INSOL EUROPE

INSOL Europe Yearbook 2022:

Restructuring and Insolvency Tools in Times of Crisis

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Editorial Preface

Whoever reads this editorial preface, has most likely attended the INSOL Europe Annual Congress in Dubrovnik, Croatia, and has managed to get a copy of this special INSOL Europe Yearbook 2022. Due to the pandemic and the government restrictions that came with it throughout Europe, it was not possible to host an Annual Congress in 2020 or 2021. Therefore, 2022 is a very special year, in which INSOL Europe has two Annual Congresses, one in Dublin in March and the second one in Dubrovnik.

To support this special occasion and as one of the new initiatives for 2022, INSOL Europe decided to publish this Yearbook and installed an Editorial Board to manage this new project, consisting of Marcel Groenewegen (chair), Evert Verwey, Emilie Ghio, Paul Newson, Ruairi Rynn and Jonathan van Ee (secretary to the board).

One of the main objectives of this project was to inspire and encourage young members of INSOL Europe to participate and to provide them with a platform to express their views on restructuring and insolvency tools in times of crisis. The Editorial Board is happy to report that great contributions have been received from young lawyers from all over Europe and even from India.

The title of this Yearbook is *Restructuring and insolvency tools in times of crisis*, linking it closely to the overall theme of this year's Dubrovnik Congress *Resilience in the face of adversity*.

This Yearbook contains contributions on a wide range of restructuring and insolvency tools, from both national and comparative law perspectives. Some contributions touch upon interesting and present-day topics, such as the implementation of the Directive (EU) 2019/1023 on preventive restructuring frameworks in several Member States of the European Union. Other contributions entail a comparison of restructuring and insolvency regimes of Member States of the European Union, the United States as well as England. One of the contributors has expressed his view on the recently rendered and long-awaited judgement of the European Court of Judgement in the Dutch *Heiploeg* case, regarding the transfer of employees and the protection of their interests in the light of a restructuring. This is, however, only a limited selection of the papers in this Yearbook.

INSOL Europe would like to express its appreciation to all contributors for the time and effort they contributed to get this Yearbook published. A special thank you to and appreciation for Olha Stakheyeva-Bogovyk from Ukraine, who – despite the very difficult and unhuman situation and circumstances in her country – managed to send in a highly interesting contribution on the new preventive restructuring framework in Ukraine. INSOL Europe stands with Ukraine and its people!

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.

INSOL Europe Editorial Board,

Marcel Groenewegen (chair)

Evert Verwey

Emilie Ghio

Paul Newson

Ruairi Rynn

Jonathan van Ee (secretary to the board)

Author Biographies

Chapter 1 – The Preventive Restructuring Framework of Ukraine

Olha Stakheyeva-Bogovyk (PhD)

is an attorney-at-law in Ukraine and an associate at McDermott Will & Emery UK LLP in London, England.
Email: ostakheyeva-bogovyk@mwe.com

Chapter 2 – A Consideration of Insolvency Processes Available to Small Businesses in the European Union and Beyond

Simon Murphy

is a partner at Beauchamps LLP in Dublin, Ireland.
Email: sa.murphy@beauchamps.ie

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Klaudia Frątczak-Kospin

is a restructuring adviser, attorney-at-law and counsel at WKB Wierciński, Kwieciński, Baehr sp. k. in Warsaw, Poland. Email: klaudia.kospin@wkb.pl

Wiktor Danielak

is an attorney-at-law and senior associate at WKB Wierciński, Kwieciński, Baehr sp. k. in Warsaw, Poland. Email: wiktor.danielak@wkb.pl

Chapter 4 – Protection of Employees and the Smallsteps and Heiploeg Judgments

Robert van Galen

is a partner at NautaDutilh in Amsterdam, the Netherlands.
Email: robert.vangalen@nautadutilh.com

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Catarina Guedes de Carvalho

is the head of restructuring and recovery at CTSU – Sociedade de Advogados, SP, RL, SA, which is the Deloitte Legal practice in Portugal.
Email: catarcarvalho@ctsu.pt

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Nicoleta Mirela Năstasie

is a retired judge at Bucharest Tribunal, a PhD researcher at the Titu Maiorescu University in Bucharest, Romania, and fellow at INSOL International.
Email: nastasie.mirela@yahoo.com

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Catherine Ottaway

is a lawyer and a partner at HOCHE Avocat in Paris, France.
Email: ottaway@hocheavocats.com

Hadrien de Lauriston

is a lawyer and a partner at HOCHE Avocats in Paris, France.
Email: lauriston@hocheavocats.com

Benjamin Gallo

is a lawyer and an associate at HOCHE Avocats in Paris, France.
Email: gallo@hocheavocats.com

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Sharon Barrett (QFA, EFA, BA Hons)

is a financial advisor and a director in the restructuring division of Kroll in Dublin, Ireland. Email: sharon.barrett@Kroll.com

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Alessandro Danovi

is a chartered accountant and auditor in Milan, Italy. In addition, he is a professor of Business Economics and Management at the University of Bergamo, Italy, and a lecturer in Management and Turnaround Management at the Bocconi University of Milan, Italy. Email: alessandro.danovi@unibg.it

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Lucas P. Kortmann

is a partner at RESOR in Amsterdam, the Netherlands, and fellow at INSOL International. Email: lucas.kortmann@resor.nl

Niels B. Pannevis

is a senior associate at RESOR in Amsterdam, the Netherlands, and fellow at the Radboud Business Law Institute of Radboud University in Nijmegen, the Netherlands. Email: niels.pannevis@resor.nl

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Mateusz Kaliński (LL.M.)

is a lawyer and manager at Tatara & Partners Restructuring & Insolvency Law Firm in Krakow, Poland, and PhD researcher at Jagiellonian University in Krakow, Poland.
Email: m.kalinski@tatara.com.pl or mateusz.kalinski@gmail.com

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Ivo-Meinert Willrodt (Executive MBA)

is a lawyer and managing partner at PLUTA Rechtswalts GmbH in Munich, Germany, and fellow at INSOL International.
Email: ivo-meinert.willrodt@pluta.net

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José Gonçalves Machado (PhD)

is a Professor at the Faculty of Law of the Universidade Lusófona and researcher at CEAD – Francisco Suarez Research Center in Lisbon, Portugal.
Email: jose.goncalves.machado@ulusofona.pt

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Krijn Hoogenboezem

is a partner and head of the Restructuring, Insolvency & Bankruptcy team at Dentons Europe LLP in Amsterdam, the Netherlands.
Email: krijn.hoogenboezem@dentons.com

Karin Sixma

is a counsel and part of the Restructuring, Insolvency & Bankruptcy team at Dentons Europe LLP in Amsterdam, the Netherlands.
Email: karin.sixma@dentons.com

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Adrián Yuste Bonillo

is an associate in the litigation and restructuring practice at Cuatrecasas in London, England. Email: adrian.yuste@cuatrecasas.com

Roma Bastús Vilanova

is an associate in the litigation and restructuring practice at Cuatrecasas in London, England. Email: roma.bastus@cuatrecasas.com

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Dennis J. Helmons

is a lawyer at Turnaround Advocaten in Best, The Netherlands.
Email: dennis@turnaroundadvocaten.nl

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Surbhi Kapur

is an assistant professor and head of the Centre for Insolvency and Bankruptcy at the Indian Institute of Corporate Affairs under the Ministry of Corporate Affairs of the Government of India. Email: surbhi.kapur@iica.in

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Chapter 1

The Preventive Restructuring Framework of Ukraine

Olha Stakheyeva-Bogovyk
PhD in law, Attorney-at-law in Ukraine,
Associate at McDermott Will & Emery UK LLP
London, United Kingdom[1]

Synopsis

This paper sheds light on the new 'kid' in the Ukrainian market, i.e., a 'preventive restructuring framework' of Ukraine, which was fully effected with the introduction of the first-ever Bankruptcy Code of Ukraine on 21 October 2019.

First, some emphasis is made on the underpinnings and evolutionary background that stood behind the development and enactment of the pre-insolvency framework in Ukraine. This paper demonstrates that this toolkit was, *inter alia*, introduced in Ukraine as a pre-condition for disbursement of a financial aid from international donors to assist Ukraine in stabilization of its economy that was about to collapse after the global economic crisis of 2008, further devaluation of national currency and Russia's occupation of the Eastern part of Ukraine as of 2014. This paper also reveals that a genuine Ukrainian pre-insolvency instrument as it is in effect now did not have a straightforward history of its development, rather was developed for and 'extracted' from the banking legislation that was being drafted then.

The paper also provides a 'first-hand' insight from some international experts, directly involved in the drafting of the pre-insolvency framework for Ukraine. According to them, the current framework of Ukraine was, in fact, modeled on a draft law prepared for Kuwait, which was based on a law prepared for Montenegro, which drew heavily on the Turkish law.

Secondly, the paper revels some 'true colours' of the Ukrainian pre-insolvency procedure, along with outlining of its key features, by making some comparative analysis of this procedure against Chapter 11 of the US Bankruptcy Code, a new restructuring plan under Part 26A of the Companies Act 2006[2], inserted

1 I want to express my greatest gratitude to Gordon Johnson, the USA's turnaround expert, and one of the authors of pre-insolvency framework of Ukraine, who kindly provided me with the invaluable insight to this framework and how it was being developed and inspired me to write this paper.

2 Part 26A of the Companies Act 2006 was inserted by Schedule 9 to the Corporate Insolvency and Governance Act 2020 ('CIGA').

by Schedule 9 to the Corporate Insolvency and Governance Act 2020 (‘**CIGA**’)[3] in the United Kingdom and the EU pre-insolvency framework under the EU Preventive Restructuring Directive. This paper argues that the Ukrainian pre-insolvency procedure is a ‘light version’ of the Chapter 11 US Bankruptcy Code pre-packaged reorganization.

The Ukrainian preventive restructuring framework may be initiated only by debtors and utilized at a mere ‘likelihood of insolvency’. It also possesses the ‘hybrid’ *pre-insolvency* features as it combines elements of an informal ‘out-of-court’ *process*, as well as of a formal insolvency process. Similar to the Chapter 11 pre-packaged reorganization, most of ‘the work’, like negotiation of the plan and solicitation of creditors’ votes, is conducted by the debtor outside of court direction and supervision and without bankruptcy protections in place. At the same time, the Ukrainian procedure also has some features of a *formal insolvency process*, which takes place at a later stage, when the debtor files for court’s confirmation of the plan. The latter triggers a ‘restrictive’ automatic moratorium only on affected/impaired creditors, which stays in place until the decision on confirmation of the plan has been taken by the court. The confirmed plan binds only the affected/ impaired creditors.

Like a true pre-insolvency framework, the Ukrainian process allows for a debtor-in-possession regime, however the option of requesting the appointment of a trustee is also available.

The Ukrainian pre-insolvency procedure, unlike the US Chapter 11, a new restructuring plan under Part 26A of the Companies Act 2006 and the EU Preventive restructuring framework, does not envisage a possibility of utilizing a *cross-class cramdown* on the dissenting class of creditors. At the same time, the Ukrainian framework sets forth quite low voting thresholds in value, without a numerosity requirement, so that in practice the utilization of this process should be quite comfortable and realistic in overcoming the dissenting creditors merely by cramming them down *within the class*.

For practical worth, this paper also briefly illustrates some observations and findings following the analysis of first ‘sprouts’ of Ukrainian court practice on confirmation of preventive restructuring plans.

[3] Corporate Insolvency and Governance Act 2020 (‘CIGA’) at https://www.legislation.gov.uk/ukpga/2020/12/schedule/9/enacted, accessed 10 May 2022.

1 Underpinnings and historical background of the pre-insolvency framework of Ukraine

1.1 Political and policy context

The preventive restructuring framework of Ukraine had an unusual and un-straightforward history of its evolution.

Back in early 2015 in Ukraine there was a flurry of activity by all kinds of donors and institutional players, including the EU, IMF, World Bank and EBRD, to assist Ukraine in developing / improving its domestic law as to facilitate the disbursement of USD 1 billion to provide budget support to Ukraine. The disbursement of that loan was subject to numerous conditions precedent, including changes to the Banking Law, the Deposit Guarantee Fund, and, among others, adopting a new law on financial restructuring to improve the banking tools for resolving non-performing loans, as well as the development of an effective framework that could be utilized at an early stage to prevent insolvency of otherwise viable businesses (hereinafter interchangeably – **'pre-insolvency'** or **'preventive restructuring procedure'**).

1.2 Conceptual evolution of Ukrainian pre-insolvency procedure

As at 2015 Ukrainian law de jure contained a so-called 'pre-insolvency procedure' (literary: 'pre-trial rescue procedure') in Article 6 of the Law of Ukraine *On Restoring Solvency of the Debtor or Declaring It Bankrupt* (ed. 2011, in effect 2013) (hereinafter **– 'the Bankruptcy Law'**)[4]. However, de facto that was only the 'imitation' of that procedure as it conceptually lacked the genuine features of a preventive restructuring framework and was totally unworkable in practice.

Improvement to a then existing framework with the aim to meet the initially declared purpose was objectively needed, and in the context of political and policy considerations of that time was actual as never.

To that end, a number of different governmental agencies and international experts were generally working on amendments to various branches of Ukrainian law, including, *inter alia*, the Bankruptcy Law and its old unworkable pre-insolvency procedure. The outcome of these joint efforts was the adoption

4 The Law of Ukraine 'On Restoring Solvency of the Debtor or Declaring It Bankrupt' (ed. 22.12.2011, in effect 2013) / Закон України 'Про відновлення платоспроможності боржника або визнання його банкрутом', 22.12.2011, see https://zakon.rada.gov.ua/laws/show/2343-12#Text, accessed 10 April 2022.

of a first ever Bankruptcy Code of Ukraine (hereinafter – '**the BCU**')[5] in autumn 2018, and its full enactment on 21 October 2019, and the introduction of a fully reshaped brand new 'preventive restructuring framework' under Article 5 of the BCU.

Therefore, an emergence of the genuine pre-insolvency procedure of Ukraine is usually associated with the 'birth' of the BCU, due to the fact that the previous unworkable framework had undergone a conceptual transformation.

The development of the Ukrainian pre-insolvency procedure wasn't straightforward though. According to ***Gordon Johnson*** (an international expert from the World Bank's side, who was directly involved in the development of Article 5 of the BCU), this legal instrument was initially developed as an expedited procedure for the Law of Ukraine On Financial Restructuring[6] ('**LFR**') as an *alternative route*, when a required full consensus of all affected parties taking part in the voting process, wasn't met. In other words, should there be no unanimous consent of a plan under the LFR, but at least a 75% approval threshold was met, an alternative court confirmation process could be availed of. However, to have two legal instruments: one in banking, another in bankruptcy law, with a practically identical approach and targeted result, was seen as impractical.

Eventually, the 'expedited procedure' was taken out of the LFR draft and *reformatted to* serve as the new pre-insolvency procedure under Article 5 of the BCU so to replace a previous conceptually incorrect and unworkable framework.

Therefore, the Ukrainian pre-insolvency procedure, as it is now, wasn't initially entirely designed as a purely insolvency (bankruptcy) law instrument, but rather evolved from a banking legal toolkit – as an 'expedited and alternative rescue procedure' within a financial restructuring framework, which primarily dealt with non-performing loans in the banking system.

1.3 Multijurisdictional origin of the Ukrainian pre-insolvency procedure

The new current Ukrainian pre-insolvency procedure, which now exists in Article 5 of the BCU, has had an unusual 'multijurisdictional origin'.

[5] The Code of Ukraine 'On Bankruptcy Proceedings' dd. 18 October 2018 (hereinafter interchangeably – 'Bankruptcy Code of Ukraine' or 'BCU') / Кодекс України з процедур банкрутства, 18.10.2018, see https://zakon.rada.gov.ua/laws/show/2597-19#Text, accessed 20 April 2022.

[6] The Law of Ukraine 'On Financial Restructuring', 2016 (Закон України 'Про фінансовуреструктуризацію'), see https://zakon.rada.gov.ua/laws/show/1414-19#Text, accessed 20 April 2022.

According to international expert's insight[7], it was modelled on a draft law prepared for Kuwait (the Kuwaitis sat on it for 4 years and never adopted), which was based on a law prepared for Montenegro, which drew heavily on the Turkish Law, designed in 2003–2004.

Given that the Turkish pre-insolvency procedure was modeled on the concept of the US Chapter 11 pre-pack, pre-solicited agreement[8], the Ukrainian framework also took a lot after the American framework, and is now even more elaborated than the Turkish one, which was then well ahead of its time as a pre-insolvency mechanism and fully in compliance with World Bank Principles, and the UNCITRAL Legislative Guide on Insolvency[9].

2 Ukrainian 'flavour' of the pre-insolvency procedure and first court cases

2.1 Key features of the pre-insolvency framework of Ukraine

Having been conceptually re-shaped against the previously unworkable framework, the current pre-insolvency procedure of Ukraine under Article 5 of the BCU now carries more features of a 'true philosophy' of preventive restructuring frameworks, but, certainly, with the Ukrainian 'flavour' described below.

First, only debtors, not creditors, can initiate the preventive restructuring procedure upon the decision of the shareholders[10].

Second, only debtors, which are legal entities, incorporated under the laws of Ukraine with a registered office in Ukraine can take advantage of this procedure. This is so, because the territorial jurisdiction of the court to consider a case on confirmation of a plan is determined by the location of the debtor[11]. Therefore, unlike in a Chapter 11 case or a new UK restructuring tool under Part 26A of CIGA, no foreign debtors shall be able to avail of the Ukrainian pre-insolvency procedure, unless they are properly incorporated and based in Ukraine, as the domestic 'jurisdictional gate' is not flexible enough to allow

[7] Gordon Johnson's insight.

[8] Under the US Law, one can start a regular reorganization with no plan, or one can file with a plan that has not been circulated or voted on, or one can submit the pre-voted plan at the time of the petition in what we call a ***prepack***, pre-solicited plan of reorganization; this approach considerably shortens the amount of time in court from years or months, to weeks or even days.

[9] See *supra* n 7.

[10] Para 1 Article 5 of BCU.

[11] Para 5 Article 5 of BCU.

for eg, a 'sufficient connection test', which was often utilized by foreign companies seeking to restructure in the United Kingdom.

Third, the Ukrainian pre-insolvency procedure can, *inter alia*, be availed of at an early stage, before the debtor meets the 'insolvency' threshold, which corresponds to the general philosophy of pre-insolvency frameworks.

The assumption on an early intervention possibility is made on the following. Starting with the name of the procedure – 'The Rescue of a Debtor Before the Opening of a Bankruptcy Case'[12] – it leads to the conclusion that it must be conducted before a bankruptcy case can begin. Also, the initiation of a pre-insolvency procedure is included into possible available 'statutory measures on prevention of bankruptcy of the debtor' (along with the provision of new money injections by shareholders etc.), exposing debtor's shareholders to a duty to timely take respective measures to avoid bankruptcy/ insolvency of the debtor[13]. Concurrently, the BCU imposes a duty on the debtor's director to file for bankruptcy within 1 (one) month as of the date of occurrence of a 'threat of insolvency'[14] (i.e., which is when the satisfaction of claims of 1 (one) or more creditors can lead to inability of the debtor to satisfy claims of other creditors in full)[15]. From this it follows that the debtor should initiate the pre-insolvency proceeding early enough – before an event of a threat of insolvency takes place (i.e., when the debtor anticipates that if it pays to one creditor, it may not be able to pay the debts to other creditors in full). Failing that, the debtor's director shall be held jointly and severally liable for the debtor's debts.

In other words, to be able to utilize a pre-insolvency procedure in Ukraine, the debtor would have to closely and timely monitor its financial situation so to ensure that it doesn't miss the 'window of opportunity' for a preventive restructuring case before the duty to file for bankruptcy overtakes. Otherwise, a full-fledged bankruptcy proceeding would have to be put in place upon the occurrence of the event of a threat of insolvency.

At the same time, while there is generally 'no requirement of insolvency'[16], and the possibility of the early intervention is as hand, which is a distinctive feature

[12] Article 5 of BCU – 'The Rescue of a Debtor before the Opening of a Bankruptcy Case'.

[13] Article 4 of BCU.

[14] The use of a criterion as 'a threat of insolvency' as a timely test to observe the debtor's duty to file for bankruptcy is somewhat disputable, as otherwise there is little space for pre-insolvency option.

[15] Para 6 Article 34 of BCU.

[16] 'Comparison of Chapter 11 of the United States Bankruptcy Code with the System of Administration in the United Kingdom (. . .): One Firm Worldwide' (2007) Jones Day 8, see https://www.jonesday.com/files/Publication/1ec093d4-66fb-42a6-8115-be0694c59443/Presentation/PublicationAttachment/e5b46572-7aeb-4c34-ab2e-bee2f8f3d3c2/Comparison%20of%20Chapter%2011%20(A4).pdf, accessed 29 May 2022.

of pre-insolvency frameworks, it has to be balanced against some level of anticipated 'financial distress' on the horizon to substantiate the need for a 'light-touch restructuring' application.

Fourth, Ukraine's framework can largely be described as a 'debtor-driven and debtor-held' process, conceptually resembling the US Chapter 11 case, which has been almost elevated to the status of a global template for formal reorganization law, due to its 'pro-restructuring' features[17], and which many regard as the 'gold standard' of restructuring mechanisms[18].

For Ukraine, the process, however, is particularly similar to a Chapter 11 pre-packaged reorganization[19], where most of the restructuring work, including the debtor's formal solicitation of acceptance of a reorganization plan[20], is conducted prior to the commencement of the insolvency proceedings[21]. This is the case for Ukraine, as most of the 'work' is conducted by the debtor neither having launched a formal court case to 'supervise' and direct the negotiation and solicitation of votes, nor with any statutory bankruptcy protections in place during the 'bargaining period'.

Unlike the free-fall Chapter 11 case, where a debtor files for a bankruptcy case and its bankruptcy protections without having an agreed exit strategy in place[22], in Ukraine the debtor would have to finalize 'the exit strategy' with its creditors before the opening of the case in court. Especially, the debtor in Ukraine proposes and negotiates its restructuring plan, designates the affected/impaired classes, summons them respectively, and solicits votes on its plan in an out-of-court informal way, without any court intervention or protections at that stage.

As any 'light touch' pre-insolvency proceeding, which 'inhabits a space on the spectrum of insolvency and restructuring law[23], somewhere between a pure

[17] I Mevorach, A Walters, 'The Characterization of Pre-insolvency Proceedings in Private International Law' (2020) 855–894 Eur Bus Org Law Rev 21, 6, see https://doi.org/10.1007/s40804-020-00176-x, accessed 29 May 2022.

[18] Jennifer Payne, 'The UK Restructuring Moratorium' (2021) Oxford Business Law Blog, see https://www.law.ox.ac.uk/business-law-blog/blog/2021/01/uk-restructuring-moratorium, accessed 30 May 2022.

[19] See *supra* n 17, at 12.

[20] Dennis F Dunne, Dennis C O'Donnell and Nelly Almeida, 'Pre-packaged Chapter 11 in the United States: An Overview' (2019) *Global Restructuring Review*.

[21] Elizabeth Tashjian, Ronald C Lease, and John J McConnell, 'An Empirical Analysis of Prepackaged Bankruptcies' (1996) 40(1) *Journal of Financial Economics* 135.

[22] Liz Downing, 'The US Chapter 11 Process', see https://www.lexisnexis.co.uk/legal/guidance/the-us-chapter-11-process?utm_source=psl_da_mkt&utm_medium=referral&utm_campaign=the-us-chapter-11-process, accessed 31 May 2022.

[23] See *supra* n 17, at 6.

contractual workout and a formal insolvency or rehabilitation proceeding[24], the Ukrainian framework also balances between informal out-of-court workout and formal insolvency procedure. The formal court intervention is quite short for Ukraine, as well as for a Chapter 11 pre-packaged case, and begins only at the stage when the debtor seeks confirmation of the pre-solicited plan. This is where the procedure transits from an out-of-court informal process into a formal court-supervised procedure.

A late intervention of the court into the formal pre-insolvency process, when most of the 'heavy work' has been done outside of court, disables the need for a two-staged process, like a convening and sanction hearing, which are typical for the UK's Part 26A restructuring process[25]. Ukraine's pre-insolvency procedure, therefore, can be described as short and straightforward, just as an US's pre-packaged reorganization. This, obviously, minimizes costs of the procedure 'when in court', increases the predictability of the outcome for the debtor, and shortens the debtor's exposure to some unnecessary stigma of a formal court proceeding. However, there may be risks at a later stage associated with such a minimum court intervention at an earlier stage – more likelihood that challenges may arise in connection with formation of creditor classes, their classification, or other 'pre-court', issues that will all have to be verified by the court at the confirmation hearing.

Another distinctive feature of the Ukrainian pre-insolvency procedure, which is typical for Chapter 11 pre-packs, but atypical for a free-fall Chapter 11 case and the EU's model (where bankruptcy protections apply from the very first day of the procedure) is the absence of a 'breathing space', while the debtor is conducting 'heavy preparatory work' almost up until the court confirmation hearing.

For the Ukrainian framework the 'breathing space' becomes available only once informal out-of-court part has been completed, and the debtor, within 5 days as of the date of solicitation of votes on the plan, files for the court confirmation of the pre-solicited plan[26]. The acceptance by the court of the request for a plan confirmation triggers a moratorium[27].

Slightly similar to the automatic moratorium under a free-fall Chapter 11 US, which gets imposed by a mere filing by the debtor for a Chapter 11 case, the

[24] JL Westbrook, 'A Global View of Business Insolvency Systems' (2010) 124–125 (Martinus Nijhoff, Leiden).

[25] Shan Qureshi, 'Restructuring Primer: Part 26A Restructuring Plan Features Cross-Class Cramdown, No Numerosity Test Requirement for Debtor Financial Difficulties; Virgin Atlantic, Pizza Express Successful Users' (2020), see https://reorg.com/debt-explained-part26a-restructuring-plan/, accessed 5 May 2022.

[26] Para 5 Article 5 of BCU.

[27] Para 6 Article 5 of BCU.

moratorium for the purpose of pre-insolvency procedure in Ukraine gets into play once the court accepts the case for its consideration, should it not find grounds for its refusal – no separate application for the moratorium/ stay is therefore needed.

The Ukrainian 'flavour' of the moratorium, however, has a narrower effect, when compared to the US's, as the former binds only to the affected/ impaired creditors, which is also the feature of the EU's process, which was transplanted into Ukrainian law.

As with other preventive restructuring frameworks, the effect of the Ukrainian moratorium ends with the court confirmation or rejection of the plan[28]. At the same time, there is a possibility to lift it before its 'expiry date' in the circumstances where there may be a risk of losing/ dissipation of a collateral[29]. Also, there is another window of possibilities for the secured creditors to get an 'automatic lift' of the moratorium upon the elapse of 60 calendar days as of the date of acceptance by the court of the application for a plan confirmation, and its failure to consider the matter within this term[30].

Fifth, another core and appealing characteristic of pre-insolvency proceedings is the debtor-in-possession regime — entry into the proceedings might not result in the replacement of the debtor's management by an officeholder[31]. The Ukrainian framework also 'borrowed' this element from the US, UK and EU's pre-insolvency frameworks.

By default, the management of the debtor remains in control of the debtor company, no trustee is appointed to conduct the preventive restructuring process. However, creditors or the debtor may request the appointment of the trustee, and such application must be considered by the court within 5 days as of the date of acceptance of the application for court confirmation/sanction of the plan[32]. Should that be the case, preliminary a candidacy of the trustee must be elected at the general meeting of creditors, holding 50% in value of the affected/impaired claims. In other words, the restructuring plan must include the provision on the trustee, and ought to have been voted for by the affected/ impaired creditors along with other terms and conditions of the plan before filing it for the court confirmation.

[28] Para 8 Article 5 of BCU.

[29] Para 7 Article 5 of BCU.

[30] Para 8 Article 5 of BCU.

[31] See *supra* n 17, at 9.

[32] Para 7 Article 7 of BCU.

Sixth, the restructuring plan ('plan'), as a central feature of preventive restructuring[33], is an exclusive discretion and 'creation' of the debtor under the Ukrainian framework. The debtor therefore designates the 'creditors or categories/classes of creditors who shall take part in the restructuring' (hereinafter interchangeably – 'affected' or 'impaired creditors') by specifying the treatment of all affected/ impaired classes[34].

Although there is no legal term and definition of the 'creditors who take part in the restructuring' in the BCU, from the analysis of Article 5 of BCU it is possible to extract the understanding that, presumably, those are the creditors, whose claims are subject to modification/alteration under the restructuring plan, in the meaning of Chapter 11 US BC or the EU Preventive Restructuring Directive. That conclusion is derived on the basis of the provision that 'the claims of creditors which haven't been altered or restructured under the plan can be excluded by the debtor from the restructuring plan'[35].

The classification of creditors is not very detailed in the BCU. No 'substantial similarity/ commonality of interest' test is expressly envisaged, unlike in the US[36] and the EU[37]. The only requirement in Ukraine is that affected/impaired creditors are divided into categories/ classes, depending on the type of claim and security[38].

At the same time, the Ukrainian pre-insolvency framework has some 'safeguards' for the claims of 1st rank[39] (i.e. wages, employee/labour compensation claims, social insurance claims, reimbursement to a State Budget claims, insurance claims, bankruptcy administration costs, audit expenses if directed by court, reimbursement of a loan/ credit taken for employee compensation purposes) and of 2nd rank[40] (i.e. social and pension insurance, compensation

33 *Tamir v United States Trustee*, 566 B.R. 278 (2016) Jan. 22, 2016, United States District Court for the District of Maine, Civil No. 2:15-CV-333-DBH, 566 B.R. 278 *Shai Shawn TAMIR, Appellant v United States Trustee, et al., Appellees*, see https://cite.case.law/br/566/278/, accessed 25 May 2022.

34 Para 2 Article 5 of BCU.

35 Para 3 Article 5 of BCU.

36 The ***classification*** of creditors is based upon the premise that claims that are substantially similar should be classified together. Secured creditors holding liens with different priorities on the same collateral are to be separately classified. As a rule, unsecured creditors are classified in one class (with exceptions).

37 Affected parties are divided into classes with a view to adopting the plan and these classes should reflect a sufficient commonality of interest. Secured creditors should be in a separate class from unsecured creditors as a minimum. The court will examine class formation issues either when the plan is submitted for confirmation or, if Member States provide, at an earlier stage.

38 Para 2 Article 5.

39 Para 1 Article 64 of BCU.

40 *Ibid*.

for damage to life and health etc.). They can't be impaired by the debtor and have to be excluded from the plan[41] by leaving them untouched.

Some 'easy deal' is possible when dealing with tax claims under the Ukrainian pre-insolvency procedure. Namely, should the plan envisage the impairment of tax claims, the tax authorities shall be conclusively deemed to have 'accepted' the plan, without the need for tax authorities to cast votes. The tax debt that occurred 3 years before the summoning of the impaired creditors' meeting ('CM') shall be deemed 'bad' and be subject to a write-off; and the tax debt which occurred thereafter, shall be impaired on the plan's terms, provided the conditions are 'no worse-off' than for other impaired creditors who voted for the plan[42].

Seventh, in Ukraine for the plan to be considered 'accepted' by a class of creditors, it is needed that the following voting thresholds are met in each class of creditors, i.e., 2/3 of votes in value of a secured creditor class; and more than 1/2 of votes in value of an unsecured creditor class[43]. These voting thresholds are quite low compared to the UK's framework, which requires at least 75% (3/4) of votes in value of a class of creditor[44], and the US's one, which has a 'double standard' by additionally imposing a numerosity requirement, i.e. at least two-thirds (2/3) of votes in value of a creditor class and more than one-half (1/2) of votes in number of a creditor class[45].

Eighth, the Ukrainian pre-insolvency procedure does not envisage a possibility of utilizing a cross-class cramdown, as do the preventive restructuring frameworks of the US, UK and the EU, enabling them to overcome the dissenting class(s) of creditors. Therefore, for the plan to be confirmed by the court in Ukraine it is necessary to obtain all impaired classes of creditors' acceptance of the plan by meeting the requisite voting thresholds in each class. For this reason, the Ukrainian framework sets forth quite low voting thresholds in value, without a numerosity requirement, so to increase the prospect of the plan confirmation, thereby making it more realistic to overcome the dissenting creditors by way of 'cramming' them down within the class, provided other conditions are met.

[41] Para 3 Article 5 of BCU.

[42] Para 3 Article 5 of BCU.

[43] Para 4 Article 5 of BCU.

[44] The UK's framework, which requires at least 75% (3/4) of votes in value of a class of creditor.

[45] The US's one, which has a 'double standard' by additionally imposing a numerosity requirement, i.e., at least two-thirds (2/3) of votes in value of a creditor class and more than one-half (1/2) of votes in number of a creditor class.

Ninth, for the plan to be confirmed by the court in Ukraine, the debtor has to 'score twice': not only to succeed to pre-solicit votes on the plan from the affected/impaired creditors, but also to produce and defend at a confirmation hearing a liquidation analysis (as part of the plan), that would evidence that the affected/ impaired creditors will be 'better-off' under the plan than in liquidation[46]. This liquidation analysis test is similar to the 'best-interest test' under the EU model and Chapter 11 US BC, which requires that a plan proponent ensures that each creditor will receive at least as much under the proposed plan as it would receive if the debtor's assets were liquidated[47], which imposes on the court a duty to determine the probable distribution that the holders in each impaired class of claims and interests would receive if the debtor's assets were liquidated[48]. For the fairness of a comparative analysis, the 'best-interest test' is somewhat different for the UK's Part 26A new restructuring process as it sets forth a standard of 'to be no worse off than in the relevant alternative'[49], which doesn't necessarily mean liquidation.

Apart from the compulsory requirement for the debtor to provide a liquidation analysis together with a restructuring plan, the debtor, at its discretion, may also provide a financial analysis to substantiate the debtor's ability to implement/execute the terms of the plan. It is not particularly clear what 'test' the legislator wanted to apply here, but the non-obligatory character of this provision does not add much certainty to this requirement either. Court practice will have to clarify it. Presumably, the idea may have been to introduce a commonly recognized 'feasibility test', which is a must for the US's[50] and EU's pre-insolvency frameworks, requiring the debtor to demonstrate that there is a reasonable prospect of preventing insolvency or ensuring the viability of the debtor's business[51]. This requirement is critical for US's framework as the Chapter 11 plan may be confirmed only if '[c]onfirmation of the plan is not likely to be followed by the debtor's liquidation, or the need for further financial reorganization of the debtor or any successor to the debtor under the plan[52].'

[46] Para 2 Article 5 of BCU.

[47] 11 U.S.C. § 1129(a)(7).

[48] Kavita Gupta, 'Confirmation Issues Facing a Nonprofit Debtor' (2012) Vol. XXXI, No. 3 ABI Journal, https://www.proquest.com/docview/1008666878, accessed 7 May 2022.

[49] *Re Deepocean 1 UK Ltd* [2021] EWHC 138 (Ch); *Re Smile Telecoms Holdings Ltd* [2021] EWHC 685 (Ch); *Re Virgin Active Holdings Ltd* [2021] EWHC 1246 (Ch).

[50] The so-called *feasibility requirement* in 11 USC s 1129(a)(11) requires a plan proponent to demonstrate by a preponderance of evidence that confirmation of the plan is not likely to be followed by the liquidation, or need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan.

[51] Gerard McCormack, 'The European Restructuring Directive' (2021) 336 Elgar Corporate and Insolvency Law and Practice series, https://www.elgaronline.com/view/9781789908800/07_chapter1.xhtml, accessed 31 May 2022.

[52] Section 1129(a)(11).

Tenth, the Ukrainian pre-insolvency procedure requires a formal court proceeding, as a confirmation hearing, to impose a binding effect of the plan on the affected/impaired creditors. The application for the court confirmation has to be filed by the debtor within 5 days following the acceptance of the plan within the requisite voting thresholds. The court is to consider such application no later than within 1 (one) month as of the date of acceptance of the application for its consideration[53].

For the court to confirm the plan, it must be persuaded that there are no grounds to refuse[54] the confirmation of the plan, which may be the following:

(1) non-observance of law which affected the voting results at the creditors meeting;
(2) the dissenting creditor substantiated that it would be 'better-off' in liquidation than under the plan, as the recovery rate in liquidation would be higher ('a liquidation test' or its analogue – 'best interests test');
(3) a debtor made a misrepresentation or provided false information that is critical for assessing the success of the plan.

Should there be no grounds to refuse the confirmation, as per above, the court confirms the plan and immediately cancels the pending moratorium[55]. In Ukraine the plan confirmed by the court is binding on all the affected/ impaired creditors to the plan[56]. This feature bears resemblance with the English and EU pre-insolvency frameworks.

2.2 First 'sprouts' of court practice in Ukraine – first 'bricks', first 'stumbles'

The genuine pre-insolvency procedure appeared in Ukraine since the introduction of the first ever Bankruptcy Code of Ukraine, with its full enactment on 21 October 2019. Since then up to 12 cases have been considered by courts of Ukraine – half of them were refusals of confirmation of the plan[57].

These first 'sprouts' of court practice on the application of a new legal instrument to help debtors restructure at an early stage so to avoid bankruptcy, demonstrate a number of curious findings and observations.

[53] Para 8 Article 5 of BCU.
[54] *Ibid*.
[55] Para 8 Article 5 of BCU.
[56] Para 10 Article 5 of BCU.
[57] The data was collected as at November 2021, since then no update was made; as at May 2022 it is yet not possible to access most of public court registers/ web-sites for technical reasons, due to Russia's pending war against Ukraine.

First, as a new legal tool the procedure so far is failing to meet its core objective – to prevent insolvency/ bankruptcy in practice. Most of the cases demonstrate that the debtors were, in fact, deeply insolvent[58], with a number of defaulted debts, when they resorted to a preventive restructuring procedure, which in essence must have been utilized at a mere likelihood of insolvency (or before the event of a 'threat of insolvency' in Ukrainian terms).

Secondly, a classification of creditors appeared to be one of the widely disputed issues in court and subject to a number of challenges. Debtors tended to manipulate with the formation of classes and abused the process. Sometimes debtors could include a partial amount of debt of the creditor to the plan, so to decrease the affecting 'voting powers' of the potentially 'dissenting creditor' as against the rest of affected/impaired creditors in a class[59], or resorted to 'artificial impairment' for the voting purposes.

Further, debtors were inclined to include some hidden 'related parties' in the plan, without disclosing that to creditors, so to 'win' votes at the stage of pre-solicitation of the plan[60]. However, those 'tricks' had no success in court as dissenting creditors managed to expose that at the confirmation hearing.

Thirdly, the question of obtaining the status of a 'creditor'[61] to be eligible to take part in the preventive restructuring. This issue is very much linked to the question of class formation. In some cases, courts rendered quite a disputable decision, which in essence is against the whole philosophy of preventive restructuring mechanism, i.e. holding that 'a person without a matured debt' to prove the amount of its claim couldn't qualify as a 'creditor' for the purposes to participate in the pre-insolvency proceeding.

Fourth, the pre-solicited debtor's plan is quite successfully defeated by the dissenting creditors at the confirmation hearing on the ground of not meeting the '*best interests of creditors*' test[62].

To sum up, the debtors in Ukraine did start to avail of this new legal instrument. However, the way it is now often utilized signalizes some undeveloped culture of Ukrainian debtors to resort to a preventive restructuring procedure in good

58 *Re Dnipro Metallurgical Plant JSC* [24.06.2020] Case No. 904/3325/20 Commercial Court of Dnipro Region.

59 *Re Plisetckyii Granit Quarry LLC* [26.02.2020] Case No. 911/482/20 Commercial Court of Kyiv Region.

60 *Re GRANO LLC* [29.06.2021] Case No. 911/1865/21 Commercial Court of Kyiv Region.

61 *Re Dnipro Metallurgical Plant JSC* [24.06.2020] Case No. 904/3325/20 Commercial Court of Dnipro Region.

62 *Re North-Ukrainian Construction Alliance LLC* [22.01.2021] Caso No. 910/965/21 Commercial Court of Kyiv.

faith and at an early stage. Also, as the court practice demonstrates, in Ukraine to secure creditors votes on the plan outside of court supervision, as a truly pro-Chapter 11 pre-packaged procedure, doesn't guarantee the debtor that its pre-solicited plan will be quickly confirmed by the court. Having no 'court intervention' at the 'preparatory stage', although this fastens and cheapens the process for the debtor, eventually may extend the duration of the court involvement and costs associated with the challenges of the process at a later stage. Still lots of space to grow, learn and improve therefore.

3 Conclusions

The introduction of a re-shaped pre-insolvency procedure in Ukraine is a significant step forward. It is not only that Ukraine needed to formally 'tick this box' before the international donors so to get the disbursement of an international loan. To have such a toolkit in Ukraine's arsenal and its proper utilization by bona fide debtors was timely and needed to help the economy of Ukraine. Moreover, to have domestic law equipped with such an instrument corresponds to the global 'legal trend' for 'light touch' restructuring mechanisms, which, in proper hands, can be both beneficial for debtors and creditors by saving viable businesses and enabling higher repayment rates for creditors.

The genuine pre-insolvency procedure of Ukraine is said to be 'born' with the full enactment of the first ever Bankruptcy Code of Ukraine – on 21 October 2019. In essence, largely it is similar to Chapter 11 prepackaged reorganization in terms of its balancing between the informal out-of-court process, which takes place along all the 'preparatory stage' (i.e., when the debtor negotiates the plan and solicits creditors' votes in support of the plan), and a formal court process, which starts almost at the end of the process and ends with a confirmation hearing. As with Chapter 11 pre-packs, the bankruptcy protections, like a moratorium against creditors' enforcement actions, take place only upon the debtor's transition into a 'formal' stage of the proceeding – when the debtor seeks the confirmation of the plan before the court.

The Ukrainian 'flavour' of the pre-insolvency procedure, regardless of its similarity to US's prepacks, appears in its low voting thresholds needed for the acceptance of a plan by each impaired class of creditors. This was deemed an intentional 'exercise' of the lawmakers for the reason that Ukrainian framework lacks a cross-class cramdown mechanism. In such a way, Ukrainian debtors can rely on a 'within class cramdown'.

For the Ukrainian preventive restructuring procedure, a 'best interests of creditors' test plays an important role in determining the outcome of the confirmation hearing. Securing votes on a plan, doesn't guarantee a fast and positive result for the debtor, as recent court practice proved.

In any case, the introduction of a preventive restructuring framework in Ukraine is a big step forward, which has to be yet shaped and perfected by court practice.

Chapter 2

A Consideration of Insolvency Processes Available to Small Businesses in the European Union and Beyond

Simon Murphy
Beauchamps LLP,
Riverside Two, Sir John Rogerson's Quay,
Dublin 2, Ireland

1 Introduction

In light of the introduction of the European Directive on Preventative Restructuring in 2019[1] (the 'Directive'), many countries in the European Union sought to update and modernise their legal restructuring framework to ensure harmonisation across the European Union and consolidation with the practices of other well-known restructuring hubs.

This submission will consider the legislative updates that have been introduced in recent years in relation to restructuring and their implications for small businesses. Many jurisdictions including Ireland, the USA, England and Wales, Germany, the Netherlands and Italy have either introduced or will shortly introduce new restructuring legislation including some insolvency processes exclusively dedicated to small businesses.

Reviewing the insolvency processes available to small businesses in Ireland and considering some of the key features of insolvency processes of well-known restructuring hubs, will provide an insight into the standard practices for restructuring small businesses. It will also provide an indication of the likely future developments in relation to the restructuring of small businesses and whether there any features currency in use in some jurisdictions that could be adopted more generally.

[1] 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.

By way of an expedited review of the position for the restructuring of small businesses in well-known restructuring hubs, a table has been prepared at Appendix 1 below to provide a breakdown of the position in Ireland, the USA, England and Wales, Germany, the Netherlands and Italy and the applicability of the most relevant provisions.

2 Ireland

2.1 Examinership

In Ireland until late 2021 the only insolvency process available to small businesses was examinership. Examinership is an insolvency process prescribed to save the business and undertaking of a company which is unable to pay its debts as they fall due, or about to become so but may benefit from restructuring by way of the limitation of certain liabilities and/or a new injection of capital.

Examinership was a well utilised tool during the COVID-19 pandemic for large businesses that required restructuring to return to profitability. In particular some of the largest aviation restructurings in many years utilised the examinership process to ensure their continued survival. Notable matters included the examinerships of Cityjet DAC and Norwegian Air. One of the advantages of Ireland as a jurisdiction for large scale international restructuring is the ability to conclude a cross-border restructuring in an efficient examinership process that is applicable in the European Union, and comparable to Chapter 11 of the US Bankruptcy Code in the USA, and the new restructuring plan in England and Wales.

While examinership is an excellent process for medium to large scale restructuring, the process requires numerous court hearings and oversight, the appointment of an insolvency practitioner and despite efforts to reduce the costs associated with it, the process became unviable for small businesses without significant resources to fund the process.

2.2 SCARP

The insolvency process for small companies in Ireland is now governed by the Companies (Rescue Process for Small and Micro Companies) Act 2021 ('SCARP').

In Ireland SCARP amended the Companies Act 2014 (the '2014 Act') to establish a new rescue process for small and micro companies that are, or are likely to be, unable to pay their debts. The new rescue process was modelled on the examinership process but has been designed to be utilised by small and micro companies. Due to the reduced role of a court in the process, SCARP is a more cost-efficient process and more accessible for small and micro companies.

A company can avail of SCARP as a small company if any two of the following conditions are satisfied:

(a) The turnover of the company does not exceed €12 million;
(b) The balance sheet of the company does not exceed €6 million;
(c) The average number of employees does not exceed 50 people.

A company can avail of SCARP as a micro company if the following conditions are satisfied:

(a) The company must qualify for the small companies regime (as defined by section 280C of the 2014 Act and whereby different rules apply to the company); and
(b) Two or more of the following requirements must be satisfied in a financial year:
    (i) The turnover of the company does not exceed €700,000;
    (ii) The balance sheet of the company does not exceed €350,000; and
    (iii) The average number of employees does not exceed 10 people.

The requirements for an eligible company to meet if it wishes to avail of a rescue plan are as follows:

(a) The company is, or is likely to be, unable to pay its debts;
(b) No resolution subsists for the winding up of the company;
(c) No order has been made for the winding up of the company;
(d) The directors of the company have not passed a resolution for the appointment of a process adviser in the previous 5 years; and
(e) No examiner has been appointed to the company during the previous 5 years.

The directors must prepare a statement of affairs setting out the financial situation of the company and confirm by statutory declaration that they have made a full inquiry into the affairs of the company.

This statement and statutory declaration are provided to an insolvency practitioner (known as a process adviser) who then determines and reports to the directors on whether there is a reasonable prospect of survival of the company as a going concern.

To avail of SCARP the company must pass a resolution to commence the rescue period within 7 days of receipt of the intended process adviser's report and the process of appointing an independent process adviser is initiated by a resolution of the company's directors, without any need for a court application (unlike examinership). The rescue period will end if either the appointment of the process adviser is terminated or where the process adviser resigns and is not replaced.

If, at any point during the rescue process, the process adviser deems that there is no longer a reasonable prospect of survival of the company, the process adviser must notify the directors and must resign. The process adviser must begin preparing a rescue plan for the company as soon as practicable after the resolution is passed.

Once the process adviser has prepared a rescue plan, he or she must call meetings of the members and creditors as soon as possible to consider the rescue plan. These meetings must be held not later than 49 days after the date of the passing of the directors' resolution. At the meetings of the creditors and members, the rescue plan will be deemed to be accepted once 60% in number representing the majority in value of the claims represented at that meeting have voted in favour of the resolution for the rescue plan.

Where the rescue plan is approved by the creditors and members, the process adviser must notify the employees, the Revenue Commissioners and any impaired creditor or member within 48 hours. The rescue plan is binding on the company, members, creditors and directors where it has been accepted by at least one class of impaired creditors, and where 21 days have passed from the filing of the notice of approval with the office of the relevant court and where no objection has been filed.

The key features of SCARP include that:

(a) The directors of the company remain in control of and responsible for the running of the business;
(b) Subject to court approval (or an alternative out-of-court procedure), the process adviser may repudiate contracts that are burdensome if it is necessary for the survival of the company;
(c) The process adviser may seek court permission to sell or dispose of charged property but the priority of the charge holder is protected;
(d) Tax liabilities may be excluded from the rescue plan; and
(e) There is no automatic protection from creditors during the SCARP process as there is in an examinership, however upon application to the relevant court, a stay on creditor enforcement actions will be available. This may be important where there is a threat of creditor action that could jeopardise the ongoing trade of the business.

SCARP allows small and micro companies to be restructured in various ways including the repudiation of onerous contracts, an application for a stay on proceedings in being, a cross-class cram down of debts and ongoing creditor engagement. It provides a new rescue framework that seeks to balance the interests of all stakeholders affected.

Many features of SCARP are similar to the examinership regime in Ireland. As examinership had become too costly for implementation by small businesses the introduction of the SCARP process has been a welcome development. As a standalone insolvency process it develops the framework available to practitioners to ensure that small businesses have access to the tools already regularly utilised by larger businesses and develops Ireland's restructuring framework in line with the guidance from the European Union and the position in other well-known restructuring jurisdictions.

3 The absolute priorities rule

Having considered the processes available in Ireland, and the newly introduced SCARP process specifically designed for small businesses, it is useful to consider the key features of more insolvency processes utilised by small businesses across the globe and the benefits or difficulties that arise for practitioners and petitioners.

One of the most common features of restructuring processes is the absolute priorities rule. In general the rule requires that the claims of a class of creditors that oppose a proposed restructuring are paid in full before any subordinate class of creditors are paid.

The absolute priorities rule is an interesting example as it is regularly applied in large scale restructuring processes but its application in restructuring of small businesses is not as universal.

For example in the USA, Chapter 11 of the Bankruptcy Code is perhaps the best known of all insolvency processes. It allows businesses to engage with their creditors and use the processes contained therein to restructure their debts and has streamlined processes for the restructure of debts for small businesses. In particular, Subchapter V[2] is specifically designed for small businesses to avail of the Chapter 11 processes. It provides a reduction in cost from the expedited timeframe in which the Subchapter V process is heard and determined.

[2] US Bankruptcy Code 11 U.S.C. § 1181.

Like most insolvency processes available exclusively to small businesses the process for a Subchapter V application under Chapter 11 of the Bankruptcy Code can only be availed of where the debtor meets specific eligibility conditions.

The debtor must be carrying on a business activity (excluding that of ownership an individual piece of property) and arising from the amendments introduced during the COVID-19 pandemic the debtor must have less than $7,500,000 in total debt, the majority of which must be attributable to the business activity of the debtor.

One of the most interesting aspects to the Subchapter V process is that the absolute priorities rule does not apply. The Subchapter V process was designed to ease the burden significantly on the debtor in the process and on that basis it differs significantly from the standard procedure under the Chapter 11 process.

In addition to the removal of the applicability of the absolute priorities rule a Subchapter V process differs from the Chapter 11 process as there is no requirement for a creditors' meeting, no requirement for a disclosure statement, there are no competing plans, there is no voting requirement for the plan and a plan can be confirmed without a consenting creditor.

While dissenting creditors are ordinarily protected from a cross cram down of debt by way of the absolute priorities rule, the approach in the USA under the Subchapter V process, provides debtors with much greater flexibility in their efforts to restructure as a small business.

The Subchapter V process is aimed at providing the debtor with as much opportunity as possible to restructure its debts but it is not usual that in the restructuring of small businesses that a cross cram down of debt may arise contrary to the absolute priorities rule.

It is not unusual that the absolute priorities rule be somewhat limited under insolvency processes for small businesses. A cross cram down of debt is a regular feature of insolvency processes for small businesses and in addition to being available under the SCARP process in Ireland it also features in the Company Voluntary Arrangement ('CVA') in England and Wales for unsecured creditors, in the Gesetz über den Stabilisierungs- und Restrukturierungsrahmen für Unternehmen (the 'StaRUG') in Germany and the Wet homologatie onderhands akkoord, (the 'WHOA') in the Netherlands, among others. However, unlike the position under the Subchapter V process in the USA, the absolute priorities rule applies under the staRUG and WHOA other than in limited exceptions.

The Subchapter V process in the USA goes further than many other insolvency processes for small businesses in an effort to expedite and simplify the process for less sophisticated businesses. The availability of streamlined insolvency processes for small business is certainly a benefit for those seeking to avail of the processes but their entitlements must also be balanced against the creditors of the business who are likely to be impaired by any restructuring plan.

For example a slightly different approach is applied in the Netherlands. Under the WHOA process a 'cash out option' is provided to dissenting creditors. Under these provisions, where a creditor has voted against the proposals in the restructuring plan and the creditor forms part of a class of creditors that have voted against the proposals in the restructuring plan, that creditor has a right to demand payment in cash of the estimated value of its claim on the liquidation of the company. This provision ensures that a creditor, whose liability from the company would be reduced in the restructuring plan against their wishes, has an alternative to the restructuring plan.

Some commentators in the USA have suggested that the parties most likely to be affected by the disregarding of the absolute priorities rule under Subchapter V are also small businesses, however it would appear that the availability of appropriate restructuring mechanisms for all businesses is far more favourable than the alternative of restructuring only being available to large businesses. The departure from the absolute priorities rule occurs in a number of insolvency processes for small businesses and as the cross cram down of debt is implemented it is important in any insolvency process that adequate balances arise to ensure that creditors' rights are not unnecessarily disregarded.

4 Exclusive process for small businesses

Many jurisdictions, as we have seen with the SCARP process in Ireland and the Subchapter V process in the USA, have adopted insolvency processes exclusively for the use of small businesses. In the European Union many jurisdictions updated their insolvency processes arising from the Directive and some introduced insolvency processes exclusively for the use of small businesses however other jurisdictions continue to utilise or adapt a general insolvency process irrespective of the size of the business.

For example, England and Wales has been a jurisdiction of historic importance for restructuring and has a number of insolvency processes including administration, CVA, scheme of arrangement, restructuring plan and Part A1 moratorium.

In England and Wales there is no exclusive insolvency process for the restructuring of small businesses. Instead specific provisions are built into the CVA which provides added protection to small businesses seeking to utilise the process.

A CVA[3] is designed to allow a company in financial difficulty to make an arrangement with its unsecured creditors to compromise the sums due and owing to those unsecured creditors. It is a court process and the directors of the company remain in control of the business although an insolvency practitioner is also appointed to oversee the process and its implementation.

The CVA will provide a moratorium for legal claims and enforcement of security against the company for between one and three months if it is a small company and satisfies two of the following criteria;

(a) has an annual turnover of GBP10.2 million or less;
(b) has balance sheet assets of GBP5.1 million or less;
(c) employs a maximum of 50 people.

Interestingly even though a CVA is considered an insolvency procedure a company does not need to be insolvent or on the verge of insolvency to invoke the process. If a company in England and Wales is insolvent or on the verge of insolvency it may initially seek to utilise another relatively new process, the Part A1 Moratorium[4].

The purpose of this process is to provide a company with protection from its creditors with respect to certain debts for a specified period of up to 40 days (subject to extension with agreement from the creditors of the company) so that the company can be restructured and continue to trade as a going concern. However, again the Part A1 Moratorium is not an exclusive process for small businesses.

It is available to all companies and does not have any specific provisions aimed at protecting small businesses, other than excluding the process from certain listed companies (which is unlikely to be applicable to a small business). The protection under this process provides that the creditors for certain debts of the

[3] Insolvency Act 1986 Part I section 1.

[4] Insolvency Act 1986 Part A1.

company are restricted from bringing any legal claims against the company and from enforcing the security held against the assets of the company.

While England and Wales has long been a major restructuring hub and has recently introduced new restructuring processes including the Part A1 moratorium and the restructuring plan it does not have a standalone insolvency process exclusively for small businesses. A similar approach has been taken in both Germany and the Netherlands where the staRUG and the WHOA have both recently been introduced as new insolvency processes but do not provided a standalone insolvency process exclusively for small businesses.

There is a difference in approach between various jurisdictions as to whether it is preferable to have a standalone insolvency process exclusively for small businesses. Some jurisdictions such as Ireland and the USA have implemented standalone processes, other jurisdictions including England and Wales, Germany and the Netherlands have instead sought to incorporate the restructuring of small businesses with the insolvency processes for larger businesses.

The utilisation of additional protections for small businesses in insolvency processes, as seen in the CVA, is deemed adequate to provide the necessary tools for the restructuring of small businesses in England and Wales, where the Part A1 Moratorium also provides an additional option for short term protection. Whether these processes are preferable to a standalone insolvency process exclusively for small businesses remains to be seen but any step to facilitate the efficient and cost-effective restructuring of small businesses is to be welcomed.

5 The impact of the Directive

The Directive sought to harmonise the position with respect to corporate restructuring in the European Union in circumstances where some of the companies undergoing restructuring were considering the requirements and obligations under the various insolvency frameworks across the European Union and bringing their application in the most beneficial jurisdiction.

The harmonisation of law in relation to corporate restructuring is a positive development and should provide all practitioners with greater certainty in relation to a range of issues. It should provide more consistency as to the outcome of a corporate restructuring in the European Union irrespective of the jurisdiction where the restructuring takes place. As a direct result of the Directive, Germany introduced the ‘StaRUG’ and the Netherlands introduced the WHOA.

The StaRUG includes two key provisions for small businesses namely a Rehabilitation Mediation and a Restructuring Scheme.

Rehabilitation Mediation is an insolvency procedure that is available to companies who wish to reach a settlement with their creditors and will have a court appointed mediator available to them. In what is a relatively simple process the company can engage with its creditors in an effort to reach agreement as to the amendment of the legal entitlements of the creditors under the company's existing obligations.

An insolvency practitioner can be appointed as the rehabilitation mediator and they can be available to the company and its creditors for a period of three months which can be extended for a further three months. The rehabilitation mediator seeks to promote engagement between the company and its creditors to ascertain whether a compromise can be concluded with respect to the debts of the company.

If agreement can be reached between the company and its creditors a settlement agreement can be executed and that agreement can be confirmed by a court. Confirmation by a court has the advantage that the settlement then becomes a final position that is no longer open to dispute by the creditors of the company.

The closing of a potential appeal to the restructure under the Rehabilitation Mediation, once confirmed by a court, is similar to the position in the Netherlands but a departure from the position in many other jurisdictions such as Ireland for example where there is a three-week period for an appeal following conclusion of the SCARP process.

The Rehabilitation Mediation process can be utilised as an out of court process and does not necessarily have to be confirmed by a court. In restructuring the debts of the company through this process out of court it is possible that the company may seek to keep publicity of its potential future financial difficulties to a minimum and continue to trade with creditors with positive sentiment into the future.

As a relatively low cost and uncomplicated process there is a clear attraction for small businesses. One difficulty that may arise is obtaining positive engagement from creditors with the process and ultimately obtaining voluntary agreement as to the nature of the restructure of the debts of the company.

Another option for small businesses in Germany under the staRUG is the restructuring plan. It is seen as a process that brings German restructuring law closer to the position and processes available in other jurisdictions such as the USA, and England and Wales. It is a pre-insolvency process and is not available to companies that are insolvent, only to companies that are imminently illiquid but not over indebted.

The restructuring plan allows companies to engage with their creditors in relation to secured and unsecured liabilities, contractual provisions and shareholder entitlements. While the process does not entitle a company to unilaterally terminate contracts, it does provide a prohibition on the termination of contacts by counterparties which ensures that the company is not unfairly penalised by its creditors from entering into the process.

The wide-ranging nature of the items that can be restructured under the process allows for a good level of flexibility in its implementation and utilisation by companies in many different industries and of various size.

In the restructuring plan a company can seek court involvement for a variety of matters including supervision of the process, the appointment of an insolvency practitioner to assist with the process, and to seek protection from the creditors of the company for a specified period.

In the process the creditors of the company are divided into different classes depending on their entitlements and for the process to be successful 75% in value in each class is required to approve of the proposals of the company. It is also possible to implement a cross cram down of debt across a class of creditors if the necessary 75% threshold is met in one class, and in the majority of the other classes of creditors. The class of creditors being crammed down must also not be left in a worse position arising from implementation of the process, and given the benefit of the absolute priority rule (subject to some limited exceptions).

Under the process the terms of agreement between the company and its creditors will usually see the creditors accept a reduction in the sums owed to them, a restructure of security held over the assets of the company and/or a debt for equity swap. These tools are very useful for any company that does not have adequate liquid asset to meet its current liabilities but has a good prospect of profitability into the future.

Pursuant to the Directive, the Netherlands has also recently introduced the WHOA. It is an insolvency process available to companies where it can be reasonably expected that they will be unable to continue to pay their debts. For companies to avail of the WHOA process they must also demonstrate that they are at the core still viable or at least partly viable.

The process itself seeks to keep the applicant company and its creditors out of court and move as efficiently as possible to the completion of the process. It provides an option for the parties to apply to specialised restructuring courts for determination of any unusual issues that may arise affecting the likelihood of the success of the process.

There is a choice when initiating the process as to whether the company will seek a public or private set of proceedings. The public proceedings see the process become registered in the Central Insolvency Register and any court hearings will take place in public. The private proceedings are not listed in the Central Insolvency Register but are not automatically recognised across the European Union.

If the company believes that it would be of assistance it can ask a court to appoint an insolvency professional to assist in the preparation of the restructuring plan and add some impartiality to the preparation of the proposals for the creditors of the company.

The beginning of the process does not provide for an automatic protection for the company from its creditors but the company can make an application to a court seeking protection from all or some of its creditors for a specific period during the WHOA process.

The process can impose amendments to the entitlements of both unsecured and secured creditors of the company, with the exclusion of contracts of employment. The process can be utilised to implement amendments to future liabilities of the company and it can also be used to make amendments to the liabilities of other companies within a wider group structure that may have joint or severable liability.

In the WHOA the creditors of the company are divided into classes depending on their rights and entitlements. For a class of creditors to consent to the restructuring plan under the process two thirds of the creditors in that class in value must agree to the proposals. Once at least one class of creditors has voted in favour of the restructuring plan, a cross-class cram down of the debt of the company can be implemented.

Once at least one class of creditors has confirmed the restructuring plan, the proposals are then brought before a court for confirmation. Once a court has confirmed the restructuring plan it is binding upon the creditors, the liabilities of the company have been altered accordingly, and the creditors do not have any option to appeal the confirmation by the court.

6 Further developments

Another European jurisdiction that has undergone extensive reform of its restructuring system is Italy. The most applicable reform for small businesses in Italy will be the new early warning procedure[5] that is due to be implemented in late 2023.

The Italian early warning procedure will seek to compel companies to act to ensure that they avoid insolvency events and are better placed to continue to trade as a going concern. The process is specifically aimed at small businesses and will provide professional expertise to ensure that the financial difficulties can be addressed in early course. It is initially a private arrangement where the company seeks to conclude a compromise with its creditors.

A company becomes eligible for the early warning procedure where it has entered into a specific set of circumstances such as a repeated breach of obligations giving rise to what would be considered a crisis, or where specific practitioners such as the auditors of the company or tax authorities have identified difficulties that should be addressed.

The company will be notified of the issues and initially the professionals will assist the company in implementing actions to address its difficulties and return the company to profitability. If the company does not correct its approach and continues to have financial difficulties the professionals will engage with the creditors of the company in an effort to restructure its liabilities.

If there is a concern that the financial position of the company may rapidly deteriorate the company may apply to a court for protection from its creditors and a stay on any legal proceedings. If the professionals form the view that the company cannot be successfully restructured they will seek to place the company into another insolvency process to determine whether the company can continue, or partially continue, as a going concern or if it must be liquidated.

The early warning system is consistent with the goals of the restructuring industry across the European Union, including with the Directive and is instigated initially as a pro-active response to a potential insolvency event in the future.

[5] Italian Law Decree no. 118/2021.

This pre-insolvency process makes expertise available to small businesses so that they can restructure and address their difficulties before they become terminal. A number of European jurisdictions have introduced pre-insolvency measures but the process in Italy delivers a greater level of involvement from professional advisors.

The proactive engagement with businesses in financial difficulty at the earliest possible opportunity would appear to be beneficial from a systemic perspective and may even provide longer term benefits if the businesses are able to harness the knowledge of the professional advices and steer the companies back to profitability. The approach that will be adopted in Italy will be closely monitored across the restructuring industry to ascertain whether these processes should be more widely implemented.

7 Conclusion

Arising from the Directive and the new legislative provisions introduced in many jurisdictions the landscape for the restructuring of small businesses has become much more defined. Various jurisdictions have moved to harmonise the position for restructuring across the European Union while also seeking to apply key practices that have been successful in other jurisdictions such as the USA and England and Wales.

With so much new legislation providing streamlined processes for small businesses and a more consistent approach to restructuring internationally, it appears that practitioners are in a much better position to offer restructuring to small businesses than they may have been even a small number of years ago.

The introduction of dedicated insolvency processes for small businesses in many jurisdictions provides a greater opportunity for small businesses to utilise the tools that have previously only been available to much larger companies. It is anticipated that more jurisdictions will provide dedicated insolvency processes for small businesses and that the restructuring landscape for small businesses will continue to change for the better.

APPENDIX 1

	Ireland	**USA**	**England & Wales**	**Germany**	**The Netherlands**	**Italy**
Exclusive insolvency process for small businesses	Yes - SCARP	Yes - Chapter 11 Subchapter V	No (but specific provisions within CVA for small businesses)	No - restructuring plan	No - The WHOA	Yes - early warning procedure
Must the company be insolvent or the verge of insolvency	Yes	Yes	No	No	Yes	No
Automatic moratorium on legal claims	No	Yes	Yes	No	No	No
Is an insolvency practitioner appointed	Yes	Yes	Yes	On application to court	On application to court	Yes
Is it a public process	Yes	Yes	It can be	Yes	At the choice of the applicant	Not initially
Any uncommon features	A 3 week appeal period at conclusion of process	The plan can be confirmed without a consenting creditor	There is no automatic conclusion of a CVA	A prohibition on the termination of company contacts by counterparties	The cash out rule	A team of three professionals are appointed to assist the company to return to solvency

Chapter 3

Dos and Don'ts of Drafting International Commercial Contracts where Polish Parties are Involved from the Perspective of Polish Bankruptcy and Restructuring Laws

Klaudia Frątczak-Kospin
Attorney-at-law, restructuring advisor, counsel at WKB Wierciński, Kwieciński, Baehr, Warsaw

Wiktor Danielak
Attorney-at-law, senior associate at WKB Wierciński, Kwieciński, Baehr, Warsaw

Overview

Both a declaration of bankruptcy or the opening of restructuring proceedings – the two general types of collective proceedings available to a Polish commercial entity which becomes insolvent or is threatened by insolvency[1] – have far-reaching effects on an entity's liabilities, and contractual relationships more generally, in certain cases even leading to the invalidity or ineffectiveness of the clauses under which said liabilities arise.

This article aims to discuss the types of clauses commonly found in international commercial contracts which could be deeply affected by the bankruptcy or restructuring of a Polish party and to provide practical tips on how one can mitigate or even avoid the negative impact of the opening of such proceedings by taking the relevant Polish regulations into account at the time of contracting.

Firstly, we will identify certain specific types of the contractual clauses which may be found invalid or ineffective where a Polish counterparty faces an insolvency scenario as well as to provide some practical tips on how such provisions should be drafted in order to minimize this risk.

Further, we will discuss the prohibition on terminating certain types of the contracts during Polish restructuring proceedings as well as some ways of structuring legal relationships with Polish business partners which would allow one to by-pass these limitations.

[1] Under Polish law, bankruptcy proceedings may be commenced only if a debtor is insolvent whereas restructuring proceedings may be commenced if a debtor is either insolvent or threatened by insolvency.

Moreover, we will also demonstrate the practical implications of a Polish debtor's bankruptcy or restructuring on the classes of security interests most often used in international commercial contracts and, in particular, discuss the requirements for the effective reservation of legal title to goods sold in the event of an insolvency scenario.

Lastly, we will present the potential implications of opening of the relevant proceedings to the arbitration clauses, so commonly included in international commercial contracts.

1 The *lex fori concursus* rule

Before we begin our analysis, we should first respond to the following question: why should one consider the consequences of a Polish business partner's bankruptcy when drafting a commercial contract, especially where the contract in question is not governed by Polish law but rather that of one's own seat?

The answer to this is, simply put, the *lex fori concursus* rule, which is a fundamental principle of international bankruptcy law. It establishes that the law of the jurisdiction where bankruptcy proceedings were initiated shall be the law applied to these proceedings, i.e., the law of the main centre of a debtor's principal activity (typically, the location of the bankrupt debtor's head office, or the location of the debtor's assets)[2].

The *lex fori concursus* rule applies in particular under Article 7(1) of Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast) (further referred to as the 'EU Regulation') which states that:

> 'Save as otherwise provided in this Regulation, the law applicable to insolvency proceedings and their effects shall be that of the Member State within the territory of which such proceedings are opened (the "State of the opening of proceedings").'

Therefore, the laws of the jurisdiction where the main insolvency proceedings are opened applies, in particular, to the effects of insolvency proceedings on the debtor's current contracts or the rules on the voidness, voidability, or unenforceability of acts detrimental to the debtor's creditors as a whole.

Therefore, one should always bear in mind that, when engaging in business with Polish entities, one will be affected by the Polish insolvency laws applicable

[2] Vladimir Ž Čolović, 'Lex fori concursus as the basic rule in the international bankruptcy' [2016] (4) *Strani pravni život* 85.

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to and governing the contractor's legal situation if they are declared bankrupt or have restructuring proceedings opened against them, irrespective of the laws governing the contract itself.

2 Termination clauses

The right to bring a contractual relationship to an end in the event of an abrupt deterioration of the other party's standing may be of paramount importance to many business entities given the nature of their business and the subject matter of the relevant contract. Thus, many international commercial contracts contain clauses conferring a right to terminate or alter the contract to a party if the other party proves to be in financial distress. In most cases, these rights are triggered by events which constitute undisputed proof that the other party's situation is acute, such as where the other party has been declared bankrupt or they have begun to seek protection from their creditors (e.g., by filing for restructuring with the relevant authority). Such clauses are commonly found in contracts for construction works because the International Federation of Consulting Engineers (or FIDIC) recommends that these contracts include clauses granting parties the right to terminate the contract if the other party (or other parties) becomes bankrupt or insolvent. The FIDIC Red Book standard conditions[3] provide that the contracting authority may withdraw from the contract if a contractor becomes bankrupt or becomes insolvent (clause 15.2. point e), with the contractor holding an analogous right (clause 16.2. point g).

First, it should be noted that the provisions of a contract which allow for the alteration or termination of the parties' legal relationship, in the event that the debtor files a bankruptcy petition or is declared bankrupt, are invalid under Article 83 of the Bankruptcy Law[4].

The nullity of contractual termination clauses of the type described above results regardless of the relevant contract's governing law. This is because the impact of a bankruptcy on contracts concluded by a bankrupt belongs to the bankruptcy statute. As mentioned above, Article 83 of the Bankruptcy Law constitutes an element of the *lex concursus*. Therefore, the circumstances under which clauses entitling a party to withdraw from or terminate a given contract are permitted under the foreign law governing the contract are irrelevant under Polish law when faced with the statutory nullity of such clauses under Article 83 of the Bankruptcy Law.

3 FIDIC, *Conditions of Contract for Construction, for Building and Engineering Works Designed by the Employer* (2nd edn, FIDIC, 2017).

4 Act of 28 February 2003 – Bankruptcy Law [*Prawo upadlosciowe*] (Journal of Laws 2020, item 1228), further referred to as the 'Bankruptcy Law'.

Similarly, the Restructuring Law[5] also provides for the nullity of such clauses where it applies.

Note that this relates in particular to clauses which grant a party the right to alter or terminate the parties' legal relationship if another party submits an application to open court-led restructuring proceedings, as well as where such proceedings are opened with respect to another party. Therefore, the nullifying effect on such clauses will only apply to certain types of restructuring proceedings, namely:

- accelerated arrangement proceedings (Article 247 of the Restructuring Law),
- arrangement proceedings (Article 247 in conjunction with Article 273 of the Restructuring Law),
- remedial proceedings (Article 247 in conjunction with Article 297 of the Restructuring Law).

It should be noted that the above-mentioned effect also applies to contractual clauses which entitle the parties to alter or terminate the contract in question if a petition for the approval of an arrangement is filed or an arrangement is actually approved (Article 225 para 1 of the Restructuring Law).

In light of the above, it should be clear that every contractual clause granting a party the right to terminate a given contract due to the submission of a bankruptcy petition or petition to open restructuring proceedings against another party, or the other party becoming subject to such proceedings if opened, is invalid.

That being said, a certain issue persists, namely, is it at all possible for a contract to contain a clause providing for certain consequences with respect to the contract in connection with the other party's poor financial situation (for instance, their becoming insolvent or being faced with the threat of insolvency)? In other words, can a clause with an effect conditional on the filing of a

[5] Act of 15 May 2015 – Restructuring Law [*Prawo restrukturyzacyjne*] (Journal of Laws 2021, item 1588), further referred to as the 'Restructuring Law'. Note that, under the Restructuring Law, restructuring proceedings are not homogeneous and are divided into four distinct types: proceedings for the approval of an arrangement (*postepowanie o zatwierdzenie ukladu*); accelerated arrangement proceedings (*przyspieszone postepowanie ukladowe*); arrangement proceedings (*postepowanie ukladowe*); and remedial proceedings (*postepowanie sanacyjne*). The first of these are out-of-court proceedings, which do not require an application addressed to the court in order to be opened. The court's role is only to approve an arrangement agreed to by the creditors on a motion filed with the appropriate court by a debtor. The last three proceedings are judicial in nature and are commenced after the appropriate court recognises a petition to open them. These proceedings are supervised by this court, in particular by a judge appointed to act as a, so-called, 'judge-commissioner', who exercises general judicial oversight of the proceedings. These types of proceedings are also ended if the court approves an arrangement agreed to by the creditors in the course of such proceedings.

bankruptcy petition or petition to open restructuring proceedings be found admissible, notwithstanding the general principle that such clauses are inconsistent with the statutory regime described above?

Answering this question is not a simple task. We would note at least two perspectives in legal doctrine which may help in reaching a solution. According to the first of these[6], such clauses may be regarded as invalid since they could be recognized as being aimed at circumventing the regulation stated in Article 83 of the Bankruptcy Law and the analogous articles of the Restructuring Law. In fact, the legal effects of these statutory provisions are triggered by a party entering into either a state of insolvency or a state of being threatened by insolvency. Therefore, it may be difficult to establish the parties' true intentions, which is why clauses which clearly refer not only to the mere filing of the appropriate petition, but also to the specific grounds on which a debtor is declared bankrupt or becomes subject to restructuring proceedings, are also null and void by operation of law.

However, according to the second perspective[7], clauses which merely provide for certain consequences with respect to the contract if the other party's financial situation deteriorates are permissible, in principle.

The reasoning behind this view is that the provisions of both the Bankruptcy Law and the Restructuring Law limiting a party's right to terminate a contract must be interpreted literally and strictly as they constitute exceptions to the general rule on the terminability of contracts.

In our opinion, this perspective is the correct one, not only for the reasons referred to above, but also because the Polish courts have applied its' logic in their rulings. For instance, in its judgment of 9 December 2014 (case reference no. III CSK 15/14), the Supreme Court of the Republic of Poland considered the hypothetical inconsistency of a clause entitling a party to withdraw from the contract if its counterparty was in a poor financial situation with Article 83 of the Bankruptcy Law. In the court's opinion, such a clause was valid since it did not refer to the specific legal events stipulated in said provision's plain text[8]. Based on this judgment, we are able to say that since conditioning a party's right to withdraw from a legal relationship on its counterparty's financial situation is not the same as conditioning said right on a bankruptcy petition being filed in

6 Rafal Adamus, *Bankruptcy Law. Commentary* [*Prawo updalosciowe. Komentarz*] (3rd edn, CH Beck, 2021), commentary to Article 84 Bankruptcy Law, para 6.

7 Piotr Zimmerman, *Bankruptcy Law. Restructuring Law. Commentary* [*Prawo updalosciowe. Prawo restrukturyzacyjne. Komentarz*] (7th edn, CH Beck, 2022), commentary to Article 83 Bankruptcy Law, para 3.

8 Also see Judgement of 9 December 2015 of the Court of Appeal in Warsaw (case reference no. VI ACa 175/15) where the court took the same position.

respect of the counterparty, or it being declared bankrupt, such a condition can be validly applied to the termination of a contract.

Considering the above, the issue now appears to shift towards how does one secure oneself against the risk of a Polish contractor entering into bankruptcy or restructuring proceedings. Our general recommendations in this regard are as follows:

- do not accept any clauses granting you the right to terminate the contract in the event of the other party being declared bankrupt, having restructuring proceedings opened against them, or filing a bankruptcy petition, petition to open restructuring proceedings, as well as a motion for the approval of an arrangement – such clauses will be null and void by operation of law if your Polish partner becomes bankrupt or subject to restructuring proceedings;
- instead of clauses such as those referred to above, propose a clause granting you the right to terminate the contract if the other party's financial situation deteriorates – note that it would be worth indicating some more precise criteria in the contract itself, specifically referring to financial issues, which will help you determine the contractor's actual financial condition and whether the circumstances allow you to exercise the right to terminate the contract.

3 Ineffectiveness of certain contractual clauses

Not only do the Bankruptcy Law and the Restructuring Law provide for the nullity of contractual termination clauses, as discussed above, but both of these acts also provide for the ineffectiveness of certain clauses in the event of a debtor being declared bankrupt or becoming subject to restructuring proceedings. This results from the following provisions:

- Article 84 para 1 of the Bankruptcy Law – 'A provision of a contract to which a bankrupt is party which provision impedes or renders achieving the aims of bankruptcy proceedings impossible shall be ineffective against the bankruptcy estate.'
- in the case of accelerated arrangement proceedings: Article 248 of the Restructuring Law – 'A provision of a contract to which a debtor is party which provision impedes or renders achieving the aims of accelerated arrangement proceedings impossible shall be ineffective against the arrangement estate.' Provisions with identical effect to this Article also

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apply to arrangement proceedings (Article 273 of the Restructuring Law) and remedial proceedings (Article 297 of the Restructuring Law)[9].

These provisions limit parties' freedom of contract in principle, however, contrary to Article 83 of the Bankruptcy Law and the appropriate provisions of the Restructuring Law, they do not constitute limitations on clauses with specific effects in the event of a party's bankruptcy or the opening of restructuring proceedings against them, but rather limit all types of contractual provisions which may impede or render achieving the aims of the relevant proceedings impossible. Based on this we can provide two crucial suggestions regarding the interpretation of Article 84 para 1 of the Bankruptcy Law and the relevant provisions of the Restructuring Law which one should keep in mind when negotiating commercial contracts with Polish entities.

First, because these provisions limit the freedom of contract, they must be interpreted strictly and literally[10].

Second, they must be interpreted in light of the aims of bankruptcy and restructuring proceedings. With respect to bankruptcy proceedings, the aims of these are: (i) satisfying the creditors' claims to the greatest extent possible, and (ii) preserving the existence of the bankrupt's estate, where reasonably practicable. With respect to restructuring proceedings, the aims of these are: (i) avoiding the debtor being declared bankrupt by allowing it to restructure its debts by way of an arrangement with its creditors (in the case of remedial proceedings, also through remedial actions), and (ii) securing the legitimate rights of creditors.

As can be seen, the aims of bankruptcy and restructuring proceedings are framed rather generally, thus it is difficult to predict exactly which clauses could be declared ineffective under Article 84 para 1 of the Bankruptcy Law or the relevant provisions of the Restructuring Law. This is why several authorities on Polish legal doctrine have expressed concerns that these provisions are too broad and so they should be ignored in practice by persons engaging in business activities[11]. However, the majority of commentators of insolvency law have

[9] Cf. Restructuring Law (n 5), Article 225 para 1, which invalidates clauses allowing a party to alter or terminate a legal relationship in the event of the other party filing a motion to approve an arrangement, an arrangement's approval, or where a certain declaration is made. However, the regulations concerning out-of-court proceedings (i.e., proceedings for the approval of an arrangement) do not include any provisions mandating the ineffectiveness of contractual clauses binding a debtor party to such proceedings. Thus, with respect to the statutory ineffectiveness of such clauses in restricting proceedings, this only applies to judicial restructuring proceedings.

[10] See our remarks above regarding the strict and literal interpretation of Article 83 of the Bankruptcy Law.

[11] Zimmerman (n 7), commentary to Article 84 Bankruptcy Law, para 2.

recognized that some types of contractual clauses are likely to be found ineffective due to the operation of these statutory provisions[12], including the following:

- *pactum de non petendo* – the essence of these clauses is that a creditor undertakes to not pursue – either temporarily or in perpetuity – claims against the debtor to which they are entitled, which deprives the claim of its actionable nature (in such cases, the debt does not expire, but become unenforceable in compulsory proceedings, i.e., by way of a suit and court order). A consequence of *pacta de non petendo* being ineffective under Article 84 para 1 of the Bankruptcy Law and the relevant provisions of the Restructuring Law is that trustees appointed in bankruptcy proceedings (or administrators appointed in remedial proceedings, or the debtor themselves in accelerated arrangement proceedings or arrangement proceedings) are entitled to file suit against the insolvent entity's debtors for payment in spite of clauses depriving the insolvent entity from doing so under a given contract. This is because bringing an action against an insolvent entity's debtor achieves the aims of both bankruptcy and restructuring proceedings since it increases the likelihood of obtaining additional funds which will contribute to the potential satisfaction of creditors' claims upon the division of the bankruptcy estate (or the arrangement's performance in restructuring proceedings).
- *pactum de non cedendo* – such clauses may provide for a general prohibition on the sale of receivables without the relevant debtor's consent, or various other restrictions on the sale of such a receivable (e.g., limiting the class of permitted assigns, specifying a period of time in which the receivables may be sold, conditioning the transfer of title on certain circumstances, events, or other conditions, or requiring the use of a specific form for the transfer agreement)[13]. The ineffectiveness of *pacta de non cedendo* where a debtor is declared bankrupt or becomes subject to restructuring proceedings facilitates the liquidation of receivables during bankruptcy proceedings (as it allows the trustee to sell such a receivable by a simple assignment agreement) or obtaining additional cash for debtors subject to restructuring proceedings, which may contribute to the potential satisfaction of creditors' claims when performing

[12] Stanislaw Gurgul, *Bankruptcy Law. Restructuring Law. Commentary* [*Prawo updalosciowe. Prawo restrukturyzacyjne. Komentarz*] (12th edn, CH Beck, 2020), commentary to Article 84 Bankruptcy Law, para 1; Feliks Zedler, commentary to Article 84, para 2 in Feliks Zedler, Andrzej Jakubecki, *Bankruptcy and Recovery Law. Commentary* [*Prawo updalosciowe i naprawcze. Komentarz*] (3rd edn, Wolters Kluwer, 2010); Wiktor Danielak, Bartosz Sierakowski, 'The impact of a declaration of bankruptcy or the opening of restructuring proceedings on the legal existence of an evidentiary agreement' [*Wplyw ogloszenia upadlosci lub otwarcia postepowania restrukturyzacyjnego na byt prawny umowy dowodowej*] [2021] (2) *Monitor Prawa Bankowego* 63.

[13] See judgment of the Supreme Court of 25 March 1969 (case reference no. III CRN 416/68) OSN 1970, No. 2, item 34; judgment of the Supreme Court of 19 January 2011 (case reference no. V CSK 204/10).

the arrangement agreed to and approved by the creditors participating in said proceedings.

- *pactum in favorem tertii* – the essence of these clauses is that a party (promising) undertakes to make a performance owed towards the other party (reserving) to the benefit of a third party. The source of the promising party's obligation (and, consequently, the third party's entitlement) is thus a contract between the parties themselves, which does not require the third party's consent. Thus, if a *pactum in favorem tertii* is regarded as ineffective, a performance owed to the third party would instead be made to the insolvent entity.
- evidentiary agreements – a commercial contract may include a clause stipulating that the parties agree to exclude specific evidence (or forms of evidence) in proceedings arising in connection with the legal relationship established between the parties (an evidentiary agreement). Any contractual clauses binding the insolvent entity prior to it being declared bankrupt or becoming subject to restructuring proceedings which may, at least, impede or postpone the liquidation of said entity's assets or the recovery of cash or other benefits owed to the insolvent entity (for instance, a clause in a contract for construction works which excludes expert opinions from the evidence which may be submitted within potential future proceedings between the parties) are ineffective pursuant to Article 84 para 1 of the Bankruptcy Law or the relevant provisions of the Restructuring Law.

In light of the above, a major question may arise after reading this article, namely, are there any ways of minimizing the risk of a given contract's provisions being found ineffective which can be applied while negotiating and drafting it?

A clear answer is more difficult to provide here than in the case of the nullity of termination clauses, as discussed above. This is because determining whether a specific clause impedes or renders the aims of bankruptcy or restructuring proceedings impossible is a fact-specific question which should be answered on a case-by-case basis, since the legislature failed to include any generally applicable evaluation criteria in this regard when drafting the appropriate statutes. Thus, it seems that the assessment of particular clauses must be made on the basis of whether they do not conflict with the aims of both bankruptcy and restructuring proceedings as expressed in statute[14], and a court's findings may differ depending on the facts of the case and the court's assessment of these facts.

[14] Judgment of the Supreme Court of 9 August 2016 (case reference no. II CSK 733/15), LEX no. 2087734.

Finally, with respect to the ineffectiveness of certain clauses under Article 84 of the Bankruptcy Law and the relevant provisions of the Restructuring Law, one should take the following remarks into consideration when negotiating contracts with Polish entities:

- the ineffectiveness only relates to the bankruptcy estate or the arrangement (remedial) estate respectively, and does not imply the nullity of the clause in question (consequently, contracts containing ineffective provisions will remain in force and the remainder of their provisions will continue to be effective against the relevant estate);
- the provisions of a contract continue to bind the parties, which is of particular importance when the bankruptcy or restructuring proceedings are discontinued and the debtor is once again authorised to independently administer its own contracts.

4 Restrictions on the termination of certain types of contracts entered into with a Polish entity prior to the opening of restructuring proceedings

The opening of bankruptcy proceedings has a wide range of consequences for various aspects of the bankrupt's operations and its relations with third parties. Due to the nature of bankruptcy, which in general aims to liquidate the debtor's assets in order to satisfy its creditors with the proceeds thereof, the relevant provisions of the Bankruptcy Law are themselves mainly aimed at facilitating the termination (in some cases, causing the expiry) of certain of the bankrupt's contractual relationships.

Quite the opposite is true in the case of restructuring proceedings. The Restructuring Law provides for a mere handful of extraordinary cases where the parties are entitled to terminate a contract early[15], and even reinforces certain contractual relations to which the debtor is party by limiting the other party's right to terminate certain types of contracts for the duration of the restructuring proceedings. This solution is intended to protect the debtor's business from further unforeseen disturbances which could result from the termination of agreements fundamental to the business's continued operation during the already difficult circumstances of restructuring proceedings.

However, one should note that the protection afforded to these agreements is not absolute since the other parties to the contract preserve their right to terminate a given contract by notice if the debtor fails to perform its duties under it after the restructuring proceedings are opened.

[15] For example, by granting the administrator appointed by the court in remedial proceedings a right to withdraw from reciprocal contracts with the consent of the judge-commissioner handing the case.

As for the types of contracts subject to limitations on termination rights, the relevant provisions of the Restructuring Law provide that, from the opening date of most types of restructuring proceedings[16] until their conclusion, or an order discontinuing them becomes final and binding, the lessor or the entity granting a tenancy may not terminate a lease or tenancy agreement concerning the premises where the debtor operates its business without the prior consent of the creditors' council established within restructuring proceedings. This also applies to facility agreements concerning funds made available to the debtor, as borrower, prior to the opening of restructuring proceedings; leasing agreements; property insurance contracts; bank account contracts; surety contracts; license agreements under which the debtor is a licensee; as well as letters or credit or guarantees granted prior to the opening of restructuring proceedings.

Based on the catalogue of interminable contracts listed above, it is clear that, in most cases, these contracts are essential for the continued operation of the debtor's business and that the termination of any of them could lead to a significant deterioration of the debtor's market position which would in turn impair the aim of the restructuring process. Moreover, given that the relevant statutory provisions precisely identify the types of contracts which should continue throughout the restructuring process, it is reasonable that the other parties thereto should be able to take them into account when entering into a given type of contractual relationship.

However, on 1 December 2021, the catalogue of interminable agreements has been expanded to also cover the open-ended category of 'other contracts of fundamental importance to the debtor's business'. The court appointed supervisor (or administrator, depending on the specific type of proceedings) will prepare a list of contracts which should be recognised as being of fundamental importance for the purposes of the proceedings in question within 3 weeks of the proceedings being opened. The other parties to such contracts have no legal instruments available with which to challenge the relevant officer's decision in this respect, which leaves these parties with only one possible course of action, that being attempting to convince the relevant officer that a given contract is not of critical importance to the debtor's business and thus that it should not be subject to the statutory restrictions on its termination. Although a number of views have been expressed in support of the proposition that such a list can be amended during the restructuring process[17], it is nonetheless recommended that

[16] See Restructuring Law (n 5), Article 256, which applies to accelerated arrangement proceedings. By reference (see Restructuring Law (n 5), Articles 237 and 297 respectively), this also applies to arrangement and remedial proceedings accordingly.

[17] Zimmerman (n 7), commentary to Article 256 Restructuring Law, para 9.

one takes steps prior to the list being prepared in the first place due to the lack of established judicial practice in this regard.

It is also worth noting that, although the deadline for preparing such a list is not mandatory (meaning, in practice, the relevant officers rarely meeting this deadline), it is relatively short in comparison to the complex process of assessing the importance of a given contract in the context of the debtor's business and operations, which itself may require the court appointed officer to make additional internal inquiries and give them due consideration, especially in light of the fact that such officers have multiple statutory duties and tasks to perform at the outset of restructuring proceedings. We believe that this may contribute to the development of a dangerous and harmful practice where court-appointed supervisors and administrators will include almost all of a debtor's contracts on the list of interminable contracts when preparing it initially, and only then amending the list further on in the restructuring process by striking out certain contract types, but only when the other party raises objections as to their inclusion on such a list.

Due to the recency of these amendments, how these provisions will be interpreted and applied in practice is yet to be seen, however, this does not in itself deprive the other parties to a debtor's contracts of legal tools to counter the adverse consequences of a contract concluded with a Polish entity being subject to termination restrictions. This is because, although the limitations referred to above prevent the other party from terminating a given contract, such limitations cannot prevent the contract from expiring in accordance with its own terms.

Of course, since the stability of contractual arrangements is fundamental to the business of many enterprises, shortening the term of all of a party's contract merely to protect oneself from the potential consequences of a hypothetical opening of restructuring proceedings would not be viable from a business perspective. However, since the filing of motions to open restructuring proceedings with the Polish courts is now publicly available information which one can easily check online through a newly established public register[18], one might imagine that, upon learning of the motion's filing but before the court rules on whether to accept it, the other party to a contract could terminate it (provided that it holds the relevant termination rights under the contract) or approach its Polish counterparty with a proposal to amend the contract so that it provides for a fixed or shorter term.

[18] See n 28 below.

5 General remarks on different forms of security from the perspective of the Polish bankruptcy and restructuring laws

Although the means by which parties to a commercial contract can secure their interests are countless, there are several specific classes of security interests which we consider to be the most commonly used when dealing with contracts concluded with Polish counterparties. Rather than entering into a lengthy and detailed theoretical legal analysis of these various legal instruments, we present a brief classification of those security interests most commonly used in international contracts from the point of view of their effectiveness in the event of a Polish entity becoming subject to bankruptcy or restructuring proceedings.

The first class we identify are those forms of security interest which are mainly aimed at facilitating the enforcement of a creditor's claims against a debtor and includes: (i) promissory notes, which under Polish law allow creditors to apply for summary judgment (being considerably faster and simpler than ordinary court proceedings); and (ii) voluntary submission to enforcement. The latter constitutes a Poland-specific form of security, which in essence consists of a debtor making a declaration before a notary agreeing to undertake a duty to pay a given debt (capped at a certain value), provided that some agreed formal requirements are first met (typically that a creditor demands payment from the debtor and attaches proof of such a demand to its application for enforcement filed with the court). In order to proceed with the enforcement of its claim, the creditor can file a motion with the court requesting that it confirms whether all necessary actions (as specified in the notarial deed) were duly performed and to certify this by putting the court's seal to the document (known as an enforcement clause). Note that the court is not entitled to consider the merits of the matter and will issue an enforcement clause without notifying the debtor thereof. Thus, debtors will typically only become aware of the fact that their business partner has acted on a voluntary submission to enforcement when the court bailiff begins enforcing the declaration. One thing which both promissory notes and voluntary submissions to enforcement have in common is that they allow creditors to proceed with the enforcement of their claims very quickly, which is often a very valuable tool.

That being said, within Polish bankruptcy and restructuring proceedings both of these instruments could prove to be of little to no value since the enforcement of claims not secured by rights *in rem* (discussed in the following paragraphs) is not possible during either bankruptcy proceedings or restructuring proceedings. Despite not being the strongest or most certain means of securing a party's interest, these instruments are often used as the only form of security in international contracts involving Polish entities.

The second class of security interest which we would like to discuss is the most classic, i.e., rights *in rem*, including in particular, mortgages, registered pledges, ordinary pledges, and security assignments. Both the Bankruptcy Law and Restructuring Law strictly regulate the treatment of claims secured by such interests.

In general terms, during bankruptcy proceedings, a creditor secured by a right *in rem* enjoys priority in satisfaction from the proceeds of sale of the property subject to this security interest. During restructuring proceedings, a claim secured in this manner would, in principle, be exempt from the arrangement and could (with certain limitations and except in the case of remedial proceedings) also be enforced from the underlying assets, in addition to being satisfied during the restructuring process (neither of which is available to unsecured creditors' claims). Further, a creditor secured by a registered pledge could also exercise its contractual right to seize ownership of the underlying assets, insofar as the relevant pledge agreement provides for such rights, regardless of the fact that restructuring proceedings have been opened. Note that, until December 2021, claims secured by rights *in rem* could not be subject to the arrangement without the relevant creditor's consent. However, recent amendments to the Restructuring Law reverse this and allow for such claims to be subject to the arrangement if the debtor provides the relevant creditor with an arrangement proposal providing for: (i) the full satisfaction of the secured claim by the deadline specified in the arrangement; or (ii) the satisfaction of the secured claim to a degree no less than that which the creditor could have expected had they enforced their security interest in that context.

The amendment referred to above has far-reaching consequences for the legal position of creditors secured by rights *in rem* during restructuring proceedings since, if the relevant conditions are met, such a creditor can not only be crammed down in the arrangement itself, but would also lose its entitlement to enforce its claims for the entire duration of the proceedings.

Lastly, in order for an *in rem* security to be effective within the insolvency-related proceedings under discussion, the appropriate 'hardening' periods must lapse, which are counted from the date of the security interest's establishment until the date on which the motion to open the relevant proceedings was filed.

The final class of security interest is the most desirable during both bankruptcy and restructuring proceedings and comprises all forms of security granted by third parties, including in particular bank and insurance guarantees, suretyships, and rights *in rem* established over a third-party's assets. Although often unavailable to a distressed debtor (mainly due to their cost), these are the sole security interests which remain entirely unaffected by a Polish entity becoming subject to bankruptcy proceedings or restructuring proceedings.

6 Reservation of legal title

In addition to the above, there is another instrument providing a creditor security which should be scrutinized in terms of its effectiveness in the event of a Polish party's bankruptcy[19], that being the reservation of legal title. Widely applied in international commercial contracts to protect against a purchaser's bankruptcy or to enforce claims against assets in the bankrupt's possession, this instrument consists of a stipulation in the relevant contract that ownership title to the goods sold under the contract shall not pass to the purchaser until payment of the purchase price is made in full, or in some part (depending on the precise terms of the contract in question).

Where effective, the reservation of title gives a seller two, alternative rights within the Polish bankruptcy regime, namely: (i) the right to claim for the exclusion of a given asset from the bankruptcy estate, meaning that the creditor may seek the return of the goods sold to the purchaser despite the latter being declared bankrupt; or (ii) a right to claim for the payment of the purchase price. The first of these rights is a powerful tool in bankruptcy proceedings since it allows the seller (creditor) to escape the risk of being crammed down by other creditors' claims within an arrangement and to repossess the goods sold. Furthermore, if the trustee sells goods subject to a seller's effective reservation of title during the bankruptcy estate's liquidation, that seller will be entitled to claim for the full value of the proceeds of such sale[20]. However, the seller should be mindful that once it makes a claim for payment of the sale proceeds, it will no longer be entitled to claim for the return of the items sold by the trustee[21].

Under Polish law[22], a reservation of title included in a contract of sale shall not expire provided that it is effective towards the bankrupt entity's creditors in

[19] Despite the operation of certain specific provisions of Article 10 of the EU Regulation, which aim to protect the validity and effectiveness of a reservation of legal title where the goods sold are located in the territory of an EU Member State other than that where the purchaser's bankruptcy was declared, in most cases Polish law would exclusively govern the validity and/or effectiveness of a title reservation clause if the goods' purchaser is declared bankrupt in Poland. Also note that, in such circumstances, the provisions of Polish law are of a mandatory nature and will be applicable notwithstanding any choice of law provisions contained in the contract.

[20] Bankruptcy Law (n 3), Article 71.

[21] See judgment of the Supreme Court of 21 January 1999 (case reference no. I CKN 955/97) OSNC 1999, No. 10, item 169.

[22] Bankruptcy Law (n 3), Article 101.

accordance with the provisions of the Polish Civil Code. The relevant provisions of the Polish Civil Code[23] further provide that a reservation of title is effective against a buyer's creditors if it is made in writing with a certified date. Therefore, there are three main conditions which must be satisfied for a reservation of title to remain effective within Polish bankruptcy proceedings.

First, it should stem from a contract of sale. Given the unequivocal reference to this specific type of contractual relationship, it does not appear possible for one to argue in favour of extending the effect of the relevant provisions of law to allow for the continued force and effect of reservation of title clauses included in other types of contracts. However, the view has been expressed in recent legal commentary that the same effect could be applied to reservation of title clauses contained in supply contracts[24]. What differentiates these two types of contracts (both common in international trade) is the element of commissioning production and the delivery of goods in instalments, both elements of which are absent from sales contracts, but which are mandatory for an agreement to be considered a supply contract. Therefore, if a Polish purchaser appears likely to be threatened with financial distress, it may be advisable for the foreign supplier to conduct a thorough analysis of the nature of the contract at hand in order to establish whether the reservation of title could be upheld as effective in the event of the purchaser's bankruptcy. Note that in some circumstances and with appropriate planning at the time of contract, a supply contract may be substituted by a series of sales contracts.

Second, the relevant stipulation must be included in the contract itself. Although there exists a line of well-established and widely accepted jurisprudence recognizing that it is sufficient for the relevant annotation to be made on the seller's invoice issued to the buyer[25], it is disputable if this would be sufficient in case of a bankruptcy and this would rarely meet the third requirement for an effective reservation of title, discussed in more detail in the following paragraph.

Lastly, the agreement containing a reservation of title must be made with a so-called 'certified date'[26]. This condition is meant to prevent the parties to a contract from backdating it and in general terms means that the date at which the parties executed it must be officially certified (e.g., by having a notary public

[23] Article 590 § 1 of the Polish Civil Code.

[24] Zimmerman (n 7), commentary to Article 101 Bankruptcy Law, para 4.

[25] See judgment of the Supreme Court of 10 October 2003 (case reference no. II CKN 119/02) Legalis; judgment of the Supreme Court of 24 July 2008 (case reference no. IV CSK 87/08), Monior Prawniczy 2008, No 16, p 844.

[26] Article 80 of the Polish Civil Code sets out the requirements for a document to be considered to bear a certified date.

certify the parties' signatures) or by subsequently obtaining official confirmation that the contract existed at a given time (which must precede the date of the purchaser's bankruptcy being declared). The latter can be achieved by the contract date being mentioned in a document issued by an appropriate public authority (e.g., in an administrative decision), a notary public subsequently certifying the date (in accordance with the appropriate procedure, which does not even require the other party's participation), or signing the agreement with qualified electronic signatures. The last of these methods appears to be the easiest, most cost effective, and practical solution.

A reservation of title may also benefit the seller or supplier of counterparties in financial distress which become subject to restructuring proceedings, since, if the reservation is effective, it gives the seller rights similar to those of a creditor whose claim has been secured by a pledge[27]. In the case of restructuring proceedings, convincing arguments may be made for the effectiveness of a reservation of title included in supply contracts, so it is not as critical for the seller to structure the underlying relationship as a sales contract.

The benefits of being treated as a secured creditor stem from the fact that secured creditors are not, in principle subject to the arrangement entered into with creditors within restructuring proceedings[28]. Consequently, the seller or supplier of goods subject to a reservation of title may, among others, claim for the return of goods delivered or, alternatively, the payment of the purchase price in full (including during restructuring proceedings, which is not the case for claims subject to an arrangement) and may set off its claims without being subject to any of the limitation specified in the Restructuring Law.

It should be noted that the Restructuring Law does not provide for any specific requirements regarding the form of sales contracts containing reservation of title clauses. However, despite there being no express requirements, there are strong arguments in favour of the proposition that the effectiveness of a reservation of title within restructuring proceedings will depend on whether the contract bears a 'certified date', even though the authors of this article are of a different opinion on this matter.

Irrespective of whether or not the requirement for a specific form applies in the case of restructuring proceedings, given that there are no doubts as to the

[27] Restructuring Law (n 5), Article 249.

[28] Restructuring Law (n 5), Article 151.

benefits such clauses give creditors within bankruptcy proceedings, this difference of opinions is of merely theoretical importance when drafting international commercial contracts. We agree that, given the undisputable advantage such clauses would give sellers in the potential bankruptcy proceedings of a Polish counterparty, it is always recommended for the seller to make efforts to ensure that the agreement's date has been official certified prior to the opening of insolvency-related proceedings against a Polish counterparty.

As a practical note, this does not mean that entities party to multiple sales contracts containing reservation of title clauses would be recommended to have the dates of each contract officially certified. It is sufficient for the supplier to take precautionary actions and monitor whether any bankruptcy or restructuring motions have been filed in respect of their Polish counterparty through the recently implemented Polish National Register of Indebted Parties (*Krajowy Rejestr Zadłużonych*[29]) and to take the actions necessary to certify a contract's date as soon as they become aware of any such filings.

7 Arbitration clauses

Since many cross-border contracts contain arbitration clauses, the impact of bankruptcy and restructuring proceedings on such clauses should also be considered.

The Bankruptcy Law includes relatively detailed regulations on arbitration clauses. According to Article 147a para 1:

> 'If proceedings before an arbitration court have not yet commenced on the date of a declaration of bankruptcy, the trustee may, after obtaining the consent of the judge-commissioner, withdraw from the clause concerning proceedings before an arbitration court, if the pursuit of a claim before an arbitration court would impede the bankruptcy estate's liquidation, in particular where the condition of the bankruptcy estate is such that it would be impossible to cover the costs of opening and conducting proceedings before the arbitration court.'

If the trustee decides to withdraw from an arbitration clause on these grounds, the clause will become ineffective pursuant to para 4 of the same article.

In general, a Polish entity's bankruptcy will, in the majority of cases, result in an arbitration clause being deemed ineffective, on account of arbitration proceedings generating excessive costs for the bankruptcy estate. This is why trustees will typically decide to withdraw from arbitration clauses contained in contracts to which the bankrupt is party.

[29] https://prs.ms.gov.pl/krz.

Significantly, the ineffectiveness of arbitration clauses from which a trustee has withdrawn, as described above, does not occur by operation of law. The following conditions must first be jointly satisfied:

- proceedings before an arbitration court have not yet commenced on the day that the entity in question is declared bankrupt,
- the bankruptcy estate's liquidation is impeded by pursuing the claim before an arbitration court (in particular, if it would be impossible to cover the costs of opening and conducting proceedings before the arbitration court from the bankruptcy estate), and
- the trustee has obtained the judge-commissioner's consent to withdraw from the clause.

In light of the above, two additional questions may arise regarding the trustee's withdrawal from an arbitration clause. The first, related to the fact that the other party's situation is uncertain since the decision to withdraw from such a clause is at the trustee's sole discretion, is: does the other party have any rights which would strengthen its position if with the risk of its counterparty's possible withdrawal from an arbitration clause due to the counterparty's bankruptcy? The second concerns the impact of a party's withdrawal from an arbitration clause on arbitration proceedings themselves, where these proceeding remain pending as on the date of the party being declared bankrupt.

With respect to the first question, note that the position of a bankrupt's contractor is regulated by Article 147a para 2 of the Bankruptcy Law, under which the contractor may submit a written request to the trustee for a declaration on whether they intend to withdraw from the arbitration clause. The trustee is obliged to respond to such a request with the appropriate declaration within thirty days. If the trustee fails to do so, he will be deemed to have withdrawn from the clause. Furthermore, according to Article 147a para 3, the bankrupt's contractor may also withdraw from an arbitration clause if the trustee refuses to participate in covering the costs of proceedings before the arbitration court, despite not having withdrawn from the arbitration clause.

With regards to the second question, it is first worth noting that the option of withdrawing from an arbitration clause will not be available to a trustee in order to halt proceedings before the arbitration court if they have already commenced by the date of the debtor's declaration of bankruptcy. In such circumstances, the proceedings would be temporarily stayed by the arbitration court *ex officio* and the next steps would depend on whether the declaration is addressed to the claimant or the defendant in the proceedings. If the declaration is addressed to the claimant, the proceedings could resume after the person acting as trustee is identified, with the trustee acting on the bankrupt claimant's behalf. However, if the declaration is addressed to the defendant, the resumption of proceedings is not so simple. In particular, a claim subject to such proceedings must first be lodged with the bankruptcy estate and only if the claim is not included in the list of claims subject to bankruptcy proceedings can the proceedings related to this claim then be resumed, with the trustee acting on the bankrupt defendant's behalf. In both of these cases, the trustee is prohibited from withdrawing from the arbitration clause itself, however, the other party retains the right to do so.

According to one view expressed in Polish legal doctrine, the other party to a contract incorporating an arbitration clause may withdraw from such a clause regardless of whether arbitration proceedings are pending if the trustee fails to bear the costs of such proceedings imposed by the arbitration court[30]. We share this opinion, since this interpretation would protect the other party's position in respect of the trustee[31].

Finally, one should consider whether the opening of restructuring proceedings impacts an arbitration clause incorporated into a contract to which a debtor is party. The general answer is 'no'. Since the Restructuring Law does not include analogous regulations to Article 147a para 1 of the Bankruptcy Law, there are no legal grounds for the debtor (or an administrator) to withdraw from an arbitration clause in the event that such proceedings are opened. The Restructuring Law instead provides that arbitration proceedings concerning claims involving the debtor may proceed, with – depending on the type of restructuring proceedings opened – either the debtor acting on its own behalf (in arrangement proceedings or accelerated arrangement proceedings) or an administrator acting on the debtor's behalf (in remedial proceedings).

The only risk remaining is related to the issue of the costs of arbitration proceedings. Specifically, the party initiating proceedings before an arbitration court will bear the costs thereof, regardless of their result, if nothing prevents the relevant claim from being entered in full in the table of claims drawn up

[30] Dariusz Chraponski, commentary to Article 147a, para 3 in Aleksander Jerzy Witosz (ed), *Bankruptcy Law. Commentary* [*Prawo updlosciowe. Komentarz*] (2nd edn, Wolters Kluwer Polska 2021).

[31] However, note that the opinion that the counterparty of a bankrupt holds a right to withdraw from an arbitration clause, even if the arbitration proceedings are pending, only relates to arbitration proceedings pending before a Polish arbitration court. Pursuant to Article 18 of the EU Regulation 'The effects of insolvency proceedings on a pending lawsuit or pending arbitral proceedings concerning an asset or a right which forms part of a debtor's insolvency estate shall be governed solely by the law of the Member State in which that lawsuit is pending or in which the arbitral tribunal has its seat'. Therefore, we would say that a bankrupt entity's counterparty may withdraw from an arbitration clause after arbitration proceedings have been commenced only on the condition that this withdrawal is admissible under the insolvency law of the Member State in which the arbitral tribunal has its seat.

during the restructuring proceedings. Note, however, that this risk does not arise in the case of accelerated arrangement proceedings.

In light of the above, the question is: can one mitigate the risks related to a trustee's potential withdrawal from an arbitration clause contained in a contract to which a bankrupt is party? The answer is, in general, yes, however, such a risk cannot be entirely eliminated. Therefore, we recommend that contracts concluded with Polish entities contain multi-tier dispute resolution clauses. Such clauses can provide for arbitration as the primary form of dispute resolution proceedings for all claims arising from the contract, while concurrently providing for the jurisdiction of the domestic courts of the bankrupt's counterparty if the arbitration clause expires, is withdrawn from, or otherwise becomes void or ineffective on account of other circumstances arising. In such case, if the trustee decides to withdraw from an arbitration clause pursuant to Article 147a of the Bankruptcy Law, any claims related to the contract can be recognized by the common courts of a selected jurisdiction.

Although in some cases, such a clause could be deemed ineffective against a contractor's bankruptcy estate due to the operation of Article 84 para 1 of the Bankruptcy Law[32], in many others, multi-tier dispute resolution clauses may prove to be an effective means of minimizing the negative consequences of a contractor's trustee withdrawing from an arbitration clause incorporated into a contract to which one is party.

8 Conclusion

Both bankruptcy and restructuring will affect the position of a business partner of an entity subject to such circumstances and proceedings. The impact thereof is not limited solely to the economic aspects of one's business with such an entity, but also influences the legal aspects of the relationship.

If a contractor is subject to Polish law and is declared bankrupt or becomes subject to restructuring proceedings, one should be aware that Polish bankruptcy and restructuring law will govern one's position as well. What's more, any choice of law clauses incorporated into a contract, according to which it is governed by a foreign law (i.e., not Polish law), will not apply in respect of bankruptcy or restructuring proceedings opened against a Polish contractor.

[32] This is likely in all cases where a trustee would be entitled to bring an action before the Polish courts had the jurisdiction clause not been included in the contract and as regards contractual claims, this especially refers to contracts the place of performance of which is in Poland.

Consequently, one should remember that when doing business with Polish entities, one should consider the impact which the provisions of Polish bankruptcy and restructuring law will have before signing a contract with them, not only to be aware of the potential risks related to the opening of the relevant insolvency-related proceedings, but also to assess whether, in the particular circumstances, it would be possible to structure the contractual relationship such that the adverse effects of the other party's bankruptcy or restructuring are minimized.

Chapter 4

Protection of Employees and the *Smallsteps* and *Heiploeg* Judgments

Robert van Galen
Partner, NautaDutilh, Amsterdam

1 Introduction

Generally speaking there are three ways to restructure a company in financial distress: (i) by way of an asset transaction, (ii) by offering a plan to the creditors and/or the shareholders and (iii) by effectuating a legal merger or demerger. Economically an asset transaction is similar to a bankruptcy plan which solely envisages a distribution in cash. In both cases the right of the creditors to take recourse against the assets of the bankrupt company is replaced by an entitlement to the proceeds/cash, although the bankruptcy plan is a more flexible instrument. However, in the Netherlands over the past few decades virtually all restructurings in bankruptcy took place through an asset deal. The main reason is that an asset deal is much more simple than a plan. The merger/demerger instrument is rather complicated and almost never used.

Pursuant to Article 101(1) Dutch Bankruptcy Act ('DBA'), the bankruptcy trustee has the right to sell the assets. Such sale is comparable to a sale under § 363 (b)(1) US Bankruptcy Code. If the assets are being sold in a private sale, he needs the consent of the supervisory judge. There are no further statutory requirements, there is no hearing of the creditors. Therefore, often a sale is achieved quickly and efficiently. The trustee will do market research (if that had not already been done prior to the opening of the proceedings), possibly obtain a valuation of the assets, conduct negotiations with one or more buyers, obtain permission from the supervisory judge and enter into the transaction. Of course if the sale concerns a substantial or complicated asset, more work may need to be done, but often the sale can be completed within a few days or weeks. In comparison a plan is complicated. Until recently a restructuring plan outside insolvency proceedings basically required the consent of all impaired creditors, the adoption of a plan during bankruptcy or suspension of payments proceedings required voting and confirmation and involved the possibility of appeal proceedings and cassation proceedings in the Supreme Court. As a main rule such plan can affect ordinary creditors only and it takes considerable time. However, recently the Netherlands recently introduced proceedings for private restructuring plan (WHOA) which can be adopted outside bankruptcy proceedings. Although it still requires voting and confirmation it is more efficient than the old-fashioned bankruptcy plans and it can impair the rights of ordinary, secured and preferential creditors as well as shareholders, but it is still not possible to impair the rights of employees. It has gained some popularity since its introduction in 2021, especially with smaller debtors. Nevertheless, the asset deal still is the most important tool in Dutch bankruptcy proceedings for achieving a reorganization of the business.

An attractive feature of the asset deal used to be that it provided an easy means to continue the business with a reduced workforce. This is made possible by a bankruptcy exception to the main regime of EU Directive 2001/23 on the approximation of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses. This contribution will discuss that Directive and the two judgments of the EC Court of Justice which chased the Dutch trustees from bankruptcy paradise.

2 Directive 2001/23

The Directive provides for the transfer of obligations arising from a contract of employment or from an employment relationship in case of the transfer of an undertaking or part thereof. Pursuant to Article 3(1) of the Directive, if assets comprising an undertaking or business or part thereof, are transferred to a buyer, the employment contracts of employees working with that undertaking or business or part thereof, are dragged along. Therefore, in case of such transfer of an undertaking, such employees automatically become employees of the buyer.

Article 4(1) sentences 1 and 2 of the Directive reads:

> 'The transfer of the undertaking, business or part of the undertaking or business shall not in itself constitute grounds for dismissal by the transferor or the transferee. This provision shall not stand in the way of dismissals that may take place for economic, technical or organisational reasons entailing changes in the workforce.'

Consequently, if a transfer of an undertaking takes place, dragging along of employees cannot be avoided by dismissing them, unless such dismissal is based on economic, technical or organisational reasons (ETO-reasons). This may for example be the case if the acquirer wishes to integrate the acquired business with an undertaking he already owns.

Under the predecessor of the Directive (Directive 77/187/EEC) the question arose whether the drag along rule applied in insolvency proceedings as well. The case was submitted to the ECJ by an administrative court in first instance in *Zwolle*[1] and concerned an employee of a factory of machines, Thole B.V. which was first granted suspension of payments (a kind of reorganisation proceedings) but, at the initiative of the administrator, was declared bankrupt shortly thereafter[2]. The bankruptcy trustee dismissed all employees and sold the business to TTP. One of the employees, Mr Abels, claimed wages with respect to the period that Thole B.V. was in suspension of payments under the wage guarantee scheme as provided for in Directive 80/987/EEC[3] from the trade organisation responsible for the payment under the guarantee (bv Metaal). The trade organisation took the position that it was not liable for those wages, because the undertaking had been transferred to TTP, Mr Abels was dragged along and TTP was responsible for the wages, including those relating to the period prior to the transfer. The ECJ considers that the Directive is intended to protect workers in order to safeguard their rights when an undertaking is transferred[4] and that 'the purpose of the Directive is (...) to ensure that restructuring of undertakings within the common market does not adversely affect workers in the undertakings concerned[5].' The subsequent core considerations read:

> '23 It is apparent from the foregoing considerations that a serious risk of general deterioration in working and living conditions of workers, contrary to the social objectives of the Treaty, cannot be ruled out. It cannot therefore be concluded that Directive No 77/187 imposes on the Member States the obligation to extend the rules laid down therein to transfers of undertakings, businesses or parts of businesses taking place in the context of insolvency proceedings instituted with a view to the liquidation of the assets of the transferor under the supervision of the competent judicial authority.
>
> 24 It must nevertheless be made clear that, even though, in view of the considerations set out above, transfers of that kind do not fall within the scope of the abovementioned directive, the Member States are at liberty independently to apply the principles of the directive, wholly or in part, on the basis of their national law alone.'

1 Raad van Beroep.

2 ECJ 7 February 1985, C-135/83 ECLI:EU:C:1985:55, *Abels/bv Metaalindustrie*.

3 Succeeded by Directive 2008/94/EC.

4 Consideration 14.

5 Consideration 18.

The ECJ considered whether this limitation of the scope of the Directive applies as well to the suspension of payments (*surséance van betaling*) which preceded the bankruptcy and answered that question in the negative. Its conclusion was:

> 'For all those reasons, the reply to the first question must be that Article 1 (1) of Council Directive No 77/187 of 14 February 1977 does not apply to the transfer of an undertaking, business or part of a business where the transferor has been adjudged insolvent and the undertaking or business in question forms part of the assets of the insolvent transferor, although the Member States are at liberty to apply the principles of the directive to such a transfer on their own initiative. The directive does, however, apply where an undertaking, business or part of a business is transferred to another employer in the course of a procedure such as a "surséance van betaling"[6].'

Consequently a bankruptcy exception was created to the drag along rules in addition to the exception for ETO-dismissals in Article 4(1) of the Directive. At the subsequent revision of the Directive in 2001, the bankruptcy exception was inserted as Article 5(1) of the Directive (Directive 2001/23/EC):

> 'Unless Member States provide otherwise, Articles 3 and 4 shall not apply to any transfer of an undertaking, business or part of an undertaking or business where the transferor is the subject of bankruptcy proceedings or any analogous insolvency proceedings which have been instituted with a view to the liquidation of the assets of the transferor and are under the supervision of a competent public authority (which may be an insolvency practioner authorised by a competent public authority).'

I think that the phrasing of the exception is somewhat awkward. It provides that the exception applies unless the Member States provide otherwise in their legislation. As appears from the above that construction was copied from the Abels judgment. In a judgment where the exception is construed through limiting the scope of the Directive whereas the Member States were not aware of such limited scope, that construction is understandable. However, it seems to me that, when drafting the revised Directive, the rule should have been inverted in the sense that the Member States were free to exclude the liquidation scenario from the implemented rules of the Directive. The present phrasing still implies a limited scope of the Directive, which is not expressed in the Directive itself.

In the Netherlands Directive 2001/23 has been implemented in Articles 7:662-666a Dutch Civil Code ('DCC'). The bankruptcy exception can be found in Article 7:666(1)(a) which reads:

> 'The articles 662 through 665 and 670(8) do not apply to the transfer of an undertaking if:

[6] Consideration 30 and dictum sub (1).

(a) the employer has been declared bankrupt and the undertaking belongs to the bankrupt estate[7].'

The provision means that in all cases where bankruptcy (=liquidation) proceedings have been opened with respect to the employer, the trustee can transfer the undertaking or part thereof to an acquirer, but the employees are not dragged along because the bankruptcy exception applies. Therefore, the standard procedure followed for saving a business or part thereof in bankruptcy is that the bankruptcy trustee dismisses all the employees of the debtor, that he sells the relevant assets to the buyer and that the buyer offers employment agreements to those employees which he considers useful or necessary. Sometimes the transfer of the undertaking will involve more than a mere sale of the assets: e.g. contracts may have to be renewed or transferred and the same may apply to licenses.

3 The Dutch pre-pack

In some cases all negotiations with the prospective buyer took place by the bankruptcy trustee after the opening of the bankruptcy proceedings, in other cases negotiations took place prior to the opening of the proceedings and the bankruptcy trustee was confronted with a draft deal which he could accept or reject. In the latter case the trustee would have to find a better deal or sell off the assets. There are also cases in which the transaction is prepared during suspension of payments proceedings in which the future bankruptcy trustee fulfills the role of administrator. More recently the instrument of the Dutch pre-pack was developed. The court 'appoints' a prospective bankruptcy trustee and a prospective supervisory judge. These officers have no statutory powers, but the prospective bankruptcy trustee can be involved in the confidential negotiations of a transaction or at least observe them and get acquainted with the undertaking of the debtor. He reports to the prospective supervisory judge. It is conceivable that no subsequent bankruptcy proceedings have to be opened or that the prospective trustee resigns for other reasons, but normally in the 'prospective' scenario, prior to the *Smallsteps* and *Heiploeg* judgments, the bankruptcy proceedings would be opened and the dismissal of the employees and the asset deal could take place within a very short time frame. In some cases the acquirer of the undertaking is a party which is not connected to the debtor, in other cases a related company buys the assets and is 'refinanced'. The pre-pack does not have a basis in any statutory provisions, which is the reason why some of the district courts are not prepared to apply it. Under the pre-pack proceedings the prospective trustee and prospective supervisory judge have no legal authority.

[7] Unofficial translation by me.

Although in some other countries these asset deals are viewed with suspicion, in particular if related parties are involved, or are only allowed with certain safeguarding measures, they have not been frowned upon in the Netherlands. In general, the idea is that the appointment of an independent bankruptcy trustee by the court and the court's supervision should provide adequate safeguards against abuse. Although the Dutch practice of asset transactions lacked transparency, participation of creditors and protection of employees, it was swift and efficient and on balance it prevented loss of capital and procured continuation of business. Paradise however is temporary and the Dutch practice was shaken by the ECJ's *Smallsteps* judgment[8].

4 The *Smallsteps* judgment

The *Smallsteps* case concerned the business of Estro Groep BV, which owned 380 childcare centers. Estro encountered financial difficulties and at Estro's request the court appointed a prospective trustee and a prospective supervisory judge in pre-pack proceedings and the prospective trustee was involved in the negotiations with the intended purchaser, Smallsteps. Next Estro opened bankruptcy proceedings and the prospective trustee became the bankruptcy trustee. He dismissed all the employees and transferred the assets of part of the childcare centers to Smallsteps. Smallsteps only offered new jobs to part of the employees that were employed by these childcare centers. Four of the employees that were left behind and the union (FNV) took the position that Article 5(1) of Directive 2001/23 was not applicable in this case and that therefore these employees had been dragged along to the new owner of the undertakings, Smallsteps. They commenced proceedings with the court of first instance which posed preliminary questions to the European Court of Justice on the interpretation of Article 5(1) of Directive 2001/23.

The ECJ identified three relevant questions relating to the applicability of the bankruptcy exception. The first question was whether the transferor was the subject of bankruptcy proceedings or any analogous insolvency proceedings, the second question was whether the bankruptcy proceedings were instituted with a view to liquidation of the assets and the third question was whether the procedure was carried out under the supervision of a public authority.

The answer to the first question is in the affirmative, as Estro was involved in bankruptcy proceedings and the transaction took place after the opening thereof.

[8] ECJ 22 June 2017, C-126/16, ECLI:EU:C:2017:489 (*FNV/Smallsteps*).

The answer to the second question, which I will henceforth refer to as the liquidation question or issue, was much more exciting. The court starts by considering that the Directive requires that the bankruptcy proceedings or analogous insolvency proceedings are instituted with a view to liquidation of the assets of the transferor[9]. This consideration implies that the question whether the proceedings have been instituted with a view to liquidation of the transferor does not only need to be answered in case of analogous insolvency proceedings, but also in case of bankruptcy proceedings themselves. In other words, the subphrase 'which have been instituted with a view to the liquidation of the assets of the transferor' in the above quoted Article 5(1) of the Directive, does not only refer to the immediately preceding words 'any analogous insolvency proceedings', but also to the words 'bankruptcy proceedings' which are situated before those words. This interpretation is not grammatically obvious in the Dutch and English versions of the provision and even less in the French version[10]. On the other hand the choice the ECJ made is understandable. Advocate-General Pitruzzella in his opinion in the *Heiploeg* case, points out that Directive 2001/23 serves the social policy of the Union. It is likely that he ECJ considered it undesirable if employees would lose the protection of the Directive by conducting a reorganisation in the disguise of bankruptcy proceedings, which are supposedly meant to serve the liquidation of the debtor. In fact that was what had happened in the Netherlands for many years.

The court explains how the concept of 'proceedings which have been instituted with a view to the liquidation of the assets' should be interpreted. First, a procedure *aimed* at ensuring the continuation of the undertaking in question does not satisfy the liquidation criterion. By contrast, a procedure focusing on the liquidation of assets is aimed at maximising satisfaction of creditors' collective claims[11]. However, the ECJ acknowledges that there may be an overlap between instituting proceedings with a view to liquidation of the assets of the transferor and doing so with a view to continuation of the business and in that case it is necessary to determine the primary objective. The ECJ furthermore considers that if the pre-pack 'is aimed at preparing the transfer of the undertaking down to its every last detail in order to enable a swift relaunch of the undertaking's viable units once the insolvency has been declared and in order to avoid the disruption that would result from an abrupt cessation of the

9 Consideration 47.

10 'lorsque le cédant fait l'objet d'une procédure de faillite ou d'une procédure d'insolvabilité analogue ouverte en vue de la liquidation des biens du cédant'. If these words are to be read in the sense the court gave to them, a comma would be expected after 'analogue'.

11 Consideration 47.

undertaking's activities on the day of the declaration of insolvency' the proedure does not meet the liquidation criterion[12]. '(T)he mere fact that the "pre-pack" procedure may also be aimed at maximising satisfaction of creditors' collective claims does not make this a procedure instituted with a view to the liquidation of the assets of the transferor within the meaning of Article 5(1) of Directive 2001/23[13].'

With respect to the third question the ECJ considers that the pre-pack, which preceded the bankruptcy proceedings has no basis in the national legislation, that it is not carried out under the supervision of the court, the prospective trustee and the prospective supervisory judge have no formal powers and that, briefly stated, the whole transaction is negotiated and agreed before the opening of the bankruptcy proceedings, although the formal authorisation is given after the opening only. '(S)uch an approach may defeat almost entirely the purpose of the supervision of the insolvency procedure by a competent public authority.'[14] Therefore the requirement of Article 5(1) of the Directive that the proceedings are conducted under the supervision of a competent public authority is not met.

5 Reaction to the *Smallsteps* judgment

The *Smallsteps* judgment torpedoed the Dutch asset-transaction practice. The direct effect was that a buyer would not be sure that Article 5(1) of the Directive (Article 7:666 DCC) could be relied upon, because that requires a determination whether the main purpose of the opening of the proceedings was liquidation or continuation. That determination is difficult to make, because usually there is a bit of both. Moreover, there was the perception that the judgment killed the pre-pack. That perception does not seem right to me as the consequence of the ECJ's judgment with respect to the pre-pack was only that it should be supervised by the court and provided for in the law.

At the time of the *Smallsteps* judgment, a bill was pending in the First Chamber of Parliament with respect to provisions on the prospective trustee and the prospective supervisory judge ('WCO I'). It had already been adopted by the Second Chamber of Parliament and the legislative proceedings had almost been completed. Nevertheless, in response to the *Smallsteps* proceedings the government decided to put the bill on ice. A discussion ensued on the question how to deal with the issue of the drag along rules, which resulted in a pre-draft of a bill on the transfer of employees in bankruptcy ('WOVOF').

[12] Considerations 49 and 50.

[13] Consideration 52.

[14] Consideration 57.

Under Dutch insolvency law, in particular the part relating to bankruptcies, the rules on dismissal of employees are rather different from the rules in the ordinary course of business. The bankruptcy trustee can dismiss all employees with the consent of the supervisory judge. The ordinary criteria for dismissals do not apply, the notice period is short, fixed term contracts can be terminated and there is no consent needed from the court dealing with labour matters or the social security board. As there was discontent with inter alia the unions about the rules on dismissal in bankruptcy, the WOVOF contained rules which aligned much more closely with the system used with respect to solvent companies. First the pre-draft provided the complete abolishment of the exception under Article 5(1). In other words, the Netherlands would no longer make use of the option provided for in that provision. This of course went much further than the ECJ had ruled, as it meant that Article 5(1) also would no longer be applied in cases where the bankruptcy proceedings were instituted with liquidation as the main purpose. The basic rule under this draft is that the trustee would still dismiss the employees, but that the purchaser of the undertaking would have to offer employment agreements to the employees that were employed in the undertaking or the part thereof that the purchaser buys. If for economical, technical or organisational reasons the purchaser would not be able to make such offer to all those employees, he would be allowed to make such offer to only part of them. This principle would implement Article 4 of the Directive, which allows for ETO dismissals in case of the transfer of undertakings, if no use can be made of the bankruptcy exception. The purchaser however, would have to select the employees to which he makes an offer by using objective criteria. The supervisory judge would review the offer in the context of his consent to the asset transaction. Pursuant to the WOVOF, a ministerial regulation which implements the rules of the WOVOF, and the explanatory memorandum to the WOVOF, these criteria are rather strict. The starting point is that the offer should mirror the workforce as it existed at the opening of the bankruptcy proceedings. For example, the ratio of employees in different age groups should be the same. According to the regulation a deviation of 10% would be allowed. Outside insolvency proceedings, such mirror systems are used for example with solvent companies if parts of the workforce have to be dismissed. Alternatively the purchaser may use other objective criteria than the mirror system, which he will have to submit to the supervisory judge. However, even if the supervisory judge agrees to the transaction, employees that have been left behind can still go to court and claim that they have been dragged along if they dispute the correct implementation of the selection plan.

6 The *Heiploeg* judgment

By judgment of 29 May 2020[15] the Dutch Supreme Court posed preliminary questions to the ECJ in another matter, the *Heiploeg* case. The Supreme Court sought further guidance on the interpretation of Article 5 of Directive 2001/23, but the wording of the judgment gives the impression that it actually constitutes an attempt to make the ECJ change its mind. As to the legislative trajectory, the government decided to stall the WOVOF draft in order to await the outcome of the *Heiploeg* case. However, in May 2021 the government circulated another pre-draft in relation to WCO I, the bill that concerned pre-packs. Pursuant to this new pre-draft, the pre-packs would be limited for the time being, to bankruptcy proceedings which concerned companies with affairs of public interest, such as hospitals. I will not discuss this new redraft here.

The *Heiploeg* matter concerned a wholesale company which was engaged in the fishtrade. In 2013 the European Commission imposed a fine of € 27 on Heiploeg for having participated in a cartel. Consequently, Heiploeg incurred financial difficulties and in order to resolve them it investigated the possibility of a pre-pack procedure preparing for an asset transaction. Next Heiploeg requested the court to open pre-pack proceedings. The court appointed two prospective bankruptcy trustees and a prospective supervisory judge. The transaction was prepared for and bankruptcy proceedings were opened in which the court appointed the prospective bankruptcy trustees as bankruptcy trustees and the prospective supervisory judge as supervisory judge. The bankruptcy trustees dismissed all the employees and sold the assets to a purchaser (Parlevliet & Van der Plas Beheer B.V.) which continued the undertaking under the Heiploeg name. New Heiploeg hired 210 of the approximately 300 employees of the former Heiploeg company. The labour union (FNV) started proceedings against the purchaser, taking the position that Article 5(1) of Directive 2001/23 did not apply and that all employees of the former Heiploeg company had been dragged along in the asset transaction. The *Heiploeg* transaction could not take into account the decision of the ECJ in the *Smallsteps* case, because it took place prior to that judgment. Actually, the *Heiploeg* bankruptcy preceded the *Smallsteps* bankruptcy by half a year. The reason why it was attended to by the ECJ so much later is, that in the *Smallsteps* case the court of first instance submitted the preliminary questions to the ECJ, whereas in the *Heiploeg* case, the matter was first litigated in the court of first instance and the court of appeal and it was the Supreme Court (the third instance) that submitted the questions.

[15] ECLI:NL:HR:2020:954.

In its *Heiploeg* judgment the ECJ maintains its starting point that in order to decide whether Article 5(1) of the Directive may be applied, it is necessary to determine whether the bankruptcy proceedings have been instituted with a view to liquidation of the assets of the debtor or with a view to continuation of the business. In that context the ECJ also considers:

> 'It is also common ground that, in the present case, the transfer of the undertaking concerned took place in the course of insolvency proceedings intended to liquidate all the assets of Heiploeg-former, that is to say the transferor's undertaking[16].'

That consideration actually seals the fate of the case. The ECJ furthermore considers that the liquidation test has to be applied to the bankruptcy proceedings also if the transfer of the business has been prepared prior to the institution of the bankruptcy proceedings 'since that provision (i.e. Article 5(1) of Directive 2001/23) does not concern the period preceding the institution of the bankruptcy or insolvency proceedings concerned.[17]'

Nevertheless the purpose of the pre-pack is also of importance for the liquidation issue, as the ECJ considers:

> 'Accordingly, where the main purpose of a pre-pack procedure followed by insolvency proceedings is to obtain, following the declaration of insolvency of the transferor and its liquidation, the highest possible reimbursement of all its creditors, those procedures, taken together, satisfy, in principle, the second condition laid down in Article 5(1) of Directive 2001/23.[18]'

And the ECJ furthermore considers:

> 'In addition, it is necessary to establish not only that those proceedings have as their primary objective to satisfy to the greatest extent possible the claims of all the creditors, but also that the implementation of the liquidation through the transfer of the undertaking or a part thereof as a going concern, as prepared in the pre-pack procedure and carried out following the insolvency proceedings, enables the achievement of that primary objective. Accordingly, the aim of the use of the pre-pack procedure, for the purposes of liquidating a company, is to enable the insolvency administrator and the supervisory judge appointed by the court after the declaration of that company's insolvency to increase the chances of satisfying the creditors' claims.[19]'

Furthermore the ECJ discusses whether the condition has been met that the bankruptcy proceedings or the analogous proceedings are supervised by a

[16] Consideration 47.

[17] Condideration 51.

[18] Consideration 52.

[19] Consideration 53.

public authority if the asset deal is prepared for in a pre-pack. The answer is that this is only the case if the pre-pack procedure is governed by statutory or regulatory provisions.

In the Netherlands the discussion about Smallsteps often revolved around the possibility to apply the bankruptcy exception if the bankruptcy has been preceded by a pre-pack. I do not think that that is the real significance of the two judgments. As the *Heiploeg* judgment explicitly reveals, the question whether the bankruptcy proceedings have been instituted with a view to liquidation of the debtor/transferor determines the permissibility of the bankruptcy exception both if the bankruptcy proceedings have been preceded by a pre-pack and if they have not. The essential question is what the main purpose of opening of the proceedings is. The present Article 7:666 sub a DCC, which excludes the drag along rule in any bankruptcy proceedings, regardless the intention with which these proceedings have been instituted, contains an exception which is too wide and the provision therefore should be amended. The significance of the two judgments for the pre-pack procedure is only (i) that if the bankruptcy proceedings are prceded by a pre-pack, both proceedings should be instituted with a view to liquidation and (ii) the pre-pack proceedings should be dealt with in statutory provisions. In that respect the government's response to the *Smallsteps* judgment, consisting of stalling the legislative process of enacting such provisions was somewhat strange.

Did the ECJ make a turn around in the *Heiploeg* judgment, allowing the bankruptcy exception after all in cases were the transaction had been planned before the opening of the proceedings? Taking the wording of the judgment at face value this does not seem to be the case. Both the *Smallsteps* judgment and the *Heiploeg* judgment apply as a rule that the requirement that the proceedings have been instituted with a view to liquidation of the transferor, does not apply to analogous insolvency proceedings only, but to bankruptcy proceedings as well. In the *Smallsteps* case the ECJ considered that if the proceedings have as their principal objective the continuation of activities, but are additionally aimed at the highest possible distribution to all of its creditors, it does not qualify as proceedings instituted with a view to liquidation of the transferor, as there can be an overlap and then the main purpose is decisive. In the *Heiploeg* case the ECJ considered that *if* the main purpose is to liquidate the transferor and subsequently provide the highest possible distribution to the creditors and if the transfer of the undertaking serves to attain that purpose, the proceedings do fall within the scope of Article 5(1) of the Directive. So the key question is as to what the main purpose is. Insofar the reasoning of the ECJ in both judgments is consistent. However, the second judgment demonstrates that the bankruptcy proceedings can meet the requirement of Article 5(1) of the Directive even if the undertaking is transferred and such transfer was premeditated. In that sense the reader might infer that the ECJ softened its approach. Obviously, where there may be an overlap between the intentions served with the proceedings and the decisive factor is which intention is dominant, the decision as to whether the bankruptcy exception may be applied very much depends on the facts. Consequently, actually the ECJ to a large extent leaves the determination for future cases to the national courts.

7 Solution to the *Smallsteps/Heiploeg* problem

As mentioned above, the Dutch practice prior to the *Smallsteps* judgment was simple. Any transfer in bankruptcy met the requirement of Article 7:666 sub a DCC, which supposedly implemented Article 5(1) of the Directive. As a result of the two ECJ-judgments, this will only be the case if the main purpose of the bankruptcy filing is to liquidate the debtor. In the present setting the purchaser of the undertaking has no certainty whether the drag along rules do not apply indeed. Both cases show that a disgruntled employee who is left behind, may claim that he/she has become employed by the purchaser as a result of the drag along rule.

The question how the problem created by the *Smallsteps* and *Heiploeg* judgments can be solved should in my view be distinguished from the question what would be the preferable way to deal with employment agreements in bankruptcy, which actually does not only concern asset transactions, but also continuation after a composition of creditors. As was mentioned above, these questions seem to have become somewhat confused after the *Smallsteps* judgment upset Dutch practice. It seems to me that a simple and effective solution for the *Smallsteps/Heiploeg* issue is that the court which opens the bankruptcy proceedings determines whether they have been instituted primarily in order to liquidate the assets of the debtor or to continue the activities of the undertaking or part thereof. If needed, employee representatives could be hard by the court, but as the opening judgment is subject to appeal and cassation appeal to the Supreme Court it would also be possible to challenge the decision. Once the decision has become irrevocable it is also certain which regime has to be applied to an asset transaction and if the decision means that the liquidation regime applies, the purchaser does no longer run the risk of ex post application of the drag along rules. The obligation of the court to make this determination should be enacted in the Bankruptcy Act, as is the case e.g. with respect to the determination whether the proceedings are main proceedings under the European Insolvency Regulation and therefore whether the centre of main interests of the debtor is located in the Netherlands[20].

8 Revision of rules on protection of employees

Another matter altogether is whether the rules on protection of employees in bankruptcy should be amended anyway. That protection is very limited at present. As mentioned above, when bankruptcy proceedings have been opened, there usually is hardly any cash and the trustee cannot but dismiss the employees, except for a few which he needs for the administration of the estate. However, it seems to me that the solution provided by the WOVOF draft is not attractive in situations where the Directive allows the enactment of the bankruptcy exception of Article 5(1) thereof. First, under the WOVOF the purchaser will still encounter uncertainty as to whether employees to whom he has not made an offer have a claim. Second, I doubt whether the mirror principle, which has been borrowed from reorganisations of solvent companies is adequate in a bankruptcy situation. In most cases, a substantial part of the employees which were able to find other jobs have left the company prior to the opening of the bankruptcy, because they perceived the downturn of the company's business. The remaining workforce, which should be mirrored by the purchaser, therefore constitutes at least in part a negative selection. I would agree that the purchaser should not abuse the situation and discriminate illegally when selecting the employees he would like to make an offer to, but I think that the mirroring technique is unfair in this context and impedes the fresh start. Although the present practice provides little protection to the employees, it should be kept in mind that the Dutch practice facilitates a quick continuation with less loss of capital than systems which take more time and are more restrictive. In the end that is beneficial from a macroeconomic perspective and serves employment in general. I am not opposed to a review by the supervisory judge in the context of the asset transaction of the plan of the purchaser with respect to offering jobs to the old workforce, but I think that that review should be limited and that employees that are left behind should not have a possible claim against the purchaser. In cases where the court has decided that the bankruptcy proceedings have been mainly opened with a view to continuation of the activities the bankruptcy exception cannot be applied and pursuant to Article 4 of Directive 2001/23, in such cases dismissal is allowed on ETO grounds only. The system proposed in the WOVOF (dismissal of all employees and re-hiring by the purchaser leaving behind part of the workforce on ETO-grounds) does not seem to fit in the system of the Directive, but more

[20] Article 6(4) Dutch Bankruptcy Act.

importantly it seems to me that here also, the mirroring technique is unattractive. More importantly, I would expect that only in a few cases it can be expected that the court will decide that the institution of the bankruptcy proceedings does not have as its main objective the liquidation of the debtor and optimal distribution of the proceeds to its creditors. At the time of the filing, usually there is no substantial cash available anymore and there are no alternatives. If the main purpose of a restructuring is to discard with part of the workforce, the planning and execution of the restructuring planning often takes place at a much earlier stage and the bankruptcy filing constitutes the final step only. Profitable activities may have been separated in other group companies for example, or refinancing may have separated viable group companies from companies that need to be liquidated. Therefore, I am afraid that the distinction that the ECJ has made in both judgments between proceedings instituted with a view to liquidation and proceedings instituted with a view to continuation of activities, will provide the employees with little solace. A better solution than distinguishing between these proceedings (although necessary) could be provided if bankruptcy trustees or employees would have more means to review reprehensible behaviour that has led to loss of employment. As an example an instrument would be conceivable by which management is held liable if mismanagement has caused loss of employment. At present the Dutch rules on liability for mismanagement in bankruptcy (i.a. Articles 2:138 and 2:248 DCC) do not provide adequate redress, because they only concern liability of the management for a deficit in the bankruptcy proceedings, but employees do not have a claim in the bankruptcy for loss of employment. Moreover, such instrument should also apply to other means of bankruptcy reorganization than asset transactions. It may be expected that reorganization plans in bankruptcy will gain in importance if the legislator decides to extend such plans to secured and preferred claims and shareholders, as is presently already the case with the WHOA.

Chapter 5

Implementation of Directive (EU) 2019/1023 in Portugal Following the Measures Adopted in Response to the Crisis Caused by COVID-19

Catarina Guedes de Carvalho
Head of Restructuring and Recovery at CTSU
Sociedade de Advogados, SP, RL, SA
The Deloitte Legal practice in Portugal

Overview

Portugal implemented the first preventive restructuring framework in 2012 with the so-called 'PER' and in 2018 it was created a new out-of-court Business Recovery Scheme, the so-called 'RERE'. Considering that two preventive restructuring frameworks for corporate recovery already existed at the time Directive (EU) 2019/1023 was published (i.e., June 2019), it emerged that in Portugal there was no need to create a preventive restructuring procedure *ex novo*.

This paper intends to provide a brief description of the preventive restructuring frameworks already in place in Portugal at the time of the publication of this Directive, with a subsequent reference to the measures implemented to face the COVID-19 pandemic, including the new extraordinary and transitional preventive restructuring framework (the so-called 'PEVE') adopted by the Portuguese Government as a further legislative response to the economic crisis. Finally, a brief analysis of the context and terms of the transposition is also carried out.

As will be seen more clearly ahead, the Portuguese legislature decided to proceed with the transposition only after the stabilization of the pandemic context and its [exceptional] legislative process and by only introducing amendments to the 'PER'. This option is justified not only because the 'PER' corresponds to the type of instruments provided for in the Directive (EU) 2019/1023, but also probably because it proved to be a highly successful procedure, with a high level of adherence during the ten years it has been in force so far. At the same time, the legislative opportunity was also taken to foresee a set of amendments to simplify and accelerate the course of insolvency and recovery proceedings, and to clarify and correct procedural and substantive aspects about which there was imprecision in the law or the need to intervene due to legal doctrine and case law.

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1 Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 (Directive on restructuring and insolvency)

1.1 Scope and deadline for transposition

The objective of 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 (Directive on restructuring and insolvency) (**Directive**) is:

> 'to contribute to the proper functioning of the internal market and remove obstacles to the exercise of fundamental freedoms, such as the free movement of capital and freedom of establishment, which result from differences between national laws and procedures concerning preventive restructuring, insolvency, discharge of debt, and disqualifications. Without affecting workers' fundamental rights and freedoms, this Directive aims to remove such obstacles by ensuring that: viable enterprises and entrepreneurs that are in financial difficulties have access to effective national preventive restructuring frameworks which enable them to continue operating; honest insolvent or over-indebted entrepreneurs can benefit from a full discharge of debt after a reasonable period of time, thereby allowing them a second chance; and that the effectiveness of procedures concerning restructuring, insolvency and discharge of debt is improved, in particular with a view to shortening their length.[1]'

Its main purpose is that every Member State puts in place preventive restructuring procedures, which comply with certain minimum principles of effectiveness and that debtors are enabled to effectively restructure at an early stage and to avoid insolvency, thus limiting the unnecessary liquidation of viable enterprises, as also preventing the build-up of non-performing loans[2].

The initially deadline for the Member States to adopt and publish the laws, regulations and administrative provisions necessary to comply with the Directive was 17 July 2021[3]. Due to the pandemic context of COVID-19, Portugal communicated to the European Union the need to extend for one year the deadline for transposing the Directive (i.e., until 17 July 2022). The transposal implementation actually occurred on 11 April 2022, with the entry into force of Law 9/2022 of 11 January.

1 Recital (1) of the Directive.

2 Recitals (2), (3) and (13) of the Directive.

3 Article 34 of the Directive.

1.2 Preventive restructuring frameworks already in place in Portugal

Even before the Directive, two preventive restructuring frameworks for corporate recovery already existed in Portugal: the Special Revitalisation Process (**PER** – *Processo Especial de Revitalização*)[4] and the Out-of-court Business Recovery Scheme (**RERE** – *Regime Extrajudicial de Recuperação de Empresas*)[5]. There is also a third one, the Special Payment Agreement Process (**PEAP** – *Processo Especial para Acordo de Pagamento*)[6], a pre-insolvency procedure, similar to the PER, but applicable to debt recovering of natural persons/individuals.

The PER and the RERE are, thus, the key preventive restructuring framework for companies, respectively of a judicial and out-of-court nature. If a company is only in a difficult economic situation of likelihood of insolvency, but still capable of recovery, it can use the PER or the RERE to try to prevent insolvency and ensure its viability by adopting a restructuring plan.

Regarding the two preventive restructuring frameworks for companies we point out some of the main aspects of each one:

1.3 PER

The PER is an urgent procedure to allow the debtor a fresh start when that is deemed to be possible, for its sustainable recovery through negotiations with all interested creditors and the conclusion of a recovery plan.

The debtor company's application begins with the support of a minority of creditors – a written declaration signed by the debtor and by at least one of its creditors (corresponding to a minimum of 10% of non-subordinated liabilities) stating the intention to enter into negotiations with a view to the debtor's revitalisation by means of the approval of a recovery plan. It is also necessary to submit a declaration from a certified accountant attesting that the company is not currently in an insolvency situation[7].

[4] Articles 17-A to 17-J of the Portuguese Insolvency and Corporate Recovery Code (**CIRE** – *Código da Insolvência e da Recuperação de Empresas*), introduced by Law 16/2012 of 20 April 2012.

[5] Approved by Law 8/2018 of 2 March 2018.

[6] Articles 222-A to 222-J of the CIRE, introduced by Decree-Law 79/2017 of 30 June 2017.

[7] A company is insolvent when it is not able to pay the debts that have fallen due (Article 3(1) of the CIRE). Company directors/management have a legal obligation to submit an application for insolvency within thirty days of becoming aware of the insolvency situation (Article 18(1) of the CIRE). Breach of this legal obligation could lead to the insolvency being classified as culpable.

Subsequent to the analysis of the initial application and the documentation provided by the debtor, the court issues a decision granting the initiation of the PER procedure by appointing a provisional judicial administrator. The debtor is subject to the duty to invite all its creditors to participate in the negotiations.

As a general rule, beginning the PER prevents any enforcement action against the company for the collection of debts. This includes any insolvency proceedings, as long as insolvency has not yet been declared. Current legislation establishes that enforcement actions to recover amounts owed to employee's are excluded from this rule.

The PER does not remove the debtor's management powers and powers to represent the company. However, during the PER, the debtor is prevented from carrying out acts of special importance without first obtaining authorisation from the provisional judicial administrator.

The maximum period for PER negotiations is three months (the rule is two months, which can be extended for a further one month). Therefore, it is possible to obtain judicial approval and ratification of a recovery plan in a short period of time (in some cases approximately between four and six months).

The recovery plan is binding on all creditors, even if they did not participate in the negotiations, as long as approved by the required majorities. Its content must comply with two fundamental principles: the principle of equality of creditors and the *no creditor worse off* principle.

Current legislation does not allow a company to open a new PER if the decision to approve the recovery plan in force was made less than two years ago. There is an exception for situations in which (i) the company has fully implemented the recovery plan or (ii) in which there are factors unrelated to the recovery plan itself and that were outside the control of the company.

According to the PER Evaluation Report dated 8 July 2020:

> 'from 2012 until the end of 2019, the PER has enabled the recovery of numerous companies that would otherwise not have had at their disposal a mechanism capable of enabling their recovery, better serving the interests of the debtor and the respective creditors, also safeguarding countless jobs. In effect, the number of companies with approved recovery plans which have not resorted to special revitalisation processes or insolvency proceedings is 55.5%. This demonstrates the extent to which the economy has embraced the PER.
>
> Another not insignificant factor that shows the good performance of the Special Revitalisation Process is the fact that more than 40% of the cases in which companies

resorted to this process managed to obtain an agreement in order to continue their activity. This figure shows that the PER has served its purpose of safeguarding jobs and the economic fabric.[8]'

1.4 RERE

The RERE has been in place since March 2018. It begins with a written agreement (called a negotiation protocol), signed by the debtor and by at least 15% of the non-subordinated creditors stating that the signatories are interested in negotiating a restructuring agreement, which is deposited at the Commercial Registry.

The RERE is voluntary in nature and the parties are free to apply or to sign up for it. As such, the debtor can call on all or only some of the creditors. It should call on the ones it considers most suitable to achieving the restructuring agreement and its desired viability (and/or those whose rights are affected under the restructuring agreement).

The procedure will be confidential, except where there is an agreement between the parties or for exceptions of a legal nature: the tax authority, the social security department and the employees must be informed of the deposit of the negotiation protocol and of its content whenever they are owed money by the debtor.

The deposit of the protocol gives rise to a specific set of obligations to the debtor and signatory creditors, in particular with respect to (i) the suspension of any judicial proceedings and as to (ii) the running of any time limits to petition for insolvency. Essential public utilities, such as electricity, natural gas, water, sewage and electronic communication, cannot be suspended while negotiations continue.

The negotiation period may last a maximum of three months from the date of deposit of the negotiation protocol. The negotiations close with the deposit of the restructuring agreement, which will be effective as of the deposit date and only for the future (except if otherwise agreed under the agreement itself). Also, it only binds the signatories[9].

The parties are free to establish the content of the restructuring agreement and it is not subject to the same principles of an insolvency plan or a PER (equality

[8] In statement of reasons of Draft Law 115/XIV/3.ª of the Government of 8 October 2021 (doc.pdf (parlamento.pt)).

[9] The main difference to the PER, besides its judicial nature, is the fact that it binds all creditors, even if they have not participated in the negotiations.

of the creditors and *no creditor worse off*). The restructuring agreement also allows for tax benefits if the restructured credits represent at least 30% of the debtor's total liabilities.

If the restructuring agreement is signed/agreed to by creditors representing the legal majorities required for the approval of a PER[10], the debtor can obtain the formal judicial approval of the restructuring agreement with a cramdown effect in relation to the creditors not signing/approving the RERE.

The conclusion of the negotiations without the approval of a restructuring agreement has no effect for the debtor (specifically, with respect to its potential situation of insolvency).

This proceeding has no fixed costs[11] and can be done in 'one shot' (skipping the negotiation period), by presenting the negotiation protocol and the restructuring agreement at once if all requirements are met[12].

2 COVID-19

2.1 Exceptional times, exceptional measures

Following the international public health emergency caused by COVID-19, many Member States of the European Union declared the national state of emergency, that led to the mandatory confinement of citizens and, consequently, to the paralysis of a number of activities. These circumstances created a situation of financial constraint for businesses due to a lack of liquidity and, in many cases, this has prevented the fulfilling of payment and other contractual obligations vis-à-vis creditors.

As an initial reply to COVID-19 pandemic impact, the only direct, exceptional and temporary measure regarding the legal framework of insolvency and restructuring approved by the Portuguese authorities was to suspend the time

[10] As provided for in Article 17-F(5) of the CIRE.

[11] In this particular respect, much different from the UK's 'English Scheme'.

[12] Nuno Líbano Monteiro and Catarina Guedes de Carvalho, 'Adjusting a pre-insolvency scheme to respond to the COVID-19 crisis', Eurofenix – INSOL Europe, Summer 2020, pp 26–27.

limit for the debtor itself to petition for insolvency[13], with effect from 7 April 2020[14] and that is still in force (until it is repealed by a law yet to be published).

The Portuguese Government has implemented other measures to support businesses affected by COVID-19, such as: (i) legal moratorium that covered all types of lending transactions entered into between regulated entities in Portugal and borrowers domiciled in Portugal[15]; (ii) financial support that took the form of State guarantee schemes[16]; (iii) simplified lay-off procedures; (iv) rent moratoriums and suspension of termination of lease agreements; (v) exemption/reduction or extension of the deadlines of some tax duties; (vi) suspension or interruption of time limits, acts or steps on certain legal proceedings[17].

These measures, although not directly related to insolvency and restructuring matters, had a direct impact on the economy and, to that extent, also impacted the effects generated by the pandemic crisis in that sector, particularly in the (un)need to resort to insolvency or preventive restructuring frameworks[18].

2.2 Further extraordinary and transitional arrangements

As the economic crisis worsened, it quickly became clear that a further legislative response was needed in the insolvency and restructuring area. The Portuguese Government could have chosen to adapt the procedures that already existed: the abovementioned PER and/or RERE. Or it could have taken advantage of this moment to implement the Directive. However, the urgency of

[13] As previous mentioned, company directors/management have a legal obligation to submit an application for insolvency within thirty days of becoming aware of the insolvency situation (Article 18(1) of the CIRE) and breach of this legal obligation could lead to the insolvency being classified as culpable.

[14] Law 1-A/2020 of 19 March, with the most recent amendments, resulting from Law 13-B/2021 of 5 April, which provides for the maintenance of this suspension – that is still in place. However, there is no impediment to the debtor itself, or any creditor, beginning insolvency proceedings.

[15] The moratorium might be applied to principal and interest or just to principal payments at the option of the beneficiary entity. The moratorium allowed borrowers to benefit from a suspension of payment obligations for principal between 31 March and 30 September 2020 (in some cases until 31 December 2021). Interest continued to accrue and would be capitalised.

[16] Under which the Government provided a guarantee of between 80% and 90% to financial institutions that provide loans to impacted businesses, measures to support start-up companies with a total value of approximately EUR 267.3 million, and also non-refundable grants to cover eligible costs.

[17] Related information on these topics available in 'INSOL – World Bank Group Global Guide – Measures adopted to support distressed businesses through the COVID 19 crisis – Portugal', INSOL International and The World Bank Group, May 2021 (globalguide.pdf (worldbank.org)).

[18] Indeed, we faced a decrease in insolvency proceedings (probably also due to the suspension of the time limit for the debtor itself to petition for insolvency) and PERs initiated in 2020 and 2021 (number of insolvency proceedings: 11597 in 2019, 9733 in 2020 and 9202 in 2021; number of PERs: 476 in 2019, 388 in 2020 and 294 in 2021) (Economic justice (justica.gov.pt), Quarterly Statistical Highlight – 4th Quarter 2021 (justica.gov.pt)).

the situation was not conducive to its implementation, particularly in view of all the choices the Directive left to the discretion of the Member States and to the complex and slow work that would imply for the Portuguese legislature.

As such, it was decided to create a new extraordinary and transitional legal framework, aimed exclusively at companies that are in a difficult economic situation or an insolvency situation, whether imminent or current, due to the COVID-19 pandemic, and that are viable: the Extraordinary Business Viability Process (**PEVE** – *Processo Extraordinário de Viabilização de Empresas*), approved by Law 75/2020 of 27 November 2020 (**Law 75/2020**).

2.3 PEVE

The objective of the PEVE is to obtain judicial approval of a debt restructuring agreement (the viabilisation agreement) established out of court between the company and its creditors. It is a hybrid procedure in nature which falls into the set of instruments typically called 'fast-track-court-approval-procedures'. There is an out-of-court part (negotiation and conclusion of the agreement) and a part to be handled before the courts (ratification of the agreement).

The PEVE begins with an application to be filed by the debtor company (it is a voluntary process) and the following documents (among others) must be presented: (i) a declaration signed by the management body attesting that its situation is due to the COVID-19 pandemic (namely by providing proof that on 31 December 2019 the company's liabilities were less than its assets[19]) and that it meets the conditions necessary for its viability, and (ii) the viability agreement, signed by creditors that represent the legal majorities required for the approval of a PER[20]. Finally, the company may not have any PER pending.

In order to ensure that it is processed particularly quickly, in addition to shortening the time limits and eliminating the phase of claiming credits, priority

[19] That is, in practice, it must provide evidence that its difficulties stem from the pandemic situation. There are two exceptions: micro and small businesses, where the liabilities may exceed the assets, and businesses which, although not in the black at 31 December 2019, have managed to regularise their financial situation under the transitional provision allowing the use of the RERE by businesses in a situation of insolvency (in the initial transitional period of 18 months, which ended on 2 September 2019, the declaration from a certified accountant certifying that the company is not in a current insolvency situation was not required).This measure is similar to the German one, where the Government approved the suspension of the obligation to submit an application for insolvency when it was caused by COVID-19 crisis and a provision was made for a presumption to facilitate its application: the insolvency is the consequence of the COVID-19 crisis whenever, as at 31 December 2019, the company was not insolvent or had the prospects to avoid it – see § 1 da Gesetz zur Aussetzung der Insolvenzantragspflicht und so weiter, das COVID-19 Insolvenzaussetzungsgesetz (COVInsAG), from 27 March 2020.

[20] As provided in Article 17-F(5) of the CIRE.

is given to this extraordinary procedure over the other equally urgent procedures (insolvency proceedings and the PER).

The PEVE has the virtue of suspending debt recovery and insolvency proceedings, provided insolvency has not yet been declared. It also prevents the suspension of essential public services provision. As is the case of the PER, acts of special importance may not be carried out without the prior consent of the provisional judicial administrator.

One of the main virtues of the PEVE is that, to promote financing and self-financing, a general moveable credit privilege is granted to all those who finance the company's activity, to make it effectively viable. This includes shareholders or other persons in a special relationship with the debtor. There is also a safeguard for the maintenance of the guarantees agreed between the company and its creditors and a provision for the non-application of any clawback for the benefit of the insolvent estate of any legal transactions set out in the viability agreement that have included the effective provision of new loans to the company[21].

Without prejudice to the general principle of intangibility of tax and social security credits, which remains unaffected, express provision is made for the possibility of reducing the rate of interest on arrears, under an approved agreement leading to the financial consolidation of the company, as well as other tax benefits (identical to those of the PER and RERE)[22].

As in the RERE, the non-ratification of the viabilisation agreement results in the termination of the proceedings and the extinction of all its effects and it has no effect on the company with regard to its possible insolvency situation.

The PEVE may only be used once. When it comes to an end, and regardless of whether the viabilisation agreement is ratified or not, the company cannot make use of this procedure again.

Sharing the opinion of Professor and Supreme Court judge Catarina Serra[23], 'the PEVE is not much more than a selection of already known provisions

[21] Nevertheless, as in insolvency and in the PER, the content of the plan must comply with two fundamental principles: the principle of equality of creditors and *no creditor worse off* principle.

[22] If the tax and social security debts are paid within 30 days of the ratification of the agreement, it will be possible to obtain full forgiveness of any late payment interest due. As in the RERE, parties may benefit from the emolument and tax benefits of the CIRE (corporate income tax, stamp duty and IMT – municipal property transfer tax), provided that the restructuring agreement covers at least the restructuring of debts that represent 30% of the total non-subordinated liabilities.

[23] Catarina Serra, 'O Processo Extraordinário de Viabilização de Empresas (PEVE) e outras medidas da Lei n.º 75/2020', Revista de Direito Comercial, November 2020, p 2026.

originated in the PER procedure (...)' and therefore the question is raised 'regarding the legislative policy option (...) if this new creation was really necessary and it would not be enough to adapt some of the already available instruments' and if it is adequate to the real needs of enterprises.

At the same time and in addition, the Government has decided to make one-off changes to provide the existing judicial instruments for recovery with mechanisms for adapting to the COVID-19 pandemic, including: (i) the possibility to grant additional time for the conclusion of the negotiations within the framework of the PER and for the proponent of an insolvency plan to adapt it; (ii) the application of the RERE to companies that were insolvent as a result of the COVID-19 pandemic but still likely to become viable and which could demonstrate that on 31 December 2019 their assets exceeded their liabilities or, although not in a positive net position on 31 December 2019, have managed to regularise their financial situation under the transitional provision allowing the use of the RERE by companies in an insolvency situation, on condition that they have deposited the restructuring agreement in due time; (iii) in cases where non-compliance with the approved insolvency plan was based on events occurring after 7 April 2020, the 15-day period to regularise the situation only began to run after this provision ceased to be in force (i.e., 31 December 2021); (iv) the obligation to make *pro rata* payments in all pending insolvency proceedings where the liquidation proceeds deposited exceed EUR 10,000, by implementing a simplified procedure, provided that certain additional legal requirements were met; and (v) priority was given to the processing of applications for the release of securities or guarantees granted under insolvency proceedings or PERs[24].

Law 75/2020 entered into force on 28 November 2020 and, with regard to the PEVE, it remains in force until 30 June 2023. The other exceptional and temporary measures provided for therein ceased their effects on 31 December 2021.

3 Law 9/2022 of 11 January 2022 – implementation of the Directive

3.1 The legislative context

The statement of reasons of Draft Law 115/XIV/3.ª of the Government of 8 October 2021[25] provides some useful insights into what, in essence, moved the Portuguese legislature. In recent years the number of pending insolvency proceedings has been reduced as well as the average duration of the procedural

[24] Articles 2, 4, 5, 16 and 17 of Law 75/2020.

[25] doc.pdf (parlamento.pt).

stages until the (final) decision. Notwithstanding, the length of this type of proceedings was still identified as one of the key factors preventing various economic agents from operating in a more competitive and agile market, also significantly influencing the value of these assets in the secondary market, since the results of these proceedings, measured as payments to creditors, are considered insufficient. Considering the constraints identified and with a view to removing any remaining entropies, it was essential to speed up insolvency and recovery procedures, thus making the judicial system more efficient and resilient, to the benefit of micro, small and medium-sized enterprises and national investors and, consequently, employees. This aspiration was transposed to the 'Recovery and Resilience Plan – *Recuperar Portugal, Construindo o futuro*' (**RRP**)[26] in its Component 18, entitled 'Economic Justice and Business Environment'[27].

Given the stabilisation of the exceptional legislative process due to the pandemic and the need to comply with the incorporation/implemetation of the Directive, on 8 October 2021 Government Draft Law 115/XIV/3.[a] was published (**Draft Law**). The Draft Law aims primarily to incorporate the Directive into Portuguese law and, at the same time, gives legal substance to a set of measures envisaged in Component 18 of the PRR, with the objectives to speed up insolvency and recovery processes, which may have an impact, in particular, on the payment of creditors, thus making the judicial system more effective and resilient.

Although public discussion has taken place and institutional entities have been heard[28], it turned out to be a surprisingly fast legislature procedure. In only three months, the Draft Law – with some minor changes – was transformed into

[26] The RRP is a nationally applicable programme, with an exceptional implementation period lasting until 2026. The RRP will implement a set of reforms and investments aimed at restoring sustained economic growth, supporting the goal of convergence with Europe over the next decade. The European Council, faced with the serious impacts of the pandemic on European economies, has created Next Generation EU, a strategic instrument to mitigate the economic and social impact of the crisis; this is capable of promoting economic convergence and resilience, helping to ensure long-term sustainable growth and meeting the challenges of the transition to a greener and more digital society. The Recovery and Resilience Mechanism has been developed on the basis of this instrument, and the RRP fits into this framework. The RRP is an investment plan for all Portuguese people, based on three structuring dimensions: Resilience; Climate Change; and Digital Transition (Plano de Recuperação e Resiliência português (recuperarportugal.gov.pt)).

[27] Pages 184–188 of the RRP dated 22 April 2021 (PRR.pdf (recuperarportugal.gov.pt)).

[28] The Draft Law provided that, in view of the matter, during the legislative process that took place in the Portuguese Parliament the following should be heard: Portuguese Association of Judicial Administrators, Portuguese Banking Association, Portuguese Judges' Trade Union Association, Commission for the Monitoring of Justice Assistants, National Council of Financial Supervisors, Supreme Judicial Council, Supreme Council of the Public Prosecutor's Office, Bar Association and Public Prosecutors' Trade(www.parlamento.pt\\ActividadeParlamentar\\Paginas\\DetalheIniciativa.aspx?BID=121187).

Law: Portuguese Law 9/2022 of 11 January 2022[29], that came into force on 11 April 2022 (**Law 9/2022**).

The legislator's effort to meet the defined objectives is recognized; however, considering the significant changes foreseen, it is regrettable that a longer discussion period was not granted in order to take a better advantage of this legislative opportunity. This could have avoided some flaws and inconsistencies, both as regards the clarification and correction of some procedural and substantive aspects on which there was imprecision in the law or the need to intervene due to case law, and as regards the requirements in the incorporation of the Directive. Let us hope that these will not have a significant impact on its practical application, which only time will tell.

3.2 Legislative amendments

Law 9/2022 transposed the Directive, established measures to facilitate and accelerate the course of corporate restructuring procedures and repayment plans and amended the CIRE and related legislation.

Contrary to other legal systems, such as the German one, in Portugal it was not necessary to create a preventive restructuring procedure for companies *ex novo*, but only to introduce changes to the existing rules to ensure compliance of the PER with the Directive[30].

As above mentioned, at the same time, a set of amendments were foreseen to simplify the course of insolvency and recovery proceedings, with the aim of making the judicial system more efficient and resilient, in execution of Component 18 of the RRP and in implementation of the Directive, which also includes measures to facilitate the course of proceedings and further reduce the length of procedures.

As also mentioned, the opportunity was also taken to clarify and correct procedural and substantive aspects about which there was imprecision in the law or the need to intervene due to legal doctrine and case law, including of the Constitutional Court.

[29] Law 9/2022 of 11 January 2022 originates in Draft Law 115/XIV/3.ª of the Government (0000300031.pdf (dre.pt)).

[30] The Portuguese legislature decided to only introduce changes in the PER. However, the RERE also corresponds to the type of instruments envisaged in the Directive and no justification was given for the 'omission' of adjustments to the RERE. The same applies to the PEVE – although, due to its extraordinary and temporary nature, it is perfectly understandable why it has not been amended in this context.

We start to briefly highlight some of the main amendments to the PER and the insolvency proceedings introduced in view of the need to implement the Directive[31]:

Obligation of the debtor – other than micro, small and medium-sized enterprises[32] (SMEs) – to submit a proposal for the classification of creditors affected by the recovery plan into distinct classes[33]:

According to the Directive[34], class formation means the grouping of affected parties with the purposes of adopting a plan in such a way as to reflect their rights and the seniority of their claims and interests. The formation of classes is also a precondition for the application of a cross-class cram-down, i.e., the imposition of the plan on dissenting classes of affected creditors, under certain conditions, through its judicial approval[35].

As this is a measure that breaks with Portuguese legal tradition regarding payment preferences and as the situation of SMEs deserves special attention specifically imposed by the Directive[36]– it allows opting out of treating the

[31] Due to the quantity and scope of amendments and considering the purpose of the present paper, we do not allow ourselves to proceed to a detailed description and analysis of all the amendments introduced by Law 9/2022.

[32] The definition of micro, small and medium enterprises appear in Article 2 of the annex to Decree-Law 372/2007 of 6 November: enterprises that employ less than 250 people and whose annual turnover does not exceed EUR 50 million or whose annual balance sheet total does not exceed EUR 43 million.

[33] Article 17-C(3)(d) of the CIRE.

[34] Recital (44) of the Directive.

[35] Catarina Serra, 'Enquadrar a recuperação das PME (rectius: MPE) à luz da Lei n. 9/2022, de 11 de Janeiro', Revista de Direito Comercial, February 2022, p 456, and Catarina Serra, 'Formação de categorias e aprovação do plano de recuperação no quadro do Processo Especial de Revitalização – Primeiras observações críticas à Lei n.º 9/2022, de 11 de janeiro', *in* the Conference 'O Plano de Recuperação e Resiliência para a Justiça Económica e a transposição da Diretiva 2019/1023, do Parlamento Europeu e do Conselho', Ministry of Justice and General Secretariat of the Ministry of Justice, Ebook 2022, p 19 (E-bookCONF-PRR-VF2.pdf (justica.gov.pt)).

[36] Recital (17) of the Directive: 'Enterprises, and in particular SMEs, which represent 99 % of all businesses in the Union, should benefit from a more coherent approach at Union level. SMEs are more likely to be liquidated than restructured, since they have to bear costs that are disproportionately higher than those faced by larger enterprises. SMEs, especially when facing financial difficulties, often do not have the necessary resources to cope with high restructuring costs and to take advantage of the more efficient restructuring procedures available only in some Member States. In order to help such debtors restructure at low cost, comprehensive check-lists for restructuring plans, adapted to the needs and specificities of SMEs, should be developed at national level and made available online. In addition, early warning tools should be put in place to warn debtors of the urgent need to act, taking into account the limited resources of SMEs for hiring experts'.

affected parties in separate categories of creditors, with the previous rules applying to them[37]. Thus, this safeguards the existence of a more flexible preventive restructuring framework, allowing for adjustment to the specific characteristics of this type of companies – although this is the only reference to SMEs introduced by Law 9/2022.

The Directive also refers the need to regulate the formation of classes based on verifiable criteria, in accordance with national law[38]. However, we should note the absence of that criteria, since the new Portuguese rule merely foresees a reference to the 'existence of sufficient common interests'[39], adding five exemplificative (but not exhaustive) types of classes[40].

The order appointing the provisional judicial administrator (i.e., the preliminary order issued in the PER) will prevent any enforcement action against the company for the collection of debts, for a maximum period of four months (which may be extended for one month on a well-founded basis), and it will also cause the suspension of actions that have already been brought against the company for the same purpose[41]:

Another relevant amendment resulting from the mandatory implementation of the Directive is the suspension of enforcement measures for a maximum period of four months. It is provided that the judge can extend the suspension for one month if one of the following situations occurs: (i) significant progress has been made in the restructuring plan negotiations; (ii) the extension is essential to ensure the recovery of the company's activity; or (iii) the continuation of the suspension of the enforcement measures does not unfairly prejudice the rights or interests of the affected parties.

Notwithstanding the above, the judge may order the termination of the suspension if it no longer serves the purpose of supporting the negotiations on the recovery plan or at the request of the company or the provisional judicial administrator.

[37] Article 17-C(4) of the CIRE.

[38] Article 9(4) of the Directive.

[39] The Portuguese law requires, firstly, a division into classes according to the nature of the credits (secured, privileged, common and subordinated) and then, among these, an optional additional division into classes depending on the existence of sufficient common interests (Article 17-C(3)(d) of the CIRE).

[40] The five classes are the following: (i) employees, regardless of the type of contract; (ii) equity holders; (iii) banks that have financed the company; (iv) suppliers of goods and service providers; and (v) public creditors (Article 17-C(3)(d) of the CIRE).

[41] Article 17-E(1) to (4) of the CIRE; recital (35) of the Directive.

The negotiation period between the debtor and its creditors (of two months that can be extended for one month) is maintained[42] and this new stand-still period (called 'suspension of enforcement measures'), of up to five months, is created.

Enforcement actions to recover amounts owed to employee's are excluded from the above rules – which is in line with the Directive[43] and based on easily understandable and acceptable reasons related to the special protection that these creditors deserve.

It is also clarified that, during the period of suspension of the enforcement measures, the company is released from the duty to file for insolvency, and insolvency proceedings in which it had previously filed for insolvency will be suspended, as long as the decision declaring the insolvency has not been handed down[44].

The concept of 'essential executory contracts' is extended to include not only essential public services but all continuous performance contracts necessary for the company to pursue its day-to-day activity[45]:

This ensures that, during the period of suspension of the enforcement measures, creditors cannot refuse to perform, terminate, accelerate, or unilaterally modify essential executory contracts to the detriment of the company, in respect of debts constituted prior to the suspension where the sole ground is non-payment of such debts[46]. It includes any contracts for the supply of goods or services whose suspension would lead to the paralysis of the company's activity.

To the same extent, and in return, the price of goods or services essential to the company's activity provided during the suspension period that are not paid will be considered a debt of the insolvent estate[47] in any insolvency of the same company declared within two years as of the end of the suspension period.

These new rules also results directly from the Directive[48].

New regime of so-called 'ipso facto' clauses[49]:

42 Article 17-D(7) of the CIRE.

43 Recital (61) and Article 6(5) of the Directive.

44 Articles 18(2)(a) and 17-E(9) of the CIRE.

45 Article 17-E(10) to (12) of the CIRE.

46 This excludes all defaults that are not related to non-payment (although this must be coordinated with *ipso facto* clauses' regime).

47 Meaning a super senior credit vis-à-vis the insolvency claims.

48 Recitals (41) and (56) and Article 7(4) of the Directive.

49 Resulting from recital (40) and Article 7(5) of the Directive.

With a view to protecting the company and like the pre-existing rule on insolvency, it is now provided the nullity of any contractual clauses that give the following events the value of a resolutive condition: (i) the application to open a PER, (ii) the opening of a PER, (iii) the application for an extension of the suspension of enforcement measures, or (iv) the granting of such a suspension. The same applies if such a clause gives the other party a right to compensation or termination of the contract[50].

The legislator was quite clear in establishing concrete events that may not lawfully serve as grounds for the verification of a resolutive condition. Therefore, it seems that only these events are banned, so that clauses allowing contractual termination on other grounds may be allowed as a ipso facto clause[51].

Regarding the insolvency procedure, it was clarified that the nullity only invalidates clauses that attribute the value of a resolutive condition to the declaration of insolvency[52]. By referring specifically to the declaration of insolvency – i.e., to the judicial declaration of insolvency by a court and no longer generically to the situation of insolvency – it was made clear that this event alone cannot lawfully serve as a basis for a resolutive condition. In other words, filing for insolvency is allowed as a ipso facto clause. Indeed, if there were any doubt, Article 119(3) of the CIRE reinforces that any event prior to the declaration of insolvency may lawfully serve to trigger the application of a resolutive condition – which, however, goes in the opposite direction to what is foreseen in Article 17-E(3) for the PER.

Additional protection granted to 'financing acts' of the debtor, either in the course of the PER ('interim financing') or in the execution of the approved plan ('new financing')[53]:

To promote financing necessary for the successful negotiation and implementation of a restructuring plan, the Directive envisage the adoption of incentives to encourage new lenders to take the enhanced risk of investing in a viable debtor in financial difficulties[54].

50 Article 17-E(13) of the CIRE.

51 However, the wording of Article 17-E(13) of the CIRE does not comply in its entirety with recital (40) of the Directive, since it is not included a reference to clauses which give the negotiation of a restructuring plan the same termination or compensatory value. According to the Directive, such clauses must also be declared null and void. This is one of the examples that should have motivated the Portuguese legislator to also introduce changes in the RERE and the PEVE.

52 Article 119(1) of the CIRE.

53 Article 17-H of the CIRE.

54 Recitals (66), (67) and (68) and Articles 17 and 18 of the Directive.

As such, additional protection is now granted to financing acts of the company, in the following terms: (i) creditors that finance the company's activity to provide it with capital for its revitalization, during the course of the PER or in the execution of the recovery plan, enjoy a credit over the insolvent estate up to a value corresponding to 25% of the company's non-subordinated liabilities at the date of the declaration of insolvency, if the insolvency is declared within two years of the date of the final and unappealable decision approving the recovery plan; (ii) credits made available above that amount (of 25% of the company's non-subordinated liabilities at the date of the declaration of insolvency) will enjoy a general preferential credit privilege that ranks ahead of the general preferential credit privilege granted to the employees[55]; (iii) claims arising out of financing made available to the company by creditors, partners, shareholders or equity holders and any other persons in a special relationship with the company in execution of the recovery plan, will enjoy the general preferential privilege that ranks above the general preferential privilege granted to employees; (iv) credits arising from both interim and new financing may not be subject to paulian actions[56]; (v) the interim financing and the new financing cannot be declared void, voidable or unenforceable; (vi) anyone granting interim financing and new financing may not incur, by virtue of that financing, in civil, administrative or criminal liability on the grounds that the financing is detrimental to the creditors as a whole, except in cases expressly provided for by law.

All these rules derive from the transposition of the Directive and are welcome as they strengthen the position of new lenders. In other words, the legislator reinforced lender's repayment possibilities by reducing their risk and thus encourage financing.

The content of the recovery and insolvency plans are set out in detail[57]:

In compliance with mandatory transposition's rules[58], the contents of both the recovery and the insolvency plan, as well as the contents of the homologation court decision, are set out in greater detail.

Now, among other aspects, the plan must contain (i) a statement of reasons containing a description of the causes and extent of the company's difficulties and explaining why there is a reasonable prospect that the plan will prevent its

[55] In essence, this 'economic' solution was already present in the previous version of Article 17-H(2) of the CIRE. Practical experience has shown that granting this benefit is not a relevant element for obtaining financing.

[56] That is, actions by creditors to have certain transactions by their debtors declared void as prejudicial to their interests.

[57] Articles 17-F (for the recovery plan) and 195 (for the insolvency plan) of the CIRE.

[58] Recital (42) and Article 8 of the Directive.

insolvency and ensure its viability (in case of the recovery plan), (ii) the parties affected and not affected by the content of the plan, together with a description of the reasons why the proposed plan does affect, or does not affect, the relevant parties, (iii) the ways in which the employees' representatives are informed and consulted, the position of the employees in the company and, where appropriate, the general consequences as regards employment, namely dismissals, temporary reduction of normal working hours or suspension of employment contracts[59], and (iv) any new financing provided for under the plan and the reasoning for such new financing being necessary to execute the plan.

New plan approval regime in case of classes formation, becoming binding upon dissenting voting classes ('cross-class cram-down')[60]:

Portuguese law allows that, when there is classes formation[61], the plan is considered approved in any of the ways set out in Article 17-F(5)(a) of the CIRE, which means that, the plan is approved, not only (i) when it obtains the favourable vote of all the voting classes (*stricto sensu* approval rule), but also (ii) when it is approved by the majority of the voting classes, provided that at least one of those classes is a secured creditors class or, failing that, (iii) at least one of them is a non-subordinated creditors class or, (iv) in the event of a tie, when it is approved by at least one of a non-subordinated creditors class. This means that, where there are only two classes of creditors, the consent of at least one class should be deemed to be sufficient to approve the plan – which is, indeed, allowed by the Directive[62].

The fact that it is accepted that the plan is deemed to be approved even when not approved by all the classes means that the option to form classes always carries with it the possibility of approval of the plan and, with it, the imposition of the plan on the dissenting classes of creditors.

[59] As a result of recital (61) and Article 8(1)(g)(iii) and (iv) of the Directive.

[60] In light of recitals (53), (54) and (55) and Article 11 of the Directive.

[61] That is optional for SMEs' debtors – Article 17-C(4) of the CIRE.

[62] Recital (54) of the Directive. However, in the preamble of paragraph (a)(5) of Article 17-F of the CIRE, it is stated that, for the approval of the plan in each of the classes, it is necessary that it is approved by more than two thirds of all the votes cast – and not of the voting credits rights. As such, it can happens that the plan may be approved by a class without having been approved by a majority of the total voting rights of that class. In fact, it is not possible to ensure that two thirds of the votes cast correspond to a majority (neither simple nor, much less, qualified) of the total voting rights existing in relation to the total liabilities of the company. Under these circumstances, it will nevertheless be possible to impose the plan on those who have not approved it, even though they may be more representative in terms of the total value of the company's liabilities than those who have approved it.

As stated in the Directive[63], 'equity holders of SMEs that are not mere investors, but are the owners of the enterprise and contribute to the enterprise in other ways, such as managerial expertise, might not have an incentive to restructure under such conditions. For this reason, the cross-class cram-down should remain optional for debtors that are SMEs'.

Provisional judicial administrator's obligation to submit to court a reasoned opinion on whether the recovery plan has reasonable perspectives of preventing the insolvency of the company or ensuring its viability[64]:

It was established – as a solution that already exists in the PEVE[65] – the obligation of the provisional judicial administrator to send to the court, together with the documentation of the outcome of creditors' vote, a reasoned opinion on whether the plan has reasonable prospects of avoiding the insolvency of the company or ensuring its viability.

The judge must then assess the reasonableness of those prospects in the confirmation decision, as a necessary basis for the approved plan[66]. One of the most profound innovations of the Directive is, indeed, this judgment of merit carried out on the plan.

The main objective of these measures is to avoid PER being misused. We should note, however, that the reasoned opinion requires special knowledge on financial management and forecasted economic and financial viability projects and that the vast majority of Portuguese judges and judicial administrators, due to their academic training and professional experience, are not qualified for that. It is clearly a new role that puts a different focus on the specialisation and education of judges and judicial administrators.

Considering the relevance attributed to preventive restructuring frameworks by the Directive, and similarly to what was done for the PER, **changes were also introduced in the PEAP**[67], in order to also facilitate and accelerate the course of this special procedure for payment agreement.

The Directive also requires that debtors are ensured access to one or more clear and transparent **early warning tools** that allow the detection of circumstances that may give rise to a likelihood of insolvency and warn debtors of the need to

[63] Recital (58) of the Directive.

[64] Article 17(F)(4) of the CIRE. Recital (24) and Article 8(1)(h) of the Directive.

[65] Article 9 of the PEVE. But it has not yet been much tested in practice, due to the low number of PEVEs so far.

[66] Article 17(F)(7)(g) of the CIRE. Recital (50) and Article 10(3) of the Directive.

[67] Articles 222-C to 222-J of CIRE.

act without delay[68]. In this respect, Portugal was also already aligned with European legislation, as Decree-Law 47/2019 of 11 April 2019 created the early warning mechanism for companies' economic and financial situation ('*Mecanismo de Alerta Precoce*'). To that extent, in order to ensure full compliance of the mechanism with the Directive, it was extended to all companies, not only to SMEs enterprises, including even those that do not show signs of activity.

In what regards the amendments foreseen in Law 9/2022 in order to facilitate and accelerate the course of insolvency and recovery proceedings, in view of the need to implement the Directive and with the aim of making the judicial system more efficient and resilient, we highlight the following:

Shortening the length of income assignment from five to three years, for all individuals, to get discharge from their debts ('fresh start')[69]:

In the strict context of the transposition of the Directive, the period of income assignment has been reduced from five to three years[70],[71], thus guaranteeing faster access to a fresh start for insolvent debtors.

Besides the reduction of this period, it is also foreseen the possibility that, at the end of assets liquidation, it will still be possible for the trustee, during the assignment' period, to seize and sell assets that are then part of the debtor's assets and, subsequently, to allocate the respective sale proceeds to the creditors, in the same manner as the available income, thus avoiding the creation of situations of unjust enrichment[72].

Insolvency administrator's task of drawing up a liquidation plan for the sale of insolvency estate assets:

In case it is decided by the creditors that the insolvency proceedings should proceed to liquidation (instead of to a presentation of an insolvency plan), the insolvency administrator must present a liquidation plan for the sale of the

68 Recital (70) and Article 3 of the Directive.

69 Article 235 of the CIRE. Recital (5) and Articles 20 and 21 of the Directive.

70 The initial planned reduction included in the Draft Law was to thirty months; Law 9/2022 changed this period to three years, i.e. to the maximum discharge period provided for in the Directive. This period can be extended for up to three years, in certain specific conditions and under a well-grounded judicial application (Article 242-A of the CIRE).

71 In the pending insolvency proceedings of individuals on the date of entry into force of Law 9/2022, in which the request for discharge from debts has been preliminarily granted and where the ongoing period of income assignment has already completed three years, the said period shall be deemed terminated (Article 10(3) of Law 9/2022).

72 Article 241-A of the CIRE.

assets within ten days as of the first creditors' meeting (i.e., the meeting for the insolvency administrator's report analysis)[73].

This plan must contain definite deadlines and a list of specific steps to be taken. Failure to present the plan or its non-fulfilment with serious misconduct will constitute grounds for dismissal of the administrator[74].

This is the assignment of an additional task to the insolvency administrator that did not exist before and for which a short deadline is granted, in order to meet the aim of speeding up insolvency proceedings.

Mandatory interim distributions, if the case is not ready for final distribution:

Partial distributions are mandatory whenever EUR 10,000 or more is deposited in the insolvent estate and its ownership is not in dispute.

However, for this to occur, the decision declaring the insolvency must have become final and assets liquidation must have started. Furthermore, the deadline for challenging the list of creditors must have passed with no challenge being filed, or any challenge filed must already have been decided, and the case must not be in a position that allows final distribution to be prepared[75].

This measure, created in the context of exceptional legislature process due to COVID-19 and as a provisional measure (it was in force until 31 December 2021)[76], allowed to release financial resources in almost 1,000 cases that would otherwise be captive in the insolvency process. Due to its success, it has now been set forth in a mandatory and definitive manner.

Reduction of the majority required for the approval of the insolvency plan, with a view to facilitating its approval:

The insolvency plan is now approved with only 50% of all votes cast (instead of the previous two thirds), provided that more than half of the votes correspond to non-subordinated claims with voting rights[77]. The deliberative quorum of one third of the total credits with voting rights is maintained.

[73] If the decision declaring the insolvency has become final and creditors' resolutions taken at the first creditors meeting did not oppose to it – Article 158(1) of the CIRE.

[74] Article 169(a) of the CIRE.

[75] Article 178(1) of the CIRE.

[76] By Law 75/2020, as above mentioned.

[77] Article 212(1) of the CIRE.

Finally, Law 9/2022 also contains amendments which essentially aim to clarify and correct specific procedural or substantive aspects about which there was imprecision in the law, dissension in the doctrine or the need to intervene due to case law, and to promote a proper operationalization of the mechanisms in force, thus allowing a better and faster application of the law, with the consequently enhancing of the protection of creditors and debtors. The main ones are the following:

A declaration of insolvency will only be made following the non-approval or non-confirmation of the PER if the company, after being heard, does not oppose to it:

To overcome issues of unconstitutionality of the rule in the previous Article 17-G(4) of the CIRE[78], the applicable legislation was amended to ensure that a declaration of insolvency will only be made following the non-approval or non-confirmation of the PER if the company, after being heard, does not oppose to it[79]. If the company opposes, the judge will determine the closure and termination of the PER, and this will cancel all its effects.

On the other hand, this amendment also aims to mitigate the risk of insolvency declaration that hovers over the company during the PER.

Clarification of the exhaustive nature of subordinate claims' list and redefinition that claims held by persons in a special relationship with the debtor are subordinated provided that the special relationship already existed at the time of their constitution:

It was clarified that the list already contained in the law of which persons or entities are considered to be in a special relationship with the debtor as a natural or legal person is exhaustive[80].

The Law 9/2022 also redefined the provision that the claims held by persons in a special relationship with the debtor are subordinated, provided the special relationship already existed at the time of their constitution (and not acquisition), and by those to whom they were transferred in the two years prior

[78] The Constitutional Court' judgment no. 675/2018 of 23 January, declared the unconstitutionality with general mandatory force of the interpretation given to the previous Article 17-G(4) of the CIRE, in the sense of considering that the opinion of the provisional judicial administrator favourable to the insolvency of the debtor, is equivalent to the presentation of the debtor itself to insolvency, for violation of Article 20(1) and (4), in connection with Article 18(2), of the Constitution of the Portuguese Republic (Acórdão do Tribunal Constitucional n. 675/2018 | DRE).

[79] Article 17-G(5) and (6) of the CIRE.

[80] Article 49(1) and (2) of the CIRE.

to the start of the insolvency proceedings[81]. This amendment is in line with the majority and practically unanimous opinion of doctrine and case law and is of great practical relevance, particularly for credit assignment operations, where there was some discussion as to the risk that credits (originally common or even secured) acquired by entities in a special relationship with the debtor could become subordinated, i.e., be considered subordinated within the relevant insolvency proceedings.

Narrower view of 'de facto' administrator's concept:

A privileged or secured creditor who appoints a natural person to the management of the debtor is excluded from the concept of *de facto* administrator (and, as such, from to be considered in a special relationship with the debtor), provided that such person alone does not have special powers to dispose of the debtor's assets[82].

This rule confirms a more restrict view of the concept of *de facto* administrator, linking it only to concrete powers of assets disposal, leaving out other acts of management which may also characterise *de facto* administration. In other words, for these purposes, a position of informative superiority over the debtor's situation will not be relevant, but rather the possibility of having special powers to dispose, by himself, of the debtor's assets.

Changes to the course of procedural issue and to the assumptions and effects of culpable insolvency:

As for the culpable insolvency's procedural issue, in which the civil liability for the cause or worsening of the debtor's insolvency situation is ascertained, the peremptory nature of the deadline for its opening is expressly provided for and the scope of the respective patrimonial conviction is clarified: up to the maximum amount of the unpaid claims (according to the previous rule, the conviction was equivalent to the amount of the unpaid claims)[83].

It should be highlighted the following clarification: in the case of breach by debtor's directors of the duty to submit an application for insolvency or the obligation to prepare annual accounts within the legal deadline, submit these to due supervision or deposit at the commercial registry office, only the existence

[81] Article 48(a) of the CIRE.

[82] Article 49(4) of the CIRE.

[83] Articles 188(1) and 189(2)(e) of the CIRE.

of serious misconduct is assumed[84]. In other words, the causal link is no longer presumed, there being as there were a reversal of the burden of proof[85].

Clarification that the measures provided for in the insolvency plan affecting the debtor's liabilities do not affect the existence or the amount of the rights of insolvency creditors against co-debtors or third-party guarantors of the obligation:

This clarification is in line with the majority and practically unanimous opinion adopted by the doctrine and case law: measures provided for in the insolvency plan affecting the debtor's liabilities do not affect the existence or the amount of the rights of the insolvency creditors, namely those who vote in favour of the plan, against co-debtors or third party guarantors of the obligation, but these persons may only take action against the debtor by way of recourse under the same terms as the insolvency creditor could exercise his rights against him[86].

Definition of compensation claims arising from employment termination by the insolvency administrator after debtor's declaration of insolvency as being claims on the insolvency:

To settle a doctrinal and case law discussion, it was established that compensation claims arising from the termination of employment contracts by the insolvency administrator after the debtor's declaration of insolvency constitute claims on the insolvency (and not on the insolvent estate)[87].

In fact, there is no reason to differentiate the situation of employees (with regard to compensation rights) whose contract was terminated before the declaration of insolvency (insolvency creditors), from those whose contract was only terminated afterwards by the insolvency administrator – which is often only due to the inaction or negligence of the debtor – and who, for this only reason, could be considered creditors of the insolvent estate.

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[84] Article 186(3) of the CIRE.

[85] Since this is a liability for breach of legal provisions that provide for special professional duties, the doctrine used to understand that the causal link was presumed.

[86] Article 217(4) of the CIRE.

[87] New Article 47-A of the CIRE.

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Chapter 6

Insolvency and Restructuring of the Group of Companies: Cross-border Cooperation: Comparative Examination of Legal Regime and Practice in Romania, UK, and the United States

Nicoleta Mirela Nãstasie

1 Introduction

Groups of companies are often structured such that there is a parent company which has subsidiaries registered in several jurisdictions which it funds and manages. A group of companies facing financial difficulty must carefully consider various issues before promoting any course of action, be it judicial or otherwise, to increase the likelihood of ensuring a successful restructuring or recovery of assets. Many questions must be considered before establishing a cross-border restructuring plan for a group of companies. These questions concern the location of the group's assets and liabilities, the location and real value of the group's contracts, the location of employees, the availability of restructuring and liquidation procedures in appropriate jurisdictions and finally, the risks and benefits associated with each alternative.

To answer these questions, we have analysed three different legal systems, namely those of, Romania, the United Kingdom and the United States of America.

Imagine that there is a group of companies whose parent company and certain subsidiaries are registered in Romania whilst other subsidiaries are registered in several other regions around the world, including the UK and USA. The group is in financial difficulty and its representatives need to find a solution to restructure the global business and rescue the group's viable entities. There are serious issues to be considered before designing and implementing an appropriate restructuring plan.

2 International assistance and cooperation with foreign authorities in the UK, USA, and Romanian in cross-border insolvency: general considerations

The *common law* legal systems found in the United Kingdom and the United States of America are based on judicial precedent created by court decisions, characterised by flexibility and wide judicial discretion. The expectations in common law systems are for judges to find and develop appropriate procedural mechanisms to meet the objectives and general principles of different areas of law, including cross-border insolvency law[1].

The *common law* legal systems can be contrasted with the *civil law* system such as the Romanian *civil law* system, which is characterised by a systemic and coherent approach, through a set of general principles applicable to private international law. This situation may impose a limitation on the degree of freedom enjoyed by the judge in addressing the issue of judicial cooperation in cross-border insolvency. Compared to *common law* jurisdictions, the role played by Romanian judges is not to create legal precedents but to enforce regulations in an ingenious and creative way. Whilst the issues related to the group of companies in the European and Romanian context are new when compared to the rich case law in the UK and the US, this should not create barriers to cross-border cooperation.

The **United Kingdom** is recognised as a jurisdiction with universalist traditions, offering different mechanisms for cooperation in cross-border insolvency. A first legislative instrument, section 426 of the Insolvency Act 1986, is designed to assist insolvency proceedings in countries specified in the Act as being common law countries and countries that share legal traditions with the UK such as Australia and Ireland[2]. Regulation (EU) 2015/848 on insolvency proceedings (EIR Recast), applies to insolvency proceedings for debtors with a centre of main interests (COMI) located in the European Union (excluding debtors in Denmark) and was a relevant international legislative instrument for the UK until Brexit occurred. The UK Cross-Border Insolvency Regulations 2006 (CBIR)[3] came into force on 4 April 2006, implementing the UNCITRAL Model Cross-Border Insolvency Act 1997 (Model Law). There is a fourth mechanism for granting assistance and ensuring international cooperation using *common law* jurisprudence which empowers the courts to recognise and assist in foreign insolvency proceedings. The process is available using the

[1] P Omar, 'On the Origins and Challenges of Court-to-Court Communication in International Insolvency Law', in A Verweij, B Wessels (eds), 'Comparative and International Insolvency Law. Central Themes and Thoughts', Nottingham-Paris, INSOL Europe, 2010, 70–75.

[2] The Cooperation of Insolvency Courts (Designation of Relevant Countries and Territories) Order 1986 (SI 1986/2123).

[3] https://www.legislation.gov.uk/uksi/2006/1030/contents/made.

common law principle that 'the court ... will use its best endeavours to cooperate ... and avoid any action which might disrupt the administration of foreign proceedings'[4]. The reality of international trade has encouraged courts to assist each other without waiting for this cooperation to be regulated by an international convention[5]. Assistance has been provided by the English courts, for example, for the suspension of local proceedings, for the issuance of decisions to transfer the debtor's assets to the foreign proceedings[6] or for the conduct of actions to support proceedings abroad.

In the **United States of America**, in applying the regulations contained in section 304 and the current Chapter 15 of the US Bankruptcy Code, US courts have recognised the need to extend the comity principle to foreign insolvency proceedings. It has been consistently held that an equitable and orderly distribution of debtors' assets or an effective reorganisation[7] requires at least the consolidation of all creditors' claims in a single proceeding. In this regard, Chapter 15 of the US Bankruptcy Code expressly provides that courts should be guided by the principles of cooperation when providing assistance to foreign courts.

In **Romania**, the legal system was previously based on an adapted form of *Napoleon's French Code* which was completed in 1887 using a commercial code modelled on *Italy's Codice di Commercio* of 1882. After 1989, the legislation was modernised by the introduction of appropriate regulatory mechanisms and instruments to the Romanian legal framework. Law No 85/2014 on Pre-Insolvency and Insolvency Proceedings has been in force since 28 June 2014 and is the main piece of legislation governing insolvency proceedings in Romania. The general principles of the UNCITRAL Model Law on Cross Border Insolvency (1997) were originally included in Law No 637/2002 which was superseded by the currently applicable Law No 85/2006 on insolvency proceedings which was supplemented by Law No 85/2014. In relation to EU Member States, the Law 85/2014 facilitates the direct application of the EIR (Recast). The Romanian Civil Procedure Code contains provisions on procedural aspects that are relevant to insolvency. A legislative project for the implementation of Directive (EU) 2019/1023 on preventive restructuring

4 *Banque Indosuez SA v Ferromet Resources Inc* [1993] BCLC, 112 at 117.

5 In *Credit Suisse Fides Trust v Cuoghi* [1998] QB 818 at 827 in *Rubin v Eurofinance SA* [2012] UKSC 46, para 30.

6 *In re Bank of Credit and Commerce International SA* (No 10) [1997] Ch 213; *In re HIH Casualty and General Insurance Ltd* [2008] UKHL 21, [2008] 1 WLR 852; *In re SwissAir Schweizerische Luftverkehr-Aktiengesellschaft* [2009] EWHC 2099 (Ch), [2010] BCC, 667.

7 In the United States of America, the US Chapter 11 of the US Bankruptcy Code provides statutory provisions for US reorganisation proceedings. The US has recently enacted the Small Business Debtor Reorganization Act 2019, specific to small businesses.

frameworks, the discharge of debts and disqualifications and measures to increase the efficiency of procedures concerning restructuring, insolvency, and discharge of debts must be adopted before 17 July 2022. While analysing assistance and cooperation in Romania, we note the insistence on providing a legal basis which, unlike common law systems, is usually required in civil law systems where cross-border cooperation is the normal way to discharge the positive duty arising from *soft law* principles, as opposed to an express legal regulation.

3 Establishing jurisdiction in cross-border insolvency

3.1 Choice of jurisdiction favourable to the corporate group: the main insolvency proceedings

For groups of companies, developing a unitary cross-border insolvency or winding-up procedure is still one of the most difficult tasks[8]. The centralised treatment of corporate insolvency is closely linked to the identification of a group centre and to the way in which to deal with the relationships between main and secondary insolvency proceedings[9]. Without intending to explore the issue of identifying the jurisdiction for cross-border group insolvency too deeply, we recognise that the concept of 'centre of main interests' (COMI) is undoubtedly the starting point of the analysis. The main criteria for determining jurisdiction in the insolvency of the single debtor relates to its place of incorporation, registered office, location of assets, main operations or creditors, centre of administration and control or a combination all[10]. COMI is a criterion which acquires universality in the sense that it is recognised by the main legal systems and international models proposed for cross-border insolvency[11].

3.1.1 Criteria for determining COMI: The European Union and Romanian approach

The EIR Recast has not provided the basis for the identification of a COMI of the corporate group. However, both US legislation and case law[12] point towards an approach that allows for the most effective coordination of insolvency proceedings. In this respect, recital 30 of the EIR Recast highlights the

8 S Bufford, 'Coordination of Insolvency Cases for International Enterprise Groups: A Proposal', The American Bankruptcy Law Journal; Ft. Wayne 86.4 (Fall 2012) 686.

9 I Mevorach, 'INSOL Europe's proposals on groups of companies (in cross-border insolvency): a critical appraisal', International Insolvency Review, 2012, 10–19.

10 I Mevorach, 'The Home Country of a Multinational Enterprise Group Facing Insolvency', 2008, 57 ICLQ, 427.

11 *Ibid*, 436.

12 *Eurofood IFSC Ltd* (cauza C-341/04) [2006] OJ 2006 C143/11, para 36.

significance of the concept *central administration and supervision* for the delimitation of the COMI, which would allow a more efficient localisation of the COMI for the parent company and for subsidiaries in the same jurisdiction[13]. Another aspect is that the location should be verifiable by creditors who should be able to obtain the necessary information through a reasonable analysis of the facts.

As regards *the tests for establishing jurisdiction for sole debtors* and the possibilities of applying them in the case of groups of companies, the case law and doctrine on the subject have analysed *the place of registration test, the location of assets test, the central administration or control test* and combined tests. Regarding the place of registration, the presumption for determining COMI is that the place of incorporation corresponds to the registered office. However, the place of incorporation test excludes any possibility of treating the cross-border insolvency of a group of companies globally, simply because the group is not incorporated in a single country and is not a legal entity recognised as such in national systems[14].

As regards the criterion of the location of the debtor's main assets, operations, activities, or creditors, it is difficult to apply it in the case of a corporate group to identify one single group COMI as the assets and operations of the group may be in more than one jurisdiction with no way to determine which is more relevant.

Romania has had limited exposure to cross-border insolvency issues and proceedings. Thus, there is still limited case law in this area. In the cases resolved by the civil judgment of 7 March 2019[15] and the civil judgment of 27 March 2018[16], the Bucharest Tribunal held that the Romanian courts did not have jurisdiction to open main proceedings based on the provisions of Article 3 para (1) of the EIR Recast where its place of incorporation was in Italy, and it had a branch registered in Romania. The court held that the presumption in the EIR (Recast) had not been overturned by evidence showing that the COMI of the debtor was not Italy.

[13] S Bariatti, I Viarengo, FC Villata, F Vecchi, 'The Implementation of the New Insolvency Regulation, Recommendations and Guidelines', MPI Luxembourg, the Universities of Milan and Vienna, 2016, 103 at 111.

[14] I Mevorach, 'Insolvency within Multinational Enterprise Groups', Oxford Scholarship, 2009, 196 at 198.

[15] https://www.jurisprudenta.com/dosare-procese/2019/8767q3q2019-3/.

[16] http://portal.just.ro/3/Lists/Jurisprudenta/DispForm.aspx?ID=797.

3.1.2 Criteria for determining COMI: The UK and USA approach

Furthering the principles promoted by the UNCITRAL Model Law on Cross-Border Insolvency (1997), the UNCITRAL Guidelines on Cooperation, Communication and Coordination in Cross-Border Insolvency (2013), at point 147 indicates relevant factors for identifying the COMI. Addressing the complex issue of group insolvency involving companies in insolvency proceedings in two or more jurisdictions, the new UNCITRAL Model Law on Enterprise Group Insolvency (2019)[17] does not define COMI but promotes alternatives for harmonising cross-border proceedings.

The *nerve centre test*, used in the US, refers to the location where management and board meetings are held, the location from which activities are directed, controlled, and coordinated and where the administration of companies is regularly conducted[18]. Although in the case law the identification of the relevant factors for determining COMI is linked to the concept of nerve centre, other elements are also considered. Such elements include *the place of the debtor's registered office, the place of its management, the place of its primary assets, its primary creditors, the jurisdiction whose law applies to most disputes*. However, the approach differs from the European one, which promotes the determination of COMI for each individual entity, even if that entity is part of a group of companies. In practice, American courts qualify the *command centre criterion* as an essential factor in determining COMI[19]. *The group centre*, described as the meeting point of the entities that are part of the group or as a connecting factor, can be used as a decisive element for the group[20]. Relevant elements for *operational headquarters* of the corporate group may be the location where the decision-makers, executives and financiers meet, the location of the main executive offices or where the policy of the whole business has been established and the jurisdiction of contracts essential to the whole business[21].

The rules applicable in the UK for identifying one's jurisdiction, including those enshrined in company law, start from the premises of *residence, domicile, and nationality*, combined with other factors enabling the connection with English

17 UNCITRAL Model Law on Enterprise Group Insolvency with Guide to Enactment (2019), http://uncitral.un.org/en/MLEGI.

18 *Hertz Corp v Friend* (2010), 559 US 77: *Re Massachusetts Elephant & Castle Group, Inc* (2011).

19 *Re Tri-Continental Exchange Ltd* 349 BR 627 (2006) (D (US)); *Re SPhinX, Ltd* 351 BR 103 (Bankr SDNY 2006); R*e Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd* 374 BR 122 (Bankr SDNY 2007); *Re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd* (US District Court. SDNY 2008); *In re Basis Yield Alpha Fund (Master)*, 381 BR 37 (Bankr. SDNY 2008).

20 *Ibid.*

21 *Ibid.*

jurisdiction, such as, where the *business is carried out or where the management and control of the entity is exercised*. In the doctrine of the state of incorporation, as a prerequisite for determining the jurisdiction of the UK courts, the place of registration is only one of the evidential factors to be considered when establishing the location from where control of the company is exercised. Foreign companies may register in the UK Companies Register, resulting in jurisdiction of the English court conferred upon those companies. It is also possible to wind up foreign companies not registered in the UK. The extension of jurisdiction by the English courts follows the principle of rational justice, as in *Metliss v National Bank of Greece and Athens (1958)*[22]. The requirements for the extension of jurisdiction, whether based on the idea of the existence of assets, a contract, or a claim for the recovery of a debt are principally linked to the reasonable prospect of a benefit to creditors.

Addressing the complex issue of group insolvency involving companies in two or more jurisdictions, the new UNCITRAL Model Law on on Enterprise Group Insolvency (2019) promotes alternatives for harmonising cross-border proceedings. Some of the sensitive topics considered by the new Model Law relate to the appointment of a single group representative, the availability of a corporate group insolvency solution for all or some of the group entities, and a single insolvency proceeding in a jurisdiction where at least one group member has its COMI. As an alternative, one of the optimistic variants offers *contractualism*[23] as a tool for identifying the jurisdiction conducive to insolvency purposes, encouraging parties to negotiate. Of course, such an option should be accompanied by the recognition of greater discretion for courts in accepting an agreement to establish the jurisdiction of a particular court to deal with insolvency proceedings for the whole group of companies or a significant part of the subsidiaries[24]. *Cooperation and coordination* between parallel proceedings is another option applicable in the situation of non-integrated groups where *centralisation, substantial consolidation* or global supervision is not possible or acceptable. This may take the form of global *procedural consolidation* of different parallel insolvency proceedings opened in several jurisdictions[25].

We note that there are procedural aspects likely to produce conflicting solutions in relation to cross-border group insolvency including: the commencement of a

[22] *Metlis v National Bank of Greece and Athens 1958* [1958] AC 509.

[23] I Mevorach, 'Insolvency within Multinational Enterprise Groups', Oxford Scholarship, 2009, 203–204.

[24] *Ibid*.

[25] *Ibid*.

separate case for each legal entity as a widely accepted solution; the identification of group members that should be included in the proceedings; the obligation of courts to review decisions in relation to the determination of COMI and the *establishment* location, i.e. the possibility of challenging the initial decision where, due to insufficient information, errors have occurred in considering the jurisdiction of the group; the possibility of transferring jurisdiction or changing the authority overseeing the proceedings; controversies relating to COMI recognition; and possible inconsistencies between judgments handed down by courts in different jurisdictions.

3.2 Eligibility conditions for accessing insolvency proceedings

When conducting a theoretical examination of the difficulties of cooperation in cross-border insolvency it is important to identify the favourable jurisdiction and procedural mechanisms to be followed. In terms of jurisdiction, some problems arise from forum shopping and the change of place of registration of different companies. In this context, the idea of positive *forum shopping*, especially in the approach of the UNCITRAL Model Law on cross-border insolvency (1997), is likely to generate competition between jurisdictions and the need for harmonisation.

Several questions should be answered when considering the choice of jurisdiction. Is territorialism a false problem? What is more relevant for a group of companies in financial difficulty, the practical purpose or the legitimacy of the place of commencement of proceedings? Perhaps neither insolvency nor the prospect of insolvency is relevant. Perhaps what is only relevant is the most effective mechanism for resolving financial challenges. From this perspective, we see that there is no single answer for choosing jurisdiction and that the choice should be based on the concrete solution depending on the purpose pursued. In addition, the existence of the group structure as a legal entity is not recognised at legislative level in most jurisdictions. Consequently, jurisdiction is typically established for each separate legal entity and the group's insolvency is to be administered by the courts where the individual entities are incorporated[26].

Both **English and US** insolvency systems share a common origin and recognise the premise of companies restructuring, which is likely to produce more economic value than liquidation. **Romania**, as a civil law jurisdiction, while benefiting from modern legislation for international insolvency, is still at the beginning of its development in the field, as evidenced by the relatively low

[26] GF Schlaefer, 'Forum Shopping under the Regime of the European Insolvency Regulation', International Insolvency Institute, 2010.

number of cross-border insolvency proceedings involving groups of companies. A challenge in all three systems is to demonstrate that the parent company and at least some of its subsidiaries are eligible to access insolvency proceedings in certain jurisdictions. Therefore, negotiations for a group-wide restructuring should be promoted well in advance of the actual proceedings.

3.2.1 Eligibility conditions for accessing insolvency proceedings in the UK

The rules applicable in the UK are found in *company law*. As a general principle, the law of the *state of incorporation* governs the status of the company from its creation to its dissolution. As we explained above, the applicable test relates to *residence, domicile, and nationality*, and other factors which establish a connection with the English law such as the place where the business is carried on, where the registered office is situated, the place of registration of the branch or the place from which the management and control of the company is exercised. According to the doctrine of the state of incorporation, the place of company's registration is only one of the evidential factors to be considered when determining where the control of the company is exercised.

The approach to restructuring in the UK offers administration as a formal insolvency process more favourable to creditors. Court involvement may occur when creditors do not agree with the debtor's proposed strategy, including the valuation of collateral but otherwise it is out of court. In the judicial administration procedure, companies will lose management control and will have less scope to decide on executory contracts than in the US procedure, including the transfer of executory contracts.

In practice, companies have less often opted for the court administration, usually choosing the *scheme of arrangement* procedure[27], in which the management of the company is maintained. The scheme of arrangement is an alternative corporate restructuring procedure that did not fall within the scope of the EIR Recast and was not included in Annex A. Foreign companies must demonstrate a sufficient connection with the UK to apply for such a restructuring mechanism. This mechanism has been used for the restructuring of companies with a COMI in different EU Member States[28]. An argument in favour of this mechanism was that the scheme is the expression of forum shopping, as can

[27] The UK Companies Act 2006; the Corporate Insolvency and Governance Act 2020 introduced a new Part 26A with provision for restructuring plans that add additional features to the previously existing schemes of arrangement procedure.

[28] *Re Rodenstock GmbH* [2011] EWHC 1104 (Ch); *Re Primacom Holdings GmbH* [2012] EWHC 164 (Ch).

be seen in *Re Rodenstock GmbH*[29], an English restructuring of a foreign company, provided that the national law of the state where the company was registered did not allow such a procedure. The explanation for the choice of jurisdiction concerned the creditors' benefits, who anticipated and used the English law to conclude the agreement to restructure the company's debts, which allowed its rapid rehabilitation[30].

Another issue brought before the English courts is the interpretation of the *asymmetric jurisdiction clause* for the scheme of arrangement. The English courts' justification for retaining cases in their own jurisdiction has been that financial creditors can sue debtors in other jurisdictions but cannot challenge the jurisdiction of the English courts when they are referred[31].

The scheme of arrangement is based on creditors' agreement. The requirements which the court should examine when confirming the agreement between creditors and debtors in such proceedings have been consistently highlighted in English case law. In *In Re National Bank Ltd*[32], it is stated that the court considers whether the statutory provisions have been complied with, whether the creditors have been consulted and represented fairly by those who participated in the consultations, whether the statutory majority is acting in good faith and whether an intelligent and honest person, a member of the class (of creditors) concerned acting in accordance with his best interest, could reasonably approve of the settlement before the court. In *Re Codere Finance*[33], the English court found that the formal requirements for confirmation of the restructuring agreement had been met, noting among the arguments that the arrangement appeared to be very much in the interests of the group of companies' creditors and had been achieved through close consultation and the overwhelming level of creditors' support; the lack of alternatives available to the group in other jurisdictions; the fact that, as the evidence showed, refusal to confirm the agreement could have caused the group and its creditors a loss of value of around €600 million.

Another practical way of attracting English court jurisdiction over the group of companies has been *to acquire or create a company in that jurisdiction* to assume obligations.

[29] *In Re Rodenstock GmbH* [2011] EWHC 1104 (Ch).

[30] J Payne, 'Scheme of arrangement', University of Oxford, Cambridge University Press, 2014.

[31] *Re Vietnam Shipbuilding Industry Group* [2014] BCC 433 at [15]–[16]; *Re Van Gansewinkel Groep BV* [2015] Bus LR 1046 (Ch); *Re Hibu Group Ltd* [2016] EWHC 1921 (Ch); *Re Global Garden Products Italy SpA* [2016] EWHC 1884 (Ch), R Perkins, 'Schemes of Arrangement, and the Judgments Regulation: The New Authorities', South Square Digest, 2017, 50 at 56.

[32] [1966] 1 WLR 819

[33] *Re Codere Finance (UK) Ltd* [2015] EWHC 3778 (Ch).

In practice, English courts also consider other factors which, taken together, give legitimacy to the decision to assume jurisdiction over restructuring proceedings. Examples[34] of this include the number of UK domiciled creditors and the proportion of their claims in the total claims mass, the law governing the loans and previous agreements that have arisen between creditors and group entities[35].

Extensive analysis of the nature, effects and recognition of schemes of arrangement with cross-border elements are carried out by academics and professionals specialising in international insolvency law. It has been noted[36] that it is not uncommon for creditors with a COMI outside of the UK to be subject to schemes brought before the English courts under Article 8 or Article 25 of Regulation (EU) No 1215/2012[37]. These schemes are based on the idea that the claims are connected with that jurisdiction or on the idea of the jurisdiction clause agreed by the creditors[38]. The effect was automatic recognition of the proceedings in other EU Member States. However, it is not clear how Article 8 was considered applicable to these proceedings by the English courts, as the case law ranges from decisions establishing that a single creditor domiciled in England is sufficient to confirm English jurisdiction, to judgments expressing the idea that the number of creditors domiciled or established in England and the amount of their claims should be considered when determining the jurisdiction.

3.2.2 Eligibility requirements for accessing insolvency proceedings in the United States of America

Any debtor with a domicile, place of business, or property in the US is eligible to open *reorganisation proceedings* under Chapter 11 of the US Bankruptcy Code. Without further requirements, solvent companies may opt for the procedure governed by US law, if the application is made in good faith, with the intention of reorganisation, liquidation, or sale. A foreign company is also eligible to open *reorganisation proceedings* under Chapter, as seen in *In Re Maxwell Communication Corp, 170 BR 800 (Bankr SDNY 1994)*, which highlighted modified universalism as an approach to cross-border insolvency[39].

[34] *In Re A I Scheme Ltd* [2015] EWHC 1233; *Re Codere Finance (UK) Ltd* [2015] EWHC 3778 (Ch).

[35] *Re Codere Finance (UK) Ltd* [2015] EWHC 3778 (Ch), para 17.

[36] R Perkins, 'Schemes of Arrangement and the Judgments Regulation: The New Authorities', South Square Digest, 2017, 50 at 56.

[37] Regulation (EU) 1215/2012 of the European Parliament and of the Council on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (recast).

[38] *Ibid*, Article 25.

[39] *Re Maxwell Communication Corp*, 170 BR 800 (Bankr SDNY 1994).

We have considered whether it would be possible for the parent company and some of its subsidiaries in our imagined corporate group, which are registered not in the USA but in Romania, and which do not have a registered office in the USA, to commence US proceedings. In this respect, following the solution in the *Global Ocean*[40] case, according to which the owner of the stock of goods and the holder of the book value of the shares was a debtor with properties in the US, the domicile of the shareholders may be considered sufficient to deem a party to the group to have property in the US and be eligible for Chapter 11 US Bankruptcy Code. In addition, a bank account may be opened, and payments may be made through that account so that the group companies are considered to have property in the USA. We know from *in re Spanish Cay Co Ltd*[41] and *In re McTague*[42], where the courts established that advertising and marketing materials, office equipment, and a bank account containing $194 represented sufficient property in the United States to create eligibility for US insolvency proceedings. Therefore, the answer is yes, in the sense that one can take advantage of the procedures offered by the US jurisdiction on easy terms.

One mechanism usually used in the US as a practical cost-saving solution is the *procedural consolidation*[43] for cross-border corporate group insolvency proceedings[44], facilitated also by the fact that local law makes it possible for several group members to apply for US proceedings even if only one of the affiliates has a sufficient connection with the jurisdiction[45]. Each company makes a separate application for Chapter 11 reorganization and then, on behalf of the group, the court is asked to issue an order confirming the procedural consolidation[46]. Proceedings are opened for all members of the group, even if the companies are solvent at the time the application is made, on the grounds that this avoids consecutive proceedings and coordination allows a single reorganisation plan to be formulated for the whole group[47]. Only one practitioner may be appointed for the group of companies, a single reorganisation plan is usually proposed, the creditors remain affiliated to their companies and the rights and

[40] *In Re Global Ocean Carriers Limited et al., Debtors*, No. 00–955 (MFW) to 00–969 (MFW), July 5, 2000.

[41] *In re Spanish Cay Co Ltd*, 161 B.R. 715, 721 (Bankr.S.D.Fla.1993).

[42] *In re McTague*, 198 B.R. 428, 429 (Bankr.WDNY1996).

[43] USC, s 1015., I Mevorach, op.cit., 161.

[44] USC, s 1015.

[45] 28 USC, s 1408; PI Blumberg; K Strasser; N Georgakopoulos; EJ Gouvin, 'Blumberg on Corporate Groups, 2nd Edition', para 88.03.

[46] I Mevorach, op. cit., 161.

[47] *Ibid.*

priorities of creditors in the distribution of proceeds obtained in the joint proceedings are respected[48].

The US Chapter 11 reorganization is more favourable because it includes an immediate stay of individual creditor actions and executions, new loans, termination of outstanding contracts and renegotiation of obligations. The American reorganisation plan may establish significant changes in the debtor's structure and financial situation[49]. One problem is the collateral valuation process. The US judge can change the status of the collateral valued on different criteria and this influences the parties, including creditors, to be more cooperative in the process of negotiations. This may be reason enough for the debtor and its advisors to access the Chapter 11 procedure as a starting point for negotiations with creditors. We also note that a foreign company, accessing the US reorganisation when its domestic law is unfavourable to restructuring will find in the US debtor-in-possession proceedings a friendly approach, given the debtor's ability to maintain control of its business.

But should it be avoided? The US reorganization is a public and expensive process and secured creditors may not look favourably to the idea of new security over the debtor's assets. Creditors are organised and strong in this process, they have well-trained professionals. Consequently, the cost of those professionals will lead to an increase in the value of the claims on the debtor's estate, making the administration of US reorganisation expensive. What are the possibilities to make US Bankruptcy Code Chapter 11 a workable procedure? Counsel for a group of companies that wish to access a US reorganisation should persuade the parties to negotiate a settlement before filing a case with the court. This flexible, transparent, debt-trading based restructuring system is often used. We believe, however, that US Code Chapter 11 may become ineffective in systems with different economic environments, such as the Romanian system.

3.2.3 Eligibility conditions for accessing insolvency proceedings in Romania

Pursuant to Article 282 of Law no. 85/2014, non-EU Member States are permitted to file a request to initiate insolvency proceedings under Romanian law, provided that all other conditions required for opening such proceedings are met. EIR (Recast) is directly applicable to EU Member States. The Romanian Insolvency Act no. 85/2014 establishes the procedural and substantial

[48] PI Blumberg s.a., op. cit., para 88.03; *In re Northeast Dairy Coop. Fed'n, Inc.*, 88 Bankr. 21, 25 (Bankr. NDNY 1998).

[49] E Altman, 'The Role of Distressed Debt Markets, Hedge Funds and Recent Trends in Bankruptcy on the Outcomes of Chapter 11 Reorganizations' (2014) 22 *American Bankruptcy Institute Law Review* 75.

rules governing the pre-insolvency and insolvency proceedings applicable to companies, banks, insurers and sole traders. It is not applicable to partnerships and non-commercial legal persons. The provisions governing the status of the legal person, its establishment, operation, dissolution and winding up are those of the domestic law of the legal person. In Romania, the criterion applied for identifying the nationality of the company is that of its registered office[50]. Under Romanian law, it has been established that insolvency proceedings may be issued against a company with its registered office in Romania, even if the shareholders are natural persons and/or legal entities domiciled/established in another State, having another nationality, provided that the company is a legal entity with its own nationality and any company with its registered office in Romania is a Romanian legal entity[51].

Romanian law contains a *positive definition of insolvency*, establishing excessive indebtedness as a ground for opening insolvency proceedings. Insolvency is defined as the imminent lack of liquidity when the debtor is unable to satisfy its claims when due. Article 6 of Law 85/2014 establishes that pre-insolvency proceedings apply to debtors in financial difficulty. Article 5 para (1) point 27 of Law no. 85/2014 defines the concept of financial difficulty, stating that a debtor in financial difficulty is a debtor who, although carrying out or capable of carrying out its obligations, has a low degree of short-term liquidity and/or a high degree of long-term indebtedness, which may affect the fulfilment of contractual obligations in relation to the resources generated by the operational activity or the resources attracted by the financial activity. Problems arising from financial distress can be resolved through informal arrangements, formal insolvency or through proceedings combining both formal and informal elements. National legislation regulates two pre-insolvency proceedings, namely the *ad hoc* mandate and the preventive concordat.

To a large extent, the Romanian domestic regulations encompass the requirements of the Directive[52]. Thus, the Romanian regulations already provide for preventive restructuring frameworks such as the principle of debtor in possession, the super-priority of new financing upon distribution, the stay of individual enforcement proceedings and norms on self-regulation and the supervision and professional training by the professional organisation of insolvency practitioners.

[50] Article 1 para (2) of Law no. 31/1990.

[51] R Bufan s.a. 'Tratat practic de insolventa', Ed. Hamangiu, Bucuresti, 2014, 933.

[52] Directive (EU) 2019/1023 on preventive restructuring frameworks, the discharge of debts and disqualifications and measures to increase the efficiency of procedures concerning restructuring, insolvency, and discharge of debts.

As regards *the Romanian informal procedures*, some remarks are necessary. In relation to hybrid procedures, legal uncertainty may arise where cross-border elements are involved. These factors may include the question of which law is applicable, the enforceability and recognition of judgments. In a cross-border dispute, providing legal certainty for debtors and their creditors presents a serious challenge. Two practical solutions have been highlighted in European law in this respect: broadening the scope of the EIR Recast and developing a parallel regulatory framework for hybrid proceedings. The first approach requires a thorough analysis in relation to EIR Recast and the amendments to its scope. There is no clear definition of the concept of pre-insolvency or hybrid proceedings in EIR Recast. From recital 10 and Article 2 para (3) we can conclude that the debtor in possession is possible in hybrid proceedings and the characteristic elements should be found in Article 1 para (1) of EIR Recast. Most European pre-insolvency and hybrid proceedings, which are not in Annex A, are considered to be outside the scope of the EIR Recast.

3.3 Practical aspects

Several conclusions can be drawn from the above analysis. In one respect, there is real competition in cross-border insolvency between the US and the UK, both of which have sophisticated insolvency law systems. Accordingly, the determining factor between the two jurisdictions will be the potential to rescue the business as early as possible in order to minimise financial distress. We find that insolvency law in the United Kingdom prioritises the rescue of companies in financial difficulty, in order to allow the business to continue and achieve better outcomes for creditors. The approach in the United States also focuses on preserving and restructuring the debtor's business and achieving the optimal outcome, either through a restructuring or liquidation strategy. In the EU, the presumption that a corporation's COMI corresponds to its place of registration is considered relevant because of the effects of direct recognition of foreign proceedings. The US takes a more pragmatic approach to the COMI concept, defining it as the location where most creditors are located. The approach commonly found in the UK may be considered less practical because of the problems associated with recognition of proceedings in the EU. In the absence of relevant case law, Romania can analyse different approaches, including those in common law systems, to discern and opt for the variants that are more in line with its traditions, legal system, and prospects of increasingly integrated and complex international business.

The question of where to engage in the restructuring of a group corporation turns on which jurisdiction, whether through informal or court proceedings, can deliver the optimum retention of business value. Accordingly, group corporations and their advisors are not only tasked with ascertaining the true financial state of the business, its overall viability at group level and the prospect of its rescue but must also decipher the most advantageous jurisdiction in which to execute corporate group restructuring.

A comparative analysis of the three legislative processes reveals significant differences between the reorganisation procedures. For instance, in the UK, the out-of-court procedure provides for the appointment of an administrator. In the US, it is the debtor's legal right to pursue judicial reorganisation proceedings without any review of its decision by the court. Romania, by contrast, offers more restrictive conditions for accessing traditional judicial reorganisation proceedings.

In our view, the business valuation process is also an important element, especially as competing valuations are needed in multiple aspects within the group. What is the correct way to determine the value of a company that can be transferred as a *going concern*? We have observed in the US practice that parties usually negotiate business value, as opposed to waiting for a proposal by the court and carry out the economic quantification of the business. The dynamics of negotiation appear to be useful, as companies and their creditors receive expert advice and are informed about the value of the assets and the business under negotiation[53].

When discussing possible ways of restructuring the group's financial obligations and operations, it should be borne in mind that creditors and shareholders have different priorities and interests. Post-insolvency finance providers are essential and should acquire significant collateral in the event of default. Lenders and banks may seek to borrow more for transaction financing, which affords bank lenders ultimate leverage and control when debt subject to charge-off is a risk. A common interest of different creditors in restructuring may lead to a pre-coordination of operations, including the procedures in which the different group entities are involved. Often creditors may resist the restructuring of corporations indebted to them with a view to recovering their claim at face value, making a profit on their interest or simply selling their claim on more favourable terms[54].

[53] K Ayotte, E Morrison, 'Valuation Disputes in Corporate Bankruptcy' (2011) 166 *University of Pennsylvania Law Review* 1819.

[54] V Buccola, A C Keller, 'Credit Bidding and the Design of Bankruptcy Auctions' (2010), 18; M M Harner, 'Trends in Distressed Debt Investing: An Empirical Study of Investors Objectives', (2008); C J Tabb, 'Credit Bidding, Security, and the Obsolescence of Chapter 11', [2013] *University of Illinois Law Review* 103.

Although the reorganisation procedure offered by US law seems more favourable to the practical purposes of a group of companies than those in Romania or the UK, in view of the possible disadvantages, alternatives could be sought in contractual and hybrid procedures as provided in the applicable legislative systems in the three jurisdictions. From this point of view, the UK scheme of arrangement offers quick and less costly solutions, as it allows for the negotiation and conclusion of agreements, including in respect of secured claims, which become binding on creditors.

4 Recognition of foreign insolvency proceedings and cross-border cooperation between companies in the USA, UK and Romania

International assistance by a group of companies involves the recognition of foreign proceedings. The UNCITRAL Model Law on Cross-Border Insolvency (1997) and EIR (Recast) on Insolvency Proceedings promotes mechanisms for the recognition of foreign proceedings, offering non-exclusive alternatives to cross-border cooperation, enhancing practicality and flexibility as principles for efficiency.

4.1 Recognition of foreign procedures from the perspective of the UNCITRAL Model Law

In the working hypothesis all three jurisdictions, the USA, UK, and Romania, have adopted the UNCITRAL Model Law on Cross-Border Insolvency (1997). The question is which route is more favourable: the promotion in the US of Chapter 11 reorganisation or a hybrid proceeding, accompanied by applications for recognition and relief in the UK, Romania, and other jurisdictions; or obtaining a UK scheme of arrangement for all or some of the entities accompanied by a subsequent application for its recognition in Romania and the US. The second issue is whether applications for recognition are main proceedings in the US or UK and the consequences of decisions to recognise such foreign proceedings.

4.1.1 Recognition of US or UK proceedings as main insolvency proceedings

In the UNCITRAL Model Law (1997) approach, the recognition of foreign proceedings as main proceedings in the three analysed jurisdictions is linked to the concept of COMI. In the EU approach, a foreign proceeding is a *main proceeding* if it takes place in the state where the debtor has its COMI. In the absence of evidence to the contrary, *the debtor's registered office is presumed to be its COMI*. The party claiming that the debtor's COMI is somewhere other than its registered office has the burden of proving the claims[55]. The presumption can only be rebutted by 'facts which are both objective and readily ascertainable by third parties'[56]. These facts include public information, excluding information only ascertainable during investigation or verification.

Under what conditions can proceedings opened in the US, or UK, be recognised in Romania as main insolvency proceedings and what case law supports such a situation? As set out in the working hypothesis, the parent company and some other members of the group of companies have their principal place of business in Romania. To apply the principles of the UNCITRAL Model Law and international case law to the recognition of foreign proceedings, it would be necessary to verify several factors: the place of management of the company, where the board of directors meet, and which is the place of 'central management'[57] if these matters were verifiable by creditors[58]. The rationale for the COMI is to enable persons interacting with group companies to ascertain what system of law would govern the debtor's insolvency[59]. What should be analysed is the 'public face' of the group members as viewed by the general body of creditors[60]. In applying the 'nerve centre' test, the operating history of the companies and the location of day-to-day management decisions should be considered as part of a holistic COMI determination[61]. The law applicable to the parent company's senior loans is also relevant, i.e., the subsidiaries, if they are governed by applicable US or UK law[62] and location of the group's principal assets. For COMI determination it is necessary to establish the *administrative centre* which has an element of permanence and can be determined with known facts[63]. A rapid relocation under threat of insolvency may be regarded as *illegitimate forum-shopping*. Although a corporation is free to relocate its business, the suspicion of bad faith manipulation of the COMI requires careful

55 UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment and Interpretation, p 143; *Re Stanford International Bank Ltd (In Receivership)* [2009] EWHC 1441 (Ch).

56 Case C-341/04 *Re Eurofood IFSC Ltd* [2006] ECR I-3813; *Re Stanford International Bank Ltd* [2010] EWCA Civ 137; *Legend International Holdings Inc v Legend International Holdings Inc* [2016] VSC 308. Case C-396/09 *Interedil Srl (In Liquidation) v Fallimento Interedil Srl* [2011] ECR I-9915.

57 *Morning Mist Holdings Ltd. v Krys* ('In re Fairfield Sentry Ltd'), 714 F.3d 127, 137 (2d Cir. 2013); Case C-396/09 *Interedil Srl (In Liquidation) v Fallimento Interedil Srl* [2011] ECR I-9915, *Lightsquared LP (Re)* [2012] ONSC 2994; *Re Lennox Holdings Ltd* [2009] BCC 155; *MPOTEC GmbH* [2006] BCC 681.

58 *Buccaneer Energy Ltd v Buccaneer Energy Ltd* [2014] FCA 711.

59 *Re Stanford International Bank Ltd* [2010] EWCA Civ 137.

60 *Re Stanford International Bank Ltd* (In Receivership) [2009] EWHC 1441 (Ch).

61 M Virgos & E Schmit, 'Report on the Convention on Insolvency Proceedings' (EU Council Doc 6500/96, 1996), 75 ('Virgos-Schmit Report'); *Re Fairfield Sentry*, 714 F 3d 127, 138 (2nd Cir, 2013); UNCITRAL Model Law on Cross-Border Insolvency Guide to Enactment and Interpretation (UNCITRAL, 2013), 145 at 146.

62 *Re SPhinX Ltd*, 351 BR 103, 117 (Bankr SDNY, 2006); Guide to Enactment, 147.

63 *Moore v Australian Equity Investors* [2012] FCA 1002 [19].

consideration of any factors which demonstrate that the COMI of the parent company and other group subsidiaries has changed[64].

4.1.2 Recognition of the US, Romanian and English proceedings as non-main insolvency proceedings

Recognition of non-main insolvency proceedings requires proof of an *establishment* in accordance with the approach proposed by the UNCITRAL Model Law (1997). The establishment is defined as any place of business where the debtor carries out a non-business economic activity with human means and goods or services or is concerned with carrying out an economic activity with human means and services[65]. Whether an economic activity is non-transitory depends on the duration, frequency, and nature of the activity. Payments through accounts opened in a particular country may be considered as non-transitory if they have the character of a constant business-type activity[66]. The economic activity carried out in the US, Romania or UK should correspond to the nature of activity that each entity in the group carries out as a holding company. While the requirement in the UNCITRAL definition may involve consideration of the nature of the relevant business activity, the location of the activity must be more than an occasional place of operations[67]. Interaction with third parties is required to demonstrate the existence of a place of business[68]. The activities of the company must have a perceptible effect on the local market[69] and the management of the companies' accounts, i.e., the group, should be more than an internal administration, similar to paying rent or business rates[70].

We consider that the US approach is less flexible than the UK approach in the adoption of the UNCITRAL Model Law. If the application for recognition of the foreign proceeding is denied, the foreign representative may commence a proceeding under US Chapter 11, with the possibility of a decision granting an interim moratorium for 30 days governed by USC & 1519. This will give companies time to access the US Chapter 11 judicial reorganization procedure. At the same time, insolvency proceedings may be opened for the other group

[64] Guide to Enactment, 148.

[65] *Olympic Airlines SA Pension and Life Assurance Scheme Trustees v Olympic Airlines SA* [2015] UKSC 27.

[66] *Trillium (Nelson) Properties Limited v Office Metro Ltd* [2012] EWHC 1191 (Ch); *In re Millennium Global Emerging Credit Master Fund Ltd.*, 471 B.R. 342 (Bankr. S.D.N.Y. 2012).

[67] Virgos-Schmit Report, 71.

[68] *Olympic Airlines Pension Trustees v Olympic Airlines SA* [2015] 1 WLR 2399, 2405 (13).

[69] Virgos-Schmit Report, 71; *Re Office Metro Ltd* [2012] BCC 829, 835 [16]; *Re British American Insurance Co Ltd*, 425 BR 884, 915 (Bankr SDFla, 2010).

[70] *Olympic Airlines*, 13.

members in Romania, the UK, and other jurisdictions, following the rules of international communication and cooperation.

4.2 Recognition of foreign proceedings from the perspective of EIR Recast

The principle applicable in the situation of EU Member States is that any court with jurisdiction under Article 3 of the EIR Recast whose judgment opens insolvency proceedings is recognised in all other Member States. The rule has an intra-EU effect, without expressly excluding non-EU debtors. The decision to open main proceedings applies, without further formalities, the law of the State of opening of proceedings provides, unless otherwise provided for in certain exceptions under the EIR Reast and if no secondary proceedings are opened in the other Member State.

4.3 Recognition of foreign proceedings between group members in light of general principles of private international law

For countries where the provisions of the EIR Recast are not applicable and the UNCITRAL Model Law on cross-border Insolvency (1997) has not been implemented, national regulations should include provisions for the identification of the applicable law to private international insolvency relationships, procedural rules in cross-border insolvency disputes and rules governing the conditions for requesting or providing assistance in insolvency proceedings.

4.4 The effects of the recognition of insolvency proceedings

In accordance with the provisions of the EIR Recast the insolvency practitioner may exercise all the powers conferred by the law of the Member State of the main proceedings, including the removal of the debtor's assets from the territory of the Member State in which they are situated for the benefit of the main insolvency proceedings. Local enforcement measures relating to the debtor's assets located in a jurisdiction within the EU are not permitted unless the foreign law governing the treatment of property located in other Member States provides for such measures[71].

In the UNCITRAL Model Law (1997) approach, the effects are also important. First, the temporary exemption may include the suspension of local enforcement proceedings, the possibility for the foreign representative to manage or capitalize on the debtor's local assets to protect or preserve the value of the assets and the suspension of the debtor's right to transfer assets. As per Article 20, automatic and immediate suspension of individual actions, proceedings,

[71] Case C-444/07 *MG Probud Gdynia sp.zoo.o*, ECLI:EU:C:2010:24.

executions, transfers or disposals of the debtor's assets are measures available to the recognized foreign main proceedings. In accordance with local regulations, a limited suspension applies to assets that should be managed in the event of unrecognized foreign proceedings. In accordance with local law, the foreign representative also has the right to participate in any procedure involving the debtor in the state of recognition. Pursuant to Article 20(3) of the UNCITRAL Model Law, the suspension does not automatically affect the rights of creditors. The court has the power (in accordance with Article 20(6)) to amend or terminate the execution or suspension (either in totality, or for a limited time), under the conditions it deems appropriate. This does not mean that local law applies to foreign insolvency proceedings. Recognition automatically creates a moratorium and makes available to the representative of the foreign insolvency proceedings the remedies that would be available to an insolvency practitioner in the local jurisdiction. Article 21 of the UNCITRAL Model Law gives the local court the discretion to grant an appropriate exemption 'if necessary to protect the debtor's assets or the interests of creditors' and any measure or suspension that may be available to an insolvent company in accordance with local national law.

5 Conclusion

The complexity of corporate group insolvency can generate a multitude of cross-border disputes, contested proceedings and conflicts of jurisdiction. Disputes arising from mutual claims between group companies, intra-group guarantees and creditors of the same asset[72] may incur additional costs. From another perspective, intra-group conflicts over financial decisions, the management of different subsidiaries, the exercise of control, liability for losses and the need to void transactions between group entities are also factors which may lead to the increase of costs and the prolongation of the duration of cross-border group proceedings[73]. The possible conflicts related to the choice of applicable law and the recognition of different procedures and foreign court decisions can also incur additional costs and time. We consider it necessary to point out that another source of conflict is the identification of the authorities responsible for supervising concurrent insolvency proceedings, the control of assets, the coordination of restructuring operations of some of the subsidiaries or of the group and the authorities called upon to resolve the multiple disputes that may arise in connection with these issues. In the case of an integrated group with global subsidiaries, disputes between practitioners appointed in the various national proceedings can become particularly burdensome on the

[72] I Mevorach, op. cit., 205 at 208.

[73] *Ibid.*

group's assets. It is worth recalling that the exercise of control over proceedings pending in different jurisdictions is a particularly sensitive issue, involving an analysis of the relationship between universalism and territoriality in the law and practice of different jurisdictions and the way in which state sovereignty is expressed in this area. The need to finance groups of companies in financial difficulty calls for urgent measures, including dispute resolution and litigation, notwithstanding the significant differences between highly developed and developing countries, the real possibilities offered by the legislation, practice and case law of the various systems and the training of the various professional categories to deal with the complex issue of cross-border insolvency.

The above comparative analysis of the legislation and practice of the three jurisdictions shows the need for flexibility in order to consider international cooperation between courts and practitioners from different jurisdictions and legal systems. Flexibility and creativity of those who must identify solutions both when they are self-evident and when they are almost an unattainable dream can be key mechanisms for cross-border insolvency domain.

Chapter 7

Legal and Economic Vision of the Resilience and Creativity of French Law Tools During the Crisis and Post-Crisis for Commercial Enterprises

Catherine Ottaway
Partner at HOCHE Avocat, Paris

Hadrien de Lauriston
Partner at HOCHE Avocat, Paris

Benjamin Gallo
Partner at HOCHE Avocat, Paris

Introduction

From the very first days of the health crisis – the first lockdown having begun in France on 16 March 2020 – the French restructuring market players immediately swung into action to provide solutions to the difficulties encountered by French companies heavily impacted by the health measures taken to curb the pandemic. This reactivity was made possible by the specificities of the French market, both in terms of the players in this market and the legal framework governing it, of which a brief overview should be given (section **1**).

Such mobilisation of the restructuring players has enabled a rapid adaptation of the tools for preventing insolvency and restructuring companies. Although such tools were already developed and effective in France, even before the transposition of the latest European Directive[1], this adaptation of the legal framework was not sufficient to face the crisis and, as in many European countries, the financial support of the French Government was also decisive to avoid a wave of insolvencies (section **2**).

These adaptations of the legal framework and the support of the State as part of the *'whatever it takes'* pandemic strategy were effective and the number of insolvencies in France fell to record levels and some of these exceptional measures were finally enshrined in statute law (section **3**).

[1] EU Directive No 2019/1023 dated 20 June 2019, transposed in French law by an Ordinance No 2021/1193 dated 15 September 2021 (*cf*. Law 'PACTE' dated 22 June 2019).

1 The specific features of the French market

Understanding the French market is important to comprehend the legal and economic environment set up for the prevention of difficulties and to facilitate the resilience of companies, especially in the interest of employees, even before those of creditors and shareholders.

The French restructuring market is characterised by a combination of actors managing corporate difficulties, including merchants' or peers' management of these difficulties (1.1), as well as a strong involvement of the public authorities through a multitude of public bodies (1.2).

1.1 Treatment between merchants with the assistance of specific actors

The **134 commercial courts** are a very old institution in France. Created in the 15th century, they deal with disputes involving traders or commercial companies, or concerning commercial acts and, in particular, preventive actions or collective proceedings.

The 3,200 judges sitting in the commercial courts are not legal professionals. They are elected from among company directors or traders registered in the Trade and Companies Register, for four renewable years. After initial training at the magistrates' school (*Ecole Nationale de la Magistrature*), they perform their duties on a voluntary basis (no remuneration). Their decisions have a rate of confirmation and reversal equal to that of professional magistrates in civil matters.

Since 1 March 2016, 18[2] of the 134 commercial courts are so-called 'specialised' in order to deal in particular with (i) safeguard, judicial restructuring and judicial liquidation proceedings when the debtor is a large enterprise (directly or indirectly more than 250 employees and more than €20M in turnover, or more than €40M in turnover); and (ii) main insolvency proceedings opened in the jurisdiction in which the centre of the debtor's main interests is located, as per Regulation (EU) 2015/848.

Within each commercial court, several actors play an important role in the prevention of business difficulties:

The '**juge commissaire**' or supervisory judge is appointed from among the judges experienced in collective proceedings by the court. They are mainly

[2] Bobigny, Bordeaux, Dijon, Evry, Grenoble, Lyon, Marseille, Montpellier, Nanterre, Nantes, Nice, Orléans, Paris, Poitiers, Rennes, Rouen, Strasbourg, Toulouse, Tourcoing (Decree n°2016-217 of 26 February 2016).

responsible for supervising the procedure and judges the admission of the various creditors of the debtors.

The **public prosecutor** is a professional magistrate and State official who represents the interests of the company before the commercial court and their presence is almost systematic in matters of prevention and business difficulties.

The **court clerk** organises hearings, formalises judgements, receives and keeps information and documents concerning companies and in particular the extract from the trade register (Kbis), which constitutes the company's 'identity card' and is public[3]. They keep the National File of those prohibited from managing, the National File of non-possessory pledges, the Trade and Companies Register interconnected in the EU.

In Paris, outside the scope of collective proceedings as such, the commercial court has an international chamber in which the judges are fluent in English and have a professional background as managers of international companies. French remains the language of the proceedings, but English may be used at the hearing by the parties and by any witnesses or technicians. The documents produced in the proceedings, however, do not have to be translated.

In 2020, the French commercial courts handed down 652,707 decisions, conducted 10,522 preventive and confidential interviews with company directors, and opened 2,638 ad hoc mandates and conciliations. The year 2020 saw the lowest level of insolvencies for 30 years, with only 32,184 proceedings[4], i.e. 19,818 fewer than in 2019 (which was not the case during the financial crisis of 2008/2009, which, by contrast, saw an increase of more than 20% in insolvencies).

France has **two atypical professions** dedicated to dealing with preventing insolvencies and judicial assistance to debtors : (i) the judicial administrator ('Administrateur Judiciaire') intervenes in safeguard and judicial reorganisation proceedings to assist the manager and identify difficulties and (ii) the creditors' representative/liquidator ('Mandataire Judiciaire') to represent creditors and safeguard the financial rights of employees, appointed in all collective proceedings.

[3] https://e-justice.europa.eu/489/FR/business_registers__search_for_a_company_in_the_eu?clang=fr.

[4] Of these 32,184 procedures, 19 concern companies with more than 500 employees, which represents an increase of 73% in insolvencies for this type of company in 2020 compared with 2019 (see the Deloitte/Altares report 'Companies in difficulty in France in 2020: asymptomatic companies facing the pandemic? May 2021').

1.2 Strong government intervention

1.2.1 The State as creditor

In France, the first debts not paid by businesses facing difficulties are often tax and social security debts. As a privileged creditor, the State therefore has a decisive role to play in dealing with business difficulties. Depending on the nature of the debts, but also on the procedure opened, public creditors can grant payment schedules and, in some cases, debt remission.

Although not strictly speaking a public creditor, it is worth mentioning here the fundamental role of the 'AGS' ('Régime de Garantie des Salaires'), which guarantees the salaries of employees of companies in difficulty and is subrogated to the rights of creditors. In 2020, the AGS advanced 142,561 employees over 1.2 billion euros[5].

1.2.2 A multitude of public bodies

Numerous public bodies can intervene in preventive restructuring procedures to facilitate the turnaround of companies.

The mission of the Inter-ministerial Committee for Industrial Restructuring (CIRI) is to help companies in difficulty with more than 400 employees to develop and implement solutions to ensure their survival and development. The CIRI has a key role to coordinate the action of the various public stakeholders.

The Departmental Committees for the Examination of Business Financing Problems (CODEFI) is dealing with companies having less than 400 employees. CODEFI is placed under the authority of the 'Préfet' (representing the State in each departmental territory) and aims, alongside the manager, to define and negotiate a plan for transforming the company's financing with the various stakeholders (shareholders, creditors, etc.).

The Commission des chefs de Services Financiers (CCSF) are a one stop shop to obtain grant repayment plan for public claims such as VAT claims or social contribution.

Positioned under the authority of the Regional *Préfet* and endowed with skills in business projects, financial analysis and knowledge of the role and means of action of the various partners of the company, the Commissioners for Restructuring and the Prevention of Difficulties (CRP) accompany companies in difficulty to preserve employment. They focus primarily on industrial companies with more than 50 employees.

[5] Délégation Unédic AGS – Rapport Annuel 2020.

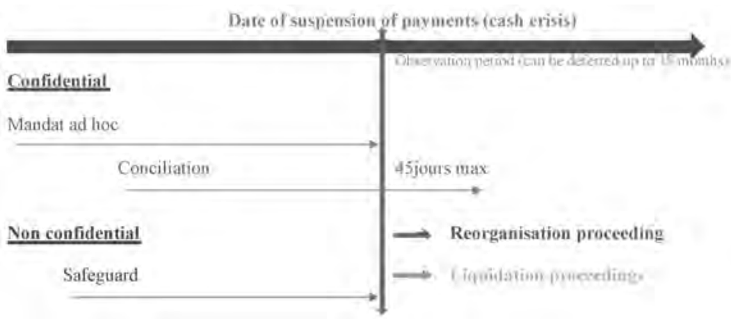
The Credit Mediation is a public mechanism which, since 2008, has been helping any company that is experiencing difficulties with one or more financial institutions (banks, credit lessors, factoring companies, credit insurers, etc.). The Credit Mediation Service is backed by the Banque de France and intervenes with banks and credit insurers; it is conducted throughout France, in compliance with the rules of confidentiality and banking secrecy, by 105 Credit Mediators who are the directors of the Bank of France. They are accompanied by trusted third parties who are appointed in each department within the consular networks (commercial courts) and socio-professionals who are part of the partner networks of the Credit Mediation and whose mission is to accompany the managers in their procedures on a voluntary basis.

2 The rapid and effective adaptation of existing legal tools in response to the COVID-19 crisis

2.1 Overview of French procedures: existing reinforced detection, warning and prevention tools

With a view to encouraging rapid detection of future difficulties, several tools have been developed to support managers in seeking help in finding solutions before they are no longer able to finance this search and find themselves in a state of suspension of payments ('Cessation des paiements').

This notion is an essential criterion for defining what type of procedure can be envisaged by the manager. The 'Cessation des paiements' is defined by Article L631-1 of the Commercial Code as '(. . .) the impossibility of meeting current liabilities with available assets (. . .). The debtor who establishes that the credit reserves or moratoria from which he benefits from his creditors enable him to meet the liabilities due with his available assets is not in cessation of payments'. In short, a serious cash crisis.



2.1.1 Third-party warnings: relatively confidential prevention

In addition to the right of alert available to shareholders, staff representatives or the auditor (when present) within the company, the prevention and detection of difficulties is the responsibility of the president of the commercial court[6] with the help of the companies registrar.

The latter are responsible for gathering information useful for detecting business difficulties and for summoning the managers if necessary. Prevention-detection can also be requested directly to the management of the company by the commercial court to explain the company's problems and discuss possible solutions.

At the president of the commercial court's request, the companies registrar convenes at a meeting the manager whose company is showing signs of difficulties such as: loss of equity of less than half the capital, launch of the alert procedure by the auditor, registration of creditors preferential rights, failure to file annual accounts, payment proceedings, etc. The interview and the minutes drawn up by the registry are then sent to the manager. The discussion and the minutes of this informal meeting remain completely confidential.

The follow-up may consist of a (i) stopping of the alert if the measures envisaged seem appropriate to the situation encountered by the company, (ii) a follow-up, (iii) the opening of amicable proceedings or the declaration of cessation of payments (the manager has 45 days to file his declaration of cessation of payments with the court, failing which he may incur personal liability).

In a company with a Social and Economic Committee (CSE)[7], when the CSE is aware of facts that could affect the economic situation of the company, it can ask the employer for explanations[8]. If the answers are deemed insufficient or if they confirm the situation detected, the CSE can decide to send a report to the management and the auditor. The information provided is confidential.

The company's auditor, if there is one (depending on the balance sheet total, turnover excluding tax and the number of employees during the financial year), should inform the management and then, if necessary, the board of directors. If effective measures are not taken to improve the situation, he must notify the president of the commercial court or the high court, as the case may be. Finally,

[6] L611-2 & R611-10 to 17 Commercial Code.

[7] A compulsory staff representation body in companies with more than 11 employees.

[8] L2312-60 Labour Code.

a special report should be submitted to the general meeting of shareholders[9]. The alert procedure thus proceeds in successive phases and can be interrupted by the auditor at each phase when he considers that corrective actions have been taken or that solutions to the financial difficulties have been found.

2.1.2 Alert by the manager: confidential prevention for the actors concerned

The *ad hoc* mandate (L611-3 & R611-18 to 21 Commercial Code) is open to all companies, regardless of their activity or legal form. The law does not provide for specific conditions to be eligible to *ad hoc* mandate and various situation may ground a petition for the appointment of a 'mandataire ad hoc': financial difficulties (late payment, customer default, etc.) or deadlock situations (conflict between partners, etc.). The 'mandataire ad hoc' is chosen by the manager and appointed on request by the president of the commercial court, after an interview hearing, for a mission defined by the manager for a defined but renewable period.

Conciliation (L611-4 to16 & R611-22 to 46 Commercial Code) is also open to all types of companies except those engaged in agricultural activities (which benefit from a special mechanism). To apply for conciliation, the company (i) must be experiencing existing or foreseeable difficulties, which may be legal (conflict between partners), economic (loss of a market) or financial (default of a customer) and (ii) must not have been in a state of suspension of payments for more than 45 days. The conciliator is chosen by the manager and appointed on request by the president of the commercial court, after an interview hearing, for a mission defined by the manager for a defined period which can be extended up to a maximum of five months.

2.1.3 Procedures without confidentiality

On the initiative of the manager, non-confidential and court driven procedures can also be used to restructure the company, but they are less flexible and more regulated. These procedures are public because they are published in the commercial register and in a legal journal. Unlike amicable proceedings, those proceedings trigger an automatic stay.

Safeguard procedures[10] are intended for companies that have not yet suspended payments ('French' chapter 11). The company must be experiencing difficulties that it is unable to deal with on its own. The objective is to facilitate the

[9] L234-1 to 4 Commercial Code.

[10] L620-1 to L626-35 Commercial Code.

reorganisation of the company by keeping the business ongoing, the preservation of jobs and the settlement of debts. During the observation period, an economic and social assessment is carried out and a safeguard plan prepared with the assistance of the procedural bodies appointed by the court. Creditors file their claims[11], which are verified, and participate in the vote to approve or reject the plan, which lasts up to 10 years (15 years in agricultural matters)

The manager remains in office (debtor in possession). The opening of the procedure (i) triggers an automatic stay of pre-petition claims (claims which arose before the opening of the proceeding); and (ii) stops the course of interest and prevent or suspend legal actions for payment of pre-petition claims.

Since 1 July 2014, companies previously involved in an ongoing conciliation procedure, which can prove that they have drawn up a proposed plan to ensure the continuity of their business and which has received sufficiently broad support from creditors, may initiate an accelerated financial safeguard procedure to submit such proposed plan to a vote by creditors' classes.

Judicial reorganisation ('redressement judiciaire')[12] is intended for companies that are in a state of suspension of payments and can also be opened at unpaid creditors request. The same rules apply as in safeguard but the powers of the manager are more limited. If no viable recovery plan over a maximum of ten years can be approved by the court, the partial or total sale of the company to third parties is then possible. If even this solution is not viable or the observation period is no longer financed or the recovery is clearly impossible, the company is put into judicial liquidation.

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In France, out of 28,171 collective procedures opened in 2020, 78% of companies opening a preventive procedure and 39% of companies in judicial reorganisation escaped liquidation. 90% of collective proceedings concerned companies with fewer than 10 employees. Note that in France, there is no receivership procedure or any equivalent to it.

[11] L622-24 & R622-21 to 26 Commercial Code.

[12] L631-1 to L632-4 Commercial Code.

2.2 Exceptional adaptations of the law on companies in difficulty to deal with the COVID-19 epidemic

2.2.1 Emergency Enabling Act No. 2020–290 of 23 March 2020

The Constitution allows the Government to ask Parliament to pass an enabling law authorising it to take measures that normally fall within the scope of the law, by means of ordinances.

To deal with the Covid epidemic, an enabling law, of immediate application, was adopted on 23 March 2020 to allow the French Government to take emergency economic and adaptation measures to combat the Covid epidemic.

These authorisations first concerned (i) economic and social measures (support for companies' cash flow, direct or indirect aid to companies, limiting the termination of employment contracts and partial activity, use of paid leave, simplification of the law on collective proceedings, suspension of water and electricity bills for very small companies, etc.); and (ii) various measures of an administrative or jurisdictional nature (adaptation of legal deadlines, rules of criminal procedure, summonses to general meetings of companies or co-owners' associations, etc.).

2.2.2 The numerous 'Covid Orders'

As of 17 June 2020, 62 Ordinances had been issued pursuant to the emergency law of 23 March 2020 to deal with the Covid epidemic. The law relating to companies in difficulty was the subject of several necessary adjustments, immediately applicable to ongoing proceedings.

2.2.2.1 The neutralisation of the economic consequences resulting from the confinement by Order No. 2020–341 of 27 March 2020

This Order temporarily adapted the law on companies in difficulty to take account of the conditions for implementing procedures during the state of health emergency and the months following its end. It encouraged the use of preventive procedures by freezing the assessment of the situation of companies regarding the possible state of cessation of payments until 12 March 2020. This 'crystallisation' of situations enabled businesses to benefit from preventive measures or procedures even if, after 12 March 2020, their situation had worsened to such an extent that they would then be in suspension of payments.

The Ordinance also extended the time limits for collective proceedings. In particular, the legal duration of conciliation proceedings was extended by law for a period equivalent to that of the state of health emergency, increased by three months.

It was also possible to extend the legal duration of safeguard and judicial reorganization plans by up to an additional year, as well as the procedural deadlines imposed on the bodies of the procedure by up to five months. In addition, the Ordinance extended the periods during which claims arising from the termination of employment contracts or sums due to employees are considered for the purposes of insurance against the risk of non-payment.

2.2.2.2 Temporary innovations resulting from Ordinance No. 2020–596 of 20 May 2020 to increase the effectiveness of the treatment of difficulties

This second Ordinance considerably strengthened the law on companies in difficulty to make it temporarily more effective in the face of the scale of the health and economic crisis. Notably, it:

Improved the early detection of difficulties by allowing more rapid and complete transmission of information to the president of the court in the context of the exercise by the auditor of his duty to alert[13].

Favoured the use of preventive procedures by allowing a debtor in conciliation to apply to the court for the suspension of the enforceability of its debts and the prohibition of legal proceedings against it, just as it opened the use of accelerated safeguards more widely by removing the eligibility thresholds.

Facilitated the adoption and execution of safeguard and judicial restructuring plans by reducing the time limits for consulting and convening creditors

[13] Article L234-1 et seq., R234-1 et seq. and L612-3 Commercial Code.

and by instituting a new privilege for the benefit of persons who make a cash contribution during the observation period or under the plan.

The Ordinance also provided, exceptionally, that at the request of the debtor or the administrator, the transfer of the business is possible to the managers or their relatives, provided that it enables jobs to be maintained. To avoid abuses, this transfer to the manager had to be subject to a specially reasoned judgment, in the presence of the public prosecutor, and after the opinion of the supervisors. This measure was eventually abolished, even though it benefited some debtors.

Lastly, this Ordinance accelerated the procedures and measures for dealing with irremediably compromised situations to enable individual entrepreneurs to bounce back.

The duration of this order was extended until 31 December 2021.

2.2.2.3 Considering the persistence of the health crisis by Order No. 2020–1443 of 25 November 2020

This third Ordinance once again favoured the use of preventive procedures by allowing the duration of conciliation procedures to be extended from five to ten months. It also made it possible for the association for the management of the employee claims guarantee scheme ('AGS') to take over employee claims more quickly. Lastly, it made the procedures for communication between insolvency practitioners and the court more flexible. All these adjustments were applicable until 31 December 2021.

2.3 The economic impact of the support measures adopted and their effect on business failure

One of the consequences of the global economic crisis resulting from the health crisis could have been a wave of business failures. However, right from the start of the health crisis, the French State and the Regions put in place numerous economic support measures to prevent the cessation of activity of companies particularly affected by the economic consequences of Covid.

In 2021, because of these measures, the number of insolvencies in France continued to fall for the second year running. Down by nearly 12% compared with 2020 and 45% compared with 2019, the number of insolvency proceedings was at its lowest level for 35 years and the number of jobs threatened had fallen below the threshold of 100,000, whereas in 2019 some 174,000 jobs were threatened.

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Except for a few emblematic insolvency proceedings, most of the support mechanisms have been maintained and their effectiveness has endured. Recourse to the safeguard procedure has thus been used more often by managers of companies with more than 50 employees (+12% compared to 2019 according to the Altares study[14]). In 2020, most sectors of activity ended the year with a very large drop in insolvencies (around -42.6% for construction, -38.2% for trade, -32.6% for services, -32.9% for industry, -41.5% for transport and -39.1% for catering). It should be noted, however, that difficulties have worsened in certain specific sectors such as travel agencies and office administration.

Among the most significant insolvencies in 2020 following the Covid crisis, the retail sector (especially clothing) was particularly affected. By way of illustration, the following insolvencies can be mentioned:

La Halle [€859.32m / 4,731 jobs], placed in safeguard in April 2020, then in judicial reorganisation in June 2020 and sold under a disposal plan in July 2020;
Camaieu International [€610.15m / 3,230 jobs], placed in judicial reorganisation in May 2020 and sold under a disposal plan in August 2020;
Celio France [€467.64m / 2,622 jobs], placed in safeguard in April 2020;
Orchestra-Premaman [€485.58m / 1,659 jobs], converted to judicial reorganisation in April 2020 and sold under a disposal plan in June 2020;
Kidiliz Group [€253.24m / 669 jobs], placed in judicial reorganisation in September 2020 and sold under a disposal plan in November 2020;
Naf Naf [€178.81m / 913 jobs], placed in judicial reorganisation in May 2020 and sold under a disposal plan in June 2020.

In 2021, this downward trend in the number of business failures continued, across all types of businesses and sectors (the number of jobs at risk fell below the threshold of 100,000, compared with 133,000 in 2020 and nearly 174,000 in 2019). At the end of the year, procedures for dealing with the end of the crisis began gradually and judicial liquidations rose slightly.

Among the largest insolvencies in 2021, the following can be mentioned:

Office Dépôt France [€345.8m / 1,820 jobs], an office supplies company, placed in judicial reorganisation in February 2021, partially sold under a disposal plan in June 2021 and converted into a judicial liquidation in September 2021;
Air Management Group (Ciel Voyage SAS [€228.1M], Ciel Voyage 2 [€153.8M], Integrated Aero Network [€78.9M], Ciel Leasing 2 [€55.64M]), specialised in the leasing of aircraft and engines in the aeronautical sector, placed under safeguard and/or judicial reorganisation in June 2021;

[14] Altares study 'Business Insolvencies and Safeguards in France – 1st Quarter 2022'.

Flunch cafétarias [€193m / 5,397 jobs], placed in safeguard in January 2021;
Appart City [€110m / 1,000 jobs], a company specialising in short-term tourist accommodation, placed in safeguard in April and exiting the procedure in September 2021 with a safeguard plan;
Manoir Pitres [€108.7m / 441 jobs], a company specialising in metal processing, placed in judicial reorganisation in February 2021 and exited in October 2021 with a 10-year recovery plan;
France Loisir [€84.8M / 464 jobs], a company specialising in book publishing, in judicial reorganisation in October 2021 following the resolution of its recovery plan, sold under a disposal plan in December 2021;

An analysis of the main sectors affected reveals that out of the hundred or so companies with a turnover of more than 10 million euros that entered into proceedings in 2021, a quarter were companies in the Building and Public Works – Construction – Wood and derivatives sector[15]. More generally, the construction and building sector, which was preserved in 2020, experienced a more complicated year in 2021, particularly in the construction of individual houses, as well as for real estate agencies and property development. The trade sector, which accounts for around 20% of total annual insolvencies, continues to decline, with the exception of the vehicle trade and repair sector, which is still weakened by the tension in international supplies.

With 9,972 insolvencies opened since the beginning of the year, the level of insolvencies has risen by nearly 35% compared with the first quarter of 2021. The increase in the number of insolvencies, which began in November 2021, is accelerating each month. All sectors are affected, but consumer-related activities – restaurants, retail, personal services, etc. – are the most vulnerable. In the regions, Ile-de-France and Corsica are holding up best[16].

3 Management of the 'end of the crisis' through exceptional or specific measures, notably integrating the European Directive

As soon as the first lockdown was over, the Government considered the question of how to manage the end of the crisis so that a possible abrupt halt to the various support mechanism would not alter the massive support provided to the French economy at the height of the health crisis.

In retrospect, it was probably too early to speak of a 'crisis exit'. On the one hand, several waves of epidemics continued to affect the French economy, as

[15] Source: study 'Business insolvencies: What is the outlook in 2022? – March 2022' AU Group / EY.

[16] https://www.altares.com/fr/2022/04/11/etude-de-defaillances-et-sauvegardes-des-entreprises-en-france-au-1er-trimestre-2022/.

well as that of the rest of the world, and, on the other hand, this health crisis was immediately followed by several other crises of varying magnitude.

The fact remains that between the maintenance of certain exceptional measures, the creation of *ad hoc* measures for exiting the crisis and the improvement of existing legal tools with the transposition of the Restructuring Directive 2019, France has a complete toolbox to support its companies not so much in managing the exit from the crisis as in managing the end of the 'whatever it takes' policy adopted by the French government.

3.1 Continuation of certain exceptional measures

As is often the case in France, some of the measures that were intended to be exceptional have been extended several times, and some of them have even been made permanent.

3.1.1 Extensions of liquidity support measures

Numerous measures to support the liquidity of companies have been extended several times. This is mainly the case for the State-Guaranteed Loan (PGE) introduced in March 2020 and allowing banks to grant loans with a State guarantee on a fraction varying from 70% to 90% of the sum lent.

Nearly 700,000 PGEs have been granted for various amounts since March 2020, three quarters of them in the second quarter of 2020. This scheme, which was initially due to end on 31 December 2020, has been extended on several occasions, most recently until 30 June 2022. In practice, however, very few new PGEs have yet been granted. It should be noted, however, that this mechanism, which was created during the Covid crisis, was reactivated during the Ukrainian crisis with the Resilience PGE for companies affected by the Ukrainian conflict.

In addition to the PGEs, the State intervened directly to support the cash flow of companies through the following measures:

- €15,000 per month for small and medium-sized enterprises;
- The so-called 'fixed costs' scheme, which allows the fixed costs of companies that have lost more than 50% of their turnover compared to the same month in 2019 to be covered,
- Partial unemployment scheme, which allows all or part of the salary of temporarily unemployed employees to be covered.

These various measures, which will have cost the State more than 80 billion euros since March 2020, have made it possible to avoid a so-called tsunami of

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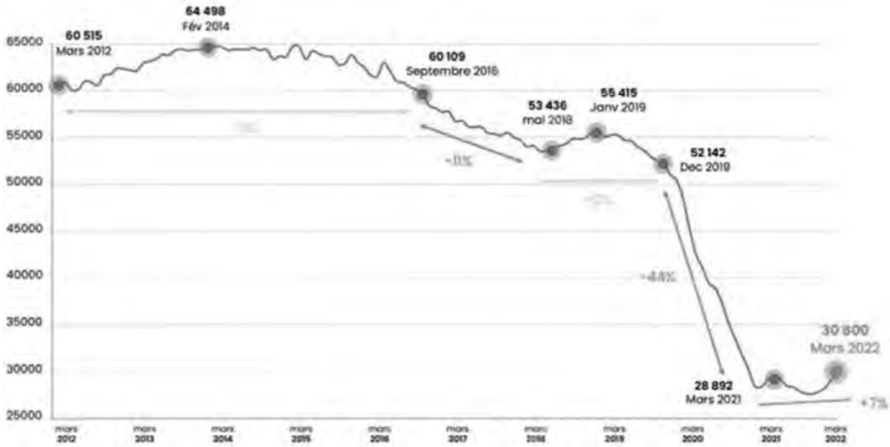
company failures, so much so that the level of company failures has never been as low as it was during the years 2020 and 2021. Although in the first quarter of 2022, business insolvencies rose slightly (+6.3%), they still remained 45% lower than before the crisis.



Source: graph ‘Change in the number of business failures in France over 10 years (12-month rolling data – March 2012 to March 2022)’, taken from the Altares study ’Défaillances et sauvegardes d’entreprises – 1er trimestre 2022’.

3.1.2 The sustainability of exceptional legal measures

Some of the emergency measures have been perpetuated by their integration into the Commercial Code concurrently with the transposition of the European Restructuring Directive in September 2021.

3.1.2.1 Payment periods granted in conciliation

In conciliation, it was already possible for the debtor to ask the president of the court that opened the procedure to grant periods of grace of up to two years[17] to certain creditors who were reluctant to participate in the conciliation procedure.

However, on the one hand, it was necessary to wait until the creditor had served notice or sued the debtor, and on the other hand, it was necessary to proceed by way of a summons to establish an adversarial debate. During the Covid crisis, the possibility was introduced of asking the president of the court, on a simple request, and therefore without an adversarial debate, to freeze, for the duration

[17] Article 1343–1 Civil Code.

of the conciliation, the exigibility of the claims of creditors who had refused a request to this effect from the conciliator. This innovation is now included in the Commercial Code[18].

3.1.2.2 The creation of the 'post-money' privilege

The Ordinance of 20 May 2020 also sought to encourage cash contributions to companies forced to open collective proceedings. Inspired by the new money privilege in conciliation proceedings, the post-money privilege allows for preferential treatment of claims related to cash contributions made during the observation period or in execution of a restructuring plan (safeguard or judicial recovery). These claims cannot be waived, rebate or delayed under a restructuring plan and will have a privileged ranking in case the restructuring fails. As with the conciliation privilege, this privilege will not be available to capital contributions or, directly or indirectly, to creditors in respect of their assistance prior to the opening of the procedure.

3.1.2.3 Provisions to facilitate the adoption of the plan

Under the previous law, case law had specified that the restructuring plan adopted by the court should provide for the repayment of all liabilities, including disputed claims[19]. This solution was likely to prevent the adoption of restructuring plans for viable companies.

This solution was first modified by the Order of 27 March 2020, which allowed the plan to cover only claims that had been admitted or not contested, as well as identifiable claims, provided that the plan was drawn up based on a certificate from the accountant or the auditor. This solution is now enshrined in the Commercial Code[20]. In the case of an amendment to the restructuring plan, contrary to what was provided for the adoption of the plan, the creditor's failure to respond to the proposal to restructure its claim did not constitute acceptance, which could lead to the restructuring plan being prevented from being amended simply because of the creditors' inaction.

To avoid such a blockage, in the case of deadlines provided for in the amended plan, the absence of a response from the creditors constitutes acceptance of the plan. However, this is not the case when a waiver is requested from the creditor. This solution is now enshrined in the Commercial Code.

[18] L611-7 al 5 Commercial Code.

[19] Cass. Com., 15 Novembre 2016 n° 14–22785.

[20] L626-10 Commercial Code.

3.2 Tools for crisis recovery

3.2.1 Establishment of a legal framework for the restructuring of PGEs

The State Guaranteed Loans total over 140 billion euros. Their repayment is therefore a major challenge. Although the estimated rate of default remains low (3.8%), some companies will have difficulty repaying the state guaranteed loan. It has been feared that financial restructuring, which will be essential to the survival of certain companies, may be made impossible given the special nature of PGEs and the need for lending institutions to maintain the state guarantee despite restructuring, which is in principle a guarantee of last resort, i.e. it should only come into play after the guaranteed lender has used all its recourse against its debtor.

The Government has responded to this concern with the orders of 8 July 2021, which provide a specific framework for the restructuring of PGEs.

3.2.1.1 Purely amicable restructuring of PGEs

If the PGE is restructured outside of any legal framework, it cannot be rescheduled over a period exceeding six years from the release of the loan, except for losing the State guarantee[21].

If the lender waives or converts the debt, the lender will be entitled to enforce the State guarantee for the waived or converted portion, but the State guarantee will lapse. Thus, in the event of a subsequent default by the debtor on the non-waivered portion, the lender is left without a guarantor.

3.2.1.2 Restructuring the PGE within a framework

If the restructuring agreement with the lenders provides for a rescheduling exceeding six years from the release of the funds, a write-off or debt to equity swap, in order to be able to maintain the State guarantee for the rescheduled portion, the agreement must be concluded within the framework of a conciliation procedure or a collective procedure (safeguard or judicial restructuring).

For the abandoned or converted part of the PGE, where applicable, the lender may enforce the guarantee at the time of restructuring, with the onus on it to allow the State to benefit from any better fortunes clause or asset sale resulting

[21] Order of 23 March 2020 granting the State guarantee to credit institutions and finance companies, as well as to the lenders mentioned in Article L548-1 of the Monetary and Financial Code, pursuant to Article 6 of Law No. 2020–289 of 23 March 2020 on amending the Finance Act for 2020.

from this restructuring[22]. The rescheduled part of the PGE will benefit from the State guarantee for the entire duration of the restructuring plan, without time limit. For smaller companies with PGE of less than €50,000, a simpler and probably cheaper restructuring procedure has been made available through the intermediary of credit mediation, an emanation of the 'Banque de France' (see above). However, the possibilities for restructuring remain limited within this framework.

3.2.2 The management procedure for the 'Crisis Exit Treatment'

The law of 31 May 2021 on crisis management introduced this new collective procedure for dealing with business difficulties. This 'Crisis Exit Treatment' procedure is temporary as it will only be in force from 18 October 2021 to 1 June 2023.

The premise of this procedure is to organise a 'simplified judicial reorganization proceedings'. Instead of two insolvency practioners, there will be only one, who will be responsible for the tasks of the judicial administrator and those of the creditors' representative. The procedure will take place without a declaration of claim process, the plan will be based on the debtor's declarations and accounts.

Only the debtor can request the opening of this procedure, which lasts a maximum of three months, a period which requires the proposed plan to be prepared in advance. The plan will only concern the creditors indicated by the debtor. No forced takeover of the company by a third party is possible. To benefit from this procedure, the company must meet certain restrictive conditions (be up to date with its payroll liabilities, have less than 20 employees and a balance sheet of less than 3 million euros) which leads us to believe that this procedure will remain very marginal. At the time of writing, only thirty procedures for dealing with crisis situations had been opened, ten of which resulted in the approval of a plan.

3.3 Transposition of Directive 2019/1023 of 20 June 2019

In France, the Restructuring Directive was transposed by Ordinance No. 2021–1193 of 15 September 2021. The changes brought about by the reform are applicable to proceedings opened as from 1 October 2022.

Since France already had an advanced system for preventing business difficulties, the major changes resulting from the transposition of the Directive were

[22] Order of 23 March 2020 granting the State guarantee to credit institutions and finance companies, as well as to the lenders mentioned in Article L548-1 of the Monetary and Financial Code, pursuant to Article 6 of Law No. 2020–289 of 23 March 2020 on amending the Finance Act for 2020.

therefore relatively limited. The main innovation was certainly the organisation of creditors, but also, where appropriate, shareholders, into classes of affected parties which replace in France the creditors' committees which had rapidly shown their limits. Until then, subordinated creditors and/or shareholders could veto the adoption of a reorganization plan even though they were no longer 'in the money', i.e. their prospects of recovering all or part of their claims or their investment from the flows generated by the company or its disposal were nil.

From now on, in certain cases, the court will be able, under certain conditions, to force the adoption of a restructuring plan notwithstanding the negative vote of one or more classes (cross class cramdown). The rights of the parties will then be more in line with the economic value of their interest in the company.

French law, often seen as too favourable to shareholders and debtor to the detriment of creditors, is thus the subject of a welcome rebalancing, even if the complexity of this new mechanism may lead to fears of a multiplication of disputes, notably on the issue of economic value of the company and the rights of each of the stakeholders. However, this must be put into perspective, as this new mechanism will only apply to companies of a certain size (turnover of more than 20 million euros or a workforce of more than 150 employees), whereas most insolvency proceedings opened concern companies with fewer than 10 employees. In the first quarter of 2022, only 20 insolvency proceedings concerned companies with a turnover of more than EUR 20 million and/or more than 100 employees[23]. Other companies can nevertheless ask the official receiver to accept the constitution of classes of creditors.

The transposition of the Directive has also led to an acceleration of collective proceedings which could last up to 18 months. This period is still possible in judicial reorganisation but now the safeguard procedure cannot last more than 12 months[24], and the accelerated safeguard procedure[25] cannot exceed 4 months.

Finally, to encourage entrepreneurs to bounce back, which is the stated objective of the European Directive, the Order of 15 September 2021 strengthened the protection measures for natural person guarantors and facilitates access to simplified procedures such as professional recovery (for natural persons) and simplified judicial liquidation.

[23] Source: Altares Study of Business Insolvencies and Safeguards in France – 1st Quarter 2022.

[24] L621-3 Commercial Code.

[25] L628-8 Commercial Code. This procedure was merged with the former accelerated financial safeguard procedure as a result of the disappearance of the credit institution committees.

* * *

In conclusion, although France had a complete toolbox for dealing with business difficulties even before the crisis, it is thanks to the mobilisation of the various players of the restructuring market, both private and public, to the adaptations made to the law on companies in difficulty and to the massive support provided by the French State, directly or through the banking system, that companies were able to get through this major crisis and that a wave of bankruptcies could be avoided.

This massive support must be stopped because it has also led to the artificial survival of 'zombie' companies, as demonstrated by the abnormally low level of company failures since the second half of 2020.

The fact remains that many French companies are emerging from the Covid crisis with balance sheets that have been severely weakened by the effects of the Covid crisis, even as they face major challenges: the Ukrainian crisis, China's 'Zero Covid' policy, inflation, labour shortages, etc.

In this context, it is essential to accompany French companies in the phase of withdrawal of state support and to benefit from a clear and balanced legal framework in order to allow their restructuring when necessary.

By adapting its legal framework, notably with the transposition of the Restructuring and Insolvency Directive, but also by perpetuating certain solutions that emerged during the health crisis, France has (hopefully) responded to this imperative.

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Chapter 8

An Overview of How Ireland Adapted its Insolvency Laws and Processes during the COVID-19 Pandemic

Sharon Barrett
Director, Restructuring, Kroll

1 Introduction

Speaking from Washington on 12 March 2020, Leo Varadkar, the then Irish Taoiseach[1], told the assembled media and watching Irish public 'I need to speak to you about the Coronavirus and COVID-19'[2]. No one predicted how this sentence would kickstart a list of measures, restrictions and guidance issued by the Irish government in reaction to the COVID-19 pandemic which would ultimately span two Taoisigh and last over two years.

Opinions on how Ireland managed COVID-19 and its associated health and economic disruption are as wide ranging as the number of variations of the virus likely to be discovered over time. There are many metrics by which this performance could be judged, but one objective measurement is *Bloomberg's* COVID Resilience Ranking[3], which scores the largest 53 economies in the world on their success in dealing with the pandemic. The methodology uses 11 factors to determine resilience, including reopening progress, vaccine doses per 100 People and lockdown severity among others. In September 2021, Ireland was ranked as the best country in the world for how it dealt with the COVID-19 pandemic[4]. Having had the worst outbreak globally in January 2021, Ireland managed to turn its performance around largely as a result of government interventions, population adherence to restrictions and the roll out of a widely lauded vaccination programme. The country is, at the time of writing, ranked

1 The head of the Irish government.

2 gov.ie – Statement by the Taoiseach on measures to tackle COVID-19 (www.gov.ie).

3 'Methodology: Inside Bloomberg's COVID Resilience Ranking', *Financial Post*.

4 Cate McCurry, 'Ireland ranked "best country" in how it has responded to pandemic' *Irish Independent*, September 28, 2021, Independent.ie.

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No. 2 in the world behind Norway, who have claimed top spot for several months[5].

The focus of this paper is on how the government adapted legislatively to the enormous and unique challenges brought about by the pandemic from an insolvency perspective. A review of the existing framework in place in the country at the outset of the COVID-19 pandemic is outlined, and thereafter, the key legislative changes and how they impacted on the insolvency regime are considered. The paper then looks to the future in respect of what may emerge.

2 An overview of insolvency laws and processes in place prior to the pandemic

This section provides a summary of both the personal and corporate insolvency regimes in existence at the outbreak of pandemic.

2.1 Personal insolvency

In Ireland, personal insolvency is governed by the Personal Insolvency Act 2012 and the Personal Insolvency (Amendment) Act 2015 (together known as the 'PI Acts'). The 2012 Act enabled the establishment of the Insolvency Service of Ireland ('ISI'), and introduced, for the first time, three new debt resolution processes for individuals who found themselves in difficulty. However, in the initial two-year period, the number of applications was surprisingly low, driven in the main by a reluctance or refusal on behalf of secured lending institutions to engage in a consensual write down of debt. The result was the 2015 Act, which made a number of changes, including the ability to appeal a decision of the creditors to reject a proposed arrangement to the High Court. The processes in place are briefly set out below.

(a) **Debt Relief Notice ('DRN')** – This is a solution for those who have low income, few or no assets, unsecured debts which they are unable to pay and where an individual can prove their financial position is unlikely to improve in the next three years. The DRN provides for the write-off of qualifying debt of up to €35,000, subject to a three-year supervision period. Debtors cannot have more than €60 income per month after reasonable living expenses have been accounted for. A debtor can exit the process any time before the three-year period is finished by paying off 50% of the total amount owed. The DRN is a formal, legally binding solution whereby unmanageable debt is formally written off at the end of the process.

[5] 'COVID Resilience Ranking: The Best and Worst Places to Be in 2022' (bloomberg.com).

(b) **Debt Settlement Arrangement ('DSA') –** This solution is suitable for individuals with unsecured debts above €35,000. There is no maximum amount, and it provides for a formal solution with creditors which allows for some debt write off. The debtor will agree to pay a percentage of their overall debt over a five-year timeline (extendable to six years in certain cases). The debtor must appoint a Personal Insolvency Practitioner ('PIP'), who will seek a protective certificate from the court on their behalf, which if granted, will give the debtor protection from creditors for a 70-day period until a DSA is prepared. The DSA requires the approval of 65% of creditors in value to be formally approved by the court.

(c) **Personal Insolvency Arrangement ('PIA') –** This enables a debtor to repay an agreed amount of both secured and unsecured debt. Secured debt of up to €3 million is eligible, together with unsecured debt of any amount. Unsecured debt will be compromised and settled over a period of up to six or seven years with the debtors being released from any residual balance of the original debt at the end. Secured debt can be restructured, and depending on the terms of the PIA, it can be settled at the end of the period or continue to be payable after the debtor exits the PIA. A protective cert is issued as with the DSA, which gives a period of 70 days to prepare the PIA. Creditors representing an overall 65% (being a minimum of 50% of the secured debt and 50% of unsecured debt) must vote in favour of the PIA. Amendments were made by the 2015 Act in an attempt to ensure that creditors could not veto reasonable PIA proposals. The amendments enabled a PIP on behalf of a debtor to make an appeal application to the courts. The court must approve the revised PIA for it to be binding.

(d) **Bankruptcy –** The PI Acts revised and modernised the existing personal bankruptcy regime and provided for a less punitive and costly approach to bankruptcy in Ireland. It is a formal solution for people with debt over €20,000. During the process, the ownership interest in all of a person's property, rights, interests and possessions transfer to the Official Assignee in Bankruptcy (an independent officer of the High Court) to be disposed of by him for the benefit of creditors. The PI Acts reduced the bankruptcy period from 12 years to one year, after which the bankrupt will be automatically discharged (unless the Official Assignee seeks to extend the period due non-disclosure, non-cooperation or other issues regarding the bankrupt's conduct).

2.2 Corporate insolvency and restructuring

2.2.1 Liquidation

This is a process under which a company is brought to a legal end. In Ireland, Part 11 (Winding Up) of Chapter 8 of the Companies Act 2014 sets out the main legislative provisions. Liquidations are either voluntary or compulsory. There are two types of voluntary liquidation, and one type of compulsory liquidation as detailed below:

(a) **Members' Voluntary Liquidation ('MVL') –** The key feature of an MVL is that the company must be solvent. This means it must be able to discharge all its debts within a twelve-month period from the commencement of the liquidation process. Once all of the debts of the company have been discharged any residual assets may be realised by the liquidator or distributed in specie to the shareholders.

(b) **Creditors' Voluntary Liquidation ('CVL') –** In this type of liquidation, the company is insolvent i.e., it is not able to discharge its debts as they fall due. Once any assets owned by the company have been realised by the liquidator, any surplus funds are then distributed to the creditors of the company in accordance with their ranking status. The liquidator also has a duty to submit a report to the Director of Corporate Enforcement on the conduct of the directors prior to the company going into liquidation. In some cases, the liquidator may be required to bring an application to the High Court for the restriction of the directors of the company unless the liquidator is relieved of this obligation by the Director of Corporate Enforcement.

(c) **Compulsory Liquidation or Winding up by the Court –** This is provided for in Chapter 2 of Part 11 of the Companies Act 2014. In order for a compulsory liquidation to be commenced, a petition must be presented to the High Court by either the company itself, a creditor, any contributory member, or where affairs of the company are being conducted in a manner that is oppressive to any member. Additionally, the Office of the Director of Corporate Enforcement ('ODCE') can petition the court to wind up a company if it can prove that it is in the public interest to do so. The most common grounds used to commence a winding up by the court is the insolvency of a company, i.e., its inability to pay its debts as they fall due. Once any assets owned by the company have been realised by the liquidator, any surplus funds are then distributed to the creditors of the company in accordance with their ranking status. As with CVLs, the liquidator also has a duty to submit a report to the Director of Corporate Enforcement to investigate the affairs of the company and the conduct of its directors prior to the liquidation. The liquidator is required to bring an application to the High Court for the restriction of the directors of the company unless relieved of this obligation by the Director of Corporate Enforcement.

2.2.2 Examinership

The examinership process was introduced by the Companies (Amendment) Act 1990, and is currently set out in Part 10 of the consolidating and modernising Companies Act 2014. It allows a company with what is termed 'a reasonable prospect of survival' to obtain breathing space in the form of protection from its creditors for a limited period to attempt to restructure the business to ensure it can continue into the future and protect employment. The timeline is typically 70 days, with extensions permitted up to 100 days (or 150 days pursuant to emergency legislation introduced in response to the pandemic as discussed below). The timeline is relatively short in comparison to other jurisdictions but encourages a focus by all stakeholders in finding a solution and ultimately limits the potential costs.

The primary duty of an examiner is to put together a rescue plan for the company, known as a scheme of arrangement ('SOA'). It will typically provide for the treatment of creditors' claims, payment proposals, restructuring of the balance sheet and the terms of new investment. The examiner must convene meetings of each type of member and creditor to get approval for the rescue plan.

If at least one class of impaired creditor accepts the rescue plan, the examiner can then bring the rescue plan before the court for approval which will confirm the rescue plan if it is satisfied that the SOA is fair and equitable to any impaired class that did not approve the scheme and is not unfairly prejudicial to any interested party (i.e. the creditor should do better under the rescue plan than in the most likely alternative to rescue such as an insolvent liquidation or a receivership).

2.2.3 Statutory Scheme of Arrangement ('Part 9 Scheme')

A Part 9 Scheme is a statutory process provided for in Chapter 1 of Part 9 of the Companies Act 2014 which allows a company to propose and ultimately enter into a binding arrangement or compromise with some or all of its creditors (or in certain cases its members). It is an extremely flexible tool which can be used to restructure any type of liability or obligation of a company.

A key feature of a Part 9 Scheme is that each impacted class of creditor is entitled to vote on the proposed scheme and if it is passed by a 'special majority' – comprising a majority in number representing a majority in value – of each impacted class an application can then be made by the company to the court to seek approval of the Part 9 Scheme. The proposals must be sanctioned by the court but the process is driven by the debtor company. The court does not appoint an examiner or officer to oversee a Part 9 Scheme, save where a post effective date claims administrator or other role is required. Part 9 Schemes are being increasingly used in Ireland, particularly in the context of large balance sheet restructurings.

2.2 Receivership

Receivership is a process used by banks and other secured lenders to sell an asset which is pledged to them as security for a loan if the borrower defaults on the loan provided by them. It is widely used in Ireland for both corporate and personal assets held by secured lenders. A receiver can be appointed either on foot of the powers contained in a debenture or mortgage document or on foot of a court order. If a receiver is appointed by a secured creditor, the loan agreement and security documents will outline the events of default and powers the receiver can exercise if appointed. In the case of a limited entity, he/she will have a broad swathe of powers under the Companies Act 2014 and the associated security documents, which generally include the power to take possession of and sell the secured assets. If a receiver is appointed by the court, the court will outline the powers the receiver can exercise.

The primary duty of a receiver is to take control over the asset that has been mortgaged to the secured creditor, realise the asset for the best price reasonably obtainable at the time of sale and apply the net proceeds against the debt due to the secured creditor. Any surplus funds are returned to the borrower or a liquidator if one has been appointed to the borrowing entity. Fixed asset receivers are commonly appointed by lenders in Ireland, whereby the receiver deals only with the asset and not the debt or other income of either the corporate body or individual. Broader appointments over all of the assets and undertaking of a company are also available depending on the scope of the security.

3 Key government legislation enacted throughout the COVID-19 pandemic, and how this affected existing insolvency processes

In March 2020, as people were forced to stay at home from their places of work, or where those workplaces were shut to contain the spread of the virus, hundreds of thousands of people became temporarily unemployed overnight. According to Gaffney, McCann & Stroebel (2021)[6], the initial effects resulted in a year-on-year reduction in consumer spending of 22% in Q2 2020. In

[6] E Gaffney, F McCann and J Stroebel, The Economics of Mortgage Debt Relief during a pandemic, Central Bank of Ireland Financial Stability Notes, July 2021.

recognition of and with a view to ameliorating the issues that the pandemic would cause, the Irish government enacted a raft of legislation from March 2020 which was amended and extended over the course of the next two years. The legislation referred to in this article focuses on protections and financial impacts for business and individuals.

3.1 Legislation related to residential tenancies

3.1.1 Emergency Measures in the Public Interest (COVID-19) Act 2020 ('Emergency Measures Act')

This Act[7] was signed into law on the 27 March 2020 and comprised nine separate parts dealing with various health, employment, tenancy, and general issues arising as a result of the pandemic. This section focuses only on the changes as applicable to tenancies.

The Emergency Measures Act made a number of temporary amendments to the Residential Tenancies Act 2004–2019. The ultimate aim was to protect the security of residential tenants during the emergency period, defined as being an initial timeline of three months commencing 27 March 2020, but extendable if necessary. It was subsequently extended to 1 August 2020 in line with public interest requirements (and was ultimately replaced by the RTV Act discussed below).

In summary, landlords were prohibited from issuing notices of termination, implementing rent increases, and evicting tenants during the emergency period. Tenants were still obliged to pay rent during this time in accordance with their lease unless separate agreements were put in place with the landlord. Exceptions only applied where vacant possession of a property was required by a Determination Order or Tribunal Order. In circumstances where a termination notice had been served prior to 27 March 2020, a revised termination date applied. The revised date was the sum of the length of the emergency period plus the time which was left to run on the termination notice as of 27 March 2020, plus one additional day.

Evictions were prohibited under the act except in certain exceptional circumstances where the Residential Tenancies Board (RTB) had issued a notice for a tenant to vacate. Rent increases due to come into effect during the emergency period were also paused, resulting in effective rent freezes.

Section 57(a) was inserted into the Act late in Dáil (Irish parliament) debates, stating that ' . . . all proposed evictions in all tenancies in the State, including

[7] Emergency Measures in the Public Interest (COVID-19) Act 2020 (irishstatutebook.ie).

those not covered by the Act of 2004, are prohibited during the operation of the Emergency Measures . . . '. This caused some initial confusion, as whilst the original Emergencies Measures Act was intended to deal with residential tenancies, this clause could be interpreted as extending cover to commercial tenants. This uncertainty was addressed by the introduction of the RTV Act.

3.1.2 Residential Tenancies and Valuation Act 2020 ('RTV Act')

The RTV Act replaced the previous relevant sections of the Emergency Measures Act. It was signed into law on 2 August 2020 and moved away from the previous blanket rent freeze and prevention of evections to a more tailored approach. The RTV Act extended restrictions on increases in rents and evictions up to 10 January 2021, but only in certain circumstances, and only for residential tenants who had found themselves in difficulty as a result of COVID-19.

The RTV Act provided for a 'Relevant Person' who was defined as anyone who had been on COVID-19 illness benefit between 9 March 2020 and 10 January 2021, had received a government wage subsidy or any other COVID-19 related government payment during the period, and who were unable to pay their rent. To be protected by the legislation, the tenant was required to serve a declaration on the RTB confirming their status as a Relevant Person, and outline that there was a risk their tenancy would be terminated by the landlord. It also made it a criminal offence to make a false declaration.

For those tenants who had made a declaration and were Relevant Persons, the protections included longer notice periods for termination of tenancies based on rent arrears. A 90-day notice was required (as opposed to the previous 28 days), and no tenancy could be terminated any earlier than 11 January 2021. In all other instances, tenants could be evicted as per the Residential Tenancies Act 2004 ('RTA 2004').

The RTV Act also made amendments to the RTA 2004 which applied to all residential tenancies. For any case where there was to be a termination on the grounds of rent arrears, the RTV Act provided that landlords must serve a copy of the termination notice on the RTB the same day as they served notice on the tenant. The RTB must then engage with the tenant to advise them of their ability to contest the notice in the RTB. Additionally, the timeline for issuing a notice to the tenant to pay the arrears in full was extended from 14 days to 28 days, and it is now required that the RTB is also served with that notice.

3.1.3 Residential Tenancies Act 2020 ('RTA 2020')

This Act also referred to an emergency period, but defined it as being the period that comes into operation whenever the Minister of Health introduces restrictions on travel outside of a 5km radius of a person's place of residence. The emergency period at the time applied country wide from 22 October 2020 to 1 December 2020, but the act also provided for multiple emergency periods. As a result, COVID-19 public health restrictions would determine when and where the usual operations of the RTA 2004 (the legislation that usually guides the rental sector) would be modified by the RTA 2020.

The RTA 2020 provided that tenants were not required to vacate their rental properties in an emergency period except in limited circumstances, relating to specific breach(es) of tenants' obligation as per their lease (anti-social behaviour, use of dwelling other than for residential purpose etc). During the emergency period notices of termination could be served. However, they could not take effect and therefore a revised notice period would apply. The revised termination date would be calculated by adding the remainder of the original termination notice given, all or the remainder of the emergency period plus a 10-day grace period. The tenant would not acquire any security of tenure rights under Part 4 of the RTA 2004 on foot of the pausing of the notice of termination to allow the tenant to remain in occupation during the emergency period. Any tenant who had been previously served with a notice of termination for a date that occurred before an emergency period but who did not vacate and remained in the property when the emergency period commences, was permitted to stay in the property until 10 days after the expiry of an emergency period. The Act outlined that during this time, the tenant must continue to pay rent and comply with the normal terms and conditions of their lease.

A tenant could serve their landlord a notice of termination during an emergency period, but a landlord could not make the tenancy termination take effect until after the expiry of the emergency period. A tenant could however proceed to terminate a tenancy during an emergency period.

3.1.4 Planning and Development and Residential Tenancies Act 2020 (PDRTA 2020)

This Act[8] was enacted on 19 December 2020 and took effect from 11 January 2021 to July 2021. This extended the protection regime for tenants who self-declared that their tenancy was at risk of termination, and from any increase in rents during the period. The protections applied once the tenant

[8] Planning and Development and Residential Tenancies Act 2020 (irishstatutebook.ie).

qualified as outlined under the RTA. The PDRTA 2020, however, also included protections for landlords. If, on the 10 January 2021 rent had been in arrears for five months or more or the tenant declaration of risk was not also accompanied by a request to the RTB for assistance in obtaining financial advice, then the tenant protections no longer applied. In addition, the tenant would also forfeit protections if they did not provide sufficient information or had not complied with a rent payment agreement with the landlord. The landlord could also serve a declaration on the RTB stating one of these conditions was met, or that the application of protections to the tenant would cause undue financial hardship to the landlord.

3.1.5 Residential Tenancies Act 2021

This extended the emergency period for a further three months from 12 April 2021 to 12 July 2021 under the RTA 2020 and the RTV Act.

3.1.6 Residential Tenancies (No 2) Act 2021 ('RTA2 2021')

The RTA2 2021[9] came operation with effect from 9 July 2021, save for Section 6 which was effective from 16 July 2021. It provided for further extensions to the protections afforded under the PDRTA for those tenants and landlords who continued to be financially affected by COVID-19 until 12 January 2022.

This Act also included some longer-term changes to residential tenancies, in that it restricted any rent increase in a Rent Pressure Zone (RPZ) from exceeding general inflation, as recorded by Harmonised Index of the Consumer Price (HICP). It further limited the amount of rent in advance and/or a deposit that landlords can ask individuals to pay to secure a tenancy (i.e., no more than one month); and provided that students do not have to give more than 28 days' notice to terminate their rental arrangement.

3.2 Payment breaks

While the government was required to legislate in terms of the rental market, it relied on the goodwill of the banking industry to protect borrowers, although it used its significant influence to ensure that support measures were meaningful. A number of meetings were held between the government and stakeholders at the outset of the pandemic. In early March 2020, the heads of the five main banks operating in Ireland agreed to provide payment breaks for customers.

[9] Residential Tenancies (No 2) Act 2021 (irishstatutebook.ie).

The Banking & Payments Federation Ireland issued a document with advice for all those borrowers who required payment breaks on loans and mortgages[10].

The primary objective of the measures introduced was to increase the support available to people who were most affected by the pandemic and were likely to experience financial distress as a result of job loss, or as a result of significantly decreased or no turnover because of the restrictions put in place. A summary of the support measures introduced for mortgage holders effective from mid-March 2020 are as follows:

(1) Temporary payment breaks for all personal and business customers, including any mortgage holders who were already in arrears. These payment break options were originally offered for three months, however, were later extended to a six-month period.
(2) The banks agreed to a simplified application process for payment breaks, and that any payment breaks requested would not adversely impact a customer's credit score
(3) Numerous working capital facilities and business supports were made readily available as a result of business closures.
(4) The Central Bank of Ireland indicated that all lenders were expected to pause repossession proceedings on all residential properties at the initial stages of the pandemic. However, the fact that the Courts Service was effectively shut down for all but urgent cases essentially led to the same thing.

In practice, lenders have shown continued forbearance on defaulting loans right up until Q1 2022. While no legal requirement existed, banks and lenders in Ireland were incredibly reluctant to be seen to enforce their security during the pandemic on either residential or commercial loans, particularly those related to the residential or hospitality sector. Lenders have only recently begun to show some increased activity in this regard.

3.3 Income and wage supports

Fearing mass redundancies on 24 March 2020, the government announced a range of COVID-19 Income Supports[11] including a wage subsidy scheme to help companies continue to pay their employees, a pandemic Unemployment Payment (PUP), and a COVID-19 illness payment. The cost of these measures was initially estimated at €3.7bn over a 12-week period. In the first 12 months

[10] Banking and Payments Federation Ireland, A Guide to the COVID-19 Payment Break (this has since been superseded by a publication in December 2021, A Guide to Coming off the COVID-19 Payment Break Final-BPFI-Coming-off-the-COVID-19-Payment-Break-1.pdf).

[11] gov.ie, 'Government announces new COVID-19 Income Support Scheme' (www.gov.ie).

of the pandemic the government provided €11.5 billion in wage support[12], by January 2022 the total fiscal response of the government was estimated at €48bn[13].

3.3.1 Pandemic unemployment payment ('PUP')

The PUP's initial level was €203 per week for workers who had lost their employment due to COVID-19. It was increased to €350 per week shortly after its introduction. The payment was originally to be made available for six weeks, however as the pandemic continued the deadline was extended. From 16 October 2020 PUP rates were linked to prior weekly earnings and ranged from €203 (for those who had previously earned €200 or less per week) up to €350 (for those who earned greater than €400). The numbers availing of the PUP payment during the pandemic surpassed all initial estimates. A tapering off of payments began on 7 September 2021, when the rates paid dropped by €50 per week in each category (or to a minimum of €203), with further reductions on 17 November 2021 and 15 February 2022. It eventually ended on 25 March 2022, when any remaining recipients were moved to a jobseeker's allowance.

3.3.2 COVID-19 illness benefit

This payment was made available to anyone who was diagnosed with COVID-19 or had been told to self-isolate at a rate of €350 per week. This was extended a number of times and is due to cease in June 2022.

3.3.3 Temporary wage subsidy scheme ('TWSS')

This came into effect from 26 March 2020 and ran until 31 August 2020. The TWSS was made available to employers from all sectors who had lost a minimum of 25% of their turnover in comparison to February 2020 (and subsequently to Q1 or Q2 in 2019)[14]. It enabled employees, whose employers were affected by the pandemic, to receive significant supports directly from their employer. The stated aim of the government was to try to keep the employer/employee relationship intact throughout the pandemic. The TWSS was based on employee's Average Revenue Net Weekly Pay ('ARNWP'). If this was less than or equal to €586 a maximum subsidy of €410 was payable, for amounts greater than €586 and less than or equal to €960 per week a maximum

[12] gov.ie, 'A Year in Review – €11.5 billion in Welfare Supports in response to COVID-19 pandemic' (www.gov.ie).

[13] PowerPoint Presentation (ntma.ie).

[14] Guidance on Employer Eligibility and Supporting Proofs for Temporary COVID-19 Wage Subsidy Scheme (revenue.ie).

subsidy of €350 was payable[15]. Tapering of the subsidy applied where additional payments from the employer exceeded the ARNWP.

3.3.4 Employment wage subsidy scheme ('EWSS')

The TWSS was superseded by the EWSS from 1 September 2020[16]. EWSS is based on an employee's gross weekly wage, including notional pay, before deductions, and excluding non-taxable benefits. Employers must be able to demonstrate a reduction of 30% in turnover form 1 January to 31 December 2021 due to the pandemic. A reduced rate of employer PRSI of 0.5% is charged on wages paid to employees who are eligible for the subsidy payment. Workers are eligible if they are in receipt of weekly gross wages between €151.50 and €1,462. The rates varied at stages throughout the pandemic, ranging from €100 to €203 per week for employees earning from €151.50 to €202.99 per week, and up to €350 per week for those earning from €400 to €1,462 per week. From 1 March 2022 to 31 May 2022 the rate is €100 per week across the board, following which EWSS will cease to exist.

3.4 Business supports

3.4.1 COVID restrictions support scheme ('CRSS')

This scheme was launched on 6 November 2020 to support businesses significantly impacted by COVID-19 restrictions[17]. Eligible businesses could make a claim to Revenue for a payment known as an Advance Credit for Trading Expenses ('ACTE'). An ACTE was payable for each week a business was affected by the restrictions. The ACTE was equal to 10% of the average weekly turnover of the business in 2019 up to €20,000, plus 5% on turnover over €20,000. In the case of new businesses, the turnover was based on the average actual weekly turnover in 2020. The ACTE was subject to a maximum weekly payment of €5,000. The scheme ended 31 January 2022.

3.4.2 Business and commercial rates

On 15 May 2020, the government announced an initial three-month waiver of rates for businesses forced to close due to COVID-19. In recognition of the fact that not only were many ratepayers forced to close their business due to the public health restrictions, but also of those who were able to reopen, most suffered substantial reductions in turnover, the waiver was extended from three

[15] Subsidy rates in the transitional phase (revenue.ie).

[16] Employment Wage Subsidy Scheme (EWSS) (revenue.ie).

[17] gov.ie, 'Government launches the COVID Restrictions Support Scheme (CRSS) to support businesses significantly impacted by COVID-19 restrictions' (www.gov.ie).

to six months until 27 September 2020. A 100% waiver was applied to all businesses excluding banks, utilities, large supermarkets, and corporates, as they were considered able to continue to operate. The government subsequently extended the waiver to the Q1 2022, albeit on a more targeted basis so that the businesses who were most impacted (such as licenced premises) would receive the necessary aid. The Department of Housing, Local Government and Heritage estimated that that the cost of the rates waiver from March 2020 to 1 December 2021 was almost €1.5bn[18].

3.4.3 Restart grant

This was a contribution towards the cost of re-opening or keeping a business operational and re-connecting with employees and customers[19]. The grant could be used to defray ongoing fixed costs during closure such as utilities, insurance, refurbishment or for measures to ensure employee and customer safety. In most cases, the grant would be equivalent to the amount of the rates assessment for the premises for 2019 with a minimum grant of €4,000 and a maximum grant of €25,000.

3.4.4 Revenue warehousing

The Financial Measures (COVID-19) (No 2) Act 2020 legislated for deferral of certain tax liabilities due by employers and self-employed individuals[20]. Liabilities which were eligible for warehousing included Value Added Tax, Pay As You Earn (PAYE), employer liabilities including income tax, Pay Related Social Insurance, Universal Social Charge and excess payments under the TWSS. The warehousing scheme has three phases:

- **Period 1:** COVID-19 restricted trading phase, which included liabilities incurred during the period of reduced or no trading which could be warehoused.
- **Period 2:** Zero interest phase, relating to liabilities from Period 2 which would attract no interest for a 12-month term.
- **Period 3:** Reduced interest phase. Liabilities would be placed into a phased agreement after Period 2 and would be subject to 3% interest until full repaid.

In June 2021, Period 1 was extended until 31 December 2021. Period 2 will therefore last to the end of 2022, and Period 3 will commence from 1 January

[18] gov.ie, 'government announces €62.3m targeted commercial rates waiver for quarter one 2022' (www.gov.ie).

[19] Restart-Grant-Plus-FAQs.pdf (enterprise.gov.ie).

[20] Revenue confirms 'warehousing' of COVID-19 related tax debt for businesses.

2023. In February 2020, the Minister for Finance confirmed that €3.3bn in tax debt has been warehoused to date[21].

3.4.5 COVID-19 credit guarantee scheme

This scheme[22] was set up to facilitate up to €2bn in lending to eligible business. A partial government guarantee (up to 80%) was provided to participating finance providers against losses on qualifying finance agreements to eligible SME's, small Mid-Caps, and primary producers. The rationale for the scheme is to incentivise lenders to continue to provide liquidity to this core section of Irish enterprise. Loans can range from €10,000 to €1 million for terms of up to 5½ years. Up to €250,000 of unsecured lending can be made available to businesses under the scheme. The total amount available to any one enterprise is limited to either double the wage bill of the business in 2019, or 25% of the total turnover for 2019. The funding is available through retail banks, credit unions and other non- bank lenders, and will cease taking applications on 30 June 2022 unless fully utilised by then.

3.4.6 Business resumption support scheme

Set out in the Finance (COVID-19 and Miscellaneous Provisions) Act 2021, the BRSS was introduced for vulnerable but viable businesses from September 2021[23]. Businesses whose turnover was reduced by 75% in the reference period (1 September 2020 to 31 August 2021) compared with 2019 are eligible for the scheme. Qualifying businesses will be able to apply to Revenue for a cash payment. Payments are calculated based on three weeks at 10% of the first €1m of ex VAT 2019 turnover, and 5% thereafter. The payments are subject to a maximum weekly payment of €5,000.

3.4.7 VAT reduction for hospitality sector

As part of Budget 2021, the government outlined that it was reducing the VAT rate of 13.5% applicable to tourism and hospitality services to 9% from 1 November 2020 to 31 December 2021. In Budget 2022, the lower rate was extended until August 2022. A further announcement was made on 10 May 2022 that the rate would stay at 9% until 28 February 2023. The government outlined that the rationale for this was that retaining the rate

[21] Revenue warehouses up to €3.2bn in business tax debt (irishtimes.com).

[22] SME Credit Guarantee Scheme (CGS) - SBCI.

[23] Business Resumption Support Scheme (BRSS) (revenue.ie).

would help business when the EWSS expires on 31 May 2022. The majority of the 4,000 business that are still availing of the EWSS are in the hospitality industry[24].

3.5 Other relevant legislation

3.5.1 Companies (Miscellaneous Provisions) (COVID-19) Act 2020

This legislation was passed by the Dáil on 30 June 2020. It made temporary amendments to the Companies Act 2014 and the Industrial and Provident Societies Acts 1893–2018 to address issues arising as a result of the COVID-19 pandemic. The aim of the bill was to assist companies in being able to hold their necessary shareholder and creditor meetings while restrictions were in place (which meant they could not be held in person), and to provide a limited level of protection to businesses. The main features of the act are as follows:

(a) Shareholder and creditor meetings could be held virtually.
(b) Documents usually required to be executed under seal could be executed in counterpart.
(c) The threshold at which a company is deemed to be unable to pay its debts on foot of a 21-day demand letter was increased from €10,000 to €50,000.
(d) Extension of examinership to 150 days (subject to court approval).

The amendments in respect of insolvency were deemed to be an important part of the Act, given that numerous businesses in Ireland that could previously have been wound up for relatively small debts of €10,000 would be able to continue trading without that threat during the COVID-19 pandemic. The measures were subsequently extended on numerous occasions, with the most recent extension lasting to the 31 December 2022. The government has indicated that it intends to retain the provision for virtual meetings and will legislate for that to be incorporated into an amendment to the Companies Act in due course.

3.5.2 Planning amendments as a result of COVID-19

A number of amendments[25] were made to the Planning and Development Act 2000 ('PDA 2000'), the Planning and Development (Housing) and Residential Tenancies Act 2016 and others in response to disruption caused to the planning process and general constriction by restrictions. The initial amendments were made as part of the Emergency Measures Act and allowed extensions to the

[24] Hospitality VAT rate of 9% to be extended for six months – Independent.ie.

[25] Planning and Development, and Residential Tenancies, Act 2020 (irishstatutebook.ie); gov.ie, 'Clarification on the operation of the planning system during the COVID-19 pandemic' (www.gov.ie).

timeframe for the determination of planning permission applications and appeals for an eight-week period from 29 March 2020 to 23 May 2020 under Section 251A of the PDA 2000. Planning restrictions were relaxed or lifted to adapt to changed practices as a result of the pandemic. Restaurants were able to operate as takeaways, and supermarkets could operate for longer hours. Hospitals, mortuaries, testing centres and other health care facilities required in order to fight against the virus could bypass planning laws.

The government designated planning-related activity within the schedule of what was considered essential services, and therefore travel restrictions did not apply to employees engaged in the planning approvals process. Oral hearings were initially postponed in line with government restrictions, but after the initial eight-week period, where such hearings were scheduled by An Bord Pleanála, they were held remotely/virtually.

Section 7 of the Planning and Development (Amendment) Act 2021 came into operation on 9 September 2021. It provides developers with the ability to apply for further extensions to planning permissions previously extended by a period of up to two years, or until 31 December 2023 (whichever is first). This amendment is subject to numerous conditions, and developers must prove that they are unable to complete their project within the original timeframe. However, it gives a reasonable period for those who genuinely experienced supply chain difficulties, and product and labour shortages as a result of the COVID-19 pandemic to complete developments.

3.6 How the legislation and supports affected existing insolvency processes

There is little doubt that without the supports put in place by the government at the outset and over the course of the two years of the COVID-19 pandemic, the country would not have had positive GDP growth in 2020 and 2021, and personal finances for those worst affected by the pandemic would be significantly worse.

3.6.1 Residential loans

The legislation enacted in relation to residential tenancies is likely to have caused issues for numerous landlords where tenants did not make payments under leases. The key issue for landlords who found themselves in that scenario was the inability to issue termination or eviction notices, coupled with the lack of ability to travel to try to resolve the situation as a result of restrictions. If landlords were unable to fund their mortgage payments from other sources, then their loans would have gone into default. Whilst normally this would result in bank intervention and some insolvencies (likely through fixed asset receiverships), the forbearance granted by lenders has meant that to date, there has not been any material increase in these types of insolvencies.

In instances where borrowers were in arrears prior to the pandemic and where that has continued, a combination of bank forbearance and the timeline for obtaining possession orders through the courts, has contributed to a wider trend where there has not been a significant increase in instances of formal insolvency to date.

3.6.2 Income and business supports

The net effect of these supports are that most businesses have been able to continue to survive throughout the pandemic. The continuation of the lower VAT rate for hospitality and tourism will be helpful to that sector but given the loss of turnover experienced by this industry over the pandemic, this measure will only aid cashflow providing there is sufficient business being generated. Without the supports that were put in place for business, there is no doubt that formal insolvencies would have increased significantly during the COVID-19 crisis, and otherwise viable businesses would not have been able to continue. However, there will inevitably be a cohort of businesses that have only been able to survive as a result of the supports that were in place, and these will be vulnerable once the busier summer season ends. It is likely that another segment of business will find it difficult to meet ongoing payments once warehoused Revenue debt needs to be paid, and there are no further forbearance measures being offered by Revenue or lenders.

3.6.3 Company law amendments

The increase in the threshold for which a company could be wound up was certainly helpful to enterprises during the pandemic and is likely to have resulted in less petitions being brought forward by creditors. The increase in the number of days for an examinership to 150 is unlikely to have materially impacted insolvency figures. This concession was granted in acknowledgement of the difficulty in convening meetings and obtaining new investment during the pandemic. The ability to convene virtual meetings is to be welcomed, and the government are putting measures in place to continue this as a permanent feature. The ability to hold such meetings virtually would have enabled the valid convening of virtual creditor meetings and shareholder meetings to place companies into a liquidation process if they so wished, but there is no evidence to date that this was done at any increased level during the pandemic.

3.6.4 Planning amendments

These had no impact on insolvency statistics but were helpful to trading businesses who were able to offer additional services that would otherwise have required planning consent, thereby increasing their turnover and enabling them to generate income to stave off any potential insolvency requirement.

4 Small company administrative rescue process ('SCARP')

One of the most significant legislative changes to occur in Ireland during the COVID-19 pandemic was a process now commonly known as SCARP. Whilst COVID-19 was not the main driver of this legislation, it formed a strategic element of the government's medium-term stabilisation response to the economic challenges of the pandemic[26].

The Companies (Rescue Process for Small and Micro Companies) Act 2021 came into effect on 8 December 2021. The process provides a route for Small and Medium Sized Enterprises ('SME's') that are experiencing financial difficulty or temporary solvency issues to restructure and rescue their enterprise[27].

SCARP is similar to the current examinership process in place in Ireland, however, is aimed at SME's that might not otherwise be able to avail of examinership due to the prohibitively high costs associated with the process.

With SCARP, a Process Advisor is appointed, and similar to an examiner, the Process Advisor is tasked with engaging with the creditors of the company and formulating a rescue plan that will see the company return to solvency. However, as the SCARP process has potentially minimal involvement of the courts, the process is a lot shorter and less costly than the examinership process. As with the examinership process, the outcome for the creditors of the company availing of SCARP must provide a better return than if the company went into liquidation.

4.1 Eligibility

To be eligible to avail of SCARP, the company must be an SME as defined by the Companies Act 2014. This means it must meet two of the following criteria:

(i) annual turnover should not exceed €12m,
(ii) its balance sheet total must not be above €6 million, and

[26] gov.ie, 'Minister Troy welcomes publication of further information on Small Company Administrative Rescue Process' (www.gov.ie).

[27] The SCARP process is discussed in more detail in the paper of Simon Murphy located at chapter 2.

(iii) it should have less than 50 employees.

The company must be, or is likely to be, unable to pay its debts. An examiner must not have been appointed to the company within the previous five years, and no order for the winding up of the company should exist.

4.2 The SCARP process

SCARP is commenced by a resolution of the company's directors as opposed to a court application. Prior to passing the resolution, the directors of the company must prepare a statement of affairs and a statutory confirmation that they have made full enquiry into all the financial affairs of the company.

The company must appoint an insolvency practitioner known as a Process Advisor. The Process Advisor must make an assessment and conclude that the company has a reasonable prospect of survival for SCARP to be availed of.

The Process Advisor will communicate with all creditors and stakeholders and devise a rescue plan for the company within 42 days of their appointment. Creditors will be required to forward proof of debt to the Process Advisor within 14 days. It is important to note that certain creditors, including the Revenue Commissioners and The Department of Social Protection can potentially opt out of the SCARP process on limited statutory grounds. However, they must provide the specific reasons for doing so. The rescue plan can include a write down of certain company debts and incorporate a cross-class cram down. Any write down must be fair and equitable.

It should be noted that unlike an examinership, there is no automatic stay or moratorium on creditor enforcement action. If this becomes an issue an application can be made to the courts for a moratorium.

The rescue plan should be prepared and agreed within 70 days. The Process Advisor is obliged to hold meetings of the different classes of creditors and members to present a rescue plan for the company within 49 days of the Process Advisor's appointment. For the plan to be accepted it must be approved by 60% of creditors in number, which represents a majority in value of creditors' claims of at least one class of impaired creditors at the creditors' meetings. If there is no objection filed within a period of 21 days, the rescue plan becomes legally binding on all members and creditors, the company and its directors without the need for an application to the courts.

Creditors and/or members can lodge a court objection to the rescue plan on several grounds. If that occurs, then the company will have to go to court to get approval for the plan.

4.3 Expectations for the process

As a result of the withdrawal of various government COVID related supports in Ireland, SCARP affords viable companies a timely and cost-efficient framework to be restructured and provides a workable alternative to examinership. SCARP is still in its infancy so as yet there are few statistics with regard to its impact on insolvencies in the Irish economy. However, the process is to be welcomed, and if utilised correctly, it should avoid scenarios where viable SME's that are experiencing temporary solvency issues would otherwise be wound up, resulting in a less favourable outcome for creditors.

5 The impact of the pandemic on the number of formal insolvencies

Whilst the pandemic has caused economic damage and distress for many individuals and businesses across the country, particularly in the hospitality and tourism sector, insolvency statistics have not shown any increase in numbers. Over the course of 2020 and 2021, the figures have fallen compared to prior years. Given the scale of the shock experienced by the economy as a result of COVID-19, the fact that insolvencies have not increased can be attributed directly to the supports put in place by the government during the two-year period in question, including income and wage supports, grant aid, warehoused tax debt and forbearance from banks on enforcement.

5.1 Personal insolvency figures

The Insolvency Service of Ireland ('ISI') publishes quarterly statistics in relation to the level of personal insolvency applications and bankruptcies that have been issued over the prior three-month period. The most recent statistics for Q4 2021 were published in February 2022. Table 1 below compares the year-on-year statistics published by the ISI.

TABLE 1: YEARLY INSOLVENCY CASE MANAGEMENT STATISTICS[28]

Year	DRN	PC – DSA[29]	PC – PIA[30]	Bankruptcies
2021	184	145	1,076	199
2020	113	208	1,194	130
2019	261	195	1,791	263
2018	189	238	1,720	397
2017	222	278	1,920	473
2016	357	314	1,472	526
2015	347	326	1,037	479

Overall, the number of protective certificates and arrangements for 2021 were down 13% and 3% on 2020, although the figures for Q4 2021 are showing slight increases in comparison to the previous quarter[31]. Interestingly, there were 52 bankruptcy applications for Q4, which was an increase of 86% compared to Q3 and represents an increase of 53% on 2020. However, on an overall basis, the table illustrates how figures for 2020 and 2021 generally remain significantly below pre-pandemic levels.

5.2 Corporate insolvency figures

Records from the Companies Registration Office ('CRO') in Ireland show a relatively low number of corporate insolvencies during the COVID-19 pandemic. This is mainly due to government supports, warehoused taxes and moratoria on enforcement action by the various financial institutions. Table 2 below summarises figures prepared by Deloitte in their quarterly and annual reviews of corporate insolvency statistics in Ireland.

[28] Figures are taken from the ISI Statistics Report for Quarter 4 2021, pp 11 and 12.

[29] PC-DSA refers to the number of Protective Certificates issued for Debt Settlement Arrangements.

[30] PC-PIA refers to the number of Protective Certificates issued for Personal Insolvency Arrangements.

[31] Insolvency Service of Ireland – Statistics Quarter 4 2021 (isi.gov.ie).

TABLE 2: CORPORATE INSOLVENCY STATISTICS[32]

Year	Total	Examiner-ship	CVL	HCL	Receiver-ship
2021	401	18	261	44	78
2020	575	34	427	44*	70
2019	568	29	364	81	94
2018	767	39**	539	64	125
2017	874	29	535	63	247

* 27 HCLS were for the same group, so the net figure is more realistically 18
** 17 Examinerships refer to the same entity, so the net figure is more realistically 23

A key sector impacted in 2021 was the services industry, which accounted for 42% of total insolvencies[33]. Construction insolvencies were next highest at 17% of the total, most likely as a result of cost inflation associated with fixed priced work. Interestingly, the hospitality and retail industries showed notable decreases when compared with the number of insolvencies recorded in 2020. There were 88 recorded insolvencies related to the hospitality sector in 2020, but only 31 in 2021, a 65% decrease year on year. Whilst the aviation sector saw a relatively small number of formal insolvencies it was one of the most severely impacted sectors in Ireland and resulted in the high-profile restructurings of Cityjet, Norwegian Air and Nordic Aviation Capital. Similarly, the retail industry had 38 insolvencies in 2021 according to Deloitte, as opposed to 101 in 2020. It is likely that supports targeting the hospitality and retail sectors helped significantly in respect of their ability to continue to trade during the pandemic. Whilst there were a number of insolvencies at the outset of the pandemic in 2020 in these sectors, the numbers tapered off as support packages were put in place.

It is evident that the figures for the pandemic are well below insolvencies recorded in 2017 and 2018. However, figures are showing a slight increase in the number of corporate insolvencies for the first quarter of 2022 with a total of 120 insolvencies recorded, representing an 8% increase on the same quarter in 2021[34]. The withdrawal of the remaining government COVID supports is likely to result in a further rise in corporate insolvencies as the year draws to a close, and businesses come under cashflow pressures.

[32] Figures are taken from quarterly corporate insolvency statistics prepared by Deloitte Ireland from 2018 to 2021 Corporate Insolvencies – A year in review 2018, Deloitte Ireland; Marginal increase for corporate insolvencies in 2020 despite economic challenges – Deloitte Ireland; Significant decrease for Corporate Insolvencies in 2021, Deloitte Ireland.

[33] 30% drop in corporate insolvencies last year (rte.ie).

[34] 8% increase in level of corporate insolvencies in Q1 2022 (deloitte.com).

6 What's next?

It's clear that the impact of COVID-19 has created significant changes in society across the world, some of which are positive, but most unfortunately are not. The physical and mental health impacts have taken a toll on populations, and sadly many families are without loved ones as a result of the pandemic. The financial impact has been keenly felt by certain sectors and workers, whilst others have not been affected at all.

In Ireland, as in many other countries, the cost to the exchequer in relation to the funding of COVID-19 vaccinations and economic supports will be a burden that will be felt by taxpayers long into the future. Hickey, Doyle, McDermott et al., authors of the Spending Review 2021 for the Department of Public Expenditure, estimated that the cost to the exchequer for pandemic wage supports was €16.7bn to the week ending 22 October 2021[35]. TWSS and EWSS combined accounted for €7.9bn, with PUP expenditure accounting for a further €8.8 bn. Including CRSS, the cost estimates in November 2021 were €17.5bn, with projections estimating a further spend of €1.26bn on EWSS payments from November 2021 to April 2022[36]. In his budgetary speech in October 2021, Pascal Donoghue, Minister for Finance, announced that the combined deficit for 2020 and 2021 was forecast to be €21.5bn, a stark contrast to 2019 when the country entered the pandemic with a budgetary surplus of €2bn. The spend was an absolute necessity to ensure that the country could protect employment and that the reopening of the economy could happen as soon as practical. However, the expenditure over the pandemic and for 2022 will bring the national debt to €240bn, or €50,000 per person in the country. This will have to be addressed and dealt with over the years to come.

One of the key questions is whether the supports put in place by the government artificially enabled some businesses that would otherwise have failed to continue to trade. This will become more evident as government supports are withdrawn, businesses approach less profitable months and warehoused tax debt starts to fall due from 2023 along with current tax liabilities. According to Revenue, approximately €3bn of debt is currently warehoused, with half of that debt related to retail, hospitality, and construction sectors[37]. It seems inevitable that some of these businesses will not be able to repay their accrued liabilities and will be unable to continue to trade.

35 N Hickey, A Doyle, C McDermott, D Coates, J O'Reilly, A Brioscu – Spending Review 2021 – The Pandemic Unemployment Payment and the Employment Wage Subsidy Scheme: Trends and Interactions; October 2021; Department of Public Expenditure and Reform.

36 gov.ie, 'Statement by the Minister for Finance Paschal Donohoe TD on Budget 2022' (www.gov.ie).

37 Retail, construction, and hospitality: The sectors 'warehousing' a looming €3bn debt problem – The Currency (https://thecurrency.news/).

The unintended consequences of providing quick access to support payments to individuals is also an intriguing question. As noted by Hickey, Doyle, McDermott et al., there may be a point at which wage supports become counterproductive in terms of labour supply. It was evident in Ireland that there was a serious shortage of labour available when the country reopened, and hospitality businesses were trying to get back on track. The PUP payment received a lot of criticism in the summer of 2021, when payments were above the minimum wage for some recipients who would otherwise have had to work for less than the amount they were getting to stay at home.

Housing continues to be a major problem in Ireland, as was evidenced by the significant amount of emergency legislation that was needed in terms of the residential tenancies sector during the pandemic. The lack of supply of housing is causing issues in the market, with demand for rental properties pushing rents to unsustainably high levels and would-be owner occupiers unable to buy suitable homes in their price range. The Daft.ie Rental Price Report for Q1 2022 published on 12 May 2022, shows that average rents in Ireland are 50% higher than any time during the Celtic Tiger[38]. At the start of May, there were only 851 properties available to rent, the lowest since the Daft.ie price report records began in 2006. As evidenced at the outset of the pandemic in Ireland, many landlords were renting properties on a short-term basis for holiday lets as opposed to long term rentals, which was in contravention of laws put in place to try to combat such scenarios. The pandemic led to a large increase in properties being made available for rent in Dublin and other populated areas when tourism halted. Supply and affordability issues need to be addressed or it will impact negatively on the ability of the country to attract and retain workers. Additionally, as the forbearance shown by banks to borrowers also starts to come to an end and they start to demand full repayments, increasing house and property prices will likely encourage them to enforce where there is no progress being made with borrowers who are unable or unwilling to pay.

The other significant and unknown factor is the war in Ukraine, the impacts of which will be felt all around Europe over the course of the next number of months and years. The loss of life resulting from this is the single largest tragedy to affect Europe for decades, and it is to be hoped that the war does not continue for long. However, the wide-ranging sanctions which have been imposed on Russia to date and which will continue to increase in severity as the war continues, have already impacted consumers in Ireland and Europe in the form of significantly increased energy prices. Given that the EU is in the throes of agreeing to impose further sanctions on Russian oil imports, energy prices are

[38] 2022-Q1-rentalprice-daftreport.pdf.

only likely to increase in the short to medium term. Ukraine produces most of the wheat, barley and rye on which Europe relies. It is also a large producer of corn and fertilizer, and therefore the inability to harvest crops or manufacture fertilizer whilst the war continues will likely lead to shortages and price increases in food. Energy price rises and increasing food costs have meant inflation has increased across the EU and indeed the globe in 2022. According to the Central Statistics Office, inflation reached 7 per cent in Ireland in April 2022[39], the highest level it has been for over 22 years. For businesses and households that are already struggling on tight cashflows and budgets, increases in these basic necessities will inevitably cause cashflow difficulties, and is likely to lead to increased insolvency requirements.

A final consideration for Ireland is tax harmonisation. On 7 October 2021, Ireland confirmed that it would join in the G20 / OECD inclusive framework agreement for International Tax Proposals. When the agreement comes into effect, Ireland will apply the new minimum effective tax rate of 15% to large multinational companies. The 12.5% rate will continue to apply for corporate businesses below the Pillar Two turnover threshold of €750 million. The impact on competitiveness in Ireland is unknown, as the 12.5% rate was long considered one of the key tax reasons the country has been able to attract large multinational corporations. Minister Pascal Donoghue indicated at the time that while he anticipates that Ireland will remain competitive, the government will not be complacent, and will reflect on both the tax and non-tax aspects of the country's offering. The cost to the exchequer is very difficult to predict, but initial government estimates suggest it may be in the region of €2 billion[40].

The response of the Irish government to the COVID-19 crises was swift, practical and given the constraints the legislation was passed under, overall it seemed to have been well thought out. The supports provided a lifeline for many individuals and businesses, in a time when there was a great deal of fear and uncertainty about the future.

However, there will inevitably be a number of businesses and individuals who are likely to come under significant pressure once the supports come to an end, and costs such as commercial rates, wages, deferred loan payments and taxes must be funded from operating cashflow. Increasing energy prices will hit every consumer and business, and inflationary pressures are mounting. Data

[39] Consumer Price Index – CSO – Central Statistics Office.

[40] Hit of €2bn to exchequer revenues from global tax accord 'still best estimate for now' (irishexaminer.com).

from KBC shows consumer confidence has fallen significantly in Ireland since the war in Ukraine began, with April showing a sharp drop[41].

There are significant challenges for businesses and individuals to face, and it is likely that the lower rates of corporate and personal insolvency evident throughout the pandemic will start to increase towards the latter half of 2022. It will be interesting to see how many smaller businesses might avail of the protections afforded under the SCARP regime over the remainder of 2022 and into 2023.

On a positive note, many households have come through COVID-19 with increased savings. The IMF has forecast that the Irish economy is likely to grow by 6% GDP for 2022, and 5% in 2023, with inflation to fall to 2.8% next year[42]. There will always be insolvencies and increases in insolvency figures should not be a cause for alarm over the next number of years given that they were curtailed during the pandemic. There are many challenges ahead, but the reaction to COVID-19 has proven that Ireland and its people can adapt to changing scenarios quickly through legislation and practical measures. And after all, we can now say we've survived a pandemic.

[41] Ireland Consumer Confidence – April 2022 Data – 1996–2021 Historical – May Forecast (tradingeconomics.com).

[42] 'IMF: Irish economy to grow, inflation to fall next year' (rte.ie).

Chapter 9

Early Warning Tools under Directive (EU) 2019/1023: Applications in the Italian Legal Framework

Alessandro Danovi
Department of Management, University of Bergamo, Bergamo (Italy)

Alberto Quagli
Department of Economics and Business Studies, University of Genoa, Genoa (Italy)

Lorenzo Simoni
Department of Economics and Business Studies, University of Genoa, Genoa (Italy)

Abstract

The aim of this paper is to inform international, mostly European, insolvency professionals and scholars on how the early warning tools described under Directive 2019/1023 are supposed to be implemented in the Italian legal framework. In February 2019, the Italian Government issued a new Insolvency Law Code (d.lgs 14/2019). Even though the Code was issued before the enforcement of Directive 2019/1023, it is consistent with the draft of the Directive available at the time. Granted there are no further delays, the Code will be enforced on 15 July 2022, except for the 'Early warning tools', or 'Alert procedure' (AP) which will be enforced on 1 January 2024. The AP is supposed to be a mandatory process which requires directors and auditors to implement an insolvency forecast algorithm (IFA), according to which the financials of a company are checked against some given thresholds. If the thresholds are exceeded, the company has to enter into a private restructuring procedure. The enforcement of the AP has been considerably postponed, due to the aftermath of COVID-19. Current volatility levels prevent us from speculating when, how and if the AP will actually be enforced as a mandatory requirement. As of June 2022, some of its aspects have been included in a merely elective private insolvency proceeding. Nonetheless, we believe it interesting to share with the international community this latest and innovative development in the Italian insolvency framework.

1 Introduction

In June 2019, the European Union, after a long preparatory work, issued the 'Insolvency directive' (Directive 2019/1023), which aims at harmonizing Member States' preventive restructuring frameworks. Among the different aims of the Directive, we will debate its objective to ensure that 'viable enterprises and entrepreneurs' that are in financial difficulties have access to effective national preventive restructuring frameworks to continue operating (EU Directive 2019/1023, premise 3). To achieve these goals, Member States should encourage early detection of distress and pre-insolvency procedures, independently from the country of origin of each company (Eidenmuller, 2017)[1]. The importance attributed to early detection of distress has led to the recommendation to identify proper early warning tools. These tools serve the purpose of warning 'debtors of the urgent need to act, taking into account the limited resources of SMEs for hiring experts' (EU Directive 2019/1023, para 17).

Our paper focuses on how the question of detecting crisis proposed by the Directive has been applied in Italy.

As Di Martino and Vasta (2010, p 137) argue, Italian insolvency regulations present a very interesting case because the Italian industrial system mainly consists of small and medium enterprises (SMEs)[2]. Italian history features many cases of liquidation and scarce use of out-of-court procedures allowing companies to restart, even when those companies were potentially viable (Danovi, 2014). Early versions of the Italian bankruptcy law did not take into account extra-judicial negotiation with creditors and did not offer tools and solutions for distressed companies. Starting from 2005, insolvency law reforms in Italy have attempted to reduce bankruptcy cases, and to promote other procedures allowing companies to continue their operations and survive during times of crisis. The foundation behind these, was the idea that a company can be a source of wealth even if it is in distress, as jobs are not lost and the relationships with stakeholders somehow maintained (Fabiani, 2004). Various reforms have then taken place with the introduction of a set of solutions to help distressed companies continue their operations. These procedures are mainly based on the research of an agreement between debtors and creditors to overcome the state

[1] The Directive states that the 'earlier a debtor can detect its financial difficulties and can take appropriate action, the higher the probability of avoiding an impending insolvency or, in the case of a business the viability of which is permanently impaired, the more orderly and efficient the liquidation process would be' (EU Directive 2019/1023, para 22).

[2] Italian companies are often small companies, have difficulties in the development of organizational capabilities and tend to be more fragile than similar companies in other EU countries. Also, the Directive focuses on small and medium enterprises (SMEs), as they play an important role in EU countries and are the companies that can apply for pre-insolvency procedures.

of crisis. The reform of 2005 contributed to the shift of the focus from judicial liquidation as the natural consequence of bankruptcy to the search for an agreed solution between debtor and creditors.

In February 2019, the Italian Government issued a new Insolvency law (d.lgs 14/2019), the 'Code of Corporate Crisis and Insolvency' (hereafter the 'Code'). Even if issued before the entry into force of the Directive 2019/1023, the Code is inspired to the draft of the Directive with its call for improving the efficiency of insolvency procedures and of minimizing their effects on creditors. In particular, the Code distinguishes and defines the concept of crisis and the concept of insolvency.

Insolvency is defined as the state of default and other observable events, which demonstrate that the debtor is no more able to satisfy its obligations. Crisis is defined as the state of financial difficulty, which makes insolvency likely[3], and can be observed through deficiency of future cash flows to satisfy both existing and planned obligations for, at least, the following twelve months.

These definitions are crucial for two reasons. First, they clearly separate the two concepts: crisis is not a 'mild' form of insolvency, but rather a state of matters which makes future insolvency likely to happen. Second, the distinction above implies that one is to detect the crisis mainly through forecast data, because a future state such as insolvency requires an investigation of future trends.

To favour the crisis detection, the Code establishes a specific early warning procedure, called 'Alert procedure' or 'AP'. The AP is supposed to be a mandatory process which requires directors and auditors to implement an insolvency forecast algorithm (IFA), according to which the financials of a company are checked against some given thresholds. If the thresholds are exceeded, the company has to enter into a private restructuring procedure. According to the EU Directive, Member States retain large discretion in the identification and implementation of early warning systems, and private entities can also be involved. In Italy, the identification of those signals has involved members of the accountancy profession and academia. This study debates the case of Italy, as this is the first time an European country pondered to implement early insolvency detection by law.

The Code, unless delayed further, will be enforced on 15 July 2022, except for the AP, which will be enforced on 1 January 2024. The enforcement of the AP

[3] 'The debtor should be able to restructure at an early stage, as soon as it is apparent that there is a likelihood of insolvency' (EU Commission Recommendation of 12 March 2014 on a new approach to business failure and insolvency, art 6(a)).

has been considerably postponed, due to the aftermath of COVID-19. Current volatility levels prevent us from speculating when, how and if the AP will actually be enforced as a mandatory requirement. As of June 2022, some of its aspects have been included in a merely elective private insolvency proceeding (D.L. 118/2021).

However, by offering a critical discussion of the Italian case, this paper sheds light on the main features of the first early warning system based on specific indicators. As all EU countries will have to comply with the recent Insolvency Directive, which places emphasis on early warning tools, the system adopted by Italy seems to be definitely worth to discuss.

The rest of this paper is structured as follows. Section 2 revises the literature on insolvency prediction models. Section 3 depicts the main features of crisis prevention and regulation in Italy. Section 4 illustrates the process that has led to the development of early warning tools in Italy. Section 5 draws conclusions.

2 Three different approaches to crisis detection

There are three approaches to crisis detection. The first approach is based on external observable inputs, such as defaults and delays in payments to suppliers, fiscal authorities, and banks. These signals are objectively and easily identifiable, and their identification does not require a specific financial know-how, but often emerge at a late stage, when a company's ability to fulfil its obligations has vanished. In this context, the possibilities of recovery are limited. Hence, the prediction of insolvency through externally observable inputs cannot be defined as a timely, early warning distress recognition.

A second approach is based on inputs derived from financial statements. These approaches, widely used in the academic business literature, use those inputs to determine significant relationships with insolvency. Academics and practitioners have long assessed the capability of different sets of indicators to predict insolvency. Starting from the pioneering study by Altman (1968), a host of studies have examined the factors most recurrently associated with insolvency (Balcaen and Ooghe, 2006)[4]. Among different methods, early works have

[4] Bankruptcy prediction using statistics and economic-financial indicators has been a central theme in international Finance and Management studies since the 1930s, when many models were developed to help banks decide whether or not to approve credit requests (e.g. Smith, 1930; FitzPatrick, 1931, 1932; Ramser and Foster, 1931; Smith and Winakor, 1935; Wall, 1936). At the end of the 1960s and continuing to this very time, the application of univariate and multivariate statistical analysis has been developed. Many authors concentrated on the possibility for prediction using several economic-financial indicators (Tamari, 1966; Beaver, 1966; Altman, 1968; Deakin, 1972, 1977; Edmister, 1972; Blum, 1974; Elam, 1975; Libby, 1975; Alberici, 1975; Taffler, 1976, 1982; Altman et. al., 1977, 1993; Wilcox, 1976; Argenti, 1976; Ohlson, 1980;

employed statistical analyses (univariate or multivariate), which identify a score to detect insolvent companies. More recent models are based on logit analysis, where the dependent variable is the probability of default (Ohlson, 1980; Mensah, 1984) or based on artificial intelligence, such as neural networks (e.g. Chung et al., 2008; Tsai and Wu, 2008). At the same time banks and other financial institutions have developed their own insolvency prediction models, used to support their decision to fund customers. Different variables are used to build these models (Kumar and Ravi, 2007), mainly ratios related to profitability, liquidity and financial structure. The main advantages of those studies are related to the use of inputs that are often publicly available and to the strength of statistical methods, which allow researchers to assess the magnitude of the impact of each indicator on the probability of default. However, the drawbacks of this second kind of approach derive from the nature of the inputs selected. Many inputs used are financial statement data, which mostly reflect the outcomes of past operations. Hence, the items used to develop those models provide evidence of relationships among data about a large sample of companies collected in the past, but they might not offer useful information about the expected future developments of a specific company and its capability to meet its obligations.

In order to overcome these limitations, a third kind of approach resorts to forward-looking proprietary data. This approach builds on business plans to obtain data about a specific entity and its capability to meet its obligations in the near future. This method, in a general sense, is the one most aligned to the Code's definition of crisis because it investigates projections of cash inflows and outflows. However, there are downsides: because business plans are not public, future results are intrinsically uncertain, and opportunistic behavior in their preparation can rise.

In summary, each of three methods has pros and cons, and they can complement each other to offer the best detection of crisis.

Appetiti, 1984; Forestieri, 1986; Lawrence and Bear, 1986; Aziz, Emanuel and Lawson, 1988; Baldwin and Glezen, 1992; Flagg, Giroux and Wiggins, 1991; Bijnen and Wijn, 1994; Kern and Rudolph, 2001; Shumway, 2002; Hillegeist, et. al., 2004; and Altman, and Rijken, et. al., 2010b). Some of these studies were also used by practitioners mainly because of the simplicity of application.

3 A multi-level system of alert mechanisms

3.1 Guiding principles in the selection of early warning tools

According to the EU Insolvency Directive, early warning tools should be clear, concise and user-friendly to debtors[5]. In the case of the Code, debtors most cases are SMEs. Hence, the legislator's aim is to offer early warning tools that can be easily understood and used by the management of small companies. Moreover, the Directive explicitly states that the early warning tools can be developed 'either by Member States or by private entities' (EU Directive 2019/1023 [insolvency directive], para 22).

A first provision of the Code is that any company, independently of size, must have sound internal control systems to early detect state of crisis. Internal controls play a fundamental role in crisis management (Van der Stede, 2011; Li et al., 2020). In the Italian context, controls over the actions of the board of directors are performed by a supervisory board (Provasi and Riva, 2013). Larger companies have also the duty to have financial statements audited by an external auditor. The Code lowered the thresholds above which a company is supposed to appoint a supervisory board and external auditors.

In the AP, both the supervisory board and the external auditor, and the directors have to trigger the alert procedure if they detect the signals of a crisis. Hence, a guiding principle of the Code is to emphasize the responsibilities of internal controls, as people inside the company might have access to information that can reveal signs of future distress. This provision emphasizes the role of internal information in predicting insolvency. The aim of the alert procedure is to identify distress early on. To this regard, the Code proposes two kinds of indicators: financial ratios and 'grave and repeated delays' in the payment of obligations.

As insolvency prediction is mainly either the object of academic studies or a tool used by practitioners, the Code decided to delegate to the national association of chartered accountants ('Consiglio Nazionale Docttori Commercialisti ed Esperti Contabili' or CNDCEC) the identification of the specific financial indicators, and their respective thresholds, that companies have to monitor. The specific indicators have to be periodically updated, at least every three years.

Academic literature and professional practice have often used several techniques mainly relying on statistical analysis to assess indicators in order to

[5] The aim of early warning systems developed by practitioners and academics is not to offer companies an indication of how to avoid insolvency or improve their performance, but to reveal that their condition is deteriorating (Korol, 2013).

predict insolvency. CNDEC's Insolvency Forecast Algorithm (IFA) requires to evaluate both financial ratios and financial forecast data. IFA follows two guiding principles, as outlined in the document published by CNDCEC[6].

First, its selection criteria are designed to minimize false positive cases, i.e., a company needs to be in really bad shape to be classified as distressed[7]. The reason behind this choice is the different consequences that false positives and false negatives imply. A false positive means that a viable company is led to activate an extra-judicial restructuring procedure, even if there is not an actual need to restructure the business. This circumstance would result in unnecessary costs for all parties involved as the company would have to bear both the costs related to the procedure, and the reputational ones. Regarding this issue, the CNDCEC has also had to face political pressures that aimed to avoid false positive cases in order not to overload the system that is going to be set up to assist distressed companies.

The second guiding principle is to offer early warning tools that are easy to understand and manage for managers and supervisory boards of all kinds of company, even for small entities. This principle is strictly related to the choice of developing a regulation for SMEs. Therefore, managers, supervisory boards, qualified creditors, external auditors and other interested parties should have access to a set of indicators that are easy to calculate starting from financial statements. Hence, interested parties only have to monitor these indicators to assess if the thresholds are violated. This choice, as indicated by the EU Directive, has led to the exclusion of models that offer a synthetic score (like the model by Altman and subsequent adaptations) and models that calculate a probability of default combining different variables or using sophisticated statistic techniques.

The IFA identifies a sequence of indicators and a threshold, which if exceeded triggers either the next step of the algorithm or a distress diagnosis. The algorithm is described in detail in the following section.

The focus on small entities is linked to another crucial feature of this regulation, which is the attention towards the practices of SMEs. The Code has not been designed for and will not be applicable to large, listed entities, which are supposed to have already strong internal control mechanisms. Indeed, the Code aims to foster the development of internal control systems in smaller entities,

6 https://commercialisti.it/documents/20182/1236821/codice+crisi_definizioni+indici+%28ott+2019%29.pdf/2072f95c-22a2-41e1-bd2f-7e7c7153ed84.

7 Every insolvency prediction system features poses the risk of misclassifying a viable company as an insolvent one (Type I error, which leads to false positives), and an insolvent company as a viable one (Type II error, which leads to false negatives).

which in many cases are reluctant to invest resources in such a process. In this view, the regulation is seen as an opportunity to draw small entities' attention to the role of internal controls and to tools and methods that can help them timely predict a crisis and react.

3.2 The steps of the early warning system and indicator hierarchy

The first step that has been introduced relates to the book value of equity. If this indicator is negative, a company is classified as distressed. Early studies show that the book value of equity is a more effective indicator of value for firms in bad health, while the value of healthy firms is better predicted by earnings (Barth et al., 1998). Despite some recent studies showing that the number of companies with negative book value has increased over time, and that many of those cannot be considered in distress (Jan and Ou, 2011; Ang, 2015), a negative book value can be interpreted as a bad signal that requires management attention. The importance of this item is witnessed by the requirements that Italian companies are subject to. Limited liability companies have to keep a book value of equity above a threshold, which can vary depending on the legal form of the entity. Equity is seen as the residual guarantee for creditors, which balances the limited liability of shareholders. When the value of equity falls below the threshold, Italian companies are required either to transform the legal form of the entity or to increase the share capital through transactions with shareholders in order to restore it. A negative book value of equity often denotes a distress that has already shown its effects. Hence, negative book value can be considered a bad signal, but in some cases not an early warning indicator. However, this item can be regarded as an item that can be easily monitored by an external party, as it is publicly available.

If the book value of equity is positive, the assessment of early warning moves on to the second step. This step is based on the assessment of the expected debt service coverage ratio (DSCR) in the next twelve months[8]. DSCR is an indicator that compares debt repayment flows with cash flows generated by a company, to assess the company's ability to repay its debt. This index has been employed in studies that assess default prediction (Altman, 1968) and is considered as one of the most important indexes in the evaluation of firm solvency (Juselius and Kim, 2017; Polato and Beltrame, 2019). The evaluation should then be based on a plan approved by the company. To be considered satisfactory, this index should be at least equal to 1. A value equal to 1 means that a company's cash resources are sufficient to cover debt repayment obligations. If the indicator

[8] The reason why a time laps of twelve months was chosen depends on the crisis definition which is contained in the Code. A company is considered in crisis if there is a significant likelihood that in the next twelve months it could become insolvent.

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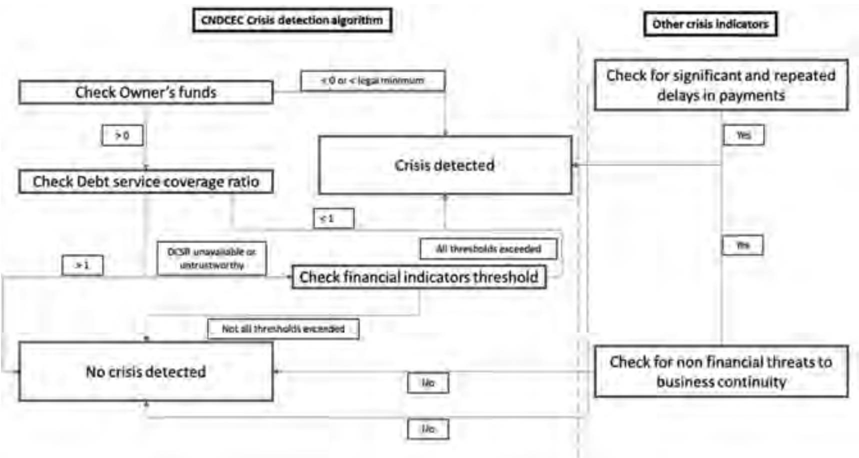
takes a value below 1, the company should be considered at risk of insolvency. While the DSCR is a ratio that compares future available cash resources to future outflows, it can be calculated in several ways. Different types of inflows and outflows can be considered. However, the regulator has chosen not to impose a formula or a calculation method, but to leave companies discretion in the choice of calculation of this index. This provision aims to help small entities, which might have some difficulties in developing an accurate plan to determine the DSCR. The reason behind this choice is the belief that the development of a plan and the use of this tool represents an opportunity to improve the managerial system of the company.

The final step consists in the assessment of a set of indicators that should be monitored in the case of the impossibility to reliably calculate the DSCR index. These indicators are financial ratios that can be calculated starting from financial statements. The indicators are coverage ratios, liquidity ratios or debt ratios. Those indicators, which suffer from the limitation of being lag indicators, calculated on the basis of backward-looking data, are considered to be subordinate to the examination of forward-looking information contained in a plan.



3.3 Forward-looking perspective, business plan and DSCR

The choice to prioritize the DSCR well describes the aim of the Code and of IFA developed by the accounting profession. The key idea is not just that the company must have cash resources to meet the obligations in the short term, but also that, if there is a business plan explaining how the company will operate in the future and plainly indicating that cash resources will be sufficient to sustain outflows, there is no need to assess the five early warning indicators. This choice puts the plan at the heart of the early warning mechanism and privileges a forward-looking perspective rather than an evaluation based on historical data.

Crisis is often hard to define punctually. Many authors emphasize how default, which is usually the event considered discriminant in insolvency prediction studies, is only the final step of a long process (Balcaen and Ooghe, 2006). As Balcaen and Ooghe (2006, p 78) state: 'the fact that the classical statistical failure prediction models *do not treat company failure as a process* results in some serious drawbacks (. . .). The underlying failure process is assumed to be stable over time and no phases are distinguished'. The path to bankruptcy often features several phases. In some of those phases, negative events are also observable by external parties, as when a company is unable to meet its obligations. In many cases, early phases of a crisis can be detected only by internal parties. For this reason, a plan developed by the management becomes a precious tool to predict insolvency before visible signs appear.

Another feature/advantage is the fact that whilst accounting ratios are derived from published annual reports, which report past data, plans have the capability to offer forward-looking information. Insolvency prediction tools based on financial ratios have a retrospective character (Balcaen and Ooghe, 2006), and tend to distinguish failed firms from healthy companies offering a descriptive distinction, rather than a real predictive ability (Keasey and Watson, 1991; Taffler and Agarwal, 2003).

Despite the importance of plans and their capability to offer managers early indication of a crisis, many small and medium entities do not usually prepare structured business plans and do not have reliable budgeting systems. This circumstance has been taken into consideration in the development of the early warning system, by introducing the financial ratios derived from financial statements. Despite the above mentioned limitations of insolvency prediction systems based on ratios and information derived from the financial statements, the availability of this kind of information on a large scale has led to the introduction of those ratios, in case a plan is unavailable or unreliable.

3.4 The five early warning indicators: sample and main results

To select the most significant indicators, CNDCEC with the help of Cerved[9] has conducted several statistical analyses on a large sample of 181,000 companies

[9] Cerved is an Italian data analysis company. Its core business is the sale of rating services to Italian businesses (banks, insurances, manufacturers, etc.), based on the mass gathering of financial statement information from the network of the Italian Chambers of Commerce.

based in Italy in the period 2010–2015, and about 568,000 firm-year observations. The composition of the sample, which is primarily composed of SMEs[10], is illustrated in Table 1.

TABLE 1 – SAMPLE USED TO IDENTIFY EARLY WARNING INDICATORS

Industry	Small	Medium	Large	Total
Manufacturing	23.4%	11.7%	3.5%	38.6%
Commerce	21.8%	6.8%	2.1%	30.8%
Services	12.7%	4.5%	1.7%	19.0%
Real estate	8.6%	1.5%	0.2%	10.3%
Agriculture	0.9%	0.3%	0.1%	1.3%
Total	**67.4%**	**24.9%**	**7.7%**	**100.00%**

Source: adaptation from CERVED methodological appendix

Within this sample, firm-years that went bankrupt or that had applied for a procedure available to debtors in distress according to the national law in the subsequent 36 months have been coded as insolvent. Overall, about 18,000 insolvency events have been detected, which represent 3.1% of total observations.

The CNDCEC elaborated a list of 56 indicators among those that are most commonly used in the insolvency prediction literature (Balcan and Ooghe, 2006) and in credit rating systems (Kumar and Ravi, 2007). The ratios can be classified among coverage, liquidity, solidity, profitability and growth measures. As the aim of the early warning tool is to help companies assess distress independently from size or industry, the CNDCEC's goal was to develop a set of indicators that every company could adopt with a minimum effort. In Italy, small and medium companies have to prepare financial statements according to Italian GAAPs and to make the related documents public. Thus, the indicators selected were indicators that can be calculated starting from the items of financial statements issued according to Italian GAAPs. This criterion has led to the exclusion of non-GAAP and non-financial indicators, which have been found to have a predictive power of default by several authors (Grunert et al., 2005; Balcaen and Ooghe, 2006).

The first step was to run univariate analyses to identify those indicators that show the strongest association with insolvency and generate a shortlist of ratios. The capability of an indicator to predict insolvency was assessed on the basis of the Accuracy Ratio (Gini index), of the differences between the median

[10] The distinction between small, medium and large companies is based on the classification developed by the European Commission. Most of the companies in the sample are small. This reflects the objective of the early warning tool, which has been developed to assist small and medium companies.

values of insolvent companies and the median values of healthy companies, and of the insolvency rates, calculated for each quantile of each indicator.

Once the shortlisted indicators were identified, the CNDCEC conducted several analyses. First, a decision-tree analysis was employed (Varetto, 1999) and integrated with an analysis of the median values (selected as a threshold) of the indicators for the companies coded as insolvent. The logic behind the identification of the indicator was the assessment of the joint presence of multiple indicators above the threshold levels. In order to take into account industry-specific characteristics, the analysis was carried out separately for each macro-sector. Several simulations, which were based on combinations of five different indicators, finally revealed the five-indicator set which was able to predict default minimizing the number of false positive cases – i.e. cases of companies wrongly coded as distressed according to the indicators.

The five indicators are:

- Interest coverage ratio, computed as the ratio between interests and net sales.
- Equity-to-debt ratio.
- Turnover ratio, computed as the ratio between cash flow and total assets.
- Liquidity ratio, computed as the ratio between total assets and current liabilities.
- Tax liabilities ratio, computed as the ratio between tax liabilities and total assets.

The CNDCEC has identified thresholds at the industry level for all five indexes. If a company exceeds the industry thresholds for all five indexes, it is considered at risk of insolvency.

The results of the application of the indicators on the sample shows that only a small percentage of firm-year observations exceed all five thresholds, but 50.9% of those companies were classified as insolvent within 3 years from the event. False negatives represent only the 0.35% of companies identified as viable according to the indicators. Results of the tests conducted are shown in Table 2.

TABLE 2 – RESULTS OF THE APPLICATION OF EARLY WARNING INDICATORS

Size	**Obs**	**At alert**	**% alert**	**False positive incidence**	**False negative incidence**
Small	382,829	2,948	46.7%	0.40%	11.90%
Medium	141,396	822	63.6%	0.20%	10.50%
Large	43,684	130	65.4%	0.10%	6.80%
Total	**567,909**	**3,900**	**50.9%**	**0.30%**	**11.10%**

Source: adaptation from CERVED methodological appendix

3.5 Discussion

While the use of financial indicators in insolvency prediction is a common professional practice and the object of many academic studies, there have been no other cases of national or supra-national regulations that require companies to monitor some indicators in order to timely detect insolvency risk. While many other EU countries have early warning systems in place, they differ from the one that shall be adopted in Italy.

The first European country to implement an early warning system was France. Balp (2019) compares France and Italy, which are considered the two most important examples of early warning systems across Europe. Besides the use of key indicators as early warning tools, some of the main differences between these two systems are the target companies, and people in charge of signaling distress. As regards the first point, French regulation requires listed companies to early detect distress, while the Code is targeted primarily at small and medium enterprises (SMEs), and listed companies are excluded from the application of early warning tools (Balp, 2019). The second difference relates to who should monitor a company's performance and signal distress. While in France statutory auditors and employee representatives play a primary role, in Italy the attention is on the debtor (management), with an emphasis on non-executive directors, and on the supervisory board. Thus, the Italian case represents the first country which requires the managers and the supervisory board, as well as external auditors when present, of SMEs to monitor financial ratios in order to timely detect distress. The use of ratios can be hampered by the difficulties in periodically updating and revising the indicators and their thresholds.

Companies subject to the new regulations will be required to implement some forms of internal control, as the minimum requirements for the appointment of a supervisory board are going to be reduced. Moreover, managers and internal control committees will have to constantly monitor financial ratios supposed to detect early signs of a crisis. Therefore, the financial ratios selected serve the purpose to offer market participants an early warning tool, as required by the EU. The decision to focus on financial ratios can be explained by several reasons. First, in Italy also small and medium entities are required to prepare financial statements. This makes financial data largely available, even to external parties. Second, many insolvency prediction systems developed by scholarly literature have been built around the capability of some sets of financial ratios to predict distress. This, combined with the above-mentioned availability of financial data, might have played an important role in the decision to adopt such an approach. Third, this approach helps not only managers and internal parties, but also external parties, to objectively evaluate the situation of distress that characterizes a company.

The limitations of the selected ratios can be partially mitigated by the great importance that has been assigned to the business plan and to future cash inflows and outflows and to internal control systems in the development of early warning systems. If a company has a reliable plan, the future cash flows and their capability to cover debt reimbursement play a pivotal role in the early warning system. When future cash flows are deemed sufficient to face monetary outflows, no other evaluations based on other ratios are needed to assess a company as healthy. The focus on future flows of money allows to overcome some of the limitations of traditional insolvency prediction models based on ratios derived from the financial statements.

4 Conclusions

The necessity to uniform the discipline of insolvency and business crisis across European countries has led the EU to issue a new Insolvency Directive in 2019. An important innovation in this reform is the attention devoted to early warning tools. However, the Directive does not specify what these tools are, and how the different member countries should develop them. In this context, Italy has been the first country to embrace a radical reform of the national insolvency code to be aligned with what the EU requires.

The enforcement of the Code as regards the IFA described above has been postponed to late 2023 due to the Covid pandemic. In this context, many Italian companies have suffered from the national lockdown that has been imposed by the government to prevent the spread of the Coronavirus. The exceptional circumstances would compromise the function of early warning tools, and many recovering procedures would be activated. Despite this scenario, the discussion of the main features of the new insolvency code can be useful to spur a reflection about the possibilities associated with the use of early warning tools to timely predict distress.

The Code focuses on the importance of internal control systems and the use of business plans as tools to forecast future cash flows. A potential limitation of this approach is related to the fact that many small and medium entities do not prepare a structured and detailed plan, and do not accurately forecast future inflows and outflows. Accordingly, the introduction of such a requirement could represent an incentive for small and medium entities to devote attention and resources to planning activities and to forecasting. For this ambitious objective to be achieved, the perceived benefits of this reform and of the adoption of early warning tools must outweigh the costs that companies have to bear to set up internal control mechanisms and to prepare detailed plans. In the absence of a plan, key indicators, which can be easily calculated and monitored, can be used to predict distress.

Differently from previous reforms of insolvency laws in different European Member States, the reform pursued in Italy has involved the accounting profession. This represents a novelty within this field and might serve different purposes. First, the involvement of a professional community aims to legitimize a choice. As the reform introduces the scrutiny of financial ratios as an early warning tool, the identification of the most appropriate ratios needs to be conducted by experts in the field to be perceived as legitimate. Second, accountants are going to become important actors in the process of timely recognizing business crises and signaling them. As they act as consultants for, and actively participate in, the internal control committees of many small and medium companies, they will have to help entities adopt the required measures. The direct involvement of the chartered accountants in the definition of the ratios to be monitored helps the transition to the new regime and facilitates the acceptance and the justification of the new rules by the whole professional community.

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Chapter 10

'Just Ban All Insolvencies' A Comparative Discussion of Lawmakers' Interventions in Existing Insolvency Frameworks in Times of Crises (in particular the COVID-19 Pandemic)

N.B. Pannevis PhD LL.M MSc
Senior Associate, RESOR, the Netherlands

L.P. Kortmann LL.M
Partner, RESOR, the Netherlands

1 Introduction

Until recently, discussions on how to improve restructuring options and prevent insolvency proceedings often ended with one participant jokingly remarking: 'we should in fact just ban all insolvency proceedings. That would solve everything.' As sarcastic and absurd as that idea may have sounded before COVID-19 hit, these radical ideas became very real as COVID-19 brought economies (or sectors thereof) to just about a complete standstill[1]. It forced governments around the globe to take drastic measures to protect both the physical health of the public and the financial health of companies. Many lawmakers considered, or even enacted, some form of a straight-out ban on (the opening of) insolvency proceedings. With the dust settling down, time has come to review such bans on insolvency proceedings. What did they protect (against)? Were they effective? Did we go too far?

This paper aims to discuss the limitations placed on the opening of insolvency proceedings during the COVID-19 pandemic. First, we discuss the reasons to curb access to insolvency proceedings amidst what seemed, at the time, to be the largest economic meltdown since the Second World War, and the reasons not to

[1] For example, at the beginning of the pandemic the Spanish, Czech and Austrian governments issued decrees that petitions by creditors to open insolvency proceedings would not be considered by the courts until 31 December 2020, 30 June 2020 and 1 September 2020 respectively; Article 43 Real Decreto-ley 8/2020 & Article 11 Real Decreto-ley 16/2020, sec. 9 para 2 2. COVID-19-JuBG, and Section 13 of Act 191/2020 Coll.

limit the access to insolvency proceedings. From that, we move on to discuss how the national context influences the limitations that are suitable to prevent unnecessary insolvency proceedings in a pandemic. For this, we focus on three jurisdictions, namely Germany, Belgium and the Netherlands. These three countries provide a palette of varying national legal backgrounds, both in terms of pre-existing national insolvency law, particularly the criteria to open insolvency proceedings, and in terms of measures taken during the pandemic to limit the access to insolvency proceedings. Lastly, we evaluate the limitations placed on the entry into insolvency proceedings, by comparing their effects in these three countries, both against each other, and as against the times before the pandemic, also in an economic context.

2 Why (not to) prevent insolvency proceedings?

2.1 Reasons to curtail insolvency

When the economy is hit by a large external crisis that brings great uncertainty, such as when the COVID-19 pandemic first hit Europe, there are several reasons to temporarily suspend or limit the possibilities to open insolvency proceedings. A common driver behind these is the notion (which was generally accepted at the beginning of the pandemic) that the crisis is a temporary, yet uncertain, aberration of normal economic operations.

First, at the beginning of the pandemic, there was a strong moral argument to be made to temporarily curtail the opening of insolvency proceedings. For many entrepreneurs, the pandemic came as a purely external crisis, for which they could not have reasonably been expected to be prepared. To the extent that the pandemic would force companies into insolvency proceedings, this would mean the end of many entrepreneurs' business through no fault of their own. One might argue that blame is not a relevant criterium in the opening of insolvency proceedings. Yet, the external factor that was the COVID-19 crisis revealed the very real threat that entrepreneurs may lose their business through no fault of their own, due to external circumstances that entrepreneurs were not expected to be prepared for. This premise was morally hard to accept at the outset of the pandemic. Such Covid-forced closure of businesses would put the economic hardship of the pandemic upon entrepreneurs, where the prevailing sentiment was that the risk of a pandemic should mostly be borne by the government and thus, by society as a whole.

Second, since the pandemic, especially at the beginning, was not expected to last long in many European countries, there was great benefit in preserving the economic networks, contacts, supply lines and organizational structures for better times. That way things could quickly go back to normal once the pandemic would end.

Third, the uncertainty at the beginning of the pandemic significantly reduced the value of most of the assets that companies held. Therefore, the opening of insolvency proceedings would not only reduce the proceeds of foreclosure with the usual negative effect of a forced sale; the opening of insolvency proceedings would also force a sale in times of great uncertainty, driving the prices down even further. While companies and assets were not necessarily undervalued at beginning of the pandemic because this uncertainty was real at the time, recovery rates for creditors would nonetheless have been even lower than usual, and residual debts for sureties would be even greater.

Lastly, the economic uncertainty at the beginning of the pandemic led to the belief that courts may not be able to deal with the large number of requests to open insolvency proceedings resulting from the economic impact of the pandemic. Further, the limited capacity of the courts was itself also encumbered further by Covid-protocols such as distancing, suspending physical meetings etc., which hindered proceedings. Therefore, suspending or limiting the possibilities to request the opening of insolvency proceedings could also serve to meet the limited capacity of the courts.

2.2 Reasons not to curtail insolvency

In contrast with these reasons to limit the access to insolvency proceedings, one should also take account of serious disadvantages to such limits.

First, limits to the access to insolvency proceedings, inevitably come with limitations on the useful effects of insolvency proceedings[2], particularly the benefits of insolvency proceedings from a macro-economic standpoint. Amongst other functions, insolvency proceedings serve to distribute means of production to those places where they can be best utilized. By liquidating or otherwise terminating underperforming companies, the resources tied up in those companies become available and can be used in a more fruitful manner. Limiting the access to insolvency proceedings hinders this process of re-allocation of resources. This becomes more pressing as the crisis perdures and the necessity grows to adjust companies towards the changed economic reality of doing business in Covid-circumstances.

[2] Cf. S Madaus & F J Arias, 'Emergency COVID-19 Legislation in the Area of Insolvency and Restructuring Law', *ECFR* 2020, 318–352.

Second, limiting the access to insolvency proceedings may prove to be a very costly undertaking. Companies that in normal circumstances would meet the test to open insolvency proceedings tend to be loss-making. Limiting the access to insolvency proceedings therefore tends to preserve essentially loss-making organizations, even when there is no 'light at the end of the tunnel'. This creates larger losses that will have to be borne by one party or another. Usually, these losses are borne by the creditors or by the state in the form of state aid. Hence, limiting the access to insolvency proceedings shifts the costs of the crisis from the failing companies to their creditors, who may also be unable to bear these losses. Another side of the same coin is the risk of doing too much. Limiting the access to insolvency proceedings inevitably causes 'throwing good money after bad money', losing more investments in a misguided attempt to save earlier investments in essentially loss-making companies.

Third, even though the extreme circumstances may justify extreme measures, one should not forget that the opening of insolvency proceedings is also a valid way for creditors to exercise their rights. Limiting the opening of insolvency proceedings limits the possibility of creditors to enforce their rights, which they may well be justified to do, and which may also be necessary for the creditors to safeguard their interests.

In the end, the core objection against limiting the access to insolvency proceedings is that one can easily overshoot the target. Providing essentially healthy companies some extra breathing room to survive a temporary crisis is in everyone's interest, yet at the start of a crisis, it is very hard to identify those healthy companies. The result can be the creation of costly breathing room for the wrong debtors.

3 Different approaches in different national contexts

3.1 Background: State aid and insolvency tests

Limitations on the entry to insolvency proceedings are always enacted in the context of the relevant national law, and other measures to curb the economic impact of the pandemic. This context plays a major role in deciding which limits on the opening of insolvency proceedings are necessary to effectively prevent unnecessary insolvency proceedings without also preventing those insolvency proceedings that would be well-placed, even in the special circumstances of the pandemic. Particularly, the national insolvency test which determines when to open insolvency proceedings, the possible obligation to file for insolvency proceedings, and other measures taken to support ailing companies, such as financial support, are relevant aspects against which to consider the limits to be placed on the opening of insolvency proceedings.

In general limitations on the opening of insolvency proceedings and the need for limitations on the opening of insolvency proceedings can be considered communicating vessels: the more government support is available for failing companies, the less it is necessary to limit the opening of insolvency proceedings in order to keep companies out of insolvency proceedings.

3.2 Amending the entry test

3.2.1 Amending balance sheet insolvency tests

Where insolvency proceedings are opened based on a balance sheet insolvency test, such as in Germany, two reasons can explain the additional incentive to limit the opening of insolvency proceedings.

First, the uncertainty brought by the start of the pandemic had a chilling effect on the value of assets. In the context of a balance sheet insolvency test, this may make healthy companies ripe for insolvency proceedings, even though the underlying economics of the company, and the business-model, may not have changed. As the depreciation in asset value was expected to be temporary and entirely due to the exceptional nature of the pandemic, this strengthened the perceived need, at least at the beginning of the crisis, for limitations on the opening of insolvency proceedings.

As a consequence, petitions to open insolvency proceedings by creditors under German law were severely limited in that they could only be approved if the filing creditor showed that the debtor already passed the insolvency test before the pandemic[3].

Second, in Germany and several other jurisdictions, the balance sheet insolvency test is combined with an obligation for directors to file for insolvency proceedings at, or soon after, the moment when the company becomes (balance-sheet) insolvent[4]. This created extra vulnerability at the start of the pandemic for otherwise healthy companies regarding the dwindling asset values. These companies could be forced into insolvency proceedings due to the directors' obligation to request the opening of such proceedings. Therefore, where the law contains a duty for directors to file for insolvency proceedings, limitations on

[3] § 15a *COVInsAG*.

[4] Such as § 15a *InsolvenzOrdnung* under German law, § 69 *InsolvenzOrdnung* under Austrian law, art. 725 and 725a of the *Zivilgesetzbuches* under Swiss law.

the opening of insolvency proceedings were commonly combined with a suspension of the duty to file for insolvency proceedings.

This happened in Germany. Under German law, directors are normally obligated to file for insolvency proceedings within three weeks after cash flow insolvency, or six weeks after balance sheet insolvency[5]. In recent German history this obligation has been eased repeatedly in situations of crisis, such as during the 2008/09 financial crisis and after the severe floods which took place in 2013 and 2016. Similarly, soon after the pandemic hit[6], on 27 March 2020, this obligation was suspended to allow directors some breathing space to steer their companies through this crisis[7]. Simultaneously, directors' liability for wrongful trading was drastically limited to allow directors of companies in distress to make payments in the ordinary course of business[8].

3.2.2 Amending cash flow insolvency tests

For countries that employ a cash flow insolvency or liquidity test, the challenges of the pandemic translated differently into the insolvency test. Companies in countries with a cash flow test were not faced with the threat of insolvency proceedings because of the dwindling asset values only. Yet, as the pandemic and the measures to combat the pandemic disrupted the course of business for many companies, and therefore disrupted their cash flow, companies still found themselves meeting the traditional criteria for the opening of insolvency proceedings, whilst the opening of insolvency proceedings at the height of the pandemic may not have been in the best interest of both the creditors, the debtor and other capital providers such as shareholders. Hence, curbing the regular criteria for opening insolvency proceedings during the pandemic also made sense in countries employing a cash flow test.

In jurisdictions that employ a cash flow test for insolvency, the companies affected by the (measures to combat the) pandemic can be more specifically identified than in jurisdictions applying a balance sheet test, because with a cash flow test dwindling asset values are not as likely to lead to insolvency proceedings. Those companies that were pushed towards meeting a cash flow insolvency test were generally the ones whose business operations were directly impacted by the pandemic, or by the measures to combat the pandemic, such as bars and restaurants, travel companies, and event organizers. In many countries, companies that were negatively impacted by such measures could receive

5 § 15a *InsolvenzOrdnung*.

6 See R. Schiebe & W. Zenker in the German Chapter of the INSOL International – World Bank Group Global Guide: Measures adopted to support distressed businesses through the COVID-10 Crisis, available online.

7 § 1 *COVInsAG*.

8 § 2 *COVInsAG*.

reimbursement from the government, although such reimbursement usually came (long) after the measures to combat the pandemic caused significant liquidity problems. This delay was an extra reason to amend cash flow insolvency tests during the COVID-19 pandemic.

In the Netherlands, however, this conundrum seems to have hit relatively few companies. Under Dutch law, insolvency proceedings are opened based on a cash flow test. That test was barely amended by the legislator during the COVID-19 pandemic and in December 2020 a temporary statutory provision was enacted to allow companies whose insolvency proceedings had been requested by a creditor some extra breathing space. In March 2020, well before the legislator enacted this statute, the informal body of insolvency judges had issued a temporary special protocol on insolvency cases during Covid[9]. This special protocol called for extra scrutiny of petitions to open insolvency proceedings given the special circumstances. That special scrutiny was not based on any specific Covid-related statutory provisions, but on the ordinary provisions regarding abuse of rights or powers, which were applied more extensively to cover the special circumstances during the pandemic. However, these special provisions were scarcely applied[10]. In the Netherlands, very few cases are known where the opening of insolvency proceedings was rejected due to the extra scrutiny that judges decided to apply during the pandemic, or due to the late statutory provisions on this topic. However, one must take into account that both the judges' special protocol and the specific statutory provisions have prevented petitions to open insolvency proceedings from even being filed with the court. Creditors may have decided not to file for insolvency at all due to these raised entry tests. Besides this effect, which is very hard to measure, the decline in insolvency proceedings in the Netherlands (see para 4) seems mostly related to the financial stimulus provided during the pandemic.

Under Belgian law, which also employs a cash flow test, all insolvency proceedings were suspended during certain parts of the pandemic[11]. For debtors that were not already in financial distress before the pandemic, insolvency proceedings could only be requested with a special waiver by the President of the Tribunal of Enterprises. Effectively, the courts used this special waiver to distinguish between companies that were already insolvent when the pandemic hit Belgium, and those only driven into insolvency by the pandemic.

[9] 'Tijdelijke Afwijkende Regeling Insolventiezaken tijdens Corona', or TARIC for short.

[10] That is, the provisions of this protocol calling for extra scrutiny in assessing the criteria for opening of insolvency proceedings were applied remarkably little. The procedural provisions of the protocol, eg those arranging for hearings by video-conference, were widely applied.

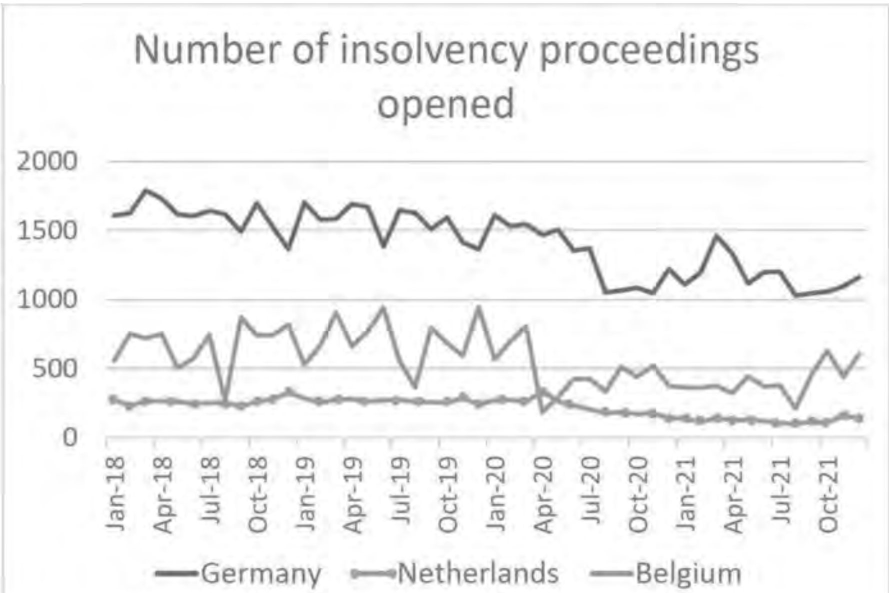
[11] Notably between 24 April 2020 and 17 June 2020 and between 24 December 2020 and 31 January 2021.

4 Evaluation

4.1 Number of insolvency proceedings

Figure 1 shows the number of insolvency proceedings opened in the Netherlands, Belgium, and Germany from 2018 until 2022. All show a significant reduction in insolvency proceedings during the pandemic compared to the years before. Only the graph for Dutch insolvency proceedings shows a small increase at the very start of the pandemic, followed by the same significant decline that is also visible in Germany and Belgium.

Figure 1: Number of insolvency proceedings opened against businesses in 2018–2021 in Germany, the Netherlands and Belgium[12].



This decline in insolvency proceedings is remarkable compared to economic trends. The Dutch, Belgian, and German economies were initially hit severely by the pandemic, with gross domestic products shrinking in the second quarter of 2020 by 9% to 13%[13]. Such a hard hit on the economy would normally go

[12] Sources: https://www.destatis.de/EN/Themes/Economic-Sectors-Enterprises/Enterprises/Business-Notifications-Insolvencies/Tables/Insolvencies.html, https://www.cbs.nl/nl-nl/nieuws/2022/02/historisch-laag-aantal-faillissementen-in-2021.

[13] Sources: https://www.nbb.be/nl/statistieken/algemeen/kerncijfers, https://www.cbs.nl/nl-nl/nieuws/2022/12/bbp-groeit-1-procent-in-vierde-kwartaal-2021, https://www.destatis.de/EN/Themes/Economy/National-Accounts-Domestic-Product/Tables/domestic-product-gdp-quarterly1970-xls.html.

hand in hand with a substantial increase in the number of insolvency proceedings, yet that was not the case during these initial stages of the pandemic.

For the rest of 2020, the economies of all three countries kept shrinking, whilst the number of insolvency proceedings remained below the numbers of the years before which showed positive economic growth. It is reasonable to expect that the limits on the opening of insolvency proceedings have played a significant role in this surprisingly low number of insolvency proceedings given the economic climate.

However, the influence of limitations on the opening of insolvency proceedings is hard to distinguish from other factors that have undoubtedly also reduced the number of insolvency proceedings, such as the state support for closed businesses.

The Netherlands, for example, has seen comparatively few limitations on the opening of insolvency proceedings and the only statutory limitation was enacted on 17 December 2020. Yet, the Dutch government has been relatively generous in financially supporting ailing business. The low number of insolvency proceedings in the Netherlands in 2020, especially compared to the dire economic circumstances, may be largely attributable to the financial support, particularly the wide-ranging postponement of taxes and the reimbursement for labour costs. Similarly, the reduced numbers of insolvency proceedings in other countries may have more to do with financial support than with limitations on the opening of insolvency proceedings.

In 2021 the number of insolvency proceedings for the Netherlands and Belgium remained low, whilst Germany showed a notable rise. This is of note given that all three countries experienced significant economic growth of over 10% in the second quarter of 2021. This may partially be attributed to the ending of the main limitation on the opening of insolvency proceedings in Germany, that is the termination of the suspension of the obligation to file for insolvency proceedings. At the end of 2020 and 2021, the obligation imposed on German directors to file for insolvency if and when their company became balance sheet insolvent was reinstated.

At the end of 2021, all three countries showed an increase in the number of insolvency proceedings. This may be related to the new wave of Covid infections that came just as government support was being winded down.

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4.2 The national background

The considerations above show that limitations on the opening of insolvency proceedings are closely connected to national circumstances. All countries in Europe experienced the same pandemic, but not all countries responded in the same manner. In some countries the lockdowns were more severe than in others; in some countries the financial support for businesses was more generous than in others. Limitations on the opening of insolvency proceedings are also closely connected to the normal rules for the opening of insolvency proceedings, which differ significantly per country. Particularly, in countries with an obligation for directors to file for insolvency proceedings once their company experiences a certain amount of financial distress, amendments to statutory insolvency law can be much more necessary in times of crisis compared to those countries that do not have such strict obligations for directors.

Conversely, the effect of the measures in the Netherlands seemed small compared to the significant dwindling of insolvency proceedings in Belgium and Germany. This may be attributed to the limited measures taken in this respect in the Netherlands where, effectively, judges on their own accord applied extra scrutiny to petitions to open insolvency proceedings, but statutory amendments were little and late.

4.3 Overdoing it

Insolvency proceedings are not all bad, and not all value-destroying undertakings. In normal times, insolvency proceedings also serve to redistribute underperforming means of production to companies where they can be put to better use. Therefore, as discussed in section 2.3 above, too many limitations on the opening of insolvency proceedings may easily have a negative impact.

Since the pandemic has loosened its grip on the economy, the Netherlands, Germany, and Belgium have all been struggling with serious shortages in the labour market. It has been suggested that this was caused by, among other things, the unusually low number of insolvency proceedings during the pandemic. Due to essentially unviable companies having been kept alive artificially, the employees of those companies are now not available to fulfill roles elsewhere in the economy. Conversely, those companies that let go of staff that were not in long-term employment contracts during the pandemic, are now having trouble to fill those positions since their original staff have found positions elsewhere.

The very low number of insolvencies in all three countries, taking into account the economic circumstances, strongly suggests that the combination of limitations on the opening of insolvency proceedings and the government support has indeed been 'overdoing it'. Moreover, the Dutch example, where very few limitations were placed on the entry into insolvency proceedings but state support was generous, suggests that this effect is largely attributable to the government support. However, this balance may differ per country.

Whether or not the combination of (financial) government support and limits on the opening of insolvency proceedings has 'overdone it' is also very much a moral and a political question. It seems that governments have erred on the side of caution, quite possibly saving more companies than intended. This policy comes with moral hazard since companies which could be expected to be placed into insolvency proceedings if the pandemic had not occurred, have now avoided insolvency with the help of the limitations on insolvency proceedings and government support. Apart from this moral hazard, the situation has certainly been very costly, which begs the question whether the government spendings on financial support of failing companies have been worth it. Lastly, this also raises unfair competition considerations, as companies that could not benefit from the limits on insolvency proceedings and generous government support in the post-pandemic era have to compete with companies that could not have survived without these very generous measures.

5 Conclusion

For a brief time during the pandemic, things that were unimaginable in normal times suddenly became the ordinary course of business. Banning insolvency proceedings was one of those things. Many countries have taken such steps, and limited insolvency proceedings in one form or another.

The best suitable way to limit the opening of insolvency proceedings was closely connected to the national environment of insolvency law and other measures to support businesses during the pandemic. Particularly in countries with a statutory duty to file for insolvency proceedings, statutory amendments can play a significant role in dealing with a sudden external crisis, such as a pandemic. However, as with all drastic measures, limiting the opening of insolvency proceedings does come with its own risks. One easily does too much, or harms creditors unnecessarily.

That being said, the limitations on the opening of insolvency proceedings, combined with other extraordinary measures that have been taken, have so far proven effective, maybe even too effective. Surprisingly few companies were put into insolvency proceedings amidst the tumultuous times of the pandemic. In economically incredibly uncertain times, Belgium, Germany, and the Netherlands all reported the lowest number of insolvency cases in decades.

Whether or not surviving companies will eventually be struck down by the looming mountain of debt incurred during the pandemic, the economic equivalent of 'long Covid', remains to be seen. It may just be that the limitations on the opening of insolvency proceedings during the pandemic will become a stimulus for post-pandemic insolvency proceedings.

Chapter 11

Polish Simplified Restructuring as a Basis for Implementation of Directive (EU) 2019/1023 and a Model of Implementation

Mateusz Kaliński, LL.M.
Tatara & Partners Restructuring & Insolvency Law Firm

1 EU Restructuring Directive 2019/1023

The European Union (EU) has sought to harmonize and to some extent regulate the restructuring and insolvency legal landscape in the EU pursuant to 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 (hereinafter the '**Restructuring Directive**').

The main goal of the Restructuring Directive is to establish a common approach on substantive matters of restructuring and insolvency law. Procedural matters such as recognition and enforcement are covered mainly by the Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast) (the '**Insolvency Regulation**').

The Restructuring Directive requires the introduction of preventive restructuring frameworks for companies that are potentially ultimately viable and have a prospect of recovery. It also provides for discharge of debt and related provisions and aims for the processes to operate mainly out of court.

Prior to introducing the simplified restructuring proceedings in Poland, which are discussed in detail below, our legal system was partially compliant with the Restructuring Directive. The Polish legal framework did however require legislative actions in the following areas to ensure compliance with the Restructuring Directive:

- Possibility for restructuring at early stage.

- Access to all rights guaranteed by the Restructuring Directive. For example, a stay of enforcement was not possible within arrangement approval proceedings (despite being available in other Polish restructuring proceedings).
- Introducing the best interests of creditors test. Polish law did have a creditor test, but this was designed for public entities not for general creditors.
- Early warning tools, which were not formally part of the law although there had been some initiatives regarding this aspect in Polish law.
- Choice of insolvency practitioner on case-by-case basis, as well as their role within proceedings. Previously in Poland there was a mandatory appointment with a choice only available in certain limited circumstances.
- Optional refusal of stay of enforcement, lifting of the stay, and possible exclusion of certain claims from the stay.
- Duration of stay of enforcement.
- Availability of on-line checklist for restructuring plans and the electronization of the proceedings.
- Examination and confirmation of the voting rights and formation of classes by the relevant authority.
- Adoption of a restructuring plan or arrangement via consultation or by means other than voting.
- Treatment of dissenting classes and cross-class cram down mechanism. This did exist albeit to a more limited extent under existing Polish Law.
- The ability to overcome unreasonable obstacles from equity holders in implementing a restructuring plan.
- Valuation of the debtor's business. This existed in a limited way under Polish law through an inventory stock count process along with assessment of value of debtor's assets.
- Protection of new financing during a restructuring (fresh money).
- Voidability and unenforceability of certain transactions.
- Collecting data related to debtors subject to restructuring and insolvency proceedings, as well as data relating to costs, recovery rates, new businesses and job losses, are discussed in this paper.

The aforementioned areas and the approach taken in Poland to implement the Restructuring Directive particularly in relation to simplified restructuring proceedings will be discussed in this paper.

Other aspects of Polish law appear to comply with the Restructuring Directive. For more in-depth analysis see i.a: K. Tatara, A. Czarnota, M. Masior, M. Kaliński, Chambers Practice Guides, Insolvency 2021, Poland, available online at: https://practiceguides.chambers.com//practice-guides//insolvency-2021//poland.

2 Polish simplified restructuring

In response to the COVID-19 pandemic, Poland, as well as many other countries introduced special measures to confront the crisis resulting from public health economic lockdowns.

Articles 15–25 of the 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 (the '**Act of 2020**') introduced, among other things, a new form of simplified restructuring proceedings in Poland (the '**Simplified Restructuring Proceeding**') from 24 June 2020 up until 30 November 2021.

The Act of June 2020 was introduced to help entrepreneurs confront the COVID-19 crisis, and the Simplified Restructuring Proceeding was mainly an out-of-court process that was quick and relatively cheap to conduct. It proved to be a successful tool for many SMEs and farming businesses with over 1,200 cases in total commenced since June 2020.

The Simplified Restructuring Proceedings were made available alongside the existing processes that were governed by the Act of 15 May 2015 on restructuring law being the main legislation covering restructuring proceedings in Poland (the '**Restructuring Law**') which comprises:

- arrangement approval proceedings;
- accelerated arrangement proceedings;
- arrangement proceedings; and
- remedial proceedings.

Each of these processes are regulated by the Restructuring Law and whilst having different features each have the common aim of allowing debtors to restructure whilst balancing the interest of creditors.

The main differences between Simplified Restructuring Proceedings and a traditional arrangement approval proceeding under Polish law are listed below:

- Simplified Restructuring Proceedings could be opened (via the announcement in the Polish Court and Commercial Gazzette) by a debtor only once. There was also a maximum period of four months for collecting votes or voting on the creditors' meeting for the acceptance (conclusion) of the arrangement.
- The court had to be notified within 3 days of the making of the announcement on the opening of the Simplified Restructuring Proceeding.

- A Simplified Restructuring Proceeding was formally opened on the day of making the announcement, which had particular importance for issues such as inadmissibility of a subsequent declaration of bankruptcy.
- A Simplified Restructuring Proceeding involved a broad and wide stay on enforcement.
- A general rule (within Simplified Restructuring Proceeding) was introduced that if arrangement proposals provided for full satisfaction of a liability to a creditor (including all incidental amounts)[1] within the time limit specified in the arrangement the creditor's consent was not required to the arrangement.
- The possibility of cancelling the effects of the announcement, including stay of enforcement, but with the Simplified Restructuring Proceeding continuing. In Poland there was an example where the court made a cancellation of the effects of making the announcement and later after a relatively short time, approved the arrangement.
- Voting electronically, which now is meant to be a standard, but upon introduction of simplified restructuring, was a novelty.
- Discontinuation of the Simplified Restructuring Proceeding upon failure to file the court application for approval of the arrangement.
- Specific provisions related to remuneration of the arrangement supervisor, which was previously very limited with regard to micro and small enterprises.
- Possibility to easily change the Simplified Restructuring Proceeding into remedial (other restructuring proceedings in Poland governed by the Restructuring Law) or bankruptcy, upon failure of the Simplified Restructuring Proceedings.
- Potential claims against debtors for making the Simplified Restructuring Proceeding announcement in bad faith.
- Specific grounds for addressing management board members' liability.

Apart from the foregoing specific matters, the provisions of the broader Restructuring Law applied to the Simplified Restructuring Proceeding. Simplified Restructuring Proceeding were not added to Annex 1 of the Insolvency Regulation.

3 Implementation of the Restructuring Directive in Poland

It is worth considering how different aspects of the Restructuring Directive were addressed, albeit temporarily, by the Simplified Restructuring Proceeding.

The Simplified Restructuring Proceeding was introduced to simplify restructuring processes and was available to both insolvent debtors and debtors who were

[1] Which is otherwise provided for in Article 260 section 1 of the Restructuring Law.

threatened by insolvency. According to Article 6.3 of the Restructuring Law, the threat of insolvency occurs to a debtor whose economic situation indicates that he may become insolvent within a short period of time.

A debtor is considered insolvent under Polish law when he has lost the ability to discharge his matured pecuniary liabilities (Article 11.1 of the Polish Bankruptcy Law) (the cash flow test).

In the case of companies or other legal persons, Article 11.2 of the Bankruptcy Law provides that a debtor is also considered insolvent where (i) its pecuniary obligations are in excess of the value of its assets and (ii) this state of facts persists throughout a period exceeding twenty-four months (or the balance sheet test).

For the purpose of analysing the threat of insolvency, in my opinion, the cash flow test is the main test because it provides the possibility to assess the state of the debtor's financial situation.

However, the balance sheet test can also be relevant in considering the threat of insolvency, especially when a debtor anticipates that his debts will soon exceed his assets, and that this will last for a long period.

The above basically means that the entry requirements for initiating a Simplified Restructuring Proceeding were relatively low because even if a debtor was not insolvent at the time, he could have made an announcement and initiate the proceedings, allowing him to benefit from protection from creditors. The process provided a broad range of possible ways to restructure including debt for equity swaps and the possibility to use a partial arrangement that was applicable only to selected creditors and which did not affect the day-to-day business operations performed by a debtor.

With regard to the rights guaranteed by the Restructuring Directive, I believe that apart from the opportunities provided due to the introduction of Simplified Restructuring Proceedings, Polish debtors have sufficient access to all of the rights guaranteed by the Restructuring Directive as part of the broader Polish legal framework and in particular under the Restructuring Law..

It is important to note that the Polish legal framework should be assessed with reference to its complexity and costs. Costs were much lower in Simplified Restructuring Proceedings than in any other restructuring proceedings, at least in relation to micro, small and medium-size enterprises.

The best interests of creditors test was not introduced directly by the Simplified Restructuring Proceedings as a separate requirement.

Rather as part of the broader Polish restructuring law a debtor must prepare a private investor test or a private creditor test which are designed for public entities and required by EU law and subject to numerous European and Court of Justice judgements regarding state aid.

This test can be a basis for undertaking the broader best interests of creditors test required by the Restructuring Directive and facilitates the use of similar and familiar documents within the proceedings, although I am perfectly aware that the purpose thereof may differ.

It is also worth noting that under Polish law, the contents of the private investor and private creditor test are regulated.

Subject to Article 140.5, the <u>private investor test</u> should include information on:

(1) foreseen return on exposed capital;
(2) an average level of return on exposed capital in comparable investments;
(3) foreseen level of risk involved in the investment;
(4) average level of risk of comparable investments

The <u>private creditor test</u> should include information on:

(1) foreseen degree of satisfaction of particular public-law creditors, as part of the performance of the arrangement. Information to include for the basis of the assessment:
    (a) the amount of the debtor's liabilities towards particular public-law creditors which are covered by the arrangement;
    (b) contents of the arrangement proposals to particular public-law creditors;
(2) information on the foreseen degree of satisfaction of particular public-law creditors in the bankruptcy proceedings which would be conducted against the debtor. Information that must include for the basis of the assessment includes the:
    (a) value of the debtor's property with the indication of encumbrances;
    (b) foreseen amount of costs of the bankruptcy proceedings;
    (c) category in which particular public-law creditors would be satisfied in bankruptcy proceedings;
    as regulated by Article 140.3 of the Restructuring Law.

These tests are also applicable to Simplified Restructuring Proceedings.

The early warning tools prescribed in broad terms in the Restructuring Directive were not introduced by the Simplified Restructuring Proceedings or the Act of 2020 as Poland already had warning tools and programs which are helping businesses correctly assess their financial situation.

Poland is part of the EU project – Early Warning Europe. d. Poland has previously introduced some early warning tools as part of that project, especially of a consulting nature, connected with the analysis of the financial situation of companies or sole traders by experts with recommendations of future steps in order to overcome the difficulties.

More than 850 entrepreneurs have used this opportunity in recent years and received advice from professionals, as well as introduced some tools to help their businesses.

According to Article 210 of the Restructuring Law, in order to prepare arrangement proposals, collect votes and lodge an application for approval of the arrangement, the debtor should enter into a contract with a person to exercise supervision over the course of the proceedings. This person will act as the arrangement supervisor. Subject to Article 15.1 of the Act introducing Simplified Restructuring Proceedings – this contract was required with regard to the Simplified Restructuring Proceedings too.

Article 38.2 of the Restructuring Law provides for a choice of court supervisor in Poland within restructuring proceedings. Upon the debtor's application with the appended written consent of the creditor or creditors holding jointly more than 30 per cent of the total sum of receivable debts (save for the same categories of creditors), the court should, in a ruling on opening the accelerated arrangement proceedings or the arrangement proceedings, appoint the person named by the debtor (who must satisfy the requirements referred to under Polish law) to perform the duties of the court supervisor. The court may refuse to appoint the named person, when good reasons occur, in particular when it is evident that such a person does not guarantee the performance of the duties. This provision also applies to remedial proceedings, according to Article 51.2 of the Restructuring Law.

Therefore, the choice of restructuring advisor – arrangement supervisor, court supervisor of receiver (administrator in remedial proceedings) is already guaranteed by Polish law and by one of the milestones of regulation regarding the cooperation between the debtor and arrangement supervisor.

A stay of enforcement is available under Polish law in accelerated arrangement proceedings, arrangement proceedings and remedial proceedings and was available in Simplified Restructuring Proceedings.

From the day of making the announcement, which is referred to in Article 15.1, until the day on which the proceedings to approve an arrangement are discontinued or closed:

(1) enforcement proceedings concerning a receivable that is subject to the arrangement, as well as concerning receivables that will be discharged in full within the meaning of Article 17 of the Restructuring Law[2], initiated before the day of opening the proceedings referred to in section 1, are suspended by operation of law;
(2) initiation of enforcement proceedings, enforcement of a decision on granting security for a claim or enforcement of an order to grant security for a claim arising from the receivable which is subject to the arrangement, as well as concerning receivables that will be discharged in full within the meaning of Article 17 of the Restructuring Law, is not allowed;

As a result, a stay of enforcement within Simplified Restructuring Proceedings in Poland was very broad and could include secured creditors.

Lifting the stay or refusal thereof was not expressly mentioned in the regulations regarding Simplified Restructuring Proceedings. At the request of the creditor, the debtor or the arrangement supervisor under Article 18.1 the court may cancel the effects of making the announcement if they are detrimental to the creditors. Before issuing the decision, the court may examine the debtor, the creditor or the arrangement supervisor. The cancellation of the effects of making the announcement also lifts the restrictions imposed on the debtor on its administration powers and the stay on enforcements.

In Poland there is already a regulation providing for non-applicability of a stay to certain creditors, especially secured ones in accelerated arrangement proceedings.

The duration of a stay could be longer than 4 months, as suggested in the Restructuring Directive, because it lasts not only the 4 months of conducting

[2] Article 17 provides that arrangement proposals provide for full satisfaction of a receivable, together with any incidental amounts due within the time limit specified in the arrangement, the creditor's consent is not required to the arrangement. Article 260.1 of the Restructuring Law provides that a creditor having a receivable debt secured on the debtor's property by a mortgage, pledge, registered pledge, Treasury pledge or a ship's mortgage may, in the course of accelerated arrangement proceedings, carry out execution out of the object of security only.

the proceedings, but also until the court makes a decision on the arrangement approval application, (or when the proceedings are discontinued).

Online check-ins of restructuring plans, although mentioned separately within the Restructuring Directive, bring attention to a wider issue of the electronization of restructuring proceedings.

Such check-ins and lists which identify what must be done before commencing proceedings should be very useful for debtors, especially smaller and even micro sized entrepreneurs, who can verify whether their efforts to reach an agreement with creditors are formally and procedurally compliant with the Polish law requirements. Compliance with the procedural requirements are critical in the Polish courts.

Simplified Restructuring Proceedings also provided for the informatization and electronization of restructuring proceedings. As provided by Article 19.3: If it is technically possible, the voting during the creditors meeting may be held with the use of electronic means of communication. Voting with the use of electronic means of communication includes the transmission of the creditors meeting in real time and when the creditors may speak during the meeting while present at a location different than the location where the creditors meeting is held. The creditors' participation in the meeting may only be subject to such requirements and restrictions which are necessary to identify the creditors and to ensure the safety of electronic communication. The minutes of the creditors meeting held with the use of electronic means of communication must include a recording of the session on an electronic data carrier.

In an effort to record the effectiveness of the manner in which restructuring takes place in Poland, the National Debtors Register was finally introduced on the 1 December 2021, but with some technical obstacles, especially within the first phase of its introduction into Polish law.

Interestingly, Polish lawmakers initially provided for the use of electronic forms of communication within Simplified Restructuring Proceedings only when it was technically possible, which in my opinion was the right choice, because some creditors and debtors, especially micro-entrepreneurs, could not utilise the systems. However, from the 1st of December 2021, restructuring proceedings are completely electronic, with very limited exceptions.

The authority's possible examination and confirmation of the voting rights and formation of classes can be treated as having been partially introduced with regard to Simplified Restructuring Proceedings with partial arrangement.

In such a scenario, according to Article 182.3 of the Restructuring Law, immediately after an application for opening accelerated arrangement proceedings has been filed, the court should adjudge in the matter of lawfulness of the criteria for separating creditors covered by the partial arrangement.

However, the abovementioned rule is a general nature, but subject to Article 182.1 of the Restructuring Law (in general), a partial arrangement may be adopted and approved exclusively in arrangement approval proceedings or in accelerated arrangement proceedings.

The Simplified Restructuring Proceedings are also a type of arrangement approval proceedings, thus a partial arrangement may be issued within this proceedings as well.

However, the idea behind the provisions of the Restructuring Directive addressing examination and confirmation of the voting rights and formation of classes seems to be an excellent idea as it may give the debtor an overview of the initial stages of the proceedings on the lawfulness of the planned restructuring. Currently in Poland, such assessment is done by the court during the examining arrangement approval application at the final stage and after the total debtor's effort to collect votes and reach an agreement with the creditors.

Corresponding regulations were indicated in the provisions of the Restructuring Directive which related to the means of reaching a conclusion of the arrangement, other than by way of voting.

Currently, these possibilities have not yet been introduced by Poland, but they seem really interesting, because they are similar to the Simplified Restructuring Proceedings being mostly out of court and may lead to a quick achievement of a consensus.

Currently in Poland, court confirmation of plans is done in every case and creditors have a right of objection as required by the Restructuring Directive.

With regard to the treatment of dissenting classes and the issue of cross-class cram down, Article 119.2 of the Restructuring Law provides that if the voting on the arrangement is held in groups of creditors covering individual categories of interests, the arrangement shall be adopted, if in each group it is supported by the majority of voting creditors from the group holding jointly at least two-thirds of the total sum of receivable debts to which voting creditors from such group are entitled. Article 119.3 provides that despite not having obtained the necessary majority in some groups of creditors, the arrangement shall be adopted if the creditors holding jointly two-thirds of the total sum of receivable debts to which voting creditors are entitled voted in favour of the adoption of the arrangement and if the creditors from the group or groups which voted against the adoption of the arrangement will be satisfied on the grounds of the arrangement to an extent no less favourable than in the event of conduct of the bankruptcy proceedings.

In my opinion, this is not an ideal cross-class cram down regulation, but this rule can be treated as protecting creditors up to reasonable extent. This regulation also applied to the Simplified Restructuring Proceedings.

Article 119.3 applies a test for the satisfaction of a dissenting creditors on the basis that the creditor should be no worse off when compared to the outcome in bankruptcy proceedings.

Equity holders' 'unreasonable prevention' of implementation of the restructuring plan should be balanced with the need to protect the legitimate interests of equity holders and their rights.

Discussing this issue, one cannot forget about the possibility of hostile takeovers involving a debt for equity swap, especially when considering the majority rule, not requiring the unanimity even with regard to the conclusion and approval of the arrangement.

Thus, it is recommended that equity holders have at least some procedural rights within restructuring proceedings such as the right to file objections towards arrangement.

Such regulations currently do not exist in Polish law, even within Simplified Restructuring Proceedings, but it is worth considering implementation thereof.

Valuation issues and 'when the value breaks' are of great importance within restructuring, because they can impact not only the value of debtor's enterprise, but also the power of the vote (thus affecting voting rights) of the secured creditors.

According to Article 151.2 of the Restructuring Law an arrangement cannot include receivable debts under an employment relationship and receivable debts secured on the debtor's property by a mortgage, pledge, registered pledge, Treasury pledge or ship's mortgage, to the extent covered by the value of the object of security, unless the creditor consents including the receivable debt in the arrangement. Consent for including a receivable debt by the arrangement should be expressed in an unconditional and irrevocable manner, no later than before commencement of voting on the arrangement. Consent may also be expressed verbally and recorded in the minutes of the meeting of creditors.

Thus, a valuation of the enterprise may be crucial whilst also referring to the secured creditors' position within proceedings. However, regarding creditors who will be satisfied in full by an arrangement one should always remember the rule set out in Article 17.1 regarding creditors whose claims are discharged in full discussed above.

Within the insolvency framework in Poland, while considering the importance of valuation, there is also inventory stock-counting, along with an assessment of the value of debtors' assets, but it is used primarily within bankruptcy – with liquidation being the main aim of the proceedings.

Adequate protection of fresh money involves new financing within restructuring and insolvency, and this is one of the key considerations to successfully restructure a business. Napoleon Bonaparte used the quote 'war' but for restructuring you need 3 things: 'money, money and money'.

Whilst new financing is treated preferentially, in Polish restructurings the regulations require development to be more favourable and more popular with lenders, especially taking into account the perspective of financial institutions.

Voidability and unenforceability of new credit transactions must also be treated specifically with regard to transactions needed for successful restructuring.

Within a Simplified Restructuring Proceedings Article 22.2 of the Act of 2020 provided that if the arrangement supervisor has consented:

(1) to conclude a credit agreement or a loan agreement, or
(2) to encumber the asset of the debtor with a mortgage, pledge, registered pledge or a maritime mortgage in order to secure a receivable not subject to the arrangement, or
(3) to transfer ownership of a thing or a right to secure a receivable which is not subject to the arrangement, or
(4) to encumber the constituents of the arrangement estate with other rights such acts may not be deemed ineffective with regard to the bankruptcy estate or remedial estate if the information concerning such acts has been included in the application to approve the arrangement and this application has been approved by a final and unappealable court decision. This also applies to the different forms of Polish restructuring proceedings identified earlier.

This means that this provision of the Restructuring Directive is currently within the Polish insolvency and restructuring law framework. However, it is not exactly within the same scope of such actions or transactions. As far as recent amendments to restructuring law are concerned, this regulation is not planned to be introduced permanently but the debate thereon continues to take place in Poland.

The efficient restructuring and insolvency procedures are issues connected with more general questions regarding court proceedings and the governance of the judiciary – sometimes technical regulations, but with great importance.

The introduction of Simplified Restructuring Proceedings in Poland did not address this issue. However, the Polish government is trying to regulate this matter, with reform aimed to flatten the structure of the judiciary and possibly removing differentiations between some details in law in different regions of Poland. Even with regard to simplified restructuring, most of the courts' approved arrangement approval applications are sent by post on the last day of the date for filing it to the court. One court in central Poland had an opinion that such an application should physically reach the court within the deadline, which was sometimes beyond the control of the debtor.

The effectiveness of the judicial system is also important with regard to timing issues. As quoted in the report on Simplified Restructuring Proceedings written by Karol Tatara and available on-line at: https://tatara.com.pl/kancelaria-prawa-gospodarczego-i-upadlosciowego-karol-tatara-english-version/ and also on INSOL Europe website: https://www.insol-europe.org/technical-content/national-insolvency-statistics-poland, the slowest phase of proceedings is the judicial one, namely the examination and decision-making by the court with regard to the approval of the arrangement, concluded between the debtor and creditors.

Collecting data related to debtors, subject to restructuring and insolvency proceedings, was not changed upon the introduction of the Simplified Restructuring Proceedings, but in my opinion should be, because it may lead to a proper assessment of the needs to make the law efficient whilst considering the business's perspective.

The importance of proper analysis, for which complete and accurate data is required, should be stressed. Data can be described as a fuel of modern times and almost everybody is aware of its complexity and usefulness for reforms or for adjusting to the rapidly changing environment.

4 Conclusions

To sum up, Simplified Restructuring Proceedings in Poland were in many aspects compliant with the Restructuring Directive and could be treated as a model – or pattern for implementation of this Restructuring Directive, not only for Poland, but for other European Union countries as well. Poland's example shows that even before the formal transposition of the Restructuring Directive, many provisions regulated therein are beneficial for all stakeholders, namely, debtors, creditors, the judiciary, businesses and investors.

However, it is worth pointing out that Poland is not compliant with all of the requirements of the Restructuring Directive and the legislative process in Poland is still ongoing.

I personally hope that the huge popularity of Polish Simplified Restructuring Proceedings will encourage the Polish legislators to reform other areas of the Polish insolvency and restructuring framework to reflect the positive aspects of the Simplified Restructuring Proceedings, and to more widely reflect the requirements of the Restructuring Directive.

Chapter 12

What About the Wave of Corporate Insolvency in Europe?

Ivo-Meinert Willrodt
Managing partner,
PLUTA Rechtswalts GmbH in Munich, Germany

Overview

Since the beginning of the Corona crisis, we have seen a significant decrease in the number of company insolvencies in whole of Europe. What is the reason for this, although everyone expected an explosion of insolvencies, and where do we go from here?

1 Illustration of the impact of the Corona crisis on the economies of Europe, shown on the impact on GNP in the UK, France, Germany, Italy, Sweden and Spain

In 2020 and 2021, the economy in Europe was under the impact of the Corona in shock. Multiple lock-downs in the economies of the Member States of the European Union, but also in China, led directly to production stoppages and associated supply difficulties. Indirectly, the subsequent impact on international supply chains was devastating.

These effects already began to hit European companies massively at the end of the first quarter of 2020 and had a significant negative impact on economic development in Europe until the beginning of 2022.

In 2020, the German economy was therefore once again hit by a severe recession after a ten-year growth phase. The outbreak of the Corona pandemic led to a decline in price-adjusted GDP of 4.6% in 2020. Price-adjusted GDP was 2.9% higher in 2021 than in 2020.

In the UK, after registering growth of 1.67% in 2019, real GDP growth declined by 9.27% in 2020. In 2021, this sharp downward trend recovered somewhat to around 7.4% year-on-year.

Similarly, in France, after rising by 1.84% in 2019, GDP growth recorded a drop of 7.9% in 2020, still slightly better than the UK. GDP in France also recovered somewhat in 2021, recording an increase of around 7%.

Italy recorded lower GDP growth of 0.5% in 2019 compared to its neighbouring countries. As in France and the UK, developments in 2020 had a negative impact on GDP, leading to a decline of 9.03%. In 2021, Italy's GDP also recovered a little bit and recorded a growth of 6.6%.

A slightly different development can be observed if one takes a look at the development of GDP growth in Sweden. Sweden is interesting in this respect, because here a different path was taken with regard to the spread of corona and there were no long lockdowns. Sweden also recorded an increase in GDP of around 2% in 2019. However, GDP growth only fell by 2.9% in 2020 – the GDP growth trend is thus significantly better than in France, the UK, Germany or even Italy. In 2021, GDP increased by 4.8 %. This already shows that the lockdowns in particular have had a significant negative impact on the main economic sectors of trade and services in the rest of Europe.

After an increase in GDP of 2.08 % in 2019, Spain records a drop in GDP of 10.8 % in 2020 and is thus the front-runner in the comparison between Great Britain, Germany, France, Italy and Sweden. Compared to the previous year, GDP growth in Spain in 2021 was 5.1%[1] of the major Western European industrialized nations, Spain is therefore having the most difficulty emerging from the crisis.

2 How did the Corona crisis affect the development of the European insolvency market in 2020 and 2021?

All market participants had expected a rapid increase in corporate insolvencies in Europe in 2020. However, this did not happen.

In fact, there has been a significant decrease in corporate insolvencies in Western Europe[2] to approximately 120,000 cases in 2020[3]. This represents a decrease of 26.9 % compared to 2019. In 2019, there were still 162,899 corporate insolvencies in Western Europe counted. When comparing the figures, 2019

[1] The data on GDP are taken from statista's information on international country data in Europe.

[2] The figures below are based on the analysis of 15 EU States plus Norway and Switzerland for Western Europe.

[3] 2021 Verband der Vereine der Creditreform e.V.; Unternehmensinsolvenzen in Europa, Neuss, 20 Mai 2021 S. 4.

represents a historic ten-year low in corporate insolvencies in Western Europe[4]. In 2020, the service sector alone will account for around 50,000 cases of all corporate insolvencies (42.0 %)[5]. Trade accounts for 30.1 %, construction for 17.4 % and manufacturing for 10.5 %[6].

The major Western European industrialised nations saw a significant drop in insolvencies from 2019 to 2020, with corporate insolvencies falling by 14.8% to 16,040 in Germany, 39% to 31,212 in France, 27.7% to 13,200 in the UK, 8.2% to 4097 in Spain and 28.5% to 10,173 in Italy[7]. In Spain, there have not been so few bankruptcies since 2008 as in the Corona crisis year 2020 and this despite the fact that economic output has slumped by about 12 %[8].

In Sweden, corporate insolvencies remained almost constant compared to the previous year 2019. This also illustrates that the special path in Sweden has had considerably less impact on the performance of companies and their business situation.

Only in Ireland was there a slight increase in corporate insolvencies already in 2020 compared to the previous year.

If one breaks down the number of corporate insolvencies in the affected Western European countries into the four main economic sectors, construction, trade (including the hospitality industry), services and manufacturing, it is surprising that the construction sector recorded the largest decline compared to 2019 with 31.7 %, followed by trade with 30.1%. Normally, the construction sector is particularly susceptible to insolvencies in times of crisis. Not surprisingly, the insolvency figures in the very crisis-proof manufacturing sector also declined, by 25.2 %[9].

4 2021 Verband der Vereine der Creditreform e.V.; Unternehmensinsolvenzen in Europa, Neuss, 20 Mai 2021 S. 5.

5 2021 Verband der Vereine der Creditreform e.V.; Unternehmensinsolvenzen in Europa, Neuss, 20 Mai 2021 S. 6.

6 2021 Verband der Vereine der Creditreform e.V.; Unternehmensinsolvenzen in Europa, Neuss, 20 Mai 2021 S.

7 2021 Verband der Vereine der Creditreform e.V.; Unternehmensinsolvenzen in Europa, Neuss, 20 Mai 2021 S. 4.

8 2021 Verband der Vereine der Creditreform e.V.; Unternehmensinsolvenzen in Europa, Neuss, 20 Mai 2021 S. 16.

9 2021 Verband der Vereine der Creditreform e.V.; Unternehmensinsolvenzen in Europa, Neuss, 20 Mai 2021 S. 7.

Again very surprisingly, however, corporate insolvencies fell again in Western Europe also in the second year of the Corona crisis in 2021 by 5.1% to around 110,000 cases[10].

Of these, the service sector still accounts for most cases, with about 47.500 corporate insolvencies (43%). But compared to 2020 the developments were already no longer the same in all major industrialised countries in Western Europe.

In Germany, for example, there was again a heavy further decline of 11.9% to 14,130 corporate insolvencies and in France there was even a further decline of 18.7% to 25,235 corporate insolvencies.

But in Great Britain and Italy corporate insolvencies were already on the rise again. In Great Britain, they rose by 11.4% to 14,820 and in Italy by as much as 17.9 % to 9,017 cases[11]. However, both countries are still well below the level of the pre-crisis years[12].

In Spain, the figures remained the same compared to 2020.

In terms of the main economic sectors, only the construction sector in Western Europe saw a slight increase in corporate insolvencies in 2021[13]. In the UK, there was a strong increase in this main economic sector in 2021.

Central and Eastern Europe also saw a decline of 8.8 % in corporate insolvencies in 2020. For example, corporate insolvencies fell from 49,119 in 2019 to 44,782 in 2020. In Poland, the backstop was 10.7 % to 576 cases and in Romania 12.8 % to 5564 cases[14].

But already in the second year of the Corona-Crisis in 2021, there was an increase in corporate insolvencies in Central and Eastern Europe of 5.9 % to 39,095 cases[15] But the picture is very inhomogeneous, if you look at the

[10] 2022 Verband der Vereine der Creditreform e.V.; Unternehmensinsolvenzen in Europa, Neuss, 18 Mai 2022 S. 2.

[11] 2022 Verband der Vereine der Creditreform e.V.; Unternehmensinsolvenzen in Europa, Neuss, 18 Mai 2022 S. 3.

[12] 2022 Verband der Vereine der Creditreform e.V.; Unternehmensinsolvenzen in Europa, Neuss, 18 Mai 2022 S. 10.

[13] 2022 Verband der Vereine der Creditreform e.V.; Unternehmensinsolvenzen in Europa, Neuss, 18 Mai 2022 S. 6.

[14] 2021 Verband der Vereine der Creditreform e.V.; Unternehmensinsolvenzen in Europa, Neuss, 20 Mai 2021 S. 23.

[15] 2022 Verband der Vereine der Creditreform e.V.; Unternehmensinsolvenzen in Europa, Neuss, 18 Mai 2022 S. 22.

individual countries. For example, corporate insolvencies in Poland fell again by 29.3 % to 410 cases. In countries such as Romania and Hungary, corporate insolvencies rose again by 9.9 % to 6,113 in Romania and 21,736 in Hungary[16].

3 What were the reasons in Europe for not having a wave of insolvencies (detailed on the basis of the implemented help programs and measures in Germany and France)?

One of the main reasons why Western European industry has come through the Corona period so well is that corporate stability has developed very positively over the last years before Corona starts. An analysis of more than 3 million annual financial statements of Western European companies from 2019 has led to remarkable results[17].

Thus, in the pre-crisis year 2019, 46.5% of the Western European companies examined had an equity ratio of more than 50%. The share of companies with a lower equity ratio of less than 10% was only 21.9% of the Western European companies examined[18].

In addition, the EBIT margin was more than 10 % for 36.6 % of the third companies considered. Overall, 49.3% of the companies generated an EBIT margin of more than 5% (including the previously mentioned cases) and only 21.9% of the companies considered had a negative EBIT margin[19].. Compared to the previous years up to and including 2012, the Western European industry here has improved considerably and had a good economic basis.

This means that the majority of Western European companies entered the Corona crisis in an extremely solid position.

But already in 2021 one can see the first changes here, caused by the crisis. The main signs of a slowdown were in the development of companies' profit margins. Thus, in the period under review in 2021, 26.7% of the 3.16 million

[16] 2022 Verband der Vereine der Creditreform e.V.; Unternehmensinsolvenzen in Europa, Neuss, 18 Mai 2022 S. 22.

[17] 2021 Verband der Vereine der Creditreform e.V.; Unternehmensinsolvenzen in Europa, Neuss, 20 Mai 2021 S. 15.

[18] 2021 Verband der Vereine der Creditreform e.V.; Unternehmensinsolvenzen in Europa, Neuss, 20 Mai 2021 S. 19.

[19] 2021 Verband der Vereine der Creditreform e.V.; Unternehmensinsolvenzen in Europa, Neuss, 20 Mai 2021 S. 18.

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Western European companies had a negative profit margin. This represents a sharp increase compared to the same period of the previous year by 4.8%[20].

Especially in the main economic sectors of trade and construction, the number of companies with a negative EBIT margin increased significantly compared to the previous year. Many companies in this sector, which still reported a low EBIT margin of up to 5% in 2020, have now slipped into the loss zone, which means that this sector is also the most likely to experience company insolvencies in the future.

There were also changes in the equity capitalisation of the companies considered. Compared to the previous year, 22.6% of the companies are now considered weakly capitalised (previous year 2020 21.9%)[21].

In addition, by putting together and implementing extensive aid measures and financing packages, the states in Europe were able to support and stabilise their national economies and delay the immediate effects of the pandemic on them. In many European countries, new regulations were introduced in the area of insolvency law and restrictions were imposed on the implementation of national insolvency laws, including time restrictions. As a result, the feared explosively increase in insolvency proceedings throughout Europe could be avoided in 2020. Even if the crisis reflected in the decline in gross national products in 2020 was severe. The growth in gross national products in 2021 clearly shows that some of the aid packages must have helped and stabilized businesses.

These financial aid packages were all financed by new debt in the states.

Also the European Union set up extensive aid packages. For example, the European heads of State and Government have agreed on a €2.018 trillion recovery package (in current prices), under which the EU budget 2021–2027 will be flanked by NextGenerationEU. This will allow the Commission to raise around €750 billion (current prices) on the markets. The funds are borrowed on the international fiance markets and must be repaid by EU by the end of 2058. At the same time, the funds are to be used to implement the EU's climate and digitisation goals. The funds raised will flow to the Member States in the amount of approximately 360 billion euros as loans and 312 billion euros as financial aid.

[20] 2021 Verband der Vereine der Creditreform e.V.; Unternehmensinsolvenzen in Europa, Neuss, 18 Mai 2022 S. 16.

[21] 2022 Verband der Vereine der Creditreform e.V.; Unternehmensinsolvenzen in Europa, Neuss, 18 Mai 2022 S. 17.

On 15 June 2021, in the first transaction under NextGenerationEU, the Commission mobilised €20 billion through a ten-year bond maturing on 4 July 2031 to finance Europe's recovery from the Corona crisis and its aftermath. Further transactions followed in June and July – so far €45 billion has been mobilised under NextGenerationEU. The funds are now being used for the first payments under NextGenerationEU, the Reconstruction and Resilience Facility and various programmes of the EU budget. The first disbursement under NextGenerationEU was already made at the end of June under the REACT-EU programme.

By the end of August, the Commission had assessed and endorsed 19 of the national recovery and resilience plans submitted. As of 21 September, the first disbursements – just over €49 billion – have already arrived in Belgium, Cyprus, Denmark, France, Germany, Greece, Italy, Latvia, Lithuania, Luxembourg, Portugal and Spain.

As a result, government borrowing by European states rose to new highs. This can be seen clearly if one takes a look at the debt of states such as Germany, France, Great Britain, Spain and Italy in the period 2020 and 2021. The EU Commission predicted that the debt ratio in France would rise to around 118% of gross domestic product in 2021. It reached a new high of around €2.79 trillion in 2021. In Italy it is even 160% with a national debt of €2.68 trillion in 2021, in Spain 122% with a national debt of €1.42 trillion[22]. A similar situation can also be noted in Germany: in the second year of the Corona pandemic, the debt ratio increased from 68.7% to 69.3%, which was higher, as in the previous year[23]. In Q4 2021, public debt in Germany amounted to €2.47 trillion, higher than in Spain.

In addition to extensive financial aid packages, there were also considerable legal interventions in the area of national insolvency laws in order to avoid the feared collapse of entire economic sectors, such as the hotel or restaurant industry.

The mere suspension of the obligation to file for insolvency for a certain period of time in the majority of Western European countries meant that companies that had actually become acutely insolvent due to the Corona crisis were able to survive for the time being. The time delay enabled them to agree new payment terms and instalment agreements with their creditors and to renegotiate rental conditions without having to file for insolvency.

22 Tokarski/Wiedmann, 'Grenzen der Stabilisierung durch die Geldpolitik und die Suche nach Alternativen', SWP 2021.

23 According to the German Bundesbank 31.03.2022.

It is questionable exactly what factors underlie the lack of an increase in insolvency cases in Europe. With regard to the various Member States, large disparities can be seen when real GDP is taken into account: While countries such as Sweden, Denmark or France can start record economic growth, Germany lags behind its neighbouring countries[24]. In examining these factors, reference is first made to the situation in Germany before finally examining the neighbouring country of France.

3.1 Initial situation in Germany and measures of the German government

As an inhibiting factor of the increase in insolvency cases, it can first be noted that the restrictions and the associated consequences of the Corona pandemic in Germany met with a stable, initial economic situation.

The German economy had been in consistent growth for 10 years before the start of the Corona pandemic in spring 2020[25]. According to the Federal Statistical Office, the German economy grew by 0.6% in 2019 alone, and gross domestic product rose for the tenth year in a row. A look at December 2019 shows the presence of stable incoming orders as well as a significant increase in German exports[26].

Thus, one factor that can be mentioned first of all as counteracting the rise in insolvency cases is the good starting situation in Germany.

The German government also tried to counteract the devastating economic effects of the Corona pandemic by means of economic stimulus packages and unprecedented financial aid. All this was set in motion early on by the German government: As early as 23 March 2020, shortly after the Corona virus had already begun to spread in the spring of 2020, the German government decided on a comprehensive rescue package in a rush. The result: the debt brake was suspended and a supplementary budget of €156 billion was passed. The federal government's goal was to strengthen the economy, support those affected by the Corona pandemic and dampen any economic challenges that might arise. The achievement of these goals was set in motion by a comprehensive economic stimulus and crisis management programme. On the other hand, it was also a matter of enabling Germany to emerge stronger and more successful from

[24] Obst, Schläger: IW-Kurzbericht Nr. 16/2022.

[25] Landeszentrale für politische Bildung Baden-Württemberg, 'Welche Folgen hat Corona für die Wirtschaft?', Landeszentrale für politische Bildung BW, 2021.

[26] So says the Federal Ministry for Economic Affairs and Climate Protection in a press release dated 16.12.2019.

the Corona crisis, for which the federal government launched a package for the future[27].

As of January 2022, the amount with which the German government had supported businesses, the self-employed and employees amounted to about €120 billion. This makes the Corona aid for companies the largest aid package ever launched in the history of the Federal Republic. The amount of 120 billion € is not only the result of loans granted and aid disbursed by the Federal Republic. Rather, it also includes the expenditure of short-time allowances (Kurzarbeitergeld) and social security contributions to employers as well as recapitalisations, guarantees, sureties and the granting of subsidies. In the present case, €60 billion was granted for aid and €55 billion for loans. The amounts spent on short-time allowances amount to about 24.6 billion euros, while 17.6 billion euros were spent on the reimbursement of social security contributions to employers.

In particular, the short-time work programme has saved approximately 2.2 million jobs in Germany. During the period in which short-time work benefits are granted, workers receive a high percentage of their gross salary paid by the state. So far, according to the head of the German Federal Employment Agency, Mr. Scheele, it has cost the German state about 46 billion euros (as of February 2022). If the employees had actually gone into unemployment, the costs are estimated at around 130 billion euros.

In this way, it was possible to avoid relieving well-trained and ingrained staff. At the same time, companies were relieved of the burden of a part of the personnel costs when turnover fell and employees could use the time for further training.

The federal government also helps all businesses through extensive tax measures, such as deferrals or adjustments of advance tax payments, which have been used to the tune of about €109 billion so far. In addition, there are permanent legal tax changes, which amount to about €39 billion to date[28].

The short-time allowance in Germany has been particularly successful. The number of workers receiving short-time allowances reached a peak of 5.98 million in April 2020. In the meantime, around €40 billion in short-time allowances have been paid to secure jobs[29].

[27] This was the result of the coalition committee on 03 June 2020.

[28] Monatsbericht des BMF November 2021 Corona –Unternehmenshilfen – eine vorläufige Bilanz S. 27.

[29] Monatsbericht des BMF November 2021 Corona –Unternehmenshilfen – eine vorläufige Bilanz S. 27.

These federal aids were furthermore supplemented by various state programmes in Germany[30].

In order to support companies that have fallen into financial difficulties due to Corona, the 'Act to Mitigate the Consequences of the COVID 19 Pandemic in Civil, Insolvency and Criminal Procedure Law' was promulgated in the Federal Law Gazette on 27 March 2020. Article 1 § 1 COVInsAG consequently establishes as a new regulation that the obligation to file an insolvency petition pursuant to § 15 a of the Insolvency Code and pursuant to § 42 II of the Civil Code is suspended until 30 September 2020, insofar as the insolvency maturity is based on the consequences of the pandemic and there are prospects that the existing insolvency can be eliminated. This regulation has been extended several times in view of the ongoing infection situation and the resulting economic challenges for companies. The aim of this regulation is to minimise liability risks for the respective companies and to ensure that uncertainties arising from the Corona situation do not hit the companies hard. This is to enable the companies to exit the Corona crisis in a stronger position[31].

3.2 Initial situation in France and measures of the French government

France was one of the countries most affected by the pandemic in Europe. Therefore, the French government also took extensive measures to counteract the consequences of the Corona pandemic and to strengthen the country's economic situation. Thus, the French government has already managed to avoid a dramatic increase in insolvency figures. Instead, cases decreased by 39% compared to 2019 and stood at 31,212 business insolvencies in 2020[32]. Despite the sharp rise in infection figures, the French economy returned to pre-crisis levels in Q3 2021. But how did it manage this?

The first thing to note is that France's export economy in particular suffered the consequences of the Corona pandemic: In Q2 2020, this slumped by 34.6% compared to previous years. To counteract this, a programme for state export insurance and a programme for state export financing measures were launched[33].

[30] Landeszentrale für politische Bildung Baden-Württemberg, 'Welche Folgen hat Corona für die Wirtschaft?', Landeszentrale für politische Bildung BW, 2021.

[31] Streifler & Kollegen Rechtsanwälte, Gesetzesänderung in der Corona-Krise: Übergangsregelungen im Insolvenzrecht, Streifler 2020.

[32] 2021 Verband der Vereine der Creditreform e.V.; Unternehmensinsolvenzen in Europa, Neuss, 20 Mai 2021 S. 12.

[33] 2020 GTAI Germany Trade & Invest, Coronakrise und Exportförderung: Wie reagiert Frankreich?, Buerstedde.

Similar to Germany, the French government began to introduce comprehensive support measures in the spring of 2020. On the one hand, a comprehensive economic stimulus package of €100 billion was put together, which became known as the 'France Relance' stimulus package. This comprised about 9.5% of the country's GDP, more than in countries like Germany or the UK. In Germany, the stimulus package comprised only about 6.9% of GDP, while the stimulus package enacted in the UK comprised 8.6% of GDP[34]. Furthermore, the France 2030 investment programme was additionally launched in October 2021[35].

The French government was also active in supporting tax measures. For example, it was planned to help companies with imminent liquidity problems by simplifying the deferral of upcoming payments of taxes or social security contributions without prior consent. This support for companies was also achieved by simplifying the use of short-time work as well as by increasing short-time work benefits[36].

An important instrument of the French government was to freeze the date for the assessment of the occurrence of insolvency (*cessation des paiments*) to 12 March 2020. This affected all insolvency proceedings that would have had to be filed by then. These would have had to file for insolvency only three months after the official expiry of the declared state of health emergency. In France, unlike in Germany, insolvency is the only reason for corporate insolvencies. In Germany, the insolvency reason of over-indebtedness is added.

Initially, the health emergency was declared in France for two months from 24 March 2020, so that the obligation to file for insolvency would not have existed until 10 October 2020. However, the health emergency was repeatedly extended in France. In concrete terms, this means for the affected companies that the assessment of whether they are insolvent will be based on the company's balance sheet as of 12 March 2020, without subsequent economic difficulties that arose in connection with the Corona crisis having any influence on the assessment of whether or not there is cause for insolvency.

In France, there is a general obligation for the management to declare insolvency to the competent court within a period of 45 days after the occurrence of insolvency. If this is not done, the management can be held liable.

[34] 2020 Euractiv, 100 Milliarden für France Relance: Frankreichs Regierung legt massives Konjunkturpaket vor, Stam, 03.09.2020.

[35] 2021 GTAI Germany Trade & Invest, Der Aufschwung hält an, Buerstedde 26.11.2021.

[36] 2021 Ambassade de France en Allemagne, Coronavirus: Frankreich unterstützt Unternehmen und Mitarbeiter, 03.09.2021.

As a result of the changes described above, the liability consequences due to late filing of an insolvency petition do not apply if the insolvency occurred after 12 March 2020 and does not continue after the expiry of the three-month period after the official termination of the state of health emergency described above.

It has been helpful in this context that there are various pre-insolvency restructuring procedures in France that can also be applied for before the occurrence of an insolvency. Depending on the restructuring case, one can choose between three procedures:

- Mandat ad hoc;
- Conciliation;
- Sauvegarde.

Due to the de facto extension of the obligation to file for insolvency, companies in France have gained more time in 2020 to prepare one of the above-mentioned procedures in a crisis in order to save their existence.

In addition, there were time extensions for proceedings already underway at the time of the declaration of the health emergency in March 2020

In summary, it can be said that France, like Germany, initiated comprehensive measures and support at an early stage to support the French economy and counteract the consequences of the Corona pandemic.

4 How will things look in the future?

At the moment there is still a considerable amount of financial support for companies in some Western European countries. At present, this still partly helps the companies. In Germany alone, for example, a helping program for companies and the self-employed was extended again until June 2022.

Also the short-time allowance was also extended in Germany until June 2022.

Only then these programs run out, the actual Corona-related dislocation will become apparent in the next years.

In Germany the volume of repayable aid disbursed (loan, guarantee, equity programs, etc.) to the industries has until today a volume from around 70 billion euros[37]. The repayable aid serves in particular to secure the liquidity of companies include various financing instruments such as loans, guarantees and

[37] Monatsbericht des BMF November 2021 Corona –Unternehmenshilfen – eine vorläufige Bilanz S. 26.

recapitalizations programs (These include the KfW Special Program including the Quick Loan, guarantee and surety programs of the guarantee banks, Mittelständische Beteiligungsgesellschaften (MBGen) and federal-state large-scale guarantees as well as the Economic Stabilisation Fund (WSF)).

The real economic impact on the industries in Germany and Europe is only likely to become apparent in the next few years, when all European and national aid measures have run out and, for example, the state financing aid loans becomes due and have to be repaid by the German Industries.

How the majority of the affected companies in Germany, for example, are supposed to manage this with regard to the 70 billion euros is completely open to question for many of the affected companies. Especially if they are undergoing fundamental changes in their business model at the same time, for example as it actual happens in the automotive and retail sectors. Fundamentally, these repayments will likely have a negative impact on profits and, with rising interest rates in the future, brew into an ominous mix for the affected industries. There will be also a lack of money for necessary investments in the future.

[Creditreform] estimates that there is an insolvency gap of at least 50,000 companies in Western Europe. These are companies that would actually have become insolvent under 'traditional' economic conditions (as in the previous years before 2020)[38]. The fact that this did not happen can only be explained by the respective national and European aid measures. However, it remains to be seen when this 'wave of insolvencies' will come.

It is also questionable to what extent the Ukraine war and China's most recent lockdown will have an impact on the existing economic situation in Europe and what this could mean for companies.

The war in Ukraine and the resulting interrupted production and supply chains are weighing on companies. In particular, a German gas import stop from Russia or further sanctions would have serious consequences, especially for companies in the automotive, mechanical engineering and metal production sectors, which would then again be dependent on additional loans or money from state aid[39].

And this one comes at an inopportune time. Currently, companies in Europe are confronted with multiple challenges. Extremely rising material prices and

[38] 2022 Verband der Vereine der Creditreform e.V.; Unternehmensinsolvenzen in Europa, Neuss, 18 Mai 2021 S. 5.

[39] 2022 Handelsblatt, Drohende Liquiditätsklemme wird für viele deutsche Firmen zum Risiko, Sommer. 27.04.2022.

energy costs are placing a heavy burden on companies. In addition, there is now a shortage of labour. And it's not even about skilled workers anymore. The lack of Ukrainian and Russian truck drivers is already having an extremely negative impact on the forwarding industry in Europe. In the meantime, you can't even get the goods from A to B on time, even if you want to and pay a lot of money for it. These logistical problems are now having an extreme impact on the just-in-time production of Western European industries. A significant rise in interest rates to combat high inflation will continue to have a considerable impact on indebted companies in particular. Under these circumstances, it is almost impossible to think of repaying the aid money that was granted to the industries, because of the Corona crisis.

The renewed immense economic burden of the Russia-Ukraine conflict on German and European markets is already becoming apparent.

It is an incredible opportunity for Europe to grow even closer together. This must be seized, otherwise it risks failure and a long-lasting recession. Business and politics are forced to find answers to the economic challenges. The focus must not be too much on the war in Ukraine and the foreign policy consequences. Rather, Europe and its Member States must finally realise that only through unity will they be an accepted player in the world between the USA, China and Russia. Moreover, not every crisis can be financed. Rather, you have to have robust industries that can survive crises without state aid. And crises also include insolvencies and job losses. This cannot be prevented. Yes, in severe crises that occur suddenly from outside, such as Corona, short-time work is a great tool to prevent the sudden loss of employees in crises that are not one's fault. However, state financing programmes must not lead to the financing of zombie companies, which otherwise leads to considerable distortions of competition and weakens the economy much more in the long run.

Chapter 13

Directors' Duty to Promote Negotiation in Times of Crisis: Some Reflections in Light of Directive (EU) 2019/1023

José Gonçalves Machado
PhD, Law Professor at Lusófona University of Lisbon,
Member of CEAD – Francisco Suarez Research Center and Lawyer,
Email: josemachado-53871c@adv.oa.pt or
josegoncalvesmachado@ulusofona.pt

1 Introduction

The recent economic and financial crises, those that erupted in the second decade of the present millennium, have shown that companies play an important role within society. It is now clear that saving a company is much more than protecting the interests of its owners. Viable companies that face economic and financial difficulties should have access to effective preventive restructuring frameworks, to help them to continue operating, in whole or in part. Consequently, the job losses, the loss of know-how and skills, and the build-up of non-performing loans are avoided or, at least, can be substantially limited. It helps to maximise the total value to creditors and companies' owners, in comparison to what they would receive in the event of the next-best-alternative scenario and contributes, also, in promoting the growth of the economy. Obviously, the earlier those frameworks are triggered, the more effective and successful the restructuring will be for all affected parties and for the economy and society as a whole[1].

[1] On the economic and social role of preventive restructuring frameworks see, *inter alia*, Jennifer Gant, 'The role of social policy in corporate rescue and restructuring: a messy business' in Paul Omar and Jennifer Gant (eds), *Research Handbook on Corporate Restructuring* (Cheltenham: Edward Elgar, 2021), 476–499.

All these concerns are deeply reflected in the Directive (EU) 2019/1023 on restructuring and insolvency[2]. Instead of forcing the Member States to implement a specific and rigid preventive restructuring framework, the European legislator preferred to establish a minimum set of rules, designed to facilitate the negotiation of an agreement between parties. Throughout the Directive, two main objectives stand out. The European legislator takes care of both private interests of affected parties and public interest inherent to the restructuring of viable companies. On the one hand, it seems clear that the European legislator wants to promote negotiation between the parties, which must follow the general principles of private autonomy and good faith. For this purpose, debtors accessing preventive restructuring procedures shall remain totally, or at least partially, in control of their assets and the day-to-day operation of their business, and rescue finance (new financing and interim financing) and restructuring related transactions have to be protected[3]. On the other hand, the European legislator suggests that these general principles cannot be fully relied upon as problems often arise when creditors seek to disrupt the negotiations by exercising hold up rights or by seeking to enforce their claims. To deal with the hold out problems, the law can assist with some mechanisms, such as imposing some form of moratorium (stay of individual enforcement actions)[4], and ensuring that a restructuring plan can be confirmed by a judicial or administrative authority and become binding upon dissenting creditors or classes of creditors where the restructuring plan fulfils at some conditions[5]. This why the European legislator adopted a hybrid system that manages both carrots and

[2] About Directive 2019/1023/EU, see, *inter alia*, Aa.Vv., 'The European Union preventive restructuring framework: A hole in one?', *International Insolvency Review* 28, no. 2 (2019) 184–209; Aurelio Gurrea-Martínez, 'The future of reorganization procedures in the era of pre-insolvency law', *European Business Organization Law Review* 21, no. 4 (2020) 829–854; Catarina Serra, 'Direito da insolvência em movimento: a reestruturação de empresas entre as coordenadas da legislação nacional e as perspetivas do Direito europeu', *Revista de Direito Comercial* (2017) 99–135; *Lições de Direito da Insolvência*, 2nd Ed. (Coimbra: Edições Almedina, 2021) 554–603; Christoph Paulus, 'Introduction' in Christoph Paulus and Reinhard Dammann (eds), *European Preventive Restructuring, Directive (EU) 2019/1023, Article-by-Article Commentary* (München: C. H. Beck, 2021) 4–6; Daoning Zhang, 'Preventive Restructuring Frameworks: A Possible Solution for Financially Distressed Multinational Corporate Groups in the EU', *European Business Organization Law Review* 20 (2019) 289–290; Juana Pulgar Ezquerra, 'Marcos de reestructuración preventiva y segunda oportunidad en la Directiva UE 2019/1023', *Diario La Ley*, no. 9474 (2019); Nicolaes Tollenaar, 'The European Commission's Proposal for a Directive on preventive restructuring proceedings', *Insolvency Intelligence* 30, no. 5 (2017) 65–81; Reinhard Dammann, 'Article 1 – Subject matter and scope' in Christoph Paulus and Reinhard Dammann (eds), *European Preventive Restructuring, Directive (EU) 2019/1023, Article-by-Article Commentary*, (München: C. H. Beck, 2021) 35–59; Stephan Madaus and Bob Wessels, 'Restructuring reform with pre-insolvency proceedings – where is the EU heading to?', in *Harmonisation of European Insolvency Law* (Nottingham: INSOL Europe, 2017) 201–218; 'Business rescue in insolvency law in Europe: Introducing the ELI Business Rescue Report', *International Insolvency Review* 27, no. 2 (2018) 255–280.

[3] Articles 17 and 18 of Directive (EU) 2019/1023.

[4] Article 6 and 7 of Directive (EU) 2019/1023.

[5] Articles 8 to 16 of Directive (EU) 2019/1023.

stick approaches[6]. That means that the law is called upon to play an important role through a system of incentives to negotiate an agreement that reasonably and fairly protects the private and public interests at stake, and through a mandatory and punitive system that sanctions fraudulent conducts, in opposition to those principles and interests.

The above-mentioned approach is clearly contained in Article 19 of the Directive and in the explanation given in recitals 70 and 71[7]. Under these legal provisions:

> 'where there is a likelihood of insolvency (or pre-insolvency *status*), directors [shall] have due regard, as a minimum, to the following: (a) the interests of creditors, equity holders and other stakeholders; (b) the need to take steps to avoid insolvency; and (c) the need to avoid deliberate or grossly negligent conduct that threatens the viability of the business[8].'

Such conduct expresses what directors have to do (conduct of positive content or *facere* conduct) and what directors have to avoid (conduct of negative content or *non facere* conduct). Regarding what directors have to do, we can see that the European legislator was inspired by the English wrongful trading regime when it is explained that directors 'should take steps to minimise losses and to avoid insolvency', including professional advice, early warning tools, and holding negotiations with creditors and entering preventive restructuring procedures, if appropriate[9]. This is 'important to ensure that directors are not dissuaded from exercising reasonable business judgment or taking reasonable commercial risks, particularly where to do so would improve the chances of a

6 See Jaka Cepec and Mitja Kovac, 'Carrots and sticks as incentive mechanisms for the optimal initiation of insolvency proceedings', *Law and Economics Review* 7, no. 2 (2016) 79–103.

7 On the implications of this rule in the Portuguese legal system, see Alexandre de Soveral Martins, *Administração de sociedades anónimas e responsabilidade dos administradores* (Coimbra: Edições Almedina, 2020) 339–352; Catarina Serra, 'The impact of the Directive on shareholders, companies' directors and workers', *Eurofenix*, no. 68 (Summer 2017) 28–30; 'O dever de prevenção da insolvência na perspectiva dos deveres fundamentais dos administradores (a crescente encruzilhada do Direito das Sociedades e do Direito da Insolvência)', in Ricardo Costa et all (eds), *Diálogos com Coutinho de Abreu, Estudos oferecidos no Aniversário do Professor* (Coimbra: Edições Almedina, 2020), 167–192; Catarina Serra and José Gonçalves Machado, 'Para uma harmonização mínima do direito da insolvência – Primeira abordagem à Proposta de Directiva de 22.11.2016, com especial atenção ao seu impacto no direito das sociedades comerciais', *Direito das Sociedades em revista* 17, Ano 9 (2017) 161–164; Jorge Coutinho de Abreu, 'Administradores e (novo?) dever geral de prevenção da insolvência' in Cataina Serra (ed), *V Congresso de Direito da Insolvência* (Coimbra: Edições Almedina, 2019) 229–235; José Gonçalves Machado, *O dever de promover a negociação e a responsabilidade civil dos gestores no âmbito dos instrumentos pré-insolvenciais de recuperação de empresas* (Fátima: Edição de Autor, 2022), 215-605; and Nuno Pinto Oliveira, 'Responsabilidade civil dos administradores pela violação do dever de apresentação à insolvência', *Revista de Direito Comercial* (2018), 609–628.

8 Article 19 of Directive (EU) 2019/1023.

9 Recital 70 of Directive (EU) 2019/1023.

restructuring of potentially viable businesses[10].' Regarding what directors have to avoid, the European legislator, inspired by the German insolvency law, says that directors need to 'avoid deliberate or grossly negligent conduct that threatens the viability of the business'. It is 'important to protect the legitimate interests of creditors from management decisions that may have an impact on the constitution of the debtor's estate, in particular where those decisions could have the effect of further diminishing the value of the estate available for restructuring efforts or for distribution to creditors'[11]. In both situations, directors have to look at (having 'due regard' to) the pre-insolvent company's equity holders, creditors, workers and other stakeholders, whose interests need to be given due regard according to circumstances[12].

2 How to deal with a conflict of interests in times of crisis?

Where the company experiences financial difficulties, it is likely that there exists the potential for conflict of interests to arise among the different parties: pre-insolvent company's creditors, equity holders, workers and other stakeholders[13]. The directors' conduct can oscillate between an atomistic or individual approach, more focused on protecting the interests of one party or group, and a pluralistic approach, more focused on conciliating all different interests at stake, where we can include the enlightened shareholderism doctrine and the stakeholderism doctrine[14]. In the first approach, the balancing of interests seems to be clear when the company is solvent or insolvent. This can be defined as a black or white approach. There is no 'twilight zone'. When a company is solvent, the equity holders' interests are prevalent, and creditors will benefit indirectly from the company success. There is no need to put the creditors' interests first. However, if the company becomes insolvent, the equity holders' interest is residual because all creditors will be paid before them. As

[10] Recital 70 and Article 19(b) of Directive (EU) 2019/1023.

[11] Recital 71 and Article 19(c) of Directive (EU) 2019/1023.

[12] Recital 71 and Article 19(1) of Directive (EU) 2019/1023.

[13] See Karsten Schmidt, 'Conflictos de interés entre socios, acreedores y administradores en la proximidad de la insolvência: reflexiones introdutórias en el contexto de la Directiva (EU) 2019/1023' in Juana Pulgar Ezquerra and Eva Recamán Graña (eds), *Reestructuración y Gobierno Corporativo en la proximidade de la insolvência* (Madrid: Wolters Kluwer, 2020) 43–128; Javier Megías Lópeza, 'Noción de gobierno corporativo y su papel en la crisis empresarial' in Juana Pulgar Ezquerra and Eva Recamán Graña (eds), *Reestructuración y Gobierno Corporativo en la proximidade de la insolvência* (Madrid: Wolters Kluwer, 2020) 129–167; José Gonçalves Machado, *O dever de promover a negociação* ..., cit. 85 s.

[14] Douglas Baird, 'Bankruptcy's uncontested axioms', *The Yale Law Journal* 108, no. 3 (1998) 573–599.

result, the directors have an obligation to prioritise creditors' interests. Accordingly, they have to protect the assets of the insolvent company, refraining from any kind of voidable transaction and excessive risk-taking[15].

However, what if the company is merely within the vicinity of insolvency, where there is a mere likelihood of insolvency? In this scenario whether a company is close to insolvency or not is an imprecise concept. It is unclear which interest should prevail, even if the law establishes a hierarchy and defines the meaning that is given to pre-insolvency *status*. That means that the decision-making processes becomes more difficult under the atomistic or individual approach. In some jurisdictions, such as Australia, the United Kingdom, and the United States, there are significant jurisprudence and doctrine defending a shift in the nature of directors' duties, in favour of creditors, when their company is in the 'twilight zone', moving from solvency *status* towards insolvency *status*[16]. However, it remains unclear when directors' duties shift. Under the pluralistic approach, this does not create issues because in this case there is no need for a deep or sudden shift of duties; all interests must be continually measured, balanced and protect by directors according to circumstances. The protection of the corporate interest (*maximise* its viability and sustainability) remains at the top of the interest list to have due regard to, and this primordial position works as reference and orientation for the harmonisation of other interests, including equity holders' and creditors' (short, medium and long term) interests. Once the company is in the vicinity of insolvency and it is not clear when the 'moment of truth[17]' arises, from which the creditors duties shift, there will be a natural tendency to harmonise all interests involved according to the circumstances. It does not mean that directors are free to do whatever they like, yet they are not merely obliged to accept or follow internal and external influences. In contrast, it entails enough managerial discretion to analyse circumstances and make reasonable and rational decisions. It is commonly said, in line with the wrongful trading regime[18] and deepening insolvency doctrine[19],

15 Andrew Keay, 'The Shifting of Directors' Duties in the Vicinity of Insolvency', *International Insolvency Review* 24, no. 2 (2015) 140–164.

16 *Ibid*.

17 Karsten Schmidt, 'Interaction of corporate law and insolvency law: german experience and international background', *International Insolvency Law: Future Perspectives* (Nottingham: INSOL Europe, 2015) 129–130.

18 Section 214 of the UK's Insolvency Act 1986. See Carsten Gerner-Beuerle and Edmund-Philipp Schuster, 'The evolving structure of directors' duties in Europe', *European Business Organization Law Review* 15, no. 2, (2014) 226; Horst Eidenmüller, 'Trading in times of crisis: formal insolvency proceedings, workouts and the incentives for shareholders/managers', *European Business Organization Law Review* 7, no. 1 (2006) 252; Kristin van Zwieten, 'Director liability in insolvency and its vicinity: West Mercia Safetywear Ltd v Dodd revisited', *Oxford Journal of Legal Studies* 38, no. 2 (2018) 382–409; Paul Davies, 'Director's Creditor-regarding duties in respect of trading decisions taken in the vicinity of insolvency', *European Business Organization Law Review* 7, no. 1 (2006) 319–320; Robert Sahyan, 'The myth of the zone of insolvency:

that directors should take all necessary and appropriate steps to avoid insolvency and to minimise losses, in order to maximise the company's value and avoid loss of key assets. So, if directors know or ought to conclude that there is no reasonable prospect of the company avoiding going into insolvent liquidation, they shall take every step to minimise the potential loss to creditors. In a similar way, if directors know or ought to conclude that there is a reasonable and realistic prospect of implementing a restructuring plan, they shall not ignore holding negotiations with creditors and entering preventive restructuring procedures as a response to avoiding insolvency. In this kind of approach, it is obvious that the company must be managed in harmony with the plurality of interests at stake, duly ordered according to the primordial interest of the pre-insolvent company, which includes everything that contributes to its viability and sustainability or, if not possible, all steps to minimise losses[20].

This discussion has been addressed in many European jurisdictions after Article 19 of the Directive came into force. Nonetheless, the Portuguese doctrine seems to be divided. Some authors[21] consider that during the pre-insolvency period, directors are obliged to act solely in the interest of the company and its owners. The corporate interest would be perfectly aligned with equity holders' interests so that before the insolvency *status*, they own fiduciary duties to equity holders, not to creditors. In contrast, the majority of the Portuguese doctrine[22] argues that, where there is a likelihood of insolvency, directors are obliged to take all necessary and appropriate steps in order to minimise losses to all affected parties (equity holders and creditors), entering into a preventive restructuring procedure in order to negotiate a restructuring plan, or, if there is no prospect of doing so, non-viable businesses should be liquidated as soon as possible.

Production Resources Group v NCT Group', *Hasting Business Law Review* 3, no. 1 (2006) 181–196; and Stephan Madaus, 'Reconsidering the shareholder's role in corporate reorganisations under Insolvency Law', *International Insolvency Review* 22, no. 2 (2013) 106–107.

19 See Nicholas Santoro, 'Deeping Insolvency: A cause of action, a tool of measuring damages, or nothing at all?', *St. John's Bankruptcy Research Library* 7, no. 23 (2015); Neil Abbott, Robert Radasevich and Keith Shapiro, 'A Deeper Look at Deepening Insolvency', *DePaul Business and Commercial Law Journal* 4, no. 4 (summer 2006), 529–544; and Robert Millner, Sally Neely and Michael Reed, 'Potential Liability for Deepening Insolvency and Breach of Fiduciary Duty to Creditors', *ABA Section of Litigation Annual Conference* (April 2007) 1–46.

20 See Robbert Goosens, 'The European Initiative on the Harmonisation of Directors' Duties in the Vicinity of Insolvency', *Nottingham Insolvency and Business Law e-Journal* 5, no 4 (2017).

21 Alexandre de Soveral Martins, '"Em casa onde não há pão, toda a gente ralha e ninguém tem razão". A propósito do dever de apresentação à insolvência e do (?) dever de evitar a insolvência', *Revista de Direito da Insolvência*, no. 5 (2021), 56–67); and Manuel Carneiro da Frada, 'A responsabilidade dos administradores perante os credores entre o Direitos das Sociedades e o da Insolvência' in Catarina Serra (ed), *IV Congresso de Direito da Insolvência* (Coimbra: Edições Almedina, 2017) 200.

22 See, *inter alia*, Catarina Serra, 'O dever de prevenção da insolvência,' 175–180; Jorge Coutinho de Abreu, 'Administradores e (novo?) dever geral,' 229–234; and Nuno Pinto Oliveira, 'Responsabilidade civil dos administradores,' 609–615.

Regardless of the path followed, directors would have to explain why the option chosen (restructuring or liquidation) is the most appropriate solution to maximise the company's value for its benefit and for stakeholders as a whole. This understanding, as it is based on broader and more flexible criteria, is the one that, in our view, is best in line with the wrongful trading regime which, admittedly, forms the basis of the aforementioned article 19 of the Directive[23].

3 Criteria to implement a consensual and non-consensual restructuring plan

Inspired by the reorganization regime, enshrined in Chapter 11 of US Bankruptcy Code, Directive (EU) 2019/1023 encourages 'consensual' as well as 'non-consensual' restructuring plans, whenever the affected parties must be treated in separate classes, which correspond to the class formation criteria under national law (nonetheless reflecting a sufficient commonality of interest)[24]. A plan is consensual when it is accepted by all classes. A plan is non-consensual when it is not accepted by all classes. A plan accepted by all classes can gather the support of all (unanimously) or only of a certain majority. The higher the majority, the higher the legitimacy of the restructuring plan. If all affected parties agree on the plan, there is a unanimous plan. Apart from this situation, consensual plans will nonetheless bind some parties (the minority in each class) who reject the plan. At first glance we might assume that a consensual plan is reasonable and fair[25]. The democratic approval in each category justifies, by itself, that consensual plans could or should bind all dissenting minorities. If this premise is valid, it does not matter what is contained in the restructuring plan. The democratic rule only cares about votes and the consensus is merely a result of a voting procedure. If it is not valid, there must be a justification for biding dissenting affected parties in each class, to justify the exception to the *pacta sunt servanda* principle[26]. The need for a justification is even more obvious when the plan is non-consensual because in that case the democratic rule does not in that sense.

[23] Catarina Serra, 'The impact of the Directive on shareholders', 29; Catarina Serra and José Gonçalves Machado, 'Para uma harmonização mínima,' 161–164; Gaia Balp, 'Early Warning Tools at the Crossroads of Insolvency Law and Company Law', *Bocconi Legal Studies Research Paper*, no. 3010300 (2018) 25–30; and Nuno Pinto Oliveira, 'Responsabilidade civil dos administradores,' 598–610.

[24] Recitals (44) and (45) and Article 9 of Directive (EU) 2019/1023.

[25] See Nicolaes Tollenaar, *Pre-Insolvency Proceedings: A Normative Foundation and Framework* (Oxford University Press, 2019) 61; and Francisco Garcimartin, 'Article 4 – Availability of preventive restructuring frameworks' in Christoph Paulus and Reinhard Dammann (eds), *European Preventive Restructuring Directive (EU) 2019/1023, Article-by-Article Commentary* (München: C. H. Beck, 2021) 93.

[26] Reinhard Dammann, 'Article 9 – Adoptions of restructuring plans' in Christoph Paulus and Reinhard Dammann (eds), *European Preventive Restructuring Directive (EU) 2019/1023, Article-by-Article Commentary* (München: C. H. Beck, 2021) 64.

According to Directive (EU) 2019/1023, the restructuring plan must fulfil some procedural and substantial requirements, such as (i) 'the debtor's assets and liabilities at the time of submission of the restructuring plan, including a value for the assets, a description of the economic situation of the debtor and the position of workers, and a description of the causes and the extent of the difficulties of the debtor'; and 'a statement of reasons which explains why the restructuring plan has a reasonable prospect of preventing the insolvency of the debtor and ensuring the viability of the business, including the necessary pre-conditions for the success of the plan' (that can 'be made or validated either by an external expert or by the practitioner in the field of restructuring if such a practitioner is appointed')[27]. Assuming that affected parties have prior and full access to all relevant information when they are called to vote on the adoption of a restructuring plan[28], we can reasonably assume that all votes reflect the creditors assessment on the fulfilment of the procedural rules and on the content of the plan. If a certain majority approves the content of a restructuring plan according to the procedural rules, and if all affected parties vote rationally, there is no plausible reason to consider that plan unfair to creditors. However, for the European legislator, this justification is not enough.

Under the Article 10(1) of Directive (EU) 2019/1023, restructuring plans are binding on dissenting affected parties only if they are confirmed by a judicial or administrative authority[29] that will control, at least, the following conditions: '(a) the restructuring plan has been adopted in accordance with Article 9 [regarding the voting rules]; (b) creditors with sufficient commonality of interest in the same class are treated equally, and in a manner proportionate to their claim; (c) notification of the restructuring plan has been given in accordance with national law to all affected parties; (d) where there are dissenting creditors, the restructuring plan satisfies the best-interest-of-creditors test; (e) where applicable, any new financing is necessary to implement the restructuring plan and does not unfairly prejudice the interests of creditors'. Further, 'judicial or administrative authorities are able to refuse to confirm a restructuring plan where that plan would not have a reasonable prospect of preventing the insolvency of the debtor or ensuring the viability of the business[30].'

This means two things: on the one hand, however legitimate the 'binding of dissenting affected parties', judicial or administrative power is required to confirm the plan and the will of a certain majority is not sufficient on its own.

[27] Article 8 of Directive (EU) 2019/1023.

[28] Article 10, 2. (c) of Directive (EU) 2019/1023.

[29] Article 10, 1. (a) of Directive (EU) 2019/1023.

[30] Article 10, 3. of Directive (EU) 2019/1023.

On the other hand, judicial or administrative authorities cannot decide according to free criteria, fixed on a case-by-case basis. There are legal requirements that must be verified and confirmed by judicial or administrative authorities, considering the content of the plan and the fulfilment of certain procedural rules. For that reason, the justification we are looking for must be based also on those legal requirements. In fact, the negotiation of restructuring plan takes place in the shadow of (modern) insolvency law that combines the common tools of traditional insolvency law with the common tools of out-of-court procedures, in order to facilitate a restructuring agreement[31].

In light of the foregoing, we can distinguish two different types of justifications: first, the judicial or administrative power; second, the fulfilment of substantial and procedural rules. Among these rules, it is crucial to pass the best-interest-of-creditors test. This test, also known as the no creditor worse off principle:

> 'is satisfied if no dissenting creditor would be worse off under a restructuring plan than such a creditor would be if the normal ranking of liquidation priorities under national law were applied, either in the event of liquidation, whether piecemeal or by sale as a going concern, or in the event of the next-best-alternative scenario if the restructuring plan were not confirmed[32].'

If the plan is not-consensual, it may still be confirmed through a cross-class cram-down mechanism[33]. The lack of consent in all classes is replaced by one of the following rules: (i) it has been approved by a majority of the voting classes of affected parties, provided that at least one of those classes is a secured creditors class or is senior to the ordinary unsecured creditors class; or, failing that, (ii) it has been approved by at least one of the voting classes of affected parties or where so provided under national law, impaired parties, other than an equity-holders class or any other class which, upon a valuation of the debtor as a going concern, would not receive any payment or keep any interest, or, where so provided under national law, which could be reasonably presumed not to receive any payment or keep any interest, if the normal ranking of liquidation priorities were applied under national law[34]. This limitation to the democratic rule can be understood against the idea that if classes had veto rights, it would

[31] See Jennifer Payne, 'The role of the court in debt restructuring', *Cambridge Law Journal* 77 (2018) 126–129; and Stephan Madaus, 'Leaving the Shadows of US Bankruptcy Law: A Proposal to Divide the Realms of Insolvency and Restructuring Law', *European Business Organization Law Review* 19 (2018) 615–647.

[32] Article 2, 1. (6) of Directive (EU) 2019/1023.

[33] See Kenneth Klee, 'All You Ever Wanted to Know About Cram Down Under Chapter 11 of the New Bankruptcy Code', *American Bankruptcy Law Journal* 53, no. 2 (1979) 133–171; Peter Coogan, 'Confirmation of a Plan Under the Bankruptcy Code', *Case Western Reserve Law Review* 32, no. 2 (1982) 301–323; and Richard Broude, 'Cram Down and Chapter 11 of the Bankruptcy Code: The Settlement Imperative', *The Business Lawyer* 39, no. 2 (February 1984) 441–454.

[34] Article 11, 1. (b) of Directive (EU) 2019/1023.

be highly unlikely for the restructuring agreement to come into force due to hold-out positions that, not rarely, are used to extract value for the benefit of some classes at the expense of other classes[35].

In addition to this minimum support test, a non-consensual plan may only bind dissenting classes of affected parties if the fairness test is met, which consists of two elements: (i) respect for priority rights of classes; (ii) and do not distribute more than the full amount of claims or interests of classe(s) of affected parties. Regarding the first element, the European legislator provides two options: the relative priority rule and, as an alternative, the absolute priority rule[36]. The relative priority rule 'ensures that dissenting voting classes of affected creditors are treated at least as favourably as any other class of the same rank and more favourably than any junior class'[37]. The absolute priority rule entails that 'the claims of affected creditors in a dissenting voting class are satisfied in full by the same or equivalent means where a more junior class is to receive any payment or keep any interest under the restructuring plan'[38]. With regard to the second element, the European legislator explains that 'no class of affected parties can, under the restructuring plan, receive or keep more than the full amount of its claims or interests'[39]. These two elements are expression of the 'no unfair discrimination principle'[40], which try to ensure that a good chance at restructuring is not lost if the reduction of the rights or interests of dissenting classes of affected parties are treated at least as favourably as any other class of the same rank and if they have access to a reasonable and fair plan which is, according to the circumstances, the best possible solution.

In light of forementioned, we conclude that judicial or administrative authorities play an important and essential role in the field of restructuring pre-insolvent companies, especially by controlling the procedural and substantial requirements for the adoption of a restructuring plan. What seems to be clear is that, even though the restructuring of pre-insolvent companies can be carried out by purely contractual means, judicial (or administrative) intervention may be necessary and indispensable to promote a fair agreement between affected parties, namely when some of them, by their misconduct and without any rational reason, try to avoid the success of the conclusion of a restructuring

[35] Michael Veder, 'Article 11– Cross-class cram-down' in Christoph Paulus and Reinhard Dammann (eds), *European Preventive Restructuring Directive (EU) 2019/1023, Article-by-Article Commentary* (München: C. H. Beck, 2021) 178.

[36] See Stephan Madaus, 'Is the Relative Priority Rule Right for Your Jurisdiction: A simples guide to RPR', *Working Paper* (2020).

[37] Article 11, 1. (c) of Directive (EU) 2019/1023.

[38] Article 11, 2. of Directive (EU) 2019/1023.

[39] Article 11, 1. (d)) of Directive (EU) 2019/1023.

[40] Michael Veder, 'Article 11– Cross-class cram-down,'184–185.

plan. In this sense, it cannot be said that judicial intervention aims to exclude the negotiation autonomy and/or the contractual nature of the reorganisation agreement. Instead, it aims to safeguard the contractual balance in the light of the principles of private autonomy, good faith and the public interest in the restructuring of pre-insolvent and viable companies. In other words, through judicial (or administrative) intervention, the parties affected by the plan, supporters or dissenters can, and must, trust that the approved agreement will meet in a fair and balanced way, the particular interests of each of the affected parties or classes and the public interest in the restructuring of pre-insolvent companies. This trust is the foundation of negotiation in good faith and, consequently, the reason of the duty to cooperate which bind all parties involved in negotiations[41].

4 Duty to promote the negotiation in times of crisis

In times of crisis, directors are called upon to manage the company and defend interests that are not their own. Instead, they must protect the corporate interest and the interests of others. By their personal conduct and their decisions, directors externalise and bind the conduct of their company. In this sense, they also know (or should not ignore) that it is up to them to promote or support the negotiation of a possible restructuring plan. Even though they are not parties to the negotiation procedure, the pre-insolvency restructuring of companies will mainly depend on the decisions of the directors, both as managers of debtor companies and as managers of creditor companies. The conduct of directors conditions, limits, and binds their company (as debtors or creditors) and their conducts contains procedural elements and substantial elements.

With regard to procedural elements, it will be said that it is up to managers to provide and/or respect the procedural rules that are necessary for the parties to communicate with each other in an appropriate manner for the purpose of the negotiations. We can think about conditions or limits regarding the individual and collective action of the parties involved in the negotiations, namely stay of individual enforcement actions, sharing relevant information, formation of classes, notification of the restructuring plan to all affected parties, voting rights and fulfilment of deadlines. In some cases, these procedural rules may be established by law or, if not, they may result from an agreement between the parties involved or from the imposition made by the judicial or administrative authority responsible for supervising the negotiation procedure. With regard to substantial elements, managers are required to contribute, fundamentally, to

[41] For an in-depth analysis of the theory of trust and its impact on civil liability, see Manuel Carneiro da Frada, *Teoria da Confiança e Responsabilidade Civil* (Almedina, 2021).

the presentation of proposals or counterproposals, for the adoption of restructuring plan. Basically, both procedural and substantial elements represent two sides of the same coin that helps to better understand the conduct of directors in the context of preventive restructuring frameworks.

The procedural elements differ depending on the legal regime of preventive restructuring frameworks[42], but the substantial elements tend to remain the same across jurisdictions, in the sense that all restructuring plans should represent a reasonable prospect of preventing the insolvency of the debtor and ensuring the viability of the business in a fair manner and more beneficial (in terms of economic value) to all affected parties. That means that directors' managerial discretion can be limited not only by procedural rules, depending on preventive restructuring framework, but also by substantial reasons. If there is a realistic and reasonable chance of implementing a restructuring plan, under the terms and conditions mentioned above, directors are bound to act in order not to lose or threaten it. They are not free to act in the opposite direction, adopting unreasonable and unjustified conduct that threatens or harms such a chance. Thus, there must be some coordination between the duties provided for in Article 19 of Directive (EU) 2019/1023 and the other legal provisions that contribute, procedurally or substantially, to the negotiation of a restructuring plan[43].

Regarding the substantive part of the negotiation, the decision to present or not present certain contributions or proposals that may form part of the possible agreement has to be made, as well as the expression of support or opposition to it. In terms of its content, a mere debt restructuring may be at stake, in the sense of reducing or allowing a moratorium, reducing the value of instalments and extending payment periods, but also granting financial support (new or interim financing)[44]: a debt-to-equity swap is also possible measure. Basically, all

[42] For example: under the terms of the portuguese Special Revitalization Process ('Processo Especial de Revitalização'), negotiations are, ab initio, conditioned by the possibility of participation of all creditors who are notified to claim their credits and, if they wish, to participate in the negotiations. In addition, the conduct of the parties involved in the negotiation is limited by a set of procedural and substantial effects that automatically arise from the opening of the process. On the other hand, the extrajudicial recovery of companies' regime ('Regime Extrajudicial de Recuperação de Empresas') allows the negotiation to involve only selected parties, who are responsible, by agreement, to define some conditions and effects regarding their individual and collective action. Ultimately, the choice of the appropriate negotiating instrument is, in itself, a management decision that aims to promote negotiations in a certain way, within certain limits and conditions, pre-established and or to be defined by mutual agreement within legal limits.

[43] See Giorgio Corno, 'Article 19 – Duties of Directors' in Christoph Paulus and Reinhard Dammann (eds) *European Preventive Restructuring, Directive (EU) 2019/1023, Article-by-Article Commentary* (München: C. H. Beck, 2021) 240–241.

[44] Under Article 2, 1. (7) of Directive (EU) 2019/1023 'new financing' means any new financial assistance provided by an existing or a new creditor in order to implement a restructuring plan and that is included in that restructuring plan. Under Article 2, 1. (8) of Directive (EU) 2019/1023 'interim financing' means any new

contributions or proposals that are intended to recover and keep the pre-insolvent company operating are admissible. Naturally, such proposals comply with basic general requirements. In general, they must be serious, necessary, adequate, reasonable and fair proposals. As a result, proposals or counter-proposals containing false information or with a merely misleading intention must not be submitted. Proposals or counter-proposals that are clearly careless and inappropriate to the specific situation and/or that abusively aim to benefit or harm one or more parties are also not admissible, compared to the situation in which they would be in the absence of agreement and leave them in a situation less favourable than other parties with claims of the same nature and rank or lower rank.

Promoting the negotiation of a restructuring plan is, certainly, a management decision, which can be more or less conditioned or limited depending on the circumstances that point in a certain direction, or even limited or excluded by any previously existing binding agreement or legal imposition. However, the question remains what the *ratio* or foundation of such a duty is. If its *raison d'être* concerns exclusively the directors-companies' contractual relationship, its scope will be limited to that relationship and, consequently, the directors will only be liable to the company. If the *ratio* is also linked to the protection of third parties, there is no justification to put aside a system of directors' liability in relation to third parties, namely, due to a legal or contractual provision specially designed to protect third parties, or due to a special relation that arises in certain circumstances between the directors and third parties. Thus, asking about the existence and scope of the general duty to promote the negotiation of a pre-insolvency recovery agreement is important to understand the consequences of its violation, within the scope of the internal relationship (towards the managed company itself) and, eventually, in the context of external relations (to third parties). In this sense, understanding the legal foundation of the general duty of directors to promote the negotiation of a restructuring plan is important in order to find an answer to the extent of the due conduct and the consequences of its violation, both within the scope of the internal relationship (manager-company) as well as in the scope of external relations (manager-third parties).

financial assistance, provided by an existing or a new creditor, that includes, as a minimum, financial assistance during the stay of individual enforcement actions, and that is reasonable and immediately necessary for the debtor's business to continue operating, or to preserve or enhance the value of that business.

One possible reason can be found in the shift of fiduciary duties theory in the vicinity of insolvency[45]. In light of this conception, the pre-insolvency situation causes a shift in fiduciary duties in the sense that directors must guide their conduct mainly in defence of creditors' rights and interests. The explanation for the shift is simple: if the company is in the vicinity of insolvency, the directors are playing with the creditors' money because the equity holders rights are subordinated, and all creditors will be paid before them in the event of insolvency. That means that when a company is close to insolvency, creditors have more to lose than equity holders whose interests are of marginal value. The pre-insolvency *status* must represent a realistic likelihood of insolvency, which is normally assessed according to the balance sheet or cash flow tests[46]. That period cannot be too far in time, otherwise it is a mere speculation. It cannot be too close in time either, otherwise there is no objective information to come to a realistic and reasonable conclusion. At some reasonable time prior to insolvency, directors know or ought to know that there is a realistic prospect of the company going into insolvency if they do nothing to avoid it. In that case, directors should take steps to protect the creditors' interests. Hence, the shift in directors' duties is a form of creditor protection[47]. Such protection is essential because it enhances certainty in respect of transactions with pre-insolvent companies and tend to reduce the fear of creditors and investors that company value will transfer to equity holders' or to highly risky transactions (which will benefit third parties) that put creditors' interests at stake. Continuing to trade in these circumstances puts directors under a duty to take account of the creditors' interests.

It turns out that the rationale behind the duty to promote the negotiation of a restructuring plan is not exactly the defence of the creditors' interests, but the best (reasonable and fair) satisfaction of the interests of all affected parties and the public interest in restructuring pre-insolvent and viable companies. Above the interest of creditors and equity holders will certainly be the corporate interest itself, which may not exactly coincide with those interests. The corporate interest is, of course, the continuity and sustainability of the company. Creditors and equity holders also benefit from it. We believe this understanding is the one that best fits with Article 19 of Directive (EU) 2019/1023 and, to some

[45] This theory started from the judgment of the High Court of Australia in *Walker v Wimborne* ((1976) 137 CLR 1; (1976) 3 ACLR 529 This position was quickly spread by the English courts, with special emphasis on the case *West Mercia Safetwear Ltd v Dodd*, in which the court ruled that directors should take into account the interests of creditors in the vicinity of insolvency). Thanks to this decision, the *shift of fiduciary duties theory* during in pre-insolvency began to assume a role more and more recognized by jurisprudence and doctrine, including in the United States, through the *deepening insolvency theory* (see above, n 20).

[46] Vanessa Finch, *Corporate Insolvency Law, Perspectives and Principles* (Cambridge University Press, 2nd edn, 2009) 146–149.

[47] Andrew Keay, 'The Shifting of Directors' Duties in the Vicinity of Insolvency,' 163–164.

extent, it is reflected, in section 172 of the UK Companies Act 2006[48], §§ 76, (1) e (2) e 93, (1) AktG and §§ 32. (1), 43. (1) e 57 of the Germany StaRUG[49],, and Article 64.º, 1 CSC, in light of Art. 186.º, 1 CIRE of the Portuguese Law[50]. Therefore, the shift of fiduciary duties theory does not seem to be fully adequate to justify the duty under analysis. At least, it seems that it would need to be, in some way, cut and reoriented to the specific context and objective of preventive restructuring frameworks. Instead of proposing a shift in directors' fiduciary duties, we defend an adaptation of their duties to the specific (and special) context of pre-insolvency, to promote a balanced approach, having due regard to all interests involved according to the circumstances.

Another alternative or competing reason to explain the *ratio* of the duty under analysis can be found in the theory of trust or special close relationships. Based on traditional foundation of *culpa in contrahendo*, it is known as a *tertium genus* of liability, located between contractual and tortious liability, and has developed in case law and German doctrine[51]. During the negotiations to conclude a contract, and because of the good-faith principle, a special relation arises without primary duties of performance, but rather, certain duties of information and clarification, loyalty, care and consideration for the interests of the counterparty (the so-called 'Schutzpflichten')[52]. These protective obligations (understood as accessory duties of conduct), could result from a legal or contractual stipulation intended to protect the interests of others or from the specific context of the negotiation of a contract, due to the exposure of their interests to the others sphere of influence, due to a relationship of special connection and trust between the parties, or due to mutual trust as a result of contacts maintained and developments and compromises made during the negotiations. Karl Larenz[53] and Klaus Hopt[54], following the Kurt Ballerstedt

[48] See Andrew Keay, 'Having Regard for Stakeholders in Practising Enlightened Shareholder Value', *Oxford University Commonwealth Law Journal* 19, no. 1 (2019)118-138.

[49] Stefan Korch, ‚Sanierungsverantwortung von Geschäftsleitern: Krisenpflichten im Lichte des Art. 19 der Restrukturierungsrichtlinie', *Zeitschrift für Unternehmens- und Gesellschaftsrecht* 48, no. 6 (2019) 1051–1061.

[50] Catarina Serra, 'Revitalização – a designação e o misterioso objeto designado: o processo homónimo (PER) e as suas ligações com a insolvência (situação e processo) e com o SIREVE' in Catarina Serra (ed), *I Congresso de Direito da Insolvência* (Edições Almedina, 2013) 90.

[51] Up to the 2002 reform, this doctrine is reflected in § 242 BGB, similar to Article 227 of Portuguese Civil Code.

[52] Dário Moura Vicente, *Comparative Law of Obligation* (Edward Elgar Publishing, 2021) 60.

[53] 'Bemerkungen zur Haftung für ‚culpa in contrahendo', *Beiträge zum Zivil- und Wirtschftsrecht: Festschrift für Kurt Ballerstedt zum 70. Geburstag am 24. Dezember 1975* (Berlin: FS Ballerstedt, 1975) 397–419.

[54] 'Nichtvertragliche Haftung außerhalb von Schadens- und Bereicherungsausgleich: Zur Theorie und Dogmatik des Berufsrechts und der Berufshaftung', *Archiv für die civilistische Praxis* 183. no. 4/5 (1983) 699–701.

teachings[55], say that this can also be valid to assert an autonomous responsibility of the directors and representatives of the companies towards third parties when, in the course of the negotiations, they used their professional and personal qualities as differentiating factors and worthy of trust or had a relevant economic interest in the conclusion of the contract to be entered into between the managed company and third parties. From this point of view, the decisive factor to uncover a direct (civil) liability of directors to third parties would be the specific and conclusive behaviour from which a legitimate expectation to third parties arises. As result, directors would be bound to compensate third parties if they breached those duties. However, we cannot forget that the restructuring plan normally aims to modify previously existing contractual conditions. Creditors are negotiating with a common debtor due to a contractual bond previously formed. In these cases, we are dealing with contractual or post-contractual relationships and not with pre-contractual relationships. This may limit the application of the third way of liability, but it does not exclude its main foundation which is the general principle of good faith and the secondary duties of information, loyalty, and cooperation.

Thirdly, taking into account the Hans Würdinger doctrine[56], the so-called 'community of interests', and admitting that preventive restructuring frameworks can generate a need for protection of several parties exposed to a common danger, threatening their rights and interests (provoked by the imminent insolvency), there will be a community of interests among them (reflecting a sufficient commonality of interest) that would justify a coordinated and collective action in order to maximize a common goal in protecting the assets of the pre-insolvent company so as to maximise value and avoid loss of key assets. Horst Eidenmüller[57] invokes a common interest comparable to the common interest of shareholders, from which reciprocal duties of cooperation and loyalty would arise. It tends to be a relationship like the shareholders relationship because all those involved have a common interest in ensuring that the restructuring plan is implemented in order do to maximise going-concern value[58]. From this perspective, we admit that the preventive restructuring frameworks aim at the composition of a common (economic) interest, comparable to the shareholders' interest. The companies' directors involved effectively in the negotiations are obliged to defend this common interest, actively promoting cooperation between parties. If the company is not yet insolvency and

[55] 'Zur Haftung für culpa in contrahendo *bei*. Geschäftsabschluss durch Stellvertreter', *Archiv für die civilistische Praxis* 151, no. 6 (1950) 501–531.

[56] Theorie der schlichten Interessengemeinschaften (Stuttgart: Ferdinand Enke Verlag, 1934) 12–78.

[57] Unternehmenssanierung zwischen Markt und Gesetz: Mechanismen der Untemehmensreorganisation und Kooperationspflichten im Reorganisationsrecht (Köln: Otto Schnnidt, 1999) 608–619.

[58] *Ibid.*

viable, directors have to hold negotiations with company creditors, enter preventive restructuring procedure, and make necessary, appropriate and reasonable proposals or counterproposals, in order to promote and facilitate the negotiation of a restructuring plan and not lose a chance at restructuring the company. In other words, directors are prohibited from adopting opportunistic strategies and unjustifiably breaking negotiations.

The theoretical-practical scope of these three approaches tends, however, to be limited if there is no third-party protection norm that clearly supports the attribution of responsibility of directors directly to third parties. Article 19 of Directive (EU) 2019/1023 seems to point to the need for Member States to implement in their legal systems a rule for the protection of third parties in the event of breach of the duties provided for therein. In the Portuguese legal system, a combined interpretation between Article 64., 1 of CSC[59] and Article 186, 1 of CIRE[60] does not seem to exclude such a possibility. However, it would be convenient for the Portuguese legislator to say so clearly. Nuno Pinto Oliveira[61] and Catarina Serra[62] defended the need to expressly enshrine a general duty to prevent insolvency and other related duties, such as those found in recital 70 of Directive (EU) 2019/1023. In Germany, Philipp Scholz[63] describes § 43 (1) of StaURG (which replaced § 45 (1) in the draft law of this

[59] Supporting this understanding, see Adelaide Menezes Leitão, 'Responsabilidade dos administradores para com a sociedade e os credores sociais', Revista de Direito das Sociedades I, no. 3 (2009) 674; Luís Menezes Leitão, Pressupostos da exclusão de sócio nas sociedades comerciais (Lisboa: AAFDL, 1988) 37–39; Manuel Carneiro da Frada, 'A business judgement rule no quadro dos deveres gerais dos administradores' in António Menezes Cordeiro and Paulo Câmara (eds), A Reforma dos Código das Sociedades Comerciais: Jornadas em Homenagem ao Professor Doutor Raúl Ventura, (Coimbra: Edições Almedina, 2007) 78; Pedro Caetano Nunes, Dever de gestão dos administradores de sociedades anónimas (Coimbra: Edições Almedina, 2012) 495; and Tânia Meireles da Cunha, Da Responsabilidade dos Gestores de Sociedades perante os Credores Sociais (Coimbra: Edições Almedina, 2nd edn 2009) 66. Against this understanding, see António Menezes Cordeiro, Direito das Sociedades I (Coimbra: Edições Almedina, 4th edn, 2020) 1000; António Fernandes de Oliveira, 'Responsabilidade civil dos administradores', Código das Sociedades Comerciais e Governo das Sociedades (Coimbra: Edições Almedina, 2008) 315–316; and Maria Elisabete Ramos, O Seguro de Responsabilidade Civil dos Administradores (Coimbra: Edições Almedina, 2010) 118.

[60] See Catarina Serra, 'Covid-19 (II)/ Lei n.º 4-A/2020, de 6 de Abril, insolvência e reestruturação de empresas', Observatório Almedina, 2020; Jorge Coutinho de Abreu, 'Direito das Sociedades e Direito da Insolvência: interacções' in Catarina Serra (ed), IV Congresso de Direito da Insolvência (Coimbra: Edições Almedina, 2017) 189–190; Manuel Carneiro da Frada, 'A responsabilidade civil dos administradores na insolvência', 683–687; Nuno Pinto Oliveira, Responsabilidade civil dos administradores: entre o Direito Civil, Direito das Sociedades e Direito da Insolvência (Coimbra Editora, 2015) 211–215; and Ricardo Costa, 'Gestão das Sociedades em Contexto de "Crise da Empresa"' in Pedro Pais de Vasconcelos et all, V Congresso de Direito das Sociedades em Revista (Edições Almedina, 2018) 193.

[61] 'Responsabilidade civil dos administradores pela violação do dever de apresentação à insolvência' 622–624.

[62] 'O dever de prevenção da insolvência,'185.

[63] 'Die Krisenpflichten von Geschäftsleitern nach Inkrafttreten des StaRUG', Zeitschrift für Wirtschaftsrecht 5 (2021) 226. In the same vein, Moritz Brinkmann, 'Die Haftung der Geschäftsleiter in der Krise nach dem Gesetz zur Fortentwicklung des Sanierungs- und Insolvenzrechts (SanInsFoG)', Zeitschrift für Wirtschaftsrecht 48 (2020) 2364–2368.

diploma) as a protective rule within the meaning of § 823 (2) of BGB. Essentially, the breach of the duty to provide information regarding the occurrence of insolvency during the course of the negotiation process can occur, but other situations are possible in order to protect creditors from directors' misconduct.

In light of the above, it is time to question which of the three approaches presented, ie the shift of fiduciary duties, the theory of trust, or the common interest is best suited to the duty to promote the negotiation of a restructuring plan. We recognize that all of them have their merits and, together, help to better understand the *raison d'être* and scope of that duty. Therefore, we would say that we should not definitively abandon any of those perspectives. Each of them advances a fundamental understanding of the same problem, which, in fact, may justify the reunion of different approaches to the civil liability of directors for the violation of the duty to promote negotiation, under Article 19 of Directive 2019/1023/EU and its recitals 70 and 71. In fact, the reasons that underlie the shift of fiduciary duties, the theory of trust, and the common interest, are somehow implicit in that legal provision and in those recitals. Where there is a likelihood of insolvency, directors must have due regard to the interests of creditors, equity holders, and other stakeholders and must take steps to avoid insolvency and minimise losses. Negotiating with creditors and entering preventive restructuring procedures meet these requirements. In other words, in times of crises, directors have to promote the negotiation of a restructuring plan in good faith if the debtor company is potentially viable.

5 Conclusion

Pre-insolvency status represents a serious chance to avoid unnecessary liquidation and the closure of viable companies, to avoid considerable loss of jobs, to prevent significant non-performing loans, and to avoid the deterioration of the economy and of social welfare in general. Such an opportunity can only be properly safeguarded if those who manage the company adopt the necessary and adequate measures to protect those interests, which, in many situations, will entail promoting, procedurally and substantially, the negotiation of a restructuring plan. It is, on a procedural level, a matter of contributing to the protection and facilitation of negotiations. On a substantial level, it is about considering reasonable and fair proposals or counterproposals or, at least, about not opposing them without any valid reason. For this purpose, it is important to ensure that directors are clearly obliged to take decisions that promote the restructuring of pre-solvent companies, which must always occur when the plan is necessary, adequate, reasonable and fair. It is necessary if the debtor company is pre-insolvent and economic and financially viable; it is adequate if it ensures an additional value to all, when compared to other alternative options; it is reasonable and fair if it ensures that affected creditors are treated at least as favourably as any other of the same rank and more favourably than any junior class.

Considering the strong incentives inherent in preventive restructuring frameworks, as presented in Directive (EU) 2019/1023, the managers' discretion is, in a way, limited, since they can only block the negotiation of a restructuring plan if they have a more advantageous and suitable alternative. To come to that conclusion, directors must have due regard to all options. In other words, they cannot simply ignore or abandon any restructuring chance without first properly evaluating and weighing its advantages and disadvantages. If directors do not act accordingly, they are, and rightly should be, held liable for damages caused not only to the company, but also to third parties. This last premise finds its roots in Article 19 of Directive (EU) 2019/1023, which can be better understood in light of shift of fiduciary duties, of trust, and of common interest theories. Nevertheless, as far as legal certain goes, it is important to implement a general duty of preventing insolvency and more specifically, a duty to promote negotiation of restructuring plan.

Chapter 14

Some Recent Developments in Cross-border Assignment of NPLs

Karin Sixma
Dentons (the Netherlands)

Krijn Hoogenboezem
Dentons (the Netherlands)

1 Introduction

High levels of non-performing loans (**NPLs**) on the balance sheets of banks have a negative impact on the banks' profitability and ability to lend, as a result of the amount of capital banks are obliged to hold against such NPLs. The 'tackling' of the issue of NPLs and facilitating the market for NPLs has been on the agenda of the European Commission for a number of years, with an increase in attention and urgency as a result of the COVID-19 crisis[1].

The Netherlands, like many other EU Member States, has an existing practice of NPL transfers. Nonetheless, in particular in a cross-border scenario, multiple jurisdictions may be involved in the transfer of an NPL or an NPL portfolio which increases risks and limits the effectivity and efficiency of the NPL markets.

In this article we will discuss two relevant recent developments in this context[2]. We will first discuss the Proposal for a Regulation of the European Parliament

[1] Already in July 2017 the Council conclusions on an 'Action plan to tackle non-performing loans in Europe' were published (Council of the European Union, 11 July 2017, *Council conclusions on Action plan to tackle non-performing loans in Europe*). Against the backdrop of the COVID-19 crisis, this action plan only gained relevance and resulted in the presentation of a (further) NPL action plan that is intended to prevent a future build-up of NPLs across the European Union as a result of the COVID-19 crisis (European Commission, 16 December 2020, *Action plan: Tackling non-performing loans (NPLs) in the aftermath of the COVID-19 pandemic*), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52020DC0822.

[2] In this article we will not discuss any particularities in case of the transfer or assignment of consumer loans.

and of the Council on the law applicable to the third-party effects of assignments of claims (the **Proposed Regulation**), see section 2)[3]. While the Proposed Regulation, when into force, does clarify the law under which the assignee can determine it has acquired legal and beneficial title to the NPL portfolio, and thereby promotes the efficient functioning of the internal market, the assignee of an NPL portfolio is not out of the woods yet. Further complications for the assignee may follow from the applicability of certain duties of care which arise as a result of the fact that the originator of the assigned loan is a regulated financial institution. As a consequence, it is not always clear whether the assignee is in the position to take such measures as raising interest rates, accelerating the loan or enforcing on its collateral. We will describe these complications, taking an example from Dutch case law, in section 3 of this article. Section 4 of this article summarizes our main findings.

2 Relevant conflict-of-law rules related to cross-border assignments

2.1 Issue of applicability of multiple legal regimes

When purchasing an NPL portfolio, the purchaser needs to make sure it will obtain a valid legal title in respect of each individual NPL, that can be enforced against any relevant person. Relevant persons in this respect are for example (i) the debtor of the NPL, (ii) the assignor or transferor of the NPL (the bank), and (iii) any third party claiming to have an interest in the NPL, eg in the capacity of assignee, (second-ranking) pledgee of the NPL or a creditor of the assignor. As the relevant persons may be located in different jurisdictions, different conflict-of-law rules may apply. The result thereof is that a purchaser may be confronted with multiple applicable legal regimes when attempting to exercise its rights in respect of the purchased NPL.

The applicable substantive laws will govern important topics that affect the ability of the assignee to carry out its envisaged strategy in respect of the NPLs purchased, such as (i) the assignability of an individual NPL, (ii) the formalities to be abided by in case of an assignment of contract or assignment of claim, (iii) the rights of an assignee against third parties claiming to have a right in respect of the NPL and (iv) the position of the assignee against the debtor.

In the EU context, uniform conflict-of-law rules are in force, or are being prepared, that designate the laws that govern these topics, as will be briefly set out below.

[3] Proposal for a Regulation of the European Parliament and of the Council on the law applicable to the third-party effects of assignments of claims, COM/2018/096 final – 2018/044 (COD), see https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM%3A2018%3A96%3AFIN.

2.2 Rome I Regulation

In an EU context, the Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (**Rome I Regulation**) provides for important conflict-of-law rules in the context of the transfer of NPLs. Any law designated by the Rome I Regulation, whether that is the law of an EU Member State or not, shall apply (Article 2 Rome I Regulation).

2.2.1 Relationship assignor vis-à-vis assignee

Article 14 para 1 of the Rome I Regulation stipulates that the relationship between assignor and assignee under a voluntary assignment of a claim against another person (the debtor) is governed by the law applicable to the contract between the assignor and assignee (usually the deed of transfer) under the Rome I Regulation. The starting principle under the Rome I Regulation is that such contract between the assignor and assignee is governed by the law chosen by the parties (Article 3 para 1 Rome I Regulation). In practice, in particular in a cross-border scenario, the contract containing the obligation to assign an NPL or NPL portfolio will often contain a written choice of law.

In absence of a choice of law, a contract for the assignment of claims is governed by the law of the country where the party required to effect the characteristic performance of the contract has its habitual residence (Article 4 para 2 Rome I Regulation), unless the contract is manifestly more closely connected with another country (Article 4 para 3 Rome I Regulation), in which case the law of that more closely connected country applies. In case of an assignment of claims, the characteristic performance is the performance of the assignor (i.c. the bank)[4].

Thus, the conflict-of-law rule set out in Article 14 para 1 Rome I Regulation refers to three potentially applicable law regimes: (i) the law chosen by the bank and the purchaser, (ii) the law of the habitual residence of the bank or (iii) the law of the manifestly more closely connected jurisdiction.

2.2.2 Relationship between the assignee and the debtor and assignability of the claim

Article 14 para 2 of the Rome I Regulation governs the relationship between the assignee and the debtor. The law governing the assigned claim – in the context

[4] Groene Serie Bijzondere overeenkomsten (Mr. M Zilinsky) II.1.10.2 Verbintenissen tussen verkoper/cedent en koper/cessionaris; art. 14 lid 1 Rome I (art. 12 lid 1 EVO), cessiestatuut.

of an NPL generally the law chosen in the loan agreement between the bank and the debtor – will determine (i) its assignability, (ii) the relationship between the assignee and the debtor, (iii) the conditions under which the assignment can be invoked against the debtor and (iv) whether the debtor's obligations have been discharged (Article 14 para 2 Rome I Regulation in conjunction with Article 3 Rome I Regulation).

In absence of a choice of law, the relationship between the assignee and debtor is governed by the law of the country where the party required to effect the characteristic performance under the loan agreement (ie the bank[5]) has its habitual residence, unless the loan agreement is manifestly more closely connected to another country (Article 4 paras 2 and 3 Rome I Regulation).

2.3 Transfer of contract

The Rome I Regulation does not contain specific provisions for the transfer of contract. Article 14 para 3 Rome I Regulation stipulates that assignment of claims within the meaning of Article 14 Rome I Regulation includes outright transfers of claims, transfers of claims by way of security and pledges or other security rights over claims, but does not mention the transfer of contract as such. As a result, one could question whether Article 14 Rome I Regulation is applicable to transfer of contract[6].

In case the NPLs are transferred through transfer of contract, the starting principle is again that such transfer of contract is governed by the law chosen by the parties (Article 3 Rome 1 Regulation). In contrast to assignment of claim, it is generally assumed that in the context of transfer of contract, all parties[7] must agree to the transfer of contract itself as well as the choice of law[8]. In the absence of a choice of law, the applicable law is to be determined on the basis of Article 4 para 2 Rome I Regulation. We refer to the description above of the analysis under this provision.

[5] Groene Serie Bijzondere overeenkomsten (Mr. M Zilinsky) II.2.3.3 Bancaire leningen/dienstverlening door banken.

[6] Asser/Kramer & Verhagen (Prof. Mr. XE Kramer and Prof. Mr. HLE Verhagen) 10-III Internationaal vermogensrecht 2022/7.6, 7.12.

[7] As the debtor is not necessarily required to become a party to the deed of assignment of contract, since merely 'cooperation' of the debtor is required, the word 'parties' in this context can refer to both the debtor as a contractual counterparty as well as the debtor as 'passive party'.

[8] From a Dutch perspective, the exact scope of the Rome I Regulation in this respect does not have much relevance, as the Dutch conflict-of-law rules refer to the conflict-of-law rules set out in the Rome I Regulation (Article 10:154 Dutch Civil Code (**DCC**)), which *de facto* leads to the application of the conflict-of-law rules of the Rome I Regulation in any scenario, see Asser/Kramer & Verhagen (Prof. Mr. XE Kramer and Prof. Mr. HLE Verhagen) 10-III Internationaal vermogensrecht 2022/7.6, 7.13.

2.4 Third-party effects

It follows from the 2019 decision of the European Court of Justice in the matter of BGL BNP Paribas that Article 14 of the Rome I Regulation does not designate, directly or by analogy, the applicable law concerning the third-party effects of the assignment of a claim in the event of multiple assignments of the claim by the same creditor to successive assignees[9]. That decision is not surprising, given the recent Proposed Regulation dealing with the third-party effects of assignments, as further discussed below.

Until the Proposed Regulation enters into force, a Dutch court will apply the Dutch private international law rule of Article 10:135 section 2 DCC, as a result of which the third-party effects of the assignment are governed by the law applicable to the agreement obliging the assignor to assign the claim (eg the deed of assignment).

2.5 Proposal for a Regulation of the European Parliament and of the Council on the law applicable to the third-party effects of assignments of claims (the Proposed Regulation)

In 2018 the Proposed Regulation was adopted by the European Commission. The goal of the Proposed Regulation is to 'help increase cross-border transactions in claims by providing legal certainty through the adoption of uniform conflict-of-laws rules at EU level, thus eliminating legal risks and potential systemic consequences and enabling cross-border investment, access to cheaper credit and market integration'[10].

On 28 May 2021 the Presidency of the Council of the European Union published the compromise text of the Proposed Regulation on which it believes a general approach can be achieved (hereinafter also referred to as the **Proposed Regulation 2021 Text**)[11]. The main rule included in both the new and the earlier 'version' of the Proposed Regulation is that the third-party effects of assignment of claims are governed by the law of the place of habitual residence of the

[9] Judgment of the Court (First Chamber) of 9 October 2019 regarding the request for a preliminary ruling from the Saarländisches Oberlandesgericht in the case between BGL BNP Paribas SA versus TeamBank AG Nürnberg, C-548/18, ECLI:EU:C:2019:848, deliberation 39.

[10] See introductory remarks in the note of the Presidency in relation to the Proposal for a Regulation of the European Parliament and of the Council on the law applicable to the third-party effects of assignments of claims, COM/2018/096 final – 2018/044 (COD) 9050/21, https://data.consilium.europa.eu/doc/document/ST-9050-2021-INIT/en/pdf.

[11] See the annex to the note of the Presidency in relation to the Proposal for a Regulation of the European Parliament and of the Council on the law applicable to the third-party effects of assignments of claims, COM/2018/096 final – 2018/044 (COD) 9050/21, https://data.consilium.europa.eu/doc/document/ST-9050-2021-INIT/en/pdf.

assignor (see Article 4 para 1, Proposed Regulation)[12]. However, it was concluded that *inter alia* in respect of the assignment of credit claims, the law of the assigned claim would be more suitable than the law of the assignor's habitual residence[13]. In that light, recital 27b has been added to the amended Proposed Regulation, which reads as follows: 'The third-party effects of assignments of claims arising out of agreements whereby credit is granted in the form of a loan should be governed by the law of the assigned claim [. . .]'. In the same vein, Article 4, para 2, introduction and under d of the Proposed Regulation 2021 Text now states that 'the law applicable to the assigned claim shall govern the third-party effects of the assignment of (. . .) claims arising out of agreements whereby credit is granted in the form of a loan'. In a European cross-border context, the law governing the assigned claim itself will be determined on the basis of the Rome I Regulation, as discussed above.

One can debate whether this exception to the main rule ('agreements whereby credit is granted in the form of a loan') is as clear as may be desired. Nonetheless, in the context of the law governing the third-party effects of assignment of NPLs, it certainly seems that in the Proposed Regulation the exception (the law governing the assigned claim) is now more important than the rule (the place of habitual residence of the assignor). For the avoidance of doubt, and specifically with an eye on NPLs governed by English law, the conflict-of-laws rule also applies if the law designated is not the law of a Member State[14].

Finally we note that, in contrast to previous drafts of the Proposed Regulation, it has been clarified that under the Proposed Regulation 'third party effects' means the right of a person to assert his legal title over an assigned claim against amongst others (i) assignees or beneficiaries of the same claim and (ii) creditors of the assignor, but that in relation to the debtor, the Proposed Regulation is without prejudice to the rights and obligations of the debtor under the law applicable pursuant to Article 14 para 2 of the Rome I Regulation[15].

3 Substantive law on assignment of NPLs

Having established that the assignee has acquired legal and beneficial title to the NPL portfolio, the assignee will want to invoke certain rights under the

[12] For the sake of completeness, the Proposed Regulation does not concern the transfer of contract, see consideration 17 of the Proposed Regulation (2021 Text).

[13] See no. 21 of the note of the Presidency in relation to the Proposed Regulation 2021 Text.

[14] See consideration 18 and Article 3 of the Proposed Regulation 2021 Text.

[15] Article 2, under (e) and Article 5 of the Proposed Regulation.

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assigned claims in the course of the management of the portfolio. These rights would include, for example, increasing interest rates or enforcing on collateral. Determining which rights the assignee exactly has vis-à-vis a debtor may be less straightforward than one may anticipate. The NPLs were originated by a financial institution which is subject to regulations specific to the financial sector that provide protection to debtors. These specific regulations may have certain knock-on effects to the assignee of an NPL-portfolio, as is illustrated by the Dutch 'Promontoria case' which we will discuss below.

3.1 Relevant basics of Dutch substantive law on transfer of contract and assignment

In the Netherlands there is an established practice of banks selling and transferring NPLs or NPL portfolios to non-banks. Such sale and transfer can take place through either (i) a transfer of contract (*contractsoverneming*) of the loan agreement (Article 6:159 DCC) or (ii) an assignment of the claim (*cessie*) against the borrower (debtor) (Article 3:94 DCC). In practice, the assignment of claim is also used as a fallback option for the event the transfer of contract turns out to be invalid.

In case of a transfer of contract, the entire loan agreement is transferred to the purchaser, including all rights and liabilities arising from it and the purchaser becomes the new so-called 'lender of record'[16]. A transfer of contract requires execution of a deed of transfer between the bank and the purchaser as well as the cooperation of the debtor. This cooperation can be granted in advance, eg at the time the original loan agreement was entered into, or needs to be obtained separately for the envisaged transfer of contract. In case cooperation has been granted in advance, the transfer of contract also requires that the debtor is notified of the transfer (Article 6:156 DCC).

In case of an assignment of the claim, the purchaser (assignee) obtains the claim and all connected rights, ancillary rights and liabilities (Article 6:142 DCC and Article 6:144 DCC). The bank (assignor), however, remains the lender of record. An assignment of claims requires the execution of a deed of assignment between the bank and the purchaser. The assignment of claims can either be disclosed (ie with notification of the debtor) or undisclosed (ie without notification of the debtor). Claims are transferable, unless this is incompatible with the law or nature of the claim (Article 3:83 para 1 DCC). Parties can also agree that claims arising from a contract are non-transferable, with proprietary

[16] Mr. JL Snijders and Mr. YC Tonino, 'Overdracht van kredietvorderingen na Promontoria', *MvV* 2020/12, p 420.

effects. Under Dutch law, credit claims are not considered non-transferable by nature[17].

3.2 The Promontoria case

In the Netherlands, the transfer of NPLs, has led to an interesting Supreme Court judgment about the validity of the assignment of claims and the consequences thereof[18].

The underlying matter is, in summary and simplified, as follows. Van Lanschot, a Dutch private bank, had placed a portfolio of NPLs with the Special Asset Management department of Van Lanschot. In 2015 Van Lanschot sold the NPL portfolio at a significant discount to Promontoria, a non-bank and a subsidiary of the US private equity fund Cerberus. The transaction was documented in a notarial deed titled 'Deed of Transfer of Contract and Assignment'. The relevant debtors were subsequently notified that (i) the credit facilities had been transferred to Promontoria by way of transfer of contract and assignment and (ii) going forward, the credit manager of the debt would be Capita Banking and Debt Solutions (Netherlands) B.V. In the years following the transaction, Promontoria cancelled and accelerated the credit facilities of several of the debtors and/or raised the applicable interest rates. Several of the debtors opposed the actions of Promontoria and initiated (separate) legal proceedings[19]. In the cases that led to the preliminary questions to the Supreme Court, the debtors were legal entities under the laws of the Netherlands and the Netherlands Antilles[20]. The relevant debtors brought proceedings before the District Court of Amsterdam, the Netherlands, in which they requested the court to declare that (i) the assignment and transfer of contract was null and void, (ii) in the alternative, the assignment and transfer of contract are annulled and (iii) the assignment and transfer of contract were unlawful[21].

[17] Supreme Court 10 July 2020, ECLI:NL:HR:2020:1274, deliberation 2.6.3. The Supreme Court explicitly ruled that this also relates to claims arising from consumer loans (deliberation 2.6.4).

[18] To be more precise, it led to two (on the content identical) decisions as the prejudicial questions related to both proceedings, namely Supreme Court 10 July 2020, ECLI:NL:HR:2020:1274 (*Alegre c.s./Promontoria c.s.)* and Supreme Court 10 July 2020, ECLI:NL:HR:2020:1276 (*Immobile c.s./Promontoria c.s.)*.

[19] According to Promontoria there were five proceedings initiated that were related to the transfer of the Van Lanschot NPL portfolio, see District Court of Amsterdam 7 August 2019, ECLI:NL:RBAMS:2019:5729 (*Immobile c.s./Promontoria c.s.*), deliberation 2.3.

[20] One case was brought by Dutch companies Alegre Beheer B.V., Rennoc Nederland B.V. and Tregobad Projectbeheer B.V., see District Court of Amsterdam 4 September 2019, ECLI:NL:RBAMS:2019:6359 (*Alegre c.s./Promontoria c.s.*). The other by the case brought by the company established under the laws of the Netherlands Antilles, Immobile Securities N.V., see District Court of Amsterdam, 7 August 2019, ECLI:NL:RBAMS:2019:5729 *Immobile c.s./Promontoria c.s.*).

[21] See n 20 above.

The debtors claimed the transfer of contract was invalid on the basis of absence of cooperation in advance and/or invoked error in respect of the cooperation in advance. According to Promontoria, the assignment of the NPL portfolio was (primarily) structured as a transfer of contract for which cooperation was granted in advance on the basis of Article 36 of the Dutch General Banking Conditions (**GBC**)[22]. Article 36 GBC provides that the debtor agrees in advance to cooperate with a transfer of contract in case the bank transfers (a part of) its business to another party. In brief, Promontoria argued that by transferring the NPL portfolio, Van Lanschot actually transferred its Special Asset Management department and therefore part of Van Lanschot's business. However, the court ruled that no transfer of the business of the bank occurred (and that only a transfer of the portfolio was intended), that as a result cooperation was not granted in advance by the debtor and that therefore the transfer of contract did not take place.

As a second line of defence, Promontoria argued the claims were validly assigned to it. In that respect the court considered that as a result of a transfer of claims, the purchaser cannot only demand repayment of the outstanding debt, but also exercise ancillary rights such as for example security rights or the right to amend the interest rate[23]. Further, the court considered that Dutch banks, such as Van Lanschot, have a duty of care (*zorgplicht*) towards their customers. Briefly put, duties of care of a Dutch bank vis-'a-vis its customer can arise from (i) Article 2 GBC, (ii) several private law legal provisions applicable to the agreement, such as the principles of reasonableness and fairness (Article 6:248 para 1 DCC), (iii) the social function of a bank[24] and (iv) applicable financial public laws[25].

Article 2 subpara 1 GBC, that is generally applicable to all banking relations of Dutch banks[26], currently reads (official translation): 'We must exercise due care when providing our services and we must thereby take your interests into account to the best of our ability. We do so in a manner that is in accordance with the nature of the services. This important rule always applies. Other rules in the GBC or in the agreements related to products or services and the

[22] See District Court of Amsterdam 29 May 2019, ECLI:NL:RBAMS:2019:3916 (*Alegre c.s./Promontoria c.s.*), deliberations 4.2 and 4.3.

[23] District Court of Amsterdam 29 May 2019, ECLI:NL:RBAMS:2019:3916 (*Alegre c.s./Promontoria c.s.*), deliberation 4.21.

[24] Also referred to as a special duty of care (*bijzondere zorgplicht*).

[25] See *inter alia* Supreme Court 10 July 2020, ECLI:NL:HR:2020:1274 (*Alegre c.s./Promontoria c.s.*), deliberations 2.9.1–2.9.3.

[26] See Supreme Court 10 July 2020, ECLI:NL:HR:2020:1274 (*Alegre c.s./Promontoria c.s.*), deliberation 2.9.1.

corresponding special conditions cannot alter this. We aim to provide comprehensible products and services. We also aim to provide comprehensible information about these products and services and their risks.'

In light of the above, the court deemed it relevant that it is determined whether the differences between the position of a bank versus the position of a non-bank can lead to the conclusion that claims of a bank against their customers are by nature not transferable to a non-bank. The court deemed it necessary to ask four preliminary questions (*prejudiciële vragen*) to be answered by the Supreme Court, which will be discussed below[27].

3.2.1 First preliminary question

Does the nature of the claim of a bank against a customer mean that it is nontransferable within the meaning of Article 3:83 para 1 DCC if it is intended to assign that claim to a non-bank?

Fortunately for the banks and purchasers involved in the transfer of NPL portfolios, the Supreme Court answered the first question in the negative, as was expected. Thus, claims of a bank against a customer are not by nature non-transferable. Another decision would have imposed serious limitations to the much-desired possibility of NPL transfers. The Supreme Court considered that after assignment of a claim, the assignee must meet several obligations, including duties of care. Those obligations do not differ in any relevant respect from the obligations that a bank must exercise towards a debtor. The possibility that the (non-bank) assignee will in fact exercise its rights in a different manner than a bank, does not lead to the conclusion that the claims are by their nature non-transferable within the meaning of Article 3:83 para 1 DCC.

Although the District Court of Amsterdam found it had sufficient reason to ask this preliminary question to the Supreme Court, the conclusion that the nature of a credit claim as such does not lead to non-transferability of the claim, was (generally) expected[28]. Perhaps that also explains why, despite an existing practice of the transfer of NPLs, this question had not been brought before the Supreme Court earlier.

[27] Dutch law provides for the possibility of lower courts to submit preliminary questions to the Supreme Court in case the answer to such questions is necessary in order to decide on (i) multiple claims that are based on the same or similar facts, or (ii) multiple similar cases where the same legal question arises (Article 392 of the Dutch Civil Code of Procedure).

[28] See eg Mr. S. Timmerman and Prof. Mr. F.E.J. Beekhoven van den Boezem, 'De ontwerprichtlijn voor de aanpak van Non-Performing Loans', *TvI* 2018/28, p 181 and Rongen, p 36. Reference is also made to the decision in summary proceedings related to the transfer of the same Van Lanschot NPL portfolio in which the court ruled that the relevant credit claim was not non-transferable by nature (District Court of Oost-Brabant 8 February 2018, ECLI:NL:RBOBR:2018:591, deliberation 4.14).

3.2.2 Second preliminary question

Does a non-bank to whom the claim is assigned owe a duty of care towards a debtor of the assigned claim? If so, how does that duty of care relate to the (financial) public laws applicable to a bank and the duty of care that is imposed on a bank?

In respect of the second preliminary question, the Supreme Court ruled, briefly put, that a non-bank assignee can be required to observe the same duty of care towards the debtor that would apply to a bank. The Supreme Court considered that the duty of care that is imposed on a bank in respect of its customer can determine the content of the claim, as a result of which the claim as assigned has its own specific limitations. After assignment, the legal relationship between the purchaser and the debtor is governed by the principles of reasonableness and fairness (Article 6:2 DCC). Those principles can dictate that the purchaser takes into account the legitimate interests of the debtors. This can entail that a duty of care is imposed on the non-bank assignee, which, under certain circumstances, means that it must act towards the debtor in the same way as can be expected of a reasonably acting bank.

3.2.3 Intermezzo – example of purchaser that wishes to increase the interest rate

The Supreme Court continued with an example in which, after assignment of the claim, a non-bank increases the interest rate and explains what the relevance can be of the above for the position of the debtor[29].

It follows from the explanation *inter alia* that (i) the limitations in respect of the ability to increase the interest rate attached to the assigned claim – either as a result of the content of the loan agreement, including what follows from principles or reasonableness and fairness between contracting parties (Article 6:248 DCC), or the special of duty of care of the bank – and (ii) the principles of reasonableness and fairness to be observed between purchaser and debtor (Article 6:2 DCC), may limit the ability of the purchaser to increase the applicable interest rate. In respect of ground (ii), the Supreme Court added that a relevant circumstance can be whether the interest rate increase is in line with market conditions.

In one of the cases that led to the Supreme Court decision re Promontoria, Promontoria tried to increase the interest rate from 3 month Euribor plus 1.2%

[29] Supreme Court 10 July 2020, ECLI:NL:HR:2020:1274 (*Alegre c.s./Promontoria c.s.*), deliberation 2.16.

to 8%. In superfluous considerations[30], the District Court of Amsterdam referred to the Promontoria decision on duty of care and hinted that, as the interest rate increase was not in line with market conditions, such increase would not hold up[31].

The limitations attached to the assigned claim, as well as the principles of reasonableness and fairness, may also limit the original strategy of the purchaser in respect of the purchased NPLs, for example in respect of (intended) (ii) acceleration and cancellation of the credit facilities or (iii) enforcement of security rights.

The answer to the second preliminary question, including the example provided by the Supreme Court, provides for more clarity and guidance within a Dutch context. More clarity and guidance on these topics may still be required and desired in many other EU Member States.

3.2.4 Third preliminary question

Does it matter, for the answers to the previous questions, whether the debtor has met its obligations under the agreement or whether the bank has terminated the banking relationship?

The third preliminary question is answered positively. The Supreme Court ruled that, to answer the first and second preliminary questions, it is irrelevant whether the debtor has fully met its obligations under the agreement or whether the bank has terminated the agreement.

3.2.5 Fourth preliminary question

What rights can the debtor exercise vis-à-vis the transferring bank if the actions of the non-bank to whom rights are assigned deviate from what could be expected of a bank on the basis of the public law rules applicable to a bank and the duty of care imposed on a bank?

The Supreme Court did not deem it necessary to answer the fourth preliminary question, as the answer thereto was not required for the Amsterdam District Court to decide on the matter at hand, which regards the legal relationship

[30] The court already ruled that based on the existing contractual arrangements between the debtor and Promontoria et al., the interest rate could not be raised, see District Court of Amsterdam 17 February 2021, ECLI:NL:RBAMS:2021:956 (*Immobile/Promontoria c.s.)*, deliberations 3.25 to 3.32.

[31] District Court of Amsterdam 17 February 2021, ECLI:NL:RBAMS:2021:956 (*Immobile/Promontoria c.s.)*, deliberations 3.33 to 3.36.

between the assignee (Promontoria) and the debtors and not (also) that between the debtors and the bank (Van Lanschot).

The Advocate-General, although he too did not deem it necessary to answer the fourth preliminary question, did make a few comments in his opinion that relate to the position of the transferring bank. The Advocate-General deemed it conceivable that the bank that intends to transfer the claim to a non-bank has a specific obligation to ensure that the customer is in good hands with the non-bank. This could translate into an obligation to investigate the non-bank and to ensure that this non-bank will properly manage the assigned claim. According to the Advocate-General, the latter can be done, for example, by including in the deed of assignment that the non-bank undertakes to observe the same care towards the debtor as the bank should do towards its customer[32].

In Dutch literature, the existence of an obligation of the bank to (i) investigate the purchaser, including its reputation and/or intentions and (ii) make appropriate contractual arrangements with the purchaser with a view to the duty of care that needs to be observed in respect of the debtor post assignment, is generally endorsed[33]. It is also argued that difficulties in eg assessing or predicting the purchaser's intentions with respect to the relevant NPL (portfolio), can be overcome by making appropriate arrangements as mentioned under (ii) above[34]. Interestingly enough, in the Promontoria case, it appeared from witness examination of the board of Van Lanschot that in any case the board of directors of Van Lanschot barely conducted any research at all into the reputation and intentions of Promontoria and hardly knew anything about Promontoria[35]. This approach has been criticized in Dutch literature[36].

In a recent judgment of the appellate court in a case between a former client of Van Lanschot and Van Lanschot, the appellate court considered that the fact that board members of Van Lanschot were not aware in detail of the way in

[32] Opinion Advocate-General 9 April 2020, ECLI:NL:PHR:2020:358 (and ECLI:NL:PHR:2020:359), under 5.9.

[33] See *inter alia* Mr. MHE Rongen, 'De overdraagbaarheid van kredietvorderingen van banken aan niet-banken. Een bespreking van prejudiciële vragen gesteld door de Rechtbank Amsterdam', *FIP* 2020/1, p 38, Mr. GJL Bergervoet and Mr. C Spierings, in their commentary in respect of the Promontoria decision in *TvI* 2021/19, par. 8, and Mr. K Vreemann and Mr. M Huizingh, 'Overdracht van een kredietportefeuille en de bancaire zorgplicht', *FIP* 2019/3, p 35.

[34] Prof. Mr. D Busch and Mr. LP Buitelaar, 'Overdracht van oninbare bankleningen na Promontoria', *WPNR* 2021/7340.

[35] See Wolter Keuning, 'Van Lanschot-bestuurders kunnen rechter weinig wijze maken' and 'Verkoop leningenportefeuille aan opkoopfonds was hamerstuk voor bestuur Van Lanschot', *Financieele Dagblad* 12 October 2017 respectively 13 October 2017.

[36] Prof. Mr. D Busch and Mr. LP Buitelaar, 'Overdracht van oninbare bankleningen na Promontoria', WPNR 2021/7340, p 702.

which Promontoria as the purchasing party was selected by Van Lanschot at the time, does not mean that Van Lanschot can be made a reproach[37]. Further, the appellate court considered that the debtor insufficiently factually substantiated that Van Lanschot should have reconsidered the sale of the relevant NPLs to Promontoria, taking into account the fact that the debtor in principle has the same means of defense against Promontoria as against Van Lanschot. The appellate court made no further mention of the scope and content of the duty of care of Van Lanschot, including any obligation to investigate the purchaser and/or make appropriate contractual arrangements as mentioned above. Ultimately, no breach of duty of Van Lanschot was established[38].

4 Conclusion

Addressing the issue of NPLs and facilitating the market for NPLs has been on the agenda of the European Commission for a number of years. An efficient and effective market in NPLs increases the banks' ability to continue their lending activities in times of crises.

In the EU context, a number of uniform conflict-of-law rules that are relevant for NPLs are already in force. The revised proposal for a regulation on the 'law applicable to the third-party effects of assignments of claims' is a welcome contribution to this existing conflict-of-law rules.

EU law does not provide for the substantive rules that apply to the relationship of a non-bank assignee and the debtor, in case the assigned claim was originated by a bank. As is illustrated by the Dutch Promontoria case, some very basic questions may still be open under the national laws of an individual EU Member State, such as the question whether it is even possible to assign a claim originated by a bank (we now know it is possible under Dutch law). It will be very interesting to see how courts in the respective EU jurisdictions will determine the rights and obligations of a non-bank assignee in respect of a claim originated by a bank. The Promontoria case shows that certain duties of care that applied to the bank may continue to apply to the non-bank assignee. However, what these duties of care entail specifically remains unclear even in the specific Dutch context. Another interesting aspect will be whether, under the laws each individual Member State, there exists an obligation of the bank to investigate the purchaser, including its reputation and/or intentions, and make appropriate contractual arrangements.

37 Appellate Court of 's-Hertogenbosch 21 December 2021, ECLI:NL:GHSHE:2021:3770, deliberation 6.27.

38 Appellate Court of 's-Hertogenbosch 21 December 2021, ECLI:NL:GHSHE:2021:3770, deliberation 6.29.

Chapter 15

A Proposal for Modernization of the Spanish Legal System on Insiders' Financing: From Automatic Subordination to an Efficiency Test?

Adrián Yuste Bonillo
Associate, Cuatrecasas, London

Roma Bastús Vilanova
Associate, Cuatrecasas, London

1 A brief introduction to the corporate structure of financially distressed companies

The capital structure of a company determines how it finances the long-term investments that allow it to create and maintain value. A company can generally be financed through equity (financing provided by its owners/shareholders) or through debt (capital borrowed by the company from unrelated third parties)[1].

Investors access the value that the company generates through financing. Shareholders are entitled to a portion of the business profits both through the increase of the value of their owned shares and through dividend distributions. Lenders' return consists in the fixed rate interests agreed in the relevant debt instrument. This way, while shareholders' return on their investment relies on the success of the company, lenders' profit has no direct link to the company's performance on the market. Accordingly, profits made by the company are in general primarily allocated to shareholders, whereas in return lenders demand priority payment rights over shareholders in a liquidation or insolvency event[2]. As the well-known rule goes, equity gets wiped out first in an insolvency scenario.

[1] This traditional classification has gradually broadened through the sophistication of financial markets. On the one hand, equity can be divided into common stock and preferred stock, where the holder has a higher claim on the business assets and earnings, in return to typically not holding voting rights; on the other, debt instruments range from bank debt, either unsecured or secured, convertible debt, bonds, etc.

[2] Charles P Normandin, The Changing Nature of Debt and Equity: A Legal Perspective (Federal Reserve Bank of Boston, Vol. 33, 1989, pp 49–79).

Companies, when financially healthy, may finance themselves through a variety of combinations of equity and capital. There is no market consensus on the ideal mixture between them. Ideally, companies shall configure their capital structure in such a way that maximizes their enterprise value. On the one side, companies should maintain a certain degree of equity to protect creditors, but an excessive amount of equity could prevent them from benefiting from more leveraged structures. On the other, financial leverage allows the company to increase the equity payoff, but high levels of debt have a potential to harm the company's ability to meet its financial obligations. Ultimately, a company's capital structure depends on numerous circumstances, that can only be addressed on a case-by-case basis.

The scenario for a company in distress[3] seeking financing is very different from the above. Indeed, a company under financial distress, which may well still be able to conduct a viable business that increases its value as a going concern, faces the challenge of obtaining the financing it requires to work its way out of its situation and avoid insolvency.

Potential financers who under normal circumstances would finance a company will be less prone to do so when it is under financial distress (underinvestment). Moreover, companies in these situations typically lack unencumbered assets to be offered as security for the new financing (debt overhang). Under these circumstances, prior lenders will prefer to act as free riders of the benefits generated by financing granted by third parties. They will only grant new financing when they believe that, strengthening their position in the capital structure of the company, they will obtain a higher benefit (defensive financing). In turn, new lenders will only grant new financing in the expectation to obtain a high return while assuming a privileged position, or with the purpose of taking over the company following loan-to-own strategies (offensive financing)[4].

If a company is unable to access new financing in a distressed scenario, it will likely fall into insolvency and be liquidated, which in turn will entail the destruction of the value of the company's business as a going concern. Therefore, the role of new money in distressed scenarios is crucial for allowing borrowers to restructure their debt and continue with their operation, which ultimately shall increase the return of all stakeholders involved.

[3] We refer to financial distress as the situation in which a company is or expects to be unable to meet its current obligations due to cashflow difficulties.

[4] Ignacio Buil Aldana, Socios y *financiació*n en tiempos de Crisis COVID-19 y *transposició*n de *la Directiva de reestructuració*n temp*rana: una propuesta de régimen jurí*dico (Revista General de Insolvencias & Reestructuraciones / Journal of Insolvency & Restructuring 1 / 2021).

The easiest alternative to obtain funding for distressed companies is often to resort to its shareholders (as well as the rest of the company's insiders[5]). Shareholders usually have a greater knowledge of the company, and therefore are ideally placed to identify upcoming distress situations and rapidly promote measures to revert them. However, shareholder financing is not without controversy, having received many critics from international scholars and judicature.

2 Shareholder financing of distressed companies and the problem of undercapitalization

As various scholars have pointed out, there is nothing inherently wrong with shareholders funding the company through loans[6]. This is, in fact, a very common practice in the market and, while the position of the funds granted by shareholders in the corporate structure of a company has no interest in a healthy financial scenario, the problem is much more complex for a distressed company that may not be able to repay all its debt.

Some of the arguments typically proposed in favor of such type of financing include (1) shareholder loans being the easier and quicker recourse than the debtor may have in a distressed situation. Also, (2) in distressed scenarios outsiders may underprice the value of a company, and therefore discard funding it, when they lack information on the quality of the company and the specific projects in which it aims to invest. In these situations, insiders will be less affected by this imperfect information and, therefore, more willing to finance the company. Lastly, (3) allowing shareholders into the debt structure of the company can also moderate their risk appetite with reference to the investment decisions they make. Shareholders with control over the distressed company are more likely to take risky business decisions that allow them to obtain a greater payoff, insofar as their recovery expectations are low-to-none unless they revert the distress situation. When shareholders also act as loan providers for the

[5] The Spanish Insolvency Law uses a broad definition of insiders, and refers to them as 'persons specially related to the debtor'. Insiders include, where the debtor is a corporation: (i) any shareholder holding at least ten percent of capital stock (five percent in the case of listed companies), unless the claim accrued prior to the acquisition of the shares (only as per financial claims), (ii) directors (also de facto or shadow) and managers (as per any claims irrespective of the accrual's date); and (iii) companies belonging to debtor's group of companies and their common shareholder, unless the claim accrued prior to the acquisition of the shares; as well as (iv) assignees of any of the foresaid claims within two years prior to insolvency declaration.

[6] James M Wilton and William A McGee, 'The Past and Future of Debt Recharacterization' (*The Business Lawyer*, Vol. 74, Winter 2018–2019).

company, they will be less prone to risk, since they will not receive such a great return from risky investments (risk shifting)[7].

At the same time, numerous arguments have been built in favor of limiting shareholder loans on the grounds of the negative effects they have on the corporate structure of the company. One of the main arguments refers to (1) the transfer of value from debtholders to shareholders. Since shareholders rank last in an insolvency scenario, by substituting equity for debt they would be transferring value to themselves that in a liquidation scenario would correspond to the company's creditors[8]. On another note, (2) shareholder loans can sometimes be granted in a scenario where liquidation is already inevitable[9] and, in such cases, the value of the distressed debtor could decrease in the course of the delay upon filing for insolvency.

The main argument that has been used against shareholder loans is (3) that of undercapitalization[10] and lies on core principles of corporate law. Undercapitalization refers to the situation where a company lacks enough equity to face the business risks inherent to its size and activity. Shareholders, in legal systems such as the Spanish[11], may decide to operate with very low levels of equity and finance the company through debt, hence, reducing their exposure to the risks attached to the company's activity. According to the undercapitalization theory, shareholders have, first, a general duty to provide the company with enough equity to undertake its business activity; and second, a duty to strengthen the equity of their undercapitalized company in a distressed scenario, rather than seeking a better treatment by financing the company through debt. These obligations derive from the shareholders' duty to exercise good business judgement when conducting their activity and rests upon good faith principles[12].

[7] Sanford U Mba, *New Financing for Distressed Businesses in the Context of Business Restructuring Law* (Springer, 1st edn, 2019), pp 42–43.

[8] Simon Landuyt, A capital question, should shareholder loans be automatically subordinated? (Financial Law Institute, Ghent University, 2018).

[9] Shareholders can sometimes favor questionable business decisions just to ensure that their equity interest in the company does not vanish, as would happen in a liquidation scenario.

[10] There are several situations that fall within the concept of undercapitalization. However, for this article's purpose, we will mainly refer to that scenario where the company has enough funds to carry out its business activity, but their shareholders have not provided them through equity, but through debt, and will therefore recover their investment as debtholders would, avoiding the main risks attached to the position of shareholder.

[11] The Spanish Royal legislative decree 1/2010, approving the consolidated text of the corporate enterprises act, establishes very low minimum capital requirements. In particular, limited liabilities companies shall need to maintain an equity level of at least three thousand euros, while joint stock companies' equity cannot fall below sixty thousand euros (art 4).

[12] Francisco Vicent Chuliá, *Introducción al Derecho Mercantil* (Tirant lo Blanch, 24th edn, 2022), pp 1383–1392.

Pursuant to the undercapitalization theory, shareholders that fund the company through debt instead of equity in a distressed scenario should be subject to liability. Theorist on undercapitalization have reasoned that shareholder loans granted in favor of undercapitalized companies should be regarded as equity and, hence, should rank below the rest of debtholders in a liquidation scenario, pari-passu with their equity contributions to the company's capital structure.

In this sense, policy makers from certain numerous countries have adopted measures to protect creditors from the negative effects of undercapitalization and shareholder loans.

Germany and the US represent the two main legal trends on creditor protection against shareholder loans, and while both promote subordination of loans granted by shareholders in distressed scenarios, the circumstances under which such subordination is applied, are very different.

Germany has some of the strictest rules against insiders' financing. Traditionally, pursuant to German law, any shareholder loan or equivalent financing was deemed to substitute equity as long as it was granted or was not immediately withdrawn by the time the company was in 'financial crisis'[13]. After an amendment of the German insolvency legislation in 2008, all loans granted by shareholders shall be subject to subordination[14]. German scholars have explained that the rationale behind this automatic subordination regime is that subordination of all shareholder loans ensures that the shareholders adequately participate in the entrepreneurial risk of the company[15].

In the US, the doctrine of subordination of insiders' financing, which was initially court-developed, is currently based on the rule foreseen in section 510(c) of the Chapter 11 of the US Bankruptcy Code[16]. Pursuant to such

[13] Under classic German insolvency law a company was in 'crisis' when it was either insolvent or 'unworthy of credit' (ie unable to obtain financing from third parties under the same terms as the one granted by the shareholder).

[14] D A Verse, 'Shareholder loans in corporate insolvency. A new approach to an old problem' (*German Law Journal*, 2008, p 1112). The removal of the requisite that the loan is provided during a 'financial crisis' was said to be inspired by the Spanish law on shareholder loans' subordination which, as will be explained in the next section of this article, also favors strict rules on automatic subordination of insiders' financing.

[15] *Ibid*, p 1115.

[16] The doctrine of shareholder equitable subordination has been complemented by US circuit courts through the principle of recharacterization of the relevant financing as an equity contribution. Recharacterization is not statutorily provided in the US bankruptcy legislation and does not rely on the conduct of the lender, but on whether the financing granted was meant to strengthen the capital structure of the business (hence, the business was undercapitalized). For the past four decades courts have attempted to set objective criteria for the application of the recharacterization principle, but no common understanding has been reached to date. However, it is generally understood that transactions entered at arm's length have a lesser potential to be recharacterized.

rule, bankruptcy courts are entitled to subordinate financing granted by lenders 'under principles of equitable subordination'. A loan shall therefore be considered inequitable where the relevant lender has received an unjustified advantage by it, or it has unfairly damaged the rest of the creditors of the distressed company[17]. For our purposes, the main group of cases where US courts have found conducts inequitable is that where dominant or controlling shareholders grant loans to the undercapitalized company that they control in a distressed scenario in order to improve their situation in their capital structure[18].

Most European legal systems include rules on subordination of shareholder loans similar to the two legal regimes described above. Others, such as UK, France, or the Netherlands, do not foresee specific rules or regulations on subordination of shareholder loans granted to companies in distress.

In all, there is no consensus on the most adequate approach to shareholder loans. One thing is certain, though: there are circumstances where creditor protection must give way to financing alternatives available to the debtor that can potentially increase its value and, by doing so, benefit all parties involved. That is the case of debtors who circumstantially find themselves in distressed scenarios. These debtors may experience financing restrictions that prevent rescue attempts by their shareholders that could ultimately result (1) in the maximization of the company's value, to be distributed amongst creditors and shareholders, and (2) in the greater preservation of the social welfare represented by the company, including the maintenance of jobs and the company's know-how, among others.

European countries are aware of the importance of addressing the issue of new financing in these distressed situations, although so far they have been unable to provide a united response to this matter. In this scenario, one of the objectives addressed by the European Commission in the Directive (EU) 2019/1023[19] is, in fact, promoting the protection of new and interim financing in restructuring scenarios (whereas (66) to (68) and Article 17) amongst Member States. However, the Spanish pre-legislator, favored to some extent by the vagueness of the rules on the promotion of distressed financing included in the Directive (EU)

[17] Xinyi Wang, The Legal Basis and Economic Rationale of Subordinating Shareholder Loans (Universiteis van Amsterdam, July 2019).

[18] Note, however, that US court have also found that undercapitalization by itself is not enough to justify subordination of shareholders loans (*In re Lifschultz Fast Freight*, 132 F.3d 339 (7th Cir. 1997)).

[19] 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.

2019/1023, falls short of the market's expectations, and shows a concerning indecisiveness when addressing shareholders loans, as will be addressed in the following sections.

3 The Spanish legal regime on shareholding financing in restructuring scenarios. A bumpy road soon to be stabilized

The Spanish legal regime has traditionally not (and, currently, does not) promoted nor protected insiders' financing within or without distressed scenarios. Instead, any sort of financing granted by insiders has been punished through equitable subordination and its severe consequences.

Paradoxically, the Spanish regime has adopted broader and more sensitive schemes in times of emergency. These amendments have embraced insider's financing when there has been a lack of other sources of financing. Although the Spanish legislator has indeed acknowledged that this financing promotes new money injections, these amendments have had a limited and temporary impact and have not constituted, so far, the 'default' rule in Spanish law. As a result, these temporary schemes, which moreover have not been consistent among them, have collated with times where the 'default rule' has applied.

This bumpy situation should come to an end with the implementation of the Directive (EU) 2019/1023. Although there is still a long way to go (please see section 5 of this article with our lege ferenda suggestions), the implementation of the Directive (EU) 2019/1023 will set certain protections over insider's new money as a 'default' rule and hence not an emergency-only resort.

3.1 The Spanish 'default' regime on insider's financing: absence of protection

The current 'default' regime foreseen in the Spanish Recast Insolvency Act ('SRIA') is the absence of protection over insider's financing in restructuring scenarios. Although Spanish law set a regime aimed at protecting new money granted in refinancing scenarios (50% is deemed as an administrative expense and the remaining 50% holds a general privileged claim[20]), this protection expressly excludes insider's financing (704.3SRIA). Noticeably, Spanish law also excludes from the new money protection contractually subordinated loans (eg PPLs), even if not granted by insiders (704.3SRIA). This entails that any new money granted by any insiders / specially related person to the debtor will automatically be subordinated.

[20] The Spanish 'default' regime does not grant new money with any priority over specific collaterals of the debtor nor envisages any sort of specific protection to the security granted to the new money.

The consequences of equitable subordination are severe, also in restructuring scenarios. Although insider's claims will not be considered for majority calculation purposes and are deprived from voting rights, their claims are bound by the terms of the refinancing agreement in case it is approved (607.3 SRIA). More significantly, in the event of subsequent insolvency of the debtor, any security granted in favour of insiders will be automatically terminated by the insolvency court (302.1 SRIA). These are 'hard law' provisions in the sense that even if all the parties involved in the transaction where to agree otherwise, these rules would still apply ope legis.

The only exception set forth in the Spanish regime deals with the concept of 'insider'. Indeed, those creditors that directly or indirectly equitize all or part of their claims in the context of a refinancing agreement will not be deemed as a 'specially related person' in the event of subsequent insolvency of the debtor (283.2 SRIA). However, this regime does not protect those creditors of the company who already qualify as 'insiders' before the refinancing agreement is executed.

3.2 The Spanish regime on insider's financing in times of emergency

The severe Spanish 'default' regime has been lifted in two specific occasions. We refer to Act no. 17/2014 of September 30 (the 'Act 17/2014'), approved in the context of a relevant financial crisis and to the Act no. 3/2020, of September 18 (the 'Act 3/2020'), approved in the context of the COVID-19 outbreak. Both acts were aimed at introducing urgent measures in Spanish law to palliate the severe effects of their respective crisis situations.

Act 17/2014 temporarily protected insiders' financing for the first time in Spain. Although the Spanish legislator acknowledged that this protection promoted new money injections[21], this regime was envisaged to apply only during a 2-year term (it was envisaged as a 'extraordinary and temporary' measure[22]).

Act 17/2014 considered as an administrative expense the 100% of new money funds granted in the context of the refinancing agreement. Act 17/2014 expressly allowed insiders to benefit from this temporary regime. Claims against the estate are paid on a cash flow basis, and hence are granted with a 'senior' treatment over the rest of insolvency claims[23]. The only exceptions set forth in

[21] 'Likewise, as a measure to promote the granting of new financing [. . .]' Explanatory memorandum (*exposición* de motivos) of the RD 4/2014.

[22] Explanatory memorandum (*exposición* de motivos) of the Act 17/2014.

[23] Except for secured claims, who in any event hold an absolute priority over the proceeds obtained from the collateral.

Act 17/2014 are: (1) the new money protection only covered the principal amounts, excluding any accrued interests linked to the new money (deemed as subordinated claims); and (2) the regime did not protect any financing granted through a capital increase.

Act 17/2014 was in force until October 2, 2016. As from that date, the application of the Spanish 'default' regime was resumed.

In the context of the COVID-19 outbreak, Spain enacted several insolvency emergency measures aimed at suffocating the effects of the pandemic in Spanish debtors. These laws tackled the crisis from different insolvency fronts. Some were aimed at granting debtors with greater room for maneuver towards insolvency situations and postponed the duty to file for insolvency (the deadline is currently set on 30 June 2022). Other measures were aimed at protecting the potential cash shortfalls that debtors could suffer and (again) enhanced new money injections, even if granted by insiders.

Once again, the Spanish legislator acknowledged that these sorts of measures were aimed at 'encouraging and incentivizing' new money injections, and that the purpose of the transitory amendments was 'easing the access to funds and liquidity' of Spanish corporations[24].

Indeed, Act 3/2020 considered that new money injections would be qualified (at least) as ordinary claims in a subsequent insolvency proceeding of the debtor, even if granted by insiders. This protection also covered indirect cash injections, as the rule also considered as non-subordinated claims those in which the insider subrogated because of the payment of the relevant claims on behalf of the debtor (ie regrettably, the rule did not envisage buy-back operations).

Act 3/2020 granted greater protections than Act 17/2014, as it protected all amounts linked to the new money injection (ie including the applicable interest). More importantly, although not crystal clear in the language of the rule, Act 3/2020 seemed to allow insiders to retain the insolvency ranking they should be entitled to. Arguably, this meant that insiders' financing holding security should be allowed to qualify as a specially privileged creditors and retain its security in a subsequent insolvency declaration of the security provider (and hence avoid the severe rule set forth in 302. 1 SRIA) or to benefit from the 'new money' privileges granted within a refinancing agreement[25].

[24] Explanatory memorandum (*exposición* de motivos) of the Act 3/2020.

[25] Note, however, that although this seems to be purpose of Act 3/2020, neither Articles 302.1 and 704.3 TRLC were amended or their applicability was temporarily suspended. This could have brough t an internal conflict of laws that, to our knowledge, has not been raised in practice.

Noticeably, this new money injection (and the security granted in its benefit) was not somehow linked to any refinancing agreement, meaning that there was a lack of ex ante control over the terms of this new money or its security by the relevant creditors.

Act 3/2020 also had a limited temporary impact. The new money protections only applied to insolvency proceedings declared up until 14 March 2022. Any new money injections done by insiders during 2020–2022 will be deemed as subordinated in insolvency proceedings declared after 14 March 2022 (until Spanish law is amended – please see below).

In this regard, we note that whilst Act 3/2020 was well envisaged as per the new money protections, its temporary regulation was deficient. A sensitive approach would have been to protect the new money injections granted during a given term (eg March 2020 – March 2022). It makes no sense to protect only those new money injections that fail to meet its purpose. The deadline was counter-productive, as it promoted insolvency filings before 14 March 2022 aimed at protecting the new money claims rather than to ensure debtor's continuity. The deadline was also counterintuitive, as Act 3/2020 stayed debtor's duty to file for insolvency until 30 June 2022.

In any event, as from 14 March 2022, the Spanish 'default' regime became again the applicable rule and insider's financing is not protected anymore.

3.3 The implementation of the Directive (EU) 2019/1023 as the new 'default' rule

The bumpy path and the interplay between the 'default' rule and emergency laws will probably come to an end with the implementation of the Directive (EU) 2019/1023 in Spain. Although the Directive (EU) 2019/1023 did not contain any hard law provisions in this regard, the Spanish legislator will also allow insiders to benefit from the new money / interim finance protections.

Pursuant to the Draft bill of amendment of the Spanish Recast Insolvency Act for the transposition of Directive (EU) 2019/1023, dated January 14th, 2022 (the 'Draft Bill')[26], insiders will be able to resort to the protections set out below as long as the following requisites are met: (1) new / interim financing (the new

[26] Proyecto de Ley 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 par*a aumentar la eficiencia de los procedimientos de reestructuración, insolvencia y exoneració*n 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 (Direc*tiva sobre reestructuració*n e insolvencia).

money) is granted in the context of a court-sanctioned restructuring plan; and (2) the restructuring plan affects 2/3 of the total liabilities of the debtor (excluding, for this majority calculation purposes, the insiders' claims).

As opposed to the regime set forth in the Act 3/2020, the Spanish legislator has considered that new money can only be protected to the extent included in a court-sanctioned restructuring plan affecting a significant majority of the total liabilities of the debtor. In other words, new money can only be protected so long it is consented by certain creditors (at least, secured creditors or in the money creditors).

In case the above requisites are met, new money granted by insiders will have the following treatment: 50% of the new money will qualify as an administrative expense (pre-deductible from the estate, as it is payable on a cash flow basis); and the remaining 50% will be treated as a general privilege claim (ie senior to unsecured ordinary claims). Also, the new money will be shielded from potential clawback actions as it will benefit from the clawback protection tied to the court-sanction of restructuring plans. Although not expressly addressed, any security in favor of the new money would also benefit from any such clawback protection to the extent the parties envisage the security as an element required to implement the restructuring plan.

4 A critical analysis of the Spanish subordination regime

The new Spanish 'default' rule included in the Draft Bill shows significant progress on the regulation on insiders' distressed financing, compared to the classic 'default' regime on automatic subordination. Spain seems to finally address, with partial success, the trade-off between creditor protection and the desirability to enable viable debtors in financial difficulties to continue business. However, the proximity of emergency measures much more ambitious in terms of the promotion of insiders' financing makes the 'default' rule included in the Draft Bill appear insufficient.

In our opinion, the Spanish law regime on insiders' financing suffers from, at least, two problems: (i) first, both 'default' subordination rules, classical and included in the Draft Bill, rely excessively on the subjective element of the financing provided; and (ii) second, the Draft Bill subjects the new protection to insiders financing to the prior approval of the financing of its creditors and the subsequent court-sanctioning of the plan.

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4.1 The unfortunate maintenance by the Spanish pre-legislator of subjective criteria as basis for the regulation on insiders' distressed financing

The Directive (EU) 2019/1023's soft law approach to the issue of new financing in restructuring scenarios contributed to the half-hearted solution proposed by the Draft Bill. Indeed, while Article 17 of the Directive (EU) 2019/1023 promoted the adequate protection of new and interim finance in restructuring transactions, it also allowed Member States to exclude that protection on 'additional grounds laid down by national law', amongst which whereas no (67) referred to 'certain type of relationship between the parties which could be associated with a conflict of interest, such as in the case of transactions between related parties or between shareholders and the company'. These grounds, regrettably, allowed the Draft Bill to maintain the Spanish traditional approach to insiders' financing.

As described in section 3 above, the Spanish legislator values negatively the potential power position and qualified information that those persons close to the relevant company may have. In this sense, the automatic subordination rules aim, on the one side, to counter this potentially prominent position and, on the other, to prevent the problem of undercapitalization. Ultimately, subordination would act as a tool to reallocate the financial risks derived from the insolvency of the company, downgrading the debt instruments owed to those who were in the best position to analyze and control the company's business activity and did not adequately capitalize it[27].

There is no doubt that this approach to insiders' financing offers advantages in terms of enforcement. Automatic subordination of all types of financing granted by insiders allows for the reduction of costs (financial, time, etc.) attached to the high volumes of litigation that entail subordination regimes based on the equitability of the financers' behavior. Courts in Spain are not burdened with the difficult task of analyzing the motives and effects of the financing granted by insiders, which would further penalize a judicial system already overloaded.

However, we believe (as do most of the scholars that have addressed the matter) that the problems attached to the Spanish regime on automatic subordination outweigh the advantages it offers. First, automatic subordination rules based on strict subjective conditions on the creditor's side fail to evaluate whether those conditions translate into the power and information position that they wish to

[27] Alberto Vaquerizo, La *protecció*n de los *cré*ditos derivados de la *financiació*n nueva (fresh money) en las reestructuraciones preconcursales (Anuario de Derecho Concursal 48, Septiembre-Diciembre 2019).

penalize[28]. Second, automatic subordination rules can prevent new financing granted by the insiders of a company that is not undercapitalized (e.g., a company under temporary liquidity constraints caused by circumstances beyond its control that needs rapid financing to continue with its business). Third, automatic subordination rules prevent an evaluation of the material aspects of the financing and the proposed rescue attempt that may show that they are beneficial for the company. And fourth, automatic subordination rules neglect that intra-group financing is frequently inherent to the operation of groups of companies, and companies within a group may decide to finance others with the sole purpose of maintaining their own value (ie without any sort of fraudulent intent)[29].

In all, the Spanish default automatic subordination regime, by focusing excessively on insider's potentially qualified power and knowledge rather than on the efficiency of the company's capital structure and the effect that the new financing would have over it, hinders some potentially effective restructurings promoted by its insiders[30].

The automatic subordination of insiders' financing, in our opinion, is not an effective tool to prevent the problems that it aims to correct. Although the Draft Bill allows to overcome the 'default' automatic subordination rules under specific circumstances, since it is based on the same subordination principles than the classical 'default' subordination regime, it suffers from the same problems affecting it. In short, unless the final version of the bill of amendment of the Spanish Recast Insolvency Act shifts the rationale of the limitations imposed to insiders' financing towards rules based on material aspects of the

[28] Alberto Díaz Moreno, Observaciones sobre administradores, acuerdos de *refinanciació*n, *«fresh money» y subordinació*n (Revista de Derecho Mercantil n 303, Aranzadi, Enero – Marzo 2017). I.e., all those qualifying as insiders under Spanish law would have their financial claims subordinated in an insolvency scenario, regardless of whether they influenced the company's business decisions, the degree of information they had over its financial situation, or the intent (fraudulent or not) that guided their decision to finance the company.

[29] Juana Pulgar Ezquerra, *Financiación preconcursal interna de empresas en reestructuración: ré*gimen vigente y normas temporales COVID-19 (Revista de Derecho Concursal y Paraconcursal n.º 34/2021, Nº 34, 1 de ene. de 2021, Editorial Wolters Kluwer).

[30] Martin Gelter in The Subordination of Shareholder Loans in Bankruptcy (Discussion Paper No. 4, 01/2005, Harvard Law School) proposed an economical analysis that showed that automatic subordination rules, on the one side, did not prevent some inefficient restructurings and, on the other, had an important deterrent effect over efficient restructurings. Examples proposed by Gelter included the situation where a company facing a restructuring is overindebted, in which case shareholders may not promote rescue attempts through capital injections, even when they believe that the company can overcome its distressed situation, because the potential increase in the company's value generated by the rescue attempt will be primarily allocated to the company's creditors . Also, Gelter explained that there will be situations where creditors may promote the liquidation of a company's assets instead of a potentially successful restructuring in order to avoid risks attached to the rescue attempt, when they believe that their position is adequately covered with the company's liquidation value.

financing proposed, we will continue to deal with a regime that each day seems a bit more outdated[31].

4.2 Implementation of the Draft Bill: the need to find a holistic solution to all stakeholders which avoids unnecessary tolls

The Directive (EU) 2019/1023 does not address the treatment that should be granted to insiders' financing in a manner that allows the debtor to avoid a non-consensual restructuring plan. Consistently, the Draft Bill also does not give a local solution to the issue described above. This is, in our view, inconsistent with the new paradigm sought by the Directive (EU) 2019/1023 and does not procure a holistic solution to all elements concurring in a distressed scenario.

The Directive (EU) 2019/1023 and the Draft Bill have put insiders yet as another element of the restructuring equation (they will be an 'affected party'). Shareholders will be deprived from their inherent veto right to refinancing agreements: in the money creditors will be able to impose non-consensual restructuring plans (the 'equity cramdown') and are allowed to block defensive insolvency petitions filed by the debtor. This can result in the 'expropriation' of the debtor, as creditors will be able to impose insiders' a great variety of measures, such as debt-for-equity swaps. Although shareholders will be vested with limited defense grounds (voting and challenge rights), they will be deprived from (almost) all their leverage in distressed scenarios.

Shareholders bear the equity cramdown risk only in the event of current or imminent insolvency. Not in the event of likelihood of insolvency. Accordingly, the purpose of the directive is to promote preventive restructuring scenarios[32] and to promote debtors from reaching consensual restructuring plans in the zone of 'likelihood of insolvency'[33] given the risks that 'current or imminent' insolvency brings to the debtors.

Although this makes perfect sense from a macroeconomic perspective and pursues a legitimate purpose, it puts the focus only in the shareholders' end and

[31] As Pulgar Ezquerra pointed out in *Financiació*n interina, nueva *financiació*n y planes *de reestructuració*n (Revista General de Insolvencias & Reestructuraciones 3/2021, Octubre 2021), the market has long stopped considering companies' equity as a safe harbor for creditors in financial distress scenarios. Professional lenders nowadays have their own resources to analyze the financial situation of a company before deciding to finance it. Also, financial covenants, aimed at controlling the risk attached to a facility and gathering financial information from the company, are common.

[32] See, for instance, Whereas no (2) of the Directive (EU) 2019/1023.

[33] Whereas no (2) of the Directive (EU) 2019/1023: 'thereby helping to reduce the risk of loans becoming non-performing in cyclical downturns and mitigating the adverse impact on the financial sector.'.

does not consider potential conflicting interest between creditors and shareholders. Hence, some creditors (at least, those in the money) may not have incentives to approve a consensual restructuring plan with the debtor or consent its new money financing on the basis that in the money creditors can impose their own plan / inject new money with significant better terms once the debtor enters the 'current or imminent' insolvency zone, which can even be potentially triggered anytime by the creditor itself[34].

Neither the Directive (EU) 2019/1023 or the Draft Bill addresses this situation. Indeed, some Spanish authors have already labelled the new shareholders position with the following description: 'recapitalize or deliver (the business)'[35]. However, whilst the Directive (EU) 2019/1023 focuses on the ability to force a 'delivery' of the business, it does not grant insiders with room of maneuver in the 'recapitalization' of the business.

Although nothing prevents insiders from recapitalizing the debtor, there are no legal incentives to the 'recapitalization' of the business. Spanish law keeps automatically punishing such recapitalization via an automatic equitable subordination of all the new money proceeds, with cancellation of security.

This situation may potentially put the debtor in the following dichotomy: (a) whether it takes the risk of recapitalizing the business through subordinated new money in case the debtor ends up in an insolvency proceeding (with potentially very low recovery expectations[36]); (b) whether it allows lenders to take control of the company through a non-consensual restructuring plan where the shareholders can be significantly diluted. This dichotomy might have perverse incentives, as whilst the debtor may not wish (or be capable of) assuming higher financial risks, it may also not want that lenders take control of the business. This might trigger premature insolvency petitions, which are usually value-destructive and tend to lean towards liquidation schemes.

Whilst it is true that the Draft Bill will allow certain protection to new money granted by insiders, this protection will be subject to (1) new money being granted in the context of a court-sanctioned restructuring plan; and (2) the

[34] The line between the 'likelihood of insolvency' and the 'current or imminent' insolvency can be thin both from a conceptual and a practical strandpoint. Indeed, an acceleration notice sent by the debtor (even if based on a 'soft' breach) will trigger the 'imminent or current insolvency'.

[35] F Garcimartin, El conflicto socios-acreedores en la reestructuración preconcursal: 'recapitaliza o entrega', at https://almacendederecho.org/el-conflicto-socios-acreedores-en-la-reestructuracion-preconcursal-recapitaliza-o-entrega, last accessed on May 13, 2022.

[36] Note that the current regime even punishes succesful new money injections from insiders. This is, the new money that potentially may have helped to overturn a transitory insolvency situation (eg because it is used to pay due suppliers' claims), will still be subordinated in a subsequent insolvency situation that appear months/years after.

restructuring plan affecting 2/3 of the total liabilities of the debtor. Accordingly, any new money must be approved by all classes of creditors (or, at least, those in the money under non-consensual schemes). Therefore, the potential conflicting interest between creditors and shareholders situation described above remains applicable. Lenders (or at least those in the money) may prefer injecting themselves new money with significant better terms (which will be able to impose to the debtor) or to directly take control of the business.

Conditioning the new money protection to the consent of the creditors (through its inclusion in a restructuring plan) is therefore an unnecessary toll that insiders will have to bear in case they want to 'recapitalize' the company to prevent any 'delivery' of the business. First, creditors might not have incentives to approve any such restructuring plan as they might be able to impose their own -better-terms over time (which can be, indeed, relatively short). Second, creditors will have incentives to include other elements (eg an better coupon, new security) in any such restructuring plan initially envisaged only to protect the new money. The commencement of a restructuring process may result in the opening of a can of worms, which the debtor will want to avoid at all cause. Third, recapitalization of the business should be incentivized, and not pushed to a costly and burdensome process, where third party experts (restructuring expert) and other advisors (lender's advisors) will be involved.

The Draft Bill should grant insiders with a legal mechanism to fight the risk of expropriation of the business through recapitalization. We understand this is an objective that ultimately meets one of the purposes of the Directive (EU) 2019/1023[37]. Although we very much welcome the new mechanism that the Draft Bill will implement, we are also of the view that the Draft Bill has not worked toward and holistic solution and has only approached the problem from a single angle (the shareholders position and their (in)ability to block restructuring processes), whilst has not vested shareholders with legal mechanisms allowing them to avoid a situation where they will lose all their leverage and, ultimately, their business.

5 Proposal de lege ferenda – towards an efficency test

In today's market, creditor protection cannot justify measures that unquestionably have the potential to prevent efficient restructurings. The Directive (EU) 2019/1023, clearly includes the rescue of the distressed company within the

[37] Article 4 of the Directive (EU) 2019/1023: 'Member States shall ensure that, where there is a likelihood of insolvency, debtors have access to a preventive restructuring framework that enables them to restructure, with a view to preventing insolvency and ensuring their viability, without prejudice to other solutions for avoiding insolvency, thereby protecting jobs and maintaining business activity.'.

objectives of pre-insolvency law for all EU Member States and, under this premise, there is no reason to impede insiders' finance where it has the potential to increase a business's value as a going concern.

On this basis, Spanish law should envisage a scheme allowing insiders to avoid expropriation of the debtor whilst ensuring that creditors' rights are equally protected. In our view, the main features of this suggested new scheme de lege ferenda should be as follows.

The first item that should be addressed is whether all or only some insiders' financing should be protected (eg that granted by shareholders). On one side, with the purpose of avoiding expropriation, there are arguments to sustain that direct shareholders financing should be protected. On the other, based on the power and control principles inspiring the subordination rules referred to in section 4 above, the same could be said about all those insiders whose position vis-à-vis the debtor does not allow them to obtain privileged information or exercise any control over it. In all, we do not see strong arguments in favor of a subordination model purely based on the subjective characteristics of the 'insider', rather than on the circumstances, purpose and effect of the new money financing.

A second point is whether the new money must be subject to court-sanction or approval by a vast majority of creditors. In our view, as detailed in Section 4 above, new money should not necessarily be subject to court and lenders' approval. Insiders should be able to decide whether they want to grant the new money within a full restructuring scheme (where other measures will likely be implemented) or without resorting to such scheme. This decision, which has not been reflected in the Draft Bill, would be sheltered by the wording of the Directive (EU) 2019/1023[38]. Accordingly, the new money granting should not be necessarily linked to the approval of a restructuring agreement and/or to the creditor's consent[39]. Spanish law should not discourage insiders from granting new money (be it through the need of conducting a restructuring process,

[38] Article 17.2 of the Directive (EU) 2019/1023 sets that 'Member States may provide that paragraph 1 shall only apply to new financing if the restructuring plan has been confirmed by a judicial or administrative authority, and to interim financing which has been subject to ex ante control' (emphasis added).

[39] Note that the Directive (EU) 2019/1023 links the 'new financing' to a restructuring plan, as it is defined as 'any new financial assistance provided by an existing or a new creditor in order to implement a restructuring plan and that is included in that restructuring plan'. In turn, 'interim financing' is not linked to a restructuring plan but, at least, a pre-insolvency notice (as per Spanish law), as it is defined as 'any new financial assistance, provided by an existing or a new creditor, that includes, as a minimum, financial assistance during the stay of individual enforcement actions, and that is reasonable and immediately necessary for the debtor's business to continue operating, or to preserve or enhance the value of that business'. On this basis and in relation to Article 17.1 and 17.2 of the Directive (EU) 2019/1023, we understand the Draft Bill could have adopted an approach where 'new money' was not necessarily linked to court/lenders' consent.

through a costly and burdensome process or through automatic equitable subordination). Instead, it should make available legal mechanism encouraging new money granting.

The scope of the protection is also a critical point. The current regime focuses on (1) equitable subordination protection, through the 'upgraded position' in the insolvency payment waterfall (and hence maintenance of the existing security); and (2) through clawback protection. The Draft Bill grants both protections to any new money provided by insiders (so long it is court-sanctioned). We believe this regime should be accommodated to our suggestion that not all (protected) new money should be granted within a restructuring plan.

New money which is subject to an ex ante court control (ie within a restructuring plan) should be granted equitable subordination and clawback protection. The rationale is that, in case both the relevant court and majority of creditors (or, at least, those in the money) consent the terms of the new money and its security, this new money should be protected as if it had been granted by a third party. The requisite that such plan is supported by qualified majorities for those protections to be triggered, as some parliamentary groups have put forward through proposals for legislative amendments to the Draft Bill[40], is unnecessary, and should therefore be removed.

Conversely, we understand that new money which is not subject to an ex ante control should not automatically benefit from any of those protections. Instead, the Spanish legislator should set a number of objective elements allowing insiders to protect the new money transactions (the financing and the potential related security), which ought to be analyzed on the framework and following the SRIA rules on credit classification.

This way, insiders would maintain their classification as specially related persons to the debtor when the legal requisites concur. However, insiders' new money granting would be included amongst those credits owned by insiders that pursuant to 281.2 SRIA elude the subordination regime under certain circumstances[41].

We understand the difficulty of determining a set of enforceable rules allowing to elude the subordination regime. However, several authors cited in this

[40] Mainly, the parliamentary group pertaining to Partido Popular, the main Spanish conservative party.

[41] Equally, securities granted in favour of insiders will not be automatically terminated by the insolvency court, since the rule forseen in art. 302.1 TRLC only applies to subordinated claims, ie it do es not necessarily rely on the insider condition of the claimholder.

article have put forward their proposals, which we largely share[42]. In this regard, insiders' financing should not be subordinated: when it has been granted in a distressed scenario, and as long as it passes a test to determine if the new money was aimed at promoting an efficient restructuring.

This 'efficiency test' would analyze (a) if the financing was necessary (at the time granting) for the continuation of the business activity of the debtor, (b) if it was granted under market standards; and, more importantly, (c) if an increase in the company's value as a going concern was to be expected at the time it was granted. So long the 'efficiency test' is fulfilled, new money financing granted by insiders would not be deemed as subordinated lenders.

Although new money financing not subject to an ex ante control would not fall within a safe harbor against clawback actions, we believe that new money passing the above 'efficiency test' should not present major clawback risk. Clawback actions filed against the new money or the security would benefit from the rebuttable presumption of detriment set forth in Article 228.1º SRIA, hence it would fall to the insider to provide evidence that the relevant act or agreement was not detrimental to the estate at the time of granting. However, to the extent insiders manage to evidence that the 'efficiency test' was fulfilled (and that the security package was also within market standards) and that the new money financing had a direct or indirect benefit for the estate, insiders should be able to avoid successful clawback actions (except for securities that did not meet market standards granted over the most valuable collaterals[43] of the debtor, or that had an 'expropriatory' nature).

On this basis, the automatism of the equitable subordination mechanism would be shifted by a more flexible approach, fully aligned with the purposes of the Directive (EU) 2019/1023, which promotes capitalization of companies whilst the stakeholder's interest is preserved through an 'efficiency test'.

[42] Gelter, The Subordination of Shareholder Loans; Buil Aldana, Socios y *financiació*n en tiempos de Crisis COVID-19.

[43] J Pulgar Ezquerra, 'Financiación interina, nueva financiación y planes de reestructuración' (Revista General de Insolvencias & Reestructuraciones 3/2021, Octubre 2021).

Chapter 16

The Cooling-off Period of the Undisclosed WHOA in European Perspective

D.J. (Dennis) Helmons
Turnaround Advocaten
The Netherlands

1 Introduction

Dutch insolvency law is dynamic and subject to continuous renewal, due to Dutch legislature and due to Europe[1]. The changes and innovations have followed each other in rapid succession in recent years, which is good news: it is and remains a relevant and dynamic area of law. But these changes can also have international consequences. This is particularly the case with the new *Wet Homologatie Onderhands Akkoord* (hereinafter referred to as the 'WHOA'), which became law on 1 January 2021[2]. The WHOA is widely published in Dutch literature, case law is thoroughly analysed and much is still being discovered by practitioners.

The WHOA provides food for thought in the Netherlands, but the international aspects of, for instance, the cooling-off period have been discussed rather briefly or only to a limited extent so far. The intent of this article is to further flesh out the debate on the (international) consequences of a mechanism under the WHOA: the 'cooling-off period'. First, I will explain the WHOA in broad outline, then the cooling-off period under the WHOA and its requirements will be discussed. Furthermore, the discussion of the status of the undisclosed WHOA procedure in Europe, whether it falls under the Insolvency Regulation or under Brussels I *bis*, or whether it falls under neither, will be briefly presented and addressed. Finally, the cooling-off period that is granted to a debtor with Dutch assets/properties versus a European creditor is discussed. What also will be discussed is the situation that a debtor has assets/commodities outside the

[1] HvJ EU 28 April 2022, ECLI:EU:C:2022:321 (*Heiploeg*).

[2] *Kamerstukken II* 2018/2019, 35 249, nr. 3.

Netherlands, but inside Europe, and the consequences of the cooling-off period on those assets/commodities[3].

2 Introduction to the WHOA

Until 1 January 2021, it was not yet possible under Dutch law to offer an undisclosed out of court restructuring plan to creditors outside of bankruptcy, whereby dissenting creditors could also be bound by that agreement. Exceptions are cases in a suspension of payments or bankruptcy situation, where this was and is possible[4]. Until 1 January 2021, the foregoing implied a gap for companies for their restructure abilities outside of bankruptcy. Outside a bankruptcy situation they could offer an amicable agreement, but a single creditor could then reject this offer in principle and thus make an agreement impossible. This was the case because all creditors had to agree to the agreement, which gave a single creditor a hold-out position and secure a higher payment, or to (unreasonably) improve his position compared to his actual position above other creditors.

Central to civil law in the Netherlands is the principle of freedom of contract (apart from some mandatory provisions in the Dutch Civil Code). Based on this principle a creditor who wants full payment of his claim and who can reasonably be expected to do so, cannot be blamed for not accepting an offer or discount and thereby making a consensual agreement impossible. Only if there is abuse of right by the creditor to not agree with the agreement, while he could reasonably have been expected to do so, can this constitute as abuse of rights on the grounds of Article 3:13 Dutch Civil Code[5]. Under such (specific circumstances) a creditor may be ordered by the court to agree with the proposed agreement. However, this is applied with restraint due to the principle of contractual freedom between the parties. Therefore, it was (and still is) possible for one sole creditor to block an consensual agreement, subject to the aforementioned exception that that creditor could still be forced by the court to agree to the proposed agreement.

The legislator's intention was to give the legal practice an extra instrument to better deal with this situation in certain cases, also to meet the developments on European level through the Restructuring Directive. Due to the introduction of

[3] The article is therefore limited to companies that are going through a Dutch WHOA with assets in the Netherlands, or that have assets in Europe for which a cooling-off period (under Dutch law) has been declared.

[4] Article 138 Dutch Bankruptcy Act (hereafter: 'DBA'), Article 153 DBA, Article 252 DBA and Article 272 DBA.

[5] Article 3:13 DCC.

the WHOA, it is possible to offer a different solution for these cases as well, thus preventing bankruptcy, or at least making an attempt to do so. The introduction of the WHOA came at a 'favourable' time when the Netherlands was hit hard by the Corona crisis. More than a year later, 120 published (interim-)decisions (and ditto amount of unpublished decisions) regarding the WHOA can be found, mainly concerning SMEs.

When introducing the WHOA, the legislator sought a link with the Restructuring Directive[6]. The WHOA makes it possible for a debtor to bind dissenting creditors to his offered agreement, because the court can confirm the proposed plan[7].

The WHOA consists of two parts: the public WHOA procedure and the undisclosed WHOA procedure (hereafter referred to as 'the undisclosed WHOA procedure'). The two WHOA procedures differ substantially from each other, but then again they do not. The only difference is that the public WHOA procedure is published, the proceedings are public and the public WHOA procedure falls under the Insolvency Regulation and is included in Annex A.

The undisclosed WHOA procedure is not published and the proceedings take place behind closed doors, the undisclosed WHOA procedure is not included in Annex A to the Insolvency Regulation and according to the Dutch government this WHOA procedure does not fall under the Insolvency Regulation or under Brussels I *bis*[8]. This statement has been the subject of discussion in the literature. I will discuss this in more detail in section 4 of this article.

When can a debtor apply for the WHOA? The WHOA is available to debtors who expect to be unable to meet their obligations in the long (or short) term, but who are fundamentally viable as a company[9]. It is up to the (board of the) debtor to decide which creditors and/or shareholders he wants to include in the agreement. These can be all creditors and shareholders, but it can also be a (select) part thereof or even one specific creditor or shareholder. The agreement may be offered by the debtor himself or by a restructuring expert appointed by the court at the request of the debtor, at the request of the debtor's works

[6] *Kamerstukken II* 2018/2019, 35 249, nr. 3, pp 3–4, Regulation (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 (Directive on restructuring and insolvency).

[7] Article 383 DBA and Article 384 DBA.

[8] *Kamerstukken II* 2018/2019, 35 249, nr. 3, pp 6–7.

[9] Article 370 DBA.

council or staff representation or at the request of creditors. Once a restructuring expert has been appointed, only the restructuring expert can offer an agreement. The debtor can prepare an agreement and submit it to the restructuring expert with the request to offer it to the creditors. However, the restructuring expert may disregard this request if the agreement offered by the debtor is not in the interest of the joint creditors[10]. The WHOA also offers the possibility of appointing an observer at the request of the debtor, or ex officio by the court[11]. The observer's task is to monitor the interests of the creditors in the WHOA procedure. If no restructuring expert has been appointed, an observer can be appointed; these positions are mutually exclusive. There cannot be a restructuring expert and an observer in one WHOA procedure at the same time[12]. In practice we see more appointments of restructuring experts and less appointments of observers.

What is the further course of a WHOA procedure? The 'goal' is to offer an agreement that is eventually approved and confirmed by the court. The proposed agreement has to classify the different creditors and/or shareholders whose rights are affected by the WHOA[13]. Examples include SME creditors, creditors with retention of title, creditors with security rights, preferential creditors and so on. It is up to the debtor (or the restructuring expert if appointed) to make the classification and to classify the creditors into the various classes. The draft of the proposed agreement has to be offered to all classes of creditors and shareholders and they have to vote on it. A class will agree to the proposed agreement if there is a two-thirds majority in that class.

The WHOA agreement can be submitted to the court for approval if at least one in-the-money creditor has agreed to the WHOA agreement. An in-the-money creditor is a creditor that would also receive a (partial) payment in the event of bankruptcy. It is therefore very important in a WHOA procedure to have an in-the-money class agree to the agreement. This class can then also bind any dissenting classes to the WHOA agreement once it is confirmed by the court[14]. Requesting the court to confirm the WHOA agreement is not without risk. A hearing will be ordered and the court will have to examine the grounds for rejection mentioned in the law to determine whether the WHOA agreement offered meets all the conditions[15]. These are both (i) general mandatory grounds for rejection and (ii) specific grounds for rejection. During and prior to

[10] Article 371 DBA.
[11] Article 380 DBA.
[12] Articla 380 DBA.
[13] Article 374 DBA.
[14] Article 385 DBA.
[15] Article 384 DBA.

the hearing, individual creditors can submit a substantiated request to the court to reject the confirmation of the proposed WHOA agreement[16].

The unique feature (for the Dutch landscape) of the WHOA procedure is that the debtor remains in full control over the company (the so-called debtor in possession)[17]. This is also the case if a restructuring expert or an observer is appointed at the company. In other Dutch insolvency proceedings, such as bankruptcy or suspension of payments, the debtor is not a debtor in possession and a trustee or administrator is appointed by the court. The debtor then loses the management of the company (in case of bankruptcy) or he has to request permission from the administrator to perform legal acts (in case of suspension of payments)[18].

The WHOA also has various instruments that the debtor or the restructuring expert can use. An especially important and interesting instrument, with possible international consequences, is the cooling-off period.

3 The cooling-off period

For this article, only the cooling-off period in an undisclosed WHOA will be addressed in European aspects. Firstly, the European aspects of a Dutch cooling-off period in the Netherlands by a Dutch debtor will be addressed. Secondly, the international aspects of a Dutch cooling-off period where the debtor has assets which are not located in the Netherlands will be addressed.

The debtor or the restructuring expert can apply for a cooling-off period if the following requirements are (summarily) met, which is not a guarantee that the court will actually grant the cooling-off period[19]:

- The cooling-off period is necessary to be able to continue the business conducted by the debtor during the preparation and negotiation of a settlement agreement, and
- At the time of the announcement of the cooling-off period, it can be reasonably assumed that the interests of the joint creditors of the debtor will be served and that the interests of third parties, garnishers and any creditors who have filed for bankruptcy will not be substantially prejudiced.

[16] Article 383 DBA and Article 384 DBA.

[17] *Kamerstukken II* 2018/2019, 35 249, nr. 3, p 27.

[18] Article 68 DBA and Article 228 DBA.

[19] Article 376 DBA.

The cooling-off period is valid for a period of four months and can be extended once by a maximum of four months, so that the total duration of a cooling-off period is eight months[20]. This maximum period of eight months cannot be extended or exceeded.

During the cooling-off period, any third-party right of recourse against assets belonging to the debtor, or if creditors wish to enforce against assets under the debtor's control cannot be exercised without authorisation from the court[21]. The court may also lift attachments at the request of the debtor or the restructuring expert. Under a cooling off period, pending bankruptcy requests, requests for suspension of payments or a petition for the debtor's own bankruptcy are suspended. All this is intended to allow the debtor to prepare and offer a WHOA agreement in relative peace.

The crux of the matter lies in the provision that, under Dutch law, the cooling-off period extends to <u>any</u> third-party right of recourse in respect of goods that are part of the debtor's assets, or third-party goods that are in the debtor's control. Any (international) exclusion of rights is not mentioned. The question is therefore: does a cooling-off period declared in the Netherlands in an undisclosed WHOA procedure extend to goods that are not located in the Netherlands but in Europe, and will European creditors also be confronted with the declared Dutch cooling-off period in respect of their goods with a debtor that falls under the WHOA? Before I get to that question, I will first discuss and explain a current discussion in Dutch literature.

4 Discussion Brussel I *bis* and European Insolvency Regulation

Prior to introducing this discussion in Dutch literature, I will introduce a problem statement in order to make the (reasons for the) discussion clearer. Suppose that the undisclosed WHOA procedure falls under the Insolvency Regulation. In that case, the judgment of the Dutch court, in which the undisclosed WHOA procedure is opened, would be recognised in Europe under the Insolvency Regulation, including the cooling-off period and the exception provided for in the Insolvency Regulation (art. 8 Insolvency Regulation). Due to this exception from the Insolvency Regulation it is for secured creditors possible to ignore the cooling-off period for goods which are situated in another Member State[22].

[20] Article 376 para 5 DBA.

[21] Article 376 para 2 DBA.

[22] PM Veder, 'Internationale aspecten van de WHOA: de openbare en de besloten akkoordprocedure buiten faillissement', *FIP* 2019/219, p 59.

If the undisclosed WHOA procedure is not covered by the Insolvency Regulation, but by Brussels I *bis*, the judgment would also be recognised in the European Member States, but the exception of the Insolvency Regulation would not apply. Therefore, the cooling-off period could possibly have a broader scope in European Member States. There is a substantial difference in the consequences of declaring a cooling-off period and its recognition in the European Member States if the undisclosed WHOA procedure would fall under the Insolvency Regulation or under Brussels I *bis*.

What is the situation if the undisclosed WHOA procedure is not covered by neither the Insolvency Regulation nor by Brussels I *bis*? Then the specific European Member State will have to determine the recognition of the Dutch court order in which the undisclosed WHOA procedure with cooling-off period is pronounced, on the basis of any underlying treaties with the Netherlands or private international law. This makes the discussion per Member State different.

An interesting debate is currently taking place between two camps: does the undisclosed WHOA procedure fall under the Insolvency Regulation, does it fall under Brussels I *bis* or under neither? Orbán explained the discussion in detail in his article from the Inside Story of Insol Europe in April 2022, for which I warmly recommend his article[23]. Hereafter, first the history of this discussion will be discussed, then the positions will be briefly presented and a side will be chosen by the author in this discussion.

The Dutch legislator has opted not to apply the undisclosed WHOA procedure to Annex A of the Insolvency Regulation, because, according to the legislator, the undisclosed WHOA procedure does not meet the requirements for admission to Annex A. This is because the undisclosed WHOA procedure is not a public procedure. Therefore, the legislator is of the opinion that the jurisdiction of the Dutch court for opening or deciding on the WHOA procedure must be determined on the basis of our own Dutch private law (in example art. 3 Rv). The legislator argues that because the undisclosed WHOA procedure has so many similarities with the public WHOA procedure, but despite these similarities the undisclosed WHOA procedure does not fall under the Insolvency Regulation, the consequence is that the undisclosed WHOA procedure cannot fall under Brussels I *bis* either[24]. As the public WHOA procedure is admitted to Annex A of the Insolvency Regulation, it is not covered by Brussels I *bis*. This

[23] Géza Orbán, 'Dull rerun or succesful spin-off? Is the new 'private' version of the Dutch Scheme covered by the EU Judgments Regulation?', *Insol Europe Inside Story*, April 2022.

[24] *Kamerstukken II* 2018/2019, 35 249, nr. 3, pp 6–7.

would mean that the undisclosed WHOA procedure would not fall under the Insolvency Regulation and not under Brussels I *bis*. I quote Orbán:

> 'At the same time, however, by virtue of it being almost identical to a proceeding that is included on Annex A, the argument goes that the 'private' version cannot possibly be brought under the scope of the EU Judgments Regulation either. After all, the EU Judgments Regulation explicitly excludes: "bankruptcy, proceedings relating to the winding-up of insolvent companies or other legal persons, judicial arrangements, compositions and analogous proceedings". Or in other words, excluded are procedures (similar to those) included, or capable of being included, on Annex A of the EU Insolvency Regulation. And with that, the Dutch legislator allegedly succeeded in puncturing the 'dovetail' and squeezing through a procedure covered by neither EU regulation . . . [25]'

Vriesendorp et al. and Nijnens are of the opinion that the undisclosed WHOA procedure falls under Brussels I *bis*, despite the fact that the legislator is of the opinion (and intended) that this is not the case. Vriesendorp et al. are of the opinion that the Insolvency Regulation is only applicable if these insolvency proceedings also fall within the material scope of the Insolvency Regulation and are included in Annex A. If this is not the case, the insolvency proceedings (like the undisclosed WHOA procedure) do not fall under the Insolvency Regulation but under Brussels I *bis* because the European legislator did not intend to leave any room between these two regulations. Brussels I *bis* can be seen as an umbrella regulation, determines the recognition and enforcement of proceedings if no specific regulation for this purpose exists[26]. Nijnens points to the case law of the Court of Justice of the European Union from which it appears, according to Nijnens, that the Court has determined that 'any overlap between Brussels I *bis* and the Insolvency Regulation must be avoided. The same applies to any vacuum between the two regulations' (*Translated from Dutch to English by the author*)[27]. Welling-Steffens argues that the undisclosed WHOA procedure falls within the scope of Brussels I *bis*, whether or not with the addition that Chapter II of Brussels I *bis* might not formally apply[28]. Welling-Steffens takes the view that in any event Chapter III of Brussels I *bis* would apply to the

[25] Géza Orbán, 'Dull rerun or succesful spin-off? Is the new "private" version of the Dutch Scheme covered by the EU Judgments Regulation?', *Insol Europe Inside Story* April 2022.

[26] RD Vriesendorp, W van Kesteren, E Vilarin-Seivane and S Hinse, 'Automatic recognition of the Dutch undisclosed WHOA procedure in the European Union', *NIPR* 2021(1), p 13 and WJE Nijnens, 'Internationaal privaatrechtelijke aspecten van de WHOA', *TvI* 2019/34, p 264.

[27] WJE Nijnens, 'Internationaal privaatrechtelijke aspecten van de WHOA', *TvI* 2019/34, p 264.

[28] LFA Welling-Steffens, 'Het internationaal privaatrecht en het merkwaardige verhaal van de WHOA', in: RF Feenstra e.a. (ed), Wet Homologatie Onderhands Akkoord (Insolad Jaarboek 2021), Deventer: Wolters Kluwer 2021.

undisclosed WHOA procedure[29]. Vriesendorp subsequently further advocated his position during the debate held at the University of Amsterdam on this issue; for a more detailed account of this debate, I refer to Orbán's article of April 2022.

On the other side are (mainly) Veder[30] and Mennens[31]. Mennens writes that although the Court of Justice has ruled more than once that there may be no gaps or overlaps between Brussels I *bis* and the Insolvency Regulation[32], and that this is also included in recital 7 of the Insolvency Regulation. Recital 7 also states that it cannot be concluded from the mere fact that a procedure is not included in Annex A and that that procedure should by definition fall under Brussels I *bis*[33]. Veder is of the view that, although the undisclosed WHOA procedure has the characteristics of an insolvency proceeding, and although the undisclosed WHOA procedure also falls within the material scope of the Insolvency Regulation, it cannot be included in Annex A and is not fully covered by the Insolvency Regulation because of its private nature[34]. According to Veder, the undisclosed WHOA procedure does not fall under Brussels I *bis* because the undisclosed WHOA procedure falls under the exception of Article 1(2)(b) of Brussels I *bis*. Veder and Orbán also refer to recitals 12 and 13 of the Insolvency Regulation, from which it follows, in their opinion, that the European legislator deliberately chose that private insolvency proceedings will not fall under the Insolvency Regulation and not under Brussels I *bis*[35]. The European legislator was aware that this choice will ensure that recognition of these proceedings and their components will not be easy in Europe.

I believe that recognition of the undisclosed WHOA procedure and therefore the cooling-off period that has been announced within the undisclosed WHOA

[29] LFA Welling-Steffens, 'Het internationaal privaatrecht en het merkwaardige verhaal van de WHOA', in: RF Feenstra e.a. (ed), Wet Homologatie Onderhands Akkoord (Insolad Jaarboek 2021), Deventer: Wolters Kluwer 2021.

[30] PM Veder, 'Internationale aspecten van de WHOA: de openbare en de besloten akkoordprocedure buiten faillissement', *FIP* 2019/219, p 60, PM Veder and JJ van Hees, 'Internationale aspecten van het dwangakkoord ter voorkoming van faillissement', in ACP Bobeldijk e.a., *Het dwangakkoord buiten faillissement, Beschouwingen over het Voorontwerp Wet homologatie onderhands akkoord ter voorkoming van faillissement*, Preadvies van de Vereeniging Handelsrecht, Zutphen: Uitgeverij Paris 2017, pp 169–203.

[31] AM Mennens, *Het dwangakkoord buiten surseance en faillissement, Onderneming en Recht, nr. 118*, Deventer: Wolters Kluwer 2020, pp 790–791.

[32] HvJ-EU, 11 June 2015, ECLI:EU:C:2015:384 (*Nortel*), HvJ-EU, 6 February 2019, ECLI:EU:C:2019:96 (*BNP Paribas Fortis*).

[33] AM Mennens, *Het dwangakkoord buiten surseance en faillissement, Onderneming en Recht, nr. 118*, Deventer: Wolters Kluwer 2020, p 790.

[34] PM Veder, 'Internationale aspecten van de WHOA: de openbare en de besloten akkoordprocedure buiten faillissement', *FIP* 2019/219, p 60.

[35] Géza Orbán, 'Dull rerun or succesful spin-off? Is the new 'private' version of the Dutch Scheme covered by the EU Judgments Regulation?', *Insol Europe Inside Story*, April 2022, paragraph C.

procedure should – for the time being – be determined according to the rules of international private law. I agree with the reading of Veder et al. to the extent that, although the intention was that the Insolvency Regulation and Brussels I *bis* should not permit any gaps or overlaps, such a thing is possible with due regard for recital 7 of the Insolvency Regulation. Recitals 12 and 13 also indicate that the European legislator made a conscious choice to exclude private insolvency proceedings from the Insolvency Regulation, noting that recognition of those legal effects in the European Union will be difficult. Per EU Member State it will therefore have to be examined, according to the rules of international private law, whether the cooling-off period declared in the Netherlands extends to the goods located in that EU Member State.

5 Cooling-off period in The Nederlands with a European creditor

What about the cooling-off period declared in the Netherlands in an undisclosed WHOA procedure under the WHOA, which extends to the debtor's assets and goods present in the Netherlands? In my opinion, this situation is (quite) simple. The Dutch court has jurisdiction by virtue of art. 3 Rv and, by virtue of Article 376 DBA, pronounces the cooling-off period over the assets and any goods that are in the power of the debtor. To narrow the scope of this article only the perspective of the European creditor is discussed. With the term 'European creditor' the following is meant. The European creditor is a creditor originating from one of the Member States and falls therefore within the scope of Brussels I *bis* or the Insolvency Regulation. For example a Belgian creditor.

European creditors will have to comply with the Dutch ruling on declaring a cooling-off period over the assets in the Netherlands, because the assets are on Dutch soil where the ruling of the Dutch court is recognised and enforced. In order for the debtor to 'use' the cooling-off period he has to inform the affected creditors of the judgment.

The creditor can, of course, turn to the Dutch court with a request to lift the cooling-off period if there are good grounds for doing so. Examples are requesting the court to limit the effect of the moratorium (in time or with regards to specific assets) or to request the appointment of the observer (to oversee the progress made within the WHOA procedure). However, the creditor can also request the Dutch court to grant authorisation to recover the debtor's assets/property despite the cooling-off period[36].

[36] Article 376 para 2 DBA and Article 376 para 10 DBA.

6 Cooling-off period regarding assets/goods located in another Member State of a Dutch debtor

What about the cooling-off period of a debtor who has started a WHOA procedure in the Netherlands, whereby a cooling-off period has been declared which extends to goods belonging to the debtor or which are in the power of the debtor abroad?

According to established Dutch case law, a Dutch bankruptcy, and thus also a cooling-off period in a bankruptcy, has effect abroad and on goods located abroad[37]. Whether an actual trustee in bankruptcy can derive any rights from this depends on the recognition of the bankruptcy proceedings and their effects abroad. I would think that the same principle applies to the undisclosed WHOA procedure under the WHOA. The WHOA has been incorporated into the Dutch Bankruptcy Act and from a Dutch perspective Dutch insolvency proceedings have universal effect.

In fact, it depends on the recognition by the foreign court of the decision of the Dutch court declaring a cooling-off period. If a judge in another EU Member State disregards that ruling because that judge does not recognise the Dutch ruling, the answer is simple. A Dutch cooling-off period will then not extend to the assets located in that specific EU Member State.

Due to the dilemma of the undisclosed WHOA procedure, as explained in the previous section, it is actually speculation as to how the cooling-off period will be recognised in the European Union. It is up to the Court of Justice (and before that it is up to the local courts) to determine whether the undisclosed WHOA procedure falls under the Insolvency Regulation, Brussels I *bis* or neither.

Veder believes that in the case of the public WHOA procedure, which is automatically recognised in the European Union on the basis of the Insolvency Regulation, the cooling-off period has no effect on (secured) creditors who have a right under property law to assets located in another Member State[38].

I believe that in the event that a Member State of the European Union under Brussels I *bis* or under international private law recognises the judgments of the Dutch court, the judgment in which the cooling-off period is pronounced also extends to goods located in other Member States. The court in that Member State recognises the effect of the WHOA procedure and the cooling-off

37 HR, 15 April 1955, *NJ* 1955, 542 (*Comfin*) and AJ Berends, 'Heeft de Nederlandse afkoelingsperiode werking in het buitenland?', *WPNR* 2005/6646, pp 966–967.

38 PM Veder, 'Internationale aspecten van de WHOA: de openbare en de besloten akkoordprocedure buiten faillissement', *FIP* 2019/219, p 59.

period, so that the effect of the cooling-off period as it applies in the Netherlands also applies, in my opinion, to goods that are subject to the cooling-off period in another EU Member State. A limitation such as that in the public WHOA procedure under the Insolvency Regulation does not apply, because the Insolvency Regulation does not apply to the undisclosed WHOA procedure.

An interesting question is if we in the Netherlands would accept a foreign moratorium on Dutch soil from – an example – Spanish proceedings. If the foreign insolvency procedure falls under the scope of the Insolvency Regulation then – in principle – the moratorium will be recognized, but the exception of secured creditors following art. 8 Insolvency Regulation will apply. If the Spanish proceedings would fall neither under the Insolvency Regulation or Brussels I *bis*, the moratorium will not be recognized for goods situated on Dutch soil. This is due to the established case law from the Dutch Supreme Court. According to the Dutch Supreme Court foreign insolvency proceedings, if not obligated by closed treaties with other countries, will have (in principle) no effect on (goods located on) Dutch soil, due to the territoriality principle of Dutch Insolvency Law for foreign insolvency proceedings[39].

7 Conclusion

The WHOA is a new, current and interesting instrument that has been added to Dutch bankruptcy law and gives debtors the option of avoiding bankruptcy by offering an (undisclosed) WHOA agreement. The possibilities offered by the WHOA and the control exercised by the court, the restructuring expert or the observer make it a useful instrument for both the debtor and the creditors. By avoiding bankruptcy, better value is realised for the creditors.

The undisclosed WHOA procedure is a 'separate' procedure about which much is still unclear, especially with regards to the international aspects. However, the undisclosed WHOA procedure makes it quite easy for international debtors to start a WHOA in the Netherlands, as long as the interested party is domiciled in the Netherlands or if there is sufficient connection with the Netherlands.

Currently it is still speculation on which grounds the recognition of a WHOA procedure will take place, this is ultimately up to the Court of Justice. The Dutch literature does not agree on a solution regarding this matter, yet. There are authors who believe that on the basis of Brussels I *bis* the undisclosed WHOA procedure (and therefore the cooling-off period) is recognised by other

[39] HR, 13 September 2013, ECLI:NL:HR:2013:BZ5668, *NJ* 2014/454 (*Yukos*) and HR, 29 June 2012, ECLI:NL:HR:2012:BU5630, *NJ* 2012/424 (*Yukos*).

EU Member States. On the other hand, there are authors who are of the opinion that Brussels I *bis* is not applicable, that the Insolvency Regulation is not applicable either and that recognition should take place on the basis of international private law. A clear answer to this question has not yet been found, but I believe that the recognition of the undisclosed WHOA procedure and the cooling-off period takes place on the basis of international private law and that therefore it must be assessed on a case-by-case basis per EU Member State whether the undisclosed WHOA procedure is recognized or not. If the undisclosed WHOA procedure is recognised in that EU Member State, the consequence, in my view, is that the cooling-off period is also recognised and can extend to goods located in that EU Member State.

Chapter 17

Towards Data-driven Insolvency Policies in the EU and India: Making Regulation Effective?

Dr Surbhi Kapur
Assistant Professor (Law) and Head, Centre for Insolvency and Bankruptcy, Indian Institute of Corporate Affairs, Ministry of Corporate Affairs, Government of India,
email: surbhi.kapur@iica.in

> 'There are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns the ones we don't know we don't know"
>
> Donald Rumsfeld, the former US secretary of Defence (2002)

1 Introduction

The future is uncertain. We cannot know for sure what will happen, even tomorrow. Major, unexpected and hard-to-predict events – or what are variously called 'black swans' or 'wild cards'- are inevitable much like the recent outbreak of the Novel coronavirus disease (**COVID-19**) pandemic[1]. The further we probe into the future, the deeper the level of uncertainty we encounter. Despite such 'unknown unknowns', many of the risks that humans and the governments face, both now and in the more distant future, can be readily ascertained using data and credible evidence for their decision-making[2] (of course the number of such risks is very large, and their likelihood and potential impacts are highly variable).

We all use evidence of some sort for everything we do: booking a holiday, purchasing a refrigerator, deciding which motion picture to watch, or designing a new talent management strategy. Why? What's the point? This sounds like a pretty weird question to ask, as the answer seems so obvious the question hardly needs to be asked. Weird as it may seem like, discerning why we nearly always choose to use evidence sheds light on the often taken-for-granted principles behind using evidence and the underlying rationale for evidence-based policy-making (**EBP**). Put simply, we use evidence because by doing so

[1] Tuomo Kuosa, *The Evolution of Strategic Foresight: Navigating Public Policy Making*, (Routledge, 2016).

[2] Denise M Rousseau, Making evidence-based organizational decisions in an uncertain world, Organ Dyn (2018), https://doi.org/10.1016/j.orgdyn.2018.05.001.

we're more likely to get the outcomes we want: a relaxing vacation, a refrigerator that fits neatly in the gap in the kitchen, a movie that will make us laugh, or a talent strategy that will reduce unwanted turnover and streamline succession. Put a bit less simply and a bit more precisely, there's more to using evidence than just making more-informed decisions. Making a more-informed decision isn't about using just any old bit of evidence we stumble across in any way we fancy. Rather, the evidence used should be both trustworthy and applicable to the specific context. EBP takes this fundamental principle and extends it by proposing that we need to be *conscientious, explicit*, and *judicious* in our use of evidence, gather it from *multiple sources*, and take a *structured approach* to deciding both what the problem and possible solutions might be.

Since the past decade or so, EBP has gained traction, with some governments and NGOs having institutionalised processes for rigorously evaluating innovations and incorporating evidence into decision-making[3]. Impact evaluations of social programmes and sound anticipatory governance (**AG**) have emerged as important tools to guide social policy in developing polities as they allow for accurate measurement and attribution of impact helping policy-makers identify programmes that work and those that do not work, so that effective and performing programmes can be promoted and ineffective ones can be discontinued. With economies around the world increasingly becoming data-driven, policymakers and researchers have embraced the importance of data for EBP. The collection of data is a fundamental step for the assessment and design of efficient and effective insolvency systems. Concrete data is vital for EBP; relevant data provides the empirical foundation for the identification of issues and subsequently, formulation of changes to the law.

Recently, two institutions of international repute have stimulated the discourse on the impact and policy challenges created by data gathering, assessment, and dissemination in structuring insolvency regimes. The researchers at the International Monetary Fund (**IMF**) in their Working Paper[4], published in 2019, have endeavoured to outline, inter alia, the development of data gathering systems that will support the analysis of insolvency regimes across the world. In doing so, a general assessment of the data sources along with the delineation of the diverse array of data available within these sources is carried out. Another twig in this evolving stream of research is the formulation of a new set of

3 *Ibid*.

4 Jose Garrido *et al*, The Use of Data in Assessing and Designing Insolvency Systems, IMF Working Paper No. 19/ 27, February 28, 2019.

Organisation for Economic Co-operation and Development (**OECD**) Indicators on the insolvency regimes[5], which gather information on the design of insolvency regimes.

Knowing who files insolvency resolution/ bankruptcy is even more important as various countries struggle to revive their economies in the wake of the COVID-19 pandemic. Policy makers targeted the insolvency and bankruptcy law revisions in legislative packages to stimulate the economy[6]. Presently, however, there exists no standard framework to track the outcomes of insolvency and bankruptcy regimes in various jurisdictions, other than the World Bank Doing Business indicators. Even in the most advanced economies, there is a need to increase the quality of insolvency-related information, in order to conduct a meaningful evaluation of insolvency systems and to make the regulation more effective and more robust. Relatedly, following the recent pandemic and the earlier financial crisis, regulators have been keen to expand their data collection and evidence base so as to better monitor financial risks and vulnerabilities[7]. They recognise the importance of ‘regulatory lookback’, tracking performance, determining outcomes to understand how well a regulation is performing, and diagnosing reasons for poor performance and generate recommendations for course corrections through a retrospective review[8]. This requires not only collecting data but putting in place proper frameworks with measurable parameters to help strengthen the effective management of limited public resources and achieve a deeper and broader impact of regulatory interventions[9].The analysis of insolvency systems should, hence, be grounded on precise empirical data and regular retrospective review.

In this milieu, from a public policy point of view, this is a ‘law in action’ research, galvanised around an appraisal of the pertinence of EBP in the insolvency resolution space in the European Union (**EU**) and India. This

5 Policies for Productivity: The Design of Insolvency Regimes across Countries.

6 Peter McGuire, Where Are All the Bankruptcies Experts Predicted?, PORTLAND PRESS-HERALD (Sept. 8, 2020), https://www.pressherald.com/2020/09/08/where-are-all-the-bankruptcies/. See, e.g., David Dayen, Unsanitized: How People Seeking Bankruptcy Will Suffer in the Pandemic, AM. PROSPECT (Apr. 4, 2020), https://prospect.org/unsanitized-how-people-seeking-bankruptcy-will-suffer-in-the/ (discussing predictions in early April 2020 that ‘the cases aren’t likely to start piling up for a few months’); Jon Chavez, Experts: Increase In Bankruptcies Likely As Pandemic Continues, THE BLADE (Apr. 2, 2020), https://www.toledoblade.com/business/development/2020/04/02/increase-in-bankruptcies-likely-as-pandemic-continues-experts-say/stories/20200402126; Adam Tamburin, Bankruptcy Lawyers’ Warning As Coronavirus Crisis Mounts: Act Now, TENNESSEAN (Mar. 18, 2020), https://www.tennessean.com/story/news/2020/03/18/bankruptcy-lawyers-warning-coronavirus-crisis-mounts-act-now/5073669002/.

7 David M Bholat, ‘The future of central bank data’, *Journal of Banking Regulation*, No 14, June/August 2013.

8 Per Nymand-Andersen et al., ‘Financial data and risk information needed for the European System of Financial Supervision’, Handbook of Financial Data and Risk Information I, Cambridge University Press 2014.

9 Annual Report 2020–21, NITI Aayog available at https://www.niti.gov.in/sites/default/files/2020-02/Annual_Report_2019-20.pdf.

research is part of the rich theoretical and empirical body of new institutional economics relating to formal institutions which regulate the treatment of debtors, both corporate and natural, whether insolvent or susceptible to insolvency. The availability of substantive data on the debtors, creditors, and the size of claims for measuring the indicator of 'time to discharge' have proved valuable in assessing the efficiency of insolvency regimes[10]. It highlights briefly the wide range of risks, both global and local, that contemporary governments must confront. One of these is endogenous: it is the risk to good governance from within – namely the failure of policymakers to exercise proper foresight. Second, it outlines various criteria for assessing the quality of AG. Third, on the basis of these criteria it briefly evaluates the quality of policymaking institutions and frameworks. Finally, it suggests a number of reforms to enhance good AG.

2 Fostering economic freedom and 'freedom to exit'

It isn't about what causes the distress; it is how we respond to the distress that matters. This dichotomy between the 'cause' and the ensuing 'response' to it sums up the game of insolvency resolution. While 'freedom to exit' the cycle of failure is the mainstay of any insolvency law, 'exiting' can take two forms viz., the phoenix form or the fresh start form. While the former encompasses the efforts towards 'restructuring' the firm, the latter is about exiting completely in the form of 'liquidation'. Both the exit routes foster economic as well as personal freedom of the entity. In fact, the higher the level of freedom, the easier it is to do business in an economy. Greater economic freedom is likely to lead to a better environment for business and hence better economic growth[11]. A businessman needs freedom to start a business when s/he finds an opportunity, and 'freedom to exit' the business when s/he fails. S/he typically commences a business when s/he has reassurance of exit. S/he fails when s/he becomes a victim of the Schumpeterian 'perennial gale of creative destruction', where the business is failing to earn normal profits, either because it is outmoded, the space is overcrowded or resources are inefficaciously economised.

It cannot be gainsaid that economic development depends on competition, innovation, and entrepreneurship (**CIE**)[12]. Innovation is crucial not only for

[10] J Garrido et al (2019), The Use of Data in Assessing and Designing Insolvency Systems, IMF Working Paper No. 19/ 27, February 28, 2019.

[11] D Asteriou, K Pilbeam and I Tomuleasa (2016), The Impact of Economic Freedom, Business Regulation and Corruption on Bank Profitability and Bank Stability: Evidence from Europe.

[12] GM Hodgson (2019), 'Prospects for institutional research', *RAUSP Management Journal, 54*(1), 112–120, https://doi.org/10.1108/RAUSP-11-2018-0112.

national economies[13], but also for overcoming the contemporary challenges of fighting COVID-19[14] and stagnation (Estrada et al., 2021). However, in order for CIE to materialise, robust formal and informal institutions are essential[15]. One of the emerging streams in heterodox schools of economics is the new institutional economics, which studies the impact of various institutions on economic activity[16]. The output of the new institutional economics contends that the existing system of incentives or 'rewards' or 'sanctions' in a given society and economy depends to a significant extent on the quality of formal and informal institutions dominant at a given time and place[17].

As North (1990)[18] puts it, institutions are certain 'rules of the game in society', which can be both formal and informal. Following North, formal institutions can be seen as inclusive of, inter alia, a system of property rights, laws (enacted, normative) and regulations (public, social, regarding the real sphere and the financial sector). Informal institutions, on the other hand, include culture, values, commonly accepted patterns of behaviour, religion and beliefs – social trust, mental models, i.e., leading ways of thinking and reasoning in a given society or in particular groups of economic and political actors. This school is largely interdisciplinary and brings together economics, law, sociology, anthropology, political science, and organisation science, among other disciplines. Its main goal is to explain how institutions work, what functions they perform, what changes they undergo and what reforms should be undertaken to achieve a positive economic effect[19]. Within this stream, one of the main research areas is law and economics, which deals with the study of the impact of legal

[13] A Cieslik, JJ Michalek and K Szczygielski (2016), 'Innovations and Export Performance: Firm-level Evidence from Poland', *Entrepreneurial Business and Economics Review, 4*(4), 11–28, https://doi.org/10.15678/EBER.2016.040402; *See also* I Kraftova and J Kraft (2018), 'The Relationship between Pro-Innovation Factors and the Performance of the European Union Member States and their Regions', *Engineering Economics, 29*(4), 424–433, https://doi.org/10.5755/j01.ee.29.4.19703; F Sell (2020), Static and Dynamic Price Effects Motivated by Innovation and Imitation: Novel Insights Using the Barone's Curve, *Contemporary Economics, 14*(1), 73–89, https://doi.org/10.5709/ce.1897-9254.333; J Tidd (2006), *A Review of Innovation Models*, Imperial College London.

[14] A Khan, N Khan and M Shafiq (2021), 'The Economic Impact of COVID-19 from a Global Perspective', *Contemporary Economics, 15*(1), 64–75, https://doi.org/10.5709/ce.1897-9254.436.

[15] D Urbano, D Audretsch, S Aparicio and M Noguera (2020), 'Does entrepreneurial activity matter for economic growth in developing countries? The role of the institutional environment', *International Entrepreneurship and Management Journal, 16*, 1065–1099, https://doi.org/10.1007/s11365-019-00621-5.

[16] *Ibid.*

[17] B Prusak, S Morawska, M Lukowski et al., 'The impact of bankruptcy regimes on entrepreneurship and innovation. Is there any relationship?', Int Entrep Manag J 18, 473–498 (2022), https://doi.org/10.1007/s11365-021-00773-3.

[18] DC North (1990). *Institutions, Institutional Change, and Economic Performance*. Cambridge University Press.

[19] C Ménard and MM Shirley, 'Bankruptcy system model and efficiency versus the entrepreneurship and innovation in selected European countries' in C Ménard and MM Shirley (eds), *Handbook of New Institutional Economics* (pp 3–18), Springer.

regulations on economic processes[20]. In this vein, positive and normative legal theories assume prominence. While the former demonstrates how the existing law(s) affects economic processes, the latter illumines what should be changed in order to improve efficacy, efficiency, and achieve positive effects in the form of economic development[21].

While applying this 'new institutional economics approach' to structure and develop insolvency laws, it is paramount to evaluate the impact of such laws in influencing the development of CIE, and thus economic growth, among other things. This exercise should be undertaken with due regard to the fact that being unable to manage one's debts can be caused by various reasons, some of which may be beyond one's control. A microeconomic interpretation of the insolvency initiation considers the firm's behaviour as causing financial distress. The macroeconomic one, on the other hand, is attributed to forces beyond the control of a firm, for example, the social, structural, institutional that create obstacles to the survival and substance of the firm.

Recently, with various frameworks of AG been introduced and incorporated in governmental systems worldwide, there is a possibility of employing AG in the insolvency space for analysing the data and being ready for future challenges. AG in the insolvency space stems from the efforts towards, *inter* alia, mapping the data in terms of the time to discharge, cost of doing business, number of applications pending, the digital nature of recordkeeping, etc.

2.1 A conspectus of research by IMF and OECD

As per the IMF, the assessment and design of insolvency regimes should be guided by a measurement of the effectiveness, efficiency, and efficacy of the insolvency procedures (Table I below). This is triggered by an establishment of the desired objective(s) or outcome(s) of the insolvency system. In this regard, the primary objective is the allocation of risk among the participants in a market economy in a predictable, equitable and transparent manner. The achievement of this outcome provides confidence to the credit system.

[20] R Cooter and T Ulen (2016), *Law and Economics*, Berkley Law Books. Book 2, 6th edn.

[21] Adrian Vermeule, 'Connecting Positive and Normative Legal Theory', 10 U. Pa. J. Const. L. 387 (2014).

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TABLE 1

Efficiency	**Effectiveness**	**Efficacy**
Relationship between inputs and outputs – achievement of the objectives – minimum utilization of the resources.	Achievement of the objectives of the system – measure the extent to which an insolvency system achieves its intended objectives	Measure of the extent to which there exists a connection or contribution of the insolvency system (subsystem) with the higher-level system like the legal, economic and financial systems.
Translates into a quick resolution of financial distress – maximum recovery. An efficient insolvency framework fosters: • Liquidation of non-viable businesses- reallocation of assets to more productive uses • Rehabilitation of viable businesses – debt restructuring Analysis can be undertaken at different points in time – *ex ante*, *interim* and *ex post* efficiency		Securing the objective of the protection and maximization of the value for the beneficiaries (interested parties) and the economy in general.

Determination of effectiveness and efficiency requires- Evaluation of both Qualitative and Quantitative Elements		
Qualitative Assessment	**Quantitative Assessment**	
Leads to an identification of the shortcomings of the insolvency system(s)	Utilisation of the indicators that incorporate variables that are measured and are of a quantifiable nature; the said indicators can be both normative and descriptive Statistics of Insolvency Regulators and other authorities	
International Standards are benchmarks of good/ best practices	Qualitative Indicators- like standards (OECD Indicators)	Quantitative Indicators – based on key variables viz. time, cost and recovery rate
UNCITRAL Legislative Guide on Insolvency Law	Provide a qualitative efficiency assessment derived from quantitative data	
World Bank Principles on Effective Insolvency and Creditor Rights System	Aimed at – Maximum recovery for secured creditors	

Assessment of Compliance with International Standards	
Stand Alone Basis	General Assessment of the Financial Sector
Report on the Observance of Standards and Codes (ROSC) administered by the World Bank and the IMF	E.g., Financial Sector Assessment Program (FSAP) of the IMF

It is also pertinent to mention here that a range of indicators/ warning signs of insolvency, if identified early, can provide the opportunity to avoid business failure, or minimise further losses. The sixth annual overview of corporate insolvencies published by the Australian Securities and Investments Commission (ASIC) on 29 September 2014 extracted data from statutory reports lodged by external administrators. It showed that the top three nominated causes of failure were inadequate cash-flow or high cash use (a factor in 41% of cases), Poor strategic management of business (37%), trading losses (33%)[22]. Some of the fundamental insolvency indicators are:

Indicator	**Type (s) of Data Collated**
Time	Duration of Insolvency (Source of Data – judicial statistics, insolvency administrator reports etc.)
	OECD Indicators – Measuring the 'Time to Discharge'[23]- The treatment of failed entrepreneurs in various jurisdictions – measuring the 'availability of a fresh start' for failed entrepreneurs with respect to the time to discharge and exemptions of their personal assets from insolvency proceedings;
	Time when the creditors receive payments from the liquidation of assets
	OECD Indicator – Prevention and Streamlining – The indicator counts the existence of early warning mechanisms, pre-insolvency regimes and special insolvency procedures for SMEs
Cost	Court/bankruptcy authority fees, insolvency administrator's remuneration, experts' fees, asset storage and preservation costs, auctioneer fees, and government levies, the cost of ongoing operations

22 https://asic.gov.au/regulatory-resources/find-a-document/statistics/insolvency-statistics/.

23 The OECD indicator assumes that a lengthier time to discharge is detrimental to productivity growth and hence is given a higher ('worse') value. Threshold values of one and three years are adopted for scoring, with the worst score given to a time to discharge above three years,.

Indicator	Type (s) of Data Collated
Recovery Rates	Comparison of the amount of the claim/loan and the valuation of collateral at the time of initiation of the procedure to generate 'under-secured' claims
Restructuring Tools (OECD Indicator)[24]	• Ability of creditor to initiate restructuring • Possibility and availability and length of stay on assets (Moratorium) • Possibility and priority of new financing • Possibility of cram down on dissenting creditors • Treatment of Management during restructuring

2.2 Globally prevailing sources of data

There are several important sources of insolvency data in many jurisdictions. However, none of these sources provide a full response to the prevailing needs for tools to evaluate and design insolvency systems. Although some of these data sources are evolving to include increasing amount of information, there are gaps in the information produced.

2.2.1 General statistics on the number and type of insolvency proceedings with the aim of monitoring economic trends

Sl. No.	Country	Authority entrusted with the Collection/publication of Data	Type (s) of Data Collated	Frequency of Collection
	France	Bank of France	Enterprise Insolvencies (inclusive of the year-to-year variation, economic sector, Segmentation-SMEs and large enterprises)	Monthly

[24] The indicator takes the value of zero for no impediments to restructuring (ie creditors can initiate restructuring, a limited stay on assets is possible, cram-down with certain conditions is possible, new financing has seniority over unsecured creditors, management is not automatically fired).

Sl. No.	Country	Authority entrusted with the Collection/ publication of Data	Type (s) of Data Collated	Frequency of Collection
	Germany	Federal Statistical Office (Destatis)	Number of Insolvency Cases in Court (differentiated by business, consumer, self-employed and decedents' estate and the value of the expected claims), Breakdown of insolvencies by economic sector and State, captures dismissal of proceedings for insufficiency of assets; and, those for which debt settlement plan was accepted; Recovery Rate	Monthly, Annually
	Spain	National Statistics Agency of Spain (INE)	Numbers of Enterprises and consumer insolvency cases, initiation of the process (creditor or debtor initiated), legal form of enterprise, economic sector, size of the enterprise[25];	Quarterly

[25] Variables utilised - number of bankruptcy proceedings presented at the court, number of bankruptcy orders - bankruptcies notified, type of bankruptcy - voluntary or necessary etc.

Sl. No.	Country	Authority entrusted with the Collection/publication of Data	Type (s) of Data Collated	Frequency of Collection
	South Africa	Statistics South Africa ('Stats SA')	Compulsory and voluntary liquidations for both companies and closed corporations, by industry the numbers of individuals or partnerships that are unable to pay their debts and have been placed under final sequestration	Monthly
	The Netherlands	Statistics Netherlands (CBS)	From May 13 2022 onwards, CBS reports on the bankruptcies of all businesses and institutions, including sole proprietorships.	Monthly[26]

2.2.2 Surveys on the management of non-performing loans

Bank surveys have proved to be a useful instrument in assessing the effectiveness and efficiency of debt resolution mechanisms, including the insolvency process[27].

- The Bank of Italy published the results of a survey conducted in 2015 on the efficiency of credit recovery procedures undertaken by 24 large banking groups. The survey included both quantitative and qualitative aspects.

[26] Official website of Statistics Netherlands (CBS), https://www.cbs.nl/en-gb/news/2022/19/historically-low-number-of-bankruptcies-in-april.

[27] IMF 2019 *supra*.

Quantitative	**Qualitative**
Amounts involved in-court and out-of-court procedures	Court backlogs
Average age of the procedures at the end of 2014; collateral	Procedural complexity
Final recovery rate by different mechanisms used (e.g., out-of-court agreements, bankruptcies, arrangements with creditors, and foreclosures)	Lack of public creditors' participation in restructuring
Percentage of initial credit recovered in each year after the procedure was started	Professionals' fees, access to interim financing
Changes in debtor companies' position in the four years following the start of the restructuring procedure	Creditor coordination issues; credit recovery costs by banks

2.2.3 Specific insolvency statistics

Specific insolvency statistics are needed to assess the overall effectiveness of the insolvency system.

- Gauging the use of insolvency – the ratio between
  - the number of insolvency cases and the number of registered companies in a country.
  - the number of companies with NPLs and the number of insolvency cases.
  - GDP and the number of insolvency cases

2.2.4 Statistics of insolvency regulators and other authorities

Although there can be an overlap with the information included in judicial statistics, the reports produced by insolvency regulators also include information on the insolvency professionals themselves (e.g., number of appointments, administrator reports, disciplinary actions). These data are extremely relevant to gain insights on the effectiveness and efficiency of insolvency systems.

Sl. No.	Country	Regulator	Data Collected/ Published	Frequency of Collection
	India	Insolvency and Bankruptcy Board of India	Corporate Insolvency Resolution Processes (CIRPs) admitted, closed for various reasons and ongoing. Sector-wise distribution of CIRPs admitted and closed, timeline of the conclusion of CIRPs, number of claims admitted in case of cases withdrawn and reasons for such withdrawal, distribution of stakeholders triggering the resolution process- Number of CIRPs initiated and closed by operational creditors (OCs), financial creditors (FCs), and corporate debtors (CD), details of CIRPs ending with liquidation in terms of the status of the CD at the time of commencement, details of CIRPs yielding resolution, in terms of date of commencement; date of approval of resolution plan, admitted claims, liquidation value, realisable value by FCs etc.	Quarterly

Sl. No.	Country	Regulator	Data Collected/ Published	Frequency of Collection
	Australia	Australian Securities and Investments Commission (ASIC)[28]	Data, arranged by economic sector and region, include: (i) size of the company; (ii) nominated causes of failure, (iii) possible misconduct and documentary evidence; (iv) assets, liabilities and deficiency; (v) unpaid employee entitlements; (vi) secured creditors; (vii) unpaid taxes and charges; (viii) unsecured creditors; and (ix) remuneration of administrators	Monthly, weekly
	Ireland	Insolvency Service of Ireland (ISI)[29]	Case management, outcomes, type of debts, and profile of applicants, number of cases, amount of debt (secured and unsecured), gender, and geographical distribution	

[28] Statistical reports on insolvency based on compulsory filings by insolvency administrators.

[29] Reports are published concerning personal insolvency procedures, such as the DRN (debt relief notice), DSA (debt settlement arrangement), and PIA (personal insolvency arrangement), apart from the personal bankruptcy process.

Sl. No.	**Country**	**Regulator**	**Data Collected/ Published**	**Frequency of Collection**
	United States of America[30]	U.S. Trustee Program of the U.S. Department of Justice	Total case filings; actions against debtors for attempts to conceal assets, evade the repayment of debts when they have disposable income available to pay them, or commit other violations; criminal referrals; professional fees; objections to plan confirmations in the Chapter 11; business re-organization issues, private trustee disbursements to creditors; and approval of, and fees charged by, appellate practice, credit counselling and debtor education[31].	
	Colombia	*Superintendencia de Sociedades*[32]	General characteristics of the insolvent businesses (size of enterprise, number of employees, location, etc.).	

30 See United States Trustee Program Annual Report of Significant Accomplishments Fiscal Year 2016, https://www.justice.gov/ust/file/ar_2016.pdf/download.

31 See United States Trustee Program Annual Report of Significant Accomplishments Fiscal Year 2016, https://www.justice.gov/ust/file/ar_2016.pdf/download.

32 Combines the role of adjudicating authority and insolvency regulator.

Sl. No.	Country	Regulator	Data Collected/ Published	Frequency of Collection
	Spain	*Registro mercantil*	Economic characteristics of the insolvent enterprises (size, sector, age, viability, and solvency), and also distinguishes between cases commenced by debtors or by creditors; Reports the changes in control over management of the insolvent business; and reorganization plans; duration of the process	

3 An '*a la carte* bankruptcy system' in India and EU?

Information empowers and emancipates. Access to information is an essential step in ensuring transparency and accountability in insolvency law systems and processes[33]. Like sunlight, it serves as the best disinfectant[34] and eradicates the germs of deception, distortion, and fraud. The efficiency, effectiveness, and efficacy of an insolvency system critically depends on reducing information asymmetry, by making available complete, authentic, and up-to-date financial information about the debtor, whether corporate or individual. Information asymmetry has long marred the seamless and timely conduct of insolvency resolution processes across the world. Creditors and other stakeholders have struggled with getting access to authentic financial information about the debtors. Debtors know much more about their ability to repay debt than the creditors. A considerable amount of time and effort has been expended to establish the incidence of default, adduce evidence about it, and ascertain the financial position of the debtor. This, inevitably, led to procedural and judicial delays and increased the cost of doing business.

[33] David Heald, 'Varieties of transparency' in Christopher Hood and David Heald (eds), Transparency: The Key to Better Governance?, 23–45, 26 (Oxford: Oxford University Press, 2006); BI Finel and Kristin M Lord, 'The Surprising Logic of Transparency', *43 International Studies Quarterly* 315–39, 316 (1999).

[34] A phrase used by Justice Louis Brandeis of the Supreme Court of the United States of America to emphasise upon the significance of transparency in governance. Louis D Brandeis, Other People's Money 62 (1914) cited in S Rajagopalan, '"Sunlight's the Best Disinfectant": A Review of the Right to Information Act, 2005', *Delhi Law Review*, 46–72 (2005).

The development of the world-wide pandemic caused by COVID-19 has generated wide interest in developing more tools available to help financially distressed businesses; however, the interest is not new. Around the globe, legal systems contain provisions regarding proceedings under insolvency law and governed by it, which can be initiated to solve the economic circumstances of a debtor in financial distress. Reorganisation and liquidation proceedings are most of the time included in these formal insolvency proceedings, however, there has been growing interest among regulators and legislators in providing another kind of solution, aiming for effectiveness of businesses' recovery[35].

Bankruptcy law is an important part of the social safety net and it can help alleviate the financial fallout from poor circumstances. But it's not a silver bullet in terms of solving one's financial problems or social problems. It certainly could be improved upon. The empirical literature linking explicitly insolvency regimes and economic outcomes is still relatively scarce, but growing. During the past 20 years this growing literature has shown that more efficient insolvency frameworks lead to deeper markets for equity and credit, easier financing conditions for companies, stronger entrepreneurship and higher productivity[36].

Understanding the characteristics of the people who file bankruptcy yields valuable insights into the bankruptcy system. Knowing who files for insolvency resolution is necessary to evaluate whether current stream of laws is achieving their goal of providing a 'fresh start' for the 'honest but unfortunate debtor.'[37]Also, although not every person in financial distress files for resolution, the data provides a window into the financial and economic stress on the populace. The financial and other problems that people bring with them to the courts and adjudicating authorities may stem from systemic disparities in the economy and society. Understanding how these issues appear in the insolvency and bankruptcy system will bring into sharper focus more effective areas for legal and policy changes.

According to White (2001, pp 39–42), the bankruptcy law system has an impact on establishing and running a business in small and medium-sized enterprises[38]. In this case, pro-debtor systems, which are characterised, among other things, by the exemption of insolvent entrepreneurs from debt, are also characterised by a higher level of entrepreneurship – more frequently exempting

[35] http://law.stanford.edu/wp-content/uploads/2021/08/valdes_eulawwp54.pdf.

[36] Agostino Consolo, Federica Malfa, Beatrice Pierluigi, Insolvency frameworks and private debt: an empirical investigation, ECB Working Paper Series No 2189 / October 2018.

[37] *Ibid*.

[38] MJ White (2001), 'Bankruptcy Procedures in Countries Undergoing Financial Crises' in S Claessens, S Djankov and A Mody (eds), *Resolution of Financial Distress. An International Perspective on the Design of Bankruptcy Law* (pp 25–45), World Bank.

them from debt results in a higher probability of establishing and running a new sole proprietorship. On the other hand, this factor results in a lower probability of receiving a loan to conduct business activity (banks tighten the criteria due to the lenient treatment of debtors). This relationship is confirmed by research carried out by Cerqueiro and Penas[39] on a sample of start-ups in the USA. Their analyses show that a higher level of debtor protection provided by U.S. personal bankruptcy law reduces the availability of financing to start-ups and, as a consequence, causes these firms to grow slower and fail more often. According to Landier[40], the stigmatisation of bankruptcy is one of the main factors determining the development of entrepreneurship. In countries with a higher level of tolerance for bankruptcy and risk acceptance, the development of entrepreneurship is greater. The author distinguishes two models: conservative and experimental ones. The former assumes a high stigma of bankruptcy (stringent bankruptcy law for debtors), whereas the latter assumes greater levels of risk tolerance and acceptance. The experimental model is characteristic of countries focused on innovation and entrepreneurs operating in an aggressive manner, whereas the conservative model is designed for countries where imitation is more prevalent. This model assumes fewer employees will decide to be entrepreneurs, as it is safer for them not to do so. Due to the high costs of bankruptcy in the conservative model, entrepreneurs choose safer projects than in the experimental model. Based on research conducted in twenty-nine countries in the period of 1990–2008, Lee et al[41]. concluded that there is a positive correlation between the friendliness of bankruptcy law towards entrepreneurs and the level of entrepreneurship measured using the rate of entry of new companies onto the market. In more recent studies, Damaraju et al. (2020)[42] analysed the effects of the interaction between bankruptcy law and culture on the level of entrepreneurial activity. They show that culture can influence the relationship between the severity of bankruptcy law and the level of entrepreneurship. Indeed, due to cultural differences, a positive relationship between the strictness of bankruptcy law and the level of entrepreneurship has been recorded in some countries.

[39] G Cerqueiro and MF Penas (2017), 'How Does Personal Bankruptcy Law Affects Startups?' *Review of Financial Studies, 30*(7), 2523–2554, https://doi.org/10.1093/rfs/hhw081.

[40] A Landier (2005), *Entrepreneurship and the Stigma of Failure*, https://doi.org/10.2139/ssrn.850446.

[41] SH Lee, Y Yamakawa, MW Peng and JB Barney (2011), 'How do bankruptcy laws affect entrepreneurship development around the world?', *Journal of Business Venturing, 26*(5), 505–520. https://doi.org/10.1016/j.jbusvent.2010.05.001.

[42] NL Damaraju, JB Barney and GD Dess (2020), 'Do Stringent Bankruptcy Laws Always Deter Entrepreneurial Activities? A Study of Cultural Influences', *Entrepreneurship Theory and Practice, 45*(2), 418–439, https://doi.org/10.1177/1042258720913017.

Armour and Cumming[43] pointed out that in this type of research, apart from the bankruptcy law regulating the insolvency of enterprises, one should take the consumer bankruptcy regulations into account. In the case of small entrepreneurs, e.g., sole proprietorships, it is difficult to separate the company's assets from the owner's personal property. Due to that fact, in many countries, small entrepreneurs go through bankruptcy proceedings intended for natural persons. Research on the impact of consumer bankruptcy law on entrepreneurship was also conducted by Jia (2015)[44]. The results show that entrepreneurs prefer more lenient bankruptcy laws that provide them with greater security. Similar results were also obtained by Fossen (2014)[45]. Contrary to previous studies such as that of Estrin et al. (2017)[46], they stated that not all debtor-friendly elements of bankruptcy law have a positive impact on entrepreneurship. Therefore, there is an optimum for debtor and creditor laws which favour entrepreneurial activities.

Innovation is also associated with the development of entrepreneurship. Based on their research, Acharya and Subramanian (2009) concluded that creditor-friendly bankruptcy laws are characterised by an excessive number of liquidations and, consequently, a lower number of innovations compared to more debtor-friendly systems, which support the continuation of business activity. According to Ederer and Manso (2011, p 94), the pattern of motivation to innovate depends on the level of tolerance for bankruptcy and has an impact on long-term success. Debtor-friendly bankruptcy law has an impact on supporting research and seeking new solutions. If the law is too restrictive for debtors it may prevent them from conducting such activities as they will fear the consequences of failure.

Taking the scientific achievements so far into account, it may be assumed that, apart from other factors, the nature of bankruptcy law affects the development of entrepreneurship and innovation. It is also reasonable to assume that only some of the factors described which affect the friendliness of bankruptcy law towards debtors have a positive impact on the level of innovation and entrepreneurship. At this point, it is worth emphasising that, apart from the existing

43 J Armour and D Cumming (2008), 'Bankruptcy Law and Entrepreneurship', *American Law and Economics Review, 10*, 303–350, https://doi.org/10.1093/aler/ahn008.

44 YG Jia (2015), 'The Impact of Personal Bankruptcy Law on Entrepreneurship', *Canadian Journal of Economics/revue Canadienne D'économique, 48*, 464–493.

45 FM Fossen (2014), 'Personal Bankruptcy Law, Wealth, and Entrepreneurship—Evidence from the Introduction of a "Fresh Start" Policy', *American Law and Economics Review, 16*(1), 269–312, https://doi.org/10.1093/aler/aht015.

46 S Estrin, T Mickiewicz and A Rebmann (2017), 'Prospect theory and the effects of bankruptcy law on entrepreneurial aspirations', *Small Business Economics, 48*, 977–997, https://doi.org/10.1007/s11187-016-9810-1.

law, how effectively and efficiently it is enforced is also important. It is difficult to imagine that inefficiently enforced entrepreneur-friendly bankruptcy law would have a positive impact on entrepreneurship and innovation (Fu et al., 2020; Prusak et al., 2018). Moreover, the relationship between the friendliness of bankruptcy law towards debtors and the development of entrepreneurship and innovation is unlikely to be linear as far as the entire relationship is concerned.

3.1 European Union (EU) Directive 2019/1023

The need for CIE was recognised, among other things, in the Europe 2020 strategy and its 'Innovation Union' initiative (European Commission, 2010). The renewed European research and innovation agenda included a number of actions to boost innovation in Europe and ensure sustainable prosperity (European Commission, 2018). For this purpose, the harmonisation of insolvency laws has been at the top of the European institutions' agenda over the last decade. EU initiatives have intensified and gained momentum in the aftermath of the Global Financial Crisis of the late 2000s. They crystallised with the adoption of the European Commission Recommendation on a New Approach to Business Failure and Insolvency in 2014 (**ECR 2014**)[47], the European Insolvency Regulation Recast 2015 (EIRR 2015)[48], and the Preventive Restructuring Directive 2019/ 1023 (the **Directive**)[49]. Both the recast Insolvency Regulation and the Directive contain provisions that aim to enhance the quality of the information available to stakeholders and the European Commission on the restructuring and insolvency procedures open in Member States[50].

The Directive represents a milestone in the development of European insolvency law. It recognises the importance of gathering authentic data on the performance of procedures concerning restructuring, insolvency and discharge of debt. For this purpose, it requires the Member States to collect and aggregate certain data items on their insolvency systems that are sufficiently granular. The exercise of data collection is required to be communicated for better decision-making to the European Commission. It is aimed at making an accurate

[47] Commission Recommendation C(2014) 1500 final of March 12, 2014 on a new approach to business failure and insolvency [2014] OJ L 74/65.

[48] Council Regulation (EU) 2015/848 of the European Parliament and of the Council of May 20, 2015 on insolvency proceedings (recast) [2015] OJ L 141/19.

[49] Directive 2019/1023 of the European Parliament and of the Council of June 20, 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 2017/1132 (Preventive Restructuring Directive) [2019] OJ L 172/18.

[50] Gerard McCormack, The European Restructuring Directive (2021), Chapter 1, pp 1–38, available at https://www.elgaronline.com/view/9781789908800/07_chapter1.xhtml?tab_body=pdf-copy1.

assessment of the working of the Directive and for monitoring its implementation. The Directive identifies certain data categories that have to be collected and aggregated by Member States on an annual basis. The issue of how insolvency courts handle conflicts has been recognised in the Directive[51].

One of the innovations in the Directive is the introduction of early warning systems. Early warning mechanisms increase restructuring options and opportunities for the survival of the enterprise and are particularly necessary for small and medium enterprises (**SMEs**). The Directive seeks to provide tools and incentives to allow early identification of debt distress, which aim to prevent the insolvency of enterprises by allowing remedial action at the earliest possible stage[52].

In the EU, measures implementing the second-chance policy have been promoted for several years by reducing the stigmatisation of honest insolvent debtors, simplifying bankruptcy procedures, easing sanctions and enabling them to discharge their debts, among other things. Such activities are supposed to contribute to the development of CIE. However, despite some universal directions of change, the bankruptcy laws of individual EU Member States still show many divergent features. The main criterion differentiating them is the 'friendliness of bankruptcy regulations' towards debtor and creditors[53]. Studies aimed at distinguishing bankruptcy systems that are more debtor-friendly or creditor-friendly have been undertaken, for instance, by Wood (1995)[54], Hussain and Wihlborg (1999)[55], Berglöf et al. (2001)[56], Falke (2003)[57], Recasens (2004)[58], Franken (2004)[59], and López-Gutiérrez et al. (2005)[60]. In these research papers, the authors both showcased the criterion that distinguishes the

51 R Hollemans and G van Dijck, G. '"Come and talk": The insolvency judge as de-escalator', *Int Insolv Rev.* 2020; 29: 360–378, https://doi.org/10.1002/iir.1388.

52 José Garrido, Chanda DeLong, Amira Rasekh, and Anjum Rosha, 'Restructuring and Insolvency in Europe: Policy Options in the Implementation of the EU Directive', May 2021.

53 *Supra* note Prusak 2022.

54 PR Wood (1995a), *Principles of International Insolvency*, Sweet & Maxwell.

55 Q Hussain and C Wihlborg (1999), Corporate Insolvency Procedures and Bank Behavior: A Study of Selected Asian Economies, *IMF Working Paper, 135*, 1–46.

56 E Berglöf, H Rosenthal and E-L von Thadden (2001), *The Formation of Legal Institutions for Bankruptcy: A Comparative Study of the Legislative History*, Background paper for the World Development Report.

57 M Falke (2003), *Insolvency Law Reform in Transition Economies*, Winter Industries.

58 G Recasens (2004), 'Financial reorganization under pro-creditors bankruptcy laws', *Finance India: The Quarterly Journal of Indian Institute of Finance, 18*, 643–654.

59 S Franken (2004), 'Creditor- and Debtor-Oriented Corporate Bankruptcy Regimes Revisited', *European Business Organization Law Review, 5*(4), 645–676. https://doi.org/10.1017/S1566752904006457.

60 C Lopez-Gutiérrez, M Garcia Olalla, B Torre Olmo (2005), Insolvency Problems in the European Union: Bankruptcy Law Orientation and Market Valuation SSRN Electronic Journal 1–31, https://doi.org/10.2139/ssrn.712501.

two systems and attempted to assign specific countries to bankruptcy systems from the point of view of their friendliness to debtors and creditors.

However, the classification of countries into individual bankruptcy regimes concerned a relatively small number of countries, apart from the research conducted by Azar (2007)[61] and Morawska et al. (2020)[62]. The former proposed the PDI (pro-debtor index) and PCI (pro-creditor index) and allocated fifty countries to more or less debtor-friendly or creditor-friendly systems, based on several criteria and data from 2003. The latter (2020) developed the 'Bankruptcy Law Severity/Friendliness Index' (**BLSI**) and used it to identify countries with more debtor-friendly or creditor-friendly bankruptcy laws. The study included twenty-three EU Member States, the United Kingdom (UK), the United States of America (USA), Canada, and Australia.

Other streams of research using the division of bankruptcy systems into those more or less favourable to debtors or creditors comprised searching for relationships between the measures of entrepreneurship, innovation, enterprise performance and the type of bankruptcy regime. Based on research conducted in four countries (France, Germany, Spain, and the UK), López-Gutiérrez et al. (2005)[63] concluded that in countries with a creditor-friendly bankruptcy system, companies filing for bankruptcy lose more in terms of value than in debtor-oriented countries.

While, there are several important sources of insolvency data in many jurisdictions, none of these sources provide a full response to the prevailing needs for tools to evaluate and design insolvency systems. Although some of these data sources are evolving to include increasing amount of information, there are gaps in the information produced.

3.2 Assessing the impact of the Indian insolvency law

With the enactment of the Insolvency and Bankruptcy Code, 2016 (**Code or IBC**) in India the defaulter's paradise is lost[64] and market-driven 'freedom of exit' was made available. A systemic structural reform, the Code has unveiled a slew of measures towards the datafication of information process, in order to eliminate information asymmetry between the debtor and the creditor(s),

[61] ZR Azar (2007), *Bankruptcy Policy: An Empirical Investigation of 50 Jurisdictions Worldwide*, Available at SSRN, https://doi.org/10.13140/RG.2.2.17692.64641.

[62] S Morawska, B Prusak, P Banasik, K Pustulka and B Groele (2020), Bankruptcy Law Severity for Debtors: Comparative Analysis Among Selected Countries', *European Research Studies Journal*, XXIII (Special Issue 2), 659–686, https://doi.org/10.35808/ersj/1847.

[63] *Supra* Lopez 2005.

[64] *Swiss Ribbons Pvt. Ltd. & Anr. v UOI & Ors* (2019) 4 SCC 17.

provide verified financial information about the debt(s) of a corporate debtor (**CD**), evidence the default(s), expedite the completion of various processes under the Code; and remove regulatory sludge/ cholesterol[65]. The outcomes of the Code started playing out since its enactment. Direct outcomes of the Code, such as, inter alia, improvement in realisations by creditors, timely resolution of the debtor and decrease in insolvency resolution process cost are plainly evident. Other than these direct or measurable outcomes of the Code, some qualitative outcomes also have been unveiled. One of the most visible qualitative outcomes nudged through the Code is the behavioural transition in both the creditors and the debtors. This is evidenced by the latest information concerning withdrawals under IBC. As per the information released by the Ministry of Corporate Affairs, 'as of February 2022, 20,071 applications for initiation of corporate insolvency resolution process under the Code involving an amount of ?6.09 trillion (crore) have been withdrawn before admission'[66].

The data collection exercise to track the outcomes of the implementation of the Code is helmed by the Insolvency and Bankruptcy Board of India (**IBBI**), the Indian insolvency regulator. The IBBI maintains and regularly disseminates insolvency resolution data/information pertaining to, inter alia, the processes under the Code viz., corporate insolvency (resolution process, liquidation process and voluntary liquidation process), and individual insolvency dealing with resolution and bankruptcy process of personal guarantors to corporate debtors (CDs). It also publishes judgments passed by the Tribunals and Courts, and the details of Insolvency Professionals (**IPs**), Insolvency Professional Agencies (**IPAs**), Information Utilities (**IUs**), Insolvency Professional Entities (**IPEs**), Registered Valuers (**RVs**), and Registered Valuer Organisations (**RVOs**) on its website. Recently, the creation of the National Dashboard for Insolvency Data, to be housed by the Ministry of Corporate Affairs, Government of India, has been proposed by the Working Group on Tracking Outcomes under the IBC. It recommended a standardised framework with a real-time data bank, with data on time, cost and recovery rates together with macroeconomic indicators to assess the success of the five-year-old Code and improve its implementation.

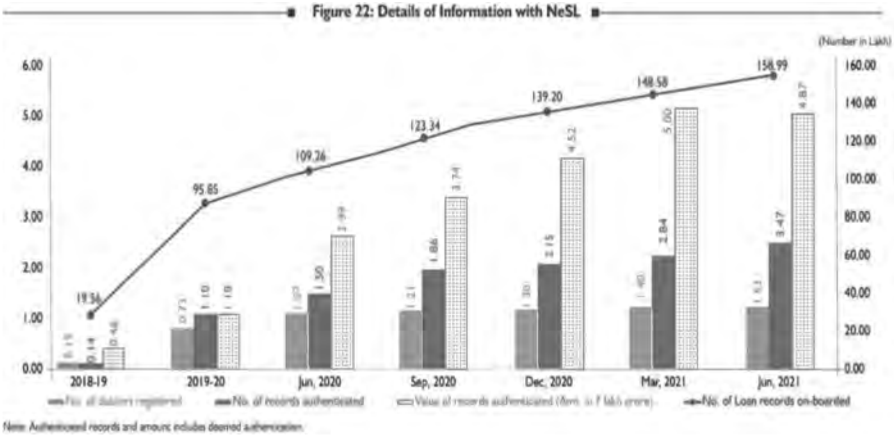
Procedural, legislative, and judicial dispensation through data and virtual portals is the swiftest innovation that the world has implemented to secure 'access to justice' and concurrently, prevent the spread of the novel coronavirus

[65] Juliana Balla, 'Regulatory Sludge: Reducing Paperwork Burdens to Preserve Our Time', March 20, 2019, available at https://regulatorystudies.columbian.gwu.edu/sites/g/files/zaxdzs3306/f/downloads/Commentaries/GW%20Reg%20Studies%20-%20Regulatory%20Sludge%20-%20JBalla.pdf.

[66] Monthly Newsletter, Volume 53, April 2022, Ministry of Corporate Affairs, p 1, available at https://www.mca.gov.in/bin/dms/getdocument?mds=mWwOv%252FtrKXeXaajSw61XAQ%253D%253D&type=download.

disease (COVID-19). In this vein, apart from creating a new class of professionals *viz.*, the IPs, and regulating the other service providers in the insolvency arena, the Code has instituted a new 'regulated information entity' of IUs. Clause (a) to sub-section (3) of Section 7 of the IBC provides that a record of default recorded digitally with the IU is one of the designated methods of furnishing proof to the AA to prove the existence of a financial debt accrued to a financial creditor[67].The importance of an IU stems from its primary function of providing 'core services' and increasing access to high-quality authenticated electronic information about debts and defaults to the Adjudicating Authorities (**AA**) under the Code[68]. To operationalise the IU ecosystem in India, the IBBI in exercise of its powers, *inter alia*, under Sections 214 and 215 read with Section 240 of the Code introduced the IBBI (Information Utilities) Regulations 2017.

Figure 1



As conceptualised by the Bankruptcy Law Reforms Committee (**BLRC**), and implemented under the Code IU is a novel concept and industry in India, with no exact parallels around the world[69]. IUs as a repository of electronic financial information bolster rule of law. In a short span of four years[70], the present and only IU, National e-Governance Services Limited (**NeSL**), has built a well-designed system, catering to the needs of both the creditors and debtors collecting authenticated data. As per the data released by the IBBI, there has been a considerable increase in the information recorded with the NeSL (**IU**).

[67] *Univalue Projects Private Limited v Union of India and others*, Writ Petition No. 5595 (W) of 2020, judgment dated August 18, 2020- High Court of Calcutta at Kolkata.

[68] *Ibid*.

[69] Report of the Working Group on Information Utilities, Ministry of Corporate Affairs, Government of India, 2017.

[70] NeSL commenced business operations on November 11, 2017.

While still at a nascent stage, in the long run, the services of an IU may be utilised in the early detection of incidence of insolvency to control deterioration and mitigate losses, thereby safeguarding the interests of all the stakeholders.

The IBBI tracks and publishes the following outcomes of various corporate processes under the Code on a quarterly basis in its Newsletters and on an annual basis in its Annual Report:

'Insolvency Resolution

(a) Quarterly summary statistics of Corporate Insolvency Resolution Processes (CIRPs) admitted, closed for various reasons and ongoing.
(b) Sector-wise distribution of CIRPs admitted and closed.
(c) Timeline of the conclusion of CIRPs.
(d) Number of claims admitted in case of cases withdrawn under section 12A and reasons for such withdrawal.
(e) Distribution of stakeholders triggering the resolution process – number of CIRPs initiated and closed by operational creditors (OCs), financial creditors (FCs), and corporate debtors (CDs).
(f) Details of CIRPs ending with liquidation in terms of the status of the CD at the time of commencement (i.e., whether it was in Board for Industrial and Financial Reconstruction (BIFR) or non-functional or both and whether its resolution value was higher or lower than the liquidation value).
(g) Details of CIRPs yielding resolution, in terms of date of commencement; date of approval of resolution plan, admitted claims, liquidation value, realisable value by FCs etc.

Liquidation

(h) CIRPs ending with orders for liquidation in terms of whether they were defunct or not, who initiated the CIRP and time taken since the commencement of CIRP and order of liquidation.
(i) Status of liquidations in terms of ongoing, submission of the final report and closed by dissolution.
(j) Reasons for liquidation such as non-receipt of resolution plan for approval by the AA, Committee of Creditors (CoC's) decision to liquidate the CD, etc.

Voluntary Liquidation

(k) Number of cases of voluntary liquidations filed quarterly, with their paid-up capital, outstanding credit, assets and dissolution orders passed;
(l) Reasons for initiation of voluntary liquidation;
(m) Status of voluntary liquidations in terms of number initiated and closed along with the time taken in completion of the process;
(n) Realisation under voluntary liquidation in terms of realisation of assets, amount due and paid to the creditors and liquidation expenses.

Status of Twelve Large Accounts

(o) Resolution of twelve large accounts was initiated by banks, as directed by the ReserveBank of India (**RBI**). The outcome of large accounts that ended with resolution plans in terms of amount admitted and realised, realisation as percentage of claims and liquidation value and successful resolution applicant is published.

Individual Processes

(p) Details of applications filed in terms of several applications, the debt amount, guarantee.

Financial Service Providers

(q) Details of cases admitted (as of end of March, 2021 only one case of the financial service provider was admitted)'[71].

4. Conclusion and way forward

Al Gore, a former US vice-president, once said, 'the future whispers while the present shouts'. It is paramount to embed the future more decisively in the present. This means making our policy-making systems, public institutions and analytical frameworks more future-oriented. Here are four suggestions designed to achieve this goal.

First, our existing public institutions that speak on behalf of future-oriented interests need strengthening. We should also create new institutions to represent future interests with weak or muted voices. Second, we should invest more in strategic foresight. Third, we must improve our monitoring and reporting of policy outcomes, trends, and risks. And finally, organisations should be legally obliged to report on the intergenerational implications of their major decisions, develop proper indices of intergenerational fairness, and produce periodic reports on their plans to tackle major intergenerational issues and long-term risks. They should report regularly on creeping or slow-burner problems. These reforms will not make the future 'shout', but they will help our long-term interests to be better represented and heard.

[71] Report of the Working Group on 'Tracking Outcomes under the Insolvency and Bankruptcy Code, 2016', November 10, 2021, available at https://www.ibbi.gov.in/uploads/whatsnew/4b74947e21c8b01f95bdcb348635ece5.pdf.

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