcome is set of inventory and normative reports on the status quo of the national insolvency and restructuring law in 13 representative EU Member States produced by expert national correspondents. These reports cover the law on the books as well as the law in practice. They are accompanied by a complementary inventory report on international soft law frameworks for business rescue. Altogether, these reports form the basis of the comparative analysis of the three reporters which is the second project outcome. Here, the project Reporters identify best practices and formulate specific recommendations that would improve the existing legal framework for a business rescue in many Member States.

8 Conclusion

The legal environment for the restructuring of failing business has changed significantly in many jurisdictions and obviously keeps changing. Insolvency and debt restructuring law seems to be a constant construction site. The ELI Project on Business Rescue in Insolvency has influenced this process when Reporters participated actively in conferences and discussions across Europe and beyond. With the EU Commission acting as an observer to the project, preliminary results of the project have been shared with the Commission. The final outcome of the project should be able to add value to the discussion that will surround a legislative proposal from the Commission in late 2016. The aim of the project goes beyond that. Its purpose is to inform lawmakers at all levels about recommended principles, instruments and institutions in a flourishing business rescue framework. Being a truly academic endeavour, one may only speculate about its actual impact.

Chapter 13

Corporate Restructuring and Corporate Dissolution of Companies in Financial Distress: From Preventing to Circumventing Bankruptcy

A Comparison of the UK and the Dutch Systems from a European Point of View

Dr S Renssen*

1 Introduction

In the EU, national restructuring and insolvency rules vary greatly in respect of the range of procedures available to companies in financial distress aiming at restructuring their business. According to the European Commission, it is of great importance that companies in financial distress have access to a framework enabling them to restructure with the objective of preventing insolvency.[1] Effective restructuring of viable companies in financial distress contributes to saving jobs and also benefits the wider economy. It is also important to encourage greater coherence between the national insolvency frameworks, as this would maximise the returns to the creditors and investors, and encourage cross-border investment.

On 12 March 2014, the European Commission published a recommendation on a new approach to business failure and insolvency,[2] which provides for minimum standards on schemes of arrangement. The report on the follow-up to the above mentioned recommendation of the European Commission, issued in March 2016, shows that the Member States have not fully adopted the recommendations. This means that without action at EU level differences between Member States will continue to exist. As a consequence, legal uncertainty would continue to exist as well as additional costs for investors looking for investment opportunities in other Member States. Moreover, the Commission is of the opinion that this would

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1 Commission Recommendation on a new approach to business failure and insolvency, COM(2014) 1500 final.

2 *Ibid*.

continue to create barriers to the efficient restructuring of viable companies in financial distress in the EU, which would lead to a high amount of accumulated private debt. Harmonisation in this field is thus needed. Therefore, the European Commission adopted its legislative proposal on preventive restructuring, insolvency and second chance.[3]

In general, in insolvency practice, the UK insolvency system is seen as rather sophisticated. In the UK, viable companies can make use of the following three formal procedures: the pre-pack procedure, the scheme of arrangement, and the company voluntary arrangement procedure. However, not all European jurisdictions provide for formal rescue procedures. Current Dutch law, for example, still lacks appropriate and efficient methods to restructure viable companies in financial distress successfully. At present, the Dutch legislator is working on the development of a framework for companies in financial distress. Despite the fact that the development of restructuring options for companies in financial distress is welcome in Europe with respect to economic and labour market policies, the question arises whether creditor protection is sufficiently ensured in restructuring proceedings.

In case of unviable companies in financial distress, the European national systems provide for several dissolution methods. In most European jurisdictions unviable companies in financial distress can be dissolved very quickly and cheaply. In the Netherlands, a company can be dissolved without pursuing liquidation proceedings if there are no longer any assets at the time of dissolution. This quick and cheap dissolving procedure - laid down in Article 2:19 sub 4 of the Dutch Civil Code (hereinafter: DCC) - is also referred to as 'turbo liquidation'. In the UK it is possible to strike off a company from the Companies Register and thereby terminate its existence, also known as the voluntary striking off procedure.[4] This procedure is considered inexpensive and easy in its process. Currently, harmonisation in the field of dissolution of companies is lacking in the EU. The question arises whether creditor protection is ensured in these quick dissolving methods. Another question is whether these dissolving methods are in fact an open invitation to commit fraud and to circumvent bankruptcy procedures.

In this contribution, the questions mentioned above will be answered for the UK system and the (proposed) Dutch system. I will therefore – first – successively

3 Proposal for a Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU, COM(2016) 723 final, 2016/0359 (COD).

4 Section 1003 CA 2006.

review the formal corporate rescue procedures in the UK, and the proposed rescue procedures by the Dutch legislator. I will then – secondly – successively review corporate dissolution in the UK, and in the Netherlands.

2 Corporate Rescue in the UK

A company in financial distress may be subjected to the following formal rescue procedures in order to restructure its business successfully:

(1) The pre-pack procedure based on the Enterprise Act 2002 (hereinafter the "EA 2002");

(2) The scheme of arrangement as laid down in Part 26 of the Companies Act 2006 (hereinafter the "CA 2006");

(3) The company voluntary arrangements procedure laid down in Part 1 of the Insolvency Act 1986 (hereinafter the "IA 1986").

2.1 Restructuring by Pre-packaged Administration

There is no clear statute providing the legality of a pre-pack; the pre-packaged administration is developed in practice.[5] During a pre-pack procedure, selling a company's business is arranged prior to the commencement of the administration procedure and thus a swifter implementation and completion of the deal is laid down in the statutory proceedings.[6] An administrator or administrative receiver will be appointed, who will then execute the restructuring transaction on behalf of the company in financial distress.[7]

According to Paragraph 2 Schedule B1, an administrator can be appointed by the court under Paragraph 10, by the holder of a floating charge under Paragraph 14, or by the company or its directors under Paragraph 22.[8] Whether or not the administrator is appointed by the court, he is an officer of the court and must act as an agent of the company.[9] According to Paragraph 6 Schedule B1, a person may be appointed as an administrator only if he is qualified to act as an insolvency practitioner in relation to the company. The administrator must perform his

5 B. Xie, "Regulating Pre-Packaged Administration - a Complete Agenda", (2011) 5 Journal of Business Law, pp. 513-527.

6 C. Shuttleworth, ''Pre-Packs: the Latest Wave of Reform'', (2015) Corporate Rescue and Insolvency, pp. 61-63.

7 V. Finch, "Pre-packaged administrations: bargains in the shadow of insolvency of shadowy bargains", (2006) 9 Journal of Business Law, pp. 568-588.

8 J. Armour, "The Rise of the 'Pre-Pack': Corporate Restructuring in the UK and Proposals for Reform", in R.P. Austin & F. JG Aoun, *Restructuring Companies in Troubled Tim*e (2012, Ross Parson Centre, Sydney), pp. 43-78.

9 Paragraph 5 and 69 Schedule B1.

functions with the objective of (i) rescuing the company as a going concern; or (ii) achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration); or (iii) realising property in order to make a distribution to one or more secured or preferential creditors.[10] Furthermore, the administrator must perform his functions in the interests of the company's creditors as a whole and as quickly and efficiently as is reasonably practicable.[11]

Under Paragraph 46 Schedule B1, the appointment of the administrator has to be announced to the company and creditors as well as advertised in the *Gazette*. The administrator shall make a statement setting out proposals for achieving the purpose of the administration, which has to be sent to the creditors of the company accompanied by an invitation to a creditors' meeting.[12] The meeting must be held on a two-weeks' notice. However, such a meeting does not need to be held in case the company is able to pay all creditors in full, in case it has insufficient property to make a distribution to unsecured creditors, or if it is not possible to rescue the company as a going concern, or to achieve better results than when winding up.

Using pre-packaged administration does not eliminate the need for the abovementioned statutory procedures as laid down in Schedule B1, but it does create at least the risk that the administration procedure will be reduced to a formal role rather than one offering real protection to creditors.[13] In jurisprudence, courts try to ensure creditor protection by underlining the importance of consulting with major creditors ahead of completing a pre-pack sale.[14] Another major criticism of the pre-pack is that the procedure lacks transparency, is open to abuse and is morally wrong, particularly considering concerns that the business may have been undersold with a disproportionate prejudice towards the interests of (generally unsecured) creditors.[15] The negative impression surrounding the pre-pack was increased by the fact that in many cases the business is bought by the company's current or former shareholders or directors (also referred to as phoenix pre-packs).[16] Despite the criticism, a pre-pack may prove useful in case the majority of

10 Paragraph 3 sub 1 Schedule B1.

11 Paragraph 3 sub 2 and 4 Schedule B1.

12 Paragraph 49-51 Schedule B1.

13 V. Finch, above note 7, pp. 568-588.

14 *DKLL Solicitors v. HM Revenue and Customs* [2007] EWHC 2067 (Ch); [2007] BCC 908; *Clydesdale v. Smailes (No.1)* [2009] EWHC 1745 (Ch); [2010] BPIR 62.

15 B. Xie, above note 5, pp. 513-527.

16 *Ibid*.

creditors make negotiating on a scheme of arrangement or a company voluntary arrangement impractical or impossible.[17]

2.2 Restructuring by the Scheme of Arrangement

A scheme of arrangement is a compromise between a company and its creditors or members or any class of them under Part 26 of the CA 2006.[18] The scheme of arrangement procedure commences with an application to the court, which may be made by the company, any creditor or member of the company, or if the company is being wound up or an administration order is in force in relation to it, the liquidator or administrator.[19] The scheme of arrangement thus applies to insolvent debtors as well as solvent debtors.[20] The application must be accompanied by a statement explaining the effect of the compromise or arrangement. Moreover, the statement has to declare any material interests of the directors of the company (whether as directors, or as members, or as creditors of the company, or otherwise), and the effect on those interests of the compromise or arrangement, in so far as it is different from the effect on the equivalent interests of other persons.[21]

The proposing party should also determine the correct classes of the creditors and members of the company.[22] According to Section 896 CA 2006, the court may then order a meeting of the creditors or of the members of the company (or any class of them). During this meeting the court will decide whether the division of the creditors or members into different classes for voting purposes is appropriate.[23] Section 899 sub 1 CA 2006 requires approval by at least 75% in value in each class of the creditors or members voting on the scheme, which will also be at least a majority in number of each class. Only the creditors and members who will be affected by the scheme of arrangement will be able to discuss and vote on the proposed scheme.[24] If the aforementioned majority is reached, again, an application to the court has to be made. During this second hearing the court will decide whether to sanction the scheme of arrangement.

17 V. Finch, above note 7, pp. 568-588.

18 C.G. Paulus, “Das englische Scheme of Arrangement - ein Neues Angebot auf dem Europäischen Markt für Aussergerichtlichen Restructurierungen” (2011) ZIP, p. 1077 ff; G. O‘Dea J. Long & A. Smyth, *Schemes of Arrangements. Law and Practice* (2012, Oxford University Press, Oxford), p. 3.

19 Section 896 sub 2 CA 2006.

20 S. Madaus, “Rescuing Companies Involved in Insolvency Proceedings with Rescue Plans” (2012) NACIIL Reports.

21 Section 897 CA 2006.

22 B. Wessels, “Scheme of Arrangement: a Viable European Rescue Strategy?” (2010) 154 Ondernemingsrecht.

23 *Ibid*.

24 R. Richards & J. Tribe, “Members’ Voluntary Liquidations - Part 2: MVLs Compared” (2005) 26(11) Company Lawyer, pp. 322-325.

According to Section 899 sub 2 CA 2006, such an application may be made by the company, any creditor or member of the company, or if the company is being wound up or an administration order is in force in relation to it, the liquidator or administrator. During this hearing, creditors may challenge the scheme on the ground that the meeting is improperly constituted, that the creditors were not given sufficient information, or on the ground that the scheme is unfair. The court will sanction the proposed scheme if it is fair,

> "i.e. a scheme that an intelligent and honest person, a member of the class concerned, and acting in respect of his interest might reasonably approve."[25]

According to Section 899 sub 3 CA 2006, a scheme sanctioned by the court is binding on all creditors/members or the class of creditors/members and on the company or, in case of a company in the course of being wound up, the liquidator and contributors of the company.

2.3 Restructuring by Company Voluntary Arrangements

According to Section 1 sub 1 and 3 IA 1986, the directors of a company, the administrator where an administration order is in force, or the liquidator where a company is being wound up, may make a proposal to the company and its creditors for a composition in satisfaction of its debts or a scheme of arrangement of its affairs (also referred to as a voluntary arrangement).[26] A nominee has to be appointed. The nominee must be a person who is qualified to act as an insolvency practitioner in relation to the company.[27] While the directors of the company remain in charge of the management of the company, the nominee is responsible for assisting the directors with the development of the voluntary arrangement and its implementation.

According to Section 2 sub 2 IA 1986, the nominee shall, within 28 days after being given notice of the proposal for a voluntary arrangement, submit a report to the court stating whether, in his opinion, meetings of the company and of its creditors should be summoned to consider the proposal, and the date on which, and time and place at which, he proposes the meetings should be held. The person calling the creditors' meeting must summon all creditors of the company whose claims and addresses he is aware of.[28] Notices are to be sent to the creditors at least

25 M. Kierce, H. Martin, A. Cotter & N. Montgomery, "Schemes of Arrangement and their Ongoing Currency" (2010) Insurance and Reinsurance, pp. 13-16; Wessels, above note 22.

26 See also: R. Mokal & L. Chan Ho, "Interplay of CVA, Administration and Liquidation", available from http://papers.ssrn.com/ (last viewed: 2 April 2017).

27 Section 1 sub 2 IA 1986.

28 Section 3 sub 3 IA 1986.

two weeks in advance of the meeting, together with the following documents: a copy of the proposal, a copy of the statement of affairs or a summary statement of affairs, a voting form, a notice of claim form and a proxy form to be completed and returned, and the nominee's report on the proposal. During the meeting, the creditors will decide whether to approve the proposed voluntary arrangement.[29] The proposal must be approved by a simple majority of the shareholders and 75% in value of the creditors present and voting.

If the decisions of the meeting of shareholders and the creditors differ, the decision of the creditors will prevail. The arrangement will bind every person who was entitled to vote at the meetings as well as every person who would have been so entitled if he had had notice of it, as if he were a party to the voluntary arrangement.[30] According to Section 7 sub 2 IA 1986, the appointed nominee shall in principle act as the supervisor of the agreed arrangement. Under Section 6 IA 1986, any person entitled to vote at the creditors' or the shareholders' meeting is able to challenge the implementation of the arrangement within four weeks of the approval being reported to the court. In order to challenge the approved arrangement successfully, it must be shown that the arrangement unfairly prejudices the interests of a creditor, member or contributor of the company, or that there has been some material irregularity at or in relation to either of the meetings. An important difference with the scheme of arrangement is that under a company voluntary arrangement, the secured and preferential creditors cannot be bound by the scheme.[31]

3 Corporate Rescue in the Netherlands

Current Dutch corporate and insolvency law lacks appropriate and efficient methods to restructure companies in financial distress successfully. In order to facilitate possibilities to effectively restructure those companies, the Dutch legislator has proposed two Acts:

(1) Act on the Continuity of Companies I on pre-pack proceedings;[32]

29 Section 4 sub 1 IA 1986.
30 Section 5 IA 1986.
31 Section 4 sub 3 and 4 IA 1986.
32 *Kamerstukken II* 2014/15, 43 218, nr. 2.

(2) Act on the Continuity of Companies II on the scheme of arrangement outside bankruptcy proceedings.[33]

3.1 Restructuring by Pre-Packing

Currently, Dutch insolvency law does not provide for an explicit legal basis for the appointment of a trustee prior to the opening of formal insolvency procedures. However, some district courts have developed a policy in which they allow pre-packs. Since 2012, there have been a number of successful pre-pack restructurings in the Netherlands.[34] The companies were restructured through a transaction that was prepared before the formal bankruptcy of the companies. A district court appointed 'silent' prospective trustee prepared the transaction. Once the transaction was agreed upon, the companies filed for their own bankruptcies. Immediately after the companies were declared bankrupt, the transactions were closed.

The main advantage of a pre-pack is that the transaction can be prepared relatively calmly and quickly, thus creating the best chances for continuation of the company or of its viable parts. In order to maximise the chances of restructuring viable companies in financial distress, the Dutch Minister of Justice and Security proposed the Act on the Continuity of Companies I.[35] The goal of the Act is to facilitate restructuring of (the viable parts of) companies in financial distress and to preserve the value of the companies in order to ensure a more efficient liquidation of the company - if needed.

The proposed Article 363 DBC provides for a legal basis for the appointment of a prospective trustee by the district court for a specific term. The appointment is silent, i.e. confidential. A request for the appointment of a prospective trustee can be made by a debtor. The district court will grant the request if it is likely that the appointment of a prospective trustee has added value. This is the case if the appointment is in the interest of the creditors as a whole or in the public interest, and if the continuity of the company and the preservation of jobs will be served. The debtor also has to clarify why the appointment of a prospective trustee is preferable to immediate bankruptcy. During a pre-pack, the directors of the company are in full control and retain the exclusive possession of its assets. This means that the prospective trustee has no authority over the company nor powers

33 Voorontwerp voorstel van wet tot wijziging van de Faillissementswet in verband met de invoering van de mogelijkheid tot het algemeen verbindend verklaren van een buiten faillissement gesloten akkoord ter herstructurering van schulden.

34 For example: retail chain Schoenenreus, lingerie manufacturer Marlies Dekkers, flower exporter Florimex, printing company Dijkman and the Ruwaard van Putten hospital.

35 *Kamerstukken II* 2014/15, 43 218, nr. 2.

to represent it. Moreover, the prospective trustee is not an agent of the company. According to the proposed Article 364 sub 1 DBC, he performs his tasks towards the interests of the company's creditors. The proposed trustee is not obliged to carry out the debtor's or the company's creditors' instructions.[36]

A prospective trusteeship can only serve its purpose if the company is willing to disclose all relevant information to the prospective trustee. Hence, the debtor has to provide the prospective trustee with all relevant information.[37] Together with the appointment of a prospective trustee, the district court will appoint a prospective supervisory judge, who supervises the prospective trustee.[38] The prospective trustee will report to the prospective supervisory judge. According to the proposed Article 367 DBC, the salary of the prospective trustee will be paid by the company, and in case of bankruptcy out of the estate as administrative expenses. Once the prospective trustee has prepared a transaction, the company will file for its bankruptcy. In most cases, the asset transaction will thereupon be closed on the same day.

With regard to the proposed Act, Dutch authors have expressed several points of criticism. There is a lack of transparency. The creditors are completely bypassed during the pre-pack procedure while the objectivity of the prospective trustee is questioned.[39]

3.2 Restructuring by the Scheme of Arrangement 'Dutch Style'

Currently, in order to prevent bankruptcy, companies in financial distress may offer an arrangement to their creditors on an informal basis, which usually entails postponement of payment or remission of debts. However, Dutch law does not provide for an explicit legal basis for such a company voluntary arrangement. Therefore, creditors are free in their choice whether to accept or refuse such a proposal. Only in very exceptional situations is a creditor obliged to cooperate with a company's voluntary arrangement. According to the Supreme Court, a creditor can only be compelled to cooperate in case he abuses his right (Article 3:13 DCC).[40] As a result, one creditor can frustrate a restructuring through an arrangement. In order to prevent a single unwilling creditor from frustrating or preventing a restructuring by an arrangement, even if the arrangement is accepted

36 Proposed Article 364 sub 2 DBC.

37 Proposed Article 364 sub 3 DBC.

38 Proposed Article 365 DBC.

39 *Ibid*.

40 Supreme Court 12 August 2005, *NJ* 2005/230 (*Payroll*).

by the majority of the creditors, the Dutch Minister of Justice and Security proposed the Act on the Continuity of Companies II.[41]

The Act aims to ensure efficient restructuring of companies in financial distress whilst guaranteeing creditor protection.[42] The proposed Article 368 DBC lays down provisions for a legal basis for the scheme of arrangement between a company in financial distress and its creditors and shareholders, whereby the creditors' and shareholders' rights are amended. According to the aforementioned article, the scheme can be proposed by the company or, if certain conditions are met, by its creditors or shareholders. The scheme can involve an arrangement offered to all creditors and shareholders or just to certain classes of creditors or shareholders.

According to the proposed Article 368 DBC, the creditors and/or shareholders can be divided into classes. Those classes must be confined to those persons whose rights are similar, in a way that it is possible for them to come to an agreement together with a view to their common interests. A proposed scheme of arrangement is accepted if all classes agree to it. A class is considered to have agreed if at least 50% of the members of the class vote in favour, and if this majority represents at least two thirds of the amount of the outstanding claims included in the class.[43] If the scheme of arrangement is accepted, both the company and the creditors and shareholders can ask the court to adopt the scheme.[44] The court will refuse to adopt a scheme if:

(1) The interests of one or more creditors or shareholders would be damaged disproportionally by adopting the scheme;

(2) The compliance of the scheme is not sufficiently guaranteed;

(3) The scheme is based on deception; or

(4) Other material reasons give grounds for refusing to adopt the scheme.

According to Article 373 DBC, it is even possible to ask the court to adopt a rejected scheme. The court will only adopt a rejected scheme if all classes of creditors and/or shareholders receive at least the amount they would receive if the company were to be declared bankrupt. Once a court adopts the scheme of

41 Voorontwerp voorstel van wet tot wijziging van de Faillissementswet in verband met de invoering van de mogelijkheid tot het algemeen verbindend verklaren van een buiten faillissement gesloten akkoord ter herstructurering van schulden.

42 R. Hermans & K. Sixma, "New Restructuring Opportunities in the Netherlands: the Dutch Scheme of Arrangement is Coming" (2014) Corporate Rescue & Insolvency, p. 231 ff.

43 Proposed Article 372 DBC.

44 Proposed Article 373 sub 1 DBC.

arrangement, it is binding on all creditors and/or shareholders within the scope, regardless of their participation in the voting process.

4 Corporate Dissolution in the UK: Voluntary Striking Off Procedure

According to Section 1003 CA 2006, it is possible to strike off a company from the Companies Register and thereby terminate its existence, also known as the voluntary striking off procedure. This procedure is considered inexpensive and easy.[45] It is for this reason that many directors have used the voluntary striking off procedure to terminate companies.[46] The procedure commences with a meeting of the board of directors. An application for striking off a company must be made on behalf of the company by the majority of the directors. Under Section 1004 sub 1 CA 2006, it is not permitted to strike off a company if at any time in the previous three months, the company has:

(1) Changed its name;

(2) Traded or otherwise carried on business;

(3) Made a disposal for value of property or rights that, immediately before ceasing to trade or otherwise carry on business, it held for the purpose of disposal for gain in the normal course of trading or otherwise carrying on business;

(4) Engaged in any other activity except activities necessary for the purpose of:

   (a) Making an application for striking off the company or deciding whether to do so;

   (b) Concluding the affairs of the company; or

   (c) Complying with statutory requirements.

The application has to be made through a prescribed form, which has to contain certain information. The completed form should be sent to Companies House accompanied by a £10 fee to cover the costs of providing the service. According to Section 1006 CA 2006, the applicant must secure that, within seven days from the day on which the application for voluntary striking off is made, a copy of the application is provided to every member of the company (usually the shareholders), employee of the company, creditor of the company, director of the company who

45 P. Davies, *Gower and Davies' Principles of Modern Company Law* (2003, Sweet & Maxwell, London), pp. 864-870.

46 Richards & Tribe, above note 24, pp. 322-325.

did not sign the application form, and manager or trustee of any pension fund established for the benefit of the company's employees.

As soon as the Registrar has received and considered the application to strike the company off, he will publish a notice in the *London Gazette* stating the intention to strike off the company and inviting any person to show cause why that should not be done (Section 1003 sub 3 CA 2006). Objections against the company's striking off should be lodged within three months. In case no (reasonable) objections are lodged, the company will be dissolved, upon which the Registrar will publish a notice thereto in the *London Gazette* (Section 1003 sub 5 CA 2006).

I think creditor protection is ensured in the voluntary striking off procedure by Section 1003 sub 3 and 6 together with Section 1006 CA 2006. Because of the provision of Section 1006 CA 2006, the creditors are informed about the intention to strike off the company. Because of the provisions of Section 1003 sub 3 CA 2006, they may lodge objections against striking off the company. The same applies to the company's shareholders. Yet, because of the three-month period from Section 1003 sub 3 CA 2006, the voluntary striking off procedure is not as 'turbo' as the Dutch turbo liquidation.

5 Corporate Dissolution in the Netherlands: Turbo Liquidation

Since 1994, it is possible to dissolve a company in one day: turbo liquidation. Article 2:19 sub 4 DCC offers the option of dissolving a company without pursuing liquidation proceedings if there are no longer any assets at the time of the dissolution. The turbo liquidation procedure consists of three steps. First, the general meeting of shareholders has to adopt a dissolution resolution under Article 2:19 sub 1a DCC. In addition, the board of directors has to certify that the company no longer has assets at the time of the dissolution.[47] Finally, the board of directors has to file a statement of dissolution with the Chamber of Commerce. The company ceases to exist immediately after the board of directors has issued this statement. As no liquidation proceedings need to be pursued, turbo liquidation is often seen as a quick and cheap way to dissolve a company. It is also seen as a safe way to dissolve a company, because turbo liquidation - and thereby the disappearance of the company - is only published in the commercial register. The question arises whether these assumptions are correct. In my opinion, the opposite is the case: dissolving a company through turbo liquidation is not as easy as is often

47 Supreme Court 27 January 1995, ECLI:NL:HR:1995:ZC1631, *NJ* 1995/579, (*Adjuncten Properties v. Söderqvist*).

suggested.[48] On the contrary, the decision whether or not to dissolve a company through turbo liquidation requires substantial legal knowledge. At the same time there are several flaws in the law applicable to turbo liquidation.

The wording of Article 2:19 sub 4 DCC seems to suggest that in order to dissolve a company through turbo liquidation only one condition needs to be met: at the time of the dissolution the company must not have any assets. Currently, the prevailing doctrine is that companies without assets, but with outstanding debts, may be dissolved through turbo liquidation.[49]

Nevertheless, in my opinion the option to dissolve a company through turbo liquidation as offered by Article 2:19 sub 4 DCC is only meant for situations in which companies have neither assets nor outstanding debts at the time of dissolution.[50] Provided that it is possible to dissolve a company with outstanding debts through turbo liquidation, this has major consequences for creditors. If a company is allowed to be dissolved with outstanding debts, it is easy to take advantage of this dissolving method and to commit fraud. All that needs to be done, is to divert all assets out of the company in order to dissolve it cheaply and quickly under Article 2:19 sub 4 DCC – resulting in the disappearance of the company without liquidation proceedings – and to ensure the company will not become insolvent. As the company ceases to exist without liquidation proceedings, no insight is obtained into the company's administration and its financial state.[51] This would be quite different in case of bankruptcy. During a bankruptcy procedure the receiver will investigate the administration, financial state and affairs of the company. The receiver will also look for any acts of fraudulent conveyance.[52] If the receiver uncovers wrongdoing on the part of the board of directors, he may bring proceedings for wrongful or fraudulent trading and hold the directors personally liable.

48 S. Renssen, *De turboliquidatie van de Besloten Vennootschap. Serie vanwege het Van der Heijden Instituut*. Deel 131 (2016, Kluwer, Deventer).

49 Court of Rotterdam 21 March 2014, ECLI:NL:RBROT:2014:2548; Court of Rotterdam 20 May 2014, ECLI:NL:RBROT:2014:4427; Court of Rotterdam 10 February 2015 ECLI:NL:RBROT:2015:1570; Court of The Hague 10 February 2015, ECLI:NL:RBDHA:2015:1976; Court of The Hague 11 March 2015, ECLI:NL:RBDHA:2015:2569; Court of Appeal The Hague 2 July 2015, ECLI:NL:GHDHA:2015:1846; Supreme Court 18 December 2015, ECLI:NL:HR:2015:3636.

50 Renssen, above note 48, pp. 49-58.

51 Indeed, Articles 2:23-23b DCC are not applicable in case of turbo liquidation.

52 Article 42 et sec. DBC.

6 Conclusion

Despite the fact that the development of possibilities to restructure companies in financial distress in Europe is welcome in respect of economic and labour market policies, the question arises whether creditor protection is sufficiently ensured in pre-pack and scheme of arrangement proceedings. In my opinion, creditor protection is not (yet) sufficiently ensured in the UK pre-pack nor in the proposed Dutch pre-pack. In the UK, the courts try to ensure creditor protection by underlining the importance of consulting with major creditors ahead of completing a pre-pack sale. Furthermore, the UK Insolvency Service drafted the SIP 16 Report, in order to ensure that creditors are informed on the reasons why a practitioner decided on a pre-packaged sale. Nevertheless, some legal experts still think that the UK pre-pack procedure lacks transparency and is open to abuse. In the Dutch proposal, the creditors are not at all involved in a pre-pack procedure. As a result, creditor protection is lacking. I think the Dutch legislator needs to make some changes in order to ensure transparency of the pre-pack procedure and to ensure creditor protection. Taking into consideration the points of criticism of the pre-pack procedures, I consider it important that the European Commission makes a proposal to harmonise the rules for restructuring companies by a pre-pack procedure.

In accordance with the Commission Recommendation on a new approach to business failure and insolvency, creditor protection is ensured in the UK scheme of arrangement procedure as well as in the proposed Dutch procedure. In the UK, creditors can challenge the proposed scheme of arrangement on the ground that the meeting is improperly constituted, that the creditors were not given sufficient information, or on the ground that the scheme is unfair. The court will only sanction the proposed scheme if it is fair,

> "i.e. a scheme that an intelligent and honest person, a member of the class concerned, and acting in respect of his interest might reasonably approve."

According to the proposed Article 373 DBC, in the Netherlands the court will refuse to adopt a scheme if the interests of one or more creditors or shareholders would be damaged disproportionally by adopting the scheme.

The second question that arises is whether quick dissolving methods as alternatives for restructuring possibilities in case companies are too broke to restructure are in fact an open invitation to commit fraud and to circumvent a bankruptcy procedure. Another question that arises is whether creditor protection is ensured in these dissolving methods. In my opinion, the Dutch turbo liquidation is indeed an open invitation to commit fraud and to circumvent a bankruptcy procedure. Currently, the prevailing doctrine is that companies without assets, but with outstanding debts, may be dissolved through turbo liquidation. If a company is allowed to be dissolved while there are outstanding debts, it is easy for fraudsters to take advantage of this method of dissolution, because it enables them to avoid bankruptcy by making the company disappear. This is quite different in the UK legal system.

In the UK legal system, creditor protection is ensured because of the requirement that creditors and shareholders must be informed about the intention to strike off the company. They may lodge objections against striking off the company. A drawback is that the procedure is not as 'turbo' as the Dutch procedures: in the UK, companies cannot be dissolved and liquidated in one day. Surprisingly, there is currently no EU harmonisation in the field of dissolution of companies. Taking into consideration the consequences of corporate dissolution for creditors of a company, especially in case of turbo liquidation, I consider it important that the European Commission propose harmonisation of the rules for dissolution and liquidation of companies.

Chapter 14

Benchmarking Insolvency Practice Frameworks: The Challenge of Creating Norms

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1 Introduction[1]

The state of insolvency office holder ("IOH") regulation worldwide is a matter of some concern to the international bodies active in the insolvency field. The European Bank of Reconstruction and Development (EBRD) held a conference on 7 November 2014 to disseminate the findings of a two-year project into the IOH regulatory environment in its client group, of which 27 out of 35 were the subject of an assessment.[2] While the laws of many of these states have been the subject of scrutiny with a view to reform, this was apparently the first time that research had been undertaken into the structure of the IOH profession in these jurisdictions. As such, the holistic view enabled as a result of the work contains some interest for those keen on understanding how IOH regulation is performing worldwide, not just in the countries surveyed, but as representative overall of the practice in a range of jurisdictions emanating from across the emerging, developing and developed worlds.

The most essential component of the project's findings was the great diversity in terms of status, qualification and training of IOHs, as well as in the framework or frameworks for their registration, supervision and discipline. Nonetheless, some indications of cross-jurisdictional trends in these countries was possible,

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1 The authors intended that this paper be presented at the IEAF Lisbon Conference on 21-22 September 2016. Owing to a variety of circumstances, the authors regrettably could not be present in Portugal on that occasion. Nonetheless, the authors wish to thank the organising committee and the Editor of this publication for kindly agreeing to publish this paper as part of the conference record.

2 A copy may be seen at: http://assessment.ebrd.com/insolvency-office-holders/2014/report.html.

a notable example being that where a self-regulatory model or state-sponsored regulatory agency was used, there was a strong correlation with performance overall across the criteria being measured. While most states had some form of licensing regime in place, less performing countries tended to include those where Government directly exercised supervision over the IOH profession, or where a regulatory framework was weak or wholly absent. The tension between private and public control was evident in a number of the jurisdictions surveyed, particularly given the diverse views of the role of IOHs, whether as private practitioners or as representatives or agents of the courts or other regulatory bodies.

Overall, while minimum educational standards and professional entrance exams were often prescribed, the project revealed weak performance in areas such as continuing professional development and training needs. Similarly, *lacunae* also existed at the level of the development of professional associations and of ethical rules. In many places, however, even where regulatory regimes were sufficiently robust, issues with resources tended to restrict active supervision of IOHs to the context of individual proceedings with the effectiveness of such monitoring dependent on the courts' own supervisory capacity. The role of the courts in the conduct of proceedings was also identified as an issue, particularly in the balance of control and supervision between creditors and the courts. Over-monitoring was stated as potentially a problem where it inhibited IOHs in the performance of their duties. Finally, the structure of the appointments system in cases, as well as remuneration, were felt to be insufficiently encouraging of competition in the market for IOH services.[3] In summary, the terms of the report revealed that there was much to do in relation to improving the environment and framework for practice in almost all of these states, which also included 10 member states of the European Union.[4]

Some of the issues reflected in the EBRD assessment were pre-figured in work carried out by the professional associations, including INSOL Europe which, as representative of the European insolvency community, has a watching brief on behalf of their membership over matters connected with reforms to insolvency law and practice. Although written in the context of the then anticipated review of the European Insolvency Regulation,[5] INSOL Europe's 2010 Report on the topic of harmonisation, presented to the European Parliament Committee on Legal

3 *Ibid*., Executive Summary, at 7-9.

4 Out of 13 countries acceding as Member States between 2004-2013 (the exceptions being Cyprus, the Czech Republic and Malta).

5 EC Regulation 1346/2000 of 29 May 2000 ("EIR"), now replaced by Regulation (EU) 2015/848 of 20 May 2015 ("Recast EIR").

Affairs, largely advocated consideration of substantive harmonisation in a number of areas of insolvency law. In dealing with insolvency practice qualifications, however, it concluded that the different systems, especially for remuneration, in the member states surveyed did not cause any difficulties, obstacles or disadvantages for companies with a cross-border dimension operating in the European Union. Harmonisation of this area was not deemed necessary pending greater harmonisation in the insolvency and company law fields.[6] Nonetheless, an issue of concern, which has since been reflected in work by the Leiden Law School commissioned by INSOL Europe, is that of a possible ethical code at European level for IOHs. The work has now resulted in the production of a set of IOH Principles and Best Practices that are still being reviewed for adoption by the professional body.[7]

By way of contrast, however, the European Parliament's Report in 2011, which also picked up the harmonisation theme for insolvency law, did consider it worthwhile to deal with insolvency practice qualifications, insofar as qualification and competence were concerned. Other issues to which reference was made included the desirability of good reputation, independence and the need to avoid conflicts of interests.[8] A small jump from the European Parliament's position saw IOH regulation appearing as one of the sub-themes in a project on "Substantive Insolvency Law and the Prospects for Greater EU Harmonisation", which was funded by the European Commission and carried out by the University of Leeds.[9] In this project, which arose from the need to analyse member state compliance with the 2014 Recommendation,[10] mention is made of the need potentially to re-examine the "caution" explicit in the 2010 INSOL Europe report.[11] In fact, the IOH-related component of the study is also reflected in the scope of the recently formed European Commission Experts' Group on Restructuring and Insolvency ("EC Experts' Group"), which began its work in January 2016, whose (ambitious) mission includes the development of, inter alia, common principles and rules in areas connected to insolvency, such as the qualifications of insolvency practitioners.[12]

6 See INSOL Europe, *Harmonisation of Insolvency Law at EU Level* (April 2010), at 23.

7 The IOH Principles and Best Practices, available at: http://www.tri-leiden.eu/project/categories/ioh-project/.

8 See K-H. Lehne (Rapporteur), *Report with Recommendations to the Commission on Insolvency Proceedings in the context of EU Company Law* (Document A7-0355/2011) (17 October 2011), p. 10.

9 See Project website at: http://www.law.leeds.ac.uk/research/projects/study-on-substantive-insolvency-law.

10 *Recommendation on a New European Approach to Business Failure and Insolvency* (Document COM (2014) 1500 Final) (12 March 2014).

11 Interim Report 3 of the Study on Substantive Insolvency Law (2016), at 58.

12 Call for Expressions of Interest in the Experts' Group (September 2015), at paragraph 3.

2 The IP Project

It is on the basis of the interest shown by the various bodies above that the insolvency practitioner regulation project ("IP Project") was conceived in late 2015, with the project beginning in earnest in 2016. The IP Project is an international collaborative project involving the Centre for Business and Insolvency Law at Nottingham Law School, as well as the Business Law Research Centre at Radboud University Nijmegen, the Centre for Advanced Corporate and Insolvency Law at the University of Pretoria and the Commercial and Property Law Research Centre at the Queensland University of Technology. The project has received funding from INSOL International and has the support of both that organisation as well as some interest shown in the project by the World Bank. The intention behind this project is to conduct a global doctrinal study of insolvency office-holder regulation in some 40 countries in four regions around the world, chosen to reflect jurisdictions from across the emerging, developing and developed worlds at varying stages of development.

The IP Project's main purpose was to ascertain trends in IOH regulation under a number of practice-related headings, including selection and appointment, qualification and training (including continuing professional development needs) as well as whether a code of ethics or professional conduct governs professionals operating in the sector. Other issues include the perennially thorny one of remuneration, liability and disqualification, removal and replacement as well as the review of practice standards, including information on the institutional, court and supervision frameworks in place. With the information collected, a series of reports will be produced dealing with regional trends as well as common developments across each category (emerging, developing and developed).[13] Ultimately, the intention is to make recommendations for minimum standards of regulation appropriate for jurisdictions at various stages of development and to feed into the process by which such standards are developed. A further and later phase of the IP Project's work would seek to actively engage with the international bodies and key stakeholders with view to achieving the goals of the project.

3 The European Commission Submission

While the IP project was ongoing, an opportunity arose to feed into the work of the EC Experts' Group, on which a number of the IP Project team members were represented. The EC Experts' Group had from the outset begun reviewing

13 The initial findings of the reports cumulatively were presented at the INSOL International Sydney Conference (March 2017) with regional findings being presented at appropriate subsequent events.

material within its scope of action with view to determining the process and form in which the initiative might take shape. One of the ways of doing this was to invite submissions on discrete themes taken from the Call for Expressions of Interest and the 2014 Recommendation. The submission that came from IP Project members was couched on the basis that many Member States already had developed insolvency practitioner frameworks and did not require much further guidance. However, the submission was predicated particularly on the fact that some Member States where institutional and regulatory frameworks were in their infancy would need to be encouraged to develop a professional corps of insolvency practitioners in order to reinforce the institutional framework as an indispensable part of the insolvency process. This was seen as particularly true in the need to reinforce the adoption of professional and ethical standards.

Given that the IP Project was not at a sufficiently advanced stage to come to any firm conclusions on trends in the field, the submission rested particularly on a number of standard setting international texts, including the *World Bank Principles for Effective Creditor/Debtor Regimes* 1995, the *UNCITRAL Legislative Guide* 2004 and the *EBRD Insolvency Office Holder Principles* of 2007. It also considered in passing the IOH Principles and Best Practices (emanating from the Leiden Project),[14] though these were admitted as not being at a sufficient level of detail that could lend itself to ready adaptation as the basis of a legislative text. Other texts considered included the various reports noted above and the generally prevailing themes of the discourse in the literature on IOH regulation.[15] With the guidance of these texts, the submission addressed four key matters: (i) selection and appointment; (ii) qualification and professional standards; (iii) ethical standards; and (iv) remuneration.

The submission, addressed in point form to the Member States, as would be the case for a Directive text making recommendations for action, first stated that Member States should ensure that IOHs were appropriately qualified and trained in insolvency and restructuring matters. IOHs should also be subject to requirements of continuing education. It went on to require that Member States ensure that the process for the appointment, removal and resignation of IOHs is clear, predictable and fair. In particular, the grounds for eligibility and the grounds upon which an IOH may be ineligible for appointment, should be clear. Furthermore, where

14 Above note 7.

15 Including, by members of the IP Project, such as: P. Omar, "Une petite histoire des défis dans la profession des praticiens du droit de l'insolvabilité au Royaume-Uni" (2013) 5 *Revue des Procédures Collectives* 41; D. Burdette and J. Calitz, "4:3:2:1... Fair Distribution of Appointments or Countdown to Catastrophe? South Africa's Ministerial Policy for the Appointment of Liquidators under the Spotlight" (2015) 3 Nottingham Insolvency and Business Law e-Journal 24.

IOHs are appointed by the court, clear guidelines should be available concerning the manner in which the court selects an IOH. In selecting an IOH for a particular case, due consideration should be given to the experience and expertise of the IOH. In insolvency proceedings with cross-border elements, due consideration must be given to the ability of the IOH to communicate and cooperate with foreign insolvency practitioners and courts. Finally, taking into account variations in practice across the Member States, the submission recommended that, where appropriate, the wishes of the debtor and creditors in the selection of the IOH should be taken into consideration.

Moving on to the issue of professional and ethical standards, the submission recommended that Member States ensure that IOHs are obliged to observe professional and ethical standards in the conduct of their work, and that appropriate sanctions are imposed where this is not the case. This includes acting independently, impartially, honestly and with integrity, with an open mind in the interests of all stakeholders. Furthermore, Member States should also ensure that IOHs are accountable towards all stakeholders and provide regular public reports on the administration of the case. To this end, the submission required that Member States ensure that the work of IOHs is appropriately supervised and, in particular, that the members of the judiciary dealing with insolvency and restructuring matters are appropriately qualified, trained and that they perform their tasks independently, impartially and effectively. Finally, on remuneration, the submission suggested that Member States ensure that IOHs are entitled to a fair and reasonable remuneration and that expenses properly incurred in an insolvency proceeding are reimbursed. Moreover, Member States should ensure that the rules on and the process for determining the remuneration of IOHs are fair, clear and transparent, while also requiring that Member States ensure that IOHs at all times maintain an appropriate level of professional indemnity insurance cover.[16]

4 The 2016 Draft Directive

In the interval between the submission and the publication on 22 November 2016 of a draft Directive, matters rested. There was no guarantee that the submission would be adopted, given the many matters competing for attention within the scope of action of the EC Experts' Group, nor was there any certainty that the issue would be taken up in the form the submission presented, given the likely principal orientation of the text towards making progress on matters identified in the 2014

16 This is the point at which the presentation in Lisbon would have ended, with some further concluding remarks on how the submission might be taken to represent early steps towards a European minimum standard for IOH regulation.

Recommendation as priorities. In that light, it is not surprising that the text which resulted, published a little later in 2016 than first scheduled, focuses chiefly on proposals aimed at introducing Europe-wide preventive restructuring frameworks. The intention behind the text is to bring focus on the problems facing enterprises at a stage prior to formal insolvency when non-performing loans constitute a major threat to their success. Though affecting enterprises of all sizes, a particular concern is paid in the text to the situation of small- and medium-enterprises, which are said to constitute the lifeblood of European commerce.

In the wake of the 2014 Recommendation, which this text is designed to complement and further extend into legislative form, attention will undoubtedly now be paid to how the various member states respond to the call for the institution of new frameworks or the overhaul of existing legislation so as to improve the chances of businesses in financial difficulties. However, interest in the text should go beyond the preventive restructuring and second chance measures it promotes. Included in Title IV of the Draft Directive are proposals aimed at addressing perceived *lacunae* in support structures for restructuring (as well as other insolvency procedures) across the European Union, chiefly associated with the qualification and training of insolvency professionals and the support for restructuring measures through the courts. How the proposals justify the extension of scope to include insolvency practice is by making reference to the need to address issues with a "direct impact" on the duration of procedures, the specialisation of the judiciary and the professionalism of practitioners being the two specifically mentioned in the Explanatory Memorandum.[17] In this respect, specialisation of both courts and IOHs, as well as reinforcement of the judiciary, are seen as helping to speed up procedures and reduce their overall length and costs, thus leading to procedures of better quality with more effective supervision, a consequent improvement of the residual value for creditors[18] and, importantly, a reduction in the legal uncertainty creditors face which are said to lead to low recovery rates at present.[19]

Title IV, which is meant to address this overall concern, is relatively short, with only 5 draft articles, the last one of which addresses the incidental use of electronic communication at various stages of proceedings.[20] At first sight, the proposals do not contain much that should alarm the world of insolvency practice. Pleasingly, they echo to a great extent the IP project submission, incidentally underlining the utility of the exercise and the practical nature of the recommendations. Thus, the

17 Explanatory Memorandum, COM(2016) 723 final (22 November 2016), p. 6.

18 *Ibid*., at 5.

19 Preamble recital (39), Draft Directive.

20 *Ibid*., Article 28.

proposals state that judicial and administrative authorities should receive training (both "initial and further", addressing foundational skills as well as continuing professional development needs) to a level appropriate for the responsibilities they are to undertake.[21]

With the caveat that preventive procedures need not involve judicial or administrative authorities, excepting insofar as there is a need to safeguard the interests of stakeholders through supervision or to intervene punctually for the purposes of expediting matters,[22] the proposals suggest that the focus of the training should be, for the courts at least, to ensure the appropriate expertise and specialisation is available, in order to allow for efficient and expeditious treatment of cases.[23] This is acknowledged as being especially important given the "potentially significant economic and social impacts" cases may have.[24]

So far as courts are concerned, the approach taken here seems uncontentious, particularly as the proposals recognise the differences in court structures across the European Union and seek to avoid prejudicing the member states' competence in matters of judicial organisation and the independence of judges themselves. Thus, member states are not required to ensure that judges have an exclusive competency in restructuring and insolvency matters, but may create specialised courts or divisions (chambers) provided their national systems so allow.[25]

Turning to the status of IOHs, the same concern for retaining as much informality in the preventive process is evident, as the proposals do not envisage appointments as mandatory, but subject to a case by case appreciation of the debtor's needs and specific circumstances of the case, including, for example, where effective supervision is needed to safeguard stakeholder interests.[26] The proposals stipulate the same "initial and further" training requirements as for judges, suggesting that this will lead to an "effective, impartial, independent and competent" provision of services.[27]

The provisions further go on to suggest that member states encourage the development of voluntary codes of conduct for practice as well as effective oversight mechanisms, which, with appropriate regulatory structures including a

21 *Ibid*., Article 24(1).
22 *Ibid*., Preamble recital (18).
23 *Ibid*., Article 24(2).
24 *Ibid*., Preamble recital (39).
25 *Idem*.
26 *Ibid*., Preamble recital (18).
27 *Ibid*., Article 25(1).

sanctions element, should lead to effective supervision of the IOH.[28] What the voluntary codes should contain might include, the proposals suggest, guidance as to appropriate levels of qualification and training, rules on the transparency of the duties to which IOHs are subject, how their remuneration is determined and requirements for professional indemnity cover, although, overall, these requirements are not intended to impose any particular obligation to create a new qualification or profession to accommodate the changes that may be required.[29]

What this reflects is the fact that, across the European Union, there continues to be considerable diversity at present in the way the profession is organised and regulated, as revealed, for certain of its members, in the 2014 EBRD Report.[30] As with the concerns about member state competence and judicial independence, the unwillingness to be more prescriptive can be seen to underline these proposals, which are firmly intended to avoid harmonisation.[31] Where the text has delved a little deeper on issues of practice organisation, however, is in connection with appointments and remuneration. Here, the proposals require that the process by which IOHs are appointed or removed or resign is "clear, predictable and fair".[32] What this means in practice is that the conditions for eligibility and grounds for ineligibility for appointment are "clear and transparent".[33] Furthermore, where responsibility for appointments falls to the courts or administrative authorities, the criteria should similarly be "clear and transparent", although the selection may be influenced by the experience or expertise of the IOHs under consideration and room may be given for appropriate consultation of the debtor and / or creditors in the making of that choice.[34]

Dealing with the specific situation of cross-border instances, other criteria for selection the text recommends could include the human and administrative resources available to the IOH and, perhaps more importantly, their ability to communicate and cooperate with foreign IOHs and courts.[35] Insofar as remuneration receives a mention in the proposals, the text suggests that the rules in member states by which fees and expenses are determined should serve as an incentive for the "timely and efficient resolution" of procedures, subject to consideration of

28 *Ibid.*, Articles 25(2) and 27(1).

29 *Ibid.*, Preamble recital (40).

30 Above note 2.

31 Explanatory Memorandum, above note 17, p. 6.

32 Article 26(1), Draft Directive.

33 *Ibid.*, Article 26(2).

34 *Ibid.*, Article 26(3).

35 *Ibid.*, Article 26(4). Interestingly, despite Article 42 of the Recast EIR, a similar competence is not required of judicial or administrative authorities in these proposals.

the overall complexity of proceedings and the availability of mechanisms for the timely resolution of any disputes over remuneration.[36]

5 Conclusion

Dealing firstly with the Draft Directive: while much in the proposals is seemingly uncontentious, questions might be asked as to whether the time is right to lay down even these modest rules. Politically, the downplaying of the proposals connected to practice, which may be conceived of as ancillary to the main objective of the Draft Directive to promote preventive restructuring, suggests the answer to this is in the affirmative. In the way the proposals are drafted with very flexible and open language, the intention is clearly to make this first step towards establishing minimum requirements for oversight and regulation more palatable for the member states. In the long run, however, it should be noted that the EBRD considered the way in which practice is organised to have an impact on the success of insolvency procedures, with jurisdictions where professional organisations were independent and active and where less tutelage by state bodies existed being perceived as more successful at inspiring public confidence in the good administration of procedures.[37] This would very much advocate for a more profound reflection on this issue when the dust has settled on this particular text. There may be then, in light of the way in which the text will have been implemented, a better idea of any consensus towards further development of practice rules and frameworks.

This is where the role of the IP Project will come to the fore, both at regional (such as within the European Union) and global levels. In historical terms, the framework for practice for IOHs has been in a state of some flux. While individual states have made advances in regulation to deal with particular problems, there is as yet no overall sense of whether it is desirable for there to be closer convergence between regulatory models and practices. Hopefully, the IP Project, together with other studies, both practice- and academic-led, that have informed the debate in this area, will point the way to understanding the critical issues that will face those desiring to improve standards and the benchmarks for practice. In the long run, improvements to practice frameworks can only be of benefit to debtors, creditors and other insolvency stakeholders alike.

36 *Ibid*., Article 27(2).

37 Above note 2.