

**Viability Assessment:**  
*Models and filtering mechanisms from U.S.  
Chapter 11 to the European Directive*

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# Fundamental Background

*Notion of Viability &  
Optimal Scope of a (European) Restructuring Framework*

# The notion of viability

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## US Law

*(both primary  
and secondary  
authority)*

- **Intricate notion** : double meaning & double role
- **Meaning of viability**
  1. **Financial viability** (financial distress) --- **solvency/insolvency**
  2. **Economic viability** (economic distress) --- **going concern vs liquidation value**

***A company can be financially distressed yet economically viable, thus worth being rescued***

- **Role of viability**

# Viability & Optimal Scope of a (European) Restructuring Framework

## ➤ “All-encompassing” scope as the optimal one

- Encompassing both solvent and insolvent debtors

(see e.g. scope of U.S. Chapter 11, eligibility for the moratorium under the UK CIGA 2020 etc.)

- “Opening up the scope” reform of the Directive

*Economic –  
Policy –  
Political –  
Methodological –  
Normative  
standpoints*

Scope  
of the  
framework

## ➤ With *viability* rather as the main point of focus

## ➤ Viability not to be assessed at the beginning of the procedure

- Open-ended, pro-rescue framework (i.e. without strict conditions of access)
  - See e.g. here the issue of the “viability test” under Art. 4 (3) of the directive

Inner  
structure of  
the  
framework

## ➤ But rather to be assessed *throughout* the restructuring procedure

- Filtering mechanisms
- Filtering safeguards

Viability assessment throughout the restructuring procedure

*Models of Viability Assessment*

# Models of viability assessment

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## 2 different models



- **“IP – centered”**

*See e.g. UK CIGA 2020 – “new moratorium” provisions*

- **Positively-worded obligation for monitor (IP) to assess the prospect of rescue in 3 different stages of the procedure**
- **Role of “monitor”:**
  - 1. Eligibility of the company – Outset of the moratorium**

Monitor should state that it is likely that the moratorium would result in the rescue of company as a going concern
  - 2. Extensions of moratorium**

Monitor’s estimation of prospect of rescue as a condition to most extensions
  - 3. Termination of moratorium**

Monitor should terminate the moratorium if prospect of rescue no longer exists

- **“Non-IP – centered”**

*See e.g. U.S. Chapter 11 or Small Business Reorganization Act (SBRA)*

- **No positively-worded ‘check obligation’ of the prospect of rescue by an IP at the outset or during the procedure**
- **Rather lift of the moratorium/dismissal/conversion of the case when the prospect of rescue/viability of the debtor lapses**

# Models of viability assessment

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## ➤ IP-centered model (Model I)

- Gives emphasis to the IP as assessor of viability
- **Positively-worded obligation of IP** → adds unnecessary extra expenses to the process? SMEs ?
- Difficulty of the initial evaluation ? Informational asymmetries ?
- Duplication of a role that can be more efficiently centered around creditors?

## ➤ Non- IP-centered model (Model II)

- Creditors as constant assessors of viability
- Viability assessment through opportunities (so-called “**filtering mechanisms**”) to “**torpedo**” the restructuring where viability lapses
- EU Directive *closer* to Model II
  - ✓ No Model I-type obligations of appointed restructuring practitioner, see Art. 2 (1) [12]; Art. 5 ; Recitals 30 & 31
  - ✓ Filtering mechanism (lift of the stay) triggered by creditors or practitioner [Art. 6 (9)]
- **Model II**, and as such the Directive as well, **presuppose** the existence of **strong filtering mechanisms** in order to filter out of the restructuring procedure **non-viable debtors**

Getting into Model II:  
“Filtering mechanisms” within U.S. Chapter 11  
*Spotlight on §1112 & §362*



# Conversion / Dismissal of a Ch. 11 case (11 U.S.C. § 1112) as a filtering mechanism

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- Involuntary Conversion/Dismissal:
  - On request of a party in interest (e.g. creditors)
  - After notice and a hearing
  - For “cause”
  
- “Cause” [*non-exclusive list, § 1112 (b) (4)*] :
  1. Substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation
  2. Gross mismanagement of the estate
  3. Failure to maintain appropriate insurance that poses a risk to the estate or to the public
  4. Unauthorized use of cash collateral substantially harmful to 1 or more creditors
  5. Failure to comply with an order of the court
  6. Unexcused failure to satisfy timely any filing or reporting requirement established by this title or by any rule applicable to a case under this chapter
  7. Failure to file a disclosure statement, or to file or confirm a plan, within the time fixed by this title or by order of the court

Etc.

# Viability as the “litmus test” of filtering mechanism: Indicators (markers) of economic distress

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2. Gross mismanagement of the estate
  3. Failure to maintain appropriate insurance that poses a risk to the estate or to the public
  4. Unauthorized use of cash collateral substantially harmful to 1 or more creditors
  5. Failure to comply with an order of the court
  6. Unexcused failure to satisfy timely any filing or reporting requirement established by this title or by any rule applicable to a case under this chapter
  7. Failure to file a disclosure statement, or to file or confirm a plan, within the time fixed by this title or by order of the court
- Attempting to divert value to insiders
  - Ignoring procedural requirements
- Extract concessions from creditors
  - In order to delay liquidation
  - Gamble the business’s resurrection

*Inability to  
maintain  
viable ongoing  
business  
operations*

# Viability as the “litmus test” of filtering mechanism

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- “Cause” (cont.) :
    1. *“Substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation”*
- ***In re AdBrite Corp., 290 B.R. 209, 216 (Bankr. S.D.N.Y. 2003)***  
***44+ citing decisions***

# Viability as the “litmus test” of filtering mechanism

## Substantial or continuing loss to or diminution of the estate

- A debtor’s **negative post-petition cash flow** and **inability to pay current expenses** establishes that the estate is suffering continuing losses.
- Even a **positive cash flow** may constitute continuing loss/diminution of the estate, when it masks **use of property of the estate** by the debtor’s insiders to fund postpetition expenses

*Indicators  
(markers)*

## Why is this an indicator of economic distress?

Think of the opposite scenario:

- It indicates that the business has managed to fund its post-petition expenses and continued operations principally by **generating positive cash flow and/or by attracting DIP (“interim”) financing**; in any case, **not by using its estate.**
- This in turn demonstrates that **its continuation value entails something beyond and above** the mere total value of its assets (**liquidation value**)
- It additionally entails the **value** generated by the **continued trust shown by its customers (positive cash flow)**, as well as the **value inherent in the DIP financiers’ support**, who believe in the prospective rehabilitation of the business and the continuation of their business relations with it.
- This **excess of value, beyond and above the mere total value of its assets**, indicates that the business is worth more if continued as a **going concern** than if channelled into **liquidation**

GOING CONCERN VALUE > LIQUIDATION VALUE  
ECONOMICALLY VIABLE

# Viability as the “litmus test” of filtering mechanism

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## Absence of a reasonable likelihood of rehabilitation

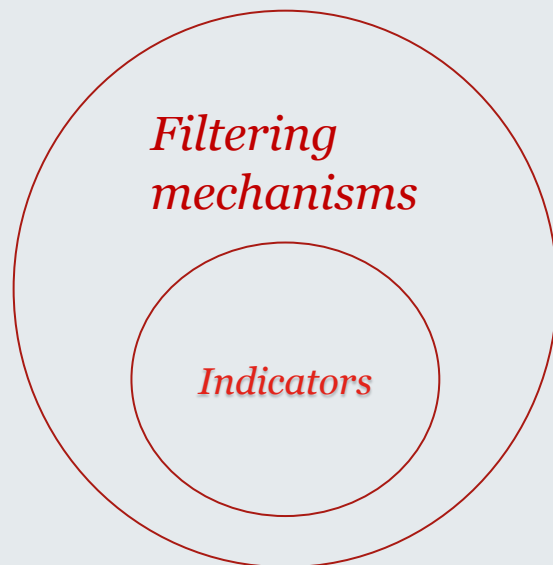
- “Rehabilitation means to put back in good condition and reestablish on a sound basis.
- It signifies that the debtor will be **reestablished on a secured financial basis**, which implies establishing a cash flow from which its current obligations can be met.
- [...] **financial viability** is **reasonably likely** in the near future”.

## Is there prospective financial viability in sight?

- Refers to the company’s ability to **repay its debt obligations**.
- It is exactly **through restructuring**, operational and/or financial, that an **optimised position** for the debtor will emerge, which will enable an economically viable business to **materialise its financial rehabilitation prospects** and therefore be finally restored to **financial viability**.

# Viability as the “litmus test” of filtering mechanism

- Economic Viability
- Financial Viability
- **Ensuring** existing economic viability and prospective financial viability [preconditions, otherwise **filtering out**]
- **Attaining** financial viability [aim]



## **Double role of viability:**

- ✓ precondition
- ✓ aim

of the restructuring  
framework

# Relief from the stay (11 U.S.C. § 362) as an additional filtering mechanism

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*“Debtors with irreversibly negative cash flow, no reasonable prospects for additional income or refinancing, and deteriorating property should be forced into liquidation at the earliest possible opportunity.*

***Stay litigation provides the courts with a vehicle for doing this. Alternatively, a creditor might move to convert or dismiss the case.” \****

*\* Jeffrey Ferriell and Edward J. Janger, Understanding Bankruptcy (4th edn, Carolina Academic Press 2019)*

- Motion for conversion and motion for relief from the stay often combined by creditors

## **Stay litigation:**

- **An “early attack” on the reorganization**
- **Most of the times, lifting the stay effectively precipitates liquidation**

**→ Thus relief from the stay = filtering mechanism**

# Relief from the stay as a filtering mechanism

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## 11 U.S.C. § 362

“[...] d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay [...] —

(1) [..]

(2) with respect to a stay of an act against property under subsection (a) of this section, if—

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization”

- **Relief from the stay if :**

- A. No Equity in the Property for the debtor and

- B. Property is Not Necessary for **Effective Reorganization**



# Viability as the “litmus test” of filtering mechanism

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➤ Spotlight on “*Property is Not Necessary for **Effective Reorganization***”



- Not sufficient that property be necessary for any possible reorganization
- The property must be necessary for an *effective* reorganization

➤ There “must be **reasonable possibility of a successful reorganization within a reasonable time**” (*United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs.* - 484 U.S. 365, 108 S. Ct. 626 (1988))

# Viability as the “litmus test” of filtering mechanism

*In re Pegasus Agency, Inc. 101 F. 3d 882 (2<sup>nd</sup> Cir. 1996) – appeal re order of relief from the stay*

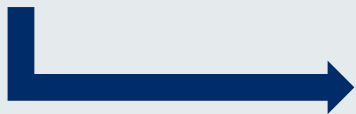
“[...] Pegasus proposed a residential development on the Davenport Property that the bankruptcy judge concluded **could not succeed within a reasonable time**. The court reached this conclusion for three reasons:

(i) **Pegasus's proposal relied on unsubstantiated assumptions and "fanciful" calculations, rather than verifiable research and financial analysis;**

(ii) **by its own calculations, the plan's projected revenues fell short of paying the full indebtedness owed Grammas; and**

(iii) **Hochman's commitment to fund the reorganization was not credible**, given his testimony that he would invest in the development only if he could reap a million dollars profit or more, while the plan itself showed no promise of any such return”.

"there is no evidence in the record [...], required to make any reliable assessment of the **financial feasibility of any plan** to develop the Property."



**Assessment of the prospective financial viability of the debtor**

Achieving filtration: From the US to the EU

*The case of the European Directive on restructuring  
and insolvency*

# Achieving filtration under the provisions of the Directive

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## Spotlight on articles:

- 7 (3) coupled with 7 (1) & (2) → REFORM/INTERPRETATION PROPOSAL
- 6 (9) (c) coupled with Recital 36 → INTERPRETATION PROPOSAL

## Article 7 - Consequences of the stay of individual enforcement actions

1. Where an obligation on a debtor, provided for under national law, to file for the opening of insolvency proceedings which could end in the liquidation of the debtor, arises during a stay of individual enforcement actions, that obligation shall be suspended for the duration of that stay.
2. A stay of individual enforcement actions in accordance with Article 6 shall suspend, for the duration of the stay, the opening, at the request of one or more creditors, of insolvency proceedings which could end in the liquidation of the debtor.
3. Member States may derogate from paragraphs 1 and 2 in situations where a debtor is **unable to pay its debts as they fall due**. In such cases, Member States shall ensure that a judicial or administrative authority can decide to keep in place the benefit of the stay of individual enforcement actions, if, taking into account the circumstances of the case, the opening of insolvency proceedings which could end in the liquidation of the debtor would not be in the general interest of creditors.

# Achieving filtration under the provisions of the Directive – Article 7

## ➤ Which debts?

### Should be interpreted / reformed into:

- Moratorium debts &
- Pre-moratorium debts *for which the debtor does not have a payment holiday* (e.g. workers' claims, see Art. 6 (5))

- **NOT** other pre-moratorium debts falling due during the stay



### **BUT!** what if the pattern of unprofitable operations can be reversed?

*“Conversion is not warranted despite the existence of **short-term post-petition operating losses** where there exists **a realistic possibility of rehabilitation.**”*

*“Small losses over an extended period may be acceptable, whereas large losses in a short period may indicate that rehabilitation is not likely” **(In re AdBrite Corp.)***

The diagram shows a light blue rectangular box with a 3D effect, containing the text "Financial viability prospects" in a bold, dark blue font. Three dashed blue arrows point from the left towards this box, indicating a flow of information or a process leading to this conclusion.

### **IN THE SAME WAY! :**

**Art 7 (3) of the Directive:** [...] a judicial or administrative authority can decide to keep in place the benefit of the stay [...], if, **taking into account the circumstances of the case, the opening of insolvency proceedings which could end in the liquidation of the debtor would not be in the general interest of creditors.**”

# Achieving filtration under the provisions of the Directive – Article 6

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## ➤ Article 6 (9) (c), coupled with Recital 36:

*“Member States shall ensure that judicial or administrative authorities can **lift a stay** of individual enforcement actions in the following cases:*

*[...] (c) where so provided for in national law, **if** one or more **creditors** or one or more classes of creditors are, or would be, **unfairly prejudiced by a stay** of individual enforcement actions; or*

## ➤ What does “unfair prejudice” mean?

- Connotes unequal or differential treatment , unjustifiable discrimination of the one compared to the other

- Can it be “unfair prejudice” for everybody? → YES

- ✓ Hockin v Marsden [2014] 2 BCLC 531

*“But I do not myself see why the requisite unfairness must necessarily be found in an unjustifiable discrimination. A **lack of commercial justification for a decision causing harm to the creditors as a whole may be unfair in the sense that the harm is not one which they should be expected to suffer**”*

- ✓ Re Meem SL Limited [2017] EWHC 2688 (Ch)

*“As a matter of language the term “unfair” is not limited to cases of unequal treatment but is capable of including conduct which is unfair to everybody within the class”.*

*UK case law  
as a starting  
point*

# Achieving filtration under the provisions of the Directive

“unfair prejudice”: “[...] *in the sense that the harm is not one which they should be expected to suffer*”

reorganization value < liquidation value  
*because the company is unviable*  
➔ thus reorganization should end  
and the company be channeled into liquidation instead



*Going concern value  
vs liquidation value –  
economic viability*

***Also supported by the wording of Recital 36:***

*Financial viability*

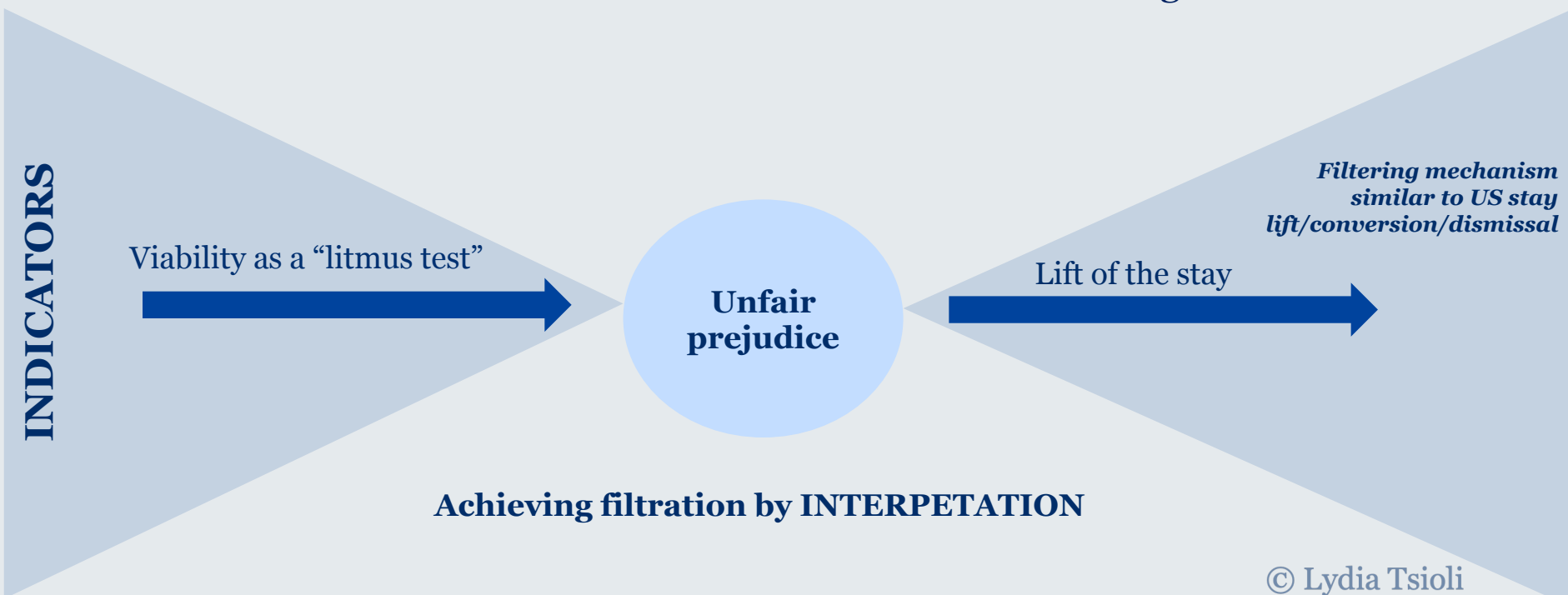
*"In establishing whether there is unfair prejudice to creditors, judicial or administrative authorities should be able to take into account whether the stay would preserve **the overall value of the estate**, and whether the debtor acts in bad faith or with the intention of causing prejudice or generally acts against the **legitimate expectations of the general body of creditors**".*

# Achieving filtration under the provisions of the Directive

## ➤ **Lift of the stay [Article 6 (9) (c)] as filtering mechanism**

Using “**unfair prejudice**” in art. 6 (9) (c) as a “**channel**” for the notion of viability and as a “**vehicle**” for transforming the **lift of the stay** into a powerful **filtering mechanism**

with the aim to achieve filtration similar to the US filtering mechanisms





# From US to EU ...

## Achieving the same result through different means

### Viability as the “litmus test” of filtering mechanism: Indicators (markers) of economic distress

2. Gross mismanagement of the estate
  3. Failure to maintain appropriate insurance that poses a risk to the estate or to the public
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- o Attempting to divert value to insiders
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See E. Morrison, *Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small-Business Bankruptcies*

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Indicators  
(markers)

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# Gradually increasing burden of proof within the viability assessment

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- In re BB Island Capital, LLC, 540 B.R. 16 (Bankr. D. Mass. 2015) referring to In re Holly's, Inc., 140 B.R. 643, 700 (Bankr. W.D. Mich. 1992):

*[...] a **four-part test** articulated in In re Holly's, Inc., 140 B.R. 643, 700 (Bankr. W.D. Mich. 1992), which describes the debtor's burden of proof as a “**moving target which is more difficult to attain as the Chapter 11 case progresses.**” [...] [the] court separated the burden of proof into four distinct stages **based on when the creditor seeks relief**: “The four broad categories can be stated as follows: (1) is it **plausible** that a **successful reorganization** will occur within a reasonable time? ; (2) is it **probable** that a successful reorganization will occur within a reasonable time?; (3) is it **assured** that a successful reorganization will soon occur?; or (4) is it **impossible** that a successful reorganization will occur within a reasonable time?”*

- *Gradually increasing burden of proof within the viability assessment*

# Gradually increasing burden of proof within the viability assessment

*“[...] while the bankruptcy courts demand less detailed showings during the four months in which the debtor is given the exclusive right to put together a plan [...], even within that period lack of any realistic prospect of effective reorganization will require § 362 (d) (2) relief” [In re BB Island Capital, stating Timbers of Inwood].*

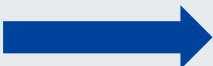
• In the case above:

○ **4 August 2015:** Voluntary Chapter 11 petition filed by the debtor

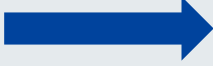
○ **19 August 2015:** Creditor’s motion for stay relief

➤ Motion granted pursuant to 11 U.S.C. § 362 (d) (2)

*“[the debtor] did not even attempt to indicate how it could refinance its assets to satisfy its outstanding obligations and reorganize its financial affairs”*

 **As such:** No minimum period during which the stay cannot be lifted (or at least such a period should be very short), but rather gradually increasing burden of proof

**As such:** Reform suggestion - Article 6 (9) last subparagraph [Directive]

 *“Member States may provide for a minimum period, which does not exceed the period referred to in paragraph 6 (i.e. 4 months), during which a stay of individual enforcement actions cannot be lifted”.*

# Viability *permeating and infiltrating* the Corporate Debt Restructuring Framework

*The research's view of the Directive*

**A) Scope**

**B) Filtration** (inner structure)

Filtering mechanisms & filtering safeguards

**REFORM**

**INTERPRETATION and/or REFORM**

Entry – (conditions of access – viability test)

Lift of the stay

Additional filtering mechanisms

Feasibility test

**VIABILITY**

Relief from the stay

Conversion/Dismissal

Future research:

- additional filtering mechanisms
- “filtering safeguards”

**Optimal framework**

- Economically
- Policy-wise
- Politically

**Thank you!**

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