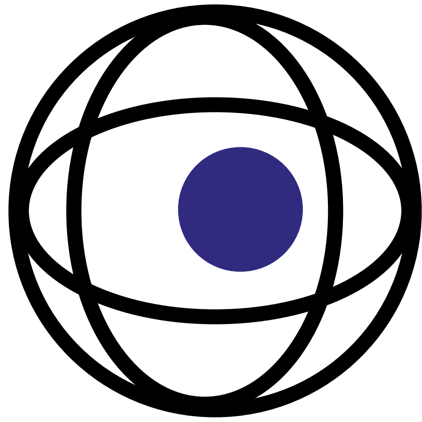

INSOL
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Harmonisation and other Challenges for the Insolvency Profession in 2023

INSOL Europe
Yearbook 2023

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Harmonisation and other Challenges for the Insolvency Profession in 2023

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Editorial Preface

After publishing our first Yearbook at the INSOL Europe Annual Congress in Dubrovnik in 2022, the decision was taken to create another Yearbook for 2023, in digital format only. The editorial board have appointed a few new members this year and the departing members are thanked for their contributions.

One of the main objectives of this and last year's publication is to inspire and encourage young members of INSOL Europe to participate and to provide them with a platform to express their views. I am pleased to confirm that articles have been received from a number of authors that have not previously submitted articles for the Yearbook. The Editorial Board is happy to report that great contributions have been received from young lawyers from all over Europe and even from India.

Insolvencies have been on the rise over the past 12 months across Europe which, together with the ever-evolving legislation across the wider industry, means that it is essential for the sharing of views and considerations across the INSOL Europe membership. This year's book provides critical insight on certain key areas. This Yearbook contains contributions across three broad areas, namely:

1) The EU Harmonisation Proposal;
2) ESG & Corporate Governance vs. Insolvency; and
3) New Legislation Impacting the Insolvency Profession.

The title of this Yearbook is *Harmonisation and other Challenges for the Insolvency Profession in 2023* reflecting the evolving challenges faced across the insolvency profession throughout the previous 12 months.

On 7 December 2022, the European Commission tabled its long-awaited proposal for a directive harmonising certain aspects of insolvency law. The proposed directive lays down common rules for all aspects related to insolvency proceedings. The impact of this harmonisation proposal will be far reaching and Section 1 of this Yearbook provides some interesting and thoughtful articles on the impacts of this new proposal on a number of countries within the European Union.

Sections 2 and 3 of the Yearbook provide useful insight into Corporate Governance measures and maximising recovery for the benefit of creditors and the tools available across a number of countries.

INSOL Europe would like to express its appreciation to all contributors for the time and effort they contributed to get this Yearbook published.

INSOL Europe and the Editorial Board encourage you to read all contributions. We hope you find this Yearbook enjoyable and informative and wish you many pleasant reading hours.

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Paul Newson
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PART I

THE EU HARMONISATION PROPOSAL

Chapter 1

Impact of the Proposed EU Harmonisation Directive for Companies utilising a Restructuring and Insolvency Process under Irish Law

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1. **Introduction**

On 7 December 2022, the European Commission (the "**Commission**") published a draft proposal for a directive of the European Parliament and of the Council harmonising certain aspects of insolvency law in the European Union (the "**Proposed Directive**").[1]

This article is not intended to cover the entirety of the proposals put forward, but rather to consider certain provisions that are likely to require the most substantial amendment to the Companies Act 2014 ("**Companies Act**") in order to give effect to the Proposed Directive in Ireland. The article addresses three of the nine titles of the Proposed Directive, namely the proposals in respect of:

(i) Avoidance actions and specifically the proposal under Article 6 for a minimum 3-month look-back period for legal acts that benefited a creditor;
(ii) Pre-pack proceedings and the goal of codifying in a structured manner a process for the marketing and sale of all or certain of a debtor's assets; and
(iii) Directors' duties and imposing upon directors of companies approaching the brink of insolvency a duty to file for insolvency proceedings in a timely manner.

The potential impact of each of these proposals is considered in turn below.

2. Title II: Avoidance Actions

The aim of Title II as a whole is to prevent legal acts prior to the commencement of a liquidation or examinership that are to the detriment of the general body of creditors.

2.1. Absence of the intention to prefer

Article 6(1) purports to introduce a minimum 3-month look-back period from the request for the opening of insolvency proceedings for legal acts or repayments benefitting a creditor to be declared void if they were perfected during that 3-month period or at any time after the submission of a request to open insolvency proceedings.

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[1] Proposal for a directive of the European Parliament and of the Council harmonising certain aspects of insolvency law in the European Union, 2022 (COM) 702 Final.

As drafted, there is no requirement to establish an intention to prefer on behalf of the debtor for transactions that fall within this window. Currently, Irish company law requires a dominant intention on the payor's part to prefer the creditor before the transaction is avoided. If implemented in this jurisdiction, this change would see a shift towards the position under the United States (US) Bankruptcy Code, where the debtor (or the Bankruptcy Trustee) can demand the claw back of all payments made by the debtor to third parties in a 90-day period prior to the bankruptcy filing. In other words, all payments (even those entered into with robust commercial justification) are held to be void unless the creditor in question proves that they are valid.

Shifting the onus of proof onto the creditor in this manner is certainly not creditor friendly and has the potential to negatively impact otherwise innocent creditors. Faced with the burden of proving that it did not know (or should not have known) that the debtor was unable to pay its mature debts or that insolvency proceedings were imminent or had commenced, creditors are likely to be saddled with the costs of defending valid transactions. If not carefully transposed, there is a risk that this change could lead to a nuanced form of 'creditor on creditor violence' emerging in this jurisdiction, as sophisticated and deep-pocketed creditors seek to undermine repayment to competitor creditors in order to influence the possible return on a winding up in their favour.

2.2. Expanding the zone of insolvency

Further, Article 8 seeks to impose a look back period of four years for instances where it is established that the debtor sought to intentionally prefer one creditor or class of creditor or cause a detriment to the general body of creditors. Irish law currently provides for acts which are deemed an unfair preference over other creditors to be invalid and void. However, the extent to which such acts are caught by section 604 of the Companies Act is limited to six months prior to the commencement of the winding up of the debtor (extended to two years in respect of acts done in favour of a connected person).

Increasing the zone of insolvency to four years would amount to a significant expansion of this lookback period for companies trading in Ireland. However, as drafted, the creditor or other party to the transaction will be required to have known or ought to have known of the debtor's intent to cause a detriment to the general body of creditors. In practice, unless the party receiving the benefit of the transaction is a party closely related to the debtor (in which case it is proposed that the knowledge is presumed) establishing this intention will be difficult to prove.

3. Title IV: Pre-Pack Proceedings

While technically already an option currently available to distressed debtors in Ireland, the proposals contained in Article IV in respect of pre-pack proceedings would formalise the process for pre-pack liquidations in this jurisdiction. Significant amendments to the Companies Act would be required to legislate for the preparation and liquidation phases and to define the role of a new class of insolvency practitioner, the Monitor.

3.1. Pre-Packs: A familiar concept

'Pre-packs' in general are a familiar concept to Irish practitioners, with pre-pack receiverships common in England and Wales and in this jurisdiction. There have been several pre-pack

receiverships over the last decade, most notably in the retail sector with Musgrave acquiring grocery chain Superquinn among the most reported.

Pre-pack receiverships have historically been conducted swiftly and with utmost privacy and confidentiality. The primary benefit of this approach is the ability of the receiver to quickly and efficiently identify a buyer and negotiate the sale and realisation of the assets while at the same time preserving the value of the assets, goodwill in the business and ultimately the jobs associated with it. There are statutory protections built in to this process. The receiver, under section 439 of the Companies Act, is required to exercise all reasonable care to obtain the best price reasonably obtainable for the assets at the time of sale. Ordinarily, in the absence of an open, transparent sales process (for example an auction or open tender), an independent valuation will be obtained in order to push back against any challenge to the price obtained. Further, the receiver is restricted from selling assets to the officers of the debtor without providing notice of any such proposal to its creditors.

Critics of the process both here and in England and Wales, point to this lack of transparency on the marketing and bidding process as typically favouring management and secured creditors over unsecured creditors and failing to maximise value. It is evident from the language used throughout the recitals to the Directive and the provisions of Article IV itself – such as "*transparency*", "*fairness*", "*scrutiny*" and "*market standards*" – that similar concerns and the need to satisfy the best-interest-of-creditors test introduced to Irish law under the European Union (Preventive Restructuring) Regulations 2022 (the "**2022 Regulations**")[2] is at the heart of this proposal.

3.2. Transparent risks

However, for all the benefits that increased transparency may offer, policymakers and legislators must be cognisant that the disclosure of the financial distress facing the company introduces a whole new set of risks. Even the most recent financial history demonstrates that once news breaks of the actual or imminent insolvency of a debtor company, its creditors, customers and partners take action. The value of the debtor's assets may depreciate as potential bidders identify an opportunity. Creditor action may be taken, suppliers may choose to discontinue supply and it is possible that staff start to look for opportunities elsewhere – resulting in a significant diminution in value for the general body of creditors for whose benefit the provisions of Title IV are being introduced.

3.3. Ireland as a destination for cross-border restructurings

Pre-pack liquidations have the potential to strengthen Ireland's hand as a jurisdiction for implementing complex cross-border restructurings. Conceptually, the proposal shares many similarities with a sale available to debtors in the United States via section 363 of Chapter 11 of the US Bankruptcy Code, most notably providing for:

(a) a court sanctioned sale process, whereby a buyer can purchase a debtors assets free and clear from encumbrances;
(b) a multi-stage process, with the Preparation Phase (aimed at finding an appropriate buyer for the debtors' business or part thereof) followed by the Liquidation Phase

[2] European Union (Preventive Restructuring) Regulations 2022 (S.I. No. 380/2022), introduced on 27 July 2022 for the purpose of giving effect to Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks.

(aimed at approving and executing the sale and distributing proceeds to the creditors) similar to the Bidding Procedures and Auction processes under a section 363; and (c) an auction process, with the initial price determined by a Stalking Horse Bid.

If implemented with thought and precision, the proposals in Article IV have the potential to bolster the restructuring options available to creditors and to provide a statutory roadmap for distressed M&A in Ireland. It would also provide bidders with a court approved sale blessed as being fair and reasonable, similar to Court approved proposals under a scheme of arrangement in examinership.

4. Title V: Directors Duties

The Proposed Directive is the latest example of European Union law seeking to expand the scope of directors' duties in Ireland. The Companies Act was amended by the 2022 Regulations so as to require for the first time in statute that directors of companies unable, or likely to be unable, to pay their debts, must have regard to the interests of creditors.

Article 36 seeks to impose an additional duty on the directors of an insolvent entity to open insolvency proceedings no later than three months after the directors become aware or can reasonably be expected to have been aware that the company is insolvent. As the Commission Staff Working Document acknowledges,[3] it is likely that each Member State comes to its own conclusion as to what constitutes "*insolvency*" when addressing this section.

4.1. What is the insolvency trigger for this duty?

Under Irish law there are two principle tests for the insolvency of a company – the balance sheet and cash flow tests. A company is insolvent on a cash flow basis in the event that it is unable to pay its debts as they fall due. Balance sheet insolvency is established whenever the value of a company's assets is less than its liabilities (which takes into account any contingent and prospective liabilities of the company).

This distinction is important. A significant number of Irish businesses are liquid but balance sheet insolvent entities, with many companies continuing to carry significant sums of debt owed to the Irish Revenue Commissioners ("**Revenue**") arising from deferred tax payments during the Covid-19 pandemic. For example, in the recent decision in Re Mac Interiors Limited[4] which confirmed the appointment of an examiner to the Petitioner company, Mr Justice Quinn noted that the Petitioner had outstanding debt due to Revenue of circa €12 million, of which the vast majority (€11,263,785) is debt owed to Revenue under the Covid-19 warehousing scheme relating to the period of 1 January 2021 – 31 December 2022.

The implementation of Article 46 will require careful consideration of how "*legal entity is insolvent*" is defined in an Irish context, otherwise viable businesses are at risk of being wound up and jobs lost unnecessarily. An absolute duty to liquidate is likely to act as a barrier to restructuring which will impact negatively on the entity itself, its creditors, employees and the wider economy.

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[3] European Commission Staff Working Document, Impact Assessment Report accompanying the Proposal for the Harmonisation Directive, 16.

[4] *In the Matter of Mac Interiors Limited and In the Matter of Part 10 of the Companies Act 2014* [2023] IEHC 395, paragraph 71.

This is a concern shared by the representative committee for the main accountancy bodies in Ireland of which the vast majority of insolvency practitioners in this jurisdiction are a member. In its submission in response to the Proposed Directive, the Consultative Committee of Accountancy Bodies – Ireland ("**CCAB-I**") comments in respect of Title V that:

> "*careful thought be given around the appropriate timing as a director could be criticised for ceasing to trade too soon with the result in loss of employment where a restructuring option may have allowed the business a chance of survival*."[5]

Regardless of the definition and timeframe decided upon, directors must have absolute clarity over the circumstances that will trigger this duty.

4.2. Potential civil liability

If Article 47 is implemented, the consequence for directors who breach this duty is civil liability for the damages incurred by creditors as a result of the failure to file for insolvency proceedings. However Irish law already provides for a similar remedy. As it stands, Section 610 of the Companies Act provides for the imposition of civil liability on directors of an insolvent company in circumstances where they carry on the business of the company in a reckless manner or with a fraudulent purpose.

While an obligation to file insolvency proceedings within a certain period of time is the current position in a significant number of Member States, the imposition of such a duty would be a radical departure for Ireland (and most common law jurisdictions) and potentially impact an entrepreneur's ability to trade through difficult periods.

Imposing a positive duty on directors to open insolvency proceedings or wind up the company within a three-month period risks causing more harm than good. It is our belief that the threat of retrospective action for breach of directors duties is more effective in that it is a deterrent to fraudulent and reckless trading while allowing honest and courageous entrepreneurs to restructure potentially viable entities. Whereas the proposed rigid time frame renders such efforts less likely and reduces the chances of a company – even one with a proven track record and robust relationships with its creditors – being able to trade its way out of financial distress.

5. Ireland's Common Law Status

As this article has sought to outline, the proposals contained in the Proposed Directive will require careful and thoughtful legislative amendment to the Companies Act. This is necessary to ensure that the restructuring options available under Irish law continue to work in a flexible and practical manner for companies and creditors operating in this jurisdiction.

As the only solely common law jurisdiction remaining in the European Union following the withdrawal of the United Kingdom after Brexit, Ireland continues to be a popular jurisdiction for international cross-border restructuring and insolvency transactions. In recent years, the Irish courts have handled notable complex restructurings including those of Ballantyne Re plc, Weatherford International plc, Norwegian Air Group and Mallinckrodt plc.

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[5] CCAB-I Response to Consultation on the EU Insolvency Directive, 23 February 2023, 2.

It is noteworthy that despite seeking to harmonise certain aspects of insolvency law across the EU, implementation of the proposals will be via Directive rather than Regulation. We welcome the Commission's comments in the Explanatory Memorandum that this choice of instrument:

> "*respects the different legal cultures and legal systems of Member States in the area of insolvency law and provides for sufficient flexibility in the transposition process*"

to adapt to local conditions.[6]

6. Conclusions

The European Commission's desire to make it easier to predict the outcome of insolvency proceedings across Member States is understandable. International investors play a significant role in corporate Ireland and are interacting with Irish restructuring and insolvency processes with greater frequency as their investments play out.

However, in our view, this search for predictability is not without risk. In light of the potential impact the proposals might have for domestic and international clients alike, as practitioners we must continue to monitor the progress of the Proposed Directive as it winds its way through the legislative process.

[6] Explanatory Memorandum to the Proposed Directive, 2022/0408 (COD), 7 December 2022.

Chapter 2

The Insolvency Practitioner as Historian: A Comparative Examination of Insolvency Claw-back Remedies in the Light of Proposals to harmonise Insolvency Law in Europe with Particular Reference to Section 423 of the Insolvency Act 1986

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1. Introduction[1]

> "It has been said that although God cannot alter the past, historians can; it is perhaps because they can be useful to Him in this respect that He tolerates their existence."

This apothegm of the English novelist Samuel Butler[2] does not offer a unique insight: Schlegel wrote of the historian as "*ein rückwärtsgekehrter Prophet*" ("a retrospective prophet").[3] Insolvency practice is not history, and its practitioners are not historians; nor does insolvency law allow the insolvency practitioner to "recreate history". It does, however, allow him/her, by using wide-ranging statutory provisions, to undo the effects of past actions resulting from the conduct of individuals, directors of companies and others and produce a contemporaneous solution to mitigate what would otherwise amount to historical effect. Although it may be argued that all litigation does this to some extent, insolvency remedies designed, for example, to restore the position of a company or individual to what it would have been but for a wrongful act are an especially powerful manifestation of that generality.

This article examines some of the remedies available under the insolvency laws of Germany, Ireland, Italy, the Netherlands, Spain and England and Wales.[4] It examines, in particular, those which draw on the *actio pauliana*[5] of Roman law which has informed, and continues to inform,

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1 The writers would like to thank the following for their assistance in relation to the law of their respective countries: Giorgio Corno, avvocato and solicitor (Italy), María Arántzazu Ortiz González, magistrada, Audiencia Provincial de Baleares (Spain), Frank Tschentscher (Germany), Alice van der Schee (Netherlands) and Barry Cahir (Beauchamps, Ireland). The writers apologise and take responsibility for any errors in relation to or misunderstanding of the material they have provided.

2 *Erewhon Revisited* (Grant Richards, 1901), Chapter 14.

3 *Fragmentensammlungen (Kritische Fragmente, Blüthenstaub, Athenäums-Fragmente, Ideen), 1797-98. Athenäums-Fragmente*, [80].

4 England and Wales being a single jurisdiction. Any reference hereafter to English law should be taken to mean the law of England and Wales. Readers should note that Northern Ireland and Scotland have distinct legal systems that follow that applicable in England and Wales but also diverge from it in significant respects. For an account of the *actio pauliana* in Scots law, see John McLeod "The reception of the actio Pauliana in Scots law", in Thomas Safley (ed), *The History of Bankruptcy: Economic, Social and Cultural Implications in Early Modern Europe* (Routledge, 2013).

5 Sometimes referred to as the *actio revocatoria*. See, generally, Francis Cumbrae-Stewart, *The Actio Pauliana: Its Origin, Development and Nature* (Oxford thesis, 1920); Max Radin, "Fraudulent Conveyances at Roman Law" (1931) 18(2) *Virginia Law Review* 109-130. That it remains a

the law relating to antecedent transactions (and not just in the context of insolvency) in a number of European and other jurisdictions.[6] It examines in comparative detail the English law action available to undo (or "rewrite" the history of) transactions in fraud of creditors, emphasising its special advantages.[7]

2. The *actio pauliana*

The *actio pauliana* now takes a number of forms or has been subsumed into causes of action known under many guises, so it is as well to begin by examining what it was and the characteristics of what it has generally become.

The Institutes of Justinian 4.4.6 describe it thus:

> "[W]here a person has transferred his property to another for the purpose of defrauding his creditors, the latter, on obtaining from the governor [or magistrate] of the province a decree vesting in them possession of the debtor's estate, may avoid [set aside] the transfer and sue for the recovery of the property; in other words, allege that the transfer never took place, and that the property consequently remains that of the debtor."

Justinian's codification did not represent original law but was, rather, a synthesis of earlier remedies (*restitutio in integrum ob fraudem* available in insolvency to the *curator bonorum*, and *interdictum fraudatorium* available to an individual creditor), thereby laying the foundation for the modern remedy. It may be described (if not defined precisely for all purposes) as a common law principle, later enshrined in statute, by which a disposition may be set aside as being *in fraudem creditorum* (in fraud of creditors), the word "fraud" bearing a civil law rather than a criminal law meaning: the test governing its applicability was and remains, generally, whether the purpose of the transaction in issue was to give one party an unfair advantage over others (usually creditors), as appears from this modern description:

> "Today, *actio pauliana* is generally used to refer to a specific type of legal remedy that provides a creditor with the possibility to have an act declared ineffective with respect to that creditor, that act having been carried out by a debtor to diminish its assets by passing them on to a third party. The creditor typically brings the action directly against the third party. The notion of *actio pauliana* is described as a 'series of techniques for granting protection to creditors in cases where the debtor diminishes his seizable assets to avoid paying his debts'."[8]

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contemporary interest is evidenced by, for example, Antoni Vaquer's chapter, "From revocation to non-opposability: modern developments of the Paulian action", in Hector MacQueen, Antoni Vaquer and Santiago Espiau (eds), *Regional Private Laws and Codification in Europe* (Cambridge, 2009); Sander Hendrix, *Transaction avoidance in insolvency law: past, present and future of the Actio Pauliana* (Weert/Limburgh, 2019). For a short account of the Roman law of bankruptcy, see Roland Obenchain, "Roman Law of Bankruptcy" (1928) 3(4) *Notre Dame Law Review* 169-200.

[6] Including England and Wales, as explained below.

[7] This is an appropriate juncture at which to acknowledge consideration of the issue in an earlier article by Reinhard Bork, "Sequana 1: Struggling with section 423 of the Insolvency Act 1986" (2022) 31(1) *International Insolvency Review* 8-22. The article deals with the Court of Appeal decision ([2019] EWCA Civ 112) and predates the decision of the Supreme Court ([2022] UKSC 25).

[8] Opinion of Advocate General Bobek delivered on 21 June 2018: *Feniks Sp. z o.o. v Azteca Products & Services SL. (Request for a preliminary ruling from the Sąd Okręgowy w Szczecinie.)* Case C-337/17. The Advocate General cites the following in support of the definition: Ilaria Pretelli, "Cross-Border Credit Protection Against Fraudulent Transfers of Assets: Actio Pauliana in the Conflict of Laws" (2011) 13 *Yearbook of Private International Law* 589-640, 590; Tuula Linna, "Actio Pauliana — Actio

The notion of "rewriting history" latent in Justinian's phrase "that the transfer never took place" resonates with the contemporary description of an action that offers "the possibility to have an act declared ineffective:" the legal remedy seeks, in effect, to deny the actuality of the very action at which it is directed.

Its principle characteristics have been analysed in the following broad terms:[9]

> (a) A triangular relationship among three parties based on:
>> (i) the existence of a debt between a debtor and a creditor;
>> (ii) a transaction between the debtor and the third party;
>> (iii) the existence of an intent to defraud on the part of the debtor; and
>> (iv) transferee awareness of that fact;
>
> (b) the availability of the remedy to individual creditors under the general civil law as well as to the general body of creditors under an insolvency regime.

With those broad characteristics in mind, we turn to some of the remedies available in certain European jurisdictions that either have their origins in the principle of the *actio pauliana* or reflect the policy informing it.[10]

2.1. Germany

The modern law of insolvency in German is to be found in the Insolvenzordnung ("InsO") which contains a number of remedies to combat improper antecedent transactions through a process called, generically, "*Insolvenzanfechtung*." In particular, s 129 InsO provides that an insolvency administrator (*Insolvenzverwalter*) may (under ss 130-146) challenge pre-insolvency transactions which prejudice creditors.[11] The policy aim is to ensure that all creditors are treated equally in accordance with the *pari passu* principle. That aim is achieved by the reversal of any offending acts.

Generally, any challenge to a pre-insolvency transaction requires, *inter alia*, a "legal act" (*Rechtshandlung*) that is detrimental to the general body of creditors. A typical example is the payment of an individual debt at a time when no other creditor receives payment (effectively the equivalent to an English law preference), but the legal act may also take the form of a promise of payment or a transfer of assets.

The insolvency administrator can challenge any of the following transactions, without limitation:

- The granting of security or the satisfaction of a current obligation made within a period of three months prior to the opening of the insolvency where the creditor

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Europensis? Some Cross-Border Insolvency Issues" (2014) 10(1) *Journal of Private International Law* 69-87; Miguel Virgós Soriano and Francisco Garcimartín Alférez, *Derecho procesal civil internacional: litigación internacional* (2nd edn) (Thomson Civitas/Cizur Menor, 2007), 704-705; Ulf Göranson, "Actio pauliana outside bankruptcy and the Brussels Convention", in Mathilde Sumampouw *et al.* (eds.), *Law and Reality*: *Essays on National and International Procedural Law in Honour of Cornelis Carel Albert Voskuil* (Martinus Nijhoff, 1992), 91.

[9] Again, see the Advocate General's opinion *supra*.

[10] The following material is necessarily brief and selective, having regard to the theme of this article.

[11] The provision also applies to forbearance or omission (*Unterlassung*).

knew that the debtor was unable to pay their debts at the time: so called "congruent coverage or satisfaction" (*kongruente Deckung*) (s 130 InsO).

- The granting of security or satisfaction within a period of up to three months prior to the opening of the insolvency where the creditor was not entitled to demand such security or satisfaction, or to insist on the specific form of settlement used, or not entitled to demand satisfaction at the time when the security was granted or a payment was made, where the creditor was aware of potential prejudice to the general body of creditors arising from the transaction on the transaction date: so called "incongruent coverage or satisfaction" (*inkongruente Deckung*) (s 131 InsO).
- Section 132 provides generally for the ability to challenge legal transactions by the debtor which constitute direct prejudice to the general body of creditors in the period of three months before the opening of insolvency proceedings.
- Section 133 InsO allows a challenge to any transaction entered into by the debtor in the period of 10 years before an application to open insolvency proceedings, or thereafter, with the intention of prejudicing creditors where the party benefitting was aware of the debtor's bad intention at the time of the transaction. Awareness is presumed where the party benefiting was aware of the debtor's imminent insolvency.
- Section 134 allows an attack on gratuitous benefits (*unentgeltliche Leistungen*), i.e. gifts.
- Repayments of shareholder loans by a corporate debtor to its shareholder(s) (or any claim that amounts to a shareholder loan) within a period of one year prior to the opening of the insolvency may be challenged. Financial difficulty on the part of the debtor is not a prerequisite. Any security given by a corporate debtor to a shareholder to secure the repayment of a shareholder loan (or similar) during the period of ten years prior to the opening of the insolvency is similarly susceptible of attack; and a shareholder who has provided security or is liable as guarantor may be required to account to the insolvency administrator for any benefit which the corporate debtor may have allowed a third party (e.g. where a company pays back a loan to a third party that is secured by a personal guarantee (or similar) given by the shareholder) within the period of one year before the opening of the insolvency (s 135, InsO).

Relief pursuant to s 133 InsO requires "wilful disadvantage" (*vorsätzliche Benachteiligung*) to be established, and is subject to an overall assessment of the circumstances of the transaction. The necessary "subjective elements" to establish wilful disadvantage are:

(i) that the receiving party was aware of the debtor's imminent insolvency and that the payment constituted a disadvantage to the body of creditors;
(ii) that the satisfaction of any claim was not something to which the creditor was entitled, or where the creditor was entitled, that did not extend to the kind of settlement or the date of settlement.
(iii) that previous enforcement measures against the debtor have failed; or
(iv) admission on the part of the debtor that they were unable to pay their debts as they fall due.

Subjective elements which do not constitute "wilful disadvantage" include:

(i) a situation analogous to a cash transaction where good consideration is given (the cash transaction exception discussed below);

(ii) where there has been a lapse of time between payment and the insolvency proceeding; and
(iii) a non-insolvency restructuring.

The look-back period is reduced to four years in the case of transactions granting or facilitating security to or satisfaction of a claim of an insolvency creditor.

In cases of congruent coverage, there are additional exceptions:

(i) payments can only be contested where the other party to the transaction knew of the debtor's inability to pay its debts and the payment was a prejudicial to the general body of creditors; or
(ii) where the creditor and debtor agreed a payment plan to settle outstanding debts, the creditor is presumed to be unaware of the debtor's inability to pay its debts.

The foregoing are subject to what is called the cash transaction exception, alluded to above. Under this, any payment by the debtor for good consideration can only be challenged where wilful disadvantage or incongruent coverage occur, and in either case only if the creditor was aware that the debtor was acting unfairly. For example, a sale and purchase agreement for good (i.e. market standard) consideration cannot, in principle and in the absence of suspicious circumstances, be challenged. The application (or otherwise) of the exception is fact sensitive but in most cases, a lapse of a maximum of 30 days between the delivery of goods and payment date should not be exceeded. Equally, the cash transaction exception does not apply if the transaction was intended to prejudice the general body creditors, for example where assets are sold at an undervalue.

The limitation period for challenging pre-insolvency transactions generally expires at the end of the third calendar year after the opening of the insolvency proceedings.

It will be readily apparent from the foregoing that the German provisions are sufficient to undo the effects of most improper antecedent transactions. Thus, a preference within the meaning of s 239 Insolvency Act 1986 will generally be caught by s 133 InsO; a transaction at an undervalue (s 238 Insolvency Act) by the gratuitous benefit provisions of s 134 InsO; and so on.

2.2. Netherlands

Insolvency in the Netherlands is governed by the Bankruptcy Act (*Faillissementswet* ("Fw")) which provides a relatively straightforward regime for tackling improper antecedent transactions.[12]

There are only two basic provisions in the Act which together cover a range of possible transactions prejudicing creditors in an insolvency. The Fw differentiates between a voluntary transaction (covered by art 42 Fw) and an obligatory transaction (covered by art 47). Both provisions draw entirely on the *actio pauliana*.

[12] See, as to this and generally, Rolef de Weijs *et al.,* "Financing in Distress Against Security from an English, German and Dutch Perspective: a Walk in the Park or in a Mine Field?" (2012) 23(1) *International Insolvency Review* 67-83.

An obligatory legal act is one performed by the debtor in a manner and at a time when the debtor was under a legal obligation to perform it. Economic necessity to perform a legal act does not make an otherwise voluntary legal act an obligatory one. A voluntary legal act is one performed by the debtor which is not obligatory. A voluntary legal act may take the form of a preference (which may include the payment of a debt that is not due or an "in lieu of" payment e.g. sale followed by set-off to pay an existing debt) or some other voluntary transaction that has the effect of compromising the integrity of the estate such as a transaction at an undervalue or gift.

An action to challenge a voluntary legal act requires the office-holder to prove that the legal act:

(a) was a voluntary act;
(b) resulted in prejudice to the creditors;
(c) in circumstances in which the debtor knew or ought to have known that the creditors would be prejudiced; and
(d) where the relevant legal act was for value received, but the counterparty knew or ought to have known that other creditors of the debtor would be prejudiced.

An obligatory legal act can only be challenged in limited circumstances: the first is where the counterparty at the time of the transaction was aware of a pending application to open insolvency proceedings; the second is where the debtor and counterparty have colluded to prefer the counterparty over other creditors. Case law at the level of the Dutch Supreme Court provides that the collusion criterion requires actual intention of the parties to the transaction, which falls to be interpreted narrowly.

Dispositions of property made by the debtor after 00.00 hours on the date of the bankruptcy are not void under Dutch law (s 23 Fw), although the office-holder may make a claim for the restitution of any property that has been disposed of.

Depending on the circumstances, transactions in fraud of creditors may fall within the scope of arts 42 and/or 47 Fw. Alternatively, they may constitute an unlawful act within the meaning of art 6:162 of the Dutch Civil Code. The Supreme Court has ruled that an office-holder may make such a claim on behalf of creditors (Supreme Court decision of 14 January 1983, *Peeters v Gatzen*).[13]

The provision requiring subjective criteria to have been met on both the creditor's and the debtor's side, makes the Dutch provisions notoriously difficult for office-holders successfully to invoke.

2.3. Italy

Italian insolvency law is governed by the *Codice della Crisi d'Impresa* ("CCII").[14] It applies a single regime to company and individual insolvency, the latter applicable only to individuals who were engaged in commercial activity and were not minor enterprises within the legal meaning of the term.

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[13] ECLI:NL:HR:1983:AG4521.
[14] The CCII came into force on 15 July 2022.

The law contemplates specific but restricted "look-back periods" in the case of gifts (two years, save in case of transactions between debtor and spouse) and payment of non-accrued debts (one year) against the recovery of which there is no defence. In these specific cases, the solvency or insolvency of the debtor at the time and the recipient's knowledge of the debtor's financial circumstances are irrelevant.

Automatic avoidance applies to gifts made within two years of the insolvency. Avoidance periods for other relief do not extend back more than two years. In addition, Italian law has numerous exceptions to the ability to challenge a transaction based on necessity or public policy (set out in CCII art. 166(a)-(g)).

The other substantial differences relate to limitation periods. The remedies in the CCII are generally subject to a three-year limitation period from the making of the insolvency order, and in any case a limitation period of five years from the act in question (art. 170).

In the case of a transaction in fraud of creditors the limitation period is, however, five years from the date on which the transaction was performed. Any action by the liquidator is taken on behalf of all creditors (art 165 CCII).

The *actio pauliana* lives in the Italian legal system in the form of an action by which a creditor may make an application challenging acts disposing of assets by which the creditor's rights are prejudiced (called an *azione revocatoria fallimentare* or avoidance claim). Antecedents of the *actio pauliana* can be discerned in the traditional requirements expressed in the legal formulae *consilium fraudis* (intent) and *eventus damni* (harm or damage).

The CCII enables the court having insolvency jurisdiction under arts 11 and 27 CCII to declare acts detrimental to creditors automatically ineffective or to declare them ineffective following a successful claim based on the *azione revocatoria fallimentare* (arts 163, 164-165 and 167 CCII). The law enables a liquidator (*curatore*) to:

(a) recover or seek other redress against a party to whom the debtor has made a gift in the two years preceding the date of bankruptcy without proof of the debtor's insolvency or knowledge of their insolvency on the part of the recipient (art 163 CCII); or
(b) recover or seek other redress against a party with whom the debtor entered into a transaction at a significant undervalue where the consideration was given in the year preceding the bankruptcy order if services were rendered or obligations assumed by the bankrupt have a value in excess of one quarter of what the debtor was to receive in return (art. 166 CCII).

In the latter case, (b), the burden is on the recipient to show that they did not have knowledge of the debtor's insolvency.

Payments of liquidated and accrued debts within six months of the bankruptcy order are also void to the extent that the liquidator can prove that the party to the underlying transaction, not being the insolvent, knew that the debtor was insolvent (art 166 CCII). Any sums payable by a creditor as a result of a successful avoidance judgment are admissible to proof in a corresponding amount (art. 171 CCII).

The following acts are void as detrimental to the interests of creditors unless the defendant proves ignorance of the debtor's insolvency:

(i) satisfaction of accrued money debts of the debtor other than by money or other usual means of payment within the year preceding the bankruptcy order (art 166 para 1 CCII);
(ii) the voluntary granting by the debtor of security such as pledges, *anticresi*[15] and voluntary mortgages for a pre-existing debt that was not due at the date of the bankruptcy order, if executed during the year preceding the bankruptcy order (art 167 para 3 CCII); and
(iii) the granting of security (voluntary or otherwise) such as pledges, *anticresi*, mortgages or judicial mortgages obtained by creditors for debts already due during the six months preceding the bankruptcy order (art 167 para 4 CCII).

The liquidator is also entitled to recover or seek other redress from a third party in favour of whom the debtor has entered into any of the following acts during the six months preceding the insolvency order, provided the liquidator can prove that the third part was aware of the debtor's insolvency:

(i) voluntary or involuntary payments made by the debtor against liquid and payable claims;
(ii) onerous acts (*atti a titolo oneroso*) performed by the debtor; and
(iii) the granting of security by the debtor, including any given for the debts of third parties at the time the debt came into existence.

Detrimental acts performed by the debtor may be subject to an avoidance claim either outside or within the insolvency proceedings if they occurred before the date of the filing of the avoidance claim or before the opening of the insolvency proceedings. The applicable period is five years for an ordinary avoidance claim, or a shorter period of two years and six months before the opening of the insolvency, depending on the nature of the detrimental act performed, where the claim is brought in insolvency proceedings. Claims in respect of detrimental acts governed by Italian insolvency law cannot be commenced more than three years after the insolvency order and in any case later than five years after the date of the relevant transaction. (art 170 CCII).

Italian insolvency law has specific but restricted look-back periods for gifts (two years, save for acts between debtor and spouse) and payment of non-accrued debts (one year) against a claim for which there is no defence. In these specific cases, the solvency or insolvency of the debtor at the time and the recipient's knowledge of the debtor's circumstances are irrelevant. Automatic avoidance applies to gifts within two years of the insolvency. Other avoidance periods do not extend back more than two years.

Italian law has numerous exceptions to recovery based on need or public policy (set out in CCII art. 166(a)-(g)). The other substantial differences as to the remedies relate to limitation periods. The remedies in the CCII are subject to a three-year limitation period from the insolvency order and in any case five years from the date of the act in question (art. 170). In the case of a transfer

[15] Antichresis: an agreement under the terms of which the creditor pledges or charges the fruits of property in lieu of the payment of interest or some analogous obligation.

in fraud of creditors under Italian law the limitation period is five years from the date the transaction was performed.

If the counterparty is not capable of making restitution of the consideration received from the debtor, such counterparty will be obliged to restore the equivalent in money to the value of the consideration received at the time it was extracted from the debtor's estate plus any interest derived therefrom.

2.4. Spain[16]

The Spanish *Ley Concursal* (Insolvency Act ("LC"))[17] contains various provisions directed at preserving the insolvent estate and giving restitution in respect of assets lost to it (see arts 226-237). They allow the *administrador concursal* (administrator) of the insolvency to challenge transactions entered into by the debtor which could be considered detrimental to the debtor's interests.

The LC sets out certain conditions which have to be satisfied:

(a) the transaction must have taken place within the period of two years prior to the filing of the insolvency declaration;
(b) the transaction must have been entered into by the insolvent debtor; no relief is available in respect of transactions entered into by third parties; and
(c) there must be detriment to the estate: the LC permits claw-back solely in respect of transactions considered to have been detrimental to the debtor's interests.

The LC relies on an objective notion of detriment: it is construed as meaning a loss or disadvantage to the debtor, regardless of whether the transaction was tainted by fraudulent intention.

In terms of assessing detriment, the following matters (which emerge from Spanish case law) need to be taken into account:

(a) The value of the detriment is established on a case by case basis, in principle by reference to market forces; and
(b) The detriment (as to both its existence and value) needs to be assessed by reference to the time when the decision as to the transaction in issue was made, not the time when it was performed.

The LC sets out a number of presumptions as to detriment, including rebuttable presumptions (e.g., in the case of transactions with related parties) and non-rebuttable presumptions (e.g. in the case of gifts). Thus, an impeachable transaction occurring in the relevant two-year period which is subject to the non-rebuttable presumption as being detrimental to the estate of the insolvent will be rescinded by the court. When an impeachable transaction in the two-year period is subject to the rebuttable presumption, the burden of proving no detriment rests with the counterparty to the transaction. Where no presumption applies, the burden of proving detriment rests with the applicant (i.e., the administrator or, in exceptional cases, the creditors).

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16 For a helpful overview of the law in English see Manuela Serrano, *The Insolvency Review: Spain* (PwC Legal, 22 October 2022), available at: <https://thelawreviews.co.uk/title/the-insolvency-review/spain>.

17 Largely brought into force on 26 September 2022.

No transaction becomes ineffective automatically as a result of the mere initiation of the insolvency proceedings: the law simply allows the administrator to investigate and seek a review of the transactions in issue, but it is the court dealing with the insolvency which ultimately decides. A judgement impugning a transaction will declare it ineffective and provide for restitution, which may take the form of a money judgment (including interest) if the counterparty is unable to return the consideration given by the debtor.

Generally any claim arising from such restitution will rank in the insolvency as a claim against the insolvent estate (*crédito contra la masa*). The only exception to this rule is where bad faith on the part of the creditor is proved, which will result in subordination of the claim.

Bad faith is not defined in the statute. It will depend on the facts of each case and on the exercise of judicial discretion. The case law shows, however, that it entails more than knowledge of the debtor's insolvency: it requires reprehensible behaviour of a level of seriousness that merits legal consequences. The higher Spanish courts have traditionally taken a narrow approach to its interpretation.

Although the existence of fraud or bad faith is not a necessary element under the Spanish law regime described above, there are elements of the *actio pauliana* here in so far as the application of law reflects bad faith and in the way in which the presumptions operate in certain cases.

2.5. England and Wales

English insolvency law (governed by the Insolvency Act 1986, offers a wide range of remedies to the insolvency office-holder. In relation to corporate insolvencies these include:

(a) s 127, which enables the court to set aside dispositions of company property between the presentation of a winding up petition and the date of the winding up;
(b) s 212, which enables proceedings to be brought against a director or others (including other office-holders) for misfeasance/breach of duty;
(c) ss 213 (fraudulent trading) and 214 (wrongful trading) which enable the court to order a contribution to be made to the company's assets where a director has allowed the company to carry on trading to defraud creditors or carry on trading to the detriment of creditors after knowing that the company was insolvent;
(d) s 238, which allows the court to set aside transactions entered into by the company at an undervalue;
(e) s 239, which enables the court to make an order setting aside a preference in favour of a creditor or creditors at the expense of the general body of creditors;
(f) s 244, which enables the court to set aside extortionate credit transactions;
(g) s 245, which provides for the avoidance of certain of floating charges;
(h) s 423, which gives the court power to make orders in respect of transactions defrauding creditors.

The Insolvency Act also contains provisions designed to preserve assets or to challenge antecedent transactions in individual insolvency cases which are similar to those applicable in a corporate insolvency, although, inevitably, there are differences arising out of the nature of

the two regimes.[18] The inclusion of the remedy in respect of actions in fraud of creditors in the list of other insolvency remedies set out above emphasises its place as part of a range of possible actions aiming to claw back assets for the benefit of creditors.

The action available in relation to a transaction in fraud of creditors in English law[19] is the product of the same Roman law tradition that has influenced the European provisions briefly canvassed above.[20] Unsurprisingly, then, it shares common features with its European counterparts, but in many respects it is much wider in its reach.

Sections 423-425 Insolvency Act 1986 ("IA") deal with what are termed "transactions defrauding creditors."[21] They are not, however, limited to cases of fraud but are directed at any transaction entered into by the debtor for the purpose of putting assets beyond the reach of a person who is making, or at some time may make, a claim against them or otherwise prejudicing the interests of such a person (referred to in these provisions as "the victim") in relation to such a claim. The provisions apply to corporate and individual debtors. They apply whether or not the debtor is subject to a formal insolvency procedure.[22] Thus, it is not necessary to show that the debtor is insolvent or was so at the time of the transaction.[23]

The term "transaction" is construed broadly.[24]

Whilst an application under the provisions is usually made by an office-holder (e.g. the official, liquidator or trustee in bankruptcy) it may also, with the permission of the court, be made by any victim of the transaction.[25] The term "victim" is defined as a person who is, or is capable of being, prejudiced by the transaction in question[26] and has been construed broadly to include parties other than a creditor. The victim does not have to be a creditor; he or she may not even have been in the debtor's contemplation at the time the transaction was made; nor need there necessarily be any connection with the victim for whose benefit the application is brought.[27]

A transaction susceptible of being impugned must have been entered into at an undervalue and for the prohibited purpose, i.e. for the purpose of putting assets beyond the reach of the person who is making, or may at some time make, the claim, or for the purpose of otherwise prejudicing the interests of such a person in relation to such a claim.[28] Undervalue may be

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18 See ss 284, 339, 340, 342A, 343, 344 and again 423.

19 For a general review of the relevant corporate law see Hugo Groves and Edward Bailey, *Bailey and Groves' Corporate Insolvency* (5th edn) (LexisNexis, 2017); for the law on individual insolvency, see Giles Maynard Connor KC *et al.*, *Schaw Miller and Bailey's Personal Insolvency and Practice* (6th edn) (LexisNexis, 2022); Alaric Watson and Stephen Baister, *Bankruptcy: Law and Practice* (Elgar, 2023), from which the following account is summarised.

20 "Section 423 [Insolvency Act 1986] is derived (through the Fraudulent Conveyances Act 1571 (13 Eliz 1 c 5)) from the *actio Pauliana*" (*per* Lady Arden in *BTI 2014 LLC v Sequana SA and others* [2022] 3 WLR 709).

21 The phrase appears in the title to s 423.

22 *Moon v Franklin* [1996] BPIR 196; *TSB Bank plc v Katz* [1997] BPIR 147.

23 See *BTI 2014 LLC v Sequana SA* [2017] EWHC 211 (Ch) and (on appeal) [2019] EWCA Civ 112, [2019] BPIR 562.

24 IA 1986, s 423(1).

25 IA 1986, s 424(1)(a), which also applies, *mutatis mutandis*, to a company.

26 IA 1986, s 423(5).

27 See *Fortress Value Recovery Fund I LLC v Blue Skye Special Opportunities Fund LP* [2013] EWHC 14 (Comm) and *Ali v Bashir* [2014] EWHC 3853 (Ch), [2015] BPIR 211.

28 IA 1986, s 423(3). On the possible meaning of "prejudicing" in this context, see *Westbrook Dolphin Square Ltd v Friends Life Ltd (No.2)* [2014] EWHC 2433 (Ch), [2015] 1 WLR 1713.

established by showing that the transaction took the form of a gift or that value of the consideration given by the non-debtor party to the transaction was significantly less than the true value of the consideration, i.e. the consideration given by the debtor.[29] Proving the requisite purpose does not involve establishing that the debtor's reason for entering into the was his sole or dominant purpose; it was sufficient that his reason constituted a substantial purpose for entering into the transaction in issue. The state of mind of the party to the transaction other than the debtor is not generally relevant.[30]

If the court is satisfied that relief should be granted it will make an order with a view to restoring the position to what it would have been if the transaction had not been entered into, and protecting the interests of the victim of the transaction.[31] The statute provides a wide but non-exhaustive list of remedies.[32] The revesting of property transferred in any person, either absolutely or for the benefit of all persons on whose behalf the application for the order was made, the release of security given by the debtor the payment of any benefits received from the debtor such sums and the provision of security for the discharge of any obligation imposed by or arising under the order. Section 423(2) IA 1986 makes clear that the court has a wide discretion as to what relief (if any) may be granted.

Any relief granted should be restitutionary:[33] the aim of the regime is not to punish those who had entered into the impugned transaction.[34]

An office-holder may (and often will) make an application under s 423 alongside an application to challenge a transaction at an undervalue under ss 238/339 in the alternative. The two regimes have their advantages and disadvantages. Section 423 is broader in terms of the scope of its reach: it is not subject to the "relevant time" constraints that apply to a s 238/339 application. As against that s 423 requires the applicant to satisfy the purpose test, which is not relevant to seeking relief under ss 238/339.

Another important difference goes to who may bring the application and in what circumstances. There is no requirement, under s 423, for the debtor to have been made the subject of an insolvency, nor is the regime constrained by having to be brought by an insolvency office-holder: any victim, within the statutory meaning of the term, may apply. As we have seen, a victim other than an office-holder will need the permission of the court to bring a claim. Such permission will usually be given subject to a condition that any recovery will be applied to satisfy the debts or liabilities of the general body of creditors (where such exists) and not just the victim who makes the claim.

Limitation is broad. It was thought that actions defrauding creditors were not subject to any limitation period. However, in *Re Nurkowski (A Bankrupt); Hill v Spread Trustee Company Ltd*,[35] the Court of Appeal rejected that view and made it clear that different limitation periods could apply, depending on the nature of the transaction under attack. The potential breadth of the applicable limitation period can be especially useful in cases involving post-insolvency

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29 IA 1986, s 339(3)(c).

30 See *Moon v Franklin* [1996] BPIR 196; but cf. *4Eng Ltd v Harper* [2009] EWHC 2633 (Ch), [2010] BPIR 1.

31 IA 1986 s 423(2).

32 IA 1986 s 425(1).

33 See *Johnson v Arden* [2018] EWHC 1624, [2019] BPIR 901.

34 See *Griffin v Awoderu* [2008] EWHC 349 (Ch), [2008] BPIR 877.

35 [2006] EWCA Civ 542, [2007] 1 WLR 2404, [2006] BPIR 789.

claims against directors for breach of duty,[36] which may have come to light only after and as a result of investigation by an insolvency practitioner.

The provisions of ss 423-425, whilst not an office-holder's first port of call in most cases, is an exceptionally valuable tool for righting wrongs in the insolvency context. A great deal of recent authority attests to its lively use.[37]

2.6. Ireland (a note)

Ireland's common legal heritage with England makes it unsurprising that its law on what it generally calls fraudulent conveyances closely resembles its English counterpart. Indeed it has similar origins.[38] It appears, however, to be limited to dispositions of land[39] (in the form of a conveyance of property) with the intention of defrauding a creditor or any person, and is voidable by any person prejudiced, but the provision is restricted and is expressed to be unaffected by any other law relating to the bankruptcy of an individual or a corporate insolvency.[40]

3. Conclusions

The foregoing brief (and selective) examination of some European insolvency regimes, with particular reference to the *actio pauliana* tradition, would appear to confirm that it lives on, albeit in many cases in an attenuated form. They respectfully suggest that, in the context of any further harmonisation of insolvency claw-back provisions, it should continue to play a role, whilst respecting the legal traditions (and reflecting the economic conditions) of individual jurisdictions.

The writers further suggest that the particular advantages of the regime under ss 423-425 Insolvency Act 1986 merit attention in the context of discussion of the harmonisation of insolvency law in the EU. The English law provisions reflect strongly the characteristics identified by the Advocate General in *Feniks Sp. z o.o. v Azteca Products & Services S* in that they provide a range of remedies (or series of techniques) to have a legal act declared ineffective where the act has had the effect of diminishing the assets available for the benefit of creditors where the aim has been to avoid paying debts and operates under the general civil law as well as under an insolvency regime, an advantage that is not available under all the regimes discussed above. They also overcome many of the limitation problems that generally bedevil insolvency provisions of the more conventional kind.

It has been recognised for some time now that in relation to anti-avoidance transactions the various national legal regimes, while having common aims, evince significant differences. These go to the identity of the party entitled to take action, the conditions to be satisfied for action to be taken, the categories of transaction susceptible of action and the length of the period

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[36] These may be statutory (see ss 171-177 Companies Act 2006) or arise under common law.

[37] See, for example, *Emirates NBD Bank PJSC v Almakhawi and anor* [2023] EWHC 1113 (Comm); *Investment Bank PSC v El-Husseini and ors* [2023] EWCA Civ 555; *Morina v McAleavey and ors* [2023] EWHC 1234 (Ch); *Henderson & Jones Ltd v Ross and ors* [2023] EWHC 1276 (Ch).

[38] In the case of Ireland in the Fraudulent Conveyances Act 1634.

[39] The predecessor of the English Law provisions discussed below was s 172 Law of Property Act 1925. It was on the recommendation of the Cork Committee that it was re-enacted in its present form to widen its scope.

[40] Land and Conveyancing Law Reform Act 2009 s 74. For a recent case on the provision, see *Allied Irish Banks Plc v Martin Burke and Deirdre Burke* [2018] IEHC 767.

preceding the opening of insolvency proceedings (or following the transaction in issue) which limits the taking of action.[41]

Reinhard Bork[42] concludes (among other things):

> "[S]ection 423 of the IA 1986 proves to be an exceptional appearance of the *actio pauliana* among its fellow transactions avoidance laws - at least in Europe and the United States. Neither the necessary prerequisite of a transaction at an undervalue nor the discretion of the court regarding the legal consequences is available in other insolvency laws. By shaping the rule so uniquely, English law makes its own life difficult. However, as often in comparative law, the results in concrete cases are not so different."

The writers respectfully agree, save to the extent of Bork's assertion that English law "makes its own life difficult." It is certainly the case that action under ss 423-425 are regarded by many as a last resort because of the heavy burden of proof that has to be satisfied as regards intention. It is often seen as an alternative to more conventional remedies, but has obvious advantages in terms of limitation and the breadth of its scope. In conjunction with the more conventional insolvency remedies for dealing with preferences and transactions at an undervalue it makes, however, a valuable contribution to the ability of an insolvency practitioner and, as we have seen others to rewrite history. It is respectfully suggested that it provides a good starting point for consideration in the context of insolvency reform in Europe and elsewhere.

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[41] See, for example, the European Parliament Directorate-General for Internal Policies note, *Harmonisation of Insolvency Law at EU Level: Avoidance Actions and Rules in Contracts* (2011), although the issue is canvassed in a wide range of literature on the topic of harmonisation.

[42] See above note 7.

Chapter 3

The EU Harmonisation Proposal: How much will need to change in the Polish, German, Austrian and French Insolvency Law Landscapes?

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1. Introduction

In December 2022, the European Commission published a Proposal for a Directive of the European Parliament and of the Council harmonising certain aspects of insolvency law,[1] opening discussions on some of the potential changes into national laws, together with the remarks and positions towards the Proposal. 49 entities issued their positions within this legislative process, and now the European Commission analyses these documents, aiming to propose a Directive by the end of 2023.

In this paper, we aim to assess how much change is needed in selected European countries – Poland, Germany, Austria and France. We chose these countries to reflect different perspectives and also taking into account the size of economies therein as well as different approaches to regulating insolvency-related law. We hope also to give a potential inspiration for the European Commission upon preparing the final version of a Directive.

The Proposal covers, according to Article 1.1, the following areas:

1. avoidance actions;
2. the tracing of assets belonging to the insolvency estate;
3. pre-pack proceedings;
4. the duty of directors to submit a request for the opening of insolvency proceedings;
5. simplified winding-up proceedings for microenterprises;
6. creditors' committees; and
7. the drawing-up of a key information factsheet by Member States on certain elements of their national law on insolvency proceedings.

[1] Document Brussels, 7.12.2022, COM(2022) 702 final, 2022/0408 (COD), available at: <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12592-Insolvency-laws-increasing-convergence-of-national-laws-to-encourage-cross-border-investment_en> ("Proposal").

It is important to mention that, within the whole European Union, the level of coherence of the abovementioned issues is relatively low, thus the article may be useful for other Member States facing the need to assess required changes and amendments to the law.

2. Required changes to Polish law

With regard to the Polish insolvency and restructuring law landscape, it is worth mentioning that significant reform has been made in 2015 and 2016, upon introducing restructuring law,[2] in 2020, when simplified restructuring was introduced as a temporary anti-Covid-19 crisis,[3] as well as in 2021, when Poland introduced National Debtors Register.[4] Currently within legislative process, on the government stage, one can observe implementation of the Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, discharge of debt and disqualifications, measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt.[5] Therefore, a lot of recent developments into insolvency and restructuring law has taken place in Poland.

Regarding the Proposal, some key aspects will need to be addressed, namely avoidance actions, asset tracing, pre-pack proceedings and creditors' committees' regulations – while also new simplified winding-up proceedings for microenterprises. However, some important objections towards this issue have been submitted and published.[6] These objections concentrated on not including insolvency practitioners within the proceedings and placing a lot of tasks on courts – practically the burden (also administrative) of the carrying out of the proceedings. However, statistics show that the opposite direction (mainly out-of-court) is more effective.[7]

A good example of effective and efficient proceedings are the Polish simplified restructuring proceedings[8] and Polish consumer bankruptcy, carried out after the reform of 2020 in most of the cases by the insolvency practitioner, with little court involvement.

2.1. Avoidance actions

In Article 2.(q), the Proposal sets out quite a broad definition of "party closely related to the debtor", including legal persons with preferential access to non-public information on the affairs of the debtor. Such definition sets high standards of assessment, having in mind the very

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2 Act of 15 May 2015 – the Restructuring Law.

3 Act of 19 June 2020 on interest subsidies for bank loans granted to entrepreneurs affected by COVID-19 and on simplified proceedings for approval of an arrangement in connection with the occurrence of COVID-19, so called "Anti-crises shield 4.0".

4 Act of 6 December 2018 on National Debtors Register, in original: "Krajowy Rejestr Zadłużonych".

5 Next stages will be parliament and publication within the Journal of Laws.

6 See, inter alia, INSO Section of the Allerhand Institute statement on Proposal for a Directive Harmonizing certain aspects of insolvency law and Statement of the European insolvency practitioners' organisations (EIP) on the EU Commission's proposal for a directive on the harmonisation of certain aspects of insolvency law dated 07.12.2022 (COM (2022) 702 final), available at: <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12592-Insolvency-laws-increasing-convergence-of-national-laws-to-encourage-cross-border-investment/feedback_en?p_id=31731599>.

7 For more data, visit: <https://www.insol-europe.org/mailer/w/n2HouVcevCugavt892892V8NgA>; <https://www.insol-europe.org/technical-content/national-insolvency-statistics-poland>.

8 For more info, see Mateusz Kaliński, 'Polish Simplified Restructuring as a Basis for Implementation of the EU Directive 2019/1023 and a Model of Implementation', in INSOL Europe, *Restructuring and Insolvency Tools in Times of Crisis (INSOL Europe Yearbook 2022)* (INSOL Europe, 2022), 197–210.

broad spectrum of potential persons involved. The Proposal precises that, with regard to the natural persons, closely related parties include – but not limited to:

(i) the spouse or partner of the debtor;
(ii) ascendants, descendants and siblings of the debtor, or of the spouse or partner, and the spouses or partners of these persons;
(iii) persons living in the household of the debtor;
(iv) persons who are working for the debtor under a contract of employment with access to non-public information on the affairs of the debtor, or otherwise performing tasks through which they have access to non-public information on the affairs of the debtor, including advisers, accountants or notaries; and
(v) legal entities in which the debtor or one of the persons referred to in points (i) to (iv) of this subparagraph is a member of the administrative, management or supervisory bodies or performs duties which provide for access to non-public information on the affairs of the debtor.

What is even more important and common, regarding the debtor being a legal person, a party closely related will include:

(i) any member of the administrative, management or supervisory bodies of the debtor;
(ii) equity holders with a controlling interest in the debtor;
(iii) persons which perform functions similar to those performed by persons under point (i); and
(iv) persons which are closely related in accordance with the second subparagraph to the persons listed in points (i), (ii) and (iii) of this subparagraph.

Under Polish law, the definition is not so broad, thus some improvements will be required within that field as long as the Proposal will become finally a Directive. Regarding avoidance actions, the Proposal may cover the possibility of confirming the voidability of transaction in question by the bankruptcy court.

From a procedural point of view, according to Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast), it should be clearly stated that the competent court for avoidance actions is the bankruptcy court where the bankruptcy was declared initially. Currently this issue is not clear, although the Court of Justice of European Union issued some important rulings with this regard.

Avoidance actions are also related to the issue of declaring bankruptcy – namely within the context of a premise to declare bankruptcy as having enough assets to cover the costs of the bankruptcy proceedings. If there are potential ineffective (voidable) transactions, the costs requirement is treated in a smoother way and this should be also related to the general voidability of a transaction. If the transaction is ineffective by operation of bankruptcy law, then the court may decide not to dismiss the case on the grounds of ‘poverty of the bankruptcy estate’. If the transaction is held ineffective by a court of law (*actio pauliana*), then the possibility not to dismiss the case for this reason should also exist.

The debtor may sometimes perfect voidable transactions, but, analysing the law literally, the bankruptcy court may not be able to declare bankruptcy, because of the lack of funds to cover the costs of the proceedings. In this sense, it is important to effectively and efficiently recover

the funds for the costs, even if some transaction is generally voidable, not only within the realm of bankruptcy law. Within this context however, we are aware that the assessment of such actions and transactions can be a challenge, as it requires more consideration and further analysis. It also can be a good idea to suggest in such cases that the bankruptcy court requests from the creditors an advance payment towards the costs of the proceedings.

A clear and unambiguous declaration on the possibility to confirm avoidance by the bankruptcy court will also be appreciated. To improve efficiency of the proceedings related to avoidance actions, it is recommended to allow the bankruptcy court, which usually assesses the question whether a particular transaction is voidable *ex lege* or not, to confirm the avoidance of the transaction. This possibility could lead to lowering the efforts and costs of the interested parties, because the avoidance will be confirmed by the bankruptcy court, rather than other courts after the usually lengthy proceedings.

2.2. Pre-pack

In the section on pre-pack, the Proposal provides, among other things, for the appointment of a special, independent body (the so-called monitor) to evaluate the pre-pack procedure and the benefits to creditors. It is envisaged that this body may next be a bankruptcy trustee and at the same time a party to the pre-pack transaction concluded with the investor. In Poland, such a person could successfully be the Temporary Court Supervisor, who would then become the Trustee of the bankruptcy estate.

2.2.1. Test of best satisfaction of creditors

The proposal of the Directive also provides for introduction of a test of the best satisfaction of creditors, as a basis for evaluating the price proposed by the investor. This test is aimed at assessing potential satisfaction within pre-pack proceedings in comparison to traditional insolvency/bankruptcy proceedings.

Such a test was postulated in Directive 2019/1023, but it has not found its way into the Polish legal framework so far. Now, there is a chance it will become a golden standard, for example, in the practice of entities responsible for assessing the debtor's situation, so as to ensure the broadest and most reliable knowledge for creditors who are parties to bankruptcy proceedings.

This test is currently being widely discussed in the course of the Restructuring Directive's implementation in Poland. It seems that no far-reaching changes to Polish law will be required when the EU Restructuring Directive is implemented.

2.2.2. Possible auction

An auction, under the supervision of the court, would also be possible and permissible. In Poland, this possibility is also provided for in the legislation. The question, however, is about the efficiency of the whole procedure, which has not attracted wider attention in practice in pre-pack procedures. Since the auction has been functioning from 2020, there is no need to amend Polish pre-pack law provisions within that area.

2.2.3. The need for efficiency but also transparency in the procedure

The Proposal for the Directive emphasizes the efficiency of the procedure and mentions the need to ensure its transparency. These values must always be properly balanced, as must the often-conflicting interests of different categories of participants in the proceedings. An auction will definitely serve the transparency of the procedure, but as at all distressed deals where time and money are extremely important factors, it may affect the time limits.

2.2.4. Preserving value for creditors

It is expedient to emphasize that pre-pack significantly increases the preservation of the value of the debtor's enterprise from the point of view of its creditors. It is also of considerable importance from the point of view of preserving the enterprise itself, as well as jobs and the principle of a smooth transition between ownership entities.

An enterprise which is operating as a going concern is almost always a better option for everyone involved. Thus, pre-pack proceedings seem to be a win-win solution both for creditors and the debtor, as well as for employees, the investor and the judiciary, since the deal is agreed up-front, and the risks are also addressed. In Poland, this aspect works already very well as Polish law provides for execution (enforcement) sale effect, meaning that pre-pack subject is being sold free of past debts and liabilities.

2.2.5. Protection from enforcement

Interestingly, Article 23 of the Proposal explicitly provides for the suspension of enforcement proceedings within the pre-pack sale, including in the event of preliminary proceedings - in the pre-bankruptcy phase. In Poland this regulation has not been introduced so far. Thus, it will be extremely interesting to see whether Polish legislator will use this opportunity to do so. Poland already has a wide protection from enforcement upon commencing insolvency proceedings. Sometimes this protection facilitates negotiations of the pre-pack agreement and preserves the value of the pre-pack subject. Court bailiffs or other enforcement bodies are prevented from acting and disrupting the essence of the enterprise or adding time pressure or engaging debtor's other resources including human resources who, can thus focus on the deal or negotiations. All this can be achieved only thanks to the fact that protection from enforcement is assured.

2.2.6. Changes to contracts and pre-emptive rights

The Proposal provides for changes to contracts entered into by the debtor by allowing them to transfer to a new acquirer and even without the consent of the other party. Hence, it would also be desirable to clarify what happens to the right of first refusal in the case of a sale in a pre-pack liquidation proceedings.

In Poland, there is currently an ongoing academic and professional discussion on the possibility to continue cooperation based upon contracts related to an enterprise which constitutes the pre-pack's subject.[9] The Polish legislator will have soon the opportunity to clarify this important issue.

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[9] See, inter alia, Karol Tatara, Łukasz Trela and Mateusz Kaliński, 'Przeniesienie praw i obowiązków z umów związanych z prowadzeniem przedsiębiorstwa w związku z jego sprzedażą w trakcie postępowania upadłościowego, w szczególności w ramach przygotowanej likwidacji (pre-pack)' [The transfer of rights

2.3. Creditors' Committees

The Proposal places great emphasis on the efficiency and speed of the Creditors' Committees' proceedings. However, it provides that the committee's decisions, such as those approving certain actions, may be subject to judicial review (appeal). The Proposal does not say whether this suspends the enforceability of the challenged action, but it explicitly mentions that the appeal procedure should be effective. Additionally, the issue of who would be entitled to file an appeal should be regulated as it may be all the more important from the point of view of the efficiency of the entire system, given the need to preserve access to legal remedies.

The Proposal also provides for the reimbursement of expenses and even remuneration for the creditors' committee members. While the reimbursement of expenses does not raise major questions, excessive operating costs do. The remuneration for the performance of the function on the committee may be the basis for assessing whether the appointment of the Creditors' Committees in a particular proceeding is not advisable – which is already signalled by the Proposal itself.

Polish law provisions seem to comply with the Proposal requirements, and, in fact, in Poland Creditors' Committees are quite popular (unlike in Germany for instance). this may inspire for European lawmakers or other Member States. when they implement the new Directive into their national legal systems in the future.

3. Required changes to Austrian law

3.1. Scope of required amendment to Austrian law

In general, within the Austrian legal framework, not too many changes will be required, as also this jurisdiction has solid bases with regard to restructuring and insolvency. This Proposal for a directive sees insolvency as the central reason for the insolvency of micro-enterprises. However, the legal definition of insolvency is left to the individual Member States, which in turn entails the risk of different definitions. The consequence would be different requirements for the existence of insolvency maturity. An aspect that would speak against the original idea of harmonisation. In addition, there is the fear that at the European level, more often than in Austria, there would be no proper operational records to recognise insolvency.

In Austria, it very often takes an expert to clarify the question of insolvency. This is also because experience has shown that the smallest entrepreneur with incomplete business records is often not in a position to recognise his own insolvency. This would also make it difficult to include realisable assets in the insolvency quota.

According to part of the opinions the goal of improving liquidation proceedings of micro-enterprises (increasing the efficiency of insolvency proceedings; shortening the duration of proceedings; reducing the costs of liquidation) cannot be achieved with the help of this directive.

Many measures would be to the detriment of creditors. Moreover, the courts do not have sufficient resources to take on additional tasks. The consequences would be a significant

and obligations from contracts related to carrying on business with regard to sale within bankruptcy/insolvency proceedings, including pre-pack] *Doradca Restrukturyzacyjny* No. 6 [4/2016].

prolongation of all proceedings, which would also unnecessarily burden the cost factor. Also, many a reorganisation would be brought to failure in the first place.

3.2. Creditors' Rights Protection Associations as an institution to protect the rights of creditors in insolvency proceedings

The institution of Creditors' Rights Protection Associations has existed and functioned for many years in Austrian law.[10] The main purpose of these associations (*bevorrechtete Gläubigerschutzverbände*) is to protect creditors in insolvency proceedings. They take an active part in them, acting especially on behalf of small and medium-sized creditors. In particular, by filing bankruptcy petitions, filing complaints, filing claims, refusing to recognise filed claims and conducting examination proceedings. Creditors grant a power of attorney to the association,[11] which represents them both at the creditors' meeting and at the creditors' council.

For the represented creditors, this represents a significant cost saving (compared to representation by lawyers and solicitors). The privilege is an exception to the general monopoly of attorneys (advocates) in the representation of creditors in insolvency proceedings. The citation of the power of attorney granted is replaced by an acknowledgement in the form of a document, in the same way as in the case of representation by a lawyer or notary public. Creditor protection associations furthermore represent the interests of creditors as a whole in bankruptcy proceedings: they support - without being bankruptcy authorities - the court, participate in the determination and preservation of the bankruptcy estate, in the preparation of the resolution plan and the payment schedule.

In addition to the insolvency proceedings, they support their members by assisting with composition negotiations and by providing them with information on the solvency and payment morality of their business partners.

The establishment of a creditors' rights protection association requires a decision by the Minister of Justice. There are currently four such associations in Austria:

i. Kreditschutzverband von 1870 [Credit Protection Association of 1870] in Vienna (KSV);[12]
ii. Alpenländischer Kreditorenverband Graz [Alpine Association of Creditors Graz] (AKV), founded in 1924;[13]
iii. Insolvenzschutzverband für Arbeitnehmer [Insolvency Protection Association for Employees] (ISA), founded in 1998;[14] and
iv. Österreichischer Verband der Vereine Creditreform [Austrian Association of Credit-reform Associations] (ÖVC), founded in 2006.[15]

By decision of the Minister of Justice, these associations have a privileged character, i.e. they are granted a special status in insolvency proceedings. The Minister is obliged to issue a decree declaring an association to be privileged pursuant to § 266 KO if such an association is trustworthy, is able to effectively carry out creditor rights protection activities throughout

[10] See Art. 11, Austrian Insolvency Law (Introduction).
[11] Art. 253 (3).
[12] BGBl (Federal Official Journal) 1925/93.
[13] BGBl 1926/291.
[14] BGBl II 1998/323.
[15] BGBl II 2006/442.

Austria and is not profit-oriented.[16] Creditors' rights protection associations are not insolvency bodies in the strict sense. They are a separate institution from the recognised consumer insolvency counsels (Schuldenbaratungsstellen).[17] Private creditors' rights associations can of course apply to participate in the proceedings, but they have a status like other attorneys. They do not receive any remuneration from the bankruptcy estate. In contrast, privileged creditor protection associations are entitled to claim remuneration from the bankruptcy estate for their supportive activities.

The standard remuneration for all participating associations combined is:[18]

i. 10% of the net remuneration awarded to the trustee, in liquidation proceedings;
ii. 15% of the net remuneration awarded to the trustee, in the event of the adoption of a resolution plan.

The court may raise or lower the standard remuneration. The claim for remuneration constitutes a claim of the bankruptcy estate.[19] The remuneration will generally be divided among the privileged creditor protection associations as follows:

i. 30% equally;
ii. 70% in proportion to the number of creditors represented.

The participation of the associations increases the efficiency of the proceedings. The court is not obliged to inform these creditors. There is also notification of claims through the association. Consequently, this reduces not only the costs for the creditors but also the costs of the entire procedure in general. In addition, it has the effect of speeding it up. It is easier to carry out various actions with the participation of a few representatives of associations than with dozens or even hundreds of creditors. The bill introducing the institution of creditors' ombudsmen has not fully passed through the legislative procedure, but it cannot be ruled out that this topic will return in the future.

It is worth mentioning that under Polish law, the legislator in the past attempted to introduce an institution along the lines of Austrian associations for the protection of creditors' rights. There were legislative plans to introduce the institution of a creditors' ombudsman who would guard the interests of creditors in bankruptcy proceedings.

In the past, there has also been a call for the creation of creditors' rights protection associations on the Austrian model. The group of experts,[20] which prepared the introduction in Polish legal system the restructuring law and amendment of insolvency law postulated establishing similar association based on the Austrian model referring to the considerable effectiveness of these proceedings in the Republic of Austria. The self-establishment of an association for the protection of creditors' rights would require a decision by the Minister of Justice.

The initiators of the proposal point out that through the active participation of creditors' rights protection associations in insolvency proceedings, the interests of creditors would be duly

[16] Art. 266, Austrian Insolvency Law, BGBL 2010/29.

[17] Art. 183, Austrian Insolvency Law, BGBl 2010/29.

[18] Art. 87a (1) sentence 2, Austrian Insolvency Law.

[19] Art. 46(1), Austrian Insolvency Law.

[20] Paweł Kuglarz was a member of the group of experts appointed by the Minster of Justice in 2012. The new insolvency law and restructuring law came into force on 1 January 2016.

protected, which would be an effective measure against the phenomenon of creditors' passivity in ongoing proceedings. It would also allow active participation in insolvency proceedings, for creditors who would otherwise not have enough money for participation in an insolvency process. The bill introducing the institution of creditors' ombudsmen has not fully passed through the legislative procedure, but it cannot be ruled out that this topic will return in the future.

Acting on the basis of a power of attorney granted by a creditor, associations would be able to file claims and participate in the proceedings related to the establishment of the list of claims. This would also contribute to a higher level of information to creditors about the proceedings and thus reduce the number of complaints, as reliable and expert information would be provided by the professionals sitting in the associations. The association's representatives would not only exercise real supervision over the actions of the insolvency practitioner, but also, due to their professional background in insolvency proceedings, provide real and useful assistance to creditors, bearing in mind the common interest of all creditors.

Certainly, the establishment of an institution to protect the rights of creditors in insolvency proceedings in the future would be essential to streamline and accelerate insolvency proceedings. In Austria, where associations for the protection of creditors' rights are in place, it is estimated that, thanks to this institution, attendance at creditors' meetings in insolvency proceedings is between 75 and 90 per cent.

4. Required changes to German law

4.1. Avoidance actions

In our opinion, German law provisions on avoidance actions, and especially *actio pauliana*, quite well reflect the ideas and issues laid down in the Proposal.

First of all, the so called *Anfechtungsrecht* will not need practically any reform, as it was in the first place the German regulation that inspired the European Commission, for instance with regard to the scope of regulation, as well as its particular provisions. When it comes to the deadlines, in Germany currently the limitation period for the commencement of avoidance actions proceedings is set at 4 years, while in the Proposal, this period is only 1 year, thus with this regard, it obviously favours creditors and insolvency office holders (trustees).

4.2. Pre-pack

Within the German legal framework, pre-pack proceedings have not been regulated yet, but there is a solution called *ubertragene Sanierung* which is similar in effect. However, this solution has one important pitfall as it does not allow for the possibility to transfer rights and obligations from contracts, as stipulated in the Proposal. Therefore, the amendments seem necessary in this regard.

Also, the German legal framework contains legal provisions on the transfer of an undertaking, in Article 313 of the BGB,[21] but this provision is quite general and requires further clarification.

[21] Bürgerliches Gesetzbuch (German Civil Code).

4.3. Duties of directors

Under German law, the directors are required to file for insolvency when the state of insolvency arises. This regulation is quite strict and more precise than the one proposed by the European Commission, and thus no substantial amendments are planned. However, the Proposal may be an impulse to amend it and modernize it by incorporating numerous judicial decisions and opinions presented within the German jurisprudence.

4.4. Special regime for micro-enterprises

German law does not provide for special regime for micro-enterprises, thus in this context, the new rules should be carefully analysed and proposed to be implemented. As far-reaching changes with this regard are predicted, many of German associations and even individual natural persons submitted their positions and statements towards the Proposal, in the context of special regime being very critical and sceptical.[22]

4.5. Creditors' Committees

In Germany, regulation concerning creditors' committees has long tradition and is very similar to the Proposal. In some areas the German provisions go even further, providing for incentives such as remuneration for taking part and active participation within the committees' meetings.

However, from a practical perspective, unfortunately not many creditors are interested in active participation. Therefore, some changes introduced taking the opportunity of the need to implement the Proposal, may be an occasion to facilitate the participance in the creditors' committees, which may be beneficial for all stakeholders.

Some examples may be outlined from Polish practice, where there is currently no remuneration for taking part in the work of creditors' committees, yet active participance is quite popular among creditors, way more than in Germany.

4.6. Some inspirations for other Member States, as well as the Commission

4.6.1. Schuldnerberatung

The term 'debt counselling' is not protected by law in Germany, nor is there a minimum qualification or regulated training for debt counsellors. The frequently used term "state recognition" refers exclusively to the right to issue a certificate confirming the ineffectiveness of an ordered out-of-court settlement attempt in consumer insolvency proceedings, for which see InsO-§ 305(1) no. 1:

> "The Länder may determine which persons or bodies are to be deemed suitable under the Insolvency Act."

The criteria on the basis of which the Land authorities grant this recognition are not uniform throughout Germany. Also, recognition by the state is not evidence of the quality of the advice provided by the authority. This applies both to reputable, state-recognised private institutions

[22] For more positions and statements see: <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12592-Insolvency-laws-increasing-convergence-of-national-laws-to-encourage-cross-border-investment/feedback_en?p_id=31731599>.

and to bodies that operate under the auspices of local authorities or recognised social organisations. Sponsors of free, not-for-profit debt advice include welfare associations, consumer centres and local authorities. Funding for charitable debt counselling is not uniform across Germany and comes from a variety of sources. There are also commercial debt counselling providers who charge for their services. Debt counselling in state and non-profit institutions is usually free of charge.. Non-profit debt counselling services are aimed at anyone who is over-indebted or at risk of over-indebtedness. In most cases, those seeking counselling are in a difficult financial and personal situation from which they are no longer able to free themselves. Often these people also need further psycho-social support.

The Arbeitsgemeinschaft Schuldnerberatung der Verbände (AG SBV) represents the interests of over-indebted people in Germany and debt counselling associations. DieBAG-SB BundesarbeitsgemeinschftSchuldnerberatung e.V. is an association of debt counselling centres and counsellors from all over Germany. In addition to information for debt counselling professionals, a calendar of events with further education and training at state and federal level and a labour market specifically tailored to the needs of debt counselling professionals, they present news media and publication series. Their cooperation partners perfectly complement the range of services offered - debt counselling software and professional literature. On the association's website we can read about the principles of successful counselling.

5. Required changes to French law

French insolvency and restructuring law is currently regulated within local legal framework, providing for several proceedings and restructuring options.

5.1. Avoidance actions

A harmonised minimum level of creditors protection throughout the EU is of the greatest importance as regard to the voidness, voidability or unenforceability of legal acts that would be detrimental to the general body of creditors. However, the ways of implementation observed give rise to considerable concern, in particular for "microenterprises".

First of all, the starting point of the suspect period in the proposal is not the date of the debtor's cessation of payments (defined as the date on which the debtor is no longer able to pay his/her debts as they mature), as is in France, but the date of the request for the opening of insolvency proceedings (Articles 6 and 8). This significantly reduces the protection of creditors and risks narrowing the scope of voidness of certain legal acts.

The suspect period is different according to the type of legal act in the proposal for a Directive, which is not the case in France, where the suspect period relates to the period between the date of cessation of payments and the decision opening the insolvency proceedings. The date of cessation of payments can be up to 18 months prior to the decision opening the insolvency proceedings (subject to the specific protection linked to the existence of a decision approving a confidential "conciliation" agreement, as such decision rules that the company is not, at the date of the decision, in cessation of payments). In the proposal, it is questionable whether the variations of the suspect period according to the type of legal act are relevant.

In the simplified winding-up proceedings for insolvent "microenterprises" (Title VI), if an insolvency practitioner is not appointed, the creditors would have to bring the avoidance actions themselves, which is impossible in practice. In small cases, creditors do not have access to the

required information and documents to suspect the existence of legal acts that would be detrimental to the general body of creditors. This means that Title II on avoidance actions would be ineffective in the case of simplified winding-up proceedings for "microenterprises" without the appointment of an insolvency practitioner.(see below).

The Directive does not prevent Member States from adopting or maintaining provisions on avoidance actions where they provide a greater protection of the general body of creditors than those provided for in the Directive (Article 5), which is appropriate.

5.2. Tracing assets belonging to the insolvency estate

This area of harmonisation is most welcomed as it would improve the information available to the insolvency professional on assets belonging to the insolvency estate in all EU countries. It would also help them to carry out their obligations regarding fight against money laundering and terrorism financing, as insolvency practitioners in France are subject to obligations of diligence and declaring suspicions in this field.

It is most welcomed that only the insolvency practitioner appointed in ongoing insolvency proceedings can request that the courts duly designated by each Member State have the power to access and search, directly and immediately, bank account information in other Member States available through the bank account registers (Article 14).

Insolvency practitioners are also given timely access to any information in the beneficial ownership registers for identifying and tracing assets belonging to the debtor's insolvency estate (Article 17), which is positive. The provisions on asset tracing strengthen the power of the insolvency practitioner, which is positive.

However, insolvency practitioners should have the power to access and search, directly and immediately, bank accounts information in other Member States, without having to request the courts to access and search such information in order to avoid lengthening proceedings and increasing costs, and to enhance the efficiency of the insolvency practitioner's task, as this access is necessary for the proper performance of his/her task (see below).

In any case, without the appointment of an insolvency practitioner in simplified winding-up procedures for microenterprises (Title VI), Title III of the proposal would be useless in practice.

5.3. Pre-pack proceedings

This proposal is most welcomed as it mainly corresponds to the "pré-pack cession" as it already exists in French law. However, it appears that the Directive seems to limit the pre-pack to liquidation procedures (Article 19). However, the "liquidation phase" referred to in Article 19(1) shall be considered to be insolvency proceedings as defined in Article 2(4) of Regulation (EU) 2015/848 on insolvency proceedings, i.e. all proceedings listed in Annex A. The terminology used in Title IV does not seem appropriate.

In France, the pre-pack is prepared during the "conciliation" procedure in practice (confidential procedure) and implemented during the reorganisation procedure (insolvency procedure during which the business continues) and it is only after the sale of the debtor's business that this 34 procedure is converted into a liquidation procedure, for the sale of the residual assets, dismissal

of the employees who are not transferred and distribution of the assets among the creditors. This sequence should be preserved.

Another difficulty arises as regards the role of the "monitor" (the conciliator in French law). The proposal states in recital 24:

> "The pre-pack proceedings should ensure that the monitor appointed in the preparation phase might propose the best bid obtained during the sale process for authorisation by the court only if it declares that, in its view, piecemeal liquidation would not recover manifestly more value for creditors."

In France, the decision not to relaunch the call for bids after the opening of the insolvency proceedings is based on the court after the opinion of the Public Prosecutor. The conciliator therefore only reports on whether formal requirements have been met and whether they are satisfactory.

Recital 24 may lead to confusion, which would result in the liability of the monitor to declare the validity of the bid received prior to the opening of the insolvency proceedings by comparison with the liquidation value. However, this liquidation value is intended to be known, in particular with the auctioneer's inventory, after the opening of the collective proceedings. This would require the conciliator to draw up a valuation of the company's assets prior to the opening of the insolvency proceedings to avoid his/her liability, making the pre-pack process more cumbersome.

Moreover, the simple comparison of the price offered in relation to the liquidation value leads to the use of only one criterion of analysis being the payment of creditors. However, the objective of the proceedings is broader and cannot exclude the rescue of viable businesses and the jobs they provide.

Finally, the proposal is contradictory as it establishes the insolvency practitioner as the key player in the pre-pack proceedings, whereas it considers the insolvency practitioner to be useless in dealing with the winding-up of microenterprises, which may also lead to sales of their business after the opening of insolvency proceedings.

5.4. Directors' duty to request the opening of insolvency proceedings and civil liability

Directors should be under a duty to file in a timely manner for opening insolvency proceedings as they are indeed typically among the first to realise whether a company is approaching or has passed the brink of insolvency. However, it is very unfortunate that the proposal does not contain a harmonised definition of insolvency, even though recital 37 contains elements of such a definition (cessation of payments and balance sheet tests). The proposal sets a limitation period for directors to fulfil this duty which makes them liable. As the provisions of this title are minimum harmonisation rules, Member States are free to maintain or introduce stricter duties for directors of companies close to insolvency. The harmonisation of the limitation period to request the opening of insolvency proceedings by 3 months would have no impact in French law which is 45 days from the cessation of payments). The lack of a harmonised definition of insolvency will have a significant impact on creditors' understanding of this obligation.

However, Recital 37 states that the balance sheet test may be unfeasible for microenterprises debtors, particularly where the debtor is an individual entrepreneur, because of a possible lack

of proper record and of a clear distinction between personal assets and liabilities and business assets and liabilities. Therefore, the inability to pay debts as they mature should be the criterion for the opening of simplified winding-up proceedings. The text could go a step further and provide that the criterion of cessation of payments is retained as the clear and harmonised definition of insolvency!

5.5. Simplified winding-up proceedings for microenterprises

The objective of Title VI is to ensure that microenterprises, even those with no assets, are wound up in an orderly manner, using a swift and cost-effective proceeding. As a rule, an insolvency practitioner will only be appointed if:

> "(a) the debtor, a creditor or a group of creditors requests such an appointment; and
> (b) the costs of the intervention of the insolvency practitioner can be funded by the insolvency estate or by the party that requested the appointment."

In practice, the insolvency practitioner will never be appointed: under the guise of lowering the costs, this proposal would in fact create a lawless regime for most liquidations in France.

This proposal is all the more dangerous, as it is far from being limited to microenterprises as they are usually understood: in fact, this proposal concerns the microenterprises as defined by Article 2 of the Annex to the Commission Recommendation of 6 May 2003 (2003/361/EC), i.e. enterprises with employ fewer than 10 persons and whose annual turnover and/or annual balance sheet total does not exceed EUR 2 million. These enterprises, thus defined, represent 93% of all collective proceedings opened in France in 2022. The lack of appointment of an insolvency practitioner in simplified winding-up proceedings for microenterprises is a serious problem as this type of debtor (individual entrepreneur) may, in many cases, be unable to keep proper record, to recognise its insolvency or to identify the list of its creditors, as the proposal itself recognises in Recital 37.

First, without the intervention of an insolvency practitioner, employees would be left to their fate, with no possibility of activating the national wage guarantee institution for outstanding employment claims operating since 1974, and with no guarantee of having their rights asserted and the documents they will need to assert their rights, in particular for unemployment insurance. Obviously, this task cannot be carried out by the debtor, due to the conflict of interest in which he/she would find himself/herself, and therefore the risk of fraud: an insurance company, whether public or private, will never accept that the debtor initiates the implementation of this mechanism. This task can only be carried out by an independent and qualified insolvency practitioner who can act as a trusted third party.

Second, without an insolvency practitioner, there would be no control over the flows prior to the opening of the insolvency proceedings, over possible fraud or mismanagement, over the use of state aids, and no sanctions could be imposed to punish wrongful behaviours. This would be a huge invitation to fraud, in particular observed with regard to social aids, concealed employment, VAT fraud and so on.

Third, the creditors would be obviously the losers, as the assets would not be effectively recovered, and the liabilities would not be established The intervention of an independent insolvency practitioner able to represent the creditors' rights is lost, without reducing the overall costs.

Fourth, in the absence of the appointment of an insolvency practitioner, the courts will not be in a position to supervise microenterprises. Indeed, the role assigned to the court, or the competent authority, would become important in the absence of an appointed insolvency practitioner as the court or the competent authority would have to ascertain the final list of the company's creditors and the amount of assets that establishes the insolvency estate of the microenterprise.

Fifth, who will investigate whether the liquidation estate has not been subject to wrongful manipulations or removals by the debtor? Title II of the proposal aims to harmonise avoidance actions but as there is no insolvency practitioner appointed in 90% of the cases, who will implement these provisions? All the measures provided for in Title II of this proposal would be useless in practice due to Title VI. There is an internal contradiction in this proposal that needs to be solved.

Sixth, allowing simplified winding-up proceedings for microenterprises without the appointment of an insolvency practitioner is inconsistent with the objective, stated in the same text, of strengthening tracing assets belonging to the insolvency estate (Title III), since only an insolvency practitioner can request the courts to access bank account registers or access registers relating to the debtor's assets.

Seventh, French insolvency practitioners also have environmental duties: who will organise, plan and ensure the effective cleaning of polluted sites in the absence of an appointed insolvency practitioner?

Eighth, French insolvency professionals are subject to duties relating to the fight against money laundering and terrorist financing. Who is going to ensure that the rules on prevention and detection of money laundering and terrorist financing will be properly implemented in these cases, which once again represent more than 90% of the cases? In practice, it is impossible to entrust such delicate task to the debtor who has failed and who may be liable for questionable or even fraudulent behaviour.

Ninth, France has a system to finance the intervention of an insolvency professional through the "Fonds de dédommagement des dossiers impécunieux" (FFDI), which pays a fixed amount of €1,500 to the insolvency practitioner appointed by the court to carry out all the necessary work in impecunious cases. This system does not cost a cent either to companies, creditors or the taxpayer, as it is financed by a share of the interests generated by the solidarity guarantee fund held by the insolvency practitioners in their accounts at the "Caisse des dépôts et consignations".

Finally, this Title VI also contains an Article 50 on the "electronic auction systems for the sale of the assets of the debtor" in which while individual assets may be advertised and publicised through an electronic platform, a company's business may not be auctioned.

The process of selling the activity of a company, even partially, remains particularly regulated. It is not reasonable to consider transferring employment contracts in an auction process, without considering the social conditions of the takeover, future working conditions and investment projects, and besides, without even consulting the employees or their representatives beforehand. Socially and politically, such proceedings would be very difficult for the insolvency practitioners to accept. Economically, such proceedings would be inefficient, since it would not

take into account the relevance of the takeover project presented by the candidates, and in particular the investments to be made in order to modernise the often-ageing tools.

Legally, such proceedings would conflict with several fundamental principles. Firstly, it would disregard the multiple objectives of the Law: it is not only a question of paying a maximum of liabilities, but also, and above all, of ensuring the rescue of viable companies and the jobs they provide. In France, any procedure for the sale of a company involves a process of information and consultation of the institutions representing the employees, subject to penal sanctions.

The complexity of a sale of a branch of activity or business of the debtor requires a more complex process than a simple auction to secure the converging interests of the vendor and buyer. While the platform set up will obviously be a guarantee of exceptional publicity, it must not, however, allow the sale of the business itself with its contracts, employees, securities, preferences, administrative authorisations and ongoing procedures. Any possibility of electronic auctioning of a company's "business" should be removed. Moreover, in France, amicable or private sales allow to maximise the sale's cost and avoid auction fees, which are often very high (in France, for example, auctions fees are circa 30%), thus reducing the costs of proceedings, accelerating their course and benefiting to creditors.

While electronic auction platforms will allow for wide publicity of assets, it should be ensured that the insolvency practitioner will decide on the form of sale required in the exclusive interest of the creditors. Auctions should be excluded for autonomous branches of activity and should only remain a possibility for sale of assets due to their cost.

5.6. Creditors' committees

The proposal introduces a "creditors' committee" for insolvency proceedings which seems to correspond to the system of "supervisors" in France. However, the system of the proposal appears to be far too cumbersome, potentially very costly and carries the risk of increasing the complexity of the procedure, which would be detrimental to its efficient handling.

In France, it is primarily the insolvency practitioner who represents the collective interest of creditors and he/she is appointed in all insolvency proceedings. In France, the court has the exclusive right to appoint the supervisors, as the creditors lost this right more than a century ago. This exclusivity is necessary to ensure the serenity and impartiality of the process. The supervisory insolvency judge appoints one to five supervisors amongst the creditors who so request and ensures that at least one of them is chosen amongst the secured creditors and that another is chosen amongst the unsecured creditors. Moreover, the supervisors are bound by confidentiality and their functions are free of charge. The supervisor is only liable in case of gross negligence.

6. Summing up

To sum up, we would like to stress that within EU Member States can benefit from each other with regard to legislative and concrete provisions relating to restructuring and insolvency. Examples from Poland, Austria, Germany and France can give an outlook on possible implementation and required changes to these countries, with regard to EC Harmonization Proposal, which can be a subject for in-depth analysis and interesting field of study, both from academic and practical point of view, as well as not only legal perspective, but also managerial and economic.

Chapter 4

The Potential Impact of Projected Harmonisation of Avoidance Rules on Financial Creditors

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1. Introduction

On 7 December 2022, the European Commission published a proposal for a Directive harmonising certain aspects of Insolvency Law ('Directive').[1] One of the Directive's aims is to establish the baseline for avoidance rules throughout the Member States by introducing a basic level of protection of the creditors against a debtor's actions detrimental to the general body of creditors.

Since Member States' legislatures will implement the Directive, it is crucial to ensure that the avoidance rules will not cause unintended effects. Please note that this text should be considered an invitation to dialogue with all stakeholders to ensure the best possible implementation of the ideas and reflection on the new Directive's effects.

After an initial analysis of the project, I realised that implementing the Directive can impact the situation of the lenders in Europe, and it would be interesting to hypothesise what the potential impact of new regulations could be, especially regarding the avoidance of payments. In my opinion, the wording of rules transpiring from the Directive can cause uncertainty for financial creditors regarding the avoidability of payments, which the lawmakers may not intend since the implementation aims to strengthen the freedom of capital movement.

2. Current avoidance rules in Poland from a lender's perspective

Currently, lenders in Poland must consider a few issues that need to be addressed to mitigate the potential risk of avoidance caused by the opening of bankruptcy proceedings against the borrower. There are three areas in which financial creditors must be aware of that a risk of avoidance applies:

- The timing of establishing collateral for financing;
- Repayment of the credit before due date; or
- Collateral provided by a non-borrower.

The current Polish legal provision governing the avoidance of premature debt payment or providing collateral to a non-due debt is Article 127.3 of the Polish bankruptcy law ('PBL'). It reads as follows:

> "Also without effect shall be the collateralisation and the payment of a not-due debt, given or made by the bankrupt within six months before filing the bankruptcy petition.

[1] 2022/0408 (COD).

> However, by bringing an action or by defending, one who received the payment or the security may request that such acts be considered effective, provided that at the time of act performance, the recipient did not know there were grounds for declaring bankruptcy of a debtor."

Under this legal provision, the repayment and/or collateralisation, performed within a suspect period, of any existing claim before it becomes due is ineffective towards the bankruptcy estate.[2] The suspect period is six months before filing for the borrower's bankruptcy proceedings. The suspect period extends to the time after such filing and before the opening of the bankruptcy proceedings. The avoidance effect under article 127.3 PBL is triggered automatically, i.e., solely by opening the bankruptcy proceedings, and no additional court decision is needed.

The effect of avoidance is the obligation of the beneficiary to return to the bankruptcy estate prematurely received amount. This means the trustee can request before the bankruptcy court to order the beneficiary return of repaid amounts, proving that the debt repayment was before the due date.

In such court proceedings, the repaid creditor can defend before the court by proving that he or she was unaware of the debtor's inability to pay due debts or his over indebtedness. The court decides whether the payment beneficiary is effective or not.

When the collateral is deemed voidable under the legal provision in question, the collateral is ignored in bankruptcy proceedings, especially when dividing the proceeds from sale of the asset encumbered with challenged collateral between the creditors. If the creditor in question intends to defend the collateral, he or she must start an action against bankruptcy estate before the bankruptcy court and prove his or her unawareness of the debtor's inability to pay due debts or his/her over indebtedness.

Given the fact the financial creditors receive and/or have access to financial information on the debtor, the financial creditors are rarely successful in arguing that they were not (or ought not to have been) aware that the debtor was insolvent at the relevant time. In practice, the payment received by a financial creditor before the due date is subject to avoidance under article 127.3 PBL, and the received sum must be returned to the bankruptcy estate. If the payment was made after due date it generally is irreversible based on current Polish avoidance regulations.

2.1. Collateral on borrower's assets

In order to be compliant with article 127.3 PBL avoidance rules, the collateral must be established no later than the signing of agreements providing financing (or at least before giving the credited amount at the borrower's disposal). If the collateral is established after the loan disbursement such collateral can be contested if it has been established within the 6-month suspect period.

[2] Polish Bankruptcy Law avoidance regulations do not sanction the debtor's detrimental acts with voidness. The regulation deprives the debtor's detrimental legal acts of any legal effect within the insolvency proceedings. For example, an ineffective mortgage does not give a secured creditor any priority. Any beneficiary of the ineffective asset transfer must return the asset in nature or cash. If bankruptcy proceedings are discontinued, the challenged legal acts are effective between the contractual parties.

In the Polish Supreme Court jurisprudence, there is a stable line of court decisions stating that in the case of bankruptcy, the collaterals established at the same time as a financing agreement cannot be declared void.[3] On the other hand, providing collateral for existing but non-due receivables will be subject to avoidance based on the discussed article 127.3 PBL.[4]

The main reason for such an interpretation by the Supreme Court was as follows:

> "Suppose a lender decides to finance a company with financial problems. In that case, the lender must be able to adjust the collateral securing financing not only to the amount lent but also to a higher risk of default. Such a lender cannot be sanctioned by avoidance to the same extent as a lender who credited the debtor and demanded additional collateral in the case of debtor insolvency. Interpretation of article 127.3 PBL, which would lead to avoidance of the collaterals provided simultaneously with entering into the loan agreement, cannot be made based on a literal wording of the article and will effectively deprive the companies in financial distress of financing."[5]

2.2. Collateral on non- borrower's asset

The lender receiving collateral on a third party's (non-borrower) asset must consider that under article 130.1 PBL, in the case of opening a bankruptcy proceeding of such non-borrower, such collateral can be subject to avoidance rules within a one-year suspect period. Under article 130.1 PBL, establishing collateral on an asset can be declared ineffective if the bankrupt was not a debtor or a guarantor of the debt in question and has received no or disproportionally insufficient fee for establishing the collateral in question. The collateral can be challenged if established within a one-year suspect period.

When the bankrupt collateral provider is affiliated with a borrower, the collateral can be challenged despite the fee payment if established within a one-year suspect period. If the conditions are met, the bankruptcy trustee can start an avoidance action before the judge–commissioner overseeing the particular bankruptcy proceedings.

The collateralised creditor can defend by proving that the collateral provider received a fair fee for providing collateral. This defence is not available when the bankrupt collateral provider is an affiliate of a borrower. In such cases, it is possible to defend challenged collateral on the grounds that it is not detrimental to the general body of creditors of the bankruptcy collateral provider. Proving that the collateral does not harm other creditors is very hard. If the avoidance action is successful, the challenged collateral does not give the creditor the right to proceeds from the sale of an asset-bearing collateral.

3. Harmonisation proposal - avoidance of the creditor preferences

The Directive consists of the avoidance provisions in Articles 4 to 12. Article 6 of the Directive states the grounds for avoidance action of the debtors' legal acts benefitting a creditor or a group of creditors by:

- satisfaction of the creditor(s)' claim;
- collateralization of the creditor(s)' claim; or

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[3] Supreme Court Decision from 9 October 2009, case no IV CSK 169/09.
[4] Supreme Court Decision from 9 October 2009, case no IV CSK 155/09.
[5] Supreme Court Decision from 9 October 2009, case no IV CSK 169/09.

- other means of preference.

The provision does not require the debtor to act with the intent to harm the general body of creditors. Avoidance may affect the debtor's payments of both due as well as non-due debts.

The access to challenge the repayments of due debts will be a dramatic change to the Polish model of avoidance actions since only non-due debts repayment can be challenged as discussed above. The Directive's Article 6 is limited to legal actions concluded by the debtor within a **3 month suspect period** before filing a motion to open the insolvency proceedings or time after submitting the motion.[6]

When the debtor satisfies a due debt or collateralises debt in the owed manner, such acts can be declared void by proving the creditor's awareness of the debtor's liquidity insolvency. It must be proved that the repaid creditor knew or at least should have known that the debtor could not pay its mature debts or that the motion for insolvency proceedings was submitted.

In my opinion, it seems it will often be easy to furnish such proof concerning the financial creditors who are obliged under European and national law to monitor the situation of their borrowers.[7]

The Directive establishes a presumption that any closely related creditor knows the debtor's financial situation. Also, the Directive introduces exemptions from avoidance rules. Based on Article 6, the netting regulations established in Directive 98/26/EC and financial collaterals from Directive 2002/47/EC are excluded from being subject to avoidance rules. Also, interim financing and new financing as defined in the Directive 2019/1023 are exempted from the avoidance rules' scope.

The avoidance on the grounds of Article 6 of the Directive would also not be possible if the debtor's legal act:

> "was performed against a fair consideration to the benefit of the insolvency estate" (article 6.3. (a) of the Directive).

This means that the repayments of both due and non-due debts will not be subject to avoidance actions if repayment will be connected with creditor's performance meeting the requirements in the Directive. From the creditor's point of view, this rule is critical. The practical interpretation of this exemption will be extremely important in the practice of avoidance cases and must be carefully implemented in members' state legislation.

In my understanding of the proposed rules, the creditor benefitting from repayment of due debt who at least should have been aware of the debtor's liquidity insolvency can effectively defend the receiving the payment only by claiming that a fair consideration to the benefit of the debtor's insolvency estate was performed. As stated above, financial creditors must monitor their debtors' financial status.

[6] As stated in Article 5, the Directive does not prevent Member States from establishing prolonged suspect periods to provide greater protection for the general body of creditors.

[7] For example, under Regulation (EU) 2019/876 of 20 May 2019.

I imagine this exemption will be a “last line of defence” of satisfied creditors in most cases where the trustee will try to claw back the repayments performed within the hardening period. For these reasons, this rule needs to be carefully reflected upon.

The sole concept of the fairness of consideration gives an idea of reciprocity between parties and can be interpreted with the help of Member State jurisprudence regarding contract law. I believe this part will not cause problems regarding the implementation and further practice. However, interpreting a concept of the “benefit of the insolvency estate” can create problems regarding implementation and may create inconsistency in practice.

I believe this creates the following questions for Member States to consider when implementing the Directive.

- Should the benefit to the insolvency estate occur after the opening of the bankruptcy proceedings?

The insolvency estate is established upon the opening of the insolvency proceedings. The timing of the establishment of the insolvency estate can impact the interpretation of article 6.3.(a) of the Directive. It can be interpreted in a way that the benefit from the creditor’s consideration should occur (at the earliest) upon the opening of the debtor’s bankruptcy. However, in my opinion, it is not a reasonable interpretation since the suspect period introduced by Article 6 covers the debtor’s actions before and after the filing.

- Should the benefit from the fair consideration for insolvency estate occur within the suspect period or may it occur earlier?

The payments made by the debtor against the fair consideration within the three-month hardening period could be defended since the fair consideration creates a benefit to the insolvency estate.

The rule focuses on the date of payment by a debtor, which is reasonable. However, article 6.3(a) of the Directive states that the payments made directly against such payment cannot be declared void. It could be argued that the wording of the clause can limit the availability of the creditor’s defence against an avoidance action if the creditor’s consideration was performed before the suspect period. The main argument is that the rule is constructed so that the debtor’s payment in the suspect period is linked directly with the creditor’s performance which could have happened before the suspect period.

The possible interpretation of the clause can lead to a conclusion that a due payment to the financial creditor can only be defended if the creditor performed fair consideration within the suspect period. An implementation - without a careful consideration - of the Directive can create uncertainty about whether repayment of overdue debts from the agreements entered into or concluded before the suspect period, for example, long-term financing agreements, can be defended on the mentioned exemption to the avoidance.

The Explanatory Memorandum of the Directive does not give much guidelines on the interpretation of “fair consideration to the benefit of the insolvency”. The recitals of the Directive provide some context on this subject. The Directive’s Recital no 9 reads as follows:

> "Certain congruent coverages, namely legal acts that are performed directly against fair consideration to the benefit of the insolvency estate, should be exempted from the scope of legal acts that can be declared void. Those legal acts aim at supporting the ordinary daily activity of the debtor's business. Legal acts falling under this exception should have a contractual basis, and require the direct exchange of mutual performances, but not necessarily a simultaneous exchange of performances, as, in some cases, unavoidable delays may result from practical circumstances. However, this exemption should not cover the granting of credit. Furthermore, performance and counter-performance in those legal acts should have an equivalence in value. At the same time, the counter-performance should benefit the estate and not a third party. This exception should cover, in particular, prompt payment of commodities, wages, or service fees, in particular for legal or economic advisors; cash or card payment of goods necessary for the debtor's daily activity; delivery of goods, products, or services against payment by return; creation of a security right against the disbursement of the loan (my underlining); prompt payment of public fees against consideration (e.g. admittance to public grounds or institutions)."

The above explains explicitly (for which see the underlining) that providing collateral to a financial creditor to secure new financing should not be subject to avoidance based on Article 6 of the Directive. However, the debtor's payments within the suspect period can concern various debts haven fallen due before the three-month suspect period. In such cases, the performance of a creditor was concluded before the suspect period.

Recital no 9 of the Directive does not indicate whether the payment of overdue debts cannot be declared void. On the other hand, it can be argued that payments of overdue debts support the ordinary daily activity of the debtor's business, which is why article 6.3.(a) exemption is introduced. If the debtor ceased to make such payments, it would risk the creditors starting enforcement actions against him.

From the lenders' perspective, ensuring how national legislators would implement the concept of the benefit to the insolvency estate would be critical. This could impact creditors' situation regarding receiving the due payments of loans and the potential risk of being deemed obliged to return received funds. The reasonable interpretation of the rules should consider the benefits of the fair consideration provided by a creditor in the past as sufficient to defend the payments received by a creditor within the suspect period.

4. The possible impact of the Directive's implementation

The main difference between the current Polish Bankruptcy law's rules on avoidance and the Directive's proposals is a potential possibility of avoidance of the debtor's payments of the due claims to creditors who at least should be aware of the debtor's liquidity insolvency or know about the filing for insolvency proceedings.

In my opinion, the wording of the avoidance derogation clause 6.3. (a) the Directive based on the benefit of an insolvency estate should concern not only the repayment of debts established within a suspect period but also the repayment of the debts arisen before the suspect period. Otherwise, the implemented avoidance rules could negatively impact financing creditors who are obliged to monitor the debtor's situation or even facilitate the debtors' payments (banks). It would be extremely hard to prove that these creditors were unaware of the debtor's liquidity

insolvency. If such creditors are not protected by clause 6.3.(a)of the Directive, the financial sector will have to seek a way to secure its interests.

Of course, there is an argument that such repayments can be defended since they are made against a consideration made prior to the suspect period.

In my understanding, it is reasonable that the financing creditor can use this clause effectively since the benefit of credit was provided to the debtor in the past. However, I can imagine that it can be argued that the benefit for the insolvency estate should happen within the suspect period.

Chapter 5

Avoidance Actions and Proposed EU-level Harmonisation: A Comparative Analysis

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1. Introduction

EU insolvency practitioners who face the question of whether it is possible to get at the value that has escaped from the bankruptcy estate have a difficult task, in particular if the value escaped through a cross-border transaction. In such cases, even if the *lex concursus* would allow an EU insolvency practitioner to challenge the transaction, the international aspect must still be addressed. In the past, the EU legislator has already taken action to assist EU insolvency practitioners by developing rules that help establish which court has jurisdiction and the applicable law regarding the voidness, voidability, or unenforceability of legal acts detrimental to the general body of creditors. EU insolvency practitioners need only rely on the Insolvency Regulation.[1] However, where assets end up outside of the EU, e.g., in England or Switzerland, an EU insolvency practitioner will be confronted by other questions of private international law.

The EU legislator has recently taken the initiative to deal with intra-EU avoidance actions with its Proposal for a Directive harmonising certain aspects of insolvency law.[2] In this article, the authors will first examine the Proposed Directive, insofar as it affects avoidance actions, and then map the changes which the Proposed Directive will bring to the legal systems of Belgium, Germany, Poland, and Slovakia. Additionally, this article will also address the English and Swiss perspectives on this new development in EU insolvency law.

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1 REGULATION (EU) 2015/848 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 20 May 2015 on insolvency proceedings (recast)

2 Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL harmonising certain aspects of insolvency law (COM/2022/702)

Currently, Articles 6, 7 and, in particular, 16 of the Insolvency Regulation guide EU insolvency practitioners in determining which court has jurisdiction and which law applies when they intend to file an avoidance action in an EU context. In essence, the Insolvency Regulation allows an insolvency practitioner to bring an avoidance action before the courts of the Member State within the territory of which the relevant insolvency proceedings have been opened. Also, the laws of the State in which proceedings are opened will determine the rules regarding the voidness, voidability, or unenforceability of legal acts detrimental to the bankrupt's creditors.

However, due to the lack of uniform avoidance rules across the EU, the beneficiary of a detrimental act has certain defences to such actions. In accordance with Article 16 of the Insolvency Regulation, the beneficiary can attempt to demonstrate that the act is subject to the law of another Member State, the laws of which do not permit such act to be challenged in the relevant matrix of facts. Thus, EU insolvency practitioners must consider two (or more) legal systems which may significantly diverge, which brings uncertainty to the process of asset recovery and may lead to the unequal treatment of creditors across the EU.

2. The Proposed Directive will complement the Insolvency Regulation, among others by setting minimum standards for avoidance rules

The Proposed Directive's primary purpose is to increase the transparency and efficacy of insolvency proceedings which, at the EU level, would increase the effectiveness of insolvency proceedings involving more than one EU Member State, rendering such proceedings more predictable and reducing barriers to the free movement of capital. Although the EU legislator has, during the legislative process, concluded that the profound differences in the insolvency regimes and legal traditions of various EU Member States makes full harmonisation of these regimes impossible, an effort was made to establish minimum standards for certain critical aspects of collective proceedings. One of the areas identified as critical for the standardisation of insolvency regimes across the EU is that of avoidance rules for transactions carried out before the opening of formal insolvency proceedings.

The Authors will consider and assess whether the Proposed Directive's contemplated scope could result in the unification of avoidance rules across the EU, consequently reducing the application of Article 16 of the Insolvency Regulation, and preventing insolvency practitioners from being confronted with laws of another Member State which do not permit such act to be challenged.

Further, in light of the broader trend to internationalise trade relations, the Authors have also decided to look beyond the EU's borders and explore the legal regimes of certain non-EU states, such as the UK – which continues to play a significant role in the European market despite Brexit – and Switzerland – which remains a financial driving force in Europe.

3. The Scope of the Proposed Harmonisation with regard to avoidance rules

The proposed regulations regarding avoidance rules are intended to be minimum standards to protect the insolvency estate from the liquidation of assets detrimental to the general body of creditors, performed prior to the opening of bankruptcy proceedings,[3] which, however, do not prevent Member States from maintaining or enacting stricter legal frameworks.

[3] Article 5 of the Proposed Directive.

First, the Proposed Directive provides for a general rule that Member States shall ensure that all legal actions (defined as any human behaviour, including omissions), perfected prior to the opening of insolvency proceedings, and causing damage to the general body of creditors, may be set aside, if the minimum standards stated in the Proposed Directive are satisfied (Article 4). One should note that, although not expressly stated in the draft Proposed Directive as published,[4] some provisions suggest that the scope of voidable legal actions could be construed broadly and cover not only the debtor's actions, but also those of a given transaction's counterparties or even third parties.

Detailed claw-back standards are specified in Chapter 2 of the Proposed Directive, which provide that, among others:

(a) with certain exceptions,[5] actions benefiting a creditor (or group thereof) by satisfaction, collateralisation, or otherwise, should be voidable if perfected:

(i) <u>three months</u> prior to the date of the insolvency filing, provided the debtor was unable to pay its mature debts; or

(ii) in any case, after the insolvency filing is made, in each case provided that in case of the creditors or those secured in the manner owed, for a transaction concerning a due claim to be voidable, the relevant creditor or the secured party are required to know (or ought to have known) of the debtor's distress (which knowledge is presumed where the parties to a transaction are closely related to the debtor);

(b) except for gifts or donations of symbolic value, the debtor's legal acts made against no or manifestly inadequate consideration are voidable if perfected <u>within one year</u> prior to the insolvency filing or after such filing;

(c) any actions of the debtor intended to be detrimental to the general body of creditors are voidable if:

(i) perfected <u>within four years</u> prior to the insolvency filing or after such filing; and

(ii) the other party knew (or ought to have known) of the debtor's intent.

The Proposed Directive also attempts to harmonise the consequences of avoiding such transactions as well as the limitation period for bringing avoidance actions. Regarding the former, local law should prohibit the invocation of claims, rights or obligations arising from annulled transactions against the insolvency estate, while parties benefiting from the transaction shall provide full compensation to the estate for any damage caused to it, without a set-off right against their receivables. Note that bona fide beneficiaries would be entitled to raise the defence that they are no longer enriched by the transaction in question.

Claims for full compensation should also be enforceable against the beneficiary's heirs or legal successors, including individual successors insofar as they acquired the asset for manifestly inadequate consideration, or they knew (or ought to have known) of the circumstances underlying the avoidance (which knowledge is presumed for entities closely related to an avoided transaction's beneficiaries).[6] Furthermore, claims arising from annulled transactions must be brought within three years of the opening of insolvency proceedings.

4 Recital 6 of the Preamble to the Proposed Directive.
5 See Article 6(3) of the Proposed Directive.
6 Article 11 of the Proposed Directive.

The Proposed Directive also provides for certain means to secure the beneficiaries of avoided transactions, namely:

(i) a beneficiary's claims will revive if they compensate the insolvency estate for the detriment caused; and
(ii) a beneficiary who performed its obligations under the avoided transaction may claim for the value of the counter-performance (if such performance remains part of the estate or continues to enrich it).

Unlike the Insolvency Regulation, the Proposed Directive does not specify which types of insolvency proceedings it shall apply to, raising the question of whether the proposed rules will also apply to restructuring proceedings. Regarding the avoidance rules, they are stated to not affect the application of instruments protecting financing and other restructuring-related transactions subject to Directive 2019/1023. Ideally, this should be clarified in the Proposed Directive's final wording.

4. Belgian transaction avoidance rules

4.1. Pre-insolvency and insolvency avoidance actions

Outside an insolvency context, Belgian law provides that, under certain conditions, a creditor can have a legal act of their debtor declared 'non-opposable'[7] when such act impairs their ability to seek recourse against the debtor's assets (so-called "*actio pauliana*").[8] In addition to the *actio pauliana*, a creditor may bring an action against any person who unlawfully contributed to the impairment of the creditors' ability to seek recourse.

Belgian bankruptcy law also provides for several specific transaction avoidance rules. On the one hand, there is the bankruptcy *pauliana* which is similar to the *actio pauliana* described above. Additionally, in certain cases, it is somewhat easier for a trustee to challenge acts that have impaired the creditors' ability to seek recourse against the debtor's assets.

4.2. Types of avoidable transactions in insolvency and time periods

4.2.1. The so called "suspect period"

A Belgian bankruptcy trustee may challenge transactions that are deemed detrimental to the insolvency creditors and that have taken place prior to the commencement of the bankruptcy proceedings.

The trustee's right to challenge is limited to transactions that occurred during the so-called "suspect period", being the period between the date taken into account for the occurrence of the company's cessation of payments and the date on which bankruptcy proceedings are opened. The date taken into account for the occurrence of the company's cessation of payments may not be more than six months before the date of the bankruptcy order.[9]

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[7] I.e., the creditor can act as if the legal act does not exist.
[8] Art. 5.243, Belgian Civil Code.
[9] Art. XX.105, Code of Economic Law: if the bankruptcy order relates to a company that was dissolved in circumstances suggesting an intent to defraud its creditors, the date of cessation of payments may be determined as being the date of the decision to dissolve the company.

Where fraudulent intent (i.e., the intent to adversely affect the position of the debtor's other creditors) can be shown, the bankruptcy trustee's right to challenge transactions can be extended to cover an unlimited period prior to the opening of the bankruptcy proceedings.

4.2.2. Types of avoidable transactions

All payments, transactions and acts that have taken place on or after the day of the bankruptcy judgment cannot be opposed[10] against the bankruptcy estate. Furthermore, the following transactions, payments and creation of securities can be declared non-opposable if they occurred during the suspect period:[11]

> (a) transactions involving the disposal of assets for free (without consideration);
> (b) transactions, acts and contracts, if the value provided by the bankrupt notably exceeds the value received by them (obvious inadequate consideration);
> (c) all payments towards immature debts;
> (d) all payments of mature debts, where made other than by cash or commercial paper; or
> (e) the establishment of a security interest (pledge, mortgage, or other) to secure a debt in existence prior to the date of the security interest's establishment.

All other payments of mature debts or acts for consideration that occur during the suspect period may be declared non-opposable if the recipient thereof or the transaction's counterparty was aware of the cessation of payments.[12]

Securities registered after the cessation of payments may be declared non-opposable if more than fifteen days have passed between the date of the deed establishing the mortgage or privilege and the registration date.[13] Any payment or transaction entered into by the bankrupt during or prior to the suspect period are not-opposable if made or entered into by the bankrupt with the fraudulent intent of prejudicing the rights of its creditors.[14]

4.3. Potential impact of the Proposed Directive in Belgium

For Belgian insolvency practitioners, the Proposed Directive does not appear to be a Copernican Revolution in avoidance rules. The Belgian avoidance rules meet most of the Directive's minimum requirements and its implementation will mainly involve technical matters or fine-tuning existing rules, such as extending the term for challenging acts made against no or manifestly inadequate consideration from 6 months to 1 year. The avoidance rules, as such, will therefore not pose much of a problem under Belgian law, while the remedies provided for in the Proposed Directive are similar to those currently available to Belgian insolvency practitioners. As far as Belgian law is concerned, several other material issues are not (clearly) answered by the Proposed Directive, for example, the meaning of insolvency proceedings (Belgian avoidance rules only apply in cases of bankruptcy), or whether transactions which took place during a prior (court supervised) restructuring can be challenged.

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[10] Under Belgian law, avoidable transactions can be declared non-opposable, meaning that the trustee can act as if the avoidable transaction did not take place (e.g. ask for a second payment; treat the asset as if it was still part of the bankrupt's estate; etc.).

[11] Art. XX.111, Code of Economic Law.

[12] Art. XX.112, Code of Economic Law. Case law has found that the bankruptcy trustee must also establish that the transaction is prejudicial to the other creditors.

[13] Art. XX.113, Code of Economic Law.

[14] Art. XX.114, Code of Economic Law.

5. German transaction avoidance rules

5.1. Pre-insolvency and insolvency avoidance actions

Under the German Insolvency Code ("**InsO**") a German insolvency administrator may, in principle, contest transactions (as well as omissions, which are deemed to be equivalent) made prior to the opening of insolvency proceedings if they disadvantage[15] the insolvency creditors and they satisfy certain conditions stipulated in the InsO.

5.2. Types of avoidable transactions in insolvency and time periods

Avoidable transactions under the InsO can be split into two broad categories.

5.2.1. Congruent and incongruent coverage

Transactions under which a creditor is granted a security interest (or satisfaction of their claims), or such interest or satisfaction is facilitated, may be contested by the insolvency administrator depending on the transaction's date and the creditor's knowledge at the relevant time. Transactions entered into within the three months immediately preceding the filing of a petition to open insolvency proceedings may be contested if the debtor was already illiquid on the relevant date and the creditor was aware of this fact, while those entered into following the opening of proceedings may be contested if the creditor was aware of the debtor's insolvency or the fact that a petition was filed: (*congruent coverage*).

Note that, if a creditor is not entitled to enjoy such a security interest or satisfaction of their claims (or to enjoy such security or satisfaction on the relevant date, or to enjoy the type of security or satisfaction purportedly granted by the transaction), then the act granting or facilitating such security or satisfaction may be contested by the insolvency administrator if it occurred within either the second or third month preceding the filing date of a petition to open proceedings (if the debtor was already illiquid on the transaction date or the creditor was aware that the transaction would disadvantage[16] the insolvency creditors on the transaction date) or the month immediately preceding this date (in all cases): (*incongruent coverage*).

5.2.2. Wilful disadvantage and gratuitous benefit

If a debtor enters into a transaction within 10 years (or 4 years, where the transaction purports to grant a security interest (or satisfaction of their claims), or facilitate such interest or satisfaction) of filing a petition to open insolvency proceedings with the intent to disadvantage its insolvency creditors, such a transaction may be contested by the insolvency administrator if the other party thereto was aware of the debtor's intention on the transaction date (which will be presumed if such party knew of the debtor's imminent insolvency (or actual insolvency in certain circumstances) and the disadvantage to the debtor's insolvency creditors resulting from

[15] A creditor is disadvantaged if the legal act has increased the debtor's assets or reduced the assets and thereby prevented, impeded or delayed access to the debtor's assets because the possibilities of satisfaction would have been more favourable without this legal act.

[16] Please see footnote 15 above.

the transaction).[17] This also applies to onerous contracts concluded between a debtor and closely related persons,[18] except where the contract was concluded more than two years before the filing date of a petition to open insolvency proceedings or the other party was unaware of the debtor's intention: (*wilful disadvantage*).

An insolvency administrator may also contest gratuitous benefits granted by the debtor other than ordinary gifts of minor value if made less than four years prior to the petition to open insolvency proceedings.

5.3. Potential impact of the Proposed Directive in Germany

In general, the InsO provisions on transaction avoidance already comply with the minimum requirements proposed in the Proposed Directive, while also going beyond them in some respects. However, there are certain areas in which the InsO provisions appear deficient.

Under the Proposed Directive, Member States must ensure that avoidable legal actions "can be declared void".[19] The InsO does not provide for the ability to declare avoidable legal actions void, in the sense of their absolute invalidity. Rather, the legal consequence of contesting a transaction is the creation of a contractual claim for the return of the asset disposed of to the insolvency estate.

Creditor's party to transactions subject to congruent coverage under the InsO are required to have positive knowledge of the debtor's insolvency or their having filed a petition to open insolvency proceedings, whereas, the Proposed Directive indicates that a transaction can be avoided if the creditor "should have known"[20] of such circumstances at the relevant time. Although the German jurisprudence has expanded the circumstances under which a creditor is presumed to have known of a debtor's insolvency almost to the point of encompassing negligent ignorance, recent judgments of the German Federal Supreme Court (BGH) have limited these grounds. Thus, legislative intervention may be required to incorporate negligent ignorance as grounds for avoidance.

The avoidance of gratuitous performances by a debtor under the InsO may also be in doubt since this could violate the Proposed Directive's minimum standards due to potentially being made for "manifestly inadequate consideration", since such performances, according to applicable BGH rulings, do not require any counter-performance from their recipient. Further, the limitation period for contesting such transactions (i.e., four years) may need to be altered to comply with the Proposed Directive's one-year period under Article 7(1).

Regarding transactions with parties closely related to the debtor, the minimum intent requirements stated in the Proposed Directive are well beyond those applicable under German law, due to imposing a presumption that a closely related person knew of the debtor's intent to disadvantage creditors. Under the InsO, such knowledge is presumed only where a contract

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[17] An "onerous contract" means any contract in which the benefits of the parties remain with each other in a relationship of mutual interest. The concept of an "onerous contract" is understood broadly in the context of Section 133 (4) of InsO. It includes contracts under the law of obligations, property law or company law, as well as agreements under the law of property or pure performance transactions. A contract is deemed to be for valuable consideration if a compensatory counter-performance is to be rendered for the debtor's performance.

[18] As defined in Section 138 *Persons with close relationship to debtor*, InsO.

[19] Articles 4, 6-11 of the Proposed Directive.

[20] Article 6(2)(1)(b) of the Proposed Directive.

(interpreted broadly, but excluding unilateral legal acts) results in a direct disadvantage to the insolvency creditors (i.e., it impairs the possibility of their satisfaction from the debtor's assets, absent other circumstances) and the contract was concluded within two years of the petition for the opening of insolvency proceedings. Since the presumption imposed by the Proposed Directive also covers indirect disadvantages and applies to transactions entered into during a period almost double that stated in the InsO, German law does not appear to meet the Proposed Directive's minimum requirements and will likely require amendments unless these minimum standards are not adjusted in their final form.

The InsO could require further amendments to bring it into conformity with the minimum requirements of the Proposed Directive governing the general consequences of avoidance actions. In particular, German law has no equivalent of the prohibition stated in Article 9(5) of the Proposed Directive, whereby beneficiaries of a voided act shall not set off debts owed to the insolvency estate against their claims against the estate. Note that the BGH has ruled that a set off against the insolvency is excluded, but has not expressed a view on claims against the estate itself. This may be problematic due to the Proposed Directive's silence on this distinction.

Finally, the InsO lacks a provision similar to Article 9(6) of the Proposed Directive, according to which avoidance actions are clearly stated to not affect actions based on general civil and commercial law for compensation of damages suffered by creditors. Under German law, transaction avoidance rules are assumed to be in a special relationship with the general provisions of law applicable to actions for compensation and standard tort law can also apply in addition to the InsO's avoidance rules if the constituent elements of the tort going beyond the requirements of the avoidance rules are met.

6. Polish transaction avoidance rules

6.1. Pre-insolvency and insolvency avoidance actions

Similar to Belgian law, Polish law allows creditors to bring *actio pauliana* where a debtor's legal action, performed to the creditors' detriment, resulted in a third party gaining a property-related benefit, provided that at the relevant time the debtor was aware of the detriment and the third party knew of it, or could have learned of it had they exercised due diligence.[21] The debtor's acts are presumed to be to the creditors' detriment if they resulted in or increased the degree of the debtor's insolvency. The limitation period for claw-back claims is 5 years.

Additionally, Polish bankruptcy law provides for separate avoidance rules for the debtor's actions performed within a specified period prior to the bankruptcy petition's filing date and ending on the date preceding the declaration of bankruptcy. Under both an *actio pauliana* and the bankruptcy avoidance rules, a successful claim renders a given action ineffective towards the creditor making the claim or the bankruptcy estate respectively.[22] The remarks below are limited solely to the bankruptcy avoidance regime.

[21] Article 527, Polish Civil Code.

[22] Under Polish law, a distinction needs to be made between the acts that are void and the ones that become or can be declared ineffective. The ineffectiveness towards either a creditor or the bankruptcy estate does not result in a given transaction being universally void with the effect towards all third parties. An act found or declared ineffective is deemed non-existent only towards a given creditor or the bankruptcy estate (the total body of the creditors taking part in the insolvency proceedings) (the inter *partes effect*). Thus, for clarity, the description of the Polish law avoidance actions regime will refer to the ineffectiveness of the legal acts.

6.2. Types of avoidable transactions in insolvency and time periods

The bankruptcy avoidance rules specify that the following transactions performed by a debtor declared bankrupt are automatically deemed ineffective towards the bankruptcy estate:

> (a) gratuitous acts, or acts where the bankrupt's benefit was grossly lower than the other party's benefit, performed by the bankrupt **within one year** preceding the bankruptcy filing, under which the bankrupt disposed of their assets (including settlements or waivers of claims);
> (b) the bankrupt's establishment of a security interest to secure as yet immature claims if established within the six months preceding the bankruptcy filing (however, the interest's beneficiary may apply to the court to find such interest nonetheless effective towards the bankruptcy estate, if the beneficiary was unaware that grounds existed for a declaration of bankruptcy at the time of the interest's establishment); and
> (c) the assignment of future claims (arising after a declaration of bankruptcy) by way of security, unless the assignment agreement was executed (in qualified written form) more than six months prior to the bankruptcy filing.

Furthermore, the judge-commissioner may declare (*ex officio* or at the receiver's request) the following legal act(s) of a bankrupt ineffective towards the bankruptcy estate:

> (a) related-party transactions (whether gratuitous or for consideration) occurring within the six months preceding the bankruptcy filing, which includes, in particular, transactions with:
>> (i) shareholders;
>> (ii) partners;
>> (iii) representatives (of the bankrupt or its stakeholders); and
>> (iv) the bankrupt's dominant entities or subsidiaries, in each case provided that the other party (benefiting from the action) cannot prove that the transaction was not detrimental to the bankrupt's creditors;
>
> (b) remuneration payable to the bankrupt's representatives or managers for a period of no more than the six months preceding the bankruptcy filing, if significantly higher than the average remuneration for like work or services and it is not warranted by the labour involved; and
> (c) encumbrances (mortgages, civil pledges, registered pledges, or maritime pledges) established over the bankrupt's assets if the bankrupt was not the secured creditor's personal debtor and the encumbrance was established within the year preceding the bankruptcy filing (in the case of transactions between non-related parties, only insofar as the bankrupt did not obtain any benefit from the security interest or the encumbrance was established for a benefit of grossly lower value than that of the interest).

6.3. Potential impact of the Proposed Directive in Poland

For Polish insolvency practitioners, the Proposed Directive's avoidance rules are not novel innovations since Polish law already protects creditors' interests to an equal or greater extent through detailed provisions preventing the liquidation of a debtor's assets.

However, regarding the Proposed Directive's minimum time limits, Polish law will need to be aligned in two significant ways. First, with respect to transactions between a bankrupt and their spouse, cohabitant, or relatives, the catchment period to declare an action ineffective will need

to be extended from six months to four years, since the Proposed Directive does not differentiate such actions and so Article 8 thereof will apply to them. Second, the statute of limitations in which actions to declare an act ineffective will also need to be extended. Under current Polish law this period is two years (unless a claim is extinguished earlier pursuant to the Civil Code), while the Proposed Directive would extend this to three years following the opening of insolvency proceedings.

The most significant change facing Polish insolvency law following the Proposed Directive's adoption appears to be the significant expansion of the personal scope of avoidance rules. Under current Polish law, these rules only apply to acts performed by the bankrupt, while the proposed rules would also apply to include the bankrupt's counterparties to such acts and, in some cases, even third-parties.

7. Slovak transaction avoidance rules

7.1. Avoidance actions regimes in Slovakia

There are two avoidance action regimes in Slovakia – those under the Slovak Civil Code and those under the Slovak Bankruptcy and Restructuring Act. Although seemingly complementary, these are two distinct regimes with similar characteristics, but separate rules. The Bankruptcy and Restructuring Act regime applies to all forms of insolvency matters, while the Civil Code regime applies primarily to non-insolvency cases. Under certain circumstances the Civil Code avoidance regime may be applied to some insolvency cases, such as low-value bankruptcies or personal bankruptcy, where even creditors can file avoidance actions on their own behalf under the Civil Code. Avoidance actions of this type are admissible where the contested act occurred within the three years preceding the opening of bankruptcy proceedings. The remarks below are limited solely to the Bankruptcy and Restructuring Act avoidance regime.

7.2. Types of avoidable transactions in insolvency and time periods

If an insolvency practitioner intends to file an avoidance action, they must first fulfil the procedural condition of filing the action with the relevant court within one year of the declaration of bankruptcy. Failure to do so extinguishes the right to challenge an act. A practitioner must then legally qualify the type of act being challenged under the action. According to the Bankruptcy and Restructuring Act, avoidance actions are admissible if:

> (a) in case of inadequate consideration – the act challenged occurred within the year preceding the initiation of insolvency proceedings (three years for related-party transactions);
> (b) in case of an advantageous act[23] – the act challenged occurred within the year preceding the initiation of insolvency proceedings (three years for related-party transactions); or
> (c) in case of a defrauding act[24] – the act challenged occurred within the five years preceding the initiation of insolvency proceedings. In certain cases, the debtor's intent to disadvantage its creditors must also be proven (while this intent is presumed to exist where the counterparty is a related party).

[23] An "advantageous act" means an act unjustifiably favouring one creditor over other creditors.
[24] A "defrauding act" will be found to have occurred if the debtor intended to defraud its creditors, and that intention was known or ought to have been known to the other party to the act.

Note that Slovakian law also provides for special cases where avoidance actions may be brought, but these apply to specific factual circumstances (e.g., permitting avoidance actions against acts performed during restricting proceedings without the insolvency practitioner's consent).

7.3. Where avoidance actions in insolvency often fail

Under the Bankruptcy and Restructuring Act, avoidance actions will only be successful if the claimant proves that, as at the date of the challenged act, the act itself resulted in at least one registered claim being diminished. This means that claimant must prove that the challenged act, performed prior to the bankruptcy, was detrimental to at least one creditor at the relevant time and thereby reduced the satisfaction of said creditor's claim. This is extremely difficult to prove in practice and often leads to the avoidance action's failure. Anecdotally, almost all avoidance actions filed in one region of Slovakia have failed, due to the competent court adopting an exceedingly strict view of the obligation to successfully prove the diminishment of at least one creditor claim. In the author's opinion, if a challenged act, performed prior to the bankruptcy, does not deprive at least one creditor of their registered claim, then Slovakian law will not provide a remedy to challenge said act. In such cases, Article 16(b) of the Insolvency Regulation can then be applied to provide some remedy.

7.4. Potential impact of the Proposed Directive in Slovakia

If enacted in its current form, the Proposed Directive will necessitate the modification of the time limits to file avoidance actions. For example, Article 8 of the Proposed Directive provides for a four-year period, while Slovakian law provides for a three-year limit in some cases. It is important to note that the Proposed Directive does not set standards for avoidance actions *in toto*, rather it provides a framework within which Member States may continue to impose additional conditions to file and pursue avoidance actions under their domestic law. While establishing the same standards regarding the time limits in which one can bring an avoidance action is a beneficial development, if a Member State's domestic law incorporates additional obstacles to bring such action, such obstacles may make it difficult (or even impossible) to effectively bring avoidance actions in particular cases.

8. Swiss transaction avoidance rules

8.1. Pre-insolvency and insolvency avoidance actions

Besides the ordinary rules on the avoidance of a contract based on vitiating factors and the restitution of payments as set out in the Swiss Code of Obligations, Swiss law[25] only provides for claw-back claims within the framework of insolvency proceedings.[26] Indeed, if a company with its seat in Switzerland were declared bankrupt, only the bankruptcy estate or creditors who requested the assignment of such rights would have standing to file an avoidance action.

[25] Specifically, the Debt Collection and Bankruptcy Act (DEBA), available in German, French and Italian at: <https://www.fedlex.admin.ch/eli/cc/11/529_488_529/de>.

[26] Claw-back actions are also possible in enforcement proceedings against individuals and in (certain) composition proceedings; however, for the sake of clarity, this Article will focus on bankruptcy proceedings.

8.2. Types of avoidable transactions in insolvency and time periods

In principle, only the acts or omissions of the debtor may be subject to avoidance actions. Moreover, such actions require the act to have been detrimental to the creditors (provided the action is causal to the detriment of the creditor(s) and that such creditor(s) would not have suffered any losses if the act had not been performed), which is presumed according to the case law of the Swiss Federal Supreme Court.

Swiss law provides for three kinds of avoidance action:

> (a) All gifts and gratuitous dispositions made by the debtor (except for customary occasional gifts) within the year preceding the opening of bankruptcy proceedings are voidable. Certain transactions qualify as gifts by law, e.g., where consideration paid to the debtor was inadequate (i.e., its value was lower than the value of the debtor's performance). If the act was made in favour of a related party (including group companies) of the debtor, the related party shall bear the burden of proving that the performance and consideration were proportionate;[27]
> (b) Providing security for pre-existing debts which the debtor was not previously obliged to secure, or discharging a debt by means other than payment in cash or other customary means of payment, or discharging a debt that is not due, can be subject to claw-back claims, provided the act was performed within the year preceding the opening of bankruptcy proceedings and the debtor was already over-indebted when the act was performed. The respondent may only be granted relief if they can establish that they did not know (or ought to have known) of the debtor's over-indebtedness;[28] and
> (c) All legal acts performed by the debtor within the five years preceding the opening of bankruptcy proceedings with the intention – recognizable to the other party – of disadvantaging their creditors, or favouring individual creditors to the detriment of others, are voidable. If the act was made in favour of a related party (including group companies) of the debtor, the related party shall bear the burden of proving that they did not know (or ought to have known) of the debtor's intent to disadvantage the other creditors.[29]

All of the above types of avoidance actions are subject to a three-year statute of limitations, which starts running from the day on which the company was declared bankrupt.[30] Avoidance actions must be filed against the debtor's contractual counterparty, or the act's beneficiary, or their heirs or successors, or against a third party acting in bad faith.[31] The respondent acquiring the debtor's assets by means of a voidable legal act is obliged to return such assets, while the consideration paid by the respondent shall be reimbursed, insofar as said consideration remains in the debtor's possession or continues to enrich the debtor. If the voidable legal act consisted of the payment (including set-off) of respondent's claim, such claim shall be reinstated upon the reimbursement of what was received. If restitution *in natura* is not possible, the respondent must make restitution in an equivalent amount to the claimant. *Bona fide* recipients of gifts are only obliged to make restitution up to the value of their enrichment.[32]

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27 Art. 286, DEBA.
28 Art. 287, DEBA.
29 Art. 288, DEBA.
30 Art. 292, DEBA (prior to 1 January 2020, the statute of limitation was two years).
31 Art. 290, DEBA.
32 Art. 291, DEBA.

8.4. Potential impact of the Proposed Directive in Switzerland

From the practical perspective, the Proposed Directive will only have any impact (either direct or indirect) in Switzerland, if:

> (a) an EU avoidance judgment must be recognised and enforced in Switzerland (since the decision applying minimum standards will be enforced in Switzerland); or
> (b) a Swiss court applies the national law of an EU Member State.

In principle, a company with its seat in Switzerland can only be declared bankrupt by the Swiss court competent for the company's seat, while avoidance actions in a Swiss company's bankruptcy proceedings must be filed in Switzerland, at the defendant's domicile (if domiciled in Switzerland) or the place where the bankruptcy judgment was issued (if not domiciled in Switzerland),[33] and Swiss substantive law will apply to the avoidance action itself. As Switzerland is not an EU Member State, respondents in avoidance proceedings may not rely on Article 16 of the Insolvency Regulation and are also precluded from invoking more favourable foreign legislation. Consequently, the Proposed Directive should not impact the Swiss domestic avoidance rules since Swiss domestic law will continue to apply.

If a "non-Swiss" company holds assets located in Switzerland, the relevant "non-Swiss" bankruptcy trustee must file for the recognition of the foreign bankruptcy decree in Switzerland to gain access to assets deemed to be located in Switzerland.[34] In this context, avoidance actions may come into play in two different scenarios:

> (a) a foreign court (i.e., outside Switzerland) issued an avoidance judgment against a respondent not domiciled in Switzerland at the time of the action's initiation – in which case, the judgment may be recognised in Switzerland (upon the recognition of the foreign bankruptcy decree), provided that the avoidance judgment was rendered in the same state as the bankruptcy decree was issued, or the avoidance judgment was recognised in such state,[35] and the other prerequisites for the recognition of foreign judgments under Swiss law are met;[36]
> (b) in the absence of a foreign avoidance judgment, – the appropriate jurisdiction for avoidance actions will depend on whether the subject matter thereof is deemed to be located in Switzerland or not. Note that this qualification remains controversial among Swiss legal scholars and the question has not yet been resolved by the Swiss Federal Supreme Court.

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33 Art. 289, DEBA.

34 Art. 166 of the Private International Law Act (PILA), available in German, French and Italian at: <https://www.fedlex.admin.ch/eli/cc/1988/1776_1776_1776/de>. Upon recognition of the foreign bankruptcy decree, the foreign bankruptcy estate may access the assets either through ancillary bankruptcy proceedings in Switzerland (in which certain creditors are privileged) or directly, under specific conditions.

35 Art. 171, PILA.

36 Inter alia: the decision is final or not subject to ordinary judicial remedy; the decision does not violate Swiss public policy; the act introducing the proceedings was duly notified to the respondent; the matter has not been already subject of a foreign decision that can be recognized in Switzerland; the matter has not already been subject of Swiss court proceedings that was initiated first; the matter has not already been decided by a Swiss court first (i.e. prior to the foreign decision).

In principle:

(i) where the avoidance claims are deemed to be located in Switzerland – Swiss courts will have jurisdiction and Swiss law will apply;[37]

(ii) where avoidance claims are deemed to be located outside Switzerland, but are to be filed against a respondent domiciled in Switzerland – Swiss courts may have jurisdiction in accordance with general private international law principles, and the predominant view is that Swiss courts will apply the *lex fori concursus* to the avoidance action itself. Consequently, the Proposed Directive may have an impact in the latter case, since Swiss courts would apply the national legislation of the EU Member State in which bankruptcy proceedings were opened, including any provisions implementing the Proposed Directive.

9. English transaction avoidance rules

9.1. Pre-insolvency and insolvency avoidance actions

In England and Wales, when a company has entered a formal insolvency process, certain transactions that were entered into by the company before the commencement of the insolvency may be attacked under the provisions of the Insolvency Act 1986 (**"Act"**). Whilst this paper adopts the term *"transaction avoidance rules",* in England and Wales these are more commonly referred to as *"reviewable transactions"* or *"antecedent transactions"*.

The focus in this paper is on reviewable transactions in the context of corporate insolvency only, although a trustee in bankruptcy, who is an officeholder in England and Wales that deals with insolvent individuals, has similar powers to challenge transactions entered into by an individual before the commencement of the bankruptcy.

9.2. Types of avoidable transactions in corporate insolvency and time periods

Principally, only an administrator or liquidator of a company may bring a claim attacking a reviewable transaction, save that a claim of transactions defrauding creditors (under section 423 of the Act) may be made by any party that is a victim of the transaction, that is:

> "a person who is, or is capable of being, prejudiced by it".[38]

The provisions of the Act provide various grounds on which reviewable transactions entered into before insolvency may be attacked and these, together with some of the key mechanics of these provisions, are summarized as follows:

9.2.1. Transactions at an undervalue[39]

These are claims that an administrator or liquidator could bring if a company transferred an asset to a third party for no consideration, or for significantly less consideration than the asset's true value, and the company was insolvent at the time of the transaction or became insolvent because of the transaction. This provision applies to any transaction that took place two years before the onset of insolvency and the relevant limitation period is:

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[37] Art. 171, PILA.

[38] Section 423(5) of the Act.

[39] Section 238 of the Act.

(a) six years from the company going into administration or liquidation, if the claim is for a sum of money;[40] or
(b) otherwise, 12 years.[41]

9.2.2. Preferences[42]

These are claims that an administrator or liquidator could bring if the company enters into a transaction that puts a creditor in a better position than it would have otherwise been on the company's insolvency, the company was influenced by a desire to prefer that creditor and the company was insolvent at the time of the transaction or became insolvent because of the transaction. Such intention is presumed where the transaction was with a *"connected person"*.[43] This provision applies to any transaction that took place six months before the onset of insolvency, or two years before the onset of insolvency if the transaction is with a *"connected person"*. The relevant limitation period is:

(a) six years from the company going into administration or liquidation, if the claim is for a sum of money;[44] or
(b) otherwise, 12 years.[45]

9.2.3. Extortionate credit transactions[46]

These are claims that an administrator or liquidator could bring if it transpires that the terms of any credit transaction entered into by the company before its insolvency were on terms that require the company to make *"grossly exorbitant payments"* or the transaction *"otherwise grossly contravened ordinary principles of fair dealing"*. This provision applies to any credit transaction made three years before the administration, or liquidation. The relevant limitation period is:

(a) six years from the company going into administration or liquidation, if the claim is for a sum of money;[47] or
(b) otherwise, 12 years.[48]

9.2.4. Avoidance of floating charges[49]

These are automatic invalidation rights available to an administrator or liquidator, if the company was insolvent at the time it granted a floating charge or became insolvent as a result. The presumption of insolvency applies if the charge is granted to a *"connected person"*. This provision applies to any floating charge made one year before the onset of insolvency, or two years before the onset of insolvency if the floating charge is made in favour of a *"connected person"*.

40 Section 9 of the Limitation Act 1980 (**"LA 1980"**).
41 Section 8 of the LA 1980.
42 Section 239 of the Act.
43 Section 249 of the Act.
44 Section 9 of the LA 1980.
45 Section 8 of the LA 1980.
46 Section 244 of the Act.
47 Section 9 of the LA 1980.
48 Section 8 of the LA 1980.
49 Section 245 of the Act.

9.2.5. Transactions defrauding creditors[50]

These are claims that an administrator, liquidator, any victim of the transaction, the Financial Services Authority or the Pensions Regulator could bring where the company entered into a transaction at an undervalue for the purpose of putting assets beyond the reach of creditors, and thereby hindering an actual or potential claim that the creditor has against the company. This provision applies to any such transaction and the relevant limitation is:

(a) six years from the company going into administration or liquidation, if the claim is for a sum of money;[51] or
(b) otherwise, 12 years.[52]

If any of the above-mentioned antecedent transactions (excluding avoidance of floating charges) are ultimately successful, then the Courts of England and Wales have various options at their disposal. For example, the Court may: (a) require any property or proceeds of sale be returned to the company, (b) release or discharge any security given by the company, or (c) require any party receiving a financial benefit from the company to repay it.

9.3. Potential impact of the Proposed Directive in England and Wales

As the UK is no longer an EU Member State, it will not be required to implement the Proposed Directive in England and Wales. However, the UK insolvency landscape, particularly in relation to reviewable transactions, already includes many of the key elements of the Proposed Directive in any event, and these will continue to apply.

Given the existing commonality between these provisions and those in the Proposed Directive concerning avoidable transactions, the impact of the Proposed Directive in England and Wales is likely to be negligible. However, the Proposed Directive will provide some further comfort to UK investors and other stakeholders with interests in EU Member States should those companies, through which such interests are held, become insolvent.

10. Conclusions

Although the attempt to harmonize the insolvency laws across Europe seems to be a step in the right direction, the question remains as to whether the institutions provided in the Proposed Directive will be sufficient to attain the ambitious goals of the EU legislator to reduce a gap between European local laws?

Firstly, the fact that the provisions of the Proposed Directive will need to be transposed to the local legal systems and, thus, at first interpreted in the light of the very distinct local insolvency frameworks by the local legislative, poses certain doubts as to whether such a harmonization tool will minimize discrepancies between various European insolvency avoidance rules in any material respect other than the uniform claw back periods. The harmonization of the preventive restructuring framework shows that only this first step may be a significant obstacle in achieving the desired result of unification of certain aspects of insolvency laws.

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50 Section 423 of the Act.
51 Section 9 of the LA 1980.
52 Section 8 of the LA 1980.

Secondly, given that the Proposed Directive sets only the minimal standards of harmonization of avoidance rules it is likely that many member states will uphold their more stringent rules thereon. Thus, even if uniformly interpreted, the Proposed Directive might not be a sufficient drive for a profound approximation of claw-back regulations. Lastly, the selective choice of insolvency process aspects to be standardized, leaving aside the most critical aspect of the insolvency definition not unified across Europe, might marginalize the importance of the entire act.

Will these concerns materialize? Does the Proposed Directive have a potential to reduce the application of Article 16 of the Insolvency Regulation and prevent insolvency practitioners from being confronted with avoidance rules of another Member State which enable by-passing the claw back rules of the main insolvency jurisdiction? This is yet to be seen, but first the European insolvency practitioners will need hold their breath for an extended period of time to see if the EU Member States agree on a common approach to these selected aspects of insolvencies regulated in the Proposed Directive draft.

PART II

ESG AND CORPORATE GOVERNANCE VERSUS INSOLVENCY

Chapter 6

The Spanish “Zone of Insolvency”: A Good Practice Guide for Directors of Companies in Financial Distress

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1. Introduction

For years now, corporate governance has been a pivotal issue in company law. Recently, it has become widely accepted that modern corporate governance systems need to consider the interests of stakeholders beyond shareholders, including creditors, employees, clients, and society as a whole. To that end, corporate governance establishes rules and controls to ensure that a company’s management is held accountable to all company’s stakeholders. In Spain, these rules revolve around the concept of a company’s “corporate interest” (*interés social*).

While the exact definition and concept of “corporate interest” is widely debated, there is a general consensus[1] that it refers to shareholders’ collective interests and aspirations in maximizing the company’s profits and increasing its value in the long term. From this perspective, the concept of “corporate interest” generally concurs with the individual interests of the company’s shareholders, since their remuneration as “residual creditors” for their equity investment depends on the profits the company obtains and its value in the medium and long term.

However, when a company is in financial distress, its interests are no longer in agreement with those of its shareholders. When a company is in a situation where it may no longer be able to meet its obligations *vis-à-vis* its creditors, the value available could be insufficient to preserve its shareholders’ interest. Consequently, the shareholders, who are last in line to recover their investment and potentially “out of the money”, in an attempt to reverse the company’s financial distress and improve their otherwise zero expectation to achieve a return on their investment, may advocate for aggressive strategies that have little chance of succeeding and the potential to cause further damage to the company’s value. They may also resist or delay implementing restructuring measures if they consider that they could result in loss of control over the company. They may also favour restructuring measures that enable them to maintain a higher stake in the company at the expense of the creditors’ ability to recover their investment.[2]

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1 Jesús Alfaro Águila-Real, ‘El interés social y los deberes de lealtad de los administradores’, in Francisco Vicent Chuliá (ed), *Introducción al Derecho Mercantil* (24th edn) (Tirant lo Blanch, 2022).

2 Jacinto José Pérez Benítez, ‘La responsabilidad de los administradores sociales en las proximidades de la insolvencia’, in Alfonso Muñoz Paredes and Amanda Cohen Benchetrit (eds), *Deberes de los administradores de las sociedades de capital* (Aranzadi, 2023).

In contrast, creditors, whose main objective is to safeguard their financial interests in the distressed company, will favour policies that allow them to maximize the company's chance of repaying the amount it owes while also minimizing potential losses. In fact, due to their payment priority rights over shareholders, they hold a more direct stake in the company's financial recovery. For these reasons, scholars generally agree that creditors' interests are more in line with those of the company in financial distress. However, this may not be strictly true in all financial distress situations, where creditors' short-term interest in the debtor may lead them to prioritize policies that enable them to recover their debts quickly. Particularly, when recovering the amounts owed does not depend on the restructuring of the company, "in-the-money" creditors' strict payment demands could hamper the company's ability to promote strategic initiatives—including the restructuring of its debt—that could enable it to overcome its financial situation.[3]

Corporate governance systems must be able to balance the rights and responsibilities of the different stakeholders, particularly those of the equity holders and creditors, when a company finds itself "in the zone of insolvency".[4] In fact, for years, directors' duties in the zone of insolvency have been a widely discussed topic among law practitioners in multiple jurisdictions.

Traditionally, the Spanish legislator has only vaguely addressed this issue. In scenarios where the debtor is already insolvent, the Spanish insolvency legislator dealt with this conflict-of-interest situation by proposing an insolvency process governed by a court-appointed independent insolvency trustee subject to a set of fiduciary duties that aim to balance the interests of the different stakeholders involved in an insolvency scenario. These duties are built around the concept of "interest of the insolvency estate" (*interés del concurso*), which refers to preserving the value of the company's assets and, consequently, maximizing the overall recovery for all stakeholders involved in the process. Therefore, directors are largely replaced by the insolvency trustee, who becomes responsible for any decisions that have financial implications, and equity holders' involvement in the company's decision-making process is minimized.

However, insolvency proceedings in Spain are increasingly becoming an exceptional remedy. This is especially so since Directive (EU) 2019/1023 was transposed into Spanish law.[5] There is a clear tendency towards insolvency proceedings being solely used by non-viable businesses that have no prospect of survival, where the interests of all stakeholders is to liquidate the company quickly and distribute the value among them. In contrast, viable companies in financial distress typically resort to pre-insolvency restructuring mechanisms that enable them to overcome their situation.

In a scenario in which pre-insolvency measures are becoming increasingly important, legal systems must establish mechanisms that balance the interests of shareholders and

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3 In this sense, scholars have consistently referred to fulcrum creditors as the stakeholders whose interest are more aligned with the corporate interests of the distressed company. They are more vested in maximizing the value of the distressed company because their recovery is not guaranteed as the value of the company does not cover their investment.

4 The expressions "in the zone of insolvency" and "in the vicinity of insolvency" have become widely used by legal scholars and practitioners to refer to situations where the relevant company is still not insolvent, but it starts to face or foresees financial difficulties.

5 Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132.

creditors in the zone of insolvency. The process of transposing Directive (EU) 2019/1023 into Spanish law seemed to be the ideal opportunity, as it emphasized the need for distressed companies' management to protect creditors' legitimate interests.[6] In fact, Article 19 of Directive (EU) 2019/1023 expressly required Member States to ensure that, in a likelihood of insolvency situation,[7] directors of companies consider "*the interests of creditors, equity holders, and other stakeholders*".

Many Spanish market players expected the Spanish pre-insolvency legislator to introduce a new regulation into the Spanish corporate governance system that would be in line with the Directive (EU) 2019/1023 requirements. In fact, although with deliberated ambiguity, the European legislator seemed to somehow require Member States to address the widely-debated problem of the potential shift in the duties and loyalties of company's directors in the zone of insolvency, commonly referred to as "duty-shift". Instead, the preamble to Act 16/2022[8] stated the following:

> "The provisions of Directive (EU) 2019/1023 regarding the duties of corporate directors are implicit in the current regulations, so no changes are introduced in the current regime of the corporate action for liability or in the potential categorization of the insolvency proceedings as guilty."

The Spanish legislator considered that the existing rules already stroke an appropriate balance between the interests of all stakeholders involved, and that modifying them in the framework of the transposition of Directive (EU) 2019/1023 could disrupt the established framework.

This article will analyse whether the Spanish legislator was right not to modify the Spanish corporate governance regime. While we are aware of the ever-changing nature of the corporate governance discipline, such as the latest trends of digital transformation and environmental, social, and governance (ESG) factors, this article focuses on the specific impact of Directive (EU) 2019/1023—and the new restructuring instruments it introduces—on corporate governance in Spain. Instead of providing a comprehensive analysis from a Spanish law perspective, our objective is to present the key elements of corporate governance for distressed companies in Spain, with the aim of encouraging a wider discussion on the best practices directors should adopt during times of crisis.

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6 See Recital (71) of the Directive (EU) 2019/1023.

7 For the purposes of this article, we will use the Spanish concept of insolvency (i.e. based solely on a cash-flow test) and the Spanish three stages of insolvency. Accordingly, "current insolvency" refers to the moment when the debtor is unable to meet its payment obligations regularly on the due date; "imminent insolvency" refers to the moment when it is foreseeable that the debtor will be unable to meet obligations falling due in the following 3 months; and "likelihood of insolvency", a concept newly introduced pursuant to the transposition of the Directive (EU) 2019/1023 into Spanish law, refers to the moment when it is objectively foreseeable that, if a restructuring plan is not reached, the debtor will not be able to regularly meet its obligations due in the next 2 years.

8 Ley 16/2022, de 5 de septiembre, de reforma del texto refundido de la Ley Concursal, aprobado por el Real Decreto Legislativo 1/2020, de 5 de mayo, para la transposición de la Directiva (UE) 2019/1023 del Parlamento Europeo y del Consejo, de 20 de junio de 2019, sobre marcos de reestructuración preventiva, exoneración de deudas e inhabilitaciones, y sobre medidas para aumentar la eficiencia de los procedimientos de reestructuración, insolvencia y exoneración de deudas, y por la que se modifica la Directiva (UE) 2017/1132 del Parlamento Europeo y del Consejo, sobre determinados aspectos del Derecho de sociedades (Directiva sobre reestructuración e insolvencia).

2. The Spanish Approach to Directors' Liability

Act 16/2022 did not impose a specific legal regime on the pattern of conduct directors should follow in a pre-insolvency situation. This determined that the debtor will still have management and administration powers over the company's assets while a pre-insolvency solution is being sought. Therefore, the first step to analysing corporate governance in pre-insolvency situations is to briefly address the main features of the Spanish general legal system for directors' liability. Our analysis is threefold and considers the regulation on Spanish directors' duty of diligence and care, the rules on compulsory dissolution due to serious losses, and the directors' insolvency liability regime.

2.1. Directors' duty of diligence and duty of loyalty and their liability for damages

Directors must perform their duties with the diligence of an orderly businessperson and loyal representative. This means that directors are obliged by a duty of diligence and a duty of loyalty when carrying out their duties. These fiduciary duties do not disappear or are otherwise mitigated in the zone of insolvency; therefore, compliance with them is critical when analysing directors' behaviour when the company they manage is in financial distress.

Duty of diligence requires directors to handle corporate matters with the diligence of an orderly businessperson. This includes preparing meetings and analysing in advance the information to be provided, collecting any additional information they consider useful to carry out their duties, attending meetings and actively participating in them, and, at all times, overseeing the company's performance.

Directors' strategic and business decisions must be made within the limits of the "business judgement rule" according to which directors must act in good faith, take no personal interest in the matter being decided, have sufficient information and follow appropriate decision-making procedures. This standard aims to prevent Spanish courts, when analysing directors' liability, from making *ex post* rulings on the technical and business rationale behind the directors' decisions.

The "business judgement rule" safe harbour plays a critical role when analysing directors' behaviour in the zone of insolvency.[9] The Spanish legislator understood that the decisions that directors must make while carrying out their duties are always affected by a relevant degree of uncertainty. Losses or, more generally, the undesirable outcome of a business decision cannot by themselves give rise to directors' liability. The key to determine whether the director acted diligently is to analyse whether, when making the business decision, the director acted diligently. The business decision will be considered diligent it if was made according to the requirements of the "business judgement rule", regardless of the outcome achieved.

Duty of loyalty requires directors to defend the corporate interest. To do so, they are obliged to act independently, over their personal interests and without being subjected to instructions, especially instructions from the shareholder that backed their

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[9] Juan Sánchez Calero Guilarte, 'Infracción de deberes y protección de la discrecionaldiad empresarial en períodos de crisis', in Muñoz Paredes and Cohen Benchetrit (eds) (above note 2).

appointment.[10] While performing their duties, directors are prohibited from using their authority for purposes other than those for which it was granted: disclosing secrets, even after they cease to hold the position; participating in discussions or decisions in which they may have a conflict of interest; and avoiding any situations that conflict with the company's interest.

Based on the above directors' duties, the Spanish Corporate Act includes a specific liability regime to compensate damages that directors may cause to the company's equity, shareholders or third parties through the negligent or incorrect performance of their duties.

Where damage is caused to the company's net worth, directors' liability is pursued through a "corporate action for liability", which seeks to indemnify the company for the damage caused by its directors when carrying out their duties. This type of action can be filed by the company and, subsidiarily, its shareholders, and even its creditors.[11] Conversely, where damage is caused directly to shareholders or third parties, liability is pursued through an "individual action for liability". This action is typically brought by shareholders or creditors when the director's misconduct or negligence is directly detrimental to their private interests (the three main groups of cases where Spanish courts have accepted directors' liability being (i) the company's progressive accumulation of debt where the director was aware that it would not be able to repay it; (ii) the director supplying false information to obtain third-party financing; and (iii) cases where damages to third parties result from the breach of a legal mandate the director should have complied with).

Current Spanish legislation does not pose any obstacle to these actions being brought in a pre-insolvency scenario. In fact, in our view, when Act 16/2022 stated that the existing corporate governance rules allowed the appropriate protection of the interests of all stakeholders involved, it expressly recognized that these rules can be maintained in the zone of insolvency. Also, the fact that the Spanish legislator grants legal standing to creditors to bring both types of actions is significant, since it means that they are regarded as having an interest in safeguarding both the company's social interest (through its subsidiary standing to exercise the "corporate action for liability") and their own (through the "individual action for liability").

2.2. Compulsory dissolution due to serious losses and directors' liability for corporate debt

Article 363 of the Spanish Corporate Act refers to a number of situations where directors are obliged to call a general meeting within two months to adopt the resolution for wind-up, or, if the company is insolvent, to apply for insolvency proceedings. From a pre-insolvency perspective, the most relevant of these situations is where the company

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[10] Article 228 d) LSC specifies that directors must "fulfil their roles under the principle of personal responsibility, with freedom of opinion or judgement and independence with respect to third-party instructions and links".

[11] Legal standing to bring legal action falls, first, with the company, following the relevant resolution passed by the general meeting. If the company fails to promote the legal claim, the Spanish Corporate Act grants shareholders subsidiary standing if they have a specific stake in the company's equity. If they also failed to initiate corporate actions for liability, the law allows the company's creditors to promote it, if its equity is insufficient to cover their claims.

incurs what legal practitioners have come to call "serious losses"; i.e., losses leading the company to a situation in which its equity is reduced to less than half of its share capital (unless the share capital is increased or reduced by the appropriate amount and the company does not meet the requirements to apply for insolvency).

When this circumstance occurs, directors are required to call a general meeting within two months to adopt the resolution for wind-up, or, if the company is insolvent, to apply for insolvency proceedings. If they fail to seek the company's wind-up under these circumstances, directors will be held liable before the company's creditors for the company's "corporate obligations" incurred from the date wind-up should have been sought.

The situation where a company in financial distress faces the risks of incurring a cause for winding up the company due to "serious losses" simultaneously to a pre-insolvency or insolvency situation is very common. When directors are in this situation, it is up to them to decide whether to seek the company's wind-up, file for insolvency, or resort to pre-insolvency mechanisms.[12] To make the appropriate decision, they will need to consider the benefits and drawbacks of each of those solutions, including addressing which one maximizes the company's value.

Directors will be automatically subject to this corporate debt liability regime if they breach their wind-up duties, and their liability will not depend on whether their conduct caused losses or damages. Therefore, they will not be able to argue that they complied with their duty of diligence to escape their liability for corporate debts.

2.3. Directors' liability in insolvency situations

This directors' liability regime is triggered after the company becomes insolvent; this is when it becomes necessary to classify the insolvency (*calificación concursal*).

The commercial court in charge of the insolvency proceedings will classify the insolvency proceedings as either fortuitous or culpable. Insolvency is classified as fortuitous where the insolvency or its aggravation is not attributable to a particular person. Accordingly, no sanction is imposed on the company's directors. Insolvency is classified as culpable when the insolvency situation is created or aggravated by the wilful misconduct or gross negligence of the directors.

If the insolvency is classified as culpable, directors responsible for insolvency proceedings being classified as culpable will face the following consequences:

(i) disqualification from administering third-party assets, representing a person, running a business activity, and holding an equity stake in a trading company;
(ii) loss of any rights held as creditors in the insolvency or against the insolvency estate, and the obligation to return all assets or rights they may have unduly obtained or received from the insolvency estate; and

[12] Instead of filing for insolvency, directors can choose to notify the competent court that they have entered into negotiations with creditors for a restructuring plan. In that case, while the effects of the notice are in force, the legal duty to seek wind-up owing to serious losses will be suspended.

(iii) in specific circumstances, the obligation to cover all or part of the insolvency estate's deficit, provided certain requirements are met.

Considering the severity of the effects of culpable insolvency, directors of a company in the zone of insolvency will be particularly cautious in fulfilling their duties, since failure to do so exposes them to the risk of becoming personally liable for the repayment of creditors, along with the company they run.

3. Interplay of the (Absence of) Regulation on Corporate Governance and the New *Status Quo* of Spanish Restructuring Scenarios: The Need for a "Best Practice Guide"/Specific Rules

3.1. Impact of the Reform: restructuring scheme

On 26 September 2022, the reform of the Spanish Insolvency Act implementing the EU Restructuring Directive entered into force (the "**Reform**").

The Reform represented a major overhaul of the Spanish restructuring *status quo*, which has shifted its paradigm, as one of its key goals is to promote the restructuring of companies as an alternative to insolvency proceedings, which will end up being a last-resort mechanism for companies whose only solution is their liquidation (including business unit sales). The new restructuring frameworks represent a considerable upgrade to the previous restructuring toolkit, bringing it closer to a US Chapter 11 or an English scheme of arrangement.

These new tools have altered the guidelines for restructuring schemes. Spanish law has moved from a relatively "basic" restructuring scheme to a complex and modern restructuring scheme.

The Reform has brought to Spain class formation, the possibility of cross-class cramdown of existing shareholders and secured creditors, the absolute priority rule, the reverse rule, and the ability to reject executory contracts in the restructuring plan.

The Reform has introduced a new scheme where creditors are allowed to play a more prominent role. This means the debtor has been deprived of its pivotal position and of its "red buttons" to either accept the refinancing (which is no longer required with the ability to cramdown the equity) or to file for insolvency as a defensive mechanism (which is deactivated under certain circumstances). Therefore, the Reform incentivizes debtors to anticipate restructuring measures before it is too late. In our opinion, the same incentives should extend to directors of companies in financial distress.

3.2. Impact of the Reform: directors' position and duties

This section analyses the impact on how directors of distressed (or potentially distressed) companies must behave, or face restructuring scenarios. The great divergences between the refinancing (pre-Reform) and restructuring (post-Reform) schemes are reflected in the following four elements, which all pose several questions where the law is silent.

3.2.1. Ability/obligation to appoint a "restructuring expert"

The Reform introduced for the first time the 'restructuring expert', "a practitioner in the field of restructuring" (as described in the EU Restructuring Directive), whose functions are:

> (1) assisting the debtor and the creditors in drafting and negotiating a restructuring plan;
> (2) preparing and presenting the reports required by law; and
> (3) preparing and presenting the reports the restructuring court may consider necessary or appropriate.

To perform their duties, restructuring experts must have legal, financial and business knowledge and restructuring experience.

The appointment of a restructuring expert does not alter or undermine the director's position in the company in distress. The director will continue to hold the director position at all times and, in the zone of insolvency, the director will need to address whether to request the appointment of a restructuring expert. The appointment of a restructuring expert can be voluntary (e.g., when requested by the debtor or by creditors representing more than 50% of the liabilities that might be affected by the restructuring plan), or mandatory (e.g., in a cross-class cramdown). Creditors (a 50% threshold) have a right to replace the restructuring expert appointed by the debtor or by a minority of creditors (without needing to justify the grounds for replacing the expert).

This new restructuring expert position raises several questions regarding the position of directors. Should directors always seek the voluntary appointment of a restructuring expert? If not, at which point should directors seek this appointment? Should the shareholder's meeting approve or name the proposed restructuring expert? Should the position of the directors be aligned with that defended by the restructuring expert? Are the director's duties affected (or discharged) by the appointment of a restructuring expert? Are directors obliged to cooperate or collaborate with the restructuring expert (even if the appointment is forced by a majority of creditors)?

3.2.2. Creditors' ability to cramdown the debtor's shareholders

One of the Reform's main developments is the possibility for creditors of the company in financial distress to cross-class cramdown existing shareholders that are financially "out of the money". This complemented the creditor's ability to cramdown other senior or junior creditors, which the former regime had envisaged.

The pre-reform Spanish insolvency law regime granted the debtor (and its shareholders) a pivotal role in negotiations, given that any refinancing agreement had to be approved by the debtor (through a shareholder's resolution). Spanish debtors also had the right to end refinancing negotiations anytime, as they were allowed to resort to insolvency if they (and their shareholders) did not like the proposed refinancing terms (e.g., capitalization of claims).

These sets of rights of distressed debtors (that ultimately corresponded to their shareholders) entailed that, even if directors had divergences of criteria with shareholders for what could be best for the viability of the company (e.g., refinance v. capitalize

claims), the director's position tended to be aligned with the shareholders' position given that their consent was mandatory for any plan to be approved (i.e., directors tended to support refinancing of liabilities rather than its capitalization, given that shareholders might be reluctant to dilute their stake).

As a result of the Reform, creditors can now impose restructuring plans on shareholders when certain requisites are met. Creditors (or the restructuring expert, if appointed) are also capable of staying insolvency petitions during a one-month term, to the extent they can prove that a restructuring plan can be potentially approved. Accordingly, the Reform has deactivated the debtor's (and its shareholders) "red button".[13] This means shareholders may no longer be able to impose restructuring mechanisms that do not prioritize the viability of the company (e.g., refinance v. capitalize claims).

Now, the pivotal element in the restructuring equation should be the ability to approve a restructuring plan that promotes the viability of the debtor as an alternative to a value-destructive insolvency process. This situation might well open cracks between the shareholders and the directors. Directors should now support and promote the restructuring plan that best ensures the viability of the debtor, and this plan may not necessarily be the plan supported by the shareholders.

On this basis, does the ability to cramdown the equity have an impact on directors' duties? Do directors have a duty to explore all potential restructuring plans that could be approved by the debtor or its creditors? Can director's draft a restructuring plan on behalf of the debtor that conflicts with the proposals made by the shareholders?

3.2.3. Potential concurrence of competing restructuring plans (or the new multidirectional scenario)

The Reform remains silent regarding potential competing restructuring plans and has not addressed how to deal with situations where different restructuring plans are promoted by different stakeholders. However, this silence does not prevent the relevant agents from submitting competing, and potentially incompatible, plans.[14]

This situation also entails a major change in the restructuring negotiations. The former refinancing negotiations were "bidirectional" in the sense that most of the refinancing negotiations in Spain have historically taken place between the debtor and a majority of its financial creditors (>51% of the total financial liabilities).

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[13] Creditors may request a stay of an insolvency petition filed by a debtor (1) during the pre-insolvency period; and (2) during the negotiation of a restructuring plan. The insolvency petition will be stayed if the restructuring expert (if appointed), or creditors representing more than 50% of the liabilities that could be affected, prove that a restructuring plan is likely to be approved. The stay would be lifted by the insolvency court if creditors do not submit a homologation petition within one month of the debtor's petition for insolvency proceedings.

[14] Commercial Court 5 of Madrid sustained in a ruling of 10 April 2023 (Single Home) that, in the event of competing restructuring plans, the rule of priority in time (or "first in, first out") must apply and homologate the restructuring plan filed by a debtor rather than the restructuring plan filed subsequently by the creditors. In that case, the court based its decision on the absence of regulation for dealing with restructuring plans and went on to explain how this lack of regulation was also part of the EU Restructuring Directive, in contrast to how this is expressly addressed in the US Chapter 11. Interestingly, the court hinted at the possibility–even if acknowledging that such option would go beyond the letter of the law–that competing plans may be presented in the context of contradictory proceedings.

The Reform has shifted from bidirectional to multi-directional negotiations, where multiple restructuring plans can be negotiated in parallel. The debtor may not only be deprived of its pivotal role but may also not be channelling or centralizing all the competing restructuring plans.

On this basis, what should directors' attitudes be towards competing restructuring plans? Do they have a duty to quickly react to the distress situation by preparing their own restructuring plans, to avoid competing plans? Should directors pursue the homologation of a restructuring plan if a competing plan was submitted first?

3.2.4. When directors should tackle insolvency

Before the Reform, a refinancing agreement could only be reached when the debtor was in an imminent or current insolvency situation. One of the Reform's goals is to allow Spanish debtors to tackle insolvency at a very early stage.[15] To this end, the Reform has set a new entry test which is the debtor being in a "likelihood of insolvency" situation, which is defined by reference to the debtor being unable to meet its payment obligations that are due within the next two years based on objective grounds.

In the event of likelihood of insolvency, directors can now resort to pre-insolvency mechanisms aimed at anticipating as much as possible the restructuring negotiations to avoid a potential value destructive insolvency. This entails that directors are provided tools that allow them to anticipate potential restructuring negotiations, to revert the company's financial distress not only when approaching "insolvency" (imminent or current insolvency) in the very short term, but also in the medium-short term. A close monitoring of the company's liabilities and fulfilment (current and future) of its contractual obligations (e.g., payment instalments and covenants) is key for directors who intend to comply with their duties.

The ability to detect early a likelihood of insolvency scenario and preventing it from becoming "insolvency" (either imminent or current) will also be critical, since creditors will only be able to impose a restructuring plan on the debtor in the event of current or imminent insolvency, but not in the event of likelihood of insolvency.

Does this mean that directors must initiate restructuring negotiations in the event of likelihood of insolvency? May directors be found personally liable if they fail to promote a restructuring plan on time or if their potential inaction leads to a competing plan being homologated once the debtor is considered to be "insolvent"?

4. Good Practice Guide

Despite all these major changes to the restructuring scheme, Spanish law has remained silent on corporate governance. The Reform does not specifically address how (or when) directors must address restructuring schemes, and nor has it envisaged any guidelines on corporate governance.

This absence of regulation has been consistent with how the Spanish legislator has approached the corporate governance of Spanish companies. However, we understand

[15] Preamble of Act 16/2022 (Section I).

that the Reform (and how existing case law has so far applied the Reform) has sent clear messages and recommendations to Spanish directors.

Most Spanish scholars and practitioners have resorted to Recitals 70 and 71 of Directive (EU) 2019/1023 to exemplify the conduct required from a director of a company in financial distress.[16]

Recital 70 exemplifies certain actions that directors of a company in financial distress can promote to minimize losses and avoid insolvency. The Directive's list includes resorting to early warning tools, avoiding the loss of key assets, refraining from promoting transactions potentially subject to avoidance, avoiding interrupting the company's trade and, importantly, promoting negotiations with the company's creditors.

Recital 71 starts by stressing the importance of protecting "*the legitimate interests of creditors from management decisions that may have an impact on the constitution of the debtor's estate*" by diminishing its value. Next, it indicates that directors should refrain from taking actions that result in their personal gain or in the gain of any stakeholder and avoid agreeing on transactions at below market value.

Directive (EU) 2019/1023's recommendations are clearly in agreement with the Spanish regulation on directors' duties of diligence and loyalty. Recital 71 expressly indicates that the Directive's provisions "*should be without prejudice to Member States' national rules on the decision-making processes in a company*", which gave the Spanish legislator wide leeway to continue applying the well-known business judgement rule mechanism when analysing directors' performance in the zone of insolvency.

That being said, these EU soft-law recommendations are clearly insufficient to give a full picture of directors' duties in the zone of insolvency. Therefore, this section suggests a "Good Practice Guide" for directors of companies that are (or may potentially be) in a distressed situation. Although each situation must be assessed on a case-by-case basis, the suggestions below aim to give general guidelines in terms of corporate governance and how directors should tackle pre-restructuring and restructuring schemes.

4.1. Anticipation of insolvency (likelihood of insolvency)

There is no legal duty for directors to start restructuring negotiations or to reach a restructuring plan as an alternative to insolvency. Yet, directors' duties (of care) in the zone of insolvency from this perspective are strengthened, as far as it will need to take the necessary steps to avoid insolvency, when possible, or to reduce its impact on the debtor's value.

The first and main duty of directors of companies under financial distress is to closely monitor the company's financial status:

(i) to anticipate the debtor entering into a potential likelihood of insolvency/insolvency status;

[16] E.g., Fernando Cerdá Albero, 'Deberes de los administradores en la proximidad a la insolvencia y la acción individual de responsabilidad', in Muñoz Paredes and Cohen Benchetrit (eds) (above note 2).

(ii) to promote appropriate business decisions to try to prevent these insolvency risks from materializing; and
(iii) if an insolvency situation is triggered, to promote negotiations with the company's creditors to try to reach a restructuring plan, if that is in the company's best interest, including requesting the appointment, if necessary or convenient, of a restructuring expert.[17]

The director's behaviour in the zone of insolvency depends on several variables: its ability to tackle insolvency will depend on the potential concurrence of "serious losses" that may compel the director to promote the company's wind-up, and the director's decisions will be conditioned by its hard-law insolvency-related filing obligations. Directors only have a duty to file for insolvency in a current insolvency (inability to regularly pay its obligations as they become due). Directors do not have a duty to file for insolvency in the event of imminent insolvency (insolvency status in the upcoming three months) or likelihood of insolvency. In turn, Spanish companies have a right (but not an obligation) to consider pre-insolvency mechanisms (e.g., filing a pre-insolvency notice or requesting the homologation of a restructuring plan) in the zone of imminent insolvency or likelihood of insolvency. The fact that the EU and the Spanish legislator have aimed to leave insolvency proceedings as a last-resort mechanism should not have a direct impact on directors' duties, which remain unaffected by this legislative policy.

Crossing the line between the likelihood of insolvency and current/imminent insolvency entails a significant impact for debtors and their shareholders. Creditors will only be allowed to cramdown a restructuring plan to the debtor and its shareholders in the event of current/imminent insolvency (not likelihood of insolvency). However, this new role for creditors in the restructuring schemes does not affect directors' duty of care or compel them to take any specific action.

In other words, directors, while bound by a "reinforced" duty of care in the zone of insolvency, do not have the duty to prevent or avoid non-consensual restructuring plans, where they are beneficial for the debtor.

4.2. Restructuring expert's role and directors' duties

Directors do not have a duty to appoint a restructuring expert. The appointment of a restructuring expert will only be required if the debtor submits a restructuring plan with cramdown effects. Directors have the right to appoint a restructuring expert if they consider it appropriate or helpful, which, again, falls under the scope of their duty of care.

Spanish law does not establish whether the appointment of a restructuring expert (and the expert's identity) should be decided by the directors or by the shareholders (through a shareholders' resolution). In our view, the regime should be the same as the appointment of external counsel: directors do not require a prior shareholders' resolution to proceed with their appointment. This does not fall within any of the matters established by Spanish law that must be approved by the shareholders (article 160 of the Spanish Corporate Act).

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[17] Vicenç Ribas Ferrer, 'La prevención y gestión del riesgo de insolvencia por los administradores sociales' *Revista General de Insolvencias & Reestructuraciones/Journal of Insolvency & Restructuring* 9/2023 (March 2023).

The restructuring expert is a neutral advisor to the restructuring negotiations. The expert's powers do not interfere in the company's management, so director's duties are not affected in any manner after the restructuring expert is appointed.

Directors do not have to be aligned with the restructuring expert's position. As opposed to directors, the restructuring expert does not solely defend the debtor's interest. The expert's goal is to work towards the restructuring and bring the different positions as close as possible. This means that the appointment of a restructuring expert does not alter directors' duties. Directors' duty of care and loyalty remain unaffected, regardless of the appointment of the restructuring expert.

Spanish law does not establish a duty to cooperate with the restructuring expert. However, practice shows that directors must cooperate, so the restructuring expert's functions can be fulfilled (to assist the parties in the restructuring negotiations). A paradigmatic example of this duty to collaborate was the Celsa Group restructuring (dealt with by Commercial Court 2 of Barcelona), where creditors sought the appointment of a restructuring expert. Given the company's unwillingness to cooperate with the restructuring expert, the court (following several out-of-court requirements from the expert) issued a resolution[18] compelling several representatives of Celsa (including the relevant directors) to share a list of documents with the restructuring expert within 48 hours.[19]

To the extent the expert requires information from the company (e.g., to analyse restructuring alternatives and their reasonability, or to appraise the company as a going concern), the expert will need a certain degree of cooperation from the company. In our view, Spanish courts tend to request that companies (and directors) cooperate with the experts, as otherwise the restructuring expert's position will become futile.

4.3. Non-consensual restructuring plans/conflicting interests between the debtor and its shareholders

The ability to cramdown the debtor and the shareholders in non-consensual restructuring plans does not affect the director's duties.

Directors owe their duties solely to the company. Restructuring plans (either consensual or non-consensual) must have a positive impact for the company. One of the legal requisites for a restructuring plan to be homologated is that it ensures the viability of the company in the short and medium term. Another requisite is that the plan offers a "reasonable perspective" of avoiding insolvency proceedings.

The Reform has allowed creditors (either a majority, or even a single creditor that is considered to be "in the money") to impose restructuring plans on the debtor and its shareholders, regardless of the company's best efforts to negotiate or submit an alternative plan. Accordingly, a restructuring plan being imposed on the company should not entail any breach of director's duties or any negligence on their part.

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18 Resolution (providencia) of 16 November 2022.

19 Note that there are also precedents where courts have declared that the company may no longer have the duty to cooperate with the restructuring expert if, among others, a restructuring plan has already been submitted to homologation (ruling from Commercial Court 1 of San Sebastian, ruling (providencia) of 16 June 2023.

Can the same conclusion be reached in a scenario where the director's inaction and lack of cooperation prevented a restructuring plan that would secure recovery for the creditors from being approved, forcing the company to promote value-destructive insolvency proceedings? The Spanish legislator has altered the answer to this question.

The Spanish Insolvency Act (in a 2015 reform)[20] considered that, in the framework of the insolvency classification, a presumption of guilt applied where the debtor's shareholders and directors refused without reasonable cause a refinancing agreement that included convertible instruments or the issuance of securities. As explained, a guilty classification could potentially result in directors' (and even shareholders') personal liability for all the impaired claims. The Spanish legislator deleted this presumption in the recast Spanish Insolvency Act.[21] Therefore, to date, directors do not have a duty to reach, promote, or collaborate in the execution of a restructuring plan. The Spanish legislator has considered it more effective to provide creditors with sufficient tools to impose a restructuring plan rather than "threatening" directors with a guilty insolvency. We concur with the Spanish legislator in that this is positive for restructuring schemes.

On a separate note, an interesting dilemma appears in the event shareholders' interests are not aligned with the company's interests; e.g., directors may be faced with creditors pushing for a restructuring plan that envisages full equitization of the debt. The implementation of this plan would allow the company to significantly improve its financial situation and would potentially grant access to further financing needs. At the same time, shareholders might be reluctant to approve this plan, given that it would dilute their position and they could potentially lose control over the company. Shareholders will likely reject any such creditor-led plan, as its approval or rejection falls within the scope of matters that must be approved/rejected by shareholders and not directors.[22] Interestingly, even if shareholders must approve the plan, shareholders do not have standing to request homologation of the plan, which is only held by the debtor and its creditor.

In this scenario, should directors' positions be necessarily aligned with that defended by the company's shareholders? The answer is clearly no. But this does not mean that their position has shifted towards that of the creditors. Directors owe their duties to the company. Therefore, directors' duty of care obliges them to pursue the alternative that works best for the company, not any particular group of stakeholders. This dilemma may lead them to align with both shareholders and creditors at any given time, but only where their position allows for the better preservation and maximization of the company's value.

5. Conclusions

Given that directors' duties are only owed to the company, there is no duty shift in the "zone of insolvency". A punctual alignment of the interests of the directors and certain creditors is a circumstantial matter, which does not impinge on directors' duties; nor does

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20 Act 9/2015, of 25 May.

21 Royal Decree 1/2020, of 5 May.

22 Article 631 of the Spanish Insolvency Act.

the likelihood of insolvency (or current or imminent insolvency) entail a change in the addressee of the director’s fiduciary duties.[23]

We share the Spanish legislator’s approach to this matter. Spanish law does not require any amendment because of the Reform.

That said, it is clear that the director’s role must be adapted to crisis and pre-crisis scenarios. Specifically, directors should promote restructuring negotiations that reconcile the corporate interest with the proximity of an insolvency situation, where the interest of several stakeholders (other than the shareholders) gain certain weight. To that end, it is critical that directors can monitor and detect situations where the risk of insolvency requires adopting specific measures, such as initiating restructuring negotiations. The business judgement rule as a safe harbour is crucial in this regard.

Even if we share the Spanish legislator’s approach to this matter, it is also clear that it has lost a good chance to determine and crystalize the rules that should govern how to preserve the interest of all the stakeholders in the “zone of insolvency”, particularly those of creditors. This paper has proposed guidelines that we believe are consistent with the duties of directors under Spanish law. Beyond this proposal, practice (and case law) will continue developing this matter.

[23] Carlos Ara Triadú, ‘La responsabilidad del administrador social en la proximidad de la insolvencia’, in Amanda Cohen Benchetrit (ed), *Nuevo marco jurídico de la reestructuración de empresas en España* (Aranzadi, 2023).

Chapter 7

The Interplay between Corporate Insolvency and Corporate Governance: Can a Good Corporate Governance Mechanism Circumvent Corporate Insolvency?

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1. Introduction

Good and stringent 'corporate governance' practices positively impact the progress of a corporate entity, whereas failure of 'corporate governance' impacts destructively to the growth of corporate entity resulting in deadlock in the company management, loss of substratum, prejudice to the stakeholders and, importantly, financial distress. The collapse of Lehman Brothers Holdings Inc. and its bankruptcy proceedings shows the link between corporate governance and corporate insolvency. Lehman Brothers Holdings Inc was the 4th largest US investment bank. The 164-year-old bank was founded in 1844 and started in the business of cotton trading. It subsequently expanded its scope of business to trading commodities and brokerage services. History shows that the company survived the Great Depression and many other economically disadvantageous situations like long term capital management collapse, World Wars etc.

One of the reasons for the collapse of Lehman was unethical management practices, including dubious mechanisms, unacceptable accounting practices coupled with blatant disregard for prudent corporate governance practices.[1] In a study of 240 Vietnamese non-financial companies, it was found that an independent Board of Directors, the separation of CEO and chairman, director ownership, autonomy of audit committees, independence of remuneration and nomination committees are essential attributes to decrease likelihood of financial distress. Upon analysis, it was found that a stronger corporate governance mechanism leads to decreased likelihood of financial distress in a firm.[2] A review of debt recovery of a distress company, a review of companies financial position before any transactions, expert advice for dealing with a company, corporate governance practices of a company, legal and regulatory compliances by the company, prior review of related party transactions can avoid situations like Lehman Brothers and Enron.

Generally, the composition of the Board of Directors, board committee composition, particularly audit committees and risk management committees, are important factors in the identification of corporate bankruptcy. The audit committee plays a crucial role in the control and management of the financial position of a company.

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1 John Mawutor, 'The Failure of Lehman Brothers: Causes, Preventive Measures and Recommendations' (2014) 5(4) *Research Journal of Finance and Accounting* 85-91.

2 Khiem Dieu Truong, 'Corporate governance and financial distress: An endogenous switching regression model approach in Vietnam' (2022) 10(1) *Cogent Economics & Finance* (online publication).

2. Corporate Governance versus Corporate Insolvency

A close observation of several corporate insolvency resolution matters uncovers the correlation between corporate governance and corporate insolvency; at times, corporate insolvency is due to failure of corporate governance. To understand the link between corporate governance and corporate insolvency, the findings of international empirical studies are presented below. They reveal that, in a corporate entity, various factors are responsible for good corporate governance, such as the structure of the Board of Directors, efficient corporate management, the age of the directors, their gender, education and qualification, conflict between management and shareholders, auditors and audit committee etc. Overall, a well-structured Board of Directors with strong governance system can protect a company from insolvency.

2.1. Structure of the Board of Directors

The composition of the Board of Directors and representation of different kinds of directors in the board matters a lot. The committees of the board such as audit committees, CSR committees, nomination and remuneration committees, stakeholder's relationship committees, risk management committees etc. are very significant for strong corporate governance. The committees can oversee and monitor their respective areas for a better governance and make the board aware of any financial risk or any other risk that leads to financial distress.

In India, the composition of the Board of Directors is different for listed companies and public unlisted companies. To have a balanced governance system, a listed entity in India must be composed of both executive and non-executive directors with one independent woman director. The number of independent directors in a board depends upon the nature of the chairman of the Board. The independent directors must review the non-independent directors of the Board. Importantly, as a part of disclosure obligations, the Indian-listed entities are required to give prior information to the Stock Exchange(s) (where the securities of the entity have been listed) about the meeting of Board of Directors, in case of certain specific items on the agendas, such as approval of financial results, buyback of securities, voluntary delisting by the entity, declaration of bonus securities, fund raising by further public offering, ADR, depository receipts etc. as part of regulatory compliance.[3] In a research study undertaken between 2011 and 2015,[4] with a sample of 190 non-financial companies of Indonesia listed on the Indonesian Stock Exchange and comprised of 95 healthier entities and 95 financially-distressed entities, the data showed that family ownership, the size of audit committees, proportion of independence directors and size of the Board of Directors and commissioners has significant effect on mitigating the likelihood of financial distress in a company.

In 2012, a study was undertaken on the relationship between characteristics of corporate governance and Lebanon's corporate financial distress. 178 small and medium enterprises (SMEs) were studied, of which 89 were financially distressed due to negative operating income between period of 2004-2008, and remaining 89 are healthy firms.[5] The study aimed to identify the correlation between different governance factors like a diversified board of members, the

3 SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015

4 Hafiz Mahmud Ahmad and Desi Adhariani, 'Corporate Governance Determinants for The Mitigation of The Likelihood of Financial Distress' (2017) 36 *Advances in Economics, Business and Management Research* (paper from the 11th International Conference on Business and Management Research) (available via: <researchgate.net>).

5 Charbel Salloum and Nehme Azoury, 'Corporate governance and firms in financial distress: evidence from a Middle Eastern country' (2012) 7(1) *Int. J. Business Governance and Ethics* 1-17.

size of the board, concentration of ownership, and outside or inside directors and their impact on financial distress. The results revealed the impact of the proportion of outside directors on the likelihood of financial distress of firm, and that the duality of CEO acting as Chairman of Board may lead to financial distress.

2.2. Attribute of Directors and Fiduciary Duty

The directors are the agents of a corporate entity. Directors owe a duty to the creditors for the repayment of the debt and the shareholders for the protection of their investments. Insolvency may be prevented by careful directors.

In one reported study,[6] research was conducted on two datasets[7] (both publicly and privately traded companies): one was comprised of 552 companies under bankruptcy protection between 1998-2009; the second of 695 companies between 1998-2007. In the second dataset, 114 companies had filed for bankruptcy protection between the time span of 1998-2009. The research aimed to uncover what attributes the directors of insolvent and solvent firms possessed and if the board's attributes are indeed important factors leading to corporate insolvency. The research drew the conclusion that there was a greater number of independent and less grey directors in solvent companies. The research also showed that CEOs of solvent companies were older and held better expertise and that the board members of solvent firms held less stock ownership than directors in insolvent firms. Further the study has identified various factors of corporate governance such as impact of board composition, director affiliation to the firm, board size, relationships among the board age of CEO and board members, expertise of board members, stock ownership, board turnover policy, committee composition and audit committee etc.

In another study conducted in 1990,[8] the impact of financial distress on capital structure was examined and attempt was made to know how a firm deals with different kinds of defaults. In this research, 111 publicly traded firms had either filed for bankruptcy or had restructured their debt from 1979 to 1985, of which 61 companies filed for bankruptcy under Chapter 11 of U.S. Bankruptcy Code and 50 had restructured their debt. It highlighted that corporate default inevitably led to changes in firms' residual claim ownership and allocation of resources. Besides this, bank investors, along with other creditors have also experienced a block in voting stock when it comes to restructuring of debt and firm reorganization under Chapter 11 and subsequently, banks appoint their own members as a member of the board. Consequently, as highlighted in the study, there was an obvious increase in the monitoring of the board of members by banks. It was found that 46% of the Board members were associated with the firm prior to financial distress, yet only 43% of CEOs remained in position after the firm recovered from such distress. The study concluded that there was a strong relation between corporate default and corporate ownership and that financial distress might lead to a change in corporate ownership of residual claims of firm.

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[6] Harlan Platt and Marjorie Platt, 'Corporate board attributes and bankruptcy' (2012) 65(8) *Journal of Business Research* 1139–1143.

[7] Authors have collected the data from two different sources: WebBRD LoPucki bankruptcy database and Riskmetrics.

[8] Stuart Gilson, 'Bankruptcy, boards, banks, and blockholders: Evidence on changes in corporate ownership and control when firms default' (1990) 27(2) *Journal of Financial Economics* 355-387.

2.3. Role of Auditor and Audit Committee

The role and responsibility of the auditor and audit committee have a direct impact on the financial aspects of the entity. The auditors' report speaks about the legal and regulatory compliances and the financial position of the company. From the audited report, one can predict the future financial position of the entity. A recent empirical study[9] of 11 commercial banks in Kenya was conducted to establish and enhance confidence of investors ensuring that their investments is safe at all costs even against financial distress. The study covered the working relationship between financial distress and other factors like ownership structure, board structure, audit committee structure and independent directorship. It revealed the existence of an insignificant relationship between independent directorship and financial distress. The study suggests that the banks in Kenya require an enhanced set of skills composition and finds that there is a positive and significant relationship between financial distress and the structure of the Board. However, there is a positive but insignificant relationship between the structure of the audit committee and financial distress. Therefore, there is a claim to be made for amending and enhancing the quality of audit committees.

Recently, the Supreme Court of India allowed the NCLT (National Company Law Tribunal) to take decision related to inquiry against the auditors of Infrastructure Leasing and Finance Limited (IL&FS.) Between June and September 2018, the IL&FS and its group entities had a debt liability of INR 91,000 crore. A research study conducted in 2016[10] tried to determine if internal and external functioning of corporate governance has any effect over likelihood and mitigation of financial distress in transportation industry in Indonesia. The research specifically aimed to determine if any negative relationship between internal mechanism as audit committee characteristics and independent commissioner and external mechanism as audit quality has any impact on likelihood of financial distress of transportation industry in Indonesia. The research focused on firms registered between the period of 2009- 2013 listed in Indonesian Stock Exchange (BEI) and the report of the same has been published by Indonesian Stock Exchange. The research statistically has depicted that there is negative relationship between corporate governance mechanism and likelihood of financial distress in a firm. It lays down that, in Indonesian context, an independent commissioner has negative effect on financial distress i.e. broader independent commissioners will enhance the monitoring and will prevent firm from financial distress and the educational background of audit committee will also aid in reducing the probability of financial distress and, similarly, the better audit quality in a firm will also prevent incidence of financial distress in the firm.

In an article on governance patterns in bankruptcy reorganisation,[11] specific focus on certain attributes of corporate governance in bankruptcy reorganisation have been highlighted. Composition of Board of Directors, investors' institutional holding and role of audit committee play a special role in the insolvency of a corporate entity The sample chosen was 53 firm filing for bankruptcy and matching 53 firms not filing for bankruptcy between 1988 and 1993. The

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9 Sammy Maina Njoroge and Job Omagwa, 'Board Characteristics and Financial Distress of Listed Commercial Banks in Kenya' (2020) 11(5) *IOSR Journal of Economics and Finance Ser. II* 22-33.

10 Yeni Januarsi and Revina, 'Internal and external mechanism of corporate governance in mitigating financial distress on Indonesian transportation industry', in Abdul Halim Abdul Majid and Ashfaq Ahmad (eds), *Proceedings of the 2nd International Conference on Business Management* (UUM School of Business, 2016) (14-27), available at: <http://www.globalcsrc.org/icbm/Proceedings%20of%20The%202nd%20ICBM%202016%20Volume%20(2)%20Issue%20(1).pdf>.

11 Catherine Daily, 'Governance Patterns in Bankruptcy Reorganizations' (1996) 17 *Strategic Management Journal* 355-375.

study aimed to determine the relationships between an audit committee composition, investors' institutional holding and bankruptcy reorganization filing, and the impact of external environment on bankrupt firms in seeking quick exit from bankruptcy reorganization. Furthermore, the study aimed to determine if audit committees affiliated with director proportions were associated positively or negatively with pre-packaged bankruptcy petition in comparison to firms not filing for pre-packaged bankruptcy petition and that if the composition of audit committees was negatively associated with time spent in bankruptcy reorganization under Chapter 11.

Upon analysis, it was found that no simple relationship exists between incidence of bankruptcy and composition of audit committee; no significant relationship exists between audit committee composition and pre-packaged bankruptcy petition. However, there exists a modest relation between audit committee affiliated with director proportion and time spent in bankruptcy filing. The findings of this study shows that independent, outside, directors are positively related to pre-packaged bankruptcy petition, i.e. to say that connections brought by independent outside directors on the negotiation table may be beneficial to the firm because the independence from the firm facilitates gaining trust from creditors with respect to this particular context. The present study concludes by laying down intriguing observations which includes upholding of agency theory when it comes to establish relationship between institutional investor holdings and form of bankruptcy filing; and also the positive association between form of bankruptcy filing and composition of audit committee upholds the resource dependence aspect.

In an empirical study,[12] it has been analysed that the existing bankruptcy models depicting positive relationship between wages and leverage or where entrenched managers is seen as indirect bankruptcy cost, predicting firms filing under chapter 11 for bankruptcy protection. The research aims at aiding the existing models in depicting bankruptcy after inclusion of corporate governance index, size of compensation committee and amount of compensation. It is furthermore also highlighted that the objective and significance of enacting SOX Act and the need of conducting a thorough investigation of proxies in the existing models was for predicting bankruptcy. Inclusion and consideration of internal factors like compensation committee size and compensation amount and external factors like corporate governance index will actually help in determining and differentiating firms which have 'stable and healthy' structure and firms which are likely to fail. The empirical analysis concludes that inclusion of corporate governance index, compensation committee index and amount of compensation will enhance the predictive power of bankruptcy models for firms filing under Chapter 11 and that executives of the firms enjoying the powers of equity holders have higher chances of filing under Chapter 11.

2.4. Conflict between Management and Shareholders

The shareholders of a corporate entity are like the watchdogs of the entity. The shareholders role in decision making is very relevant to a good and strong corporate governance. Many a times, the shareholders intervene for the oppressive act of the management. In exceptional situations, the shareholders have the right and power to call the extra ordinary general meeting and resolve any agenda. In case of conflict between the shareholders and management may make the company non-functional and leads to insolvency situation. In another article,[13] the

[12] Chia-Ying Chan *et al.*, 'The role of corporate governance in forecasting bankruptcy: Pre- and post-SOX enactment' (2015) 35C *North American Journal of Economics and Finance* 166-188.

[13] Montserrat Manzanequ, Alba Maria Priego and Elena Merino, 'Corporate governance effect on financial distress likelihood: Evidence from Spain' (2016) 19(1) *Revista de Contabilidad* 111-121.

impact of corporate governance on firms in Spain has been highlighted taking into consideration the firms listed in Spain from 2007-2012 and 308 observations have been divided into financially and non-financially distressed firms. It is based on previous research done from 2008 and is also based on the notion that merely financial and economic data alone do not provide sufficient predictive power to predict bankruptcy. Emphasis has been given on corporate governance as a factor contributing towards occurrence of financial distress. It is also built on Agency Theory that internal conflicts in machinery within the firm like managers and stakeholders may lead to a more severe crisis; also it has also been emphasized that managers' behaviour in a firm if primarily addressed and focused on self-interests will lead to ethical conflict with the shareholders. Lastly, since the research has been focused on firms based in Spain, it will also enhance the efficiency in countries like U.S., Singapore, China and Taiwan. The current article adds to the already available literature on the relationship between ownership and likelihood of financial distress; it provides for a negative relationship between the two and emphasizes that institutional or non-institutional ownership has no effect on occurrence of financial distress in Spanish context.

One research study[14] aimed to establish a relationship between characteristics of corporate governance and status relating to financial distress in a firm. The study was conducted on 46 financially distressed and 46 not financially distressed firms in Canada. The study reviewed literature prior to this empirical research addressing general relation between bankruptcy as an incidence of failure and governance mechanism and asserts that there are only limited studies which deal with bankruptcy as general parameter for signifying failure. This particular study highlighted this gap between the two ends and concludes that corporate governance structure or the structure of the board lays effect on financial distress of a firm. Also, the major contribution of this study is the finding that there is difference between financially distressed firms on the basis of CEO turnover.

The role of the Board and their attitude is a significant factor for the growth and promotion of the entity. The Board of Directors as the brain of the company, directly influence all the management decisions of the company and their active involvement with a positive attitude makes a difference. A research study[15] aimed to find out the effect (if any) of Board attributes on likelihood of financial distress in non-financial firms in the Asian perspectives. The research was conducted with a sample size of 146 non-financial firms listed in Pakistan stock exchange between 2005 and 2019. the financial data for these entities are obtained from the Annual reports published by PSE. The analysis of the financial data of these listed entities reflects that the Board attributes contribute towards likelihood as well as prevention of financial distress. Significant negative relationship has been established between financial distress and Board autonomy i.e. independence of Board of director, which will reduce likelihood of financial distress, also there is an insignificant positive relationship with higher probability of financial distress i.e. entities adopting CEO duality have higher chances of experiencing financial distress in Pakistan. The Board of Directors and the Key managerial persons are responsible in many ways and vested the powers to take decisions in the process of fund raising, restructuring of the company including the business expansion.

14 Fatthi Elloumi and Jean-Pierre Gueyié, 'Financial Distress and Corporate Governance: An Empirical Analysis' (2001) 1(1) *Corporate Governance* 15-23.

15 Shahab Ud-Din *et al.*, 'Board Structure and Likelihood of Financial Distress: An Emerging Asian Market Perspective' (2020) 7(11) *Journal of Asian Finance, Economics and Business* 241–250.

3. Corporate Fraud and Financial Distress - Failure of Corporate Governance

'Corporate Fraud' impacts negatively the corporate entity and mostly the result is financial distress. In some cases, the consequence of corporate fraud is financial losses for the company, shareholders, creditors and employees, damage to reputation and goodwill, criminal action, action by regulators, penalty, fine etc. Nevertheless, the ultimate result is economic loss. The reason in maximum cases is corporate fraud, irregularity in company and failure in corporate governance system. Thus, the financial distress is the outcome of corporate fraud and corporate fraud is the outcome of failure of corporate governance. If we examine some corporate scams, like Enron scandal, Satyam Scandal, IL & FS scandal etc., then the root cause is failure of corporate governance. In the Satyam scandal, the collapse of the company was due to fraud by inflating the profits and assets of the company by billion dollars. The IL and FS bankruptcy was connected with several fraudulent activities and financial irregularities in the company. Similarly, we see the direct or indirect connection of failure of corporate governance in some of the corporate insolvency and bankruptcy matters in India i.e. Dewan Housing Finance Ltd. insolvency matter, Bhushan Power and Steel (US$ 6.9 billion), Essar Steel, Lanco Infra, etc.

The case of Enron and Parmalat[16] was due to failure of Corporate Governance in Enron, a Houston based Energy Company founded in 1985 and became one of the world's largest energy trading companies, after the merger of the two companies i.e. Enron and Parmalat, an Italian giant in sector of dairy and food. The author has highlighted the failure of corporate governance structure in both of these companies and primarily laid focus on the role of corporate governance in transition countries on a market economy. In the case of Enron, the emphasis has been laid on the situation where Chief Financial Officer waived off conflict of interests allowing the CFO to establish private partnership with firms and these partnerships appeared to have debts and liabilities. Besides, the existence of unfettered power in the hands of Chief Executive led to downfall of Enron.

However, when it comes to Parmalat, the company was owned by several and complex set of companies and was also controlled by one strong block holder, the Tanzi family. The company's control was in the form of pyramid and opaque pattern of ownership. The corporate governance in Parmalat was inflicted with serious blows of absolute control with executive, strong block holders and neglecting minority shareholders. Furthermore, certain basic principles of better corporate governance were also not complied with by the Italian company like, segregation of chairman and chief executive position, independence of non-executive director from managerial control and lastly when group of shareholders control a company, it is imperative to have on board some independent directors however the same was also not the scenario in Parmalat.

The downfall and wreckage of Enron and Parmalat display that corporate governance play crucial role in functioning of companies and although corporate governance cannot prevent unethical practices at top level but it can contribute towards detection of such malpractices in the top level management before it is not possible to overturn the adverse situation. In an article,[17] the authors have focused on the importance of debt in proper functioning of corporate governance. Primarily, it has been emphasised that absence of debt lead directors to adopt practices favourable to them rather than adopting practices which aim at increasing

16 Rezart Dibra, 'Corporate Governance Failure: The Case Of Enron And Parmalat' (2016) 12(16) *European Scientific Journal* 283.

17 Michael Bradley and Dong Chen, 'Corporate Governance and the Cost of Debt: Evidence from Director Limited Liability and Indemnification Provisions' (2011) 17(1) *Journal of Corporate Finance* 83-107.

shareholders' wealth. The authors have attempted to highlight the correlation between effect on bondholders and self-serving behaviour. Initially authors believe there is no adverse impact of the covenants focused at self-interests. They indulge in explaining a less discussed principle of limited liability and indemnification of directors by conducting a study of 1500 S&P firms between 2002-2005 which have traded publicly and have outstanding senior security bonds. In the present study, the extensive review of literature by authors have led to realization that only a few studies have been done with respect to impact of self-serving behaviour of managers/directors on shareholders.

The inclusion of bondholders is the first choice of the authors in the present study. It is believed that fragile or weak governance does not affect the shareholders because it is inclined towards benefit of manager/directors but because of adoption of practices possessing low-risk lead to decreased cost of agency debt. Moreover, inclusion of clause providing for limited liability and indemnification of managers/directors provide larger alignment towards self-indulging interests because of operation of lower risk strategies which in turn lead to low-cost of debt and will eventually result in benefit of stockholders.

Stein Tomer in his article[18] focuses on extensive relationship between managers/directors and shareholder and evolves a new idea where corporate governance assumes accountability of the complete firm's debt. The article analyses how debtors' impact or influence firm's decision-making capability and form restrictions on rights for control and composition of board, on sales of assets and transfer of cash. Additionally, the author has highlighted that with gradual passage of time, as the firm incurs debt and refinances it later, there is a gradual and consistent shift in control towards the debtor's and since contract with debtor's is unlike any charter-based rights the debtors incur more and more power to control and have more leverage for the governance system of the firm. Besides, the author has laid primary emphasis on how model of debt-and-equity is better at framing better corporate governance than equity-only aspect of corporate governance and how corporate governance through debt is a better at defining purpose of the corporation than maximization of value through stockholders. It was concluded in the article by the author that debt holders by default act as controllers of corporate governance and also have proved to be efficient in benefitting the society at large by way of enabling Corporate Social Responsibility as well.

The study[19] was based on the question if corporate governance characteristics help in prediction of financial distress in Taiwanese companies. The study was based on financially distressed firms and non-financially distressed firms listed between January 1996 and December 1999. The analysis by the authors highlights that there is a negative relation between adjusted control rights and likelihood of financial distress, i.e. if there is decline in stock market, more stocks are supposed to be bought by the controlling shareholders. The corporate fund represents the easiest way to support stock price, however if the stock price eventually falls, the firm might face financial distress. Similarly, the authors also highlighted that there exists a positive relationship between the number of board and supervisory seats occupied and the probability of financial distress.

According to the analysis, if the major board seats are acquired by non-large shareholders, they may help reduce the probability of financial distress. Another analysis by the authors also state that there is higher probability of financial distress which continuously change leadership than those who have founders more than the new comers. The variables for corporate governance

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18 Tomer Stein, 'Debt as Corporate Governance' (2023) 74 *Hastings Law Journal* 1281-1330.

19 Tsun-Siou Lee and Yin-Hua Yeh, 'Corporate Governance and Financial Distress: Evidence from Taiwan' (2004) 12(3) *Corporate Governance* 378-388.

included control rights deviation from rights relating to cash flow, the number (percentage) of seats controlled by largest shareholders and shares pledged by board members and managers. Upon analysis, it was found deviation from control rights from cash flow rights is directly proportional control of shareholder over directors and thereby higher the stock pledge ratio and consequently it is likely for firm to go into financial distress. On the basis of analysis of the said sample, it was found that approximately 63% firms were financially distressed and remaining firms were healthy.

In the Indian context, it has been discussed[20] that the leading cases of insolvency which unduly entrenched upon principles of corporate governance at a rampant pace and left no remedy for the innocent shareholders and it evaluates the landmark and infamous incidents of frauds and like Satyam Scams and Ketan Parekh incident and as a consequence , India had to deal with more complex problem of lack of transparency and accountability and existence of complex Board structure.

4. The Corporate Insolvency and Governance Act 2020 (UK): An Overview

The Corporate Insolvency and Governance Act 2020 (CIGA) was enacted with some permanent measures for Insolvency law and some temporary modifications during Corona Pandemic outbreak for the rescue of the companies. The permanent insolvency measures include Moratorium, Restructuring and Arrangement during Financial Distress, Termination Clauses in Supply Contracts, Implementation of Insolvency Measures etc. During the moratorium, the directors of the company make attempt to rescue the distress company, which is a welcoming procedure to prevent the action by creditor. This 'Debtor in possession' model does not exclude the accountability of the Directors of the company to rescue it. There were some temporary modifications for the rescue of the companies during the COVID 19 like suspension of liability for wrongful trading.

There was a review[21] done by the Government of UK on the operation of the CIGA and an independent research was conducted by Prof. Peter Walton and Dr. Lezelle Jacobs(from University of Wolverhampton) as a part of that review. The interim research report has concluded that the CIGA was welcomed by the stakeholders. However, few concerns were shown in the policy objectives of the Moratorium. Such a model is very much beneficial for rescuing of distress entities in an initial phase.

5. Concluding Remarks

There is no doubt about the linkage between the corporate governance and corporate insolvency. Failure of corporate governance for whatsoever reason, can disrupt the corporate entity from each aspect and mostly resulting in financial disruption. Financial disruption impacts the interest of the company, stakeholders including the shareholders and creditors and it may lead to insolvency resolution proceedings.

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20 Anant Vijay Maria and Kanwal Singh, 'Decoding Corporate Governance and Insolvency Related Issues in India', Chapter 5 in Harpreet Kaur (ed), *Facets of Corporate Governance and Corporate Social Responsibility in India* (Springer, 2021).

21 See: <https://www.gov.uk/government/publications/corporate-insolvency-and-governance-act-2020-evaluation-reports/corporate-insolvency-and-governance-act-2020-final-evaluation-report-november-2022>.

A newly styled theory of interactive corporate governance has been emphasized to focus on the role of lenders in the overall framework of corporate governance. It has been highlighted that divided interests between the debtors and shareholders may not adversely affect the common interests of the firm but may lead to reduce net profits. Additionally, the interactive corporate governance works on two premises. One is on stakeholder activities, which will yield positive net result for other and the other one is the convey of information related to firm's activities to other stakeholders. According to this theory, the inter-stakeholder system in a firm enables the stakeholders to communicate to the stakeholders who have better option to correct the managerial slack. The interactive theory is thus far better in disciplining and correcting managerial slack. This is illuminated that the crucial role that debtor plays in interactive governance and further considers and builds on debt as corporate governance aspect and efficacy of integrated model of corporate governance as an instrument for the purpose of analysis of present-day corporate affairs.[22]

The Board of Directors can play an important role to avoid the financial distress. The Board should try to make the company functional unless any extreme situation has not been arisen. The Board should take extra care for the protection of the creditors and investors. In case of any indication about the insolvency condition, the Board may take precautions like negotiation for debt restructuring, implementation of other schemes of corporate restructuring like acquisitions, sale of assets, Equity infusion etc. The Board must be careful about the avoidable transactions such as fraudulent transactions, preferential transactions, undervalued transactions etc. and extra care should be taken for Related Party Transactions. All Related Party Transactions are not detrimental to the entity but many times, some of the Related Party Transactions are not in the interest of the company, shareholders, creditors. Legal and Regulatory compliances are the fiduciary duties of the directors and an important part of Corporate Governance. In Indian aviation sector, three flourishing airlines are subject to insolvency resolution in the last five years. The factors are directly or indirectly related to poor corporate governance in different forms like non-payment of debt, non-payment of lease rent of the aircrafts, dispute between the aircraft lessors and the airlines etc. which could have been avoided by the Board of Directors.

Prevention of financial distress is better than cure of financial distress. Prevention of financial distress is the responsibility of the corporate management. Even though the corporate entities can be rescued by insolvency proceedings, formerly a strong corporate governance system may avert the insolvency issues in a corporate entity. The legal and regulatory policy framework of each country must address the prevention of insolvency issues as a repercussions of failure of corporate governance. The rescue process also creates difficulties for all stake holders. The Board of Directors of a corporate entity should be entrusted the responsibility to rescue the company before the initiation of statutory insolvency resolution proceeding. A good corporate governance practice can definitely circumvent the financial distress of a corporate entity.

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[22] George Triantis and Ronald Daniels, 'The Role of Debt in Interactive Corporate Governance' (1995) 83(4) *California Law Review* 1073-1113.

Chapter 8

Is Insurance a Solution to Address Environmental Considerations in Insolvency? A Conceptual Exploration

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1. Introduction

Insolvency law tries to make the best of a bad bargain—that is, it tries to maximise the value of a failing firm. In doing so, insolvency regimes prioritise some interests over others, referred to as "conscious prioritizations".[1] Conscious prioritizations are based on factors ranging from economic and social interests to appeasing interest groups. In India, the Insolvency and Bankruptcy Code 2016 (IBC) consciously prioritises secured over unsecured debt, and private debt over government debts and dues.[2]

Such prioritisation allows for extinguishing or only paying out a small percentage of unsecured debt.[3] While there have been no environmental claims under the IBC so far,[4] environmental claimants would likely be treated as unsecured contingent claimants.[5] As environmental claims generally arise from tortious actions (which are also litigable under the statutory framework in India),[6] they are given low priority under the IBC. Such prioritisation of secured debt over environmental debt likely has an adverse effect on environmental policy in India.

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1 See, generally, Carlos Cuevas, 'The Rehnquist Court, Strict Statutory Construction and the Bankruptcy Code' (1994) 42 *Clev St Rev* 435, where Cuevas provides instances of the US Congress consciously prioritising one interest over the other for the purposes of bankruptcy.

2 Section 53, Insolvency and Bankruptcy Code 2016 ("IBC").

3 There are many cases where under the IBC, the resolution plan prioritises repayment of secured debt. The Insolvency Regulator's data shows that financial creditors (who generally are secured creditors) recovered 34.2% of their claims compared to operational creditors (generally are unsecured creditors), who recovered 17.6% of their claims. See *IBBI Quarterly Newsletter Data Jan – March 2023* (IBBI, 2023), available at: <https://ibbi.gov.in/uploads/publication/51cd3268be50c04f9745bb3959b09a89.pdf>.

4 Namrata Nair and Medha Shekar, 'Green Insolvency: Perspective and Policy Prescription', in IBBI, *Exploring New Perspectives on Insolvency* (IBBI, 2002), 351.

5 A contingent claim is a claim whose exact value depends on a contingency, such as the outcome of arbitration or a trial, and is assigned a nominal value (INR 1) during insolvency resolution.

6 See Environment (Protection) Act 1986, Water (Prevention and Control) Act 1974 and Air (Prevention and Control of Pollution) Act 1981.

There are instances in jurisdictions such as United States[7] and United Kingdom,[8] where an application of insolvency law has adversely affected the goals environmental policy seeks to achieve. In Europe, the interaction between environmental considerations and insolvency is unclear. Emmanuelle Inacio observes, "the question of the insolvent polluter is not covered by the European law".[9] In India, where environmental claimants are unsecured creditors, a seemingly apparent solution would be treating environmental claimants as secured creditors. However, that is not the case and it is pertinent to understand the logic and limits of insolvency law. Insolvency law is seemingly agnostic to social issues

Treating claims arising from tortuous liability or statutory considerations on par with secured debt would challenge one of the core principles of insolvency law, which is respecting the nature of debt as according to the principles of contract, as reflected in the priority a creditor receives. On this, Emmanuelle Inacio remarks that:

> "(p)rotecting the environment when a company is insolvent is extremely costly and prevention appears to be key."[10]

In our paper, we explore a different solution. As adequately addressing environmental considerations during insolvency seems impractical, we explore if environmental considerations under insolvency be addressed through insurance.

In this paper, the first part details treatment of environmental claims under IBC and explores why treating environmental claims on par with secured claimants may not be the most efficient solution to address environmental claims. The second part of the paper discusses if environmental claimants can be brought under the Public Liability Insurance Act 1991 and the limitations of such an approach. The third part looks at whether insurance can be a better and more efficient solution in guarding environmental considerations during insolvency.

2. The treatment of environmental claims under the IBC

Environmental claims can broadly be defined as any claim caused due to environmental harm or liability.[11] Environmental harm or liability caused would also likely incur government fines and a clean-up cost to be paid according to the polluter pays principle. Such a policy furthers the goal of environmental protection. The IBC lacks any specific provision for the treatment of environmental claims. Therefore, environmental claims would have to be classified within the existing framework.

Under the IBC, environmental claims would be of two types—claims arising out of decrees obtained and claims arising out of on-going litigation. These claims would be classified as contingent claims and claims by decree holders, both of which have lower priority in the dispersal of money compared to secured claims. Even government fines classified under

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7 See Joshua Macey and Jackson Salovaara, 'Bankruptcy as bailout: coal company insolvency and the erosion of federal law' (2019) 71 *Stan L Rev* 879, where the authors examine how coal companies have used bankruptcy to evade environmental and labour laws.

8 See Carolyn Shelbourn, 'Can the Insolvent Polluter Pay? Environmental Licences and the Insolvent Company' (2000) 12 *Journal of Environmental Law* 207, where the author analysed two insolvency cases which externalised the cost of environmental protections during insolvency on the government.

9 Emmanuelle Inacio, 'When environment meets insolvency' (2019/20) *Eurofenix* (Winter issue) 14.

10 Ibid., 15.

11 Deborah Parker, 'Environmental Claims in Bankruptcy: It's a Question of Priorities' (1995) 32 *San Diego L. Rev.* 221 ('Environmental Claims In Bankruptcy').

"Government debts and dues" are provided lower priority compared to secured creditors. Under the IBC, many resolution plans have done away with government debts and dues.[12] Therefore, in all probability, environmental fines and clean-up costs may also be extinguished under the IBC.

In this manner, IBC, either consciously or unconsciously, impedes goals set forth by environmental policy. In understanding the interaction between insolvency and environmental law, merely viewing insolvency as overriding another law may be short-sighted.[13] Insolvency is a symptom and not a cause. Insolvency law attempts to address this symptom. If insolvency occurs due to mismanagement, fraud or criminal activity, the company is restructured or wound up, as guided under insolvency law. Insolvency laws also have look-back periods to recover monies lost to fraudulent and related party transactions. Other laws address the criminality behind insolvency, and as the case may be, any money recovered is to be reimbursed.[14] It is difficult to envisage an adequate solution for environmental considerations within the scope of insolvency, where a company causes environmental harm, incurs liability, and subsequently seeks recourse under insolvency. Cases involving economic fraud can often be reversed, unlike cases concerning environmental harms, which are often irreversible and may require long-term efforts to remedy.

2.1. Is providing higher priority to environmental claims a possible solution?

As briefly touched upon in the introduction, a seemingly apparent solution is treating environmental claims as secured debt within insolvency, or providing environmental claims a higher priority in insolvency, as has been advocated by some commentators in the past.[15] Let us examine how this fares under IBC, which reflects many standard features observed in insolvency regimes across jurisdictions.

A moratorium is imposed on all ongoing litigation against the company (termed the Corporate Debtor under the IBC) as soon as a case is admitted to insolvency. This would also mean that if cases are ongoing against the Corporate Debtor (CD), the claim's value would be uncertain. Claims which are uncertain are called contingent claims and pose a dilemma of

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12 See cases such as *Ghanashyam Mishra & Sons (P) Ltd. v. Edelweiss Asset Reconstruction Co. Ltd.,* (2021) 9 SCC 657 (India); *Punjab National Bank v. Bhushan Power & Steel Limited*, 2019 SCC OnLine NCLT 18702 (India); *Shaji Purushothaman v. S. Rajendran*, 2020 SCC OnLine NCLAT 651 (India), among others.

13 See, generally, Thomas Jackson, *The Logic and Limits of Bankruptcy Law* (Harvard, 2001), where Jackson cautions scholars against "viewing bankruptcy law as somehow conflicting with and perhaps overriding some other urgent social or economic goal" and implores them to examine bankruptcy in the context of what it is. However, such an approach has been critiqued by other scholars for ignoring social and economic goals. See David Carlson, 'Philosophy in Bankruptcy' (1987) 85 *Michigan Law Review* 1341; HongYin Teo, 'Bankruptcy Law: Is It Really Only about Debt-collection?', in *The True Function of Bankruptcy Law (Cross-sections Vol V)* (2009).

14 Preferential, Undervalued, Fraudulent and Extortionate transactions can also be recovered under the IBC by the Insolvency Professional. Currently, the value of the claims filed by Insolvency Professionals to recover such transactions is INR 285368.39 crore (around EUR 32 billion). See Table 15, *IBBI Quarterly Newsletter Data Jan – March 2023* (IBBI, 2003), available at: <https://ibbi.gov.in/uploads/publication/51cd3268be50c04f9745bb3959b09a89.pdf>.

15 See Christopher Symes, 'Environmental protection orders and insolvency: It is onerous to disclaim, or to prioritise or to resolve the conflict of two public interests' (2018) 37 *Australian Resources and Energy Law Journal* 29; see also Parker (above note 11).

determination.[16] The issue particularly takes precedence in environmental claims, where the impact of the environmental harm often takes time to materialise—and some claims may also arise after the process of resolution. In cases where the claim arises after the process of resolution, the claimants may have no recourse as the company would be provided a fresh start. Similarly, in case of liquidation, the claimants may have no party to pursue their claim against.[17]

If the courts determine a tortious environmental claim in favour of the claimant, they would provide the claimant a decree awarding compensation. Treating such decrees as secured would challenge one core principle associated with insolvency. The principle under challenge would be that the nature of debt and the priority afforded to the debt is determined on basis of pre-existing contractual rights. The classification of creditors based on the pre-existing contractual relationship is one of the core principles the IBC is based on and seems unlikely to be done away with or changed.

Further, if environmental claims are treated alongside secured debt, the special treatment afforded to environmental claims under insolvency would spur other special interest groups to seek higher priority for their claims. For instance, in India, farmers having unsecured claims may seek higher priority. These are the predominant concerns in treating environmental debt as secured debt. Regardless, even if the environmental debt were to be treated as secured debt, it would be subject to the same challenges secured creditors face, such as the time taken and the figure of compensation received.

Environmental claimants would often require immediate assistance and relief, which would not be possible under either insolvency resolution or litigation. Even in the unlikely event of environmental claims being treated as secured debt, under the IBC, secured debtors only recover around one-third of their admitted claim.[18] Therefore, a solution outside the scope of insolvency seems better suited to address environmental claimants and liability. The Public Liability Insurance Act 1991 (PLI Act) with adequate tweaking provides an avenue to consider.

3. The Public Liability Insurance Act

In December 1984, a gas leak at a chemical plant in Bhopal, located in Madya Pradesh, claimed thousands of lives, commonly known as the Bhopal gas tragedy.[19] In this case, the compensation the victims received was astonishingly low, with there being numerous attempts to increase the compensation. Recently, in 2023, the Supreme Court rejected an

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[16] The practice currently is to assign contingent claims a nominal value and set aside a fund for them, where they may be litigated upon after the moratorium ends due to a successful resolution. For instance, in *Punjab National Bank v. Bhushan Power & Steel Limited*, 2019 SCC OnLine NCLT 18702 (India), the contingent claimants were allowed to proceed with their claims as a fund of INR 35 crores had been set aside for contingent claims. However, their claims were capped at 10% and had to be filed within a two year period from the date of approval of the resolution plan.

[17] The claim can be filed against the Directors or Promoters of the company in their personal capacity but is unlikely to be successful due to the high burden of proof placed on the claimants.

[18] Above note 3, as seen in the data provided by the Insolvency Regulator, financial creditors (who are generally secured creditors) receive 34.2% of their claims.

[19] Danish Siddiqui and Nita Bhalla, 'Bhopal's toxic legacy lives on, 30 years after industrial disaster' (*Reuters*, 28 November 2014), available at: <https://www.reuters.com/article/us-india-bhopal-widerimage-idUSKCN0JC0WD20141128>.

appeal to reopen the case and increase the compensation observing the case to be settled once and for all.[20]

In light of the Bhopal gas tragedy, the government enacted and notified the PLI Act in 1991. The PLI Act mandated companies handling hazardous substances (as notified by the government) to compulsorily purchase insurance policies guarding against accidents.[21] The PLI Act defines accident as "a fortuitous or sudden or unintended occurrence while handling any hazardous substance resulting in continuous or intermittent or repeated exposure to death of, or injury to, any person or damage to any property"[22] and omits accidents caused due to war or radioactivity.[23] Under Section 6(1) of the PLI Act, "the person who has sustained the injury" and "the owner of the property to which the damage has been caused" can file an application of relief. Where the accident has resulted in death, the legal representatives and agents of the deceased can file a claim.[24]

In case of an accident, the insurance policy would ensure compensation was provided to the victims. In this regard, if environmental harm were to occur due to the accidental discharge of hazardous substances, the environmental claimants would have an avenue to claim compensation under the PLI Act. As discussed earlier, environmental claims can broadly be defined as any claim caused due to environmental harm or liability. If a company pollutes a river and causes damage to a drinking water source, farmlands or personal injury—the company has caused environmental harm and any claims arising from such would be "environmental claims".

The determination of compensation under the PLI Act is comparatively straightforward. The concerned Collector, a quasi-executive and quasi-judicial authority present in each district, makes the determination based on the principle of no-fault liability.[25] The Collector can then pass an order for compensation on determining if the case involved hazardous substances and was an accident.

However, the compensation under the PLI Act has not been updated since 1991 and is outdated. In case of a medical injury, compensation is capped at INR 12,500 (EUR 141.08) and INR 25,000 (EUR 282.16) in case of death. For permanent disablement, the compensation is capped at INR 25,000 (EUR 282.16) in addition to an INR 12,500 (EUR 141.08) cap for medical expenses.[26] People with partial disability are to be paid INR 1,000 (EUR 11.29) per month for three months. In case of damaged property, compensation is capped at INR 6,000 (EUR 67.72).[27]

It is also to be noted that the compensation under the PLI Act does not prohibit civil actions or civil courts from providing additional compensation.[28] Efforts are also underway to try and

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20 Arpan Chaturvedi, 'India's top court rejects govt plea seeking more compensation for Bhopal gas disaster victims' (*Reuters*, 14 March 2023), available at: <https://www.reuters.com/world/india/indias-top-court-rejects-govt-plea-seeking-more-compensation-bhopal-gas-disaster-2023-03-14/>).

21 Section 4, The Public Liability Insurance Act, 1991 ("PLI Act").

22 Section 2(a), PLI Act.

23 The Civil Liability for Nuclear Damage Act, 2010 addresses nuclear pollution.

24 Section 6(1), PLI Act.

25 Section 3, PLI Act.

26 The conversion rate is as of 26 May 2023 and amounts to EUR 1 = INR 88.60.

27 Schedule, PLI Act.

28 Section 8, PLI Act.

amend the PLI Act, towards updating the compensation.[29] Apart from the compensation, another limitation under the PLI Act is that there should be an "accident" involving a "hazardous substance". This would exclude many instances of environmental pollution caused due to negligence, intentional tort, among others. For instance, in the case of *M. C. Mehta v Union of India* (1988),[30] many tanneries knowingly discharged untreated wastewater across the river Ganges. M. C. Mehta, an environmental lawyer, secured the order to prevent the tanneries from doing so. In such a case where there is intentional tort, claims arising from the pollution caused by the tanneries would not be covered under the PLI Act as the wastewater discharge was intentional and not accidental. This is a limitation of insurance in general, which will not protect against acts of wilful pollution.

The insurance schemes under the PLI Act also have general caveats which exempt the insurance policy from covering government fines and court-mandated clean-up costs. Overall, the PLI Act is limited in its current scope,[31] possibly more so when interacting with insolvency law.

3.1. The Public Liability Insurance Act and Insolvency

In India, there have been no environmental claims under the IBC as of today. Consequently, the IBC and the PLI Act have not interacted so far, leading to certain grey areas which may complicate claiming insurance under the PLI Act if the company is admitted to insolvency.

Once a company is admitted to insolvency, a moratorium on all ongoing cases against the company is enforced. The logic behind a moratorium is to protect the value of the company's estate from the stresses of litigation and aid smooth resolution. Quasi-judicial proceedings are also prohibited during a moratorium. However, the Court allowed a claim to be determined under the Customs Act (which is a quasi-judicial proceeding) but not the enforcement of the claim. The determined claim had to be filed with the insolvency professional. Therefore, while the Collector's proceeding under the PLI Act is a quasi-judicial proceeding, there is scope that it may be allowed to proceed. Furthermore, there are two arguments against applying the moratorium to such proceedings. One, in insurance policies, insurance companies have a general clause which allows them to defend the case. Two, as the Collector has to determine the case on the principle of no-fault liability and verify the facts of the accident, the determination is straightforward and does not require complex legal work. Legal costs are also generally covered under the insurance policies and would not diminish the value of the insolvent company's estate.

Another issue that may arise is, what if the insolvency results in a resolution of the stressed company, leading to a fresh start under the IBC.[32] Then, the company is only bound by the liabilities agreed to in the resolution plan. All remaining liabilities, which may include

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[29] Ministry of Environment, Forest and Climate Change, *Note for consultation on the proposal to make amendments in the "Public Liability Insurance (PLI) Act, 1991"* (F. No. 12/96/2020-HSM), which introduces the amendments and proposes that the compensation provided would be prescribed in the Rules which can be decided by the Ministry and not be present in the Act, This would enable the Ministry to keep updating the Rules (through Executive orders) as and when required compared to amending the Act each time they would want to update the figures for compensation.

[30] *M. C. Mehta v. Union of India* AIR 1988 SC 1037 (India).

[31] According to some reports, lack of compliance with the PLI Act is an issue as well, where many companies handling hazardous substances have not brought any insurance as mandated under the PLI Act.

[32] Sections 31, 32A of the IBC.

environmental claims and government dues, are extinguished. The resolution plan has to be approved by the courts, which in the past have approved resolutions that extinguish contingent claims (the category environmental claims will most likely fall under) and government dues, as allowed under the IBC.[33]

A question that follows is, if a company limits or does away with its contingent liability, would the insurer still be liable to pay compensation for the environmental harm the company caused? The answer is unclear. Public liability insurance policies use language which indemnifies the insured on suffering any loss caused by the accident. This means the insurer's liability arises out of the insured's liability. Where some environmental liability has been extinguished during insolvency, the insurer may refuse to indemnify such loss—as no loss can arise from the extinguished environmental liability. A similar situation may arise where the company is liquidated, where the insurer may deny claims as the company no longer exists.

3.2. Harmonising Public Liability Insurance with Insolvency

A moratorium and a fresh start provided under insolvency may hinder claims under the PLI Act, as seen in the previous part. The uncertainty regarding how insolvency would interact with insurance, as seen in its possible conflicts with the PLI Act, highlights the necessity to harmonise insurance and insolvency law. Such harmonisation would guarantee the ability to pursue insurance claims even in cases of insolvency. There should also be a provision to ensure the continuing of the insurance policy during insolvency where the payment of premiums should be counted as insolvency costs.

One way to harmonise insurance with insolvency is allowing claimants to sue the insurer directly. This would ensure that no proceedings are halted due to the insolvency of the insured company. A similar approach exists in New South Wales, Australia, through the Civil Liability (Third Party Claims Against Insurers) Act 2017.[34] Such a law allows third parties who had a claim against the insolvent insured to sue the insurer directly.[35] Similarly, clarifying that the insurer's liability would not end if the insured company is liquidated or receives a fresh start addresses the possibility of denying claims due to a fresh start. Here, the insurer's liability exists regardless of a fresh start or liquidation, but it does not mean the insurer's liability exists for eternity. Limitation periods, as applicable under insurance law, apply.

In such a manner, PLI Act can be harmonised with IBC, where there is no substantial change to how the IBC operates or any of the core principles insolvency law is based upon. While currently limited in its scope, the PLI Act provides insurance as an alternate avenue to address environmental concerns. In the next part, we explore whether insurance would provide a better avenue than insolvency to address environmental claims.

4. Insurance or insolvency: which better addresses environmental considerations?

Before delving into what better addresses environmental considerations, we need to understand how environmental considerations manifest in insolvency. Environmental liability

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[33] See *sub nom. Ghanashyam Mishra & Sons (P) Ltd. v. Edelweiss Asset Reconstruction Co. Ltd.*, (2021) 9 SCC 657 (India).

[34] Civil Liability (Third Party Claims Against Insurers) Act 2017 (NSW).

[35] Ibid., s 4.

can either cause insolvency or be a cause of insolvency. For instance, an accident causes a chemical spill and incurs environmental liability—due to which the company faces much litigation and has to declare insolvency. This is a case of environmental liability causing insolvency. In another instance, a company facing financial stress may cut corners and accrue environmental liability due to negligence. In this situation, an adverse financial situation is the cause of insolvency and the corresponding environmental harm.

Companies in either situation can seek recourse under insolvency law. Insolvency law, as observed earlier, is agnostic to the cause of insolvency and instead tries to remedy the situation of insolvency. The cause of insolvency, if malicious or criminal, is to be addressed through other laws. Insolvency law merely focuses on trying to maximise the value of the company. The IBC has adopted the approach of keeping the company a going concern to protect and maximise its value.[36]

To maximise value and keep the company a going concern, insolvency law consciously prioritises the company's immediate interests over other interests. This is seen in the implementation of a moratorium. The principle of fresh start is also reflective of value maximisation. These principles and application of insolvency law denote the limited yet crucial purpose insolvency law serves, which is maximising the value of a stressed company. It also clarifies how insolvency law tries to save as much value as possible for the claimants (although the distribution of value among the claimants is based on pre-insolvency contractual rights) and is not responsible for environmental claimants not receiving adequate compensation. While some may argue, in prioritising secured creditors over environmental claimants, insolvency law is unfair in distributing value, as previously discussed, there are many challenges in the treatment of environmental claimants as secured creditors. Also, fair treatment on par with secured creditors under insolvency does not guarantee adequate compensation, as in insolvency, there is almost always a haircut taken by the creditors.

Rather than trying to accommodate environmental considerations within insolvency, where it is impractical to expect complete compensation, alternate avenues to address environmental considerations should be explored. Insurance may provide such an alternative solution to efficiently address environmental concerns in ways insolvency would never be able to address. The scope of providing compensation through insurance is far greater than compared to insolvency.

This is partly exemplified by the PLI Act, under which claiming compensation is comparatively straightforward. Insurance is also mandatory under the PLI Act if a company handles hazardous substances. The PLI Act is although limited in its current iteration where the amount for compensation is low. Also, the interaction between insurance and insolvency is uncertain, where clarifications with how a moratorium and a fresh start affect the insurer's liability are needed. Solutions to harmonise the uncertain interaction between insurance and insolvency are straightforward, as are reflected in Part 3.2 and briefly discussed further as well. Also, if a company already has an insurance policy similar to PLI to address environmental risks, the interaction of insurance and insolvency would still need harmonisation.

[36] See Report of the Bankruptcy Law Reforms Committee, November 2015, available at: <https://ibbi.gov.in/BLRCReportVol1_04112015.pdf>.

Allowing claimants to directly sue the insurer if the insured company is under insolvency would address the problems moratoriums pose. Another feature that may be needed to harmonise insurance law with insolvency would be ensuring that the insurer's liability continues to exist, regardless of the insured company being liquidated or receiving a fresh start, according to the relevant limitation period. Such a provision is needed to ensure insurers do not refuse claims on grounds that the insured's liability has ceased to exist. These are some ways to harmonise insurance law with insolvency, enabling insurance to protect environmental considerations during insolvency.

Also, if one were to design an insurance scheme to protect environmental considerations during insolvency in India, some key factors, as indicated in the paper, would need to be explored. One, the insurance would have to be mandatory and paying the premiums would have to continue during insolvency. However, it is important to safeguard against creating a barrier to trade and entry. The criteria for companies covered under such an insurance scheme must be explored and studied in great detail. Two, the scope of the law would have to extend beyond the current scope of the PLI Act, which limits itself to hazardous industries. The scope and definition of "accident" may also need to be broadly classified.

5. Conclusion

A prima facie exploration of insurance as an avenue to address environmental concerns in insolvency seems promising and should be studied further. There have been cases in the past where the use of insolvency has resulted in undermining environmental policy. However, it is not appropriate to understand insolvency as the cause leading to the effect of undermining environmental policy. It is rather instructive to understand insolvency as an effect of a cause that also leads to environmental policy being undone.

It is not the case that insolvency law cannot be misused or abused, although using law to gain an advantage is not endemic to merely insolvency law. Insolvency law, when misused, evolves with stricter anti-abuse provisions to prevent future misuse. In this regard, we need to find a solution for environmental considerations being left unaddressed during insolvency. Insolvency laws predominantly address financial distress. Similarly, insurance can be used to address environmental considerations which are not prioritised during insolvency and should be developed as a solution, given the growing importance of the need to protect the environment.

PART III

NEW LEGISLATION IMPACTING THE INSOLVENCY PROFESSION

Chapter 9

Recent Legislative Revisions governing Director's Liability in Cases of Corporate Insolvency in the Czech Republic

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1. Introduction

On 1 January 2021, an extensive amendment to Act no. 90/2012 Coll., the Business Corporation Act became effective in the Czech Republic. The amendment relates to the various areas of the corporate law in the Czech Republic. Among other things, it substantially modifies the legal framework for civil delicts of directors[1] in corporate insolvency and relevant sanctions. The particular changes brought about in the amendment concern disqualification of a director, obligation of a director to return benefits based on his or her service agreement (*clawback*) and statutory guarantee for debts of the company.

While the disqualification of a director from his or her function and clawback principally remained in place with partial modifications, the statutory guarantee of director was removed altogether. Instead of this, a new legal institute was introduced in the Business Corporations Act – a so-called claim for supplementing passives. From a procedural perspective, the previous fragmented rules were to a large extent unified into a single legal proceeding initiated by an insolvency administrator in the main insolvency proceedings.

The declared aim of these changes was to simplify the previous solution and make it more effective. The purpose of this contribution is to provide an brief insight into the current legal framework in the Czech Republic governing the liability of directors in corporate insolvency in light of the recent legislative changes.

2. Due managerial care and business judgement rule

In order for any liability to be potentially triggered, a director needs to have breached its obligations. Commonly, the breach relates to the obligation of a director to act with due managerial care. The duty to act with due managerial care is the general and overarching standard of directors' actions. It consists of three essential elements:

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[1] The term "director" is in this contribution used interchangeably for any member of an executive body of a Czech company, most commonly an executive director (*jednatel*) of a limited liability company or member of the board of directors (*člen představenstva*) of a joint-stock company. It also covers a former member of an executive body, person in a similar position as a member of an executive body or person who is factually in the position of a member of an executive body, even if not formally appointed (shadow director).

(i) necessary loyalty;
(ii) required knowledge; and
(iii) required diligence.

It is necessary that all three aspects are met cumulatively.

In case of commercial corporations (companies), this standard is viewed is through the optics of a *business judgement rule.* The business judgement rule and its application for actions of directors presents a safe harbour, i.e. a safe area for decision-making of directors who have an obligation to act with due managerial care. The business judgment rule under Czech law provides that if a directors could in his or her business decision-making in good faith reasonably expect that he or she acts with sufficient information and in justifiable interest of the company, he or she acts diligently and with required knowledge. This does not apply in case a decision is not made with required loyalty.

The business judgement rule is not construed as a direct obligation of a director, but rather a special rule providing protection (safe harbour) for directors' decision making. If the conditions prescribed under applicable legal regulations (and as further developed and specified by relevant case law) are fulfilled, it protects directors from liability for negative consequences to the company caused by their actions. It takes into account the fact that decisions of directors are (and need to be) inherently undertaken with more or less amount of risk, which cannot be fully avoided.

A company typically operates in a competitive business environment and needs to undertake certain amount or risk in order to stay in business and grow. A director is not liable for the negative consequence *per se*, including insolvency, but for the failure to observe a required standard of knowledge and loyalty towards the company.

3. Liability of directors in case of insolvency

A failure to act with due managerial care potentially has potentially various legal consequences for a director. This contribution deals in particular with certain civil legal consequences and liability in the event that this failure results in an insolvency of the company, as recently amended by an amendment to the Business Corporations Act.

Following a proposal made by the insolvency administration, the legal sanctions below potentially apply to a director under Czech law, subject to the conditions that:

(i) a director breaches his or her obligations;
(ii) such breach causes, or at least contributes to, the insolvency of the company; and
(iii) the manner of resolving insolvency has been decided upon.[2]

[2] Bankruptcy or reorganization proceedings.

3.1. Clawback

The insolvency court will decide that the director is obliged to provide to the insolvency estate benefit gained on the basis of his or her service agreement (or any other benefit) received from the company for a period of up to two years prior to initiation of the insolvency proceedings; if it is not possible to provide the benefit to the insolvency estate (e.g., in case of already consumed in-kind benefits), the director is obliged to provide a monetary compensation to the insolvency estate. This consequence applies only in case the insolvency proceedings are initiated upon a petition submitted by a person other than the debtor.

3.2. Obligation to contribute to liabilities

The insolvency court might also decide that the director is obliged to provide to the insolvency estate performance (compensation) up to the amount of difference between sum of debts and value of assets of the company. This consequence applies only in case the insolvency is resolved by way of bankruptcy (i.e., it does not apply in the event of reorganization proceedings). When considering the amount of performance (compensation), the insolvency court should take into account the extent to which the breach of director's obligations caused a lack of assets in the insolvency estate.

The essential conditions for application of the above sanctions are two-fold:

(i) initiation of insolvency proceedings against the company (as debtor) and decision on the manner of resolution of the insolvency (bankruptcy or reorganization); and
(ii) breach of director's obligations, which contributed to the insolvency of the company.

The above are two primary legal sanctions that can arise for a director in corporate insolvency - clawback and claim for contribution to the liabilities. Additionally, if an insolvency court imposes either of the above sanctions, the competent court will also resolve on disqualification of the director executive function.[3] This effectively means that the director ceases to be a member of all executive bodies in all companies and is prohibited from taking on a position of a director in the future for up to 3 years.

The particular sanctions are further described in this contribution.

4. Obligation to provide benefits from the service agreement (clawback)

The obligation to provide to the insolvency estate the benefit gained on the basis of a service agreement (or other benefit gained from the company) applies if the general conditions above are fulfilled. Furthermore, the following prerequisites need to be met:

(i) insolvency proceedings have been initiated upon a petition of a person other than the debtor (i.e., upon an insolvency petition filed by a creditor); and

[3] Specific sanction (liability for damages) can also arise on the basis of the Insolvency Act, if an insolvency petition is not filed without undue delay after the director knew (or should have known) about the insolvency of the company.

(ii) the director received remuneration (or other benefits) from the company on the basis of a service agreement or otherwise.

If the action of the insolvency administrator is successful, the insolvency court will impose an obligation on the director to provide to the insolvency estate benefit received during the period of up to two years before the initiation of the insolvency proceedings. Under the previous legal regulation applicable in the Czech Republic until 31 December 2020, the decisive moment was the legal force of the decision on insolvency and the relevant look-back period for return of benefits by the director was 2 years from this moment. This provided an adverse incentive to directors threatened by this obligation to attempt to postpone and obstruct the legal force of the decision on insolvency, which effectively shortened the period for which the benefits had to be returned (as directors typically do not receive any remuneration after the insolvency proceedings are commenced). As the insolvency proceedings are legally initiated upon a filing of an insolvency petition to the competent insolvency court (and the decision on insolvency and its legal force only follows with a shorter or longer delay), the currently applicable rules are more stringent for the directors.

This obligation can only be imposed based on an insolvency petition imposed by other person than the debtor. Effectively, in most cases this means that the insolvency proceedings need to be initiated by a creditor for this obligation to be potentially triggered. The purpose is to motivate directors of a company to duly and timely file an insolvency petition if the company becomes materially insolvent. If they fulfil this obligation and duly and timely file the insolvency petition on behalf of the company, they avoid the risk of being obliged to return to the insolvency estate their remuneration received for the past 2 years.

5. Obligation to cover the liabilities of the insolvency estate

This institute was newly introduced in the Business Corporations Act effective from 1 January 2023. It replaced the previous statutory guarantee, which could be imposed on the director, but was in practice used very rarely. This new legal regulation was inspired by the French Code de Commerce,[4] in particular by the institute called *la responsabilité pour insuffisance d'actif* (previously *l'action en comblement de passif*).

The purpose of this, similarly with the previous legal regulation, is to provide creditors with additional assets for satisfaction of their claims in insolvency proceedings. The imposing of this obligation upon a director is in a discretion of the insolvency court[5] and besides the general conditions is subject to the prerequisite that the insolvency of the company is resolved by way of bankruptcy (i.e., it does not apply in reorganization). The liability to supplement passives imposes on the director an obligation to provide (supplement) assets to the insolvency estate of the company, which is not sufficient for satisfaction of creditors' claims.

It can be imposed in cases of insolvency proceedings initiated by both the debtor or creditor(s).[6] It should also motivate the director to duly and timely file an insolvency petition. The longer

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[4] Article L 651-2 et seq.

[5] As opposed to the obligation to provide benefits to the insolvency estate described above, which is imposed obligatorily by the insolvency court upon a proposal by the insolvency administrator.

[6] As opposed to the obligation to provide to the insolvency estate benefits received from the company, which can be only imposed in case of creditor's insolvency petition.

the director is in default with filing the insolvency petition when obliged to do so, the higher would be the difference between assets and debts of the company. Thus, the higher would be the potential amount that the director might be obligated to pay to the insolvency estate.

The maximum amount is the difference between:

(i) sum of all debts; and
(ii) the value of all assets.

When deciding on the particular amount, the insolvency court needs to take into account the aspect of proportionality, in particular the extent in which the director's breach contributed to the insufficient value of the insolvency estate.

The full extent of the lack of assets in the insolvency estate will be definitely known only retrospectively at the end of the insolvency proceedings, typically from the final report. Correspondingly, the insolvency court will decide on the obligation of a director to supplement passives only at the end of the insolvency proceedings. Especially in complex insolvency cases, the whole insolvency proceedings can take significant amount of time (number of years). This presents a certain risk regarding the future solvency of the director at the time that the obligation is imposed. Also, it might provide an adverse motivation and additional opportunity for the director to attempt to divert his or her assets in order to avoid this obligation. Taking this into account, the French courts often issue interim decisions imposing this obligation, while the exact and final amount is decided later on when the final status of the company's debts and value of assets is known. The practice of Czech insolvency courts is yet to be established in this regard.

It is also not entirely clear as of which moment the difference between the sum of debts and value of assets should be calculated. A possible approach is to calculate it as of the commencement of the insolvency proceedings and do not take into account any further debts arising after the insolvency proceedings have been initiated (e.g., costs associated with termination of employment contracts or court or advisors' fees). The reasoning for this approach is that a director cannot be liable for further debts occurring after the commencement of insolvency as he or she no longer has control over the company's affairs. This concept appears to have been adopted in various judgements of French courts.

In the Czech insolvency legal framework, the insolvency proceedings are legally commenced upon a filing of an insolvency petition by the debtor or creditor and the commencement is not conditional upon any formal decision of the insolvency court. The insolvency court should (after the insolvency petition is filed) proceed with undue delay and decide on insolvency of the debtor. However, this decision does not come immediately and there may be a shorter or longer delay before the decision on insolvency is given by the insolvency court. Additionally, the debtor can apply for a moratorium enabling the director enabling the director to maintain a certain level of control over the company, including obtaining additional financing for operation of its business. These actions can ultimately result in further debts of the company. Therefore, under Czech law the decision of the insolvency court on insolvency of the company might also be considered as the relevant moment as of which the deficit between the sum of debts and value of assets is calculated.

Further significant change from the previous legal regulation applicable until 31 December 2020 (and also deviation from the French Civil Code), is the fact that the performance provided by the director becomes part of the insolvency estate and is distributed among creditors according to the same rules and principles as the proceeds from the sale of the insolvency estate (e.g., taking into account various classes of creditors). This aims to ensure the maximum fairness in distribution of proceeds to all creditors of an insolvent company.

Previously, the concept relied on the statutory guarantee of the director for fulfilment of obligation of the insolvent company, which could be claimed by either the insolvency administrator or creditor. If claimed by the insolvency trustee, the competent court would in its decision establish guarantee of the director for the benefit of all creditors, but the particular creditors would still need to separately proceed with a legal action against the director in order to enforce its payment (unless provided voluntarily). If claimed by a particular creditor, the competent court would in its decision establish guarantee only with respect of that particular creditor.

Thus, the preceding legal regulation favoured an individual and pro-active approach of creditors and enabled to some extent to avoid the principles of collective and proportionate satisfaction of all creditors in an insolvency (contrary to one of the main principles of insolvency proceedings). Effective from 1 January 2023, this was replaced by a significantly different concept where potential proceeds become part of the insolvency estate and are distributed among all creditors according the Insolvency Act. This favours the collective interest of all creditors.

From a more practical perspective, the fact that the proceeds become part of the insolvency estate also results in a potentially higher remuneration of the insolvency administrator, if the claim of the insolvency trustee is successful. As the remuneration is dependent on the value of the whole insolvency estate, this should motivate the insolvency administrator to follow through with these claims against directors.

5. Procedural aspects

A significant change brought about by the amendment concerns the procedural aspects. Under the previous legal regulation, the various cases of liability of directors (disqualification, clawback and guarantee) were subject to separate fragmented procedural regimes, even though the factual circumstances of the case assessed were largely the same. In each case, the court had to separately and repeatedly assess whether:

(i) the director breached its obligations; and
(ii) such breach was one of the causes of insolvency of the corporation.

This solution was not ideal from the perspective of costs and time required for the court and participants.

Newly, both cases of liability are procedurally unified in one court proceedings, which is maintained by the insolvency court as an incidental dispute (i.e., as secondary court proceedings tied to the “main” insolvency proceedings). The insolvency court will, as a preliminary question, in this proceeding assess whether the director breached his or her obligation and such breach contributed to the insolvency of the company. Once it has settled this underlying

question, it can proceed with decision whether or not to impose a sanction based on particular circumstances.

The proceedings are subject to a petition submitted by the insolvency administrator (i.e., the insolvency court cannot initiate the proceedings and decide on these matter *ex officio*). The insolvency administrator is the sole subject with an active legitimation to initiate these proceedings. The rationale is that the insolvency administrator is the subject which is most familiar with the affairs of the company (debtor) and has the ability to obtain supporting documentation and evidence for this claim. The insolvency administrator is also typically in a closer contact with the creditors and is obliged to protect the interests of all creditors.

The decision whether or not to file the petition should be made by the insolvency administrator with due care; he or she should not only evaluate whether the legal conditions for filing the petition are met, but also asses if filing the claim is beneficial in terms of potential increase of the value of the insolvency estate. The creditors also retain a certain level of control over filing the petition, as the insolvency administrator is bound to file the petition if requested to do so by the creditors' committee. In such case, the insolvency administrator is entitled to request a reasonable advance payment from creditors to cover the costs of these proceedings.

As regards the disqualification of the director, this is still subject to separate court proceedings. However, in case the insolvency court imposes either of the above obligations (clawback or contribution to the liabilities), the decision on disqualification is only formal; the court is bound to decide on the disqualification and does not re-assess whether the director breached his or her obligations.

6. Summary

The intertemporal provisions of the amendment provide that the amended rules apply for insolvency proceedings initiated after the effective date of the amendment (i.e., after 1 January 2021). Given the usual length of the insolvency proceedings and the necessary involvement of higher Czech courts when unifying case law, it can be expected that a substantial additional time is needed for a particular practice to be established in the Czech Republic.

The unification of the various proceeding under the umbrella of single proceedings maintained by the insolvency court can be viewed as a step in the right direction from the perspective of procedural economy. At the same time, the amendment left the previously preferred individual approach of individual directors for the sake of collective approach initiated by the insolvency administrator for the benefit of all creditors, which is in line with the underlying principle of insolvency law. On the one hand this should simplify the use of these institute and make them more effective. On the other hand, it puts significantly more competence and responsibility in the hands of the insolvency administrator, who can sometimes be inclined to cooperate with the largest and most important groups (secured) creditors and disregard the interests of the smaller ones. Under the amendment, the advantage of proactive creditors is to a large extent eliminated.

Chapter 10

Maximising Creditor Recovery: Evaluation of Restructuring Options following an Impairment of Equity Value

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1. Introduction

Low and falling interest rates fostered a most benign financing environment post the global financial crisis in which financings or refinancings where possible at falling costs and with increased availability over time, often including light covenant restrictions. This environment enabled a steady increase in leverage. Due to the rising availability of debt capital, companies and their shareholders could largely avoid financial restructurings.

The global increase in interest rates since 2022 has changed this environment drastically as both debt capacity, and also availability of financing capital, have steadily become more restrictive. Lower company valuations limit refinancing options and may also fall below the nominal debt volume – reducing equity value to a pure option value and often making creditors, albeit not the formal shareholders, the economic owners of companies, effectively bearing equity risk.

If the shareholder is not willing or not capable of providing additional funding in such a situation, traditional options for creditors in an out-of-court restructuring largely necessitate a consensual deal that enables the shareholder to participate in the upside of a restructuring without providing additional funds – a misallocation of risk and return. A commonly used structure - particularly in Germany – in this regard is a dual-purpose trust ("*Doppelnützige Treuhand*").

In this article, we will show why an innovative concept that has gained increasing traction in Germany and other jurisdictions in recent years – the restructuring shareholder/RIVA – solves the disadvantages of the commonly used structures – namely, a Debt/Equity swap, on the one hand, and the dual-purpose trust, on the other hand. The RIVA concept enables creditors to monetise the full upside of a financial restructuring without leakage to the (former) shareholder, and avoid the impairment of their incumbent position as creditor.

2. Background

Low interest rates led to a boom in debt issuance for European corporates as availability of financing increased and return expectations of financiers were, at the same time, compressed. As a result, high yield issuance in Europe across both bonds and loans rose more than 6x from the EUR 40.1bn low in 2009 to the record 2021 level of EUR 255.1bn.

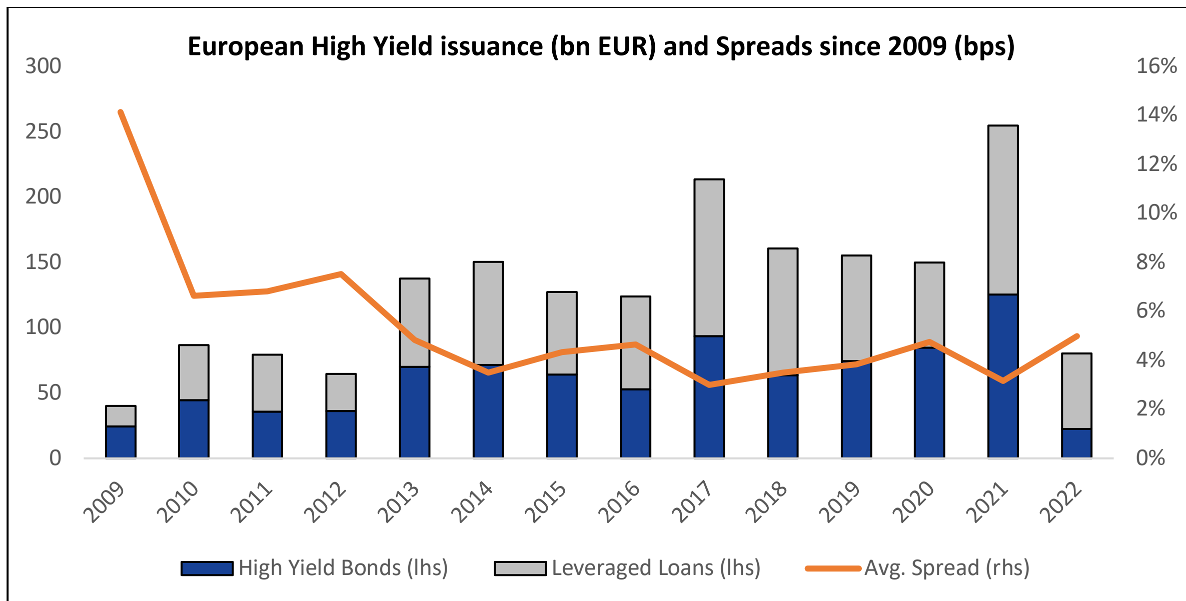

Figure 1: High Yield Bonds/Leveraged Loans issuance in bn EUR/High yield spreads
Source: Average Spread (Bank of America (ICE BofA High Yield Index Option-Adjusted Spread)); Loan Volumes (S&P LCD)

Over the same time period, issuance spreads over base rates have dropped from more than 14% to just over 3%.

Not only did capital markets activity significantly increase - new financing providers (debt funds and other non-bank lenders) entered the market and were shown to be more accommodating than traditional banks, especially in financing PE-backed buyouts. Total assets under management across debt funds rose nearly 10x from barely EUR 35bn in 2009 to ~EUR 320bn in 2021.

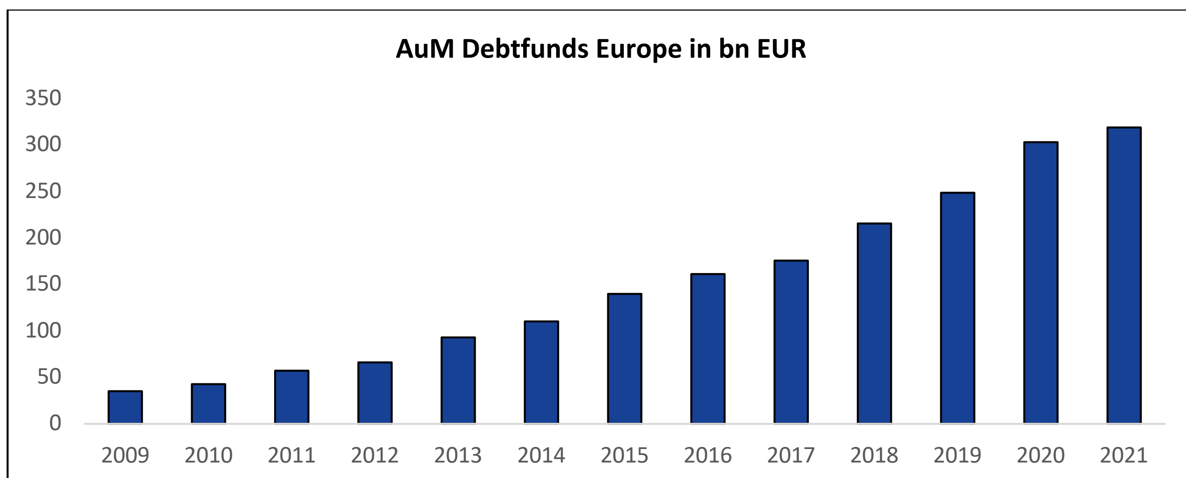

Figure 2: AuM Debt Funds Europe in bn EUR
Source: Preqin Pro

Not surprisingly, corporates – and especially PE sponsors as traditional heavy users of debt financing – tapped the attractively-priced financing opportunities with vigour and increased their leverage – the average EBITDA multiple of private equity buyouts in Europe has increased from ~8 in 2009 to 12.7x and thus, by more than 50%.

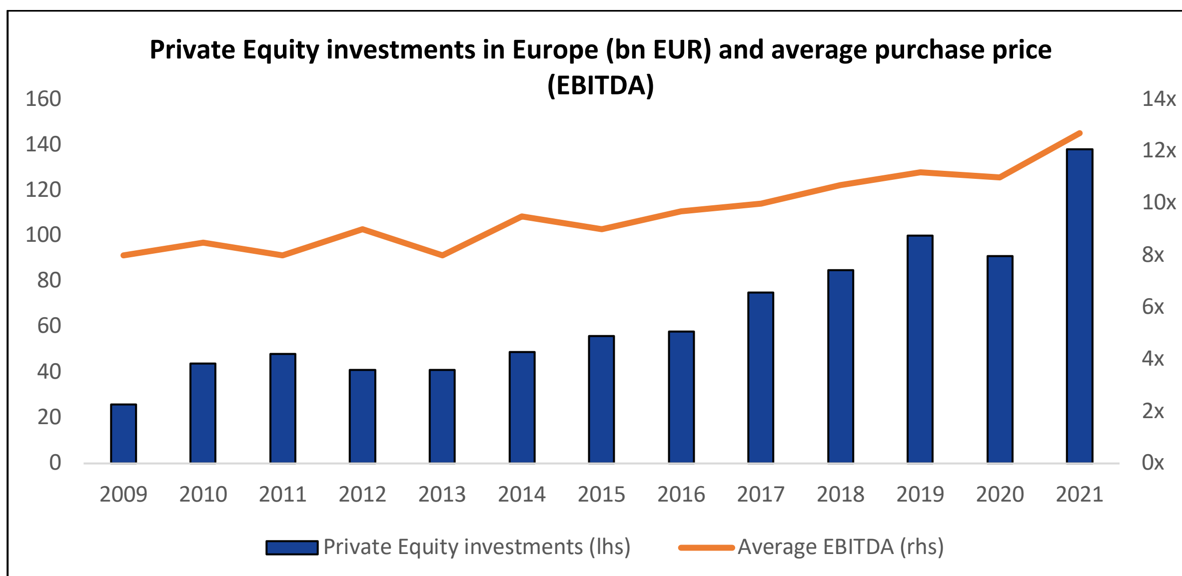

Figure 3: Private Equity investments in Europe (bn EUR)/Average EBITDA purchase price multiple for leveraged buyout transactions
Source: Invest Europe & S&P LCD

The era of minimal base rates came to a (provisional) end in 2022 as high inflation had necessitated a monetary tightening throughout the world.

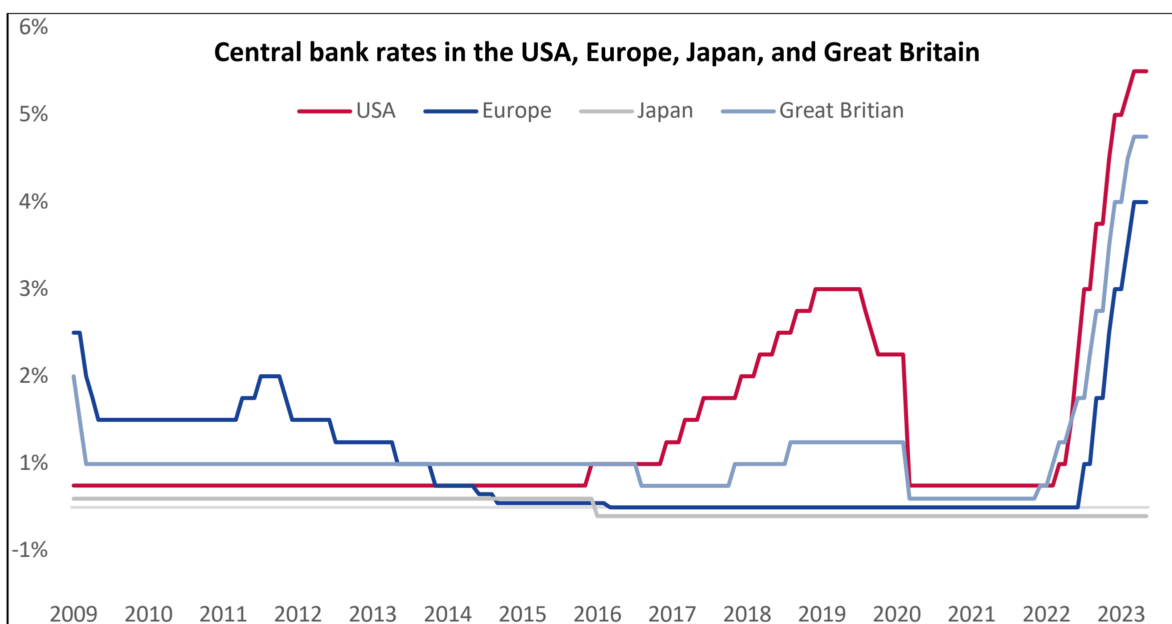

Figure 4: Interest rate development in the USA, Europe, Japan, and Great Britain
Source: European Central Bank, Federal Reserve, Bank of England, Bank of Japan

Correspondingly, most central banks reacted and have significantly increased base interest rates since. Increased base rates fundamentally change the environment corporates and their capital providers operate in as it affects both valuations (through a higher discount rate) and affordability of financing (through higher interest expense). Both effects lead to a fall in debt capacity and thus, to a reversal of the prior trend.

The resulting shift in paradigm, in combination with an ailing world economy, has serious implications for capital providers. Lower valuations imply reduced equity values which might – even if the company itself stays solvent– be reduced to a pure option value if the company is

highly levered. Higher rates also pose a cash-flow risk through increased interest payments and can require additional capital infusions even if the operating business itself is cash generating.

As a result, conflicts between equity and debt capital providers will increase and the necessity for financial restructurings will rise. In this context, restructuring options depend on whether the equity holder is willing to provide additional financing to remedy cash shortfalls and/or cure covenants as part of a restructuring package. This article aims to compare the options available to creditors If the equity holder is not willing or capable of providing additional capital.

Outside of an insolvency, traditional options in Germany available to creditors that do not want to directly assume control of the equity for regulatory or business reasons largely imply a consensual deal. A commonly used structure - particularly in Germany - is a double-sided trusteeship. The trustee assumes control of an asset while the equity holders are still in a position of capturing any equity surplus that might be generated post a restructuring/infusion of fresh capital. At this juncture, a misallocation of risk and return becomes manifest.

In this article, we aim to juxtapose the commonly used structures – D/E swap and double-sided trusteeship - with the alternative of using a restructuring shareholder, also referred to as RIVA structure.

3. Restructuring options following an impairment of equity value

The equity value is impaired if either a credit event occurs or after a company valuation using established valuation methods estimates a value that does not fully cover outstanding financial debt should the company be sold to a third party.[1]

Following such an impairment the equity value is reduced to a pure option value. The value break has no direct implications for the control of the company - equity holders still control the company and appoint management. While decisions made by the company's management will now first and foremast impact creditor value, creditors will need a credit event to exert leverage and change the corporate governance, should all other financial restructuring options fail.

A credit event then triggers a financial restructuring. The most economic option for creditors in a restructuring is derived from the value of the relevant alternatives and the restructuring prospects of the company. The options of the debt holders are limited in a situation where:

a) a suitable third-party is not willing to pay an adequate economic recovery to creditors;
b) debt and equity holders cannot agree an amendment of credit terms nor is the incumbent owner willing to cure an equity shortfall; and
c) the going concern-value of the company exceeds its liquidation value.

Should all financial restructuring options fail, creditors have the following options available:

(i) Debt/Equity Swap;
(ii) Transfer of shares to dual purpose trust; or
(iii) Transfer of shares to Restructuring Shareholder/RIVA.

The remaining alternative would be an insolvency.

[1] This technical value break can be evidenced by financial debt instruments trading significantly below par, where the price move cannot be explained by changes in base interest rates.

The implementation of each of the three options can be done either consensually or via a pre-insolvency restructuring framework such as the German StaRUG, the British Restructuring plan or the Dutch WHOA. Importantly, the implementation of a RIVA structure can also be achieved by unilateral action of the creditors and outside of a formal restructuring or insolvency process. The tried-and-tested enforcement route solely requires a validly perfected share pledge, commonly used as security in syndicated loans. Therefore, the possibility of a RIVA structure may provide creditors with enormous bargaining power.

In this section we will describe the mechanics of the different alternatives.

3.1. Debt/Equity Swap

In a debt-equity swap the company's creditors exchange some or all of the debt they hold in the company for equity in the same company. This reduces the company's debt and interest burden while increasing the equity capitalisation and improving debt coverage and leverage metrics.

The role of the involved creditors changes from financing providers to owners of the company. As such, effective governance systems will need to be installed and the right management selected.

Depending on the jurisdiction related claims of equity holders of a company might be subordinated to other creditors in the event of the insolvency of a company either in full or in part and thus, are more likely to be left out of any later distribution out of the insolvency estate. Thus, in case part of the existing debt is not affected by the Debt/Equity swap or the equitised creditor holds unaffected other debt instruments in the company, this creditor risks that his new equity position taints the priority and securities of his other holdings of debt instruments of the same company.

This equitable subordination risk needs to be considered in the economic analysis of the restructuring proposal as it limits the ability to provide new non-equity financing from shareholders as well as significantly lowers recoveries in an insolvency. The criteria for subordination of debt instruments held by an equity holder (and possible mitigants) vary by jurisdiction.

In Germany, holders of more than 10% of the equity of a company will generally find their debt claims subordinated to all other creditors as those debt claims are viewed as economically equivalent to shareholder loans. This should also apply to newly acquired non-subordinated debt although existing case law on this topic is minimal. An exception only exists in a restructuring where new funding provided by a shareholder is not subordinated if a restructuring opinion – typically in the form of an IDW S-6 opinion - provided by an independent auditor or other qualified advisor establishes its necessity for the completion of the restructuring.

In Italy, generally all claims of shareholders are subordinated if they are provided at a critical time for a company which is defined as the time when there is a material undercapitalisation or if an equity injection appears necessary given the company's financial situation. Once a claim has been subordinated, a change in ownership does not alter its economic status. Any form of economic assistance (delivery of services/materials and/or supplies) during this critical time period will be subordinated.

In Spain, loans and financings from shareholders holding at least a 10% share as well as any credit provided by directors of the company is subordinated except if the shareholder is in a

commercial relationship with the company or the financing is injected in a restructuring where only parts of the new funding would be subordinated which needs to be confirmed by a court.

Control and equity holding imply the need for consolidation in compliance with IFRS 9 and IFRS 10 and/or the consumption of expensive regulatory equity according to Basel rules.

3.2. Dual-Purpose Trust

A dual-purpose trust is a trust structure in which the incumbent shareholders of a company in distress transfer their shares to a trustee as part of a restructuring process. The trustee manages the company on behalf of the existing shareholders and is, at the same time, obliged to meet the contractual requirements of the financial creditors. Thus, he acts simultaneously for the conflicting interests of the two different stakeholders, hence "double-sided".

The dual-purpose trust enables the financing party to avoid equitable subordination risks should the company later file for insolvency and can also preserve/recover value that otherwise would be lost in a direct insolvency or in an alternative fire sale of the company. Even if security to the financing would fully cover the existing claim, liquidation costs and estate contribution could still leave a shortfall in an insolvency.

Depending on the trust agreement between the parties, the trustee is obliged to immediately to start a sales process or to first undertake restructuring efforts. If successful, this would eventually lead to the transfer of the shares back to the existing shareholders. The agreement can be structured flexibly so that a tailored solution for an individual case is possible. Often, the agreement includes the appointment of a CRO.

The trust agreement is concluded between the existing shareholders and the trustee. The banks are not a party to the trust agreement but will derive their own rights from it. The trust agreement thus acts as a genuine contract in favour of third parties vis-à-vis them.

Central provision of the trust agreement is the waterfall clause which governs the distribution of the sales proceeds. Usually, the purchase price costs and expenses of the trustee are paid first followed by the satisfaction of financial creditor claims. Any residual amount is then paid out to the former shareholders.

The existing shareholders will agree to the transfer of their shares to a dual-purpose trust if this is a palatable alternative to the total loss of their investment in an insolvency.

The dual-purpose trust thus enables banks to enforce their interests while avoiding equitable subordination risks and with a non-partisan trustee as steward of the company. The trustee, however, will not be inclined to take decisive actions often critical in a situation of distress. Rather, he will act as care-taker.

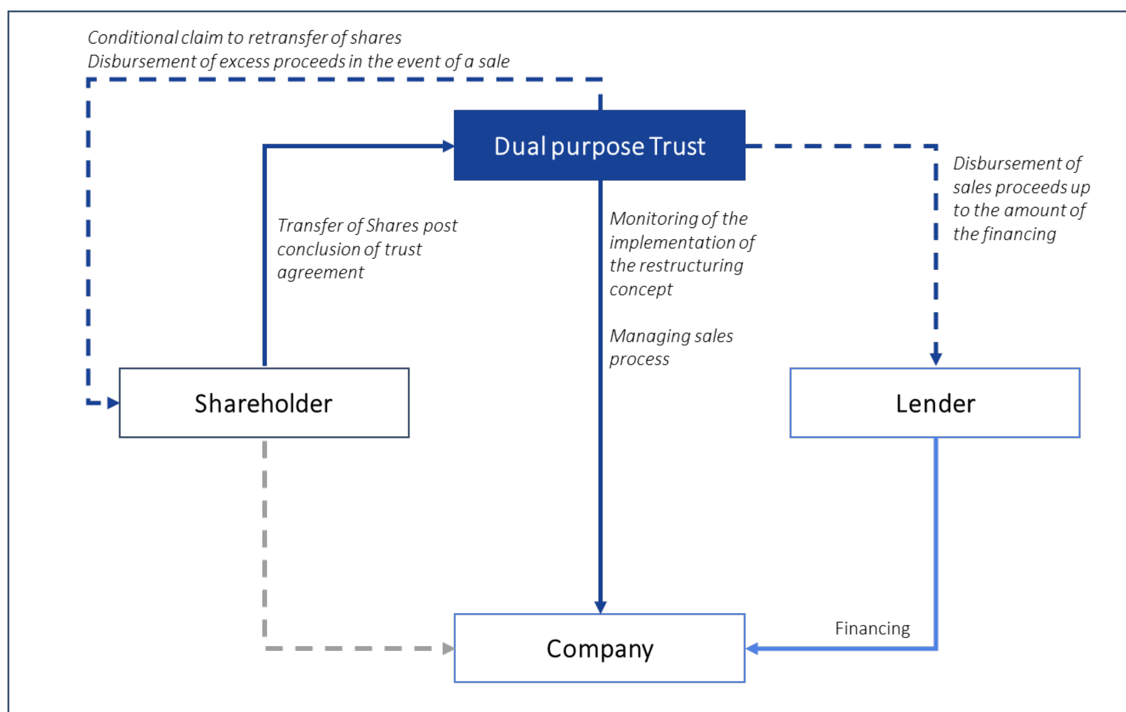

Figure 5: Schematic overview of dual purpose trust
Source: Authors' Own

3.3. Restructuring Shareholder/RIVA

A Restructuring Shareholder/RIVA ("Rescue Investment Vehicle Alternative") combines elements of a debt-to-equity swap and the dual-purpose trust. The idea is to install a true new shareholder assuming equity control while enabling the *economic* owners – i.e. its creditors – to capture the upside/risk premium from a successful restructuring. The mechanics of the change-of-control include a consensual deal, an enforcement or an insolvency combined with a credit bid.

In contrast to a trusteeship, the restructuring shareholder acts as a true new shareholder – equipped with all statutory shareholders' rights. Combined with the right management and restructuring skills, the restructuring shareholder will then be in the position to drive a restructuring much more forcefully. This can greatly accelerate and deepen the implementation of the restructuring – and with it the likelihood of its success.

The company will be managed with the mindset of a return-focused private equity fund. A strong corporate governance framework will be installed that consists of a clear operational framework for management and the set-up of regular operations council meetings in which performance will be monitored in detail and far-reaching operational decisions will be made. The restructuring shareholder will ensure that the right management team is in place to support the implementation of the restructuring; he will – if necessary – provide capable interim managers for missing functions/know-how.

The incentivisation of the restructuring shareholder/RIVA ensures that no comprehensive trust agreement is needed and thus, that the company can be managed entrepreneurially so that opportunities can be fully captured when they arise.

The financial debt, being momentarily impaired at the time of the restructuring as evidenced by a restructuring opinion or a company valuation, may be irrevocably assumed by the RIVA

acquisition company. Thus, the single credit relationship between participating creditors will be split into two parts. This debt assumption will be booked as a hidden contribution increasing the book value of the operating company. The result will be a financially robust operating company, critical in the eyes of its key stakeholders, suppliers, and credit insurers.

The terms of the newly assumed AcquiCo debt will be adjusted to reflect its economic risk – and de-facto equity-like risk profile – and will feature high PIK interest and other fee components that will ensure that the AcquiCo debt will grow at a sufficiently high rate to capture any increase in OpCo value following a successful restructuring. This feature ensures that the interests of the shareholders and creditors are aligned but will avoid consolidation on the creditor's balance sheet.

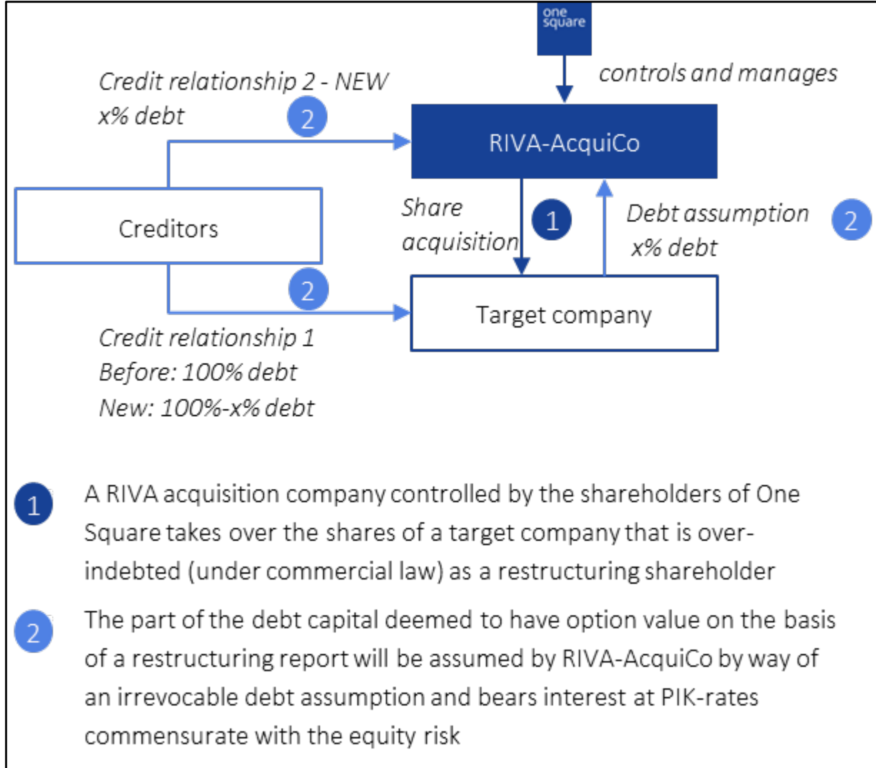

Figure 6: Schematic illustration of the set-up of a restructuring shareholder/RIVA
Source: Authors' Own

The RIVA shareholders will typically be incentivised on the recovery of the creditors in addition to a compensation for the governance work and the supervision of the restructuring process.

The ultimate goal of the structure is to sell the company to a suitable owner post restructuring and thus, harvesting the value recovery and the benefits of a better timing.

4. Evaluation of restructuring options

A comparison of the three alternatives will show why the restructuring shareholder/RIVA was specifically developed to mitigate the shortfalls of the other two options. A summary of the features of each alternative is shown in Figure .

Comparison of Restructuring Alternatives	Debt/Equity Swap	Dual-Purpose Trust	RIVA
Shareholder consent avoidable	✓	✗	✓
Consolidation at debt provider avoidable	✗	✓	✓
No equitable subordination	✗	✓	✓
Avoidance shadow directorship	✓	✓	✓
Commercial owner	✓	✗	✓
Improved influence of debt provider	✓	✗	✓
Possibility to avoid write-down	✗	✗	✓
Avoid real estate transfer tax	✗	✓	✓
Participation in the upside potential	✓	✗	✓
Raising of fresh money	✓	✗	✓
Reduce reputational risks	✗	✓	✓
Design exit plan	✗	✗	✓

Figure 7: Comparison of features of the restructuring alternatives described
Source: Authors' Own

The fact that the RIVA - in contrast to the dual-purpose trust - is a genuine new shareholder with all shareholder rights proves to be a decisive advantage over the dual-purpose trust in practice. This ensures that the company is managed similarly to a return-seeking private equity sponsor and is not merely "administered". This already structurally increases the chance of increasing the value of the company, i.e. the trust property.

The dual-purpose trust will, on the other hand, depending on the form of the trust agreement, still allow a certain (possibly disruptive) influence of the former shareholder; it does also grant him an option value. The RIVA, on the other hand, involves a genuine and indefinite change of shareholders. Depending on the contractual arrangement, the RIVA ensures that all potential influence – and also the free option - of the former shareholder is finally and permanently eliminated. The RIVA ensures that risk and opportunity are aligned again.

In comparison to a debt/equity swap, a decisive characteristic is that the RIVA structure does not have to be consolidated on the creditor's balance sheet under IFRS 10 accounting rules. The contractual design of the AcquiCo loan documents ensures that the beneficiaries – the creditors - cannot influence their own potential variable returns of capital. This lack of influence over business development is documented with the existence of a new genuine and formally independent shareholder.

Loans to the RIVA AcquiCo and/or the operating company (trust property) that either already exist or were newly issued for the financing of the business operations and/or the acquisition of the company can be treated - in accordance with IFRS 9 - using amortized cost accounting. This way, regular fair value tests can be avoided. For this purpose, it must be ensured that the lender - or holder of the loan receivable - only intends to hold the loan on its balance sheet (and will to sell it), will receive only the contractually agreed interest and repayments from it ("business

model test”), and that the cash flows from the loan are only interest and principal payments (“SPPI (“Solely Payments of Principle and Interest”) test”).

In conclusion, the RIVA offers the same features as the dual-purpose trust, but in addition offers further advantages which are denied to the beneficiaries of the dual-purpose trust. In comparison to a debt/equity swap, the RIVA avoids consolidation requirements and equitable subordination risk following an insolvency. The RIVA structure thus has established itself as an important amendment to the creditor’s toolkit in recent years and offers a compelling alternative to the two commonly used structures in restructuring situations both in and outside of Germany.

5. Case Studies

In this section, we will highlight selected case studies that showcase the recovery potential that can be achieved using the RIVA structure. The flexibility of the structure enables a wide range of possible use cases that are largely industry-agnostic and benefit a wide range of stakeholders. In 2021, the RIVA concept has also been successfully implemented outside of Germany with the acquisition of the Belgian business of Metro AG.

5.1. Primacom

At the time of the takeover in 2010, Primacom AG was the fourth-largest German cable network operator with a business focus on Eastern Germany with approximately EUR 100m of revenues and EUR 395m of outstanding financial debt.

An M&A process delivered third party offers for an enterprise value of approximately EUR 250m - significantly below the outstanding debt volume of EUR 395m and reducing EUR 145m of nominal debt capital to a pure option value. To avoid a permanent loss of capital, the mezzanine lenders decided to deploy the RIVA concept. A RIVA AcquiCo then acquired the shares of the borrower through a foreclosure of a share pledge of the management holding company, which controlled the 34 operating subsidiaries.

A viable debt structure was subsequently determined based on an IDW S6 opinion, including an injection of EUR 30m of fresh capital. The mezzanine capital of EUR 155m was transferred to the acquisition company by means of a debt hive-up. Following the take-over and financial restructuring, the new owner then installed a clear governance framework for operational management which was complemented by an industry-experienced supervisory board. Primacom senior management (CEO/CFO) was over time replaced and a comprehensive operational restructuring initiated.

In the following years, an ambitious growth plan was pushed forward to strengthen Primacom’s market position both organically and by acquisition. As a result, a direct competitor, Deutsche Telekabel, was taken over in 2014. Following the acquisition, synergies of c. 20% of the combined EBITDA of the two companies were achieved within 12 months. As a sign of the strong turnaround of the business, EUR 350m of senior debt post the acquisition could successfully be refinanced in 2014.

After the operating business had been stabilised, Primacom was sold to Telecolumbus AG in July 2015 for an enterprise value of EUR 710m.

This increased the enterprise value by 284% within 5 years, allowing the mezzanine capital providers to generate an IRR of 15% on the original non-valuable debt capital of EUR 145m.

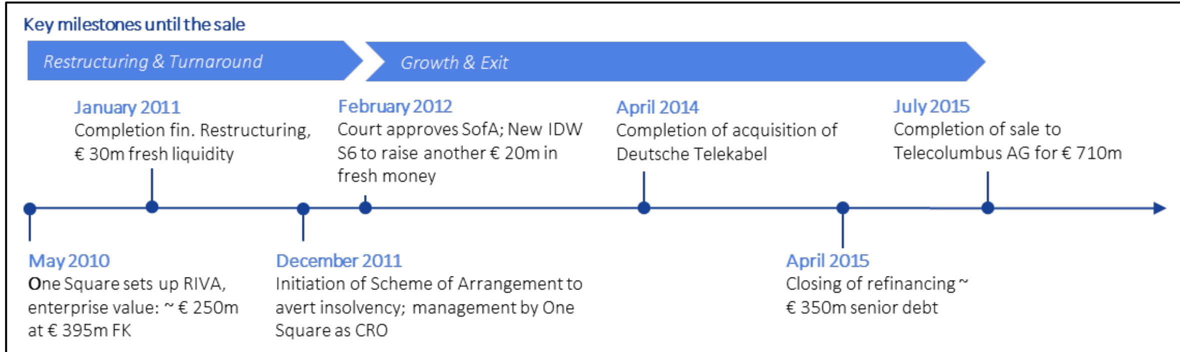

Figure 8: Timeline of Primacom transaction
Source: Authors' Own

5.2. Mainsite

In the wake of the crisis in the automotive industry between 2009 and 2011, Finacor B.V. – shareholder of automotive supplier PHP as well as Mainsite, Europe's largest synthetic fibre manufacturing site - underwent a major financial restructuring via a Dutch trust-like STAK. The trustee initially managed the sale of PHP to Indorama Thailand at an attractive price (>12x EBITDA), which already resulted in a recovery rate of 80% on PHP's debt capital.

In the further course, an insolvency petition was filed for the holding of the residual group. A share pledge enforcement over the shares of the residual group combined with a public auction group led to the transfer of control to a RIVA.

Subsequently, an intensive operational and corporate reorganisation was carried out, including a replacement of management. The existing power plant at the site was extensively refurbished in line with the German power-heat act (KWKG) at an investment amount of EUR 55m; a new logistics centre was built investing approximately EUR 60m, which was then sold to a strategic buyer in 2020.

A sale of the business is planned for 2023/2024.

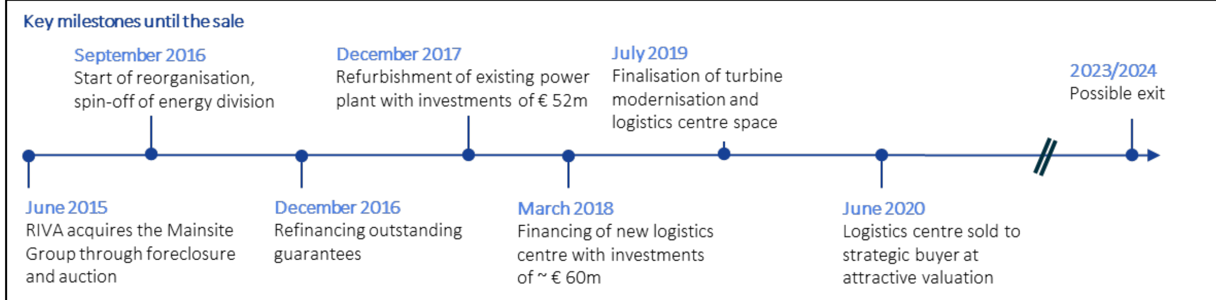

Figure 9: Timeline of Mainline transaction
Source: Authors' Own

5.3. Metro Belgium

In November 2021, Metro AG, a German listed wholesale group, initiated a sales process for the Belgian business incorporated within Makro Cash & Carry Belgium NV ("MCC BE").

Under MCC BE, initially six Makro stores - wholesale stores for end consumers, extensive assortment on 20,000-30,000 square meters of sales space per store - and afterwards also 11 Metro stores - wholesalers for restaurants, hotels and caterers - were opened, generating a total annual turnover of around 700 million euros and employing 2,000 employees.

Due to changing consumer preferences in the 2000s, the Makro business became heavily loss-making. Thus, following a strategic review Metro AG made the decision to initiate an M&A process for MCC BE. A RIVA, in partnership with a financing partner specialising in retail situations, succeeded in the competitive M&A process and was able to acquire the shares of MCC BE in June 2022.

Subsequently, following a comprehensive review of strategic option judicial reorganisation proceedings were initiated in order to separate the viable parts of the business and to satisfy the remaining creditors (mainly employees who had not been taken over) as best as possible from the proceeds of the sale.

RIVA performed its corporate governance functions and the development of the restructuring strategy. The reorganisation process was financed through a sale of inventory, so that no additional external capital was required.

Most of the Metro stores were sold to the Dutch competitor Sligro. In total, recoveries to the remaining creditors of MCC BE of around EUR 100 million can be expected. The remaining assets are currently being liquidated. Economically, the RIVA structure enabled the crystallisation of the asset value, which by far exceeded the going concern value of the company. The main beneficiaries were its creditors, both incumbent creditors and the new financing partner.

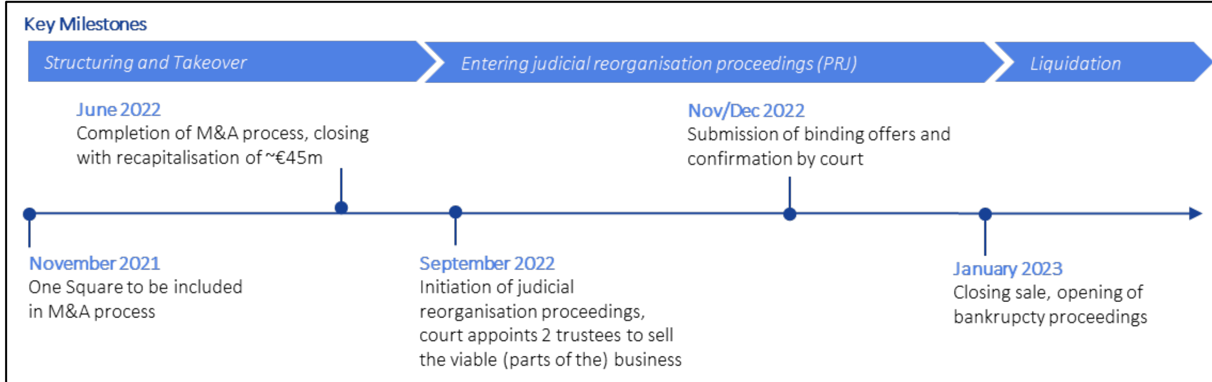

Figure 10: Timeline of Metro Belgium transaction
Source: Authors' Own

6. Conclusion

The RIVA structure/restructuring shareholder has established itself as a credible alternative for creditors in restructuring situations in Germany and other countries in recent years. It offers a compelling restructuring alternative that enables creditors to monetise the upside from a successful restructuring without impairing the creditor position. Past transactions have shown significant success in capturing the restructuring premium that previously would have been monetised by the out of the money shareholders of the financially distressed company. As such, the integration of the structure into the creditor's restructuring toolkit should complement existing solutions and ensure sufficient leverage and optionality in restructuring negotiations.

As seen in the Metro case, the RIVA structure can also be deployed in cases where the ultimate beneficiaries are not only incumbent creditors but other stakeholders, be it former owners or new funders. Given the volume of expected debt restructurings in the upcoming years, we expect the RIVA to play an increasingly important role in future financial restructurings.

Chapter 11

The Relationship between Shareholders and Directors at the Stage of Access to a Company's Insolvency Plan Procedure: A Comparative Perspective

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1. The problem under discussion and the solution embraced by Italian law when transposing Directive (EU) 2019/1023

Directive (EU) 2019/1023 (the "Directive") explicitly establishes the possibility for a restructuring plan to provide for measures that are capable of affecting shareholders' rights and strongly stresses an early intervention approach. An analysis aimed at understanding the mechanisms and techniques of shareholders' participation in the procedure as well as their interaction with other corporate bodies is crucial. This consideration seemingly takes on particular significance in light of the fact that:

- (i) the Italian (and European) economic environment is predominantly made up of small/medium-sized firms,[1] often with a strong family structure, in which the figure of the shareholders is quite important for the business model of the company itself; and
- (ii) the firm's default is considered[2] as a natural moment in the business life and as a situation to be addressed at an early stage. This results in the opening of a restructuring/liquidation procedure being an increasingly recurring phenomenon.

In this context, the paper explores the topic of corporate governance in relation to the specific stage of access to an insolvency plan procedure[3] with regard to the relationship between the powers of

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[1] See the Directive Recital no. 17, which explicitly recognizes that SMEs "represent 99 % of all businesses in the Union".

[2] To date, under Italian law, directors of all types of companies have exclusive power and responsibility in the establishment of appropriate business frameworks and structures, which are defined, by Article 2086, second paragraph of the Civil Code, as functional (also) to the early detection of the firm's distress and the preservation of business continuity. This has been considered by some (see, for example, V. PINTO, *Diritto delle società e procedure concorsuali nel codice della crisi*, in *Riv. dir. comm.*, 2021, I, 265 ff.) a sign that the firm's crisis is conceived by Italian law as an ever imminent and pivotal scenario in the life of the company.

[3] The expression insolvency plan procedure is intended to refer to a procedure that regulates the company's default (whether it is qualified as a simple "likelihood of insolvency" or as the more severe "insolvency") outside a formal bankruptcy procedure and that is based on the negotiation between the parties involved (debtor company and creditors) having as its object a plan (with industrial, financial, etc. content), which if approved by the prescribed majorities is confirmed by the judicial authority and is put into execution. However, for the sake of simplicity, with reference to the Italian legal system which embeds several insolvency plan procedures, the focus will be exclusively on the composition with creditors procedure ("concordato preventivo", Article 84 ff. and 120-*bis* ff., Business Crisis and insolvency Code as better detailed below in the text) and any reference to the "procedure" or to the "insolvency plan procedure" shall be understood as made to the composition with creditors procedure.

shareholders and those of directors. The question arises in terms of whether shareholders shall be informed of the distress of the firm (and if so, when and how) and whether they could participate in the decision on access to the restructuring/liquidation procedure and in determining the contents of the plan, as well as the manner in which such participation shall be articulated.

This article intends to analyse the problem from an Italian law perspective but aims to propose an interpretative solution by reviewing the regulatory choices made by some other Member States and the most significant outcomes of the related academic research.

This article aims to test the hypothesis that in small and medium-sized firms undergoing restructuring procedures that may affect shareholder rights, shareholders should participate with an "advisory" role in the directors' decision to initiate the procedure provided that they are not given any strong "reaction" powers at a later stage. Indeed, this solution would seem:

(i) capable of reducing the risk of intra-company conflicts that could jeopardize the successful outcome of restructuring measures;
(ii) coherent with the preferable thesis according to which the firm's distress does not result in the replacement of shareholders' interest with creditor's interest, but in a coexistence of the two interests; and
(iii) consistent with the provisions of the Directive.

The choice made by Italian law when transposing the Directive on the distribution of powers regarding access to the procedure (regardless of the actual content of the plan) turns out, among the various conceivable solutions, to be particularly burdensome to the rights of shareholders.[4]

The relevant provision is article 120-*bis* of the Legislative Decree of 12 January 2019, no. 14 (Italian Business Crisis and Insolvency Code/"BCIC"). Article 120-*bis*, first paragraph of the BCIC establishes the directors' mandatory competence regarding the choice of access to the procedure and the definition of the contents of the proposal as well of the terms of the plan.[5] Paragraph 4 provides that the dismissal of directors is only permitted for just cause (from the recording of the access decision in the commercial registry until the confirmation of the plan) and specifies that the application to begin a restructuring/liquidation procedure does not necessarily amount to sufficient just cause. Paragraph 3 then requires directors to inform shareholders of the decision to initiate an insolvency procedure and to report periodically on its progress.

In a nutshell, the decision on access to the procedure is left exclusively to the directors and shareholders are only given a right of disclosure. Such right of disclosure, would not seem to be an effective form of protection, since:

[4] See F. GUERRERA, *L'espansione della regola di competenza esclusiva degli amministratori nel diritto societario della crisi fra dogmatismo del legislatore e criticità operative*, in *Riv. soc.*, 2022, 1277, for a critique of the decision to entirely exclude shareholders from any participation in the decision-making process about the choice of the specific procedure to be initiated, the time at which to initiate it, and the content to give to the underlying plan.

[5] The former Bankruptcy Law (Royal Decree no. 267 of 16 March 1942) in relation to limited liability companies allowed a statutory derogation from the directors' competence rule in favour of the shareholders' general meeting and in partnerships it attributed to the shareholders general meeting the power to decide the access to the procedure: see Article 152, second paragraph, in connection with Article 161, fourth paragraph, Bankruptcy Law.

(i) it is triggered only after the decision has been made by the directors and not before;
(ii) there are no express rules on the frequency or means of the information, which may be capable of ensuring an actual disclosure; and
(iii) the rule would seem to refer to a disclosure concerning not the contents of the plan, but exclusively the fact that the decision to initiate the procedure has been made, as well as the progress and course of it, from a purely procedural standpoint.[6]

2. The reasons supporting the choice made by Italian law

The Italian legal framework in force before the implementation of the Directive was characterised by the absence of a specific and comprehensive regulation of the position of shareholders in the context of insolvency proceedings.

This attitude of the national lawmaker probably has, among others, "cultural" motivations, which can be identified both in:

(a) the historical origin of the composition with creditors procedure and its original function as an instrument for the enforcement of claims against an insolvent debtor;[7] and
(b) the assumption of "neutrality", that is, the extraneousness of insolvency law to the internal organizational rules of the company.[8]

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6 However, if any substantive meaning is to be attributed to the right to periodic information, also for the purpose of exercising the powers whose activation is left to shareholders (e.g., the submission of competing proposals) and for the purpose exercising the right to vote on the proposal, it should be held that the information relates to the details of the plan underlying the proposal drafted by the directors. In any case, given that shareholders (holding 10% of the share capital) are entitled to submit competing proposals, the view that would seem to be prevailing is that they have the right to request from the court-appointed administrator, in the same way as creditors under Article 92, third paragraph, BCIC, all information relevant for the submission of such competing proposals, including the details of the directors' proposal and plan. See, G. SCOGNAMIGLIO, F. VIOLA, *I soci nella ristrutturazione dell'impresa. Prime riflessioni*, in *Nuovo dir. soc.*, 2022, 1179, note 31; A. ROSSI, *I soci nella regolazione della crisi della società debitrice*, available on www.ristrutturazioniaziendali.ilcaso.it, article dated 22 September 2022, 4-5; S. AMBROSINI, *Il codice della crisi dopo il D.lgs. n. 83/2022: brevi appunti su nuovi istituti, nozione di crisi, gestione dell'impresa e concordato preventivo (con una notazione di fondo)*, in *Dir. fall.*, 2022, I, 843.

7 It should be noted that the composition with creditors procedure was originally conceived as an instrument for the benefit of the honest but unlucky debtor-entrepreneur, who was offered the possibility of avoiding bankruptcy and obtaining rehabilitation as a result of the commitment to pay part of its debts. Hence the focus was on the relationship between creditors and debtor, while shareholders were out of this picture. For an analysis of the original characteristics of the composition with creditors procedure see, among others, L. BOLAFFIO, *Il concordato preventivo secondo le sue tre leggi disciplinatrici*, Torino, Unione tipografico-editrice torinese, 1933, 1 ff.

8 According to the idea of neutrality, insolvency law should not have dealt with the position of shareholders, and more generally, with the organizational aspects of the firm, as these were directly governed by "general" company law. The principle of neutrality is generally traced back to A. NIGRO, *Le società per azioni nelle procedure concorsuali*, in *Trattato delle società per azioni*, directed by Colombo-Portale, vol. 9**, Torino, 1993, 336; For a critical review of such idea see V. PINTO, *Concordato preventivo e organizzazione sociale*, in *Riv. soc.*, 2017, 100 ff.

However, the idea that the insolvency plan could affect the position of shareholders gradually penetrated the Italian system. Indeed, even before the Directive was enacted,[9] it was generally accepted that the plan could provide for restructuring measures, even involving the reshaping of the financial structure of the firm, for example through mergers, divisions or other corporate transactions as well as through debt-to-equity swaps.

In light of this, it now seems impossible to justify the substantial absence of shareholders' voice rights at the access stage of the procedure on the assumption that they are extraneous to the agreement or non-affected by the plan. It seems rather the result of a conscious choice. There would seem to be three main reasons behind this choice.

2.1. Technical reasons

Article 120-*bis* BCIC would seem to prioritise preserving the residual value of the firm and preventing any damage capable of affecting the amount of the overall available resources and the level of satisfaction of all the parties involved as a result. The decision on access is placed in the hands of the corporate body which is convened more rapidly and which works more expeditiously, in view of the need to reduce delays and slowdowns at this initial stage.[10] In this perspective such a decision is also adopted by those who generally have a higher level of technical expertise, at least in certain types of companies.

The choice is also consistent with and strictly consequential to the principle[11] according to which the entrepreneur (and on behalf of it its management board in case of a debtor-company) must take action without delay for the adoption and implementation of one of the instruments provided by the law for overcoming the distress situation and recovering business continuity.[12]

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[9] The Directive definition of "restructuring" [Article 2, first paragraph, no. (1)] certainly embraces transactions that may affect shareholders' rights. Indeed, it embeds "measures aimed at restructuring the debtor's business that include changing the composition, conditions or structure of a debtor's assets and liabilities or any other part of the debtor's capital structure, such as sales of assets or parts of the business and, where so provided under national law, the sale of the business as a going concern, as well as any necessary operational changes, or a combination of those element".

[10] Reference is made to the need to enhance organizational efficiency by F. GUERRERA, *supra* nt. 4, 1274. In the sense that granting directors competence at the access stage would positively affect the speed of the procedure see, although under the former Bankruptcy law, R. SACCHI, *Le operazioni straordinarie nel concordato preventivo*, in *Riv. dir. soc.*, 2016, 785; V. CALANDRA BUONAURA, *La gestione societaria dell'impresa in crisi*, in *Società, banche e crisi di impresa.* Liber amicorum *Pietro Abbadessa*, directed by M. CAMPOBASSO, V. CARIELLO, V. DI CATALDO, F. GUERRERA, A. SCIARONNE ALIBRANDI, III, Torino, Utet, 2014, 2604-2605.

[11] See Article 2086, second paragraph, Italian Civil Code.

[12] See A. ROSSI, *supra* nt. 6, 3; O. CAGNASSO, *L'accesso agli strumenti di regolazione della crisi e dell'insolvenza delle società: la posizione degli amministratori*, available on www.dirittodellacrisi.it, article dated 1 February 2023, 7.

2.2. Economic analysis of law reasons

It is widely recognized that in a distress situation, company directors are encouraged to behave opportunistically (so-called moral hazard behaviours) in the interest and for the benefit of shareholders and to the detriment of creditors. This incentive of directors would follow, at least in closed companies and in small and medium-sized firms where the shareholder-director relationship is closer,[13] from the strong pressures carried out by shareholders on directors in favour of over-investment management strategies, with a high level of risk. This, in turn, would depend, on the one hand, by the limited liability rule in the company types in which this is provided for, and, on the other hand, by the qualification of shareholders as residual claimants. Thus, shareholders would have interest in promoting highly risky projects, in the awareness that any (but likely) negative consequences would be borne by creditors who would become the actual "shareholders".[14]

Based on this assumption, the thesis on the shift of fiduciary duties of directors has been developed, albeit with different nuances, according to which in a distress scenario directors would be under an obligation to take into account also the interest of creditors.[15] By interpreting this thesis in a strong fashion, it would have to be argued that directors must only consider the interests of creditors, and that shareholders, who have lost any risk in the firm because their capital contribution has been supposedly wiped out by losses, no longer have any right to voice their concerns, which is linked to

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13 See indeed A. KEAY, *The Shifting of Directors' Duties in the Vicinity of Insolvency*, in 24 *Int. Insolv. Rev*., 2015, 145; P. DAVIES, *Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency*, in 7(1) *EBOR*, 2006, 308; see, more in general P. AGSTNER, *Gli azzardi morali dei soci nelle s.r.l. in crisi*, in *Società, banche e crisi d'impresa.* Liber amicorum *Pietro Abbadessa*, directed by M. CAMPOBASSO, V. CARIELLO, V. DI CATALDO, F. GUERRERA, A. SCIARRONE ALIBRANDI, III, Torino, Utet, 2014, 2485 ff.

14 In general, for this view see, in the Italian literature F. DENOZZA, *Logica dello scambio e "contrattualità": la società per azioni di fronte alla crisi*, in *Giur. comm*., 2015, I, 38 ff.; L. STANGHELLINI, *Le crisi di impresa tra diritto ed economia. Le procedure di insolvenza*, Bologna, Il Mulino, 2007, 35 ff.; A. ZOPPINI, *Emersione della crisi e interesse sociale (spunti dalla teoria dell'*emerging insolvency), in *Diritto societario e crisi d'impresa*, by U. TOMBARI, Torino, Giappichelli, 2014, 54 ff.; P. AGSTNER, *supra* nt. 13, 2477 ff. In the international literature see among others, L. LIN, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, in 46 *Vand. L. Rev*., 1993, 1489; B.E. ADLER, *Re-examination of Near-Bankruptcy Investment Incentives*, in 62 *U. Chi. L. Rev*., 1995, 590 ff.; R.K.S. RAO, D.S. SOKOLOW, D. WHITE, *Fiduciary Duty a la Lyonnais: An Economic Perspective on Corporate Governance in a Financially-Distressed Firm*, in 22 *J. Corp. L*., 1996, 72 ff.; A. KEAY, *The Director's Duty to Take into Account the Interests of Company Creditors: when is it triggered?*, in 25 *Melb. U. L. Rev*., 2001, 317 ff.

15 See on this point L. STANGHELLINI, *supra* nt. 14, 40 ff. See also F. DENOZZA, *La gestione dell'impresa di fronte alla crisi*, in *Le soluzioni concordate delle crisi d'impresa*, by A. Jorio, Atti del Convegno, Torino, 8-9 April 2011, Milano, Giuffrè, 2012, 181 ff., according to whom the interest to be promoted would be that of non-adjusting creditors. In the international literature see., among others, D. BAIRD, T.H. JACKSON, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, in 55 *U. Chicago L. Rev*., 1988, 762; P. DAVIES, *supra* nt. 13, 301 ff. In US case law see *Credit Lyonnais Bank Nederland N.V. v. Pathe Communications Corp*, (Del. Ch. Dec. 30, 1991). The view expressed by that judgment, according to which directors of distressed companies have a fiduciary duty not only toward shareholders, but also toward third parties, including creditors, has been overcome, most recently, by *Quadrant Structured Products Company Ldt v. Vertin Laster, 102*, *2014* (Del. Ch. Nov. 7, 2013).

that risk and follows from the existence of that capital.[16] The current Italian regulation could thus be explained precisely on the basis of this strict thesis.[17]

2.3. Reasons concerning compliance with the Directive

Finally, from the first comments to the new rules[18] as well as from the analysis of the relevant explanatory report,[19] it appears that the assignment to the directors of any power regarding the decision on access to the procedure arose from the need to implement in the domestic legal system (at least with reference to restructuring plans) the principle, expressed in recital no. 57 and established by Articles 12 and 32 of the Directive, pursuant to which Member States shall identify means to prevent shareholders from unreasonably creating obstacles to the adoption and implementation of the restructuring plan.

The fundamental idea that stems from an overall reading of the Directive is indeed that the shareholders whose position the plan is likely to affect could have a negative interest with respect to its adoption and could therefore undertake obstructive behaviours. This could potentially result in shareholders blocking restructuring measures, thus depriving creditors of the possible benefits which may arise in a restructuring procedure as compared to a formal bankruptcy procedure.

3. The arguments under 2.2. and 2.3. are not fully convincing

The reasons explained in 2.2. and 2.3. above would not seem to be fully convincing to justify the provisions set forth in Article 120-*bis* BCIC.

With reference to the argument based on the economic analysis of law perspective 2.2., it may be noted that in essence it is based on the idea that as shareholders have lost all risk in the firm (since the capital has been presumptively entirely consumed and the value of corporate shares reduced to zero) it would be correct to remove also any decision-making power from the shareholders.

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16 In other words, recalling the residual owner doctrine (see D.G. BAIRD, T.H. JACKSON, *supra* nt. 15, 761) parties other than those who suffer the positive or negative effects of the strategic choices made by directors (shareholders) should lose all their organizational rights and powers (albeit attributed by general corporate law), as otherwise the primary interest of those who suffer the effects of the aforementioned choices (so-called residual owners – typically unsecured creditors) would be adversely affected.

17 See F. GUERRERA, *supra* nt. 4, 1277-1278 who believes that Article 120-*bis* BCIC implies a view of the company as a bankruptcy asset in the hands of creditors. See also M. CAMPOBASSO, *La posizione dei soci nel concordato preventivo della società*, in *Banca borsa tit. cred.*, 2023, I, 169, according to which our legal system fully embraced the thesis of the shift of fiduciary duties.

18 See O. CAGNASSO, *supra* nt. 12, 4; F. GUERRERA, *supra* nt. 4, 1274; M. SPADARO, *Il concordato delle società*, in *Diritto della crisi*, *Numero speciale Settembre 2022. Studi sull'avvio del codice della crisi*, 112.

19 See the Explanatory Report to the Draft Legislative Decree implementing the Directive, released in June 2022, (available on www.dirittodellacrisi.it), 74, which mentions that, under the new provisions, while shareholders retain a right of information on the initiation and progress of the procedure, they do not have the possibility of blocking "even one of the [...] stages [of the restructuring]", as they cannot dismiss the directors (except for just cause) and as they do not contribute to directly shape the contents of the plan. In the sense that Article 120-*bis* BCIC is consistent with Article 12 of the Directive see also the Opinion of the Council of State on the Draft Legislative Decree Implementing the Directive expressed at the meeting of the Special Commission on April 1, 2022, No. 00359/2022, 129 ff.

It should be pointed out that, although widely supported, this view is not unanimous.[20] First, the sacrifice of the administrative rights of shareholders, on the assumption that the economic value of their shares is reduced to zero as a result of the loss of capital, does not seem always rationally justifiable given that where there is only a likelihood of insolvency a positive value of the net assets (and consequently of corporate shares) could still exists. However, it has been noted[21] that the loss of the whole capital is not necessarily and automatically associated with the reduction to zero of the value of the shares, since, on the one hand, some values – such as goodwill – are not accounted for and, on the other hand, the value of the assets recorded in the balance sheet is calculated according to prudential criteria, which do not take into consideration the firm's prospective revenues, even if such revenues are actually to be expected once the procedure will be closed (hence reference is made to "hidden" surplus).

It has also been suggested that the risk, to which the decision-making powers of shareholders is linked, should be understood from a "dynamic" perspective, as a "future" risk.[22] This risk, while absent in relation to the firm's capital at the stage of access to the procedure (entirely burnt by losses) is nonetheless conceivable with reference to the value of a future positive net worth (which can be estimated at the time of access to the procedure). It was also noted that it is difficult to argue that in a strict technical/legal sense one can truly speak of a transfer of "ownership" of the distressed firm from shareholders to creditors.[23]

Considering what has been noted in the previous paragraph, it is accepted that the interest of creditors should gain a greater prominence in the governance of the distressed firm compared to the scenario of a performing company. However, for the reasons outlined in this paragraph, this should not lead to an understanding that a total replacement of shareholders interest with creditors' interest should take place in the vicinity of insolvency proceedings.[24] Therefore, I believe that the argument under

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[20] See F. GUERRERA, *supra* nt. 4, 1277-1278, arguing that the company should not be considered a bankruptcy asset in the hands of creditors. Further support that the thesis of the non-relevance of shareholders' interests and of the absence of any shareholder power is not unanimous can also be drawn from the choice made by the German legal system when implementing the Directive. Indeed, in the final version of the StaRUG (the German law implementing the Directive) all references to the shifting duty of directors, which was provided for in an earlier draft, have been removed. See on this point C.G. PAULUS, *European and Europe's Efforts for Attractivity as a Restructuring Hub*, in 56 *Texas Int. L. J.*, 2021, 105.

[21] See F. GUERRERA, *La ricapitalizzazione "forzosa" delle società in crisi: novità, problemi ermeneutici e difficoltà operative*, in *Dir. fall.*, 2016, I, 428, who highlights the importance of considering unrecorded assets and hidden surpluses.

[22] See G. MEO, *I soci e il risanamento: riflessioni a margine dello schema di legge-delega proposto dalla Commissione di riforma*, in *Giur. comm*., 2016, I, 294; See also M. MAUGERI, *Partecipazione sociale e attività di impresa*, Milano, Giuffrè, 2012, 395; F. GUERRERA, M. MALTONI, *Concordati giudiziali e operazioni societarie di «riorganizzazione»*, in *Riv. soc*., 2008, 33; P.P. FERRARO, *Il governo delle società in liquidazione concorsuale*, Milano, Giuffrè, 2020, 179 ff.

[23] See A. NIGRO, *Le ristrutturazioni societarie nel diritto italiano delle crisi: notazioni generali*, in *Riv. dir. comm*., 2019, I, 401.

[24] See F. BRIZZI, *Proposte concorrenti nel concordato preventivo e* governance *dell'impresa in crisi*, in *Giur. comm*., 2017, I, 347 ff., arguing the need to find a balance between the interests of shareholders and those of creditors, and excluding the replacement of the former with the latter; in a similar direction see F. GUERRERA, *Le competenze degli organi sociali nelle procedure di regolazione negoziale della crisi*, in *Riv. soc*., 2013, 1122 ff.

consideration is not sufficient to justify the cancellation of any power of shareholders to participate in the decision-making process about the initiation of an insolvency plan procedure.

With reference to the argument under 2.3. above, it may be noted that the Directive itself does not provide any specific rules on the distribution of internal powers and responsibilities among corporate boards in relation to the decision to initiate a preventive restructuring plan procedure.

On the one hand, it makes clear that access to a preventive restructuring framework shall be allowed exclusively upon the "debtor's" application;[25] on the other hand, it only establishes an obligation to achieve a specific result, namely the elimination of the risk of unreasonable shareholder obstructive behaviours.

Although the prohibition of obstruction appears to be an apex principle and potentially applicable to each of the stages into which the procedure is articulated, it would not seem that the Directive requires Member States to necessarily implement this principle in each of these stages. On the contrary, also in accordance with the minimum harmonisation approach adopted by the EU, it would seem sufficient for each national system to define a framework of obligations, powers and rights of the parties involved, such that – on an overall basis – shareholders are not given a power to block the restructuring measures and an incentive to use that power.

In addition, Article 12 of the Directive prohibits obstructive behaviours which are actually "unreasonable" and specifies, in its third paragraph, that Member States may define such unreasonableness differently depending on, but not limited to:

(i) whether the firm qualifies as an SME;
(ii) the nature of the measures provided for in the plan and, therefore, also on the level of their impact on shareholders' rights; and
(iii) the "type" of shareholders.

As a result, the EU concept of obstructive behaviour is flexible and it can possibly be shaped differently according to the above-mentioned elements.

Italian law would instead seem to have decided to implement the principle of the prohibition of obstructive behaviours throughout the procedure and in a rather rigid fashion:

It should also be noted that the Directive itself explicitly takes into account the interest of shareholders, insofar as it requires in Recital no. 2 that preventive restructuring frameworks be aimed at maximizing "the total value to creditors […] as well as to owners and the economy as a whole".

25 See Directive, Article 4, seventh paragraph. The eighth paragraph of Article 4 does not introduce any possibility of derogating from the rule of debtor-only legitimacy to file the application, despite its apparent meaning. Indeed, while it allows member States to provide that the preventive restructuring framework may be also available at the request of creditors (it is not specified, however, whether of individual creditors or of a specific percentage of creditors) or of employees' representatives, it always requires the debtor's consent (at least in SMEs). In this regard, I believe that Article 9, first paragraph, second subparagraph should be understood as referring to competing proposals, while the aforementioned Article 4, seventh and eighth paragraphs would concern to the main proposal.

(i) in the access stage, as observed in the previous paragraph, with the provisions of Article 120-*bis* BCIC; and
(ii) when the procedure is pending, by giving shareholders the right to vote on the plan and by the related cross-class cram-down mechanism, which offers no meaningful protection to shareholders.

The soundness of the argument under analysis may be undermined by the fact that, in light of what has been observed here, the choice of Italian law was not a mandatory choice and alternative solutions could have been adopted. However, if such a choice were not to be considered disproportionate due to excessive restriction of shareholders' rights (at least in certain particular cases: e.g., SME restructuring), it would still seem to be undesirable for the reasons outlined in the following paragraph.

4. Argument under 2.1. is sound but not sufficient in light of the issues the new framework raises

In general terms, the argument under 2.1. above seems to be sound. Indeed, it is reasonable that, in order to protect the residual/future value of the firm the decision on access to the procedure is to be attributed to the corporate body which has generally higher technical skills and which can decide more easily and quickly. However, some possible weaknesses cannot be overlooked.

First of all, such an argument seems to be more closely related to the internal dynamics of open or otherwise larger firms. By contrast, in smaller companies shareholders often have high technical skills or other personal qualities that, in relation to the company's business, are quite influential with shareholders often participating in a number of ways in the management of the firm. Removing shareholders from the decision in SMEs may therefore mean squeezing out qualified individuals who actively participate in the management.[26]

Additionally, it could also be the case that assigning exclusive competence to directors has the effect of discouraging upstream lending to firms or raising interest rates. This is because potential lenders, whose initial choices are affected by the prospects for credit recovery in the event of default, as well as, more in general, by the relevant framework of insolvency law, might fear a system that continues to attribute important executive powers to the same body that has led the firm into a distressed situation.[27]

[26] The problem seems to be somewhat mitigated, however, when in smaller companies directors are the shareholders themselves: in that case the directors' decision becomes a decision of the shareholders as well.

[27] Or, in any case, to the corporate body to which the management function of the company is attributed by law, even irrespective of the possible liability of the directors for having contributed to causing insolvency or likelihood of insolvency. On the relationship between the cost of lending and insolvency law, see, in the U.S. literature, A. SCHWARTZ, *A Normative Theory of Business Bankruptcy*, in 91 *Va. L. Rev.*, 2005, 1203 ff.; ID., *The Absolute Priority Rule and the Firm's Investment Policy*, in 72 *Wash. U. L. Rev.*, 1994, 1221 ff.; L.A. BEBCHUK, *Ex Ante Costs of Violating Absolute Priority in Bankruptcy*, in 57 *J. Fin.*, 2002, 453. It should be also noted that the increase of interest rates is one of the main points around which the debate on priority rules runs. In particular, proponents of the absolute priority rule (possibly mitigated by specific exceptions) believe that such distributional pattern is the one most likely to maximize the satisfaction of creditors and, as a result, reduce interest rates (see, for example G. BALLERINI, *The priorities dilemma in the EU preventive restructuring directive: absolute or relative priority rule?*, in *Int. Insolv. Rev.*, 2020, 6-7). In this regard, it is worth noting, expanding on the implications of those theses, that the need to keep interest rates law increases in a system that, like the Italian system, has chosen to implement the European relative priority rule (which is a more relaxed priority rule) also in the relationship between shareholders and creditors.

Beyond these remarks, the framework set out by Italian law could raise some significant problems of intra-company conflict (between directors and shareholders), which more than outweigh the possible advantages of having the decision taken quickly and by expert players.

Indeed, an incentive for shareholders to engage in obstructive behaviour could result, if a system – such as Italian system – jointly:

(i) allows that the restructuring plan may affect the rights of shareholders;
(ii) excludes them from the initial decision on access to the procedure; and
(iii) does not, under any circumstances, give them strong powers of "reaction" to the directors' choice.[28]

Such risk is increased if shareholders are allowed to receive a portion of the surplus value (in excess to the liquidation value),[29] but are at the same time precluded from having a formal claim to receive it, if the choice regarding whether and how much to distribute to shareholders is left to the directors when drafting the plan.[30]

It could be argued that such obstructive behaviour is not a problem precisely because shareholders would no longer have any legal means to exercise it. Actually, it can be noted that, under Italian law, shareholders "unhappy" with the provisions of the plan could always:

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[28] In Italy, shareholders' approval of the transactions necessary to implement the plan is replaced with the confirmation order, since shareholders are placed in a specific class and vote the plan *ex latere creditoris*, thus cross-class cram-down is applicable to them: in practice it is easy to cram down shareholder's class, since the conditions to be fulfilled do not attribute strong protection to them (see Article 112, second paragraph, BCIC). Italian law then provides for reaction powers which I believe are not particularly meaningful. It is true that shareholders are entitled to submit competing proposals pursuant to Article 120-*bis*, fifth paragraph, BCIC, but such proposals, in addition to increasing the length of the procedure, end up discriminating between rich and poor shareholders (competing proposals require costs that not all shareholders can afford, especially in SMEs) and between shareholders who have a certain percentage of share capital and shareholders who do not (competing proposals can only be submitted by shareholders who have at least 10 % of share capital). In addition, competing proposals do not allow shareholders (not even indirectly) to affect the content of the plan if the competing proposal is rejected and a different proposal is approved: in such a case, shareholders cannot complain to the directors for the latter having implemented a different proposal (allegedly detrimental to the shareholders). To be sure, it would seem to remain untouched for shareholders the possibility to approve the early termination of the company or to exercise the exit right form the company (exit, however, can only be exercised after the implementation of the plan pursuant to Article 116, fifth paragraph, BCIC, at least in relation to the transactions mentioned in Article 116 BCIC). However, these are powers that often end up attributing nothing to shareholders or that may trigger complicated disputes over the value of the shares to be liquidated. Italian scholars are also currently discussing whether shareholders may challenge the directors' decision to enter the procedure (see F. GUERRERA, *supra* nt. 4, 1286 ff.; A. NIGRO, *La nuova disciplina degli strumenti di regolazione della crisi e dell'insolvenza delle società*, available on www.ristrutturazioniaziendali.ilcaso.it, article dated 11 October 2022, 12-13). Even granting such a remedy, what seems to be difficult to argue is that shareholders shall be able to complain about an insufficient assignment of resources in their favour.

[29] Shareholders always have an individual right to the liquidation value. See Article 120-*quater*, fifth paragraph, BCIC.

[30] See G. SCOGNAMIGLIO, F. VIOLA, *supra* note 6, 1204; see also L. STANGHELLINI, *Verso uno statuto dei diritti dei soci di società in crisi*, in *Riv. dir. soc.*, 2020, 303.

(i) adopt disruptive conduct (by systematically voting against the proposal, raising objections to the plan confirmation, removing directors even in the absence of just cause once it becomes possible again);[31] but more importantly

(ii) reduce or eliminate their "active" contribution to the restructuring, refusing to bring to the company even intangible values such as knowledge, know-how, information, business relationships, personal reputation, which are often essential to the successful implementation of restructuring plans.[32]

A comparative analysis shows that all the systems examined give shareholders major "reaction" powers or otherwise provide for a greater shareholders involvement in the procedure, which counterbalance the possible impact of the plan on their rights and mitigate the risk of the aforementioned intra-company conflicts, always within a framework aimed at counteracting obstructive behaviours and thus in compliance with the Directive.

In particular, the French system with reference to the ordinary *sauvegarde* procedure provides that when shareholders are grouped in a voting class, their vote against the plan cannot be overcome with the cross-class cram-down mechanism in small companies[33] and that in larger firms it can only be overcome under certain conditions.[34]

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[31] That is, after the confirmation of the plan pursuant to Article 120-*bis*, fourth paragraph, BCIC, and provided that shareholders have not been entirely squeezed out of the firm.

[32] Such values are usually referred to as "soft variables". The emphasis on shareholders being kept in the picture, also for them to be encouraged to contribute soft variables seems to be demonstrated by the fact that, with reference to the choice between the different priority rules, all the European legal systems examined (Germany, Netherlands, France, Spain, Italy), regardless of the model they have embraced (Absolute priority rule, Absolute priority rule with specific exceptions under the control of the court, European relative priority rule), agree on the need to find a solution that departs from the strict APR for the benefit of shareholders, at least in specific cases and under certain circumstances. For the German system see § 27(1)2 in connection with § 28(2), Gesetz über den Stabilisierungs- und Restrukturierungsrahmen für Unternehmen [Unternehmensstabilisierungs- und -restrukturierungsgesetz – StaRUG] (Corporate Stabilization and Restructuring Act); for the Dutch system see Article 384, fourth paragraph, b), Faillissementswet (Bankruptcy Code); for the French system in relation to the ordinary sauvegarde procedure see Article L626-32, I, 3, in connection with Article L626-32, II, Code de Commerce (Commercial Code); in relation to the sauvegarde accélérée procedure see the reference to ordinary sauvegarde in Article L628-8, Code de Commerce; in relation to the redressement judiciaire procedure for debtors in a state of insolvency see Article L631-19, Code de Commerce; for the Spanish system in relation to large firms see Article 655, second paragraph, no. 4, in connection with Article 655, third paragraph, Ley concursal (Bankruptcy Code); in relation to small firms see Article 684, fourth paragraph, Ley concursal; in Italy see Article 120-*quater*, first paragraph, BCIC.
A similar solution has been embraced by U.S. law through the introduction into Chapter 11 of a new Subchapter V, applicable to small and medium-sized firms, which envisages a system that departs from APR (see in this regard P.W. BONAPFEL, *A Guide to the Small Business Reorganization Act of 2019*, in 93 *Am. Bankr. L.J.*, 2019, 608-15; E.J. JANGER, *The U.S. Small Business Bankruptcy Amendments: A Global Model for Reform?*, in 29 *Int'l. Insolv. Rev.*, 2020, 260; G. BALLERINI, *supra* nt. 27, 15-16).
In Italy, see A. ROSSI, *supra* nt. 6, 11, who highlights the direct correspondence between shareholders contribution to the success of the plan and the value of corporate shares.

[33] See Article L626-32, I, 5, a), Code de Commerce, in connection with Article R626-63, Code de Commerce.

[34] Such conditions are: (i) the preservation of pre-emptive rights of the shareholders in case an increase in the share capital is provided for by the plan [Article L626-32, I, 5, c), Code de Commerce]; (ii) the circumstance that the plan does not provide for the transfer of even part of the "rights" of the shareholders placed in the class that voted against the plan [Article L626-32, I, 5, d), Code de Commerce] (iii) the fact that the dissenting class members are out of the money with respect to the distribution of the value of the firm (on a going concern basis) in accordance with the rules applicable in the event of liquidation [Article L626-32, I, 5, b), Code de Commerce].

In Spain, a shareholders meeting resolution is still required, if the plan provides for transactions that need shareholders consent under corporate law[35] and the minority remains entitled to challenge the resolution (among others) according to substantive reasons pursuant to the general corporate law rules.[36] In addition, the resolution of shareholders is an essential condition for the plan to be confirmed in case of SMEs restructurings.[37] In larger firms, the protection of shareholders is strengthened only in a non-current or non-imminent insolvency scenario, as in those cases the plan cannot be confirmed or can be challenged if shareholders resolution in favour of the plan is lacking.[38]

In the Netherlands, while all shareholder powers *ex latere debitoris* are abolished[39] and shareholders' approval of the transactions necessary to implement the plan is replaced with the confirmation order, there is at least one view (which leverages the silence of the law on the topic) that shareholders retain significant powers to counteract the plan. These powers include, above all, the power to remove directors.[40]

In Germany, the principle of shifting the duty of directors has not been formally incorporated into the final text of the StaRUG.[41] This has led to the contention that, in the absence of any contrary provision, directors remain liable to shareholders in the event that they fail to obtain shareholders' approval of the decision to access a restructuring procedure.[42]

See L.C. HENRY, *Les classes de parties affectées. La consécration des classes de parties affectées et les nouvelles modalités de vote des plans, une double innovation majeure*, in *Revue des sociétés*, 2022, paragraph 23.
All the above also applies to accelerated sauvegarde procedure (see Article L628-8, Code de Commerce). In addition, it is also worth noting that according to a view (with specific reference to accelerated sauvegarde procedure) the dismissal of the directors by shareholders would still be possible: See R. DAMMANN, M. GERRER, *The transposition of the EU directive on early corporate restructuring and second chance into French law*, in *Revista General de Insolvencias & Reestructuraciones (I&R)*, 2022, 400.

[35] See Article 631, Ley concursal.

[36] See F. GARCIMARTIN, *The Spanish Approach to Corporate Restructuring: A "Pre-packaged Chapter 11"*, in *EIRJ*, 2022, 11, who (p. 9) also explains the preservation of shareholders general meeting by referring to the circumstance that while the "collectivization" of creditors works *ex lege*, shareholders are contractually bound towards each other, with the consequence that rules governing the agreement (corporate law rules) shall be applied.

[37] See the introductory part of Ley 16/2022, dated 5 September 2022, Sec. I. Pág. 123694 BOE and Article 684, 2, Ley concursal.

[38] See Articles 656, first paragraph, no. 3, 662 and 663, no. 2, Ley concursal. See also Article 640, Ley concursal.

[39] See Articles 370 fifth paragraph, 381 second paragraph, 383 second paragraph, Faillisementswet.

[40] See S.C.E.F. MOULEN JANSSEN, *De positie van aandeelhouders bij preventieve herstructureringen. In het bijzonder onder de Wet homologatie onderhands akkoord*, Wolters Kluwer, 2020, 316, according to whom the pressures thus arising on the directors (who would act in the sole interest of shareholders) are mitigated by the fact that the court at the request of (among others) creditors may appoint an expert to prepare the plan and file the proposal: directors would indeed be incentivized to draft a sound plan in a timely manner, so as not to lose legitimacy with regard to the filing of the proposal. However, Moulen Janssen acknowledges (p. 317) the possibility of challenge/appeal by the directors of the dismissal resolution on the grounds that it infringes the principles of reasonableness and fairness in light of the WHOA's apex purposes. In addition, there would also be the power to approve the voluntary termination of the company, but even in this case some potential issues of illegitimacy in relation to the principles of reasonableness and fairness could arise (p. 319).

[41] See C.G. PAULUS, *supra* nt. 20, 105; ID., *The new German preventive restructuring Framework*, in *Rivista ODC*, 2021, 15; W. PRUSKO, D. EHMKE, *Restructuring Lessons from the Covid Pandemic: Bail-Out vs. Market Approach. Country View: Germany*, in 24 *EBOR*, 2023, 221.

[42] See W. PRUSKO, D. EHMKE, *supra* nt. 41, 221 and notes 53-54; A. GALLAGHER, A. MORAWE, *Crisis as Opportunity: Distressed M&A Transactions in Germany. What to Look Out for as a Seller and Buyer*, in *ABI*

5. The proposed solution: involvement of shareholders, with an "advisory" role, in the directors' decision to initiate the procedure

In light of the above, although deeper research should be performed in this regard, it could be suggested that there might be an obligation for the directors to convene shareholders in an advisory capacity (to get a non-binding opinion) prior to the directors' decision to access the procedure.[43]

Such shareholder involvement with an advisory role could in fact work as a form of mitigation of the risk of intra-company conflict discussed above. The "non-obstructionism" principle (which, as noted, is flexible in nature) would still be complied with since, on the one hand, shareholders could not directly shape the terms of the plan and, on the other hand, it would still be implemented at a later stage through the cross-class cram-down mechanism in relation to the shareholders' class.[44] Such a solution seems also to be coherent with the preferable thesis (see *supra* paragraph 3) according to which the firm's distress does not result in the replacement of shareholders' interest with creditor's interest, but in a coexistence of the two interests.

From a technical perspective, the failure of the directors to convene shareholders could affect the "rituality of the proposal" (which the court is required to review at the initial stage of the restructuring composition agreement procedure) and prevent the procedure from moving forward.[45] On the other hand, when shareholders are convened in the particular case, their decision:

(i) could serve to legitimise the decision-making power of the directors, in the context of a procedure-based expression of the company's will;
(ii) could represent a tool in the hands of shareholders to show the directors their own preferences, also in connection with transactions that are capable of affecting their rights and on which they lose, pending the procedure, any specific decision-making power;

Journal, 22 February 2023, note 1. See also C.G. PAULUS, *supra* nt. 20, 105, according to whom if the principle of shifting duty had been implemented, the directors could have ignored the directions of the shareholders, which also implies that since that principle has not been implemented, as of today, the directors cannot ignore such directions.

[43] Or, at the very least, one could argue for the legitimacy (and desirability) of a statutory provision that gives shareholders the right to be informed in advance and the right to give a non-binding opinion: see O. CAGNASSO, *supra* nt. 12, 10. See also F. BRIOLINI, *I conflitti tra amministratori e soci in sede di accesso a uno strumento di regolazione della crisi e dell'insolvenza. Prime riflessioni*, in *Nuovo dir. soc.*, 2023, 19, who believes that a statutory provision that anticipates the time when directors are required to inform shareholders would be legitimate.

[44] See the Directive, Article 12, from which it can be inferred that the application to shareholders of the cross-class cram-down mechanism could itself operate as implementation of the "non-obstructionism" principle.

[45] See Article 47, first paragraph, b), BCIC. Otherwise, a problem concerning the "regularity of the procedure" could be argued, which, according to the wording of Article 112, first paragraph, BCIC, should be reviewed only at the confirmation stage. A deficiency such as to make the proposal "inadmissible" could also conceived, which, however, would require finding the failure to involve shareholders to be an hypothesis of clear unsuitability of the plan for the satisfaction of creditors, as proposed by the debtor, and for the preservation of corporate values [Article 47, first paragraph, b), BCIC]. The failure to convene shareholders could then result in the removal of the directors for just cause (or in their possible direct liability towards the shareholders, with, however, considerable problems in terms of identifying damages).

(iii) would not be binding on the directors, but could require them (by means of the principle of diligent management) to take the shareholders' opinion into account and to properly justify any choice that deviates from it.[46]

However, I believe that this solution should not have general applicability, but be applied to SMEs' restructuring procedures.

First, it should not be applied to liquidation procedures. Here indeed, given that all assets are being sold it is more difficult to contend the idea of "future" shareholders' risk, which instead, as discussed above (see *supra* paragraph 3) serves as a strong support for the thesis of the persistent relevance of shareholders' interest. Moreover, since it is not a matter of reorganisation there is theoretically no problem of incentive for shareholders to contribute "actively" to the project and their involvement would only have the effect of slowing down the procedure. In addition, under Italian law,[47] there is uncertainty whether shareholders may receive a portion of the company's value in liquidation procedures which reduces the issues of intra-company conflict outlined above.

The limited application of the proposed solution to SMEs stems from the fact that here shareholders involvement is usually easier, given the generally closer relationship between shareholders and the management board. Additionally, as shareholders are often more engaged in the running of the business, their involvement could encourage them to contribute to the reorganization in a more meaningful way (including through contributions of soft variables), which in SMEs could prove crucial.

Conversely, any failure to involve them could potentially encourage obstructive/disruptive behaviours or discourage their "active" contribution to the success of the project, which could prove fatal in SMEs. Finally, to draw distinctions for smaller companies would emphasise the option that Article 12 of the Directive provided for, that is, to differentiate the definition of unreasonable obstruction also taking into account the company's qualification as SME and the "type" of shareholders.[48]

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[46] See, among others, P. ABBADESSA, *Assemblea e operazioni con parti correlate (prime riflessioni)*, in *Le operazioni con parti correlate*, by V. CARIELLO, Milan, Giuffrè, 2011, 24 ff.; M. MAUGERI, *Le deliberazioni assembleari «consultive» nella società per azioni*, in *Riv. dir. soc.*, 2014, 143 ff. (see specifically, 155). But see V. PINTO, *sub* art. 2364 c.c., in *Le società per azioni*, directed by P. ABBADESSA, G.B. PORTALE, Milan, Giuffrè, 2016, 857 (arguing that directors are not obliged to justify any choice that deviates from shareholders non-binding opinion).
The circumstance that directors could be under an obligation to properly justify any choice that deviates from shareholders non-binding opinion would affect the actual dynamics of a possible directors' liability case (first and foremost towards the individual shareholders allegedly damaged). In addition, shareholders would be able to dismiss the directors, in the absence of just cause, since until the access decision is recorded in the commercial registry, the new rules do not affect the general rules that allow the dismissal of directors without just cause subject to compensation for damages: and see F. BRIOLINI, *supra* nt. 43, 19 f.

[47] See Article 84, fifth paragraph, BCIC.

[48] A further question, which can only be touched upon here, is whether such shareholder involvement should apply only in the case of likelihood of insolvency of the firm or also in a more severe situation of insolvency. If shareholders' powers stem from the risk they hold in the firm, it is quite clear that in the event of insolvency shareholders may have lost more than in likelihood insolvency (thus they may bear less risk and they shall have less powers).
However, it is also true that it is not theoretically impossible that corporate shares retain positive economic value even in insolvency, since this is a financial and not a patrimonial situation [see Article 2, first paragraph, (b),

BCIC]. In addition, insolvency does not seem (see L. STANGHELLINI, *supra* nt. 14, 131 ff. and 152-153) to be in itself inconsistent with restructuring (the Directive only regulates restructuring that is grounded in the likelihood of insolvency because this seems the most efficient solution with respect to the purpose of "preventing job losses and the loss of know-how and skills, and maximiz[ing] the total value to creditors [...] as to owners and the economy as a whole": Recital no. 2). Indeed, it is restructuring itself, rather than the situation of likelihood of insolvency or insolvency that is connected with the idea of a "future" risk (see paragraph 3 above). Finally, I contend here the existence of a mandatory shareholder involvement only for SMEs in which such involvement is easier and quicker and therefore raises fewer concerns even when (insolvency) needs for speed become more compelling.
As noted above, however, the Spanish system (see paragraph 4 above) in relation to large firms makes a distinction depending on the scenario (likelihood of insolvency or insolvency) and strengthens shareholders protection only in the event of likelihood of insolvency.