

Banking and Financial Insolvencies: The European Regulatory Framework

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Editorial Preface

In the wake of the Global Financial Crisis of 2008, whose effects can still be felt today, member states of the European Union proceeded to re-examine their domestic legislation and in many cases introduced new procedures to cope with financial institution indebtedness and the consequent impact this has on confidence in the banking sector and on the lending environment more generally. Emphasis also began, more or less concurrently, to be placed on how the institutions of the European Union itself, particularly those involved in ensuring the stability of the Eurozone, would cope with any future financial crisis.

The subsequent history of financial institution-related initiatives is complex and is not simply an insolvency-related story, although of course insolvency and the risks of financial failure have loomed high in the thoughts of legislators and policy-makers keen to avoid a repeat of events after 2008. As measures are introduced to ensure systemic integrity and that financial institutions can withstand strains placed upon them, through periodic “stress-testing”, the latest exercise having been carried out in mid-2016, the foundations of a strong Capital Markets Union are being systematically laid down. Alongside this, other insolvency-related measures targeted at the general economy and, in particular, business are emerging, not least the work that began in 2012 that has seen the adoption in 2015 of a Recast European Insolvency Regulation. At time of writing, work by the European Commission’s Experts’ Group in Restructuring and Insolvency, constituted in 2015, is likely to lead to a number of draft instruments emerging in the course of 2016-2017 which will further accentuate the need for member states to review their domestic rules in the insolvency field.

The intention behind the present text, consisting of papers delivered at the Annual Conference of the INSOL-Europe Academic Forum in Berlin, Germany on 30 September-1 October 2015, is that it will form an up to date account of viewpoints on measures taking place in the financial sector and the reform process. It is particularly noteworthy that members of both INSOL Europe and the Academic Forum have been engaged in the process by which various texts have been elaborated, from the Recast European Insolvency Regulation to the texts that are likely to emerge as a result of the most recent Experts’ Group. Furthermore, many members have also added their voices to the deliberations and studies looking into how the legal and regulatory environments for banking and financial institutions have been developed across the European Union. The skills and talent of members of the Academic Forum have played a more than modest role in shaping the texts that have emerged and those that are forthcoming.

As such, the papers here are truly cutting edge and will increase awareness of the impact of European insolvency law within domestic, regional and global contexts. Submissions for this collection have come from prominent academics, researchers

and doctoral students in the field representing a number of jurisdictions from common law, civilian and mixed traditions within Europe and further afield. This has ensured that the contents of the research and analyses included in this text are of the highest quality and will be useful and thought-provoking. It is hoped that this will render the contributions here as well as the further references they contain of great value for researchers in the field.

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

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A Note on the Academic Forum

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

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

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

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

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

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

PART I
THE BERLIN PAPERS

Chapter 1

Bank Insolvency: How can Ring-Fencing ensure the Continuity of Banking Services in an Insolvent Banking Group?

Andrew Campbell and Paula Moffatt

Introduction*

In November 2014, Mark Carney, Governor of the Bank of England and Chair of the Financial Stability Board (“FSB”) stated that:

“Globally systemic banks that fail will, in future, be resolved without recourse to the taxpayer and without jeopardising financial stability.”¹

His assessment was based on the fact that, since 2007 when the financial crisis began, much work had been done by banks to improve their stability. First, these so called G-SIBs (global, systemically important banks) had been largely recapitalised so were less likely to fail; second, their balance sheets were now more transparent so that contingent liabilities were more clearly accounted for; and third, the introduction of bail-in (whereby shareholders and specified classes of subordinated creditors would absorb losses in the event that a bank was failing) would mean that there would be no need to seek financial help from governments.

Perhaps surprisingly, there was no mention of ring-fencing banks in this speech, so where does ring-fencing fit in to the new financial world order? Despite Governor Carney’s lack of reference to this aspect of the regulatory regime, the necessary legislation is in place and the Bank of England has been building a model for ring-fencing banks for some years. In January 2016, the Bank of England published what it describes as “the last element of its bank ring-fencing framework”, which is a consultation document entitled “The Financial Policy Committee’s Framework for the Systemic Risk Buffer”.² The proposed date for implementation of

* This chapter forms a preliminary paper in our detailed study of ring-fencing. A full length paper will be published at a later date.

1 M. Carney, “The Future of Financial Reform” (17 November 2014), available at: www.bankofengland.co.uk/publications (last viewed 17 June 2015).

2 Bank of England (2016, London), available at: <http://www.bankofengland.co.uk/publications/Pages/news/2016/026.aspx> (last viewed 6 February 2016).

ring-fencing is the beginning of 2019 and the Bank of England appears to be well on track to meet this deadline. Not everyone, however, agrees that ring-fencing is the best way forward and there has been significant opposition from many in the banking industry and their criticisms will be considered.

This paper will seek to define ring-fencing and explore it from the UK perspective, since the UK has taken the decision to adopt a ring-fencing regime for banks that will be implemented, as already noted, by January 2019. The development of ring-fencing in the UK through the Report of the Independent Commission on Banking, chaired by Sir John Vickers, and generally referred to as the Vickers Report (“Vickers”)³ and its translation into the Financial Services (Banking Reform) Act 2013 (“FSBRA”) will be considered. The adoption (or not) of ring-fencing beyond the UK will be examined briefly and its relationship with bank resolution explored.

Defining Ring-Fencing

Schwarz has defined ring-fencing as:

“legally deconstructing a firm in order to more optimally reallocate and reduce risk.”⁴

What does this mean in the context of banks? A consideration of the term requires the concept of the universal bank to be re-visited. A universal bank is one which undertakes a full range of banking activities.⁵ It incorporates retail banking (being banking that involves individuals and small businesses and the taking of deposits), as well as commercial banking, investment banking and wholesale banking. These latter forms of banking activity are necessary for universal banks in order to raise loans that cannot be obtained purely from deposits. Universal banks are, inevitably, linked to the shadow-banking world through their dealings with securities, securitisations and derivative products. Shadow banking has been defined by the FSB as:

“credit intermediation involving entities and activities (fully or partial) outside the regular banking system.”⁶

3 Report of the Independent Commission on Banking (Final Report, September 2011), available at: <http://webarchive.nationalarchives.gov.uk> (last viewed 25 June 2015). Note that only the ring-fencing aspects are considered here.

4 S. Schwarz, “Ring Fencing” (2014) 87 *Southern California Law Review* 69, at 72.

5 Some universal banks offer services which go beyond what would be considered normal banking activities.

6 “Transforming Shadow Banking”, available at: www.fsb.org (last viewed 5 February 2016).

The connection between shadow banking entities and investment banks through a multiplicity of contractual obligations can pose significant risks for investment banks in the event that these entities are not “good for the money”. Shadow banks have not, traditionally, had to retain capital in the way that banks are required to, so investment banks dealing with shadow banks are exposed to the risk of their insolvency.⁷

In this instance, ring-fencing is then, the legal separation of the retail banking arm of a universal bank from that bank’s higher risk investment banking activities. Schwarcz describes ring-fencing as a regulatory tool that can be used to minimise systemic risk. In this context, the separation of high risk functions from low risk functions (by re-allocating risk to specified arms of the bank) should reduce systemic risk.⁸

The idea of ring-fencing is not new and there is some history associated with it; in the US, the Glass-Steagall Act of 1933 prevented deposit-taking banks from undertaking trading activities. Some, including Senator Elizabeth Warren, have argued that this separation under Glass-Steagall was responsible for the prolonged period of financial stability in the US that lasted until it was repealed by the Clinton administration in 1999.⁹ While it is beyond the scope of this article to examine this argument in detail it is undoubtedly the case that it does provide considerable ammunition for supporters of ring-fencing. However, we would argue that many other factors were involved in this prolonged period of financial stability.

The discussion could lead to the perception that all investment banking activities are “bad” but this is not, in fact, the case. There are a number of important investment banking activities that are carried out that will be of use to retail bank customers, such as foreign exchange and interest rate swaps. This begs the question as to what activities should be separated if ring-fencing is to be pursued.

The UK Perspective

The UK work on ring-fencing banks began shortly after the financial crisis and culminated in the publication of the final Vickers Report in September 2011.

7 Ibid.

8 There is much scope for discussion about the effect of ring-fencing on systemic risk but it is beyond the scope of this article to consider this in detail.

9 E. Warren. See: <http://elizabethwarren.com/blog/glass-steagall> and sec 2 of ‘Findings and Purpose’ of the 21st Century Glass Steagall Act of 2013 (her Senate Bill) reintroduced on 7 July 2015 and available at: <http://www.warren.senate.gov/files/documents/21stCenturyGlassSteagall.pdf>. See also: <http://www.doddfrankupdate.com/DFU/ArticlesDFU/Senators-reintroduce-bill-with-GlassSteagall-prot-64276.aspx> and J. Authers, “Markets make best case for Glass-Steagall” (14 July 2013), at: <http://www.ft.com/cms/s/0/14e08822-eb04-11e2-9fcc-00144feabdc0.html#axzz3gJc8Wam> (all last viewed 18 July 2015).

Vickers and his committee members proposed the introduction of a form of ring-fencing for certain banks in the UK and the UK banks affected by the proposal agreed to accept this, albeit with a degree of reluctance. Vickers identified the following purposes of a ring-fence: first, to isolate essential retail banking activities and insulate them from shocks within the financial system so that essential services could be maintained in a crisis; and second, to curtail reliance on government guarantees and enable banks to be resolved without having to use taxpayers' funds.

Vickers considered how to establish the ring-fence; that is, what activities should it cover (the location of the fence) and how far should it extend (the height of the fence)? There has since been considerable discussion as to how its implementation can be enforced (the so-called electrification of the fence). He identified some principles which are outlined below.

The Location of the Fence

Principle 1 stated that only ring-fenced banks should be granted permission by the UK regulator to provide “mandated” services. These were defined as taking retail deposits and providing overdrafts and payment services. Under principle 2, ring-fenced banks should not be allowed to undertake activities, to the extent that they were, broadly, ‘high risk’ or might make it difficult to resolve the bank in a crisis situation. Principle 3 established that ring-fenced banks should only participate in non-prohibited activities.

These three principles have been largely adopted under FSBRA 2013 and its supporting secondary legislation. FSBRA introduces the concepts of “core activities” and “core services”. The only core activity under FSBRA is deposit-taking, while core services are those that are linked to the deposit-taking activity and are essentially deposit, overdraft and payment services. There is an exemption for small deposit-takers.

Under FSBRA, a ring-fenced body cannot deal in investments as principal, but could undertake some derivatives activity. There is, therefore, a nuanced approach in recognition of the fact that some investment banking activities will be necessary for retail clients.

How Effective are these Provisions likely to be?

It is unclear how effective these provisions are likely to be. It will depend on how rigorous the scrutiny of the UK bank regulator, the Prudential Regulation Authority (“PRA”) will be. The PRA is a subsidiary of the Bank of England and has replaced the

Financial Services Authority (“FSA”) which was perceived to have failed to monitor the banks sufficiently in the period leading up to the financial crisis. It is difficult to know whether the PRA is likely to be any better than the FSA at this stage.

It is possible for HM Treasury to relax the rules relating to prohibited activities in relation to specific banks. It seems unlikely that there will be any relaxation of the ring-fencing rules in the short term, but it is a possibility. As memories of the crisis fade, could there be a rise in the number of relaxations which could lead to a re-exposure of retail banks to risky investment bank activities?

The Height of the Fence

Principle 4 stated that ring-fenced banks should be separate legal entities within their corporate groups and their subsidiaries limited to ring-fenced activities. Universal banking therefore remains a possibility, but the ring-fenced bank functions would be legally and operationally separated so that the ring-fenced bank could continue to provide core functions in a crisis situation. This model is therefore distinguishable from the Glass-Steagall model.

Principle 5 addressed the question of economic separation; a ring-fenced bank should have to meet its regulatory requirements on a standalone basis. In addition, any relationships between the ring-fenced bank and other entities within the group would have to be managed on an arm’s length basis.

In effect the UK has opted for a “sibling” structure within a banking group for implementing ring-fencing. A non-ring-fenced UK holding company can cluster its subsidiaries into two chains; one is a ring-fenced group of companies and the other is a non-ring-fenced group of companies. As a ring-fenced body can only undertake ring-fenced activities, all its subsidiaries must also be ring-fenced bodies so that there is no crossing-over of risk from the non-ring-fenced part of the group into this ring-fenced part of the group. This also requires that a ring-fenced body must have direct access to the payment system without going through a non-ring-fenced body.

A partial geographical ring-fence is also established under the new regime, as a ring-fenced body cannot have a branch or participating interest in an undertaking carrying on a regulated activity outside the European Economic Area.

Electrifying the Fence

The PRA is in the process of drafting rules to help to ensure that the board of directors of a ring-fenced body remains truly independent of the board of its UK

holding company. This immediately raises matters of conflict and tension. Will the board of the ring-fenced body be able to resist pressure from the board of its parent if it is asked to relax its approach to ring-fencing? Why would a parent company want to own a company that it cannot control?¹⁰ The latter question is more easily resolved since the ultimate holding company can simply decide to sell the ring-fenced part of the business if it becomes too difficult to manage.

The PRA rules also envisage establishing and recruiting individuals to specified Senior Manager positions for the purpose of ensuring that the ring-fence is maintained. Directors and Senior Managers cannot work across the ring-fence; they can only work within the ring-fenced part of the bank and so could not have a separate directorship of a non-ring-fenced entity within the bank. There are some concerns that the pool of people available for these roles will be small.

Managing the Capital

Generally, banks are evaluated on a consolidated basis. Ring-fencing presumes, however, that the ring-fenced bodies will be separately capitalised. The PRA is in the process of developing the prudential requirements for ring-fenced bodies on the basis of the sibling structure, which would allow capital and liquidity requirements to be “sub-consolidated”. This would allow the ring-fenced part to be distinguished from the non-ring-fenced part.

The View of the Banks

The UK banks have committed to implementing ring-fencing within the time frame set out by the legislature.¹¹ For those banks with a global reach, such as HSBC, the costs are much greater than for those banks with a more local UK presence, such as Lloyds. For HSBC, the costs are viewed as wasted costs as the capital used to implement ring-fencing could be better used elsewhere, for example, in its work on changing the culture. Perhaps surprisingly the Chief Executive of Lloyds Bank, Antonio Horta-Osorio, argues that the principle behind ring-fencing is right and he does not view the proposed ring-fencing rules as overly burdensome.¹² This view is not shared by Barclays Bank former Chairman, Sir David Walker, who is quoted as saying it is “actively harmful to the UK”.¹³

10 Questions discussed by the House of Lords Economic Affairs Committee on 30 June 2015. See video recording of session available at: Parliamentlive.tv <http://parliamentlive.tv/event/index/2019e0ca-4235-4853-8c17-af30b00f3ee3?in=15:36:33> (last viewed 29 July 2015).

11 Ibid.

12 Financial Times (20 June 2015).

13 Ibid.

Regardless of whether or not the introduction of ring-fencing is supported there is no doubt that the financial costs will be extremely large, both for implementation and on an annual basis thereafter. Some estimates have been as high as GBP 5 billion to implement, although HM Treasury's estimates are lower at GBP 3 billion to implement and thereafter up to GBP 4 billion a year.¹⁴ For Vickers, the presumption is that whatever the costs are, they are likely to be less than the costs that would be imposed on the taxpayer in the event of another banking crisis.

Beyond the UK

While considerable work on ring-fencing has been undertaken by the EU with the publication of the Liikanen Report in 2012 and the preparation of draft legislation, little seems to be happening at present. The Liikanen Report had much in common with Vickers and would have led to ring-fencing throughout the EU. However, work on this across the EU has stalled.¹⁵ But within the EU, both France and Germany have instigated a form of ring-fencing which means that, in effect, the three largest banking markets have gone ahead with ring-fencing in any event without waiting for the EU.

In response to the financial crisis, the US introduced the “Volcker Rule” under which deposit-taking institutions are prohibited from proprietary trading.¹⁶ Interestingly, however, Australia has actively decided not to introduce ring-fencing. Following the Australian Government's Financial System Inquiry Report of November 2014, it was concluded that it would be sufficient for the Australian banks to work towards international best practice with regard to the capitalisation and regulation of banks.¹⁷

Ring-Fencing and Bank Resolution

The UK and EU regulators have claimed that ring-fencing will assist in the resolution of failing banks. Will this be achieved? In theory, ring-fencing may

14 Ibid.

15 The Proposal was rejected by the Committee on Economic and Monetary Affairs on 26 May 2015 ECON_PV (2015) 0527_1, available at: <http://www.europarl.europa.eu> (last viewed 6 September 2015). On 19 June 2015, the European Council agreed its position but is waiting for the EU Parliament to respond. See Press Release 474/15 available at: <http://www.consilium.europa.eu/en/press/press-releases/2015/06/19-restructuring-risky-banks-council-agrees-negotiating-stances> (last viewed 5 August 2015).

16 Title VI of the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (US).

17 See the Australian Government (The Treasury) Financial Systems Inquiry “Themes of Report” at “Resilience”, available at: <http://fsi.gov.au/publications/final-report/overview/themes-of-this-report> (last viewed 5 August 2015) and also the Response of the Australian Government to the Financial Systems Inquiry (20 October 2015), available at: <http://www.treasury.gov.au/PublicationsAndMedia/Publications/2015/Govt-response-to-the-FSI> (last viewed 20 October 2015).

help with the resolution of banks. First, it is hard to see how a fully capitalised ring-fenced entity would fall to be the subject of a resolution procedure. Second, the legal and operational separation of ring-fenced bodies within a banking group must be of help when creating Recovery and Resolution Plans (“RRPs”) under the Banking Resolution and Recovery Directive and Single Resolution Mechanism.¹⁸ In the event that an RRP required implementation, much of the work of separating core activities would already be in place.

Other Issues

Maintaining core functions across borders requires a great deal of international co-operation. Despite the best laid plans, it may be the case that, in a future crisis, regulators will come under pressure from governments to hang on to the capital in their own jurisdictions to benefit local bank customers (being the people who would vote them into or out of office) and not allow it to be transferred into another jurisdiction to help to serve the interests of depositors there. This has been a problem in the past with the authorities in the US in particular refusing to adopt a universalist approach to a bank insolvency where there are assets situated in the US.

It is also recognised that simply moving risk from one place to another does not necessarily eliminate or even reduce it. And if banks are not allowed to undertake universal functions, how will a purely deposit-taking business ever generate sufficient capital from interest either to grow or to sustain itself? Is it the case that there are some non-core functions that are necessary to generate growth to enable credit intermediation in that sector to continue? The Vickers Report presupposes that all the risks lie in the investment banking sector. Is this in fact the case?

Concluding Thoughts

It is not entirely clear that ring-fencing is necessary as there are other possible ways of providing protection as the Australians have demonstrated. Also, ring-fencing has not been identified by the FSB as something which is necessary and a number of jurisdictions have actively decided not to take it up. On the other hand there is undoubted support from many quarters for various approaches which represent some form of ring-fencing and this may create a level of uncertainty about the regulation and supervision of banks globally. Instead of a unified approach to international best practice we are witnessing considerable divergence which is arguably a backward step.

¹⁸ Bank Recovery and Resolution Directive [2014] OJ 2 173/190; Single Resolution Mechanism [2014] OJ 2 225/1.

As has been seen the proposed UK approach is likely to go some way towards achieving the Vickers objectives and is likely to facilitate the bank resolution process. Nonetheless, ring-fencing is going to be expensive to implement in practice, as has already been seen in the UK where those banks which have to ring-fence have had to draw up detailed proposals as to how they will achieve this. Those bankers who are critical of ring-fencing point to the expense and the duplication of activities it will cause.

The UK government was enthusiastic in its support of the Vickers proposals and the Bank of England appears also to provide its backing. The latest Bank of England consultation demonstrates that we are still on course for the introduction of ring-fencing for the UK's largest banks on 1 January 2019. The jury is out over whether ring-fencing is the best way forward and it is far from clear whether there will eventually be an EU proposal for ring-fencing. In the UK, however, it is going to happen in any event.

Chapter 2

The Changing Role of the Judiciary in Insolvency: The Case of Bank Resolution

Matthias Haentjens

Introduction¹

“Judge-made law has played its part. To statute-law belongs the future. Let us pray for well-drawn statutes.”

Augustine Birrell (1850-1933), who was Chief Secretary for Ireland, but also the author of humorous essays, an academic and a lawyer, reportedly said so. It was Eduard Maurits Meijers, the main draftsman of the current Dutch Civil Code, who attributed the saying to him, and he cited it on several occasions.² One can easily see why Meijers was so fond of this saying, for he interpreted it as meaning that civil law should be based on a well-drawn civil code, instead of being based on case law.

In this contribution, I will show that in insolvencies, more specifically in bank insolvencies, judge-made law has indeed played its part. Current bank insolvency law must be found in administrative law statutes, and the role of the bankruptcy judge is taken over by government authorities who act on the basis of those administrative law statutes. Thus, if any court is involved, it is the administrative court. But this administrative court can play but a minimal role, which entails dramatic consequences for legal protection of any relevant stakeholder.³

- 1 Parts of this contribution have been based on lectures held at the yearly IEEI colloquium on 12 June 2015 (Lisbon) and at the EBA proportionality workshop on 3 July 2015 (London). I am grateful to the audiences of both lectures for their comments.
- 2 At least in the following three lectures: lecture of 30 June 1922, lecture of 8 May 1948 and lecture of 16 May 1951, printed in *Verzamelde privaatrechtelijke opstellen van prof. mr. E.M. Meijers, Eerste deel*, Leiden (1954), at 24, 158 and 189 (continued at 193), respectively.
- 3 Indeed, the new regime represents a dramatic shift for those countries where bank insolvencies were previously governed by civil law. These countries include, as will be discussed, the Netherlands, but also France, Germany and the UK. Other countries, including the US, Japan and Switzerland, already had an administrative bank insolvency regime, and for those countries, the new regime is less revolutionary in this respect. See C. Hendren, “Judicial and Administrative Approaches to Bank Resolution: Prospects for International Harmonization” (Huntsman Program, Wharton Papers 2011), available at: <http://fic.wharton.upenn.edu/fic/papers/11/11-73.pdf> (last viewed 16 December 2015).

The development just referred to is very recent, for it was in reaction to the last global financial crisis that many jurisdictions have drastically overhauled their rules governing bank insolvencies. In short, previous bank insolvency regimes mainly consisted of, either direct or indirect application of general insolvency law, and have been replaced with an administrative resolution regime. In this administrative regime, wide-ranging powers have been conferred to government authorities to resolve banks in financial distress.

Also general corporate distress law is undergoing a process of overhaul in many countries so as to enhance the possibility of rescue of viable businesses and to streamline the liquidation of unviable ones. The changes in both fields just discussed share a remarkable common characteristic: the minimization of the role of the judiciary – traditionally omnipresent in insolvency. On the one hand, corporate insolvencies are ever more subjected to prearranged restructurings, out of court workouts and (partial) out of court liquidations. On the other hand, crisis management in the banking sector has been taken away from the insolvency judge and laid in the hands of government agencies. In this contribution, I will focus on the role of the judiciary in the new European bank resolution regime, which has dramatically changed as of 1 January 2016.

Background⁴

In the financial and economic crisis that ensued since 2008, a large number of banks and, more generally, of financial institutions, suffered from grave financial difficulties. The relevant governments most often believed a bankruptcy of the larger ones of those institutions would have caused serious consequences for the stability of the financial system as a whole, and they therefore chose to prop these institutions up with taxpayer money, sometimes by means of nationalization. These institutions were, in other words, perceived to be *too-big-to-fail*. Between 2008 and 2012 in Europe alone, the European Commission approved EUR 591.9 billion (equivalent to 4.6% of the GDP of the EU) of state aid for financial institutions.⁵ Thus, bankruptcy law as it then existed was perceived to be inadequate to cope with the insolvency of financial institutions.

More specifically, traditional bankruptcy law proved to be antiquated and inadequate when having to deal with financial institution insolvencies in two respects. First,

4 This paragraph has been based, in part, on M. Haentjens, “Bank Recovery and Resolution: An Overview of International Initiatives” (2015) 24 *International Insolvency Law Review* 255-270.

5 See: http://ec.europa.eu/competition/state_aid/scoreboard/financial_economic_crisis_aid_en.html (last viewed 28 April 2014).

traditional bankruptcy law has always been directed at the maximization of a debtor's liquidation value so as to satisfy his creditors' claims. In the instance of financial institutions that are deemed to be systemically important, this approach may result in severe disruptions of the stability of the global financial system – and the bankruptcy of Lehman Brothers proved to be a case in point. Moreover, the application of traditional bankruptcy law to banks may cause social unrest even if payment services become unavailable to consumers only locally – of which the Dutch DSB Bank bankruptcy proved to be an example.

Consequently, various international organizations have called for the modernization of bankruptcy law, so as to tailor it to the needs of systemically important financial institutions and banks in general. The authoritative Financial Stability Board (“FSB”) has argued that these new bank insolvency rules should be directed at the preservation of crucial functions, at the preservation of financial stability, at the minimization of (the need for utilization of) tax payer money and at the protection of, in short, retail clients.⁶

Second, the 2008 global financial crisis has shown that where internationally operating banking groups may have been international in life, they proved to be national in death.⁷ In other words, they were usually resolved along national lines, which did not always yield the most optimal result. A tragic example may be found in the demerger and nationalisation of the Belgian/Dutch conglomerate Fortis after its acquisition of ABN AMRO. The bank was eventually split up along national lines, which was partly the result of different assessments of the bank's predicament by the relevant Dutch and Belgian authorities.⁸

The Basel Committee for Banking Supervision (“BCBS”) has therefore argued that a harmonized regime would help to address such cross-border inefficiencies by creating compatible national bank insolvency frameworks. In the BCBS's analysis, international compatibility would facilitate the continuity of key functions across borders and thus the maintenance of financial stability.⁹ I believe the BCBS was right where it stated that while coordination between the national processes remains

6 See FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions (2011); Recitals (1) and (27), Article 26(2), BRRD.

7 Saying attributed to both Bank of England Governor Mervyn King and economist Charles Goodhart. See R. Epstein and M. Rhodes, “International in Life, National in Death? Banking Nationalism on the Road to Banking Union” (KFG Working Paper Series No. 61, December 2014).

8 Basel Committee for Banking Supervision, Bank for International Settlements, Report and Recommendations of the Cross-border Bank Resolution Group (2010), at 11 (“BCBS Report”).

9 Ibid., at 5.

a necessary condition to achieve this result, such coordination may be helped by a harmonized regime.¹⁰

A vicious bond between sovereign and bank industry finances emerged as a specifically European consequence of the global financial crisis. In Greece, for instance, the banking sector had taken on large amounts of local government bonds so that when it became evident that government finances were deplorable and government bonds were downgraded to junk status, the government took the banking sector with it in its financial downfall. Conversely, in Spain and Ireland, banks broke the government. Spanish and Irish banks had taken on large real estate portfolios and were therefore most vulnerable to any serious downturn of the real estate market. When that happened, their governments had to bail them out at enormous costs.¹¹ To break this doom-loop between European sovereigns and banks and, even more ambitiously, prevent a future crisis, several initiatives have been taken under the title “Banking Union”. This Banking Union was aimed, in part, to achieve a truly modernized and harmonized bank insolvency regime. It was originally intended to consist of three legs or pillars.

First, a Single Supervisory Mechanism (“SSM”) has been put in place, under which the European Central Bank (“ECB”) acts as the single prudential supervisor responsible (directly or indirectly) for all 6,000 banks in the Eurozone. The ECB has become directly responsible for, in short, systemically important and cross-border operating banks, whilst it supervises indirectly, i.e. through the local supervisory authorities, all other banks. The ECB thus supervises, for instance, Dutch banks ABN AMRO, BNG, Rabobank, ING Bank, NWB, RBS N.V. en SNS Bank, while all other Dutch banks continue to be supervised by the Dutch Central Bank (*De Nederlandsche Bank*, “DNB”).¹² Certain supervisory powers, such as the granting of a banking licence, have been conferred on the ECB irrespective of the bank’s size and operations. The basis of this SSM is a Regulation that has been enacted on 1 November 2013. The ECB has performed its operational tasks since 4 November 2014.

Yet, as Yves Mersch, member of the ECB executive board, has explained, this single supervisor cannot give objective verdicts on the viability of banks if they cannot be resolved in an orderly way without the risk of contagion.¹³ In other

10 Ibid., at 25 and Recommendation 3.

11 See, e.g., M. Lewis, *Boomerang: The Biggest Bust* (2011, Penguin, London), at 83 et seq.

12 Cf. <https://www.nvb.nl/contentpagina-s/3434/bankenunie-single-supervisory-mechanism-ssm.html> (last viewed 11 December 2015).

13 Y. Mersch, “Europe’s Ills Cannot Be Healed Only by Monetary Innovation” (*Financial Times*, 25 April 2013).

words, a modernized and harmonized bank insolvency regime is a necessary condition for the common supervisor to function properly and to be able to show its teeth. Such a modernized and harmonized bank insolvency regime therefore forms the Banking Union's second leg. This leg is based on the Bank Recovery and Resolution Directive (“**BRRD**”), which applies to all EU Member States, and the Single Resolution Mechanism Regulation (“**SRM Regulation**”), which is a uniform mechanism that applies to the Eurozone only. The SRM Regulation uses the same division of powers as the SSM, so that the Single Resolution Board (“**SRB**”) manages the resolution of so-called significant banks and banks with cross-border operations, while national resolution authorities (in the Netherlands: DNB) manage the resolution of non-significant or purely domestic banks. The BRRD has been adopted on 15 May 2014 and should have applied as of 1 January 2015.¹⁴ The SRM Regulation had been adopted on 19 December 2014 and applies as of 1 January 2016.

Finally, any bank insolvency needs funding. Initially, the Commission proposed to create a common European deposit guarantee scheme (“**DGS**”) as the third leg of the Banking Union, so as to provide funding and protect EU's depositors in the newly created bank insolvency framework. But this plan has proven – at the moment at least – too ambitious politically.¹⁵

Next to these three “legs” stands the European Stability Mechanism (“**ESM**”), which is based on a Treaty concluded between the Member States of the Eurozone, but which does not form part of the constitutional framework of the EU. The ESM is intended to support Member States that experience financial difficulties and it provides for a fund with a EUR 500 billion lending capacity.¹⁶

Previous Regime (NL)

As just explained, the 2008 global financial crisis led various jurisdictions to enact modernized bank insolvency regimes. While such a regime has been proposed and enacted in the EU in the form of the Banking Union's second leg, it has also been accomplished in the US. Both regimes have in common that they aim to facilitate

14 In the Netherlands, however, its implementation legislation has been enacted only on 26 November 2015, while the Commission had already initiated an infringement proceeding.

15 Some economists, however, have argued that one should start with the introduction of the common fund – and then work backwards, via a common insolvency regime to a single supervisor. See, e.g., D. Schoenmaker, “Banking Union: Where We're Going Wrong” in T. Beck (ed.), *Banking Union for Europe, Risks and Challenges* (2012, Centre for Economic Policy Research, London), at 95 et seq.

16 See: <http://www.esm.europa.eu/press/releases/esm-reaches-target-level-of-80-billion-in-paid-in-capital1.htm> (last viewed 11 December 2015).

expeditious measures to resolve a failing bank, and these measures are taken in an administrative process rather than in a judicial one.¹⁷

In this paragraph, I will illustrate some of the changes the new bank insolvency regime has brought for judicial protection by taking the laws of the Netherlands as an example. I will compare the Netherlands bank insolvency regime as it existed prior to the implementation of the BRRD and the SRM with the current situation. For this exercise, I will use three points of comparison, viz. three different instruments that can be used when a bank experiences severe financial difficulties:

- 1) bankruptcy or liquidation;
- 2) reorganization in the form of an asset or share transfer to another entity; and
- 3) bail-out, i.e. government support through nationalization.

First, under the Netherlands law (as under virtually any other legal system), bankruptcy has been the traditional means of resolving a failing bank and, more generally, of any insolvent company. As stated above, bankruptcy is an instrument directed at the maximization of the failing company's liquidation value with an aim to satisfy creditors' claims, and it involves the sale of the insolvent's assets and distribution of the proceeds amongst creditors. Bankruptcy law has been codified in the Dutch bankruptcy code in 1893. As an iconic historic example of the application of bankruptcy law to a failing Dutch bank, the Teixeira de Mattos bank was declared bankrupt in 1966, with Messrs H.M. Burghardt and R. Korthals Altes having been appointed as liquidators (*curatoren*). As a more recent (but no less iconic) example, the Dirk Scheringa Bank was declared bankrupt on 16 October 2009.

Critical elements of the instrument of bankruptcy are, first, that the state of bankruptcy follows from a court decision (art. 1(1) Bankruptcy Code (*Faillissementswet*, "Fw")). For this court decision the debtor may have been heard *ex ante* (Article 6 Fw). All stakeholders, i.e. any creditor, other interested party (*belanghebbende*) and the debtor itself may challenge the court decision *ex post* (Articles 10 and 8 Fw, respectively). Since the enactment of the so-called Intervention Act in 2012, however, creditors, nor other interested parties are allowed to challenge the bankruptcy declaration of a bank, while the debtor may

17 For the EU, see, e.g., BRRD Impact Assessment, at 8 et seq. and for the US, see, e.g., R. Bliss and G. Kaufman, "U.S. Corporate and Bank Insolvency Regimes: An Economic Comparison and Evaluation" (Federal Reserve Bank of Chicago, Working Paper 2006-01), at 28-30.

challenge the court decision *ex post* only if no transfer plan has been approved (Articles 114hi Fw, see on such transfer plan immediately below).

Nonetheless, the entire bankruptcy proceedings take place under court supervision. This means a dedicated magistrate or supervisory judge (*rechter-commissaris*) needs to approve all material issues (Article 64 Fw), and chairs creditors meetings (Article 80 Fw). Virtually all decisions taken by this judge are open to appeal with the bankruptcy court (Article 67 Fw), and ultimately with the Supreme Court (*Hoge Raad*) (Article 426(1) Code of Civil Procedure (*Wetboek van Burgerlijke Rechtsvordering*)). Any interested party has standing to initiate such appeal proceedings.

Since 1970-1971, “emergency proceedings” (*noodregeling*) have been introduced as a stand-still regime specifically for failing banks. Also this regime follows from a (bankruptcy) court declaration (Article 3:162d(1) Financial Markets Supervision Act (*Wet op het financieel toezicht*, “**Wft**”). As in the case of a bankruptcy declaration, the emergency proceedings declaration includes the appointment of a supervisory judge (*rechter-commissaris*). Importantly, the court empowers administrators (*bewindvoerders*) to either reorganize, or liquidate the failing bank (Article 3:163 Wft) under supervision of the supervisory judge. In practice, however, emergency proceedings are virtually always followed by bankruptcy, as was the case, for instance, with DSB Bank.

Since the enactment of the Intervention Act in 2012, a (bankruptcy) court may also declare a failing bank or insurance company subject to a so-called “transfer regime” (Article 3:159v Wft). This means the shares or assets of a failing bank or insurance company are transferred to another entity by means of the same court’s declaration. As for the bankruptcy declaration just discussed, the court may decide to hear *ex ante* the debtor, i.e. the failing bank itself, but also any shareholder holding more than 5% of the outstanding capital (Articles 3:159x and 3:159w Wft, respectively). *Ex post*, other shareholders may challenge the decision before the relevant court, which is the Amsterdam District Court.

Third, the Intervention Act has codified the Minister of Finance’s power to nationalize a failing bank or insurance company, i.e. his power to expropriate all shareholders and creditors of the bank or insurance company (Article 6:2 Wft). The Dutch Minister of Finance has used this power for the first – and until now: last – time within a year after enactment of the Intervention Act when he decided to nationalize SNS REAAL N.V. on 1 February 2013. This decision is not open to any *ex ante* hearing.

In a nationalization scenario, court involvement is limited to two types of *ex post* proceedings. First, the legality of the expropriation decision itself may be challenged with the judicial wing of the Council of State (*Afdeling Bestuursrechtspraak van de Raad van State*) (Article 6:7(5) Wft). Any interested party (*belanghebbende*) has standing to challenge the decision, but must do so within 10 days (Article 6:7(1) Wft). Additionally, separate proceedings must be initiated to have the court determine the damages that the Minister has to award to compensate the expropriated shareholders and creditors. These proceedings must be brought before the Enterprise Chamber of the Amsterdam Court of Appeals (*Ondernemingskamer*) (Article 6:10(1) Wft), are open to any expropriated party (*rechthebbende*) and are not time barred as the proceedings before the Council of State.

New Regime (EU)

Now let us take a look at what has happened to these three instruments of bank insolvency (i.e. bankruptcy, transfer regime and nationalization) under the new European bank insolvency regime, which now applies throughout the EU and the Eurozone – including the Netherlands – on the basis of the BRRD and the SRM Regulation.

Formally, the new European regime has not affected bankruptcy as an instrument of bank resolution. Moreover, as a matter of principle, the BRRD states that

“a failing institution should in principle be liquidated under normal insolvency proceedings” (Recital 45),¹⁸

while “normal insolvency proceedings” are meant to include, most notably, bankruptcy.¹⁹ On the other hand, BRRD provides that bank bankruptcy proceedings can only be initiated by the relevant resolution authority (Article 86(1) BRRD²⁰). Moreover, they may not be opened parallel to resolution measures that have been introduced by the new EU regime (Article 86(2) BRRD).

Additionally and perhaps even more importantly, bankruptcy proceedings may only be opened if such proceedings would not result in a threat to critical functions,

18 Cf. also Recital 46, BRRD: “The winding up of a failing institution through normal insolvency proceedings should always be considered before resolution tools are applied.” and the almost identical Recital 59, SRM Reg.

19 More precisely, Article 2(47), BRRD, which provides: “‘normal insolvency proceedings’ means collective insolvency proceedings which entail the partial or total divestment of a debtor and the appointment of a liquidator or an administrator normally applicable to institutions under national law and either specific to those institutions or generally applicable to any natural or legal person”.

20 Implemented in Article 212ha, Fw. Before implementation, this article provided that bankruptcy could – beside the Dutch Central Bank as the relevant resolution authority – be requested by the failing institution itself. This possibility has now been removed.

have adverse effects on financial stability, cause reliance on extraordinary public financial support or endanger the position of depositors and investors, client funds and client assets (cf. Recital 45 BRRD/58 SRM Reg.²¹). This is important, for – as I have argued elsewhere²² – it would only be in very rare cases that these requirements would be met in ‘normal insolvency proceedings’, considering that the purpose of normal insolvency proceedings such as bankruptcy is liquidation so as to maximize creditor value.

It may therefore be safely assumed that as a matter of principle, the BRRD and SRM Regulation require the application of its new bank resolution regime, and that only in exceptional circumstances a traditional bankruptcy can be declared. As I see it, such circumstances could only be either in the instance of the failure of a very local bank or a bank with a small client and investor base (when bankruptcy can safely be applied instead of the new bank resolution regime), or so as to complement the exercise of the new resolution regime.²³ In all other cases, resolution of a failing bank is managed by the relevant resolution authority, which means, in short, DNB for non-significant or purely national banks, and the SRB for significant and cross-border banks. The role of traditional bankruptcy and the bankruptcy court has therefore been marginalized.

The new EU bank insolvency rules have significantly amended the previously existing transfer instrument. Other than under the previous regime, it is not upon a court decision that the transfer regime is declared and transfers are effectuated. Under the new EU bank insolvency rules, it is the relevant resolution authority, i.e. DNB or the SRB, that has become empowered to effectuate a transfer of any assets and shares of a failing bank. Such a transfer can form part of either the “sale of business tool”, the “bridge institution tool” or the “asset separation tool”.²⁴

In short, under the “sale of business tool”, resolution authorities may effectuate the sale of the shares and any other assets (including liabilities) of the failing bank to a private purchaser, i.e. any purchaser willing to buy those assets. Under the “bridge institution tool”, the authorities may transfer shares and assets to a

21 Cf. Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EEC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010 (**‘BRRD Proposal Text’**), n. 11: “If authorities assess that financial stability and taxpayers are not threatened, a bank (or parts of it) may be allowed to fail in the ordinary way.”

22 M. Haentjens, “National Insolvency Law in International Bank Insolvencies” in B. Santen and D. van Offeren (eds.), *Perspectives on International Insolvency Law: A Tribute to Bob Wessels* (2014, Kluwer, Deventer), at 69 et seq.

23 Normal insolvency law could apply, for instance, to specific parts of the bank when certain bank resolution tools have been used. See, more extensively, Haentjens, above note 22, at paragraph 3.1.

24 Articles 37 et seq. BRRD; Article 22 et seq., SRM Reg.

bridge institution, which is a government-controlled entity, if no private party can be found willing to purchase these assets. Under the “asset separation tool”, the resolution authorities may transfer non-performing assets, rights or liabilities to an asset management vehicle in a so-called “bad bank construction”. Thus, the loss generating operations are insulated from the failing bank so that this institution may survive.²⁵

All of the resolution tools just discussed are employed by the relevant resolution authorities, and none requires the consent from the owners of the assets transferred, i.e. from shareholders or management of the failing bank. Also, and other than under the previous regime, the resolution authority’s decision to effectuate a transfer is not open to a judicial hearing *ex ante* for any party.²⁶ *Ex post*, on the other hand, the decision to employ any of the tools may be challenged. But such a challenge must be under administrative law rather than under civil law, as was the case in the previous regime. Moreover, the administrative proceedings are far from straightforward. They must be initiated either under national administrative law or under European administrative law, and it is not always immediately apparent, which of those two would be the appropriate route.

The appropriate route to challenge *ex post* the application of a resolution tool depends on the resolution authority employing the tool, and therefore on the category of bank subjected to the tool. In case of significantly important and cross-border operating banks, the tools are to be employed by the SRB by means of the adoption of a resolution scheme, while for other banks, the national resolution authority is empowered to take resolution measures directly (Articles 18(6)(b) SRM Regulation, and 63 and 82 BRRD, respectively).

If the national resolution authority has employed a resolution tool, appeal must be lodged under national administrative law (Article 85(2) BRRD). Under common Dutch administrative law, such national administrative proceedings would mean, first, administrative appeal with DNB. Appeal against the ensuing DNB decision must be lodged with the Rotterdam District Court, while appeal in second (and last) instance can be initiated with the Administrative High Court for Trade and Industry (College van Beroep voor het Bedrijfsleven). As a derogation from this

25 Article 36(4)(ii), BRRD. Under Article 36(4)(i) and (iii), BRRD, the asset separation tool may also be used to prevent market disturbance that might result from the liquidation of the assets transferred, or to maximise the liquidation proceeds of those assets.

26 Pursuant to Article 86(1), BRRD, the decision to employ any of these tools may be challenged *ex ante* in court provided the relevant Member State has opted in to that possibility. Pursuant to Recital (92), BRRD, such a challenge should be adjudicated within 24h of the resolution authority decision. The Netherlands has not opted in. In as far as the SRM Regulation applies (i.e. in case of significantly important and cross-border banks) there is not even an option.

regime, an appeal against DNB's decision to employ a resolution tool resulting in a forced share or asset transfer can only be directly lodged with the Administrative High Court for Trade and Industry, and the appeal is time-barred after 10 days (Articles 8:1 General Administrative Law Act (*Algemene wet bestuursrecht*) and 3a:64(1) *Wft*). Ultimately, preliminary questions could be posed to the CJEU so as to obtain a decision on the application of EU law.

For the first category of cases, i.e. for cases where resolution tools are to be employed through the adoption of an SRB resolution scheme, appeal against the (adoption of the) scheme itself can probably not be lodged with the SRB Appeal Panel, but may be admissible directly at the CJEU under Article 263 TFEU.²⁷ A resolution scheme contains instructions to the national resolution authority to carry out certain (resolution) measures regarding the failing bank. Where and under what law should the bank in question challenge the subsequent measures taken by the national authority, i.e. DNB? The answer would probably depend on the margin of discretion the scheme's instruction has left for DNB. If the scheme's instruction to DNB does not leave much margin of discretion for DNB, appeal against it must probably be lodged with the CJEU directly.²⁸ If, conversely, the scheme's instruction to DNB would leave DNB a substantial margin of discretion, DNB would probably be the appropriate forum to challenge it.²⁹ In all, the complexity of this structure in itself may already severely impede an affected party's judicial protection.

The nationalization instrument as it existed before 1 January 2016 is probably not affected by the new EU regime. Not only does the BRRD itself allow national governments to temporarily nationalize a failing bank (Article 58 BRRD), but the Dutch Government has also considered that the Minister of Finance's power to nationalize a failing bank would not be contrary to (the purpose of) the SRM Regulation.³⁰ Consequently, also the existing *ex post* court proceedings with the Council of State and the Enterprise Chamber of the Amsterdam Court of Appeals have remained possible.

27 See Recital 120, SRM Reg. Article 18 is not included in the list of articles under which administrative appeal with the SRB Appeal Board is admissible (Article 85(3), SRM Reg.). Also, such a scheme would be addressed to the national resolution authority (rather than to the failing bank in question). See S. Nuyten, "Legal protection against actions under the Single Resolution Mechanism – or the lack of it" (NautaDutilh paper 2015), at 18-19 and 21, available at: <http://www.nautadutilh.com/> (last viewed 15 December 2015).

28 T. Arons, "Judicial Protection of Supervised Credit Institutions in the European Banking Union" in D. Busch and G. Ferrarino (eds), *European Banking Union* (2015, OUP, Oxford), at 459-460.

29 Parliamentary Proceedings, *Tweede Kamer*, 2014–2015, 34 208, nr. 3, at 31-33. See also Nuyten, above note 27, at 20 et seq.; Arons, above note 28, at 433 et seq.

30 Parliamentary Proceedings, *Tweede Kamer*, 2014–2015, 34 208, nr. 3, at 50-51.

In sum, the role of the bankruptcy court has been marginalized, while administrative appeal proceedings are terribly complex and judicial protection may, already for that reason alone, be hampered.

Arguments for and against the Paradigm Shift

As stated above and illustrated with the example of the Netherlands law, the modernized bank insolvency regimes enacted around the globe as a consequence of the global financial crisis have resulted in bankruptcy courts having had to cede their place to government authorities and administrative law courts.³¹ This shift – which I consider nothing less than dramatic – is a reflection of the minimisation of the role of private creditors and commercial law in favour of a preeminent role for government authorities and administrative law. Various arguments have been put forward to substantiate this change.

First, it has been argued that where banks perform functions that are critical to the functioning of society at large (such as payment functions), government authorities should manage their resolution, because government authorities serve the public interest. Bankruptcy courts, on the other hand, traditionally are focused on private creditors who would serve only their own interests.³²

Second, banks in the form as we know them today borrow short from the public to lend long. This means that bank debt (such as deposits) is commonly immediately payable, whereas bank claims (such as bank loans) may not be payable for decades. Moreover, depositors have no preference amongst each other and their claims on the bank rank *pari passu*. In addition, banks lend almost everything they borrow, which phenomenon is called “fractional banking”. Consequently, there is an inherent risk that all the bank’s customers reclaim their deposits at once, which claims the bank must, but cannot honour because of its fractional banking model. It is therefore rational for depositors to try to out-run fellow-depositors so as to withdraw their money from the bank when they believe it may be insolvent. In such instance, a bank-run ensues, which can take place within hours as modern technologies allow customers to electronically withdraw their deposits in the blink of an eye. This means that when it becomes public that a bank is suffering from financial difficulties, time is of the essence.

31 But see above note 3.

32 Cf., e.g., Board of Governors of the Federal Reserve System, Study on the Resolution of Financial Companies under the Bankruptcy Code (July 2011), at 7, and all the references there given.

It has been argued that the lengthy negotiations between private creditors that commonly take place in a traditional bankruptcy scenario are ill suited to the severely constricted time frame of a bank insolvency. Consequently, the argument goes, bank resolution should be managed by government authorities that need not cater for negotiations with private creditors, and are therefore in a better position to act expeditiously.³³

Third, it has been argued that modern banking has become an increasingly complex business and that modern banks, especially the systemically important ones, are very complex structures. Courts would not have the ability or the capacity to handle such complex structures and businesses, so that their resolution should be left to specialized agencies, viz. government authorities with a specific banking expertise.

Finally, as stated in the beginning, the global financial crisis has stressed the importance of harmonized insolvency regimes so that cross-border operating banks may be effectively resolved in multiple jurisdictions. Traditional bankruptcy law, it is argued, is ill suited for such harmonization, for bankruptcy law often is an expression of fundamental choices of public policy.³⁴ Therefore, bank resolution should be taken away from bankruptcy courts and traditional bankruptcy law, and laid in the hands of government authorities under administrative law, which would be more susceptible to amendment so as to achieve international harmonization.³⁵

Against all of these arguments, both individually and collectively, counter arguments could be formulated. It has been argued, first, that bank resolution managed by government authorities would become influenced by undue political considerations, which are largely absent where bankruptcy courts oversee a resolution process that is driven by private parties.³⁶ This argument is evidenced by several recent examples of bank resolutions across Europe that have proven to be highly politically charged, as was the case with the resolutions of Banca Etruria (Italy), Alpe Adria Bank (Austria), and Banco Espírito Santo (Portugal), which all happened in 2015.³⁷

33 *Idem*.

34 E.g., P. Wood, *Law and Practice of International Finance* (2011 reprint of 2008 University Edition, Sweet and Maxwell, London), at 536.

35 Hendren, above note 3.

36 P. Wallison, "The Meaning of the Lehman Bankruptcy", paper given to the American Bankruptcy Institute (5 November 2009, American Enterprise Institute for Public Policy Research), as quoted by T. Jackson, "Chapter 11F: A Proposal for the Use of Bankruptcy to Resolve (Restructure, Sell or Liquidate) Financial Institutions", available at: <http://www.southbaylawfirm.com/blog/upload/bankingbailoutschapter11f.pdf> (last viewed 16 December 2015), at note 8.

37 See, e.g., "Renzi faces political backlash over Italian banks' rescued" (*Financial Times*, 10 December 2015); "Austrian court rejects Hypo bondholders case" (*Financial Times*, 29 July 2015); "'Sócrates effect' looms large in Portugal poll; Corruption claims: General election" (*Financial Times*, 29 September 2015) respectively.

Second, private creditors, unlike government authorities, have a personal stake in the remaining value of a failing bank as well as in its ability to (continue to) generate profits. Consequently, they are incentivized to monitor *ex ante* the bank's risk taking activities, and work *ex post* towards a swift and optimal reorganization of the same bank.

Also, it has been argued that as bankruptcy judges have the greatest expertise as regards an efficient and fair organization of insolvency proceedings, they should be responsible for the same, also where it concerns banks and (other) financial institutions.

Finally, the argument has been made that unlike the new bank insolvency regime under administrative law, traditional bankruptcy law has been applied for decades, if not centuries. Consequently, bankruptcy law would provide legal certainty based on a large body of established jurisprudence especially with respect to creditor priorities, which certainty is absent for administrative resolution measures.³⁸

Example: Judicial Protection re: Resolvability

In this paragraph, I will investigate by way of an elaborate example what room has been left for the courts to deliver justice in individual cases, i.e. to provide judicial protection. The example I have chosen concerns an invasive power that the new EU bank insolvency regime has conferred upon resolution authorities, and against the application of which the relevant EU instruments themselves require that judicial protection be provided.

Under both the BRRD and the SRM Regulation, the relevant national resolution authority and the SRB, respectively, have been granted wide-ranging powers to “remove impediments” to a bank's “resolvability” (Articles 10 BRRD and 17 SMR Regulation). A bank is deemed “resolvable” if it is reasonably feasible to liquidate or restructure the bank under normal insolvency proceedings (such as bankruptcy) or administrative resolution (Articles 15(1) BRRD and 10(3) SMR Regulation). On an on-going basis,³⁹ the resolution authorities must assess whether the banks under its remit are indeed “resolvable”. If a bank is deemed not resolvable, the relevant resolution authority will require the bank in question to propose measures to address the impediments to resolvability. If the measures proposed are inadequate in the resolution authority's opinion, it will take a decision:

38 Board of Governors of the Federal Reserve System, Study on the Resolution of Financial Companies under the Bankruptcy Code (July 2011), at 6.

39 More accurately, any time the relevant resolution authority drafts or updates a so-called resolution plan (Articles 10(3), BRRD and 10(1), SMR Reg.).

- (a) establishing that the bank in question is deemed not “resolvable”; and
- (b) either (in the case of the SRB) instructing the relevant national resolution authority, or (in the case of a national resolution authority) directly requiring the bank to remove the impediments to resolvability (Articles 10(10) SRM Regulation, and 15(1) and 17(1) and (4) BRRD, respectively).

More specifically, the authorities thus have the power to require a bank to divest specific assets, to require the institution to limit or cease specific existing or proposed activities, and to require changes to legal or operational structures of the institution or any group entity, so that critical functions may be legally and operationally separated from other functions through the application of the resolution tools (Articles 17(5) BRRD and 10(11) SRM Reg.). This list is certainly not exhaustive. A resolution authority’s decision to deem a bank not resolvable and to require it remove impediments to its resolvability may therefore have significant consequences for the bank in question. Consequently, the BRRD and SRM Regulation require that the decision just referred to be open to appeal (Articles 17(6)(c) BRRD and 85(3) SRM Regulation).

Let us assume the SRB has taken a resolvability decision as just discussed regarding a systemically important Dutch bank, and instructed DNB to require the institution in question to take certain measures, amongst which to divest certain assets. Especially if these measures are invasive enough, they are likely to be challenged by the institution. The SRB resolvability decision itself is to be challenged with the SRB Appeal Panel first, and ultimately with the CJEU. The national resolution authority’s request to implement the measures may probably be challenged with the relevant national administrative court, viz. the Rotterdam District Court, and ultimately with the CJEU. But, as discussed earlier in the context of judicial protection against a forced share or asset transfer, this route would only be appropriate if the SRB’s instruction to DNB leaves DNB a substantial margin of discretion. In other cases, DNB’s request may also have to be challenged with the SRB Appeal Panel. In any event, it may be prudent litigation strategy for the bank to initiate both proceedings in parallel, and it may be reiterated that the complexity of the structure severely impedes the institution’s judicial protection.

As the challenge to the SRB’s resolvability decision, but also to the national resolution authority’s implementation request may ultimately be decided by the CJEU, it seems logical to consider how the CJEU would have to decide on such a challenge. Before turning to the elements the CJEU must consider when having to decide on a challenge of a resolvability decision, it must be noted that the new European bank resolution regime sets out several general restrictions to any judicial

appeal. First, an appeal against any decision of the resolution authorities does not (automatically) suspend the effects of the challenged decision, and the decision is immediately enforceable (Article 85(4) and recital 90 BRRD and Article 85(6) SRM Regulation). On the other hand, summary proceedings may be initiated to achieve temporary suspension *ex post* (Recital 92 BRRD).

Second, Member States must have explicitly opted-in to the possibility of *ex ante* judicial control of a national resolution authority decision. When opted-in, such an *ex ante* challenge should be adjudicated within 24h of the resolution authority decision (Article 85(1) BRRD and recital (92) BRRD). As indicated above, the Netherlands has not opted-in. Moreover, in as far as the SRM Regulation applies, i.e. in case of significantly important and cross-border banks, there is not even an option, so that judicial control is always limited to *ex post* redress.

Third, when reviewing crisis management measures taken by resolution authorities, national courts must use:

“the complex economic assessments made by national resolution authorities”

as a basis. On the other hand:

“the complex nature of those assessments should not prevent national courts from examining whether the evidence relied on by the resolution authority is factually accurate, reliable and consistent, whether that evidence contains all relevant information which should be taken into account in order to assess a complex situation and whether it is capable of substantiating the conclusions drawn therefrom.” (Recital (89) BRRD).

Back to our example. Let us assume the SRB’s resolvability decision has been challenged on the basis of the claim that the “proportionality principle” has been violated. This ground is often invoked as it represents a “key stone of EU law”,⁴⁰ and its violation can be classified as an infringement of the EU Charter of Fundamental Rights. Consequently, the European Banking Authority systematically investigates whether the instruments it issues conform to the principle.⁴¹

40 Arons, above note 28, at 467.

41 See, e.g., EBA Guidelines on Measures to Reduce or Remove Impediments to Resolvability, EBA/GL/2014/11 (19 December 2014), at 6 and 10, and EBA’s Proportionality Workshops, latest edition held on 3 July 2015, see: <https://www.eba.europa.eu/> (last viewed 16 December 2015).

For a proportionality challenge to succeed, the court must be convinced the challenged authority's decision does not meet a "suitability and necessity" test, and that it has not been proportionate *stricto sensu* to the desired goal.⁴² More specifically and applied to the case at hand, the court must deem the SRB's resolvability decision and the requested measure not suitable and necessary to remove the apparent resolvability impediments, and thus not to fit the purpose(s) of the BRRD and the SRM Regulation. Also, it will assess whether the relevant resolution authority has taken into account all relevant elements. Finally, it will determine how much discretion the relevant resolution authority had to take the resolvability decision and select the requested measure, and whether its decision has been adequately reasoned.

As regards the "suitability and necessity" test, the court will consider, from the outset, that the purposes of the BRRD and SRM Regulation are the avoidance of the use of public funds and the safeguarding of bank critical functions, and thus the avoidance of a destabilization of financial markets (Recitals 1 and 5 BRRD). I think these purposes are so broadly drafted that most authority decisions will pass this test.

More specifically, the court may consider whether the requested measure would be:

"able to reduce or remove the relevant impediment in a timely manner" (suitability)

and whether the measure would be required for:

"the feasible or credible implementation of a resolution strategy (...) and (...) there are no less intrusive measures which are able to achieve the same objective to the same extent" (necessity).⁴³

These specific assessments require complex economic investigations, which must have been carried out by the resolution authority in question per the EBA Guidelines on Measures to Reduce or Remove Impediments to Resolvability. Consequently, the court will have to use them:

"as a basis (...) when reviewing the crisis management measures concerned" (Recital 89 BRRD)

and will, more generally, refrain from making its own assessment.

42 Cf. Arons, above note 28 at 467.

43 EBA Guidelines on Measures to Reduce or Remove Impediments to Resolvability, EBA/GL/2014/11 (19 December 2014), at 10.

When having to establish whether the SRB has taken all relevant elements into account so as to decide whether the requested measure had been proportionate *stricto sensu* to the desired goal, viz. the removal of impediments to resolvability, the court will probably consider the following elements. First, it will consider whether the relevant resolution authority, i.e. the SRB, has adequately taken into account the threat to financial stability of the impediments to resolvability in question and the effect of the required measures on the business of the institution, its stability and its ability to contribute to the economy, on the internal market for financial services and on the financial stability in other Member States and the Union as a whole (cf. Articles 10(10) SRM Regulation and 17(4) and (7) BRRD).

Second, when considering the relevant resolution authority's assessment of the resolvability of the institution in question,⁴⁴ the court may refer to 28 criteria, which the BRRD requires the national resolution authority to examine (“as a minimum”!) to base its resolvability decision on (Article 15(2) and Annex, Section C BRRD).⁴⁵ These criteria include, amongst others, the extent to which the resolution of the institution could have a significant direct or indirect adverse effect on the financial system, market confidence or the economy, and the extent to which the resolution of the institution could have a significant effect on the operation of payment and settlement systems (Annex, Section C, nos. 26 and 27 BRRD).

Again, as all these elements just discussed are complex and economic in nature, the court will have to use them:

“as a basis (...) when reviewing the crisis management measures concerned” (Recital 89 BRRD)

and will, more generally, refrain from making its own assessment.

Finally, the court will have to determine how much discretion the relevant resolution authority had to take its resolvability decision and to select the requested measure, and whether its decision has been adequately reasoned. The resolution authorities' discretion in this regard has been limited by the specific EBA Guidelines on Measures to Reduce or Remove Impediments to Resolvability and the Regulatory Technical Standards (“RTS”) on the Content of Resolution Plans and the Assessment of Resolvability.⁴⁶ Consequently, the court will assess closely

44 See also EBA Guidelines on Measures to Reduce or Remove Impediments to Resolvability, EBA/GL/2014/11 (19 December 2014), at 7.

45 See also Recital 14, BRRD.

46 Contra: EBA Guidelines on Measures to Reduce or Remove Impediments to Resolvability, at 3.

whether these guidelines and RTS have been complied with. Also, it will closely assess the adequateness of the reasoning of the resolvability decision.

In conclusion, national resolution authorities and the SRB have been granted wide-ranging powers to remove impediments to a bank's resolvability, and the BRRD and SRM Regulation have justly opened the resolution authority's resolvability decisions to appeal. However, such an appeal is severely restricted. First, the complexity of the procedural structure impedes the affected bank's judicial protection. Second, judicial redress is limited to appeals *ex post*. Third, when considering a case in which the CJEU is requested to review an SRB resolvability decision on the ground of proportionality, it has been seen that virtually any resolution authority's decision will pass the broad suitability and proportionality test. On the other hand, the court will be confronted with complex economic assessments, which the court will not redo itself. The court will probably only assess closely whether the relevant guidelines and RTS have been complied with, and whether the resolvability decision has been adequately reasoned.

Final Remarks and Conclusion

The above analysis begs the more normative question what the (remaining) involvement of the court in bank insolvencies should be. To this question, different answers are possible, and it has indeed been answered differently. The CJEU, for instance, has held that:

“The review by the European Union judicature (...) is necessarily limited and confined to verifying whether the rules on procedure and on the statement of reasons have been complied with, whether the facts have been accurately stated and whether there has been any manifest error of assessment or misuse of powers.”⁴⁷

The Dutch Supreme Court, on the other hand, has held, when considering the damages the State should award in the context of the SNS REAAL nationalization:

“the court (...) independently determines the amount of damages, and can ground that decision on all facts and circumstances proven in the proceedings as well as on testimony it has ordered to be given [rather

47 Judgment of the General Court (First Chamber) of 2 March 2012, in cases T-29/10 and T-33/10 (ECLI:EU:T:2012:98), nr. 103.

than merely assess the Government’s proposal for damages].”⁴⁸
(my translation)

Certainly, the difference in the approach both courts have taken may be attributed to their different nature; in the cases cited, the CJEU administered administrative EU law, while the Dutch court administered tort law/civil law. However, this is not an answer to the question what the (remaining) involvement of the court should be. To the contrary, it shows the variety of possible answers and stresses the importance of formulating one.

In conclusion, I think I have shown that in bank insolvencies, judge-made law has played its part and that bank insolvency law is now administered by government agencies. These agencies act on the basis of administrative law statutes and the role of the administrative court has been marginalized. This may be the result of a recent preference for public welfare over individual justice in bank insolvencies. I therefore concur with Meijers when he approvingly quoted Birrell as having said:

“Judge-made law has played its part. To statute-law belongs the future. Let us pray for well-drawn statutes.”

But where Meijers added:

“let us pray also for judges (...) clever men with an independent spirit and who can stand the weight of honours”,

our prayers must be trained on the government agencies administering bank insolvency law. Let us pray for their fair and equitable judgment.

48 Hoge Raad 20 March 2015, ECLI:NL:HR:2015:661 (Minister of Finance vs. VEB et al.), nr. 4.8.2. In the original: “(...) dat de ondernemingskamer – ongeacht of verweer is gevoerd en binnen de grenzen van art. 6:8 en 6:9 Wft – de hoogte van de schadeloosstelling zelfstandig vaststelt, en dat zij zich daarbij kan baseren op alle in de procedure gebleken feiten en omstandigheden of op een door haar zelf bevolen deskundigenbericht.”

Chapter 3

Directors' Duties to Consider Creditor Interests: A Solution in Search of a Problem?

Anil Hargovan

1. Introduction

The genesis of the fiduciary duty of directors to consider creditor interests is credited to the oft-quoted dictum of Mason J in *Walker v Wimborne* made over a quarter of a century ago in Australia.¹ The jurisprudence however, on the nature of the directors' duties to creditors, has remained largely undeveloped since the expression of the imprecise dicta. Unsurprisingly, much ink has been spilt on the topic of directors fiduciary duties to creditors in the Commonwealth countries² and North America³ – including a spirited debate amongst commentators on the doctrinal question of whether such a duty is independent and enforceable by

- 1 (1976) 137 CLR 1, at 6-7: "...it should be emphasised that the directors of a company in discharging their duty to the company must take account of the interests of its shareholders and its creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them." *Westpac Banking Corporation v Bell Group Ltd (in liq) (No 3)* (2012) 89 ACSR 1; [2012] WASCA 157 at [2034] per Drummond JA: "This obligation cannot now be described as a "so-called duty" ... the principle [concerning directors fiduciary duties to creditors] ... is now firmly entrenched in company law jurisprudence in Australia."
- 2 For instance in the UK, see *Winkworth v Edward Baron Development Co Ltd* [1986] 1 WLR 1512; *West Mercia Safetywear Ltd v Dodd* [1988] BCLC 250; *Facia Footwear v Hinchcliffe* [1998] 1 BCLC 218; *MDA Investment Management Ltd* [2004] 1 BCLC 217; *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638. See *Hellard & Anor (liquidation of HLC Environmental Project Ltd) v Carvolho* [2013] EWHC 2876 for collection of UK authorities. For New Zealand authorities, see *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 242; *Hilton International Ltd v Hilton* [1989] 1 NZLR 442. For Australian authorities, see above note 1 and below note 4.
- 3 For example, in Canada, see *Peoples Department Stores Inc (Trustee of) v Wise*, [2004] 3 SCR 461; in Delaware (USA), see *N.Am.Catholic Educ. Programming Fund Inc. v Gheewalla*, 930 A.2d 92, 103 (Del. 2007); *Quadrant Structured Products Company Ltd v Vertin* 115 A.3d535 (2015); in California (USA), see *Berg & Berg Enterprises, LLC v Boyle*, 178 Cal. App. 4th 1020 (2009).

creditors⁴ and, if so, whether it is dead or alive in Australia.⁵ The directors' duty to consider creditor interests during corporate financial distress is a misnomer to the extent it suggests an independent duty owed directly to creditors. To the extent that there is uniformity in this area of law,⁶ courts in North America,⁷ UK⁸ and Australia⁹ are unanimous in the view that individual creditors of an insolvent company have no right to assert direct claims for breach of fiduciary duty against directors.

The broad formulation of the directors' duty to consider creditors interests during insolvency faces many unresolved issues resulting in a legal "conundrum"¹⁰ which has plagued this area of law in Australia for over three decades. The duty arises when the company enters into that "ill-defined sphere"¹¹ known as the zone or vicinity of insolvency, which, as recognised by US Appellate Courts, is:

"even less objectively determinable than actual solvency."¹²

When a company is in financial distress, and directors' duties to consider creditors intrude, it creates a "challenging framework"¹³ within which decisions must be made to comport with the overarching duty to act in the company best interests.

- 4 For judicial authorities supporting the proposition that the obligation of the insolvent company not to prejudice creditors is an imperfect obligation incapable of enforcement directly by creditors, see *Re New World Alliance Pty Ltd* (1994) 122 ALR 531; *Spies v R* (2000) 201 CLR 603; [2000] HCA 43; *International Swimwear Logistics Ltd v Australian Swimwear Company Pty Ltd* [2011] NSW 488. For supporting academic commentary, see R. Austin and I. Ramsay, *Ford's Principles of Corporations Law* (15th ed) (2013, LexisNexis, Sydney), at [8.100]. Cf section 588G, *Corporations Act 2001* (Cth) which, unlike the general law, permits creditors to recover their debts in certain circumstances from the directors for insolvent trading.
- 5 See the scholarly debate between J. McConvill, "Directors' Duties towards Creditors in Australia after *Spies v The Queen*" (2002) 20 *Company and Securities Law Journal* 4; in reply A. Hargovan, "Directors' Duties to Creditors in Australia after *Spies v The Queen* – Is the Development of an Independent Fiduciary Duty Dead or Alive?" (2003) 21 *Company and Securities Law Journal* 390; J. McConvill, "Geneva Finance and the "Duty" of Directors to Creditors: Imperfect Obligation and other Imperfections" (2003) 11 *Insolvency Law Journal* 7; in reply A. Hargovan, "Geneva Finance and the "Duty" of Directors to Creditors: Imperfect Obligation and Critique" (2004) 12 *Insolvency Law Journal* 134. The weight of judicial authority firmly rejects the existence of an independent duty to consider creditors interests. See above note 4 and below notes 7 and 8.
- 6 Cf *Harlequin Property (SVG) Ltd & Ors v O' Halloran & Anor* [2013] IEHC 362 which reflects judicial uncertainty on this issue in Ireland.
- 7 For example, see *N.Am. Catholic Educ. Programming Fund Inc. v Gheewalla*, 930 A.2d 92, 103 (Del. 2007); *Peoples Department Stores Inc (Trustee of) v Wise* [2004] 3 SCR 461.
- 8 *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1991] AC 187; *Yukong Lines Ltd of Korea v Rendsburg Investments Corp* [1998] 4 All ER 82; *West Mercia Safetywear Ltd v Dodd* [1988] BCLC 250. For collection of judicial authorities, see *Jetivia SA & Anor v Biltta (UK) Ltd & Ors* [2013] EWCA Civ 968.
- 9 See above note 4.
- 10 See R. Baxt, "Just to Whom do Directors Owe their Duties? Will This Conundrum Ever be Satisfactorily Resolved?" (2002) 30 *Australian Business Law Review* 455; "The Conundrum Thrown Up by the Bell Group Decision in the Western Australian Court of Appeal: To Whom Do Directors Owe their Duties?" (2012) 30 *Company and Securities Law Journal* 534.
- 11 *Berg & Berg Enterprises, LLC v Boyle*, 178 Cal. App. 4th 1020 (2009), at 1037.
- 12 *Ibid.*, at 1041.
- 13 C. Mallon and S. Waisman (eds), *The Law and Practice of Restructuring in the United Kingdom and United States* (2011, Oxford University Press, New York NY), at 27.

The reason for the challenge is that judicial authorities in the Anglo-American jurisdictions to date, until the recent Appellate Court decision in the Supreme Court of Western Australia in *Westpac Banking Corporation v Bell Group Ltd (in liq) (No 3) 2012*, have not gone much beyond simply articulating a need to consider creditor interests when the company is insolvent to nearly insolvent¹⁴- save for confirmation by the High Court in *Spies v R* that directors do not owe an independent duty to creditors capable of enforcement by the creditors in their own right.¹⁵ It is through the mechanism of liquidation that the creditors' interests are protected.

This valuable development aside, the law on this significant issue is remarkably short of specific judicial guidance as to how directors should discharge their duties, without harming the interests of creditors, when engaged in commercial risk-taking with a view to corporate rescue. It is for such reasons that a commentator has labelled the doctrine a "mess",¹⁶ noting that:

"it is extraordinarily difficult to slice the world into categories of solvency, insolvency, and the vicinity of insolvency."¹⁷

Notwithstanding such practical difficulties,¹⁸ courts in the Anglo-American jurisdictions have, for better or worse, adopted this wide formulation which, indeed, has led to the current doctrinal mess in Australian company law arising from the decision in *Westpac Banking Corporation v Bell Group Ltd (in liq) (No 3) 2012* which appears to have elevated the directors duty from one of consideration to one of protection of creditors interests during a failed attempt at corporate rescue.

The conventional wisdom based on the seminal judicial authorities,¹⁹ prior to the appellate decision in *Bell*, is that the duty requires directors of insolvent or nearly insolvent companies to have regard to the interests of the company creditors – the duty is not pitched any higher, for example, to ensure that directors acted to the

14 See judicial authorities above notes 2 and 4.

15 (2000) 201 CLR 603. For a similar position in the UK, see *Yukong Lines Ltd of Korea v Rendsburg Investments Corp* [1998] 4 All ER 82.

16 J. Lipson in R. de Barondes *et al.*, "Twilight in the Zone of Insolvency: Fiduciary Duty and Creditors of Troubled Companies – History & Background" (2007) 1 *Journal of Business & Technology Law* 229, at 238.

17 *Ibid.*, at 239.

18 *Peoples Department Store Inc. (Trustee of) v Wise* [2004] 3 SCR 461 at 505-506: "The directors' fiduciary duty does not change when a corporation is in the nebulous "vicinity of insolvency". That phrase has not been defined; moreover, it is incapable of definition and has no legal meaning. What it is obviously intended to convey is a deterioration in the corporation's financial stability."; *Berg & Berg Enterprises, LLC v Boyle*, 178 Cal. App. 4th 1020 (2009) at 1041: "[there are] practical problems with creating such a duty, among them a director's ability to objectively and concretely determine when a state of insolvency actually exists such that his or her duties to creditors have been triggered."

19 See authorities cited above notes 2 and 4.

best advantage of creditors,²⁰ nor is it impermissible for a director to advance the interests of a particular creditor so long as he or she believes in good faith that this action will be in the interests of creditors as a class.²¹

In light of this, there is a key proposition espoused in the majority judgment in *Bell* that forms the central focus of this chapter. The proposition is that directors have an elevated duty at general law to ensure that creditor interests are properly protected during commercial decisions taken prior to insolvency to ensure a *pari passu* outcome,²² as opposed to having their interests merely considered as one of a number of stakeholder groups.²³ Absent self-dealing and/or shirking, the juridical basis of such a wide interpretation of the law by the majority in *Bell* is highly questionable.

This chapter considers the context of the *Bell* decision and comments on the legal and policy basis of this key proposition underpinning the majority judgment. It will be submitted that the majority view is arguably out of touch with commercial realities and will cause numerous practical problems for companies attempting to restructure their affairs during times of financial distress.

The discussion in Part 2 of this chapter centers on the theoretical and legal framework concerning the duty to act in good faith in the interests of the company before proceeding to discuss the facts and result in the *Bell* case. The chapter thereafter, in Part 3, examines the litigation history in *Bell* and discusses the directors' duty to act in the best interests of the company during the context of insolvency. Part 4 of the chapter critiques the novel application of directors' duties to creditors by Drummond AJA in the Appellate judgment in *Bell*. The chapter concludes in Part 5 by offering reasons as to why a future High Court should reject any move towards a direct duty by directors to consider the interests of individual classes of creditors.

The potentially adverse consequences such a duty is likely to have on corporate rescue efforts involving distressed companies is a key reason. A more fundamental objection, however, rests on the superfluous need for such a duty. Existing statutory provisions under the *Corporations Act 2001* (Cth)²⁴ in Australia adequately

20 See *Re Welfab Engineers Ltd* [1990] BCC 60.

21 *GHLM Trading Ltd v Maroo* [2012] EWHC 61.

22 (2012) 89 ACSR 1, 335; [2012] WASCA 157, [2031] (Drummond AJA).

23 *Walker v Wimborne* (1976) 137 CLR 1; *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722; *Spies v R* (2000) 201 CLR 603.

24 See Parts 2D (directors duties), 5.7B (voidable transactions and the duty to prevent insolvent trading) and 2H.5 (prohibits payment of dividends that would materially prejudice the company's ability to pay its creditors).

covers the potential mischief directors may cause to harm creditor interests. It is submitted that gaps in the regulatory protection of creditor interests, particularly for involuntary tort creditors, can instead be addressed by the legislature. Before commenting on these issues, it is essential to briefly examine the nature and rationale for directors fiduciary duties to the company, including creditors.

2. Nature and Rationale of Fiduciary Duties to Creditors

Directors' fiduciary duties, underpinned by biblical principles,²⁵ include the duties to act in good faith in the best interests of the company, to act for proper corporate purposes and to avoid conflicts of interest. At general law, when a company is solvent, directors owe fiduciary duties to the shareholders as well as to the company. There is an expectation that creditors' interests, during solvency, will protect their interests by contractual means.

From an economic perspective, shareholders in a solvent company are viewed as the residual claimants of the company's assets and as the residual risk bearers. In the event of corporate insolvency, however, the dynamics may change. Shareholder value can become greatly diminished and, more often than not, can become worthless. In such circumstances, shareholders are no longer viewed as the residual claimants. The following rationale for the imposition of fiduciary duties on the directors of a financially distressed company is offered by Street CJ in *Kinsela v Russell Kinsela Pty Ltd (in liq)*:²⁶

“In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise ... But where a company is insolvent the interests of creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholder's assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration.”

25 For the genealogy of fiduciary duties, see M. Steel, “The Moral Underpinnings of Delaware's Modern Corporate Fiduciary Duties” (2012) 26 *Notre Dame Journal of Law Ethics & Public Policy* 3.

26 (1986) 4 NSWLR 722 at 730, affirmed by the High Court in *Spies v R* (2000) 201 CLR 603; [2000] HCA 43. For collection of UK judicial authorities adopting this view, see *Madoff Securities International Ltd v Raven* [2013] EWHC 3147.

The fact of insolvency, as noted by the judiciary:

“places the creditors in the shoes normally occupied by the shareholders – that of residual risk-bearers.”²⁷

Legal theory states that the alteration of incentives upon corporate distress requires legal principles to restrain self-dealing. When directors and shareholders no longer have any equity in the company, it is said that they have little or nothing to lose and all to gain by increasing their appetite for risk. During this time, directors may feel compelled to gamble and roll the dice preferring highly risky strategies that may be no longer aligned with the company’s interests.

There is thus a moral hazard problem where the directors are accountable to shareholders but the shareholders may encourage the directors to take increasingly risky bets with the company’s assets to the detriment of creditors. Accordingly, the rationale for the doctrine of directors’ duties to creditors is underpinned by the ‘at-risk theory’, alternatively known as the “slot machine hypothetical”, is explained below with reference to the following scenario:²⁸

“... where the stockholders are clearly out of the money and the creditors maybe are going to get seventy-five cents on the dollar as the company goes into bankruptcy or winds down. If you only have the interests of the stockholders in mind, zero is no different from zero is no different from zero in any circumstance. So why not take the remaining assets of the company, throw them into a slot machine and see if you hit the jackpot?”

The interests of shareholders and creditors can be “starkly divergent”²⁹ under such circumstances, thus the fiduciary relationship is modified or expanded to include directors duties to the company’s creditors at a time when the company is insolvent or near insolvency. The law addresses this problem by a range of statutory measures such as insolvent trading³⁰ and voidable transactions.³¹ The duty to consider creditor interests also has a role to play, but is not the only regulatory tool, as evidenced by

27 *Prod. Res. Grp., LLC v NCT Grp., Inc.*, 863 A.2d 772, 790-791 (Del. Ch. 2004).

28 R. Silberglied in de Barondes *et al.*, above note 16, at 233.

29 *Prod. Res. Grp., LLC v NCT Grp., Inc.*, 863 A.2d 772, 790 (Del. Ch. 2004).

30 Part 5.7B Divisions 3 and 4, *Corporations Act 2001* (Cth).

31 *Ibid.*, Part 5.7B Division 2.

the mixed judicial reaction to this broad formulation of directors fiduciary duties to creditors in North America³² and in the Commonwealth jurisdictions.³³

3. The Bell Litigation³⁴

A The Facts

The *Bell* litigation³⁵ concerned a refinancing arrangement to reorganise the debt obligations owed by The Bell Group Ltd and its offshore fundraising entity to separate groups of banks. At the time of the refinancing (known as a “workout”), the loans were unsecured and several subsidiaries in the Bell group of companies had assets that were not exposed to the parent company’s debt obligations. The key feature of the workout was to convert the unsecured loans into secured obligations and to bring all the companies in the group into the security agreement so that their assets could be used to pay down the secured debts. The workout contained a cash sweep provision that required all free cash generated by the group companies to be paid to the banks to pay off the restructured secured loans. The banks did, however, allow some of these funds to be used for general operating expenses.

The central company involved in the case was The Bell Group Ltd (“BGL”), which was a listed holding company for the Bell. BGL had a significant interest (39 per cent) in another listed company, Bell Resources Ltd (BRL). Both BRL and BGL were controlled and managed by persons associated with Bond Corporation. There were more than 100 companies in the domestic and international group that comprised the Bell group.

The major assets of BGL consisted of the controlling interest in BRL and a publishing division that centred on West Australian Newspapers. The shares in BRL had generated significant funds to BGL over the years, but in 1989, close to AUD 1 billion was taken out of BRL by Bond Corporation via a series of loans. Complications with the loan transactions caused Bond Corporation to convert

32 See, for example, the California Court of Appeal decision in *Berg & Berg Enterprises, LLC v Boyle*, 178 Cal. App. 4th 1020 (2009), at 1041: “...there is no broad, paramount fiduciary of due care or loyalty that directors of an insolvent corporation owe the corporation’s creditors solely because of a state of insolvency ... we decline to create any such duty ... we also perceive practical problems with creating such a duty ... the scope of any extracontractual duty owed by corporate directors to the insolvent corporation’s creditors is limited in California, consistent with the trust fund doctrine, to the avoidance of actions that divert, dissipate, or unduly risk corporate assets that might otherwise be used to pay creditors claims.”

33 See judicial authorities above notes 2 and 4.

34 The following discussion draws upon A. Hargovan and J. Harris, “For Whom the Bell Tolls: Directors’ Duties to Creditors after Bell” (2013) 35 *Sydney Law Review* 433.

35 *Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* (2008) 39 WAR 1 (trial) (“*Bell Group (No 9)*”); *Bell* (2012) 270 FLR 1 (appeal).

them into a deposit for the acquisition by BRL of Bond Corporation's brewery assets, which were valuable assets that were later sold for a significant amount. The stock market crash of 1987 had caused the Bell group of companies to engage in a program of asset sales to help pay down debt. This left the group with valuable and income producing assets aside from the publishing division, shares in BRL and the deposit in the brewery assets.

Prior to being taken over by Bond Corporation, the Bell group had engaged in large external financing programs both from bank loans and by issuing bonds in both domestic and overseas markets. The group had a treasury subsidiary (Bell Group Finance Pty Ltd) and had an offshore company (Bell Group NV) that issued European bonds from the Netherlands Antilles. The group's British operations were controlled by BGUK. The funds from these bond issues were then lent to BGL and Bell Group (Finance), although the transactions were not formally documented. One of the major legal issues in the case was whether the intra-group loans from Bell Group NV were subordinated or not. This went to the heart of what prejudice the bondholders (as creditors) suffered as a result of the workout.

After the stock market crash of 1987, the Bell group's banks became increasingly concerned about the repayment of the unsecured loans. While Bell group executives initially believed that the asset sale program would generate sufficient funds to pay off the Australian bank debt and had advised the banks of this, by mid-1989 it was clear to the Bell group executives that there would not be sufficient funds to clear the debts. This left the banks opposed to providing any further funding to the group. All of the Australian loan facilities at this time were operating "on demand" so that any of the banks could call for full repayment. If any bank pressed a demand for repayment it would have been likely that others would follow suit and the company would have to enter liquidation. This left the group little choice but to pursue workout negotiations.

During the time of the workout negotiations (December 1989) the banks received internal financial information from the Bell group companies and were also advised that their debts might rank equally with bondholders if the bonds were not subordinated. At the same time, receivers were appointed over Bond Corporation's brewery assets which complicated their transfer to BRL, although this was subsequently completed when the court overturned the receiver's appointment.

At the time of the debt refinancing the financial position of the group was poor and several companies in the UK division of the Bell group were in the process of being liquidated. The banks did not enforce their new security for a further 16 months, although they received some proceeds of asset sales during that time.

It should be noted that had the banks enforced their security within six months of its creation the security may have been rendered void.³⁶ It was clear that the purpose of the workout was simply to give the group time to restructure its affairs, as no new funds were provided by the banks to support the workout. When no viable restructuring developed, the companies in the group were placed into liquidation and the banks realised their security and recovered AUD 283 million from asset sales.

B The Proceedings

The liquidators commenced proceedings against the banks and the directors (although the actions against the directors were discontinued) claiming that the refinancing was a breach of directors' duties because the directors knew the companies were insolvent and knew that the refinancing benefited the banks to the prejudice of the companies' other creditors. Importantly, the liquidators claimed that the banks had knowledge of these matters and therefore were liable to disgorge the proceeds gained from realising their security over the group companies' assets. This was the main claim for relief and was based on:

- Knowing participation by the banks in breaches of directors' duties and knowing receipt of assets resulting from these breaches;
- Equitable fraud; and
- Voidable transactions in the *Bankruptcy Act 1966* (Cth), which applied to companies at the time of the events, and other statutes.

The banks responded that they had no knowledge of the insolvency or of any breaches of duty. Further, the banks claimed that the directors could have reasonably believed that the refinancing was in the best interests of the companies because it gave the group time to develop a long-term rescue proposal.

C Judicial Findings

The *Bell* case has been subject to four separate sets of judicial reasons: the trial judge (Owen J) and on appeal (Lee, Drummond and Carr AJJA).

³⁶ See section 588FJ, *Corporations Act 2001* (Cth).

1 The Trial Judge

The trial judge (Owen J) held that the companies in the Bell group were insolvent at the time of the refinancing.³⁷ The directors' duties arguments centered on whether the directors of the Bell group companies acted in the best interests of their particular company, or rather acted to promote the other interests, namely the interests of the holding company (BGL) or the ultimate controller Bond Corporation.

Justice Owen applied the long-established rule that the duties of company directors are owed to the company.³⁸ In considering what were the interests of the company, his Honour noted that while the interests of the company (as a separate legal entity) may intersect with the interests of members, the two interests are still distinct. Similarly, when the company is insolvent, the interests of the creditors may intersect with the interests of the company but the two sets of interests are not one and same.³⁹ His Honour went on to state that while the content of the duty will usually include consideration of the interests of shareholders, there may be other considerations that should also be included.⁴⁰ His Honour held that the Australian directors were aware of the financial problems faced by the companies in the group but:

“looked at the problem of solvency from a group perspective and said something to the effect: “We all survive or we all go down”. They did not look at the circumstances of each individual company that was to enter into a Transaction.”⁴¹

The UK-based directors were in a different situation. They seemed to be acting diligently and were actively engaged in trying to ensure that the refinancing transaction would benefit their company. However, they identified that the ongoing solvency of BGL was critical to the success of the refinancing and they did not have sufficient financial information available to determine its future prospects. They relied upon assurances as to the company's solvency from the Australian directors (Bond and Mitchell).⁴² His Honour found that the actions of Bond and Mitchell were primarily concerned with promoting the interests of Bond Corporation.

37 See *Bell Group (No 9)* (2008) 39 WAR 1, Chapters 9 (in particular the summary of findings at [9.20]) and 10.

38 *Bell Group (No 9)* (2008) 39 WAR 1, at 533-534 [20.3.2].

39 *Ibid.*, at 534 [4393].

40 *Ibid.*, at 534 [4395]. See further *Teck Corp Ltd v Millar* [1973] 33 DLR (3d) 288.

41 *Ibid.*, at 658 [6040].

42 *Ibid.*, at [26.13].

Owen J held that the conduct of the directors had failed to demonstrate consideration of the interests of the creditors of the group companies that were pledging their otherwise unsecured assets for the benefit of the parent company (BGL). Importantly, his Honour stated the assessment constituted a balancing exercise where the risk to creditors could be included as one of several considerations to be taken by management. The greater the risk to creditors, the more directors and executive officers should take those considerations into account.

His Honour noted that the relevance of creditor interests will wax and wane depending upon the circumstances and the significance of the risk to creditors. He stated that:

“It may be, therefore, that in particular circumstances the only reasonable conclusion to draw, once the interests of creditors have been taken into account, is that a contemplated transaction will be so prejudicial to creditors that it could not be in the interests of the company as a whole. But that will be because of the particular circumstances and not because a general principle has mandated that the treatment of the creditors’ interests is paramount.”⁴³

The balancing exercise that directors must undertake to include the interests of different stakeholders that make up the interests of the company does not mean that creditor interests must necessarily be paramount, however. Owen J held that such a view was “going too far” as it would come perilously close to substituting for the duty to act in the interests of the company, a duty to act in the interests of creditors.⁴⁴

2 Appeal Decision

All of the banks appealed to the Western Australian Court of Appeal, originally on 144 grounds.⁴⁵ The appeal judgments, by a 2:1 majority (Lee and Drummond AJJA; Carr AJA), confirmed the banks’ liability but for slightly different reasons to the trial judge. Significantly for the banks, the appeal court determined that a different measure of calculating the compensation should be used which effectively doubled the banks’ liability (to as much as AUD 3 billion).

While accepting that the duty to act in good faith was subjectively assessed, Lee AJA agreed with the trial judge that the court must analyse the assertions of the

43 Ibid., at 545 [4440].

44 Ibid., at 545 [4439].

45 *Westpac Banking Corp v Bell Group Ltd (in liq)* [2009] WASCA 223, at [14].

directors that they acted in good faith and genuinely believed that the company's best interests would be served by their conduct in the surrounding circumstances. His Honour held that directors could not have genuinely acted in the interests of the company where it was clear that the creditors' interests would be prejudiced.⁴⁶ His Honour went further and held that the duty to act in the interests of the company would necessarily be breached by conduct during a time of insolvency that would prejudice creditor interests.⁴⁷

In this case, the directors made no enquiries as to how the refinancing would affect the group companies' non-bank creditors and hence had failed to consider their interests. Lee AJA also placed considerable emphasis on the conduct of the banks and the directors as constituting equitable fraud because the directors acted to prefer one group of creditors (the banks) over another (the bondholders and the ATO).⁴⁸ In his Honour's view, the equitable fraud case supported the breaches of directors' duties because it demonstrated the failure even to consider how the transaction would affect the non-bank creditors of each company.

Drummond AJA took a different approach and focussed primarily on the ability of the court to assess objectively whether creditor interests had been adequately considered by the directors. His Honour went beyond the trial judge's focus on balancing by holding that:⁴⁹

“[t]he duty will not ordinarily be satisfied by directors who consider the impact that entry into a particular transaction by the company will have on its creditors but proceed with the transaction even though it causes significant prejudice to those creditors. By doing that, the directors will usually, in my opinion, be in breach of their fiduciary duty to the company to exercise their powers for proper purposes and the transaction will be voidable at the election of the company or its liquidator.”

Drummond AJA's reasoning showed readiness to depart from the deference courts usually give to the decisions of directors when involving judgments on matters of business or management.⁵⁰ Such an approach was considered necessary in order to ensure that creditor interests are properly protected.⁵¹ His Honour viewed the test

46 *Bell* (2012) 270 FLR 1, at 188 [1092].

47 *Ibid.*, at 176 [993].

48 *Ibid.*, at 171 [953].

49 *Ibid.*, at 363 [2042].

50 *Ibid.*, at 360 [2029].

51 *Idem.*

for breach of the duty to act bona fide in the interests of the company as subjective and the test for breach of the duty to act for proper purposes as objective.⁵² This allowed his Honour to review the directors' decisions, and supports a more interventionist approach in commercial decision-making.

In a detailed dissenting judgment, Carr AJA treated the duty to act in good faith and for a proper purpose as a composite duty and therefore applied a subjective test. Such an approach, absent dishonesty and irrationality, means less judicial interference with commercial decision-making. His Honour observed that directors are not trustees and recognised that the law gives greater latitude to business people to conduct their company's affairs.⁵³

His Honour viewed the role of law as facilitating, rather than stifling, the exercise of business skills and did not see the need for any legal intervention if directors acted honestly and not irrationally in making their business decisions.⁵⁴ His Honour expressed the concern, in relation to the facts of the Bell case, that directors would be limited in their choices and take the easy option of liquidation rather than exploring possibilities corporate rescue if the law was otherwise.⁵⁵

Significantly, Drummond AJA held that Owen J had misconstrued the seminal cases on directors' duties to creditors,⁵⁶ with his Honour going so far as to suggest that the directors' duties included a duty to protect creditor interests, as opposed to giving consideration to creditors' interests.⁵⁷ This goes even further than Lee AJA's judgment, which stated that entering into decisions that prejudiced creditors during times of insolvency would result in no rational belief that the conduct was in the interests of the company.

4. Critique

There are strong jurisprudential arguments to support overturning the majority decision in the *Bell* appeal. It is respectfully submitted that the approach of Drummond AJA in *Bell* on the nature of directors' duties to creditors adds yet another layer of gloss⁵⁸ to the classical dicta in *Walker v Wimborne*⁵⁹ and should

52 Ibid., at 351 [1988].

53 Ibid., at 539 [2797].

54 Idem.

55 Ibid., at [2797].

56 *Walker v Wimborne* (1976) 137 CLR 1; *Spies* (2000) 201 CLR 603.

57 *Bell* (2012) 270 FLR 1, at 544 [2819].

58 See L. Sealy, "Directors Duties — An Unnecessary Gloss" (1988) 47 *Cambridge Law Journal* 175.

59 (1976) 137 CLR 1.

not be adopted by the High Court. This conclusion is aided by the instructive judicial remarks made by the High Court in *Spies*⁶⁰ on the nature of directors' duties to creditors, discussed below.

It is appropriate, at the outset, to repeat the influential and oft-quoted dictum of Mason J in *Walker v Wimborne* before analysing its conventional meaning:

“it should be emphasised that the directors of a company in discharging their duty to the company must be taken into account the interests of its shareholders and its creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them.”⁶¹

Walker v Wimborne cautions that directors must remember that creditors may also be affected by a particular management decision. The case indicates that when a company is in financial difficulty, directors must ensure that they balance the interests of various affected persons. The High Court majority in *Spies* endorsed the dicta in *Walker v Wimborne* and recognised that insolvency alters the relative weight that directors should give to shareholder interests as opposed to creditor interests, while rejecting the idea of directors' independent fiduciary to creditors. In offering insight on the meaning of the dictum in *Walker v Wimborne*, the majority judgment in *Spies*⁶² supported the quote of Professor Sealy who offered the following rationale for the dicta of Mason J:

“[these] were words of censure directed at conduct which ... comes within some well-established rule of law, such as the law imposing liability for misfeasance, the expropriation of corporate assets or fraudulent preference.”⁶³

Against this legal framework and judicial understanding, the approach adopted by Drummond AJA in *Bell* towards the issue of directors' duties to creditors warrants attention. In particular, the following sweeping statement by Drummond AJA in *Bell* invites further scrutiny:

“Directors, in discharging their fiduciary duties to their company must, if the company is sufficiently financially distressed, have regard *and give proper effect to the interests of creditors* ... courts

60 (2000) 201 CLR 603. For detailed analysis, see Hargovan, above note 5.

61 (1976) 137 CLR 1, at 7.

62 (2000) 201 CLR 603, at 636.

63 Sealy, above note 58.

will now intervene in an appropriate case, irrespective of the directors' beliefs and business judgments, to ensure that creditors are properly protected."⁶⁴

The thrust of this judicial statement is problematic for two main reasons. First, it represents a radical departure from orthodox authorities.⁶⁵ Drummond AJA's approach unreasonably shifts the directors' duty to creditors away from its traditional focus of consideration (a balancing exercise), to become a positive duty to protect their interests when a company is in financial distress. In the authors' view, the balancing approach taken by the trial judge, and also adopted by Carr AJA in dissent, is preferable because it recognises the practical difficulties that directors face during times of financial distress. As noted above, if the workout had resulted in the Bell group being able to enter into a long term refinancing arrangement, all stakeholders would have been better off.

Second, the approach undertaken by Drummond AJA seems to elevate the duty to a direct one to creditors, or at a minimum makes them the sole stakeholder group, rather than including their interests as merely one of a number that must be considered by corporate managers. The obligation to have regard to creditors' interests, as espoused in *Walker v Wimbourne*, arises as part of the process of acting in the best interests of the company. The ultimate goal of the duty is to benefit the company, and through it the creditors.⁶⁶ The interests of the company, in the context of impending insolvency and corporate rescue attempts, should not be subordinated to the interests of sharing *pari passu* between unsecured creditors.

The *pari passu* rule is one that is aimed at distributional equity where claims are of the same rank. The goal of creditor protection during times of financial distress is adequately addressed by existing statutory rules. It is not illegal to obtain security by contract, although in some cases the *Corporations Act 2001* (Cth) (and the *Bankruptcy Act 1966* (Cth) which applied at the time of the Bell facts) may allow transactions that were not illegal when made to be set aside by the court because they occurred too close to the date of liquidation.⁶⁷ It is submitted that these statutory rules provide an appropriate balance between creditor protection and commercial decision-making.⁶⁸

64 *Bell* (2012) 270 FLR 1, at 361 [2031] (emphasis added).

65 *Walker v Wimborne* (1976) 137 CLR 1; *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722; *Spies* (2000) 201 CLR 603.

66 *Geneva Finance Ltd v Resource & Industry Ltd* (2002) 20 ACLC 1427, 1438.

67 Part 5.7B Division 2, *Corporations Act 2001* (Cth).

68 See, e.g., the carve outs to void security interests in section 588FJ(s), *Corporations Act 2001* (Cth).

If the approach undertaken by the majority in *Bell* is affirmed by the High Court of Australia, it will have the effect of reformulating directors' duties to creditors in a manner that will have a chilling effect on corporate rescue initiatives by directors. The new elevated duty would not only include an obligation to safeguard creditor interests generally, but an obligation to see that creditors of the same degree were treated equally. It will be exceedingly difficult to comply with such a duty. While trading on the business may involve prejudice to creditors, as it uses up scarce resources, shutting the business down prematurely for fear of potential prejudice may itself cause greater harm to creditors due to the lower returns in formal insolvency compared with informal workouts.

5. Conclusion

The Appellate Court decision in the *Bell* case significantly alters the landscape – it is the most important pronouncement in Australia on the implementation of fiduciary duties claims brought by creditors, since the High Court dicta in *Walker v Wimborne*⁶⁹ and *Spies*⁷⁰ on the nature of such claims. In elevating directors duties to creditors in the manner discussed above, the judicial approach adopted by the majority judges in *Bell* raises a broader and more fundamental question as to the possible justifications for the ill-defined duty.

In an extra-curial address and article, Justice Hayne of the High Court of Australia has questioned and rejected the premise underlying directors' duties to creditors at common law on the basis that the law has adopted a solution in search of a problem.⁷¹ In attempting to unravel this messy reality, Justice Haynes has found favour with the view that recognising “fiduciary duties to creditors” in circumstance of insolvency may involve using the law of fiduciary duty to fill gaps that do not exist,⁷² as recognised by the Delaware Court in the *Gheewalla* case.

It can be strenuously argued that, save for involuntary tort creditors, the legislature provides adequate protection for creditor interests.⁷³ In Australia, Pt 5.7B of the *Corporations Act 2001* (Cth) targets certain transactions as voidable transactions, such as unfair preferences, uncommercial transactions, unfair loans and unreasonable director-related transactions. The Supreme Court in the UK in

69 (1976) 137 CLR 1.

70 (2000) 201 CLR 603; [2000] HCA 43.

71 Hayne J, “Directors’ Duties and a Company’s Creditors” (2014) 38 *Melbourne University Law Review* 795.

72 *Ibid.*, at 814.

73 See section 563A, *Corporations Act 2001* (Cth) providing for the deferral of debts owed to members in their capacity as members until after all non-member claims have been satisfied.

*Rubin v Eurofinance SA*⁷⁴ recently described the policy underlying such avoidance provisions as being:

“...to protect the general body of creditors against a diminution of the assets by a transaction which confers an unfair or improper advantage on the other party, and it is therefore an essential aspect of the process of liquidation that antecedent transactions whose consequences have been detrimental to the collective interest of the creditors should be amenable to adjustment or avoidance...”

In addition, creditors are given a measure of protection through the insolvent trading provision, which allows a liquidator, ASIC or a creditor to take action against directors who allowed the company to continue incurring debts at a time when it was insolvent and there were reasonable grounds to suspect insolvency.⁷⁵ It is clear that the insolvent trading provision imposes a threat of financial penalty, or even criminal sanctions,⁷⁶ against directors and these are important factors in their decision-making processes during reorganisation attempts.

For reasons advanced in this chapter, it is submitted that the expansion of the liability regime for directors and officers during financial distress by the majority in the *Bell* appeal is unnecessary and inappropriate from both a policy and doctrinal standpoint. In light thereof, it is, indeed, legitimate to query whether the development at common law of the directors duty to consider creditor interests is a solution in search of a problem?

74 [2012] UKSC 46; [2013] BCC 1, at [95].

75 Part 5.7B Divisions 3 and 4, *Corporations Act 2001* (Cth). Empirical evidence (based on 103 insolvent trading cases from 1961 to 2004) showed that the majority of cases are brought by creditors (60 per cent) and that in 75 per cent of cases, the defendant was found liable. See further, P. James *et al.*, “Insolvent Trading — An Empirical Study” (2004) 12 *Insolvency Law Journal* 210.

76 The prospect of criminal penalties is not an empty threat. Empirical evidence showed 15 per cent of insolvent trading cases involved criminal proceedings. See James *et al.*, above note 75.

Chapter 4

New Sanctions for the Fraudulent Debtor in Romanian Insolvency Law

Lavinia Iancu

Introduction

In 1995, the first modern law of insolvency was regulated in the Romanian law. After several important legislative reforms, which followed the trends of the French Parliament, in 2006 Law no. 85 concerning the insolvency procedure was passed. Law no. 85/2006, that represented a profound reform of the provisions concerning the insolvency domain and the subsequent normative acts that provided several modifications to the legal text, did not reform the core of the mechanism of personal civil liability determination.

Only recently (June 2014), the Insolvency Code entered in force, which indicated the particular interest of the Parliament to transform the civil liability determination in the insolvency domain from a mechanism characterized by inefficiency and practical inapplicability in an efficient and functional one.

At present, there are two applicable legal documents: Law no. 85/2006 referring to the insolvency procedures initiated before 27 June 2014 and Law No. 85/2014 referring to the insolvency procedures initiated from 28 June 2014 onwards. Right now, the personal liability determination for members of management bodies is grounded on Articles 138 through 142 of Law no. 85/2006 concerning the insolvency, as well as on Articles 169 through 173 of Law no. 85/2014, the Parliament setting out the conditions, framework, and rules applicable to determining the patrimony liability of members of management bodies and/or insolvency monitoring bodies.

Patrimony Civil Sanction

According to Law no. 85/2006, the institution of civil liability determination of members of management bodies that committed illicit deeds and caused the insolvency state was limited as regards the functionality and application due to three reasons:

- impossibility to determine the liability of members of management bodies that would not submit the accounting documents of the debtor to the insolvency practitioner, time when any possibility to analyze the activity developed by the persons considered was practically annulled;
- the express and limitative character of the illicit deeds enumerated in Article 138 paragraph 1 of Law no. 85/2006 for which the civil liability could be determined;
- the direct causality between the illicit deed and the damage that had to be proven as element of the tort civil liability.

The New Insolvency Code profoundly alters the institution of personal liability determination of the members of management bodies and/or monitoring bodies by the legal text provisioned by Article 169 paragraph (1). The new regulation eliminates those three limitations, thus:

- for the first time in the insolvency legislation of Romania, the premises for determining the personal liability of the members of management bodies not collaborating with the insolvency practitioner for delivering the accounting documents is created. The Parliament stipulates in Article 169 paragraph 1 letter d) a relative presumption concerning the guilt and the causality relation for the members of the management bodies that do not deliver the accounting documents to the legal administrator/liquidator;
- for the first time in the insolvency legislation of Romania, it is allowed the determination of the personal patrimony liability of the members of management bodies for any deed committed with intent. Although the Parliament takes over in the Insolvency Code the seven deeds set out as limitation (in Article 138 paragraph 1 letters a – g of Law no. 85/2006 that became Article 169 paragraph 1 letters a – g by renumbering of Law no. 85/2014) according to which the liability can be determined, within the same Article letter h) is introduced, which refers to any other deed committed with intent;
- the causal relation required for determining the liability for the illicit deed and the damage is redefined by replacing the expression “caused the insolvency state” by the expression “contributed to the insolvency state”. By using the “contributed” term, the domain of illicit deeds that can lead the legal person to the insolvency state comprises not only those deeds that directly caused the insolvency, but also those that represented a condition such an opportunity for producing the result. The relevancy of that modification appears in the

meaning that between the deed and the insolvency state no firm causality relation must exist; the committed deed can represent a favorable condition for the appearance of the insolvency state.

The new regulations set out by the Insolvency Code are meant to revitalize the institution of patrimony civil liability determination in the insolvency area, creating the actual possibility for the persons guilty of the debtor entering the insolvency state to bear personally the damage caused to the creditors. The Parliament did not limit only to activating that mechanism, whose latent state has been called upon by experts for over 10 years, but it brought as a novelty in the insolvency procedure the non-patrimony sanction for those that are proven guilty of the debtor's insolvency state.

Non-Patrimony Civil Sanction

The Insolvency Code introduces in Article 169 two new legal provisions: on one hand, in paragraph 9 is set out the court of law's obligation to send to the National Trade Registry Office the sentence ordering the determination of the patrimony liability of the statutory director and, on the other hand, paragraph 10 stipulates a non-patrimony civil sanction (interdiction to hold the director position for 10 years).

At first sight, the Parliament's intention to introduce a non-patrimony sanction next to the patrimony one derived from setting out the damage to be paid personally by the person that contributed to the debtor's insolvency state seems commendable. The years when the determination of personal liability for insolvency had no practical applicability corroborated with the double civil sanction stipulated in the Insolvency Code, patrimony on one hand, for which the barriers existing in Law no. 85/2006 have been eliminated and non-patrimony, leads to the idea that this time the Parliament actually analyzed that institution in a real payment instrument of the receivables to the creditors.

Text of Article 169 paragraph 10 provisions that the person to whom a final decision of determining the liability was given can no longer be designated director or, if he is a director of other companies, he will lose that right for 10 years since the date when that decision remained final. Thus, the conclusion is without a doubt that creating a mandatory and not facultative non-patrimony sanction was desired and that it operates *de jure (ope legis)* and was not left to the discretion of the syndic judge. The non-patrimony sanction stipulated by Article 169 paragraph 10 must not be ordered by the syndic judge by the request of liability determination. It will acquire legal strength by the simple giving of a final decision of liability

determination, its applicability being ensured by Article 169 paragraph 9 that binds one to communicate that sentence to the Trade Registry Office.

Critiques and Proposals

Nevertheless, when carefully analyzing Article 169 paragraph 10, several critiques can be submitted. On one hand, although the liability determination is possible for the members of the management bodies and/or monitoring bodies within the company, as well as for any other persons that contributed to the insolvency state, the patrimony sanction is limited to the director position. That means the person against whom a final decision was given of liability determination cannot be designated director or, if he is a director of other companies, he will lose that right for 10 years since the date when that decision remained final.

Persons holding positions such as manager or shareholder can lead the companies, which positions are not considered by the legal text or those persons can even hold no position in the company they run. Practically, the legal text as it is now formulated allows, from my point of view, a series of manners of escaping the non-patrimony sanction. Being a sanction, the analyzed provisions are determined by interpretation and they cannot be construed by analogy.

From our point of view, the patrimony civil sanction created by the Insolvency Code in Article 169 paragraph 10 strictly refers to holding the director position, not being any restriction in connection to exercising the specific attributions of other decision-making positions.¹ Also in that context one can naturally ask which would be the situation of documents concluded (employment contracts, bank contracts, commercial contracts, etc.) by a person affected by a non-patrimony sanction and acting while breaching the provisions of Article 169 paragraph 10 of Law no. 85/2014.

For reaching its maximum efficacy, the interdiction should refer to any decision-making position within a company and not just to the director one; the actions forbidden to him matter and not the position in which they have been committed. My proposal that I believe would render the legal text efficient would envisage applying the non-patrimony civil sanction by the interdiction to run, manage, administer, directly or indirectly control a business, no matter the position held by that person.

¹ For the contrary, please refer to R. Bufan, *Tratat practic de insolvență* (2014, Ed. Hamangiu, București), at 834.

Another criticism that could be brought to the new law text refers to the rigidity of the sanction that forbids the director position for a fixed 10-year period without considering the committed deed, the total amount of the caused damage or the paying of the damage set out by the decision of liability determination to the creditors. Although I acknowledge the preventive role of that sanction, I believe it is radical by the simple fact that it cannot be differentiated among various cases and more important, it cannot be lifted if the damage is paid to the creditors.

We believe that applying the non-patrimony sanction by the syndic judge is particularly useful, upon the request of the persons that can lodge also the petition of determining the personal liability, for a period between 3 and 10 years, and with the possibility that the syndic judge lifts that sanction when receiving the proof of paying the damage set out by the decision of liability determination. As well, the possibility of lifting the non-patrimony civil sanction by paying the damage will lead to recovering the creditors' receivables in a shorter period of time, as against the perspective of being punished for a 10-year period no matter if the damage is paid or not.

Conclusions

Even if the regulation chosen by the Parliament as the non-patrimony civil sanction is questionable, as least a first step for that was made; its practical application follows to prove the efficiency of the legal text. The same cannot be said of correlating the provisions in the area of fraudulent bank transfers to the provisions in the personal liability determination, an aspect called upon by the doctrine² as being necessary, but which did not catch the Parliament's eye.

As a conclusion, one can state that the institution of personal liability determination of members of management bodies in insolvency faced an unprecedented evolution by the entry into force of the Insolvency Code. The real perspective of the members of management bodies of a debtor of being held personally accountable for the deeds committed prior to beginning the insolvency procedure but also during its development will certainly contribute to rendering more responsible the business environment participants and to recreating a natural climate in the development of an insolvency procedure in which the accounting documents can be analyzed and pertinent conclusions can be drawn in connection to those that contributed to the debtor's insolvency state.

2 A. Buta, *Raportul cu acțiunea pentru atragerea răspunderii fostelor organe de conducere a debitoarei, Anularea actelor frauduloase în procedura insolvenței* (2014, Ed. C.H.Beck, București), at 438 et seq.

Chapter 5

The Irish National Asset Management Agency: A Case Study on the “Bad Bank” Option

Irene Lynch Fannon

Introduction

This chapter begins with a brief description of the Irish bank bailout process which led to the creation of the National Asset Management Agency (“NAMA”) as a type of “bad bank” broadly defined and will trace the activities of the agency to this point where the Irish banks have stabilised. NAMA was created under the National Asset Management Agency Act 2009¹ to provide a structure whereby “bad” or non-performing loans held by Irish banks which had been bailed out through a government bailout scheme could be transferred, together with underlying securities, to NAMA. These loans and the underlying securities were to be managed for a period with a view to these loans being sold off for value to outside investors. The period of establishment led to a number of challenges and debates regarding the structure of the legislation itself and the operation of the Agency. This early phase will be considered in the first part.

The second and core part of the chapter will specifically consider the operation of NAMA against criteria which are derived from Law and Economics analysis. These issues concern oversight and monitoring to address agency problems; the problems created by market intervention; rent-seeking and finally more egregious problems concerning allegations of lack of transparency and possibly corruption regarding the finalisation of transactions between investors and transferees.

The final part will conclude that the operation of NAMA to date has given rise to a range of competing interests, these interests having emerged over time since the initial phase which occurred in the depths of a severe financial crisis. Even now in 2016, the most recent inquiry (concluded in January 2016) conducted into the Irish bank bailout (referred to colloquially as “the Banking Inquiry”)² has made

1 National Asset Management Agency Act 2009, available at: <http://www.irishstatutebook.ie/eli/2009/act/34/enacted/en/html>. See also the website of NAMA at: www.nama.ie and a contemporary commentary at: www.namawinelake.ie.

2 See: <https://inquiries.oireachtas.ie/banking/>.

recommendations which specifically refer to NAMA. Having attempted to locate the resolution of these competing interests and issues in an analytical context, this chapter concludes that the consequent complexities will bear further legal and economic analysis in future years.

I – Establishing NAMA

As described, the National Asset Management Agency Act was passed in 2009. Some time elapsed before NAMA became really operational, but from the outset it met with some criticism. The context in which it was established was fraught with uncertainty where the complete financial collapse of the Irish banking sector was a real and significant threat. Hindsight and more information provides further clarity to the issues which had arisen and so this chapter does not seek to provide a definitive conclusion on whether, either the bank bailout in its entirety,³ or the creation of NAMA following that bailout were optimal solutions. Instead, this chapter is more focused on the problems which have arisen as a result of the establishment of NAMA.

Leaving aside the merits of the decisions which had been made surrounding the financial crisis, it had nevertheless been decided in September 2008 to bail out the main Irish banks. As part of this guarantee structure NAMA was created to facilitate the rescue of the Irish banking sector. NAMA took over bad and under performing loans from various Irish banks as part of the process of the government bailout/guarantee of these banks. The sum of the loan books were valued at EUR 71.2 billion⁴ at face value but at the time of their acquisition by NAMA they were valued as having between 25% and 40% of their face value. The loans were spread across a number of Irish Banks including banks which had significant engagement with retail banking, including Allied Irish Banks where EUR 18.5 billion of loans were acquired by NAMA, and Bank of Ireland where EUR 9.4 billion of loans were acquired by NAMA.

However, the most controversial of the banks was Anglo Irish Bank plc which had no retail banking presence. Its loans which were taken over by NAMA had a

3 Ibid., noting that, interestingly, the most recent inquiry into the banking crisis which has been concluded in January 2016 provides additional light on the question of whether the bank bailout should have included the decision not to “burn” senior bondholders.

4 Previous enquiries have provided considerable information as to the how the Irish banks had got into such an overexposed position. See “*The Irish Banking Crisis: Regulatory and Financial Stability Policy 2003-2008*” (The Honohan Report, May 2010). K. Regling and M. Watson, “*A Preliminary Report on the Irish Banking Crisis*” (May 2010). “*Misjudging risk: causes of the systemic Banking crisis in Ireland: Report Of The Commission Of Investigation Into The Banking Sector In Ireland*” (The Nyberg Report, March 2011).

face value of EUR 34 billion.⁵ The establishment of NAMA was followed in 2010 by a full government guarantee of all banks. In turn this created a sovereign debt problem of unprecedented proportions, which in turn was followed by support being received for the state from the European Central Bank and the IMF.

Issues surrounding the Establishment of NAMA in the Context of the Bank Bailout by the Irish Government in 2008

Criticisms of NAMA made at the time came from respected sources, including a former Minister for Finance who had presided over a period of successful economic growth,⁶ and who expressed concern regarding the establishment of a state agency with the remit which NAMA had. In particular this criticism focussed on the fact that NAMA would now operate as a property management company, because of the fact that the underlying securities of the loans taken over by NAMA were almost exclusively of one asset type, namely real property. Joseph Stiglitz, a Nobel prize winning economist also criticised the creation of NAMA,⁷ but his criticism was focussed on the complete bank rescue of which NAMA was a part. Various Irish economists collectively expressed considerable reservations around the establishment of NAMA, focussing on transparency issues, the scope and duration of NAMA and the price paid for assets.⁸

Criticisms of the Legislation itself

Others expressed concerns about the detail of the legislation establishing NAMA and in particular the extensive powers given to the Minister for Finance under the legislation. There was some discussion about the possibility of the President referring the legislation to the Irish Supreme Court under the provisions of the Irish Constitution which allow for a judicial review of legislation before it is enacted.⁹ These matters will be discussed where relevant in the next part. For example, this chapter concerns itself with issues of oversight and accountability and it is noted

5 These values and discounts are taken from the Report of NAMA for 2010, available at its website (last viewed September 2015).

6 Former Minister for Finance, Ruairi Quinn, describing NAMA as “the biggest property company in the world”, expressed reservations as to the wisdom of a state agency taking on such a role: “Opposition criticises NAMA Bill” (*Irish Times*, 30 July 2009).

7 Joseph Stiglitz spoke against the establishment of NAMA in 2009 at Trinity College Dublin, although his main criticisms were focussed on the idea that all of the banks operating at this time would be rescued by the state and ultimately the Irish tax payer. He observed that only “banana republics” rescued banks in this manner and in retrospect it seems to be the case that at least one bank, Anglo Irish Bank plc seemed both less deserving but more importantly less centrally concerned with mainstream economic activity in the country. This bank was eventually liquidated by the Irish Bank Resolution Corporation under the Irish Bank Resolution Corporation Act 2013.

8 Open letter to Irish Times: “Nama set to shift wealth to lenders and developers” (*Irish Times*, 26 April 2009).

9 These provisions are found in Article 26, Irish Constitution 1937. See I. Lynch Fannon and G. Murphy, *Corporate Insolvency and Rescue* (2nd ed) (2012, Bloomsbury Professional, Dublin), at 13.

that the relevant Minister, in this case the Minister for Finance, has extensive powers in relation to information surrounding the operation of NAMA and the control of that information. For example, the Minister has powers in relation to the content of reports which NAMA is obliged to furnish.¹⁰ The Minister also has extensive powers in relation to the operation of NAMA as a state agency, specifically in relation to the issuing of guidelines¹¹ and more significantly in relation to the issuing of directions to the Agency.¹²

Constitutional Challenges

During the initial period, the most significant events concerned the actions of particular borrowers who either threatened to challenge or did challenge the taking over by a State agency of the loans which they had with banks. These concerns led to the challenge by a property developing company group including Dellway Investments Ltd. and other companies to the taking over of its loans by NAMA. These companies were all owned by a prominent property developer, Paddy McKillen, who held shareholdings in each of the companies of between 50% to 100%. The loans which were to be taken over by NAMA were valued at nearly EUR 2 billion.

In the initial phase of the litigation, the Irish High Court characterised the constitutional law issues as resting on two arguments. First, that the process by which the loans were acquired was unconstitutional with regard to constitutionally protected rights to fair procedures and second, that the acquisition of unimpaired loans was an unjustified attack on property rights. The High Court rejected the challenge to the operation of NAMA in this regard.¹³ On appeal to the Supreme Court, the appeal was successful in part relating to claims as to how the process to acquire the loans had been initiated before NAMA had been formally established. In rejecting the other arguments the Court effectively provided guidelines for the Agency as to how it would or should conduct its operations in the future to ensure that rights of those it affected were protected:

10 Section 53(4), National Asset Management Agency Act 2009. “The issue of confidentiality and the protection from dissemination of confidential information is also a consistent theme throughout the Act” in H. Byrne and L. McEntagart, *The National Asset Management Agency Act 2009 – Annotations and Commentary* (2010, Bloomsbury Professional, Dublin). See also sections 56, 113 and 120.

11 *Ibid.*, section 13.

12 *Ibid.*, section 14. Annotations to section 14 state: “The powers given to the Minister under this section are extensive. If the Minister gives a direction to NAMA, the direction must be complied with.” (Byrne and McEntagart, above note 10).

13 *Dellway Investments Ltd and Ors. v NAMA and the Attorney General* [2010] IEHC 364.

“In the light of the decision given by the court... the appellants, in the event of NAMA proceeding to acquire any eligible assets related to them, will be entitled to be afforded an opportunity to make appropriate representations to it as indicated above. NAMA will be bound to take account of those representations. Following such a process borrowers in a position such as the appellants will be entitled to seek relief by way of judicial review if it is considered that the decision of NAMA has not been made in accordance with the terms of s. 84...and there are no grounds for considering that the appellants would in any way be hindered or restricted in their ability to seek such relief from the courts....”¹⁴

II- How NAMA operates

Analytical Criteria

Over the intervening period these loans with underlying property securities have been managed and operated through NAMA. It is important to emphasise that since 2009 the management of the loans, not only involved ensuring that the loans remained performing to some extent, but that the assets underlying the loans, namely the real property assets were also managed effectively.¹⁵ Eventually, as economic conditions improved and particularly from 2014 onwards, the loans and underlying securities have been sold on by NAMA to investor capital companies. A number of these transactions will be considered.

As stated in the introduction it is intended to consider the actions of NAMA against a number of criteria derived from analytical tools prevalent in law and economics analysis. The first concerns what law and economic theory describes as agency problems. Although the discussion of agency problems often concerns the internal governance of corporations, it is clear that similar problems will occur in relation to the taxpayer, the state and the operations of an agency such as NAMA. Monitoring and oversight are therefore crucial issues. Undoubtedly such questions regarding oversight should concern oversight of the initial acquisition of the loans. As described above, these acquisition were not without controversy. However, this chapter will focus on the management and sale of the loan portfolios in the period since the establishment of NAMA.

14 *Delway Investments Ltd and Ors. v NAMA and the Attorney General* [2011] IESC 13 and 14. See further Lynch Fannon and Murphy, above note 9, at 14.

15 The engagement by NAMA with management of properties which not only included apartment buildings, empty or nearly empty housing projects, incomplete housing projects and operating hotels is of particular interest and concern.

A second issue which is related to the management and sale of the loan portfolios concerns the problem of market intervention. As mentioned NAMA has been described as the “largest property owning company” in the world. Considering it is a State agency, the nature of this market intervention and its consequences cannot be underestimated. A third issue concerns opportunities for rent seeking¹⁶ at each point of any given transaction. Finally, it seems that there is a real danger that in the process of selling assets and loan portfolios more serious issues concerning oversight of irregularities and accountability for certain types of transactions has become an issue.

Agency Costs,¹⁷ Oversight and Monitoring: Reporting Obligations in the Legislation

As described the National Asset Management Agency Act 2009 provides that the Agency will issue reports to the relevant Minister, in this case the Minister for Finance. The Act makes provision for the submission of an annual statement under section 53 which in turn will be submitted to Parliament, but as described, the Minister has power to omit information from this report under section 53(4). NAMA is also obliged to prepare annual accounts under section 54. This provision gives the Minister power to direct the format of this report, and section 57 provides for the auditing of these accounts by the Comptroller and Auditor General with a subsequent presentation of these accounts to the Minister, who in turn puts these before Parliament. Section 58 provides that the Chairperson and Chief Executive Officer of the Agency shall be accountable to a Committee of the Dail (the lower house in the Irish Parliament). In doing so, section 58(3) expressly states that:

“the Chairperson and Chief Executive Officer... shall not question or express and opinion on the merits of any policy of the Government or a Minister of the Government or on the merits of the objectives of such a policy.”

This would seem to put an end to the possibility of any extensive debate on matters arising from the accounts. Section 55 also provides that quarterly reports will be submitted by NAMA to the Minister and this provision includes a list of items which must be included in these reports. Finally, section 56 provides for the

16 For the purposes of this chapter, “rent-seeking” simply refers to the problem of poor allocation of government resources, lost government revenue, increased income inequality and undue influence of special interests. C. Kershaw Rowley, *The Political Economy of Rent Seeking* (1988, Springer, New York NY).

17 M. Jensen and W. Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure” (1976) 3(4) *Journal of Financial Economics* 305–360; E. Fama and M. Jensen, “Agency Problems and Residual Claims” (1983) 26 *Journal of Law & Economics* 327–349.

provision by NAMA of further reports to the Minister as may be required and, again under section 56(4), the Minister has the power to omit information of a confidential nature but there is no obligation to submit this report to the Parliament.

Overall there is an interesting variation between the obligation under section 55 providing for quarterly reports on specified matters and the other reporting obligations outlined above. Under section 55, the Minister has no authority to omit information of a confidential nature before these reports are presented to the Parliament, whereas he or she may exercise this power in relation to annual reports. This unusual variation in reporting obligations has been commented upon elsewhere.¹⁸ It is difficult to assess what the real effect of this distinction in the legislation is nor what its purpose was. Given concerns expressed regarding transparency from the outset the legislation itself is not consistent in its approach to the management of information flowing from the Agency, to the Minister and from there to parliament.

Oversight-Freedom of Information

Despite the reporting structure provided for in the legislation, it is clear that there is considerable discretion left to the Minister regarding the exclusion of confidential information. The Minister has the discretion to exclude confidential information from all reports and accounts which are presented to the Parliament with the exception of the section 55 “quarterly report”. However, this report is designed to cover a prescribed list of items and so there is a discretion given to the Minister outside the list of defined items. A definition of “confidential information” is provided for in section 202. This definition is very broad.¹⁹

The operations of NAMA were exempt from the Freedom of Information Acts, the first of which had been passed in 1997. This distinguished it from most public sector organisations. This meant for example that particular kinds of information which might have been of interest to the public generally, for example the price paid to professionals and others regarding fees and salaries which we consider

18 Byrne and McEntagart, above note 10, at 118.

19 Section 202(1), National Asset Management Agency Act 2009: “In this Act “confidential information “ means—
(a) information relating to the commercial or business interests of a participating institution or of a person who is or has been in a relationship with a participating institution,
(b) information that is subject at law or in equity to a duty of confidentiality,
(c) information that, if it were contained in a document, would have the result that a person could not be compelled to disclose the document in evidence,
(d) information the disclosure of which would tend to place NAMA, a NAMA group entity or the NTMA at a commercial disadvantage, or
(e) information about proposals of a commercial nature and tenders submitted to NAMA, a NAMA group entity or the NTMA.”

under the heading of “rent-seeking” were not available and there has indeed been considerable speculation on these matters. Following considerable speculation around this matter NAMA finally became subject to the Freedom of Information Acts following the enactment of the Freedom of Information Act 2014. Along with a number of other state bodies which had hitherto been excluded from the Freedom of Information Acts, NAMA is now covered as of 14 April 2015. These bodies were given a particular “lead in” period to prepare them for such access.²⁰ What is not clear is whether information can be requested regarding matters occurring before this date of 14 April 2015.

Market Intervention

Consideration of the scale of the value of the loan portfolios and underlying assets will quickly lead any observer to conclude that the concentration of this level of property activity into one entity, whether this is a private company or a state agency would have significant effects on the market. In this section the chapter will recount some particular issues of concern. However, to begin it is worth considering information regarding activity provided by NAMA itself. In its Annual report for 2014 NAMA described the nature of the assets which secured its loan portfolio by sector. 17% of these assets was classified as “land” – property awaiting designation for zoning as building land or otherwise; 20% of its asset base was characterised as “development property” – indicating property for which some sort of zoning or planning authority had been issued. 15% of property was categorised as residential property, and similarly a second 15% was categorised as office property. It is very clear therefore that from 2010 onwards NAMA controlled significant levels of property based assets in Ireland.²¹ The effect on the property market was quite simply one of stagnation.

Of more significance in the immediate short term in terms of those who continued to operate businesses throughout the really difficult initial period of the financial crisis in Ireland, a significant portion of NAMA assets were held in the retail sector (15%) and in the hotel sector (6%).²² The presence of NAMA in these sectors and

20 A particular issue had arisen in the intervening years regarding environmental information. In July 2015, the Supreme Court unanimously rejected arguments by the National Asset Management Agency that it is not a public authority subject to freedom of environmental information requests. An information request had been made to NAMA under the 2007 European (Access to Information on the Environment) Regulation. This had been denied and following a decision of the Commissioner, and the High Court against NAMA, the Supreme Court upheld the request but differed in its reasoning from the Commissioner. “Although Nama is obliged to act commercially, is it undoubtedly vested with special powers well beyond those which result from the normal rules applicable in relations between persons governed by private law.”

21 NAMA Annual Report 2014.

22 *Idem*.

its continued management of properties in the retail and hotel sector had significant impacts on those operating businesses outside of NAMA controlled properties. Effectively parts of these sectors were being operated as state run operations with all that entails, and these businesses were intersecting and competing with businesses being run under ordinary market dynamics to the detriment of those trying to continue to trade in these sectors.²³

Further information which became significant in 2015 was that 45% of NAMA held properties were located in Dublin, with 20% in the rest of the country (i.e. the Republic of Ireland). The remainder of NAMA assets were located in other parts of the world. This means that the effect of NAMA as a market player would be most keenly felt in Dublin, as distinct from the rest of Ireland, once it began to act in relation to the sale of these properties.

Market Intervention-The Property Market in 2014

While the effect of NAMA operating properties in the retail and hotel sector had been experienced by other market actors in the period from 2010-2014, the effect of NAMA in relation to the sale of its properties only became apparent in 2014. According to its own Annual Report, NAMA has stated that 59% of its total sales occurred in 2014. It also reports that these sales amounted to “63% of Irish property sales in 2014.”²⁴ The 2014 Annual Report stated that “disposal receipts... generated [EUR 7.8 billion]”. At the same time, newspapers in Dublin began to report a resurgence in the property market in 2014. This resurgence seems to have become somewhat illusory by the end of 2015.

Market Intervention-Some Individual Cases

As discussed above, there were some early challenges from particularly disgruntled developers to the operation of NAMA based on the disruption of their banking relationships. The acquisition of loan portfolios by NAMA from various banks was by and large conducted without any prior consultation with individual companies. On the one hand it is of course argued that this kind of intervention was demanded by the nature of the financial emergency and the depth of the crisis is not disputed here. On the other hand the Supreme Court did take the view that it was appropriate to provide some cautionary guidelines as to how NAMA would proceed following the challenge from Dellway Investments Ltd. and others.

23 A. Ahearn, *The Next Steps: Restoring Financial Stability to the Hotel Industry* (Irish Hotels Federation, June 2014).

24 NAMA Annual Report 2014.

As time has gone on we have had further opportunities to consider the actions of NAMA. Most recently the inquiry into the financial crisis conducted by the Irish Government²⁵ has allowed us to hear from various business people regarding the effect of the actions of NAMA on their businesses.²⁶ It is difficult to assess the veracity of such claims in any forensic way, particularly within the confines of this chapter, but nevertheless there is a legitimate perception that the presence of NAMA significantly influenced the markets. Whether matters would have been even worse without NAMA is not an easy question to answer. More concretely, once NAMA began to dispose of properties from 2014 on we can see that there have been unforeseen consequences for the operation of businesses and it is to this issue that we now turn.

III – Competing Interests

Disposal of the Loan Portfolios and Unforeseen Consequences

Eventually, particularly from 2014 onwards, the loans which were originally acquired during 2009 and 2010 have been sold on by NAMA to investor capital companies. A number of these transactions will be considered to illustrate how the selling on by the state agency to outside investors of “bad loans” originally entered into by rescued banks with property related enterprises has led to unforeseen consequences for the original debtors.

In the disposal of its loan portfolio NAMA has given names to the particular projects involving the sale of loan portfolios to investors. So for example Project Tower involved the sale of loan portfolios where the loans had been originally taken out by the O’Flynn Construction Group based in Cork. These loans were acquired by Blackstone Capital in early 2014 and some time later, in August 2014, Blackstone Capital operating through its Irish subsidiary Carbon Finance Ltd. applied for Examinership (the process in Irish law which allows for the restructuring and rescue of companies) for the O’Flynn Construction Group with a view to restructuring the group and, in particular, with a view to reducing the shareholding by the O’Flynn family. For various reasons, which need not detain us here, the O’Flynn shareholders were successful in defeating the appointment of

25 See: www.bankinginquiry.ie.

26 Johnny Ronan, who was the main owner of property development companies Fronterra Investments and Treasury Holdings, complained to the Oireachtas (Parliamentary) Banking Inquiry that “Nama destroyed my business”. “Johnny Ronan claims NAMA destroyed his business” (*Irish Times*, September 2015): “Nama, by its founding legislation, was granted such wide reaching and potentially unconstitutional powers that, unless it came under constant and careful scrutiny, it was always open to abuse. . . . In addition, it seemed to me, Nama was granted an endless financial budget to engage legal, public relations and other professionals to ensure that it would always have the financial muscle to win every argument.”

an Examiner to the Group.²⁷ The only point to be made here is that the application for the appointment of an Examiner to this company which had operated since the 1970s nearly destroyed the company. However, since 2014 the O’Flynn Group has sought to reposition itself with its new investors and reports are that the parties are working on new developments together.²⁸

In relation to Project Eagle and Arrow, a second large US capital fund company, Cerberus capital took over loans relating to properties in Northern Ireland. Issues were raised about the valuation of the properties and the manner in which these were acquired. The relevant developers there have complained of ‘ruthlessness’ and ‘unrealistic expectations’ on the part of the new owners of the loans which has made the operation of the businesses and management of the properties particularly challenging.²⁹ In response to these allegations the following statement was made by the Chairman of Cerberus:

“Cerberus is a patient, long-term investor and has a well-established track record of making significant improvements to the assets that it manages. We believe Cerberus has the ideal base of expertise and experience to manage the Eagle portfolio and will be a strong partner for NAMA, for Northern Ireland and for all the stakeholders associated with this transaction.”³⁰

However, these two Projects have also come under additional scrutiny in relation to the valuation of the loan books and assets and in relation to payments made around the sales.³¹ These allegations have been denied by NAMA.

Rent-Seeking

The fact that NAMA was not subject to the Freedom of Information Acts 1997 (as amended) until very recently (as described above) led to continued and sustained criticism of the potential for “rent-seeking” which the establishment of NAMA created. Rumours abounded regarding levels of professional fees paid to solicitors and other lawyers regarding the transactional activities of NAMA. In the early years fees were also paid to those charged with managing NAMA assets from everything to hotels, other retail outlets and half developed properties.

27 *O’Flynn Construction Group and Ors. v Carbon Finance Ltd. and Ors.* [2014] IEHC.

28 “Michael O’Flynn signs binding deal with Carbon Finance” (*Irish Independent*, 14 February 2015); “O’Flynn and Blackstone – it’s a deal” (*Irish Examiner*, 31 January 2015).

29 “Belfast developer Gareth Graham claims Cerberus ‘ruthless’” (*Irish Times*, 4 September 2015).

30 John Snow, Chairman, Cerberus Capital (4 April 2015).

31 “The controversy around Nama’s property deal has just gotten deeper” (*The Journal*, 23 October 2015), available at: http://www.thejournal.ie/project-arrow-ni-controversy-change-northern-ireland-2407079-Oct2015/?r_dir_d=1.

Indeed some of the individual property developers were also paid consultancy and other fees and salaries to assist NAMA in the management of the extensive property portfolios. Information asymmetries regarding these amounts has led to considerable concern on these matters.

Further issues arise regarding the valuation of assets and loans even now as these are being sold on. For example, the sale in 2013 of the O’Flynn Construction Group portfolio valued at over EUR 1.5 billion for EUR 980 million was queried quite publicly by individuals close to the businesses concerned. In response NAMA stated that as a matter of policy it did not comment on individual transactions. In the same vein it was reported that in early 2015 Cerberus Capital:

“...has agreed to acquire the [GBP 4.5 billion] nominally valued Project Eagle loan portfolio for above [GBP 1 billion] in cash, in line with previous reports”³²

Further Difficulties

In addition to the normal problems of “rent-seeking” allegations are being made which would indicate certain types of activity which are more serious. In relation to Project Eagle and Arrow, the valuations placed on the properties were queried, most recently by Independent member of parliament Mick Wallace who stated in the parliament that:

“Cerberus have been able to sell loans for double what they paid for them in a very short period of time.”

He alleged that Nama sold the loans in what was called “Project Eagle”, for approximately 27 pence in the pound when in contrast Cerberus had profited from these sales. He went on to state:

“The missing 73 pence in the pound has been picked up by the taxpayer in the south.”

The allegations continued with this particular TD alleging in parliament (Dail) before the summer of 2015 that GBP 7 million was lying in an Isle of Man bank account, linked to the Nama sale and intended for “fixers”. On 24 September, he made further allegations that “[EUR] 45 million has been paid to fixers.”³³ It has been reported that these matters and particular claims made regarding payments to

32 *CoStar Finance*, 4 April 2015.

33 The same TD has been the target of litigation by Cerberus Capital and it has been reported recently (*Irish Times*, 30 January 2016) that they have obtained a judgement of EUR 2 million against him.

intermediaries in relation to this particular set of transactions are currently being investigated in both NI and the US.

Conclusion

In its concluding parts, this chapter has sought to demonstrate that the range of vested interests has increased as the activities of NAMA unfolded. Originally the purpose was to ensure the stability of the Irish banking system. Once the sovereign debt issue developed, it then became clear that the concerns and interests of the sovereign and tax payers had to take centre stage. NAMA was entrusted with acquiring the best value possible for these investments, loans and securities which the State had taken on. As matters unfolded however, those closest to the banking transactions, namely the developers and their companies were affected by decisions and steps taken by NAMA, not least during the initial phases when loans were taken over and the state became involved in managing assets. Two kinds of problems emerged, questions of valuation and second, the manner in which the assets and loans were to be managed. Subsequently, when the loans were eventually sold, the unforeseen actions of third parties such as the capital funds mentioned also affected the original borrowers. In the meantime, those impacted by the market effects of the presence of NAMA, for example in the hotel and retail sector had an interest in how NAMA continued to operate in those markets.

Leaving the question of vested interests aside, one must return to the fundamental question by which NAMA will ultimately be assessed. Was value obtained for the State? It must be clarified that there is no doubt that the extent of the crisis was such that something drastic and effective had to be done. This chapter seeks to explore the question of whether NAMA has acted effectively and to consider analytical tools as to how that question will be answered. It is envisaged that NAMA will be wound down by 2019 and in fact a 10 year period was envisaged from the outset as its lifespan. Assessment of efficacy is extremely difficult. This chapter highlights some of the analytical tools by which lawyers might assess the establishment of NAMA and its operation. Further analysis, including economic assessments of the achievements of NAMA, will be ongoing as more information becomes available over time.

Chapter 6

Australian Banks and Crisis Management: Recent Developments

Rosalind Mason and Michael Murray

Introduction

While some Australian banks experienced funding pressures during the height of the 2008 Global Financial Crisis (“GFC”) in 2008, none failed. Financial stability was maintained by a well-coordinated regulatory response. Public sector intervention was largely limited to a guarantee for deposits and to wholesale funding (in order to “backstop” the access of banks to funds).¹ Indeed, the International Monetary Fund (“IMF”) has noted that:

“Australia has a history of few bank failures, even fewer financial crises, and its banking sector emerged from the global financial crisis relatively well.”²

The IMF undertakes a Financial Sector Assessment Program which examines a country’s financial system, assessing it against international standards, in order to assist the country to identify and remedy vulnerabilities.³ In 2012, the Financial Stability Assessment Report (“FSAR”) on Australia identified that a review of its crisis management tools may be necessary because of the structure of its banking sector.⁴ A key factor was the highly concentrated nature of the Australian banking sector.⁵

- 1 G. Turner, “Depositor Protection in Australia” (2011) *Reserve Bank of Australia Bulletin* (December Quarter) 45, at 50: <http://www.rba.gov.au/publications/bulletin/2011/dec/pdf/bu-1211-5.pdf>.
- 2 International Monetary Fund (“IMF”), *Australia: Financial Safety Net and Crisis Management Framework*, (Financial Sector Assessment Program Update, Technical Note, 2012), at [11]: <http://www.apra.gov.au>.
- 3 Following the GFC, the G20 established a Financial Stability Board (“FSB”), which in 2011 endorsed Key Attributes of Effective Resolution Regimes for Financial Institutions: Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (2011): <http://www.financialstabilityboard.org/>.
- 4 IMF, *Australia: Financial System Stability Assessment*, (IMF Country Report No 12/308, 2012), at [51]: <http://www.apra.gov.au>.
- 5 B. Donovan and A. Gorajek, “Developments in the Structure of the Australian Financial System” (2011) *Reserve Bank of Australia Bulletin* (June Quarter) 29, at 39: <http://www.rba.gov.au/publications/bulletin/2011/jun/pdf/bu-0611-5.pdf>.

Also in 2012, the government issued a Consultation Paper⁶ on strengthening the Australian prudential regulator's crisis management powers over the formally termed "authorised deposit-taking institutions" ("ADIs").⁷ Then in late 2013, the government established a Financial Systems Inquiry⁸ which handed down its final Financial System Inquiry Report ("FSI Report2) in December 2014.⁹ There was further public consultation on the final report however at the time of writing the government has not yet announced its response on implementing the FSI Report recommendations.¹⁰

This chapter will first outline the regulation of Australian ADIs. (That is, banks, credit unions and building societies although for simplicity we use the term 'banks' in the chapter.) It will then describe those aspects of regulation that apply where a bank is facing financial difficulty and potential insolvency. Next, it will provide details of the 2014 Financial System Inquiry Report, concentrating on the recommendations regarding capital adequacy and crisis management. Thereafter it will address some current issues in Australia – the significant reliance upon prudential regulation; some concerns about the concentration of the banking sector; and the competing pressures to both comply with international standards on capital adequacy and to retain competitiveness and lending flexibility. In conclusion it comments on a key policy issue which was debated in the FSI Report has been the need to achieve a necessary balance between public expectations of government intervention during a financial crisis on the one hand, and market discipline through competition or self-regulation on the other.

Regulation of Australian Banks

The Australian Prudential Regulation Authority ("APRA"), the Reserve Bank of Australia (the Reserve Bank; the central bank) and the Australian Securities and Investments Commission ("ASIC") oversee the Australian financial system. The Australian Competition and Consumer Commission is also relevant in so far as it

6 The Treasury, *Strengthening APRA's Crisis Management Powers* (Consultation Paper, 2012): <http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2012/APRA>.

7 Section 5, *Banking Act* (Cth).

8 Australia's financial system has largely been based on the last inquiry in 1997, commonly known as the Wallis Report: Financial System Inquiry, *Final Report* (1997), at 128: <http://fsi.treasury.gov.au/content/FinalReport.asp>.

9 Final Report of the Financial System Inquiry (7 December 2014), under the chairmanship of Mr David Murray, AO.

10 Note: following presentation of this chapter at the INSOL Europe conference, the government handed down its response on 15 October 2015. This recent development is referred to briefly in the conclusion: <http://www.treasury.gov.au/PublicationsAndMedia/Publications/2015/Govt%20response%20to%20the%20FSI>.

regulates competition policy.¹¹ APRA and ASIC have specific responsibility under their establishing statutes to supervise financial institutions.

A Council of Financial Regulators comprises APRA, the Reserve Bank, ASIC and the key government department, the Australian Treasury.¹² The Council was created to provide a high-level forum for cooperation, collaboration and information exchange among its members. It operates in normal times as well as in crisis situations.¹³ The agencies overseeing the Australian financial system are to be independent of the government of the day. The Reserve Bank is an independent central bank and as such is accountable to the democratically elected federal Parliament.¹⁴

Even though APRA and ASIC are required to act independently and objectively in performing their functions and exercising their powers under their respective statutes, the Minister (in practice, the Australian Treasurer) retains responsibility for policy formulation and operational priorities.¹⁵ In 2014, statements of government expectations were issued to each of ASIC and APRA to the effect that, while each must continue to act independently and objectively, they were also expected to “take into account the government’s broad policy framework”.¹⁶

The Treasurer has some particular statutory involvement. In order to promote a policy objective on the spread of bank ownership,¹⁷ the Treasurer can apply to court if an unacceptable shareholding situation exists in relation to an ADI.¹⁸ In addition, there are circumstances in which APRA must inform the Treasurer, for example when applying to wind-up or restructure an ADI.

The FSI Report concluded that Australia’s regulatory architecture did not need major change. However, it recommended some improvements. In particular, it referred to the lack of a regular process that allows the government to assess the overall performance of financial regulators. It also identified some significant weaknesses in the regulators’ funding arrangements and enforcement tools,

11 APRA Brochure (2010), at 3: <http://www.apra.gov.au/AboutAPRA/Publications/Documents/APRA-Brochure-FINAL-08Jan2010.pdf>.

12 The Council is a non-statutory body which chaired by the Governor of the Reserve Bank.

13 IMF, *Australia: Financial Safety Net and Crisis Management Framework*, (Financial Sector Assessment Program Update, Technical Note, 2012), at [2]: <http://www.apra.gov.au/>.

14 Sections 11 and 13, *Reserve Bank Act 1959*.

15 Section 12, *Australian Prudential Regulation Authority Act 1998*.

16 See: <http://www.apra.gov.au/AboutAPRA/Documents/140417-SOE-APRA-Statement-of-Expectations.pdf>; <http://www.asic.gov.au/asic/asic.nsf/byheadline/Statement-of-expectations--April-2014?openDocument>.

17 Section 12, *Financial Sector (Shareholdings) Act 1998*.

18 As defined in section 5, *Banking Act 1959*. An ADI is essentially a corporate entity to which APRA has granted an authority to carry on banking business in Australia and includes banks, credit unions and building societies.

particularly for ASIC. It also asked whether adequate consideration is currently given to competition and efficiency in designing and applying regulation.¹⁹

Crisis Management

Australia's insolvency regime for trading companies is governed by the national *Corporations Act 2001* (Cth) ("*Corporations Act*"). This Act governs corporate law generally, of which corporate insolvency, in Chapter 5, is a part. ASIC is the relevant corporate insolvency regulator.²⁰ The corporate structure and insolvency of certain bodies in Australia are, for policy reasons, governed by separate legislation. Such bodies are overseen by separate regulators. ADIs are separately governed by the *Banking Act 1959* (Cth) and are regulated by APRA.

While APRA regulates banks, given they are corporations, the *Corporations Act* also applies to them.²¹ ASIC therefore also has a role in their regulation, for example in relation to their financial reporting, market conduct and disclosure requirements.²² To assist in coordination and communication between the two regulators about potential risks to an ADI's financial stability, APRA and ASIC each operate under a Memorandum of Understanding in relation to the sharing of information and other relevant matters under their respective authority.²³

Australian Prudential Regulation Authority (APRA)

APRA is established under the *Australian Prudential Regulation Authority Act 1998* (Cth) ("*APRA Act*"). It is funded largely by the industries that it supervises. Its purpose, relevantly, is to regulate the financial sector operating under prudential requirements, and to develop the administrative practices and procedures to be applied in performing that regulatory role and administration. Importantly, it also administers the government's Financial Claims Scheme ("*FCS*") by which bank depositors are protected to a certain monetary amount in the event of a bank's failure.

19 "Overview", *FSI Final Report*, at xx.

20 Established under the *Australian Securities and Investments Commission Act 2001*.

21 Section 70B, *Banking Act 1959* provides that it "has effect despite any provision of the *Corporations Act*".

22 In so far as they are companies listed on the Australian Stock Exchange ("*ASX*") they are also regulated by the ASX.

23 Memorandum of Understanding between the Australian Prudential Regulation Authority and the Australian Securities and Investments Commission (September 2014): <http://download.asic.gov.au/media/2225959/afsa-mou-published-1-october-2014.pdf>.

The *APRA Act* provides that:

“(i)n performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia.”²⁴

According to APRA, it promotes this:

“by requiring these institutions to manage risk prudently so as to minimise the likelihood of financial losses to depositors, policy holders and superannuation fund members. Through its supervision, APRA’s aim is to identify potential weaknesses in its regulated institutions as early as possible. APRA follows a risk-based approach under which institutions facing greater risks receive closer supervision. After an institution is licensed by APRA, it is subject to ongoing supervision to ensure it is managing risks prudently and meeting prudential requirements, and to identify those institutions that are unable or unwilling to do so.”²⁵

APRA’s prudential framework for ADIs includes the issue of Prudential Standards,²⁶ Prudential Practice Guides and Guidance Notes. The Standards implement the Basel III risk-based capital regulations²⁷ and apply to all locally incorporated ADIs, including small- and medium-sized commercial banking institutions that are not internationally active.

The Basel framework deals with systemically important banks. While Australia has no global systematically important banks (“G-SIBs”),²⁸ it has a number of “D-SIBs” (domestic systemically important banks), which could, if they were to come under stress, have an important impact on the domestic financial system and

24 Section 8(2), *Australian Prudential Regulation Authority Act 1998*.

25 APRA, “Supervision”: <http://www.apra.gov.au/AboutApra/Pages/Supervision.aspx>.

26 By authority under section 11AF, *Banking Act 1959*.

27 See the Basel Committee’s report, *Regulatory Consistency Assessment Programme – Assessment of Basel III regulations – Australia* (March 2014).

28 G-SIBs are systemically important financial institutions (“SIFIs”) of such size, market importance and interconnectedness that their distress or failure would cause significant dislocation in the international financial system and adverse economic consequences: APRA, *Information Paper: Domestic Systemically Important Banks in Australia* (Information Paper, December 2013): <http://www.apra.gov.au/adi/Publications/Documents/Information-Paper-Domestic-systemically-important-banks-in-Australia-December-2013.pdf>.

economy.²⁹ APRA has outlined the approach that it is taking in implementing the D-SIB framework in Australia.³⁰

The *Banking Act* contains a range of legal measures allowing APRA to maintain and regulate financial stability in the banking sector, and measures to allow a crisis management response by APRA in the event that it is required. The Act also allows the formal insolvent winding-up of the ADI.³¹

The *Banking Act* deals with the authorisation for, and carrying on of, “banking business”³² under the authority of APRA, covering APRA’s prudential supervision and monitoring of the compliance of ADIs with prudential standards. The criteria to revoke the authority to carry on “banking business” include, for example, that it would be contrary to the national interest or contrary to financial system stability for the authority to remain in force.³³ A further criterion is that the bank is insolvent and is unlikely to return to solvency within a reasonable period of time.³⁴

There are necessarily certain procedures to be undergone before APRA revokes an ADI’s authority, although in matters of urgency, APRA has the authority to act promptly. Those procedures allow or require APRA to give directions to an ADI, again on broad based criteria that include insolvency, or that there is a “material risk to the security of the bank’s assets, or its financial condition”,³⁵ or that the ADI is conducting its affairs in a way that may cause or promote instability in the Australian financial system.

The kinds of direction that APRA may give to an ADI include not to give any financial accommodation or to accept deposits, or to borrow, or to give directions about:

29 IMF, “IMF Expanding Surveillance to Require Mandatory Financial Stability Assessments of Countries with Systemically Important Financial Sectors” (Press Release No 10/357, 2010): <http://www.imf.org/external/np/sec/pr/2010/pr10357.htm>.

30 APRA, *Information Paper: Domestic Systemically Important Banks in Australia* (Information Paper, December 2013): <http://www.apra.gov.au/adi/Publications/Documents/Information-Paper-Domestic-systemically-important-banks-in-Australia-December-2013.pdf>.

31 Sections 7-36, *Banking Act 1959*.

32 Ibid., section 5: “banking business”, defined by reference to the banking and related powers under the *Australian Constitution*.

33 Ibid., section 9A.

34 Ibid., section 9A(2)(e). Under section 5, insolvency is defined as “not able to pay all its debts as and when they become due and payable”. However the words “unlikely to be returned to solvency within a reasonable time” allow more flexibility in relation to APRA’s decision to take action.

35 Ibid., section 11CA(1)(g).

“anything else as to the way in which the affairs of the [ADI] are to be conducted or not conducted.”³⁶

Where the ADI is subject to an APRA direction, a party to a contract with the ADI may not deny any obligations under that contract; accelerate any debt under that contract; or close out any transaction relating to that contract.³⁷

The *Banking Act* also covers APRA’s statutory duty regarding the protection of depositors. Where an ADI which may be showing signs of financial stress, APRA has power to address a range of circumstances, including appointing an “investigator” to assess the ADI’s position. APRA may also give recapitalisation directions to a failing ADI by way of directing the ADI to issue shares in the ADI, or in other capital instruments determined by APRA.³⁸ In addition, APRA has power under the *Financial Sector (Business Transfer and Group Restructure Act) 1999* (“*Business Transfer Act*”) to direct a transfer of business from one ADI to another, or to a body corporate. The *Business Transfer Act* enables some or all of the business of an ADI to be transferred to another ADI, or to be transferred to an asset management vehicle. Such a vehicle enables impaired assets of the ADI to be quarantined and dealt with separately while efforts are made to resolve the distress of the ADI. A compulsory transfer may be effected without the need for the approval of the ADI.³⁹

If the investigator or APRA finds that the ADI’s financial position is in serious decline, APRA may decide to appoint an “ADI statutory manager”. Typically that person would be a registered company liquidator.⁴⁰ That manager takes immediate control of the ADI’s business and has a range of powers and duties in effect to resolve the ADI’s financial distress. The directors are removed and their authority is displaced. The ADI statutory manager must report to APRA as required. The manager can recommend action by APRA, including that APRA apply to wind-up the ADI.

Separately, in the absence of any notice from the ADI, the *Banking Act* allows APRA to appoint a statutory manager to an ADI on various bases, including if

36 Ibid., section 11CA(2)(p).

37 Ibid., section 11CD.

38 Ibid., section 13E.

39 APRA must be satisfied that the transfer is appropriate, having regard amongst other things to the interests of the financial sector as a whole, and that complementary legislation to facilitate the transfer has been enacted to ensure that, when a certificate of transfer comes into force, the receiving body is taken to be the successor in law to the transferring body, to the extent of the transfer: section 25(2), *Business Transfer Act*. Such legislation is required to address the transferring body’s assets, liabilities, duties, obligations, immunities, rights and privileges applying to the receiving body, to the extent of the transfer: section 28.

40 Registered and regulated by ASIC under the *Corporations Act 2001*.

APRA “considers” it is likely that the ADI will be unable to carry on banking business in Australia consistently with the interest of its depositors; or it is likely that the ADI will be unable to carry on banking business in Australia consistently with the stability of the Australian financial system.⁴¹

Once the ADI statutory manager is appointed, its role will vary depending on whether APRA has adopted, in the words of the IMF, an “open” or “closed” resolution strategy. In an open resolution, the role of the statutory manager is to enable the ADI to meet its existing obligations and to continue business either through the existing ADI or in another entity. In doing so, the statutory manager acts in conjunction with APRA, and at APRA’s direction. In a closed resolution, the role of the statutory manager is to position the ADI for its orderly liquidation. This could involve withdrawing the ADI from the payment system or facilitating the transfer of its deposit book to another ADI. The ADI would be closed to new business. APRA may then apply to the court to wind-up the ADI.⁴²

The *Banking Act* then allows APRA to apply to the court for an order that an ADI be wound-up if APRA considers that the ADI is insolvent and cannot be restored to solvency within a reasonable period.⁴³ That winding-up of the ADI is conducted in accordance with the *Corporations Act*, upon which the role of the ADI statutory manager ends. Separately, APRA also has authority under the *Corporations Act* to apply to wind-up an ADI and have an official liquidator appointed.⁴⁴ On the appointment of a liquidator, APRA may terminate the position of the ADI statutory manager.⁴⁵

The winding-up of the ADI would then largely proceed under the *Corporations Act* regime. Significantly, the court order for winding-up allows the government to immediately implement the Financial Claims Scheme (“FCS”) established under the *Banking Act* by which depositors of the failed bank would be paid.⁴⁶ The liquidator has a significant role in assessing depositors’ claims and facilitating payment. Account holders of the ADI may then be paid from the FCS. Australia

41 Section 13A(1)(b) and (c), *Banking Act 1959*.

42 IMF, *Australia: Financial Safety Net and Crisis Management Framework*, (Financial Sector Assessment Program Update, Technical Note, 2012), at [39].

43 Section 14F, *Banking Act 1959*.

44 In cases of urgency, a liquidator may be appointed provisionally.

45 Termed an “ultimate termination of control”: section 13C, *Banking Act 1959*.

46 The FSI Final Report recommends ensuring Australian ADIs have sufficient loss absorbing and recapitalisation capacity in resolution to make it feasible to implement an orderly resolution of an ADI’s position and reducing perceptions that some institutions have an implicit government guarantee. Australia does not have a bail-in regime, whereby depositors’ funds are applied to meet a failed bank’s liabilities, as an option for dealing with crisis management in its banking sector. See A. McCunn, “Insolvencies, bailouts and resolutions: Dealing with banks when the music stops” (2014) 25 *Journal of Banking and Financial Law and Practice* 71.

does not have a bail-in regime, whereby depositors' funds are applied to meet a failed bank's liabilities. Instead deposits are protected through an explicit guarantee under the FCS, supported by depositor preference. The scheme is administered by APRA in conjunction with the liquidator of the insolvent ADI.

Australian law in relation to insolvency proceedings for ADIs is now explained in some more detail.

Insolvency Proceedings

The outcome of a failing ADI may be its formal insolvency. A winding-up action may be brought before the court by APRA under the *Banking Act*⁴⁷ or through its right to do so under the *Corporations Act*.⁴⁸ APRA's right to apply under the *Banking Act* exists only if an ADI statutory manager remains in control of the ADI's business and:

“APRA considers that the ADI is insolvent and could not be restored to solvency within a reasonable period.”

The winding-up of the ADI is to be conducted in accordance with the *Corporations Act* with only limited continued application of the *Banking Act*. APRA is to inform the Treasurer who may then choose to activate the FCS so that depositors can receive earlier and higher payments than they would through the winding-up process.

A creditor or shareholder may apply to wind-up an ADI under these general *Corporations Act* provisions. In such cases, the *Banking Act* imposes an obligation on such an applicant to give advance notice to APRA; a breach is a criminal offence.⁴⁹ Importantly, the legal consequences of the appointment of a statutory manager include the imposition of an automatic stay on legal proceedings being brought against the ADI, including winding-up proceedings, and the termination of the appointment of any pre-existing external administrator.⁵⁰

The requirement under the *Banking Act* to formally notify APRA of an application to the court is not imposed in circumstances where an insolvency administrator is voluntarily appointed under the *Corporations Act*. The ADI could place itself into voluntary liquidation, or into Part 5.3A voluntary administration or into a scheme of arrangement. Once in insolvency administration, it is open to the various

47 Section 14F, *Banking Act 1959*, s 14F.

48 Section 459P, *Corporations Act 2001*. APRA is a “prescribed agency” under Corporations Regulation 5.4.01 for the purposes of section 459P.

49 Section 62B, *Banking Act 1959*.

50 *Ibid.*, section 15A.

insolvency appointees to place the ADI into other types of administration, for example from liquidation into a Part 5.3A administration or into a Part 5.1 scheme of arrangement, as means of dealing with the ADI's insolvency.

The winding-up of an ADI is conducted according to the *Corporations Act*, which gives the liquidator extensive powers and discretions, including selling the business of the company or any part of it. The *Banking Act* imposes some overlays by way of limiting and oversighting the role of the liquidator. For example, section 63 requires the Treasurer to consent to any reconstruction of the affairs of an ADI that may be proposed by a liquidator. The *Banking Act* also imposes responsibilities on the liquidator to manage the FCS.

Beyond that, the *Corporations Act* is the sole source of how the winding-up is to be conducted.⁵¹ As with other comparable jurisdictions, it requires the liquidator to gather in and realise assets, ascertain the creditors, take proceedings for recovery as may be possible, and pay dividends to creditors. Creditors' claims against the ADI are stayed, save for secured creditors. A liquidator may trade on the insolvent company's business only to the extent necessary to facilitate its winding-up.

It is apparent that the ADI would have been wound-up at the end of a process of earlier intervention by APRA. The funds of depositors would necessarily be assets of the ADI over which the liquidator retains control; a freeze on depositors' funds would apply but at the same time the FCS would immediately apply to allow payments to depositors to be made. A major task of the liquidator would be to assess and facilitate those payments. No other banking business could be conducted. Loan books of the ADI would continue to be managed and may be sold.

Creditors of a bank are ranked and paid in the ordinary course according to the provisions of the *Corporations Act*. Depositors are creditors of the bank and as such they must prove for the amount of the debt and, subject to specific provisions mentioned below, would rank behind secured creditors and any preferential creditors, such as employees.⁵² Also, APRA's costs of having an ADI statutory manager in control of an ADI's business are payable from the ADI's funds and are a debt due to APRA.⁵³

51 See generally M. Murray and J. Harris, *Keay's Insolvency: Personal and Corporate Law and Practice* (9th ed) (2016, Thomson Reuters (Professional) Australia Limited, Sydney).

52 A. Tyree, *Banking Law in Australia* (8th ed) (2014, LexisNexis, Sydney), at [3.4.1]. Also see FSI Final Report, in Figure 3: ADI liability structure and prudential requirements.

53 Section 16, *Banking Act 1959*. These priorities apply over all other unsecured debts, but subject to the statutory priorities for the application of assets of an ADI in Australia, under section 13A(3).

A significant feature of the *Banking Act* is that it provides, in relation to both insolvent Australian banks and the Australian branches of insolvent foreign banks, that deposit liabilities in Australia receive a priority out of Australian assets. That is, the assets of the bank in Australia are to be available to meet the bank's liabilities in Australia in priority to other liabilities of the bank.⁵⁴ In support of these priorities, ADIs that take retail deposits in Australia are required to hold assets in Australia at least equal to their deposit liabilities in Australia.⁵⁵

The Financial Claims Scheme

The Financial Claims Scheme (FCS) was introduced into the *Banking Act* in 2008 and provides deposit protection for bank depositors.⁵⁶ It established a government funded⁵⁷ Early Access Facility for Depositors, administered by APRA. Its purpose is to ensure that depositors in a failed ADI have immediate or early access to funds more quickly than they would receive through the winding-up process and the depositor preference arrangements.

Since 1 February 2012, the FCS guarantees deposits up to a cap of AUD 250,000 for each account-holder of an Australian incorporated ADI.⁵⁸ This includes Australian banks and locally incorporated foreign subsidiary banks. If such an ADI becomes insolvent, then both individual and business depositors have quick access to their deposits.

The FCS is only activated when APRA applies to have an ADI wound-up and the Treasurer declares that the FCS will be applied to that ADI. APRA may require the liquidator to assist APRA in paying account holders their entitlements, to which the liquidator must give precedence over any other aspects of winding-up the ADI, including any requirements under the *Corporations Act*.⁵⁹ Priority is given to prompt payment to depositors; for example, the liquidator may admit

54 Ibid., section 11F in relation to a foreign bank and section 13A(iii) in relation to an Australian bank. There is a similar priority to that found in section 116, Insurance Act 1973.

55 Ibid., section 13A(4). Since 2011, ADIs may issue "covered bonds"; however, in the event of an ADI's insolvency, the cover pool does not form part of its assets and so is not affected by section 13A. APRA retains a power to order (for the benefit of depositors) that an ADI stop maintaining a cover pool: section 31A(5).

56 Ibid., Part II Division 2AA (section 16AB ff).

57 The Scheme, which has not been called upon in respect of ADIs, provides that the government may recoup payments from the winding-up and if there is any shortfall then APRA may apply a levy on the ADI sector: see APRA, *Financial Claims Schemes or Authorised Depot-taking Institutions* (1 February 2012), available at: <http://www.apra.gov.au/CrossIndustry/Documents/ADI%20Financial%20Claims%20Scheme%20FAQ%2001%2002%2012.pdf>. See FSI Final Report, at 82: "Government should retain the current FCS funding model for ADIs, under which payouts are recovered from liquidating the failed ADI and, where this is insufficient, an ad hoc levy can be placed on the banking industry."

58 The original cap of A\$1 million was reduced following a government review.

59 Section 16AJ, *Banking Act 1959*.

a depositor's claim even if it has not been proved according to the requirements of the *Corporations Act*.⁶⁰ When depositors are paid, APRA then “stands in the shoes” of each of the depositors as a creditor in the winding-up of the ADI. As such, APRA is entitled to receive a dividend in respect of those payments in the final winding-up of the ADI.⁶¹ Costs incurred by APRA in administering the FCS are admissible as a debt due to APRA.⁶² The liquidator's remuneration and expenses are given priority.

In addition to the FCS, the Australian Government operated a Guarantee Scheme for Large Deposits and Wholesale Funding from late 2008 and closed it for new liabilities at the end of March 2010.⁶³ It was designed to assist eligible ADIs⁶⁴ to continue to access funding during the height of the GFC. It was also intended to ensure these ADIs were not disadvantaged compared to international competitors that were able to access similar government guarantees on bank debt.⁶⁵ The government decision to close the scheme followed advice from the Council of Financial Regulators that economic conditions had improved to the point where it was no longer required.

Consultations and Inquiries

In 2008, 2009 and 2010, a series of legislative reforms in relation to banks, insurers and superannuation (pension funds) providers implemented measures to enhance prudential regulation and to protect consumers. Then the Australian Government's 2012 Consultation Paper⁶⁶ sought submissions on a range of options for enhancing and streamlining financial services legislation. In particular, it sought to align Australia's regulatory framework with international standards for crisis management arrangements in response to the FSB's focus for its member countries.⁶⁷

60 Ibid., section 16AQ.

61 Ibid., section 16AL. To date, there appear to have been no claims against an ADI under the FCS.

62 Ibid., section 16AO.

63 See: <http://www.treasury.gov.au/Policy-Topics/FinanceAndMarkets/Deposit-and-Wholesale-Funding-Guarantees/Report-on-the-Operation-of-the-Guarantee-Scheme-for-Large-Deposits-and-Wholesale-Funding>.

64 These are listed in the Scheme Rules and include Australian-owned banks; Australian-incorporated ADIs which are subsidiaries of foreign banks; branches of foreign banks; building societies and credit unions: www.guaranteescheme.gov.au.

65 Idem.

66 The Treasury Consultation Paper, 2012: <http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2012/APRA>.

67 Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (2011).

During 2014, the broader Financial System Inquiry referred to earlier was undertaken. Prior to this, the last major inquiry into Australia's financial system had been the 1997 Financial System Inquiry report (commonly known as the Wallis Report) upon which Australia's financial system has since largely been based.⁶⁸ The FSI Final Report recommended strengthening three aspects of Australia's regulatory framework for the orderly resolution of ADIs:

1. Completing the existing processes for strengthening crisis management powers that have been on hold pending the outcome of the Inquiry;⁶⁹
2. Effective pre-positioning and planning for the use of those powers. The Inquiry supported further work by government on this aspect.⁷⁰
3. Implementing a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice, sufficient to facilitate the orderly resolution of Australian ADIs and minimise taxpayer support.⁷¹

These recommendations remained under consideration by the government until mid-October 2015.⁷²

Conclusion: Current Issues in Australia

Reliance upon Prudential Regulation

The history of Australia's dealing with banks' financial instability and potential insolvency is based more on their strict prudential regulation by APRA rather than on APRA's use of its crisis management powers under the *Banking Act* or the *Corporations Act*. Should that prudential regulation not in fact forestall or prevent an ADI's failure, the question would arise whether an Australian government would in fact "allow" that ADI to fail. That issue raises a tension between a strict regulation of banks and a more open and competitive banking market. What

68 Financial System Inquiry *Final Report* (1997) (Wallis Report), at 128: <http://fsi.treasury.gov.au/content/FinalReport.asp>.

69 *FSI Final Report*: The Treasury, *Strengthening APRA's Crisis Management Powers* (Consultation Paper, 2012) refers to APRA directions powers, group resolution powers and powers to assist with resolving branches of foreign banks; and the Council of Financial Regulators recommendations include a specialised resolution regime for financial market infrastructure and the need for the clarifying of the application of location requirements for financial management infrastructure operating across borders.

70 *FSI Final Report*: "All proposals should go through the appropriate consultation, regulatory assessment and compliance cost assessment processes."

71 *Ibid.*, at 67-75.

72 NB: the government handed down its response following presentation of this chapter at the INSOL Europe conference, for which see: <http://www.treasury.gov.au/PublicationsAndMedia/Publications/2015/Govt%20response%20to%20the%20FSI>. This subsequent development is mentioned briefly in the conclusion.

governments require of banks in difficulty is that they be targeted at an early stage and reorganised so as to ensure the continuing viability of their operations. In that context the focus is more on whether adequate legislative and regulatory mechanisms are available, rather than on the perhaps unlikely outcome of a bank's formal insolvency.

Governance of an ADI

As an ADI is a company, it has a board of directors and management. Directors are subject to the general obligations of corporate governance and the duties of directors at general law and also under the *Corporations Act*, for example in relation to the exercise of good faith, and the avoidance of conflicts of interest.⁷³ Under the *Banking Act*, APRA may remove a director of an ADI, as well as a "senior manager".⁷⁴ Statutory management takes the place of the directors and management, whose authority ceases, where APRA does not have confidence that the board and management of the ADI is capable of resolving the ADI's financial distress satisfactorily or indeed where the actions of the board and management may have led to the ADI's financial position.⁷⁵

In other circumstances, the statutory manager may seek to have the existing management of the ADI retained, in order to seek to preserve the core business and functionality, and the economic value, of the ADI entity with a view to its business continuing. Equally, existing management may be retained to prepare and pre-position the ADI for an orderly discontinuation of business.

Corporate governance of ADIs was raised during the Financial System Inquiry and in 2014, APRA issued Prudential Standard CPS 510 Governance setting out minimum foundations for good governance of an APRA-regulated institution. Its objective is:

"to ensure that an institution is managed soundly and prudently by a competent Board (or equivalent), which can make reasonable and impartial business judgements in the best interests of the institution and which duly considers the impact of its decisions on depositors and/or policyholders."⁷⁶

73 Sections 180-4, *Corporations Act 2001*; the definition of director and related persons is in section 9; section 11CA, *Banking Act* provides that the term "director" has the same meaning as it has in the *Corporations Act*.

74 Section 11CA, *Banking Act 1959*. A senior manager is defined in section 5 as "a person who has or exercises any of the senior management responsibilities (within the meaning of the prudential standards) for the ADI..."

75 *Ibid.*, section 15.

76 See: [http://www.apra.gov.au/CrossIndustry/Documents/Final-Prudential-Standard-CPS-510-Governance-\(January-2014\).pdf](http://www.apra.gov.au/CrossIndustry/Documents/Final-Prudential-Standard-CPS-510-Governance-(January-2014).pdf).

Concentration of the Banking Sector

A key issue in the FSAR was the highly concentrated nature of the Australian banking sector. The comparatively high ownership of banking assets by four banks⁷⁷ increased following the GFC:

“with the major banks’ share of total ADI assets increasing from 65.4 per cent in September 2007 to 78.5 per cent in March 2014.”⁷⁸

The risks associated with this concentration are exacerbated by the predominance of similar business models focused on housing lending, in that a problem at one bank could cause issues for the sector and financial system as a whole. During 2015, APRA strengthened the capital adequacy requirements for residential mortgage exposures.⁷⁹ Also the FSI Final Report recommended the preservation of the longstanding “Four Pillars” policy, which precludes mergers between the four major banks.⁸⁰

Balancing Public Expectations of Government in a GFC and Private Market Discipline through Competition or Self-regulation

The 1997 Wallis Report stated that in general terms:

“the government should not provide an absolute guarantee in any area of the financial system (just as it does not do so in other areas). Primary responsibility should remain with those who make financial promises.”⁸¹

Nevertheless a decade later during the GFC, the Australian government did provide additional support through the Wholesale Debt Guarantee Scheme⁸² and the Financial Claims Scheme.

The 2014 Financial System Inquiry considered the wisdom of the changed public expectations on government intervention during a financial crisis.⁸³ It preferred

77 The Australia and New Zealand Banking Group Limited (ANZ); the Commonwealth Bank of Australia (CBA); the National Australia Bank Limited (NAB); and Westpac Banking Corporation (Westpac).

78 *Interim FSI Report* (2014), at 2-6.

79 See: http://www.apra.gov.au/mediareleases/pages/15_19.aspx.

80 *FSI Final Report*, at 34.

81 Financial System Inquiry *Final Report* (1997) (Wallis Report), at 128: cited by David Murray in his address to the Australian Business Economists (1 May 2014), available at: <http://fsi.gov.au/2014/05/01/australian-business-economists/>.

82 See: <http://www.guaranteescheme.gov.au/>.

83 Murray, above note 81.

market discipline, through competition or self-regulation, to government intervention.⁸⁴

Competition and competitive markets are at the heart of the Inquiry's philosophy for the financial system. The Inquiry sees them as the primary means of supporting the system's efficiency. Although the Inquiry considers competition is generally adequate, the high concentration and increasing vertical integration in some parts of the Australian financial system has the potential to limit the benefits of competition in the future and should be proactively monitored over time.⁸⁵

In its response to the Financial System Inquiry Report,⁸⁶ the government has acknowledged that Australia's financial system is strong, stable and well regulated. However, it also accepts that its reliance on foreign capital leaves Australia vulnerable to financial shocks and as a result, its regulatory framework needs to be stronger than those of comparable economies. Since the Report, APRA had already announced measures to improve the resilience of the banking system and that it will take further action on regulatory capital requirements. The government also accepts that it needs to act to strengthen crisis management powers for APRA and ASIC to ensure they have the tools they need "in the unlikely event" that an Australian financial institution or market fails.

The government has also accepted that financial accountability and capabilities of the regulators could be strengthened. It proposes to revise the respective Statements of Expectations and require the financial regulators to report on their capabilities and how they balance competition with the other elements of their mandates. The government is already conducting a capability review of ASIC and consulting on an industry funding model for ASIC.

In conclusion, Australia is moving closer to international standards in its approach to the crisis management of banks so that there are adequate tools available for such an event. Thus Australia is addressing the crisis management powers of the financial regulators and is implementing loss absorbency capacity and leverage requirements in line with emerging international practice. Yet Australia is likely to maintain a strong reliance on prudential regulation and supervision as an important *ex ante* protection against the perhaps unlikely failure of an Australian bank.

84 Discussion of objectives regarding "Loss absorbing and recapitalisation capacity": *FSI Final Report*, at 68-69.

85 *Ibid.*, at xvi.

86 The government response was released on 20 October 2015, for which see: <http://www.treasury.gov.au/PublicationsAndMedia/Publications/2015/Govt%20response%20to%20the%20FSI>.

Chapter 7

The Opt-out and Opt-in Rules for Group Coordination Proceedings in the EIR: A Critical Evaluation and Focus on Large-Scale Insolvencies

Jessica Schmidt

Introduction

The recast of the European Insolvency Regulation has brought many innovations. Among the most striking is undoubtedly the introduction of special rules on group insolvencies. With the new Chapter V, the Recast EIR has finally filled this often bemoaned gap. The central piece is the new possibility of group coordination proceedings (Articles 61 – 77 EIR). Especially in cases of large groups, effective coordination is generally of paramount importance for a successful restructuring. But even if it turns out that restoring financial soundness and economic viability is not possible, the coordinated realisation of the assets of the individual group members will often yield a higher revenue than an uncoordinated “asset stripping”.¹

But the crucial question is, of course: Will the new concept of group coordination proceedings work in practice? Needless to say, this will hinge not only on the general soundness of the legal framework, but on a myriad of different practical parameters. The one specific feature which will be the focus of this paper are the opt-in and opt-out rules. These rather intriguing mechanisms may actually prove to be one of the critical breaking points of the new legal framework.

Group Coordination Proceedings at a Glance

But before I come to the specifics of opt-in and opt-out, let me first provide a brief outline of the legal framework for group coordination proceedings in general. The concept of group coordination proceedings consists of three key elements:

¹ Cf. the explanatory notes to the German draft, BT-Drs. 18/407, at 38 ff.; R. Bork, K. van Zwieten and J. Schmidt, *Commentary on the European Insolvency Regulation* (2016, OUP, Oxford), at 72.16; P. Mankowski, M. Müller, J. Schmidt and J. Schmidt, *EulnsVO 2015* (2016, C.H. Beck, München), Article 72 paragraph 17.

- (1) a coordination court;
- (2) a coordinator; and
- (3) a group coordination plan.²

Group coordination proceedings may be requested before any **court** having jurisdiction over the insolvency proceedings of a member of the group; a request may be filed by any insolvency practitioner of a group member (Article 61(1) EIR). If multiple requests are filed at different courts, the priority rule applies (Article 62 EIR). But Article 66 EIR allows the choice of another (more appropriate) court by agreement of a two-thirds majority of the insolvency practitioners involved (Article 66 EIR).

The **coordinator** has two essential tasks:

- (a) to identify and outline recommendations for the coordinated conduct of the insolvency proceedings; and
- (b) to propose a group coordination plan (Article 72(1) EIR).

The **group coordination plan** shall identify, describe and recommend a comprehensive set of measures appropriate to an integrated approach to the resolution of the group members' insolvencies (Article 72(1)(b) 1 EIR). But its function is that of a mere "reference plan": its implementation is not effected centrally, but within the framework of the individual insolvency proceedings.³ The group coordination plan is not binding upon the insolvency practitioners, they are not obligated to follow it either in whole or in part (*cf.* Article 70(2) subparagraph 1 EIR). In fact, the EIR relies on a "comply-or-explain"-mechanism: If an insolvency practitioner does not follow the group coordination plan, he shall give reasons for not doing so to the persons or bodies that he is to report to under his national law, and to the coordinator (Article 70(2) subparagraph 2 EIR).⁴

Opt-in and Opt-out as Manifestations of the Voluntary Nature of Group Coordination Proceedings

As already indicated, a rather intriguing feature of the legal framework is that no group member can be forced to participate in group coordination proceedings.

2 *Cf.* J. Schmidt, "Das Prinzip "eine Person, ein Vermögen, eine Insolvenz" und seine Durchbrechungen vor dem Hintergrund der aktuellen Reformen im europäischen und deutschen Recht", *KTS* 2015, 19, at 38.

3 *Ibid.*, at 41.

4 *Idem.*

Initially, the group coordination proceedings include all insolvent⁵ members of the group of companies (as defined in Articles 2(13) and (14) EIR). But each insolvency practitioner has the right to declare an **opt-out** for “his” group member (Article 64(1)(a) EIR), with the consequence that it will not be included in the group coordination proceedings (Article 65 EIR).

The possibility of an opt-out is intended to ensure the **voluntary nature** of the group coordination proceedings.⁶ During the legislative debates in the Council, there had apparently been concerns with respect to the “coercive nature” of the group coordination proceedings.⁷ The French delegation had even suggested that group coordination proceedings should generally only include those group members whose insolvency practitioner had explicitly given his assent.⁸ Ultimately, the Member States agreed on the now implemented opt-out-model as a compromise. However, the voluntary nature of group coordination proceedings extends also to the reverse side: As a counterpart to the **opt-out** right, Article 69 Recast EIR establishes the possibility of a subsequent opt-in – albeit only under certain conditions.⁹

Opt-out

So let’s take a closer look first at the opt-out.

Entitlement to Opt-out

Any insolvency practitioner appointed in respect of a group member is entitled to make an objection against the inclusion in the group coordination proceedings (Article 64(1) EIR).¹⁰ In case of a debtor-in-possession, the right to object lies with himself (cf. Article 76 EIR).¹¹ The size and the role of the group member within the group is irrelevant.¹² The only (implied) exception is the insolvency practitioner who filed the request to open group coordination proceedings – it would be rather

5 With respect to the limitation to insolvent group members see Mankowski *et al.*, above note 1, Article 56 paragraph 10.

6 Cf. Recital 53 subparagraph 1 sentence 1; Bork *et al.*, above note 1, Article 64.4; Mankowski *et al.*, above note 1, Article 64 paragraph 4.

7 Cf. Schmidt, above note 2, at 39; Bork *et al.*, above note 1, Article 64.4; Mankowski *et al.*, above note 1, Article 64 paragraph 4.

8 Cf. the proposal of the French delegation in doc. 10688/14 (Article 42 da1(2), EIR draft).

9 Cf. L. C. Henry, “Le nouveau «règlement insolvabilité»: entre continuité et innovations” *Dalloz* 2015.979, at 987; V. Legrand, “Le nouveau règlement Européen relatif aux procédures d’insolvabilité transfrontalières: premier aperçu”, *Petites affiches* 2015, n° 16, 8, at 15; Bork *et al.*, above note 1, Article 69.2; Mankowski *et al.*, above note 1, Article 69 paragraph 2.

10 Cf. Bork *et al.*, above note 1, Article 64.7; Mankowski *et al.*, above note 1, Article 64 paragraph 7.

11 *Idem.*

12 *Idem.*

paradoxical if he were allowed to object to his own request.¹³ Yet, the right to object is limited exclusively to the insolvency practitioners: creditors, other courts or public authorities involved are not entitled to file for an opt-out.¹⁴

Opt-out Period

Moreover, it is important to note that the opt-out right is subject to a strict time limit. This is imperative, because group coordination proceedings could never work effectively if there was a constant threat that group members might opt out at any given moment. Hence, the EIR limits the opt-out right to a 30-day-period before the actual opening of group coordination proceedings.

A court seized of a request to open group coordination proceedings first executes a kind of preliminary examination whether the three conditions for the opening of group coordination proceedings laid down in Article 63(1)(a)-(c) EIR are fulfilled.¹⁵ If it has satisfied itself that these conditions are fulfilled, it shall give notice as soon as possible to the insolvency practitioners appointed in relation to the members of the group (Article 63(1) EIR). This notice shall be sent by registered letter attested by an acknowledgment of receipt (Article 63(3) EIR). The receipt of the notice triggers the start of the 30-day-objection period (cf. Article 64(2) EIR), which runs separately and independently for each insolvency practitioner (depending on when he received the notice).¹⁶

The decision to open group coordination proceedings must not be made before this objection period has elapsed (Article 68(1) 1 EIR). This serves a three-fold purpose: Firstly, it ensures that the insolvency practitioners really have the full time period to raise their objections.¹⁷ Secondly, this also guarantees that at the time of the decision whether or not to open group coordination proceedings the court knows which group members would be included; if too many group members have opted out and/or the ones which have opted out were of vital importance to the success of the group coordination proceedings, the court may come to the conclusion that the conditions for opening are no longer fulfilled, because – due to the opt-outs – group coordination proceedings would not be appropriate to facilitate the effective administration of the insolvency proceedings relating to the different

13 Cf. Bork *et al.*, above note 1, Article 64.7; Mankowski *et al.*, above note 1, Article 64 paragraph 7.

14 Cf. Bork *et al.*, above note 1, Article 64.8; Mankowski *et al.*, above note 1, Article 64 paragraph 8.

15 Cf. Bork *et al.*, above note 1, Article 63.5; Mankowski *et al.*, above note 1, Article 63 paragraph 5; Schmidt, above note 2, at 39.

16 Cf. Bork *et al.*, above note 1, Article 64.15; Mankowski *et al.*, above note 1, Article 64 paragraph 16.

17 Cf. Bork *et al.*, above note 1, Article 68.8; Mankowski *et al.*, above note 1, Article 68 paragraph 8.

group members (*cf.* Article 63(1)(a) EIR).¹⁸ Thirdly, once the opening decision has been made, the group members included are – metaphorically speaking – “caught” – in a way, the old maxim “cling together, swing together” applies.

Form of Objections

In order to streamline the procedure, there will be a **standard form** for making objections (the use of which, will, however, not be mandatory).¹⁹ Article 64 EIR does not explicitly require the giving of **reasons** for the opt-out.²⁰ Nevertheless, an insolvency practitioner objecting would be well-advised to provide a substantiated statement of the reasons for his objection.²¹ Although the objection leads to an automatic opt-out of the proceedings of the objecting insolvency practitioner, it does not stop the opening of group coordination proceedings for the other members of the group.²² The objecting insolvency practitioner can only achieve this by making such convincing objections that either all others will also opt-out or that the court will come to the conclusion that the conditions for the opening of group coordination proceedings set out in Article 63(1) EIR are not fulfilled.²³

Approval required by National Law

Although the entitlement to opt-out lies solely with the insolvency practitioner (or the debtor-in-possession, respectively), Article 64(3) EIR requires him to obtain any prior approval which may be required under the law of the State of the opening of insolvency proceedings for which he has been appointed. Hence, a German insolvency practitioner will, for example be required to obtain the prior consent of the creditors’ committee (or if there is none: the creditors’ meeting) (*cf.* § 160(1) InsO²⁴).²⁵ Special authorisation requirements and/or procedures may in particular apply in case of a debtor in possession; under German law, for example, the debtor in possession also needs to obtain the consent of the creditors’ committee (*cf.* §§ 276, 160(1) 2 InsO²⁶).²⁷

18 *Cf.* Mankowski *et al.*, above note 1, Article 68 paragraph 17.

19 *Cf.* Bork *et al.*, above note 1, Article 64.13; Mankowski *et al.*, above note 1, Article 64 paragraph 13.

20 *Cf.* Bork *et al.*, above note 1, Article 64.14; Mankowski *et al.*, above note 1, Article 64 paragraph 14.

21 *Idem.*

22 *Idem.*

23 *Idem.*

24 Insolvenzordnung (InsO) v. 5.9.1994, BGBl. I, 2866.

25 *Cf.* Bork *et al.*, above note 1, Article 64.17; Mankowski *et al.*, above note 1, Article 64 paragraph 19.

26 See below note 30.

27 *Cf.* Bork *et al.*, above note 1, Article 64.18; Mankowski *et al.*, above note 1, Article 64 paragraph 20.

This is an important restriction because it ensures that with respect to the opt-out decision, the insolvency practitioner (or debtor-in-possession) will be subject to the same approval requirements which he is subject to for comparable important decisions under national law.

Evaluation

Attempting a provisional evaluation, the opt-out mechanism undoubtedly fits into the general concept of the voluntary nature of group coordination proceedings, which is, for example, also manifested in the non-binding nature of the group coordination plan. However, overall it seems rather problematic.

- Firstly, it complicates things immensely.
- Secondly, the 30-day objection period delays the opening of the group coordination proceedings; in some cases, where time is of the essence, this may be crucial. The only possible way to obtain a faster opening may be to try to get all the insolvency practitioners to waive their opt-out right (but such a waiver is not explicitly provided for in the EIR and it may be very problematic to get it in practice).
- Thirdly, the opt-out right constitutes a very powerful weapon which may be abused by individual insolvency practitioners as a strategic leverage in order to push through inappropriate demands or even induce parties willing to cooperate to pay a “vexation premium” or bestow certain benefits to the disrupter as a consideration for not opting-out.

To provide a drastic example: Let’s imagine a large international group with subsidiaries in each EU Member State and let’s imagine that the group’s business model is based on a patent held by a small subsidiary which essentially does nothing else than administrate the patents of the group. The opt-out right would *de facto* enable the insolvency practitioner appointed for that subsidiary to sort of “dictate” the terms of the group coordination by threatening to opt-out if his demands are not met. Of course, this danger is somewhat counterbalanced by the requirement to obtain the prior approval pursuant to national law. Moreover, the insolvency practitioner may face civil or even criminal liability if the opt-out would constitute a violation of his duties. But it remains an open question whether these “safety devices” will be sufficient to effectively prevent abuse. There will not always be an approval requirement or the insolvency practitioner may even collude with the creditors’ committee and liability will only be a deterrent if it is effectively enforced.

Opt-in

So what about the opt-in?

Overview

Like the opt-out, the opt-in mechanism is also a manifestation of the voluntary nature of group coordination proceedings.²⁸ Its purpose is to ensure that group members who initially did not participate in the group coordination proceedings – either due to an opt-out or because they only entered insolvency proceedings after the group coordination proceedings had already been opened – have the possibility to opt-in subsequently.²⁹ However, since such a subsequent opt-in of another group member may have significant repercussions for the entire coordination concept, there is no unqualified right to opt-in; instead, the opt-in requires the coordinator to accede to the opt-in request, which is subject to certain conditions being met.³⁰

Opt-in Request

The opt-in procedure is initiated by a request of the insolvency practitioner appointed for the group member whose proceedings are to be included (Article 69(1) EIR) (or the debtor-in-possession, respectively, Article 76 EIR) to the coordinator.³¹ Article 69(1) EIR requires the request to be made by the insolvency practitioner “**in accordance with its national law**”. This apparently refers to any requirements of prior authorisation by a specific body (e.g. a creditors’ meeting or committee; a public authority; the court) before making such a request. Hence, a German insolvency practitioner would – just like in the case of an opt-out – need to obtain the consent of the creditors’ committee (or if there is none: the creditors’ meeting) (cf. § 160(1) InsO).³²

There is neither a standard form nor any other **formal requirements**.³³ But for evidentiary purposes, text form would certainly be advisable.³⁴ There is also no requirement to give any **reasons** for the request to opt-in.³⁵ However, a well-

28 Cf. Henry, above note 9, at 985; Legrand, above note 9, at 15; Bork *et al.*, above note 1, Article 69.2; Mankowski *et al.*, above note 1, Article 69 paragraph 2.

29 Cf. also Recital 56 sentence 3; Bork *et al.*, above note 1, Article 69.2; Mankowski *et al.*, above note 1, Article 69 paragraph 2.

30 Cf. Bork *et al.*, above note 1, Article 69.2; Mankowski *et al.*, above note 1, Article 69 paragraph 2.

31 With respect to the coordinator as addressee see Bork *et al.*, above note 1, Article 69.10; Mankowski *et al.*, above note 1, Article 69 paragraph 11.

32 Cf. Bork *et al.*, above note 1, Article 69.9; Mankowski *et al.*, above note 1, Article 69 paragraph 10.

33 Cf. Bork *et al.*, above note 1, Article 69.11; Mankowski *et al.*, above note 1, Article 69 paragraph 12.

34 *Idem*.

35 Cf. Bork *et al.*, above note 1, Article 69.12; Mankowski *et al.*, above note 1, Article 69 paragraph 13.

founded statement of reasons would nevertheless be advisable, since the success of the request ultimately depends on persuading either the coordinator or all the other insolvency practitioners involved of its merits.³⁶ Finally, there is also **no specific time limit**.³⁷ However, the later the request is filed, the smaller its chances for success will most likely be.³⁸

Decision of the Coordinator

The request is decided upon not by the court, but solely by the coordinator.³⁹

Prior Consultation of the Insolvency Practitioners

Before making his decision on the request, the coordinator has to consult the insolvency practitioners involved.⁴⁰ Since there is no specific procedure for the manner of consultation, it is up to the discretion of the coordinator to decide on an effective manner of consultation.⁴¹ He can, for example, call a (real or virtual) meeting or simply call or e-mail each insolvency practitioner individually.⁴²

Conditions for the Approval of the Request

The coordinator may only – and must – accede to the request if one of the two criteria set out in Article 69(2) EIR is met.⁴³

Fulfilment of the Criteria set out in Articles 63(1)(a) and (b) EIR

Firstly, Article 69(2)(a) EIR permits (and obligates) the coordinator to accede to the request if he is satisfied, taking into account the stage that the group coordination proceedings have reached at the time of the request, that the criteria set out in Article 63(1)(a) and (b) EIR are fulfilled. Since these provisions pertain to the original opening of group coordination proceedings, they can naturally only be meant to apply *mutatis mutandis*.⁴⁴

Hence, the coordinator firstly has to satisfy himself that the opt-in of the group member in question is appropriate to facilitate the effective administration of the insolvency proceedings relating to the different group members (i.e. not only the

36 Cf. Bork *et al.*, above note 1, Article 69.12; Mankowski *et al.*, above note 1, Article 69 paragraph 13.

37 Cf. Bork *et al.*, above note 1, Article 69.13; Mankowski *et al.*, above note 1, Article 69 paragraph 14.

38 Cf. Mankowski *et al.*, above note 1, Article 69 paragraph 14.

39 *Ibid.*, Article 69 paragraph 15.

40 Cf. Bork *et al.*, above note 1, Article 69.14; Mankowski *et al.*, above note 1, Article 69 paragraph 16.

41 Cf. Bork *et al.*, above note 1, Article 69.15; Mankowski *et al.*, above note 1, Article 69 paragraph 17.

42 Cf. Mankowski *et al.*, above note 1, Article 69 paragraph 17.

43 Cf. Bork *et al.*, above note 1, Article 69.16; Mankowski *et al.*, above note 1, Article 69 paragraph 18.

44 Cf. Bork *et al.*, above note 1, Article 69.17; Mankowski *et al.*, above note 1, Article 69 paragraph 19.

one requesting to join, but also those already participating) (Article 69(2)(a) EIR in conjunction with Article 63(1)(a) EIR).⁴⁵

Secondly, he has to satisfy himself that no creditor of any group member already participating in the proceedings or requesting to participate is likely to be financially disadvantaged by the inclusion of that member in the proceedings if they henceforth also include the member requesting to join (Article 69(2)(a) EIR in conjunction with Article 63(1)(b) EIR).⁴⁶

In this context, the coordinator has to take into account the stage that the group coordination proceedings has reached at the time of the request. Generally, a subsequent inclusion will be all the more difficult and all the less sensible the further the group coordination proceedings have already advanced.⁴⁷ It may be the case that the proceedings have already advanced so far that it would no longer be practically feasible to include another group member.⁴⁸ Let's suppose, for example, that the group coordination plan provided for the sale of the assets of all participating group members to an investor and the group members participating in the coordination have already signed a deal with an investor, but the closing is still pending. Including another large group member into the group coordination proceedings at this point would probably be very problematic, especially if the investor is not willing to buy also the assets of this group member. If, however, the investor is actually keen on also getting the assets of this group member, the coordinator would have to accede to the request.

Agreement of all Insolvency Practitioners involved

Article 69(2)(b) EIR permits (and obligates) the coordinator to accede to the request if all insolvency practitioners involved agree. Each insolvency practitioner has to agree under the conditions provided by his national law. This apparently again refers in particular to any requirements of prior authorisation by a specific body (e.g. a creditors' meeting or committee) before making such a request.⁴⁹ Hence, a German insolvency practitioner would have to obtain the consent of the creditors' committee (or if there is none: the creditors' meeting) (*cf.* § 160(1) InsO).⁵⁰

45 *Cf.* Bork *et al.*, above note 1, Article 69.18; Mankowski *et al.*, above note 1, Article 69 paragraph 20.

46 *Cf.* Bork *et al.*, above note 1, Article 69.19; Mankowski *et al.*, above note 1, Article 69 paragraph 21.

47 *Cf.* Mankowski *et al.*, above note 1, Article 69 paragraph 22.

48 *Cf.* Bork *et al.*, above note 1, Article 69.20; Mankowski *et al.*, above note 1, Article 69 paragraph 22.

49 *Cf.* Bork *et al.*, above note 1, Article 69.22; Mankowski *et al.*, above note 1, Article 69 paragraph 27.

50 *Idem.*

Communication of the Decision and Challenges against the Decision

In order to guarantee a fair procedure, Article 69(3) EIR requires all insolvency practitioners to be informed of the coordinator's decision and Article 69(4) EIR gives them the possibility to contest it before the court which has opened the coordination proceedings.⁵¹ The procedure for the challenge is governed by the law of the Member State where group coordination proceedings have been opened.

Time and Consequences of Opt-in

If the coordinator validly accedes to the request and there is no successful challenge pursuant Article 69(4) EIR, the group member in question participates *ex nunc* from the time the coordinator's decision becomes effective.⁵² The opt-in does not have retroactive effect.⁵³ From the moment the opt-in becomes effective, the group member is a **full participant** in the group coordination proceedings with all corresponding rights and duties.⁵⁴ However, the time of the opt-in may be taken into account for purposes of the final allocation of the costs.⁵⁵

The opt-in is, on principle, final; there is no possibility to opt-out again.⁵⁶ Yet, in light of the concept of the voluntary nature of the group coordination proceedings⁵⁷, nothing should prevent an agreement by all insolvency practitioners involved allowing a group member to no longer take part in the group insolvency proceedings.⁵⁸

Evaluation

Attempting again a provisional evaluation, my verdict on the subsequent opt-in is much more positive. Admittedly, it adds another layer of complexity. However, in contrast to the opt-out right, the opt-in does not delay the progress of the group coordination proceedings and there is no comparable danger of abuse. Moreover, giving group members who have so far remained "outside" the possibility to join group coordination proceedings – provided that this is either beneficial for the effectiveness of the proceedings or all involved agree – is evidently sensible in order enable effective group coordination proceedings.

51 Cf. Recital 56 sentence 4; Bork *et al.*, above note 1, Article 69.3; Mankowski *et al.*, above note 1, Article 69 paragraph 3.

52 Cf. Bork *et al.*, above note 1, Article 69.31; Mankowski *et al.*, above note 1, Article 69 paragraph 37 ff.

53 Cf. Bork *et al.*, above note 1, Article 69.31; Mankowski *et al.*, above note 1, Article 69 paragraph 38.

54 Cf. Bork *et al.*, above note 1, Article 69.32; Mankowski *et al.*, above note 1, Article 69 paragraph 39.

55 Cf. Bork *et al.*, above note 1, Article 69.32, Article 77.20; Mankowski *et al.*, above note 1, Article 69 paragraph 39, Article 77 paragraph 25.

56 Cf. Bork *et al.*, above note 1, Article 69.33; Mankowski *et al.*, above note 1, Article 69 paragraph 40.

57 Cf. Recital 56 sentence 1.

58 Cf. Bork *et al.*, above note 1, Article 69.33; Mankowski *et al.*, above note 1, Article 69 paragraph 40.

Conclusion

So which overall conclusions can be drawn with respect to the value and effectiveness of the opt-in and opt-out rules? Both opt-in and opt-out can be perceived as manifestations of the general concept of the voluntary nature of the new group coordination proceedings. This concept further manifests itself in the non-binding nature of the group coordination plan, the reliance on a “comply-or-explain”-mechanism for its enforcement and the absence of any powers of the coordinator to unilaterally make binding decisions for the entire group. The opt-out and opt-in mechanisms fit in seamlessly into this concept.

However, they add yet another layer of complexity to already very complex proceedings. Whereas this may be acceptable with respect to the opt-in as it is now designed, the right of each insolvency practitioner of a group member to opt-out may prove to be a real problem and significant stumbling block for effective coordination. Admittedly, an opt-out mechanism is still much better than the requirement of explicit assent of each individual insolvency practitioner contemplated during the legislative procedure in the Council. Especially in case of large groups, this would probably have spelled doom. In this respect, the current system – being “in” as the “default setting” and requiring an active objection in order to opt-out – is certainly preferable. Nonetheless, the 30-day opt-out period brings about a significant and problematic delay of the opening proceedings and, what is more, the opt-out right undeniably entails a huge potential of obstruction and abuse.

Whether the “safety devices” currently installed will be a sufficient deterrent remains to be seen. Especially for large group insolvencies the possibility that the opt-out of a pivotal group member or of a significant number of group members may thwart an effective coordination and restructuring may be a real problem. Then again, one might argue that “forcing” unwilling group members to be included into coordination proceedings might not be the best way to ensure effective restructuring or liquidation either – i.e. better to let them opt-out beforehand than enabling them to obstruct the entire coordination afterwards – or: it’s better to make a painful break early on than to draw out the agony.

Ultimately this brings us back to the inherent general problem of the concept of group coordination proceedings as they are now regulated in the Recast EIR: Due to their non-binding and voluntary nature, they will only work if all parties involved are able and willing to work together effectively.

Chapter 8

Coordination of Group and Financial Insolvencies in the SADC Region

Leonie Stander

Introduction

Because of the substantial differences between conventional corporate insolvency and bank insolvency, the writer is of the opinion that two separate insolvency regimes are necessary. Apart from that, the resolution of cross-border bank insolvency in the Southern African Development Community (“SADC”) Region is governed by several national insolvency laws. These laws differ considerably for substantive insolvency law and have not yet been harmonized by any Insolvency Regulation. There is no need to emphasize the necessity that the SADC develop a uniform insolvency law approach to regulate cross-border insolvency disputes, especially where cross-border banks are concerned. In the words of Saurombe, in order to have meaningful economic integration and a free and reliable trade zone, it is important to have uniform trade laws and commercial practices within the region as well as uniform cross-border insolvency legislation and insolvency regulation for group and financial institution insolvencies.¹ The underlying objective of a uniform insolvency law approach would be to create a level playing field, and to avoid a race to the bottom and forum shopping practices.² Keeping in mind that cross-border insolvency law is a very complex process, the significant question is how the insolvency of financial institutions such as banks will be coordinated in the SADC Region?

The purpose of this chapter is to provide guidance that will simplify the whole process in this Region, based on the example provided by the European Union and the United States of America, but which can effectively be applied to the unique circumstances of the SADC.

- 1 See A. Saurombe, “The SADC Trade Agenda, A Tool to facilitate Regional Commercial Law: An Analysis” (2009) 21 *South African Mercantile Law Journal* 695.
- 2 N. Leno, “Development of a Uniform Insolvency Law in SADC: Lessons from OHADA” (2013) 57(2) *Journal of African Law* 259, at 260.

1. The SADC

The SADC was established within the framework of an agreement³ between certain southern African states. It can thus be seen as a “treaty-based organisation”.⁴ Its main purpose is to create a development community through regional co-operation and integration for the economic liberation and development of the community.⁵ The countries concerned are Angola, Botswana, the Democratic Republic of Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe. These countries co-operate politically and socially and on various policy levels such as in issues pertaining to human rights.. Although this has not yet progressed very far, they are in the process of integrating aspects of their economies.⁶ To bring about meaningful economic integration the SADC heads of state and government agreed to establish a free trade zone with the East African Community (“EAC”) and a Common Market for Eastern and Southern Africa (“COMESA”). To this end the SADC has created community organs to oversee the implementation of its objectives.⁷ There are many problems and obstacles in this area of regional development, however.

2. Problems

First of all the financial systems of the various SADC countries are extremely diverse. Countries with highly developed financial systems (like South Africa and Mauritius) co-exist with fragile states facing severe economic challenges (such as the Democratic Republic of Congo or Zimbabwe) and countries with less-developed financial systems (such as Angola or Mozambique).⁸

Since the trading activities and business transactions in the SADC will involve several multinational enterprises from different States, the very relevant question is how cross-border insolvency disputes, especially involving groups and financial institutions such as banks, can be best resolved? It is common knowledge that there is an absence of a common legal tradition, language, currency or uniform

3 SADC Treaty, Windhoek, 17 August 1992.

4 P. Sands and P. Klein, *Bowett's Law of International Institutions* (6th ed) (2009, Sweet & Maxwell, London), at 16.

5 Article 21, SADC Treaty. The areas of cooperation, ranging from food security and agriculture to international relations and peace, are set out in this article.

6 T. Kruger, “Regional Organizations and their Dispute Settlement Bodies” (2008) 41 *De Jure* 305.

7 Article 9, SADC Treaty. See D. Leno, “Regionalism: Lessons the SADC can learn from OHADA” (2012) 75 *Contemporary Roman-Dutch Law* 256, at 259.

8 See the discussion of this aspect in M. Cabello *et al.*, “Cross Border Banking Supervision in SADC Region” (2013) 4(2) *Banking on the African Moment* 36, at 36.

commercial insolvency law in the SADC region.⁹ Each country in the SADC region has a distinct legal framework and mechanism, and that the insolvency regimes and procedures within the SADC region are very diverse. There are currently no proposals to reform commercial laws in the region.¹⁰

It is important to remember, and Garrido¹¹ emphasizes the fact, that in all insolvency system there are crucial differences in the treatment accorded to personal or contract rights and *in rem* rights. Insolvency is defined by the existence of a conflict between competing claims over the assets that form the insolvent estate.¹² Garrido explains that in the case of the insolvency of a financial intermediary such as a bank, the main risk is that the interests of investors¹³ come into conflict with those of the creditors¹⁴ of the intermediary; more so where the bank and some of the investors and creditors are in another jurisdiction.¹⁵

The fear of non-compliance with treaty provisions is one of the major challenges. Non-compliance arises from a number of issues, including the complexity of the implementing agreement and the ambiguity and indeterminacy of treaty language.¹⁶ Very relevant in the circumstances of Southern Africa are the limitations on the capacity of parties to carry out their undertakings, and the temporal dimension of the social, economic and political changes contemplated by regulatory treaties.¹⁷

Cabello and others¹⁸ mention other factors that make a cross-border bank insolvency law in the SADC region particularly challenging, including:

- (1) the high level of financial heterogeneity in the SADC region;
- (2) the differences in the incentives for host and home administrators to share information;

9 B. Chinsinga, "The Challenges of Globalization and Regional Integration: The Case of the Southern African Development Community" in M Milazi (ed), *Democracy, Human Rights and Regional Co-operation* (2002, Africa Institute of South Africa, Pretoria), at 115; Leno, above note 2, at 4; D. Ailola, "UNCITRAL Model Law on Cross-Border Insolvency: Its Efficacy and Sustainability as a Basis for a SADC Convention" (2000) 11 *Stellenbosch Law Review* 215.

10 Chinsinga, above note 9, at 115; Leno, above note 2, at 263.

11 J. Garrido, "The Loss-sharing Rule in the Insolvency of Financial Intermediaries" (2010) *Uniform Law Review* 779, at 780.

12 *Ibid.*, at 782.

13 Those who have financed the bank.

14 Those who have entered into contracts with the bank.

15 Garrido, above note 11, at 782.

16 Leno, above note 2, at 280.

17 *Idem.*

18 Cabello et al., above note 8, at 36, 38.

- (3) the fact that regional guidelines to improve cross-border banking supervision are not binding, and are therefore difficult to implement;
- (4) the lack of effectiveness of Memoranda of Understanding to drive cross-border cooperation; and
- (5) the existence of political constraints preventing deeper regional integration.

*The High Level of Financial Heterogeneity in the SADC Region*¹⁹

This high level of diversity is one of the main obstacles to the development of an integrated framework for cross-border supervision in the region, and **a lack of supervision** from the different countries will definitely hamper the development of cross-border bank insolvency law – not every country will have the capability to supervise. Because regional initiatives to improve banking insolvency regulation must be built upon some basic consensus, the actual agreed initiatives in the SADC region will force regional authorities to operate according to a “lowest common denominator” approach (this means the most basic, least sophisticated level of development, regulation, sensibility, or opinion among a group of countries). Judged in an international context, this approach or attitude toward the problem is not acceptable. Furthermore, while all SADC countries have committed to implementing the *Basel Core Principles for Effective Banking Supervision*, actual compliance varies significantly.

*The Differences in the Incentives for Host and Home Administrators to share Information*²⁰

The differences in supervisory capacity among SADC countries will complicate efforts to promote information sharing among financial administrators. Cabello and others declare, and rightly so, that it is difficult to imagine that a home-country administrator such as South Africa or Mauritius would be comfortable relying upon information from a country that is non-compliant with several BCPs and does not apply International Financial Reporting Standards (“IFRS”). I agree that it is not far-fetched to think that a host-country administrator in such a country would struggle to analyse and incorporate information from a home country with a more developed supervisory framework. According to these writers the obstacles and challenges which are closely linked to this problem in the SADC region include the following:

¹⁹ Ibid., at 36 discussing the issue.

²⁰ Idem.

- The fact that banks involved in cross-border banking operations in the region originate from different regulatory backgrounds;²¹
- The true home country of a bank is not always fully clear;²²
- The complex corporate structures of many of the financial groups make them inherently difficult to administer;²³
- Several of the big financial groups have high intra-group exposures.²⁴

*Non-Binding Nature of Regional Guidelines to improve Cross-border Banking Supervision*²⁵

Regional financial authorities in the SADC, namely the SADC Committee of Central Bank Governors and the SADC Subcommittee of Banking Supervisors, signed the *Finance and Investment Protocol* in order to address some of these challenges. This protocol came into effect on 16 April 2010. An initiative in this regard has been the development of the *SADC Model Central Bank Law*. Cabello and others indicate, however, that the effective implementation of the provisions included in the *Model Central Bank Law* remains a major issue. The reason for this is that regional agreements are not binding on the member states and are therefore difficult to implement.²⁶

*The Lack of Effectiveness of MoUs to drive Cross-border Cooperation*²⁷

Cabello and others note that the relevant memoranda of understanding (MoUs) lack a strong legal framework. Bilateral information sharing within the SADC region is limited because of the absence of any legal requirement to cooperate under MoUs that are not legally enforceable. It is essential that incentives of home and host administrators to exchange information should exist because capacity to share information and the willingness to work together are critical for the future of cross-border bank insolvency law in this region.

21 *Idem*. This aspect makes it more difficult for host country administrators to ensure that they are suitably familiar with the type and quality of the information available to them and the reliance that can be placed upon it.

22 *Idem*. This is true for example, of the United Bank of Africa (“UBA”), Ecobank, Afriland and BancABC.

23 *Ibid.*, at 37, noting that the Standard Bank Group (“SBG”) and the FirstRand Group have complex holding company structures and a variety of banking, insurance, and other financial subsidiaries, a fact which complicates the determination of the home country of those banks.

24 *Idem*, examples being the Standard Bank Group and Ecobank. Members of such financial groups are more exposed to intra-group risk. As a result, problems in one country of operation are more likely to spread across borders.

25 *Idem*.

26 *Idem*.

27 *Idem*.

The Existence of Political Constraints preventing Deeper Regional Integration

There is also an important political economy aspect which plays a huge role with regard to the whole issue under discussion. The existence of political forces below the surface of the regional integration process in the SADC affects the implementation of a successful cross-border bank insolvency law system in the region. At issue are the forces of sub-regionalization and localization.²⁸

3. Preliminary Summary

The SADC does not operate a uniform commercial law system and, as said before, no attempt has been made to unify the commercial laws or private international rules applicable to cross-border disputes. This means that, in the event of a cross-border insolvency dispute, the debtor will be subject to diverse national insolvency law regimes. From the above exposition it is also clear that in an era of globalization a collective effort is necessary. Leno emphasises that:

“when states cooperate in the enactment of an insolvency law for financial institutions such as banks, one end result should be that the contracting states will enjoy a simple, modern and accessible insolvency law.”²⁹

For an effective cross-border bank insolvency law, information sharing and communication between the countries concerned are essential. Therefore measures should be put in place to facilitate this “working together” of the administrators from the different countries. These issues have to be addressed because the financial situation in the SADC Region is not entirely stable. The region lacks the financial foundation of first world countries and regions. An economic shock such as the failure of a transnational bank could trigger the failure of a chain of banks or precipitate a chain of significant losses to banks in the whole region, resulting in increases in the cost of capital or decreases in its availability³⁰ – something the region in my opinion could not afford. Such an event would in all likelihood

28 *Idem*, defining “sub-regionalization” as efforts aimed at creating closer relationships among a smaller subset of countries which share certain similarities and common interests. The Common Monetary Area (“CMA”), which includes South Africa, Namibia, Lesotho and Swaziland, is an example of a “sub-regionalization” process within the SADC framework. “Localization” is defined as the manner in which countries take steps to reinforce their political and supervisory autonomy. In explaining the effect of this phenomenon these writers use the case of Mozambique, which could see its political autonomy reduced in the event of deeper integration in the SADC.

29 Leno, above note 2, at 276.

30 Also see S. Schwarz, “Systemic Risk” (2008) 97 *Georgetown Law Journal* 193, at 204-205; P. Sester, “Towards a Transnational Bank Restructuring Law?” (2010) 7 *European Company and Financial Law Review* 512, at 523.

necessitate undesirable bail-outs³¹ of financial institutions at taxpayers' cost. It is also my view that such an event would necessitate substantial support on (usually scarce) state aid – states would provide financial assistance to stabilize the region.

The provisions of a legal framework for cross-border bank insolvency law should be self-executing so as to enjoy precedence over nationally enacted insolvency law. This is also the view of Leno, where he motivates for a general uniform insolvency law in SADC.³² Upon ratification of a uniform bank insolvency treaty by a state, the internal laws of the signatory states would be modified and the state would automatically be bound by the provisions of the treaty. The contracting states would then be bound by their international obligations.

4. Recommendations

In order to warrant a higher degree of legal certainty, transparency and predictability, the provisions of the unified legislation should be contained within a legal framework of either:

- (1) a treaty; or
- (2) a regulation.

Treaty

Those in favour of a treaty argue that the treaty should actually impose a duty of adherence on member states.³³ A few issues that would then arise might be the following:

- The SADC Council of Ministers should be empowered as a “guardian of treaties”, and should be able to bring before the SADC Tribunal enforcement proceedings against a non-complying state.³⁴
- It is essential in the banking environment that the rights of investors in their securities need to be respected in the event of the financial intermediary's

31 See: <https://en.wikipedia.org/wiki/Bailout>, where it is stated that a bail-out is a colloquial term for giving financial support to a company or country which faces serious financial difficulty or bankruptcy. It may also be used to allow a failing entity to fail gracefully without spreading contagion. Financial contagion refers to “the spread of market disturbances -- mostly on the downside -- from one country to the other, a process observed through co-movements in exchange rates, stock prices, sovereign spreads, and capital flows. Financial contagion can be a potential risk for countries who are trying to integrate their financial system with international financial markets and institutions. It helps explain an economic crisis extending across neighbouring countries, or even regions.”

32 Leno, above note 2, at 277.

33 Ibid., at 20.

34 See M. Cuthbert, *European Community Law* (6th ed) (2009, Sweet & Maxwell, London), at 12; compare Article 226, Treaty Establishing the European Community (10 November 1997).

insolvency.³⁵ This principle ensures that the rights of investors over the securities are not threatened by the peculiarities of the specific legal regime for intermediated securities and the combined impact of the insolvency law.³⁶

- Certain protection techniques are raised in connection with this functional approach. One such is the recognition that the investor has a proprietary interest in the securities. The investor will then be seen as the owner of the securities and his proprietary claim would not conflict with the credit claims by third parties.³⁷

According to some writers a protection technique should include the default loss-sharing rule.³⁸ When a shortfall materializes, the rule provides a possible solution for the distribution of damage among the affected investors. This loss-sharing rule mirrors the origins of the *pari passu* rule in insolvency law. However, in my opinion this rule still needs further investigation, refining and research.

Legal Framework of Regulation

The second possibility is a Regulation and Directive Framework. Some argue that a regulation-based regime is necessary for systemic cross-border banking groups such as the Barclays Group and the Standard Bank Group, because a full harmonization approach is needed.³⁹ Focus should be on the facilitation of a private sector solution with limited state aid, for example the takeover of the distressed bank by a competitor. In the case of non-systemic and national banks such as ABSA Bank and African Bank in South Africa, a directive-based framework should be employed. This would leave sufficient leeway for the national legislator. Again, the focus should be on the facilitation of a private sector solution with limited state aid, like the takeover of the distressed bank by a competitor.

35 UNIDROIT Convention on Substantive Rules for Intermediated Securities Geneva 2009 (“Geneva Convention”), available at: <http://www.unidroit.org/english/conventions/2009intermediatedsecurities/main.htm>.

36 See e.g. the Geneva Convention. This Convention takes a functional approach with regard to securities, where financial institutions are involved. Garrido, above note 11, at 783 declares that it is the only way of achieving results in an area where legal concepts and techniques are diverse, although the nature of the problems and the results to be achieved are substantially similar worldwide. The Convention includes key principles that are instrumental in solving the problems presented by the insolvency of financial intermediaries such as banks. The most important one is the principle of the effectiveness of rights in insolvency proceedings, which addresses the question of the protection of the investor against the claims of third parties in the event of the insolvency of the financial intermediary. In this way, the Convention states that “rights that have become effective against third parties are effective against the insolvency administrator and creditors in any insolvency proceeding in respect of the relevant intermediary.”

37 Garrido, above note 11, at 783.

38 Ibid., at 785.

39 Sester, above note 30, at 544.

It is Sester's opinion that the framework should facilitate a fast and smoothly coordinated reaction by supervisors with first-step harmonization, procedural safeguards and speedy intervention.⁴⁰ Restructuring is of the utmost importance. Where in the case of a treaty it is recommended that a Council of Ministers should be formed to act as the "guardian" of the treaty, it is suggested that in the case of a regulation-based regime a Resolution Authority should be established.⁴¹ This Authority would become the lead supervisor to oversee the insolvency proceedings and apply certain intervention and resolution tools. The structure of systemic bank groups should be subject to regular review and discussion between the group's management and supervisors.⁴² It is imperative that there should be some kind of authority to oversee the process.

There should also be a legal framework for intra-group asset transfer. It is recognised and acknowledged, however, that many points of critique exist against this technique of handling the matter. Further, a right of appeal is necessary because the Resolution Authority might interfere with management. Therefore – and I feel very strongly about this recommendation – the establishment of a separate insolvency court should be a priority.⁴³ Another option is the introduction of a SADC Banking Charter to support an effective crisis management and resolution system.⁴⁴

Tools for the Authority

Sester⁴⁵ lists a number of tools. To my mind, the following measures are vital aspects or facets for the successful implementation of a cross-border bank insolvency law and should be mandatory for an effective legal framework in this regard:

- The establishment of legally binding support commitments from group members;
- The setting up of measures to minimize activities that pose excessive risk to the soundness of a banking group;

40 Idem.

41 Idem.

42 Ibid., at 539.

43 Leno, above note 2, at 278 notes that the one obstacle to the OHADA drafters' drive for uniformity is the fact that there are general courts which vary from one member state to another and no specialized commercial or insolvency court for the settlement of both national and international insolvency disputes within the OHADA.

44 Because resolution tools will necessarily interfere in corporate governance structures and shareholders rights of the various legal entities belonging to the same group: Sester, above note 30, at 545.

45 Sester, above note 30, at 546.

- The restriction of expansion plans;
- The imposition of reduction strategies regarding refinancing⁴⁶ risks;
- The mandatory review of group structures;
- Grounded and motivated interference with shareholders' rights in company and property law;
- The mandatory application of "haircuts" to the claims of secured creditors;⁴⁷
- The temporary limitation of compensation.

It is recognized that criticism can and will be levelled against each of these measures, and it is my opinion that this subject will become a popular topic in the SADC region for further research.

Conclusion

A separate legal framework in the case of cross-border bank insolvency should be established for the SADC region. It is vital for this purpose that measures or regulations there should be established as soon as possible to enable a uniform and even operation of the regional (SADC) inter-bank market in the event of cross-border bank insolvency. The advantage of this would be that the establishment of such measures would at least minimize the need for financial aid that could

46 Refinancing is described at: <https://en.wikipedia.org/wiki/Refinancing> as a term that may refer to the replacement of an existing debt obligation with another debt obligation under different conditions. "The terms and conditions of refinancing may vary widely by country, province, or state, based on several economic factors such as, inherent risk, projected risk, political stability of a nation, currency stability, banking regulations, borrower's credit worthiness, and credit rating of a nation. In many industrialized nations, a common form of refinancing is for a place of primary residency mortgage. If the replacement of debt occurs under financial distress, refinancing might be referred to as debt restructuring. A loan (debt) might be refinanced for various reasons: (1) to take advantage of a better interest rate (a reduced monthly payment or a reduced term; (2) to consolidate other debt(s) into one loan (a potentially longer/shorter term contingent on interest rate differential and fees); (3) to reduce the monthly repayment amount (often for a longer term, contingent on interest rate differential and fees); (4) to reduce or alter risk (e.g. switching from a variable-rate to a fixed-rate loan; (5) to free up cash (often for a longer term, contingent on interest rate differential and fees."

47 "Secured creditor haircuts" occur when a portion of fully secured creditors' claims are treated as unsecured. The more equitable way to reorganize a financially distressed bank would be to make shareholders and bank bondholders take the hit, rather than the taxpayer. In these circumstances it would help if bank regulators would insist that bad loans be written down on the books. See: http://www.liquisearch.com/debt_restructuring/bondholder_haircuts, where it is stated that "(b)ondholders would take haircuts, but these losses are already priced into deeply discounted bond prices. If the key issue is bank solvency, converting debt to equity via bondholder haircuts presents an elegant solution to the problem. Not only is debt reduced along with interest payments, but equity is simultaneously increased. Investors can then have more confidence that the bank is solvent, helping unfreeze credit markets. Taxpayers do not have to contribute money and the government may be able to just provide guarantees in the short term to buttress confidence in the recapitalized institution. For example, where a bank owes its bondholders ZAR 267 billion, a 20% haircut would reduce this debt by about ZAR 54 billion, creating an equal amount of equity in the process, thereby recapitalizing the bank significantly."

create many problems and concerns specifically in the SADC region. Bail-outs at the taxpayer's cost and the support on state aid should be limited as far as possible. These regulations should where possible also warrant the protection of shareholders' rights in liquidation and the equal access of all of the banks to equity⁴⁸ capital, by creating a regional level playing field with regard to capital requirements in the case of systemic cross-border banks. These regulations should also reduce the refinancing costs of banks. This would in turn promote the credit demand for investment projects.

48 Reducing bank debt levels by converting debt into equity would increase confidence in the financial system. See: [https://en.wikipedia.org/wiki/Equity_\(finance\)](https://en.wikipedia.org/wiki/Equity_(finance)), where it is explained that “equity is the difference between the value of the assets/interest and the cost of the liabilities of something owned. For example, if someone owns a car worth ZAR 55,000 but owes ZAR 25,000 on that car, the car represents ZAR 30,000 equity. This means that equity can be negative if liability exceeds assets. This source also explains that in an accounting context, shareholders' equity represents the equity of a company as divided among individual shareholders of common or preferred stock. Accounting shareholders are the cheapest risk bearers as they deal with the public. Negative shareholders' equity is often referred to as a (positive) shareholders' deficit. For the purposes of liquidation during bankruptcy, ownership equity is the portion of a business's equity which remains for the owners after all liabilities have been paid and all other creditors have been reimbursed.”

PART II
THE YOUNG ACADEMICS'
NETWORK IN INSOLVENCY
LAW PAPERS

Chapter 9

Influence of the EU Regulations on Banking and Financial Insolvency in Candidate Countries

Djuro Djuric

1. Introduction: EU Regulations on Insolvency of Banking and Other Financial Institutions

The question of insolvency of banks and other financial institutions has become a particularly “hot topic” since the onset of the world financial crisis in 2008. Since many banks and other financial institutions from EU countries are major players in financial markets across the world, and since some of them have been hit hard by the problems that the crisis has brought, it is natural that EU and its regulations in this field have come under scrutiny. The crisis has shown that the models that have previously existed were not sufficient and did not enable an adequate level of cooperation between the member states, in order to minimize the spreading of negative effects of individual insolvencies and problems of individual financial institutions across the EU and all over the world. Therefore, changes were needed in the regulations, and indeed, certain changes have been made.

For years, the main regulatory instrument in this field was Directive 2001/24/EC of 4 April 2001 on the reorganisation and winding up of credit institutions.¹ It provided elementary rules that gave member states significant freedom to set up respective legal regimes that suited their legal traditions, economic policies and goals and preferences. Several rules and principles are the most important:

- credit institution and its branches form a single entity, subject to the supervision of the competent authorities of the state where an authorisation valid throughout the Community was granted (home member state);

¹ Directive 2001/24/EC of 4 April 2001 on the reorganisation and winding up of credit institutions, OJ L 125, 05.05.2001, at 15-23.

- the administrative or judicial authorities of the home member state have the sole power to decide upon and implement the reorganisation measures provided for in the law of that member state;
- member states are obliged to inform one another when undertaking measures according to this Directive;
- creditors of the credit institution are to be treated equally, regardless of the member state of their origin;
- decisions of the competent authorities of the home member state are to be recognised in other member states without any special formalities.

The financial crisis that started in 2008 brought about several notable insolvencies in the financial sector that were handled mostly by national governments in different ways: from various kinds of bail-outs to full bankruptcies and ex post interventions. The events have shown that the effects of a failure of a single financial institution can spread far across national boundaries. The prevailing conclusion was that the authorities of involved countries other than only the home country should be involved in the decision-making process and that the regular procedure for bankruptcy of non-financial companies is not entirely suitable for financial institutions, especially for those operating on an international scale. Also, joint international financial funds for rescuing failing financial institutions have been set up. Devastating economic consequences of the crisis have shown that the financial sector requires stricter regulations and supervision.

The main regulatory reform effort on the EU level was the adoption of Directive 2014/59/EU of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms (EU Bank Recovery and Resolution Directive/“BRRD”),² which has also amended several other EU directives and regulations, including Directive 2001/24/EC.

Main characteristics of the legal regime set up by BRRD are the following:³

- the goal of BRRD is that the consequences of the failure of financial institution (bank or investment firms that fall within the scope of BRRD) are borne by its shareholders and creditors, instead of the taxpayers;

2 Directive 2014/59/EU of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, OJ L 173, 12.06.2014, at 190-348.

3 Ibid., for which see: http://europa.eu/rapid/press-release_MEMO-14-297_en.htm (last viewed 14 September 2015).

- financial institutions have to prepare a full recovery plan with measures that are to be taken in different cases of financial difficulties; those plans are to be coordinated with and presented to competent national resolution authorities;
- resolution authorities are authorised to intervene in case of deterioration of financial situation of the financial institution; measures include requiring that the recovery plan measures be undertaken by the institution, requiring that management be changed, or even appointing a special manager to replace existing management of the financial institution in question;
- when it is determined by the competent authorities that the institution is failing or likely to fail and when any other measures are not deemed to be sufficient under the circumstances, resolution is triggered, which means that the resolution authority can use some of the resolution tools provided by BRRD: sale of the part of the business without shareholder's consent, forming a bridge institution and a "bad bank" (separating the good and healthy parts of the institution from the "bad" assets), or even using a bail-in tool, which allows liabilities to be written down or turned into equity, so that the institution can survive as a going concern;
- banks and investment firms are required to contribute financially to national funds established for fulfillment of the tasks of BRRD, for example creating a bridge bank and securing capital or loans for it to operate; contributions of the institutions are to be in proportion with their respective liabilities and risk profiles.

BRRD has brought certain amendments to Directive 2001/24/EC, broadening its reach to include investment firms and their branches, as defined by Regulation (EU) No. 575/2013 of 26 June 2013. It has also replaced the provisions on the duties of informing the competent authorities and known creditors about the provisions on the duties of the resolution authorities in Article 83 of BRRD.

Although the enlargement of the EU is currently not on top of EU political and economic agenda, the candidate countries are in the process of adjusting their legislation and practices in order to be better prepared for negotiating with the EU, but also in order to make their respective economic conditions and markets more harmonized with the EU countries, therefore making them more attractive to potential foreign investors. We shall attempt to give a brief analysis of how several

West Balkans EU candidate countries have reacted to the described changes in EU regulations regarding financial institutions and handling their financial difficulties.⁴

2. Regulatory Framework in the Republic of Serbia

The banking law legislation reform in Serbia in 2015 has been significantly influenced by the changes in EU legislation, specifically the new BRRD. First of all, Serbian Parliament has enacted a completely new Law on Bankruptcy and Liquidation of Banks and Insurance Companies.⁵ This Law provides a legal procedure that falls within the scope of the Directive 2001/24/EC on the reorganisation and winding up of credit institutions, which has also been revised by the BRRD in 2014.

This Law applies to the bankruptcy and liquidation of banks, insurance companies and also the companies that provide the services of financial leasing, which means that it is intended to provide the same legal framework for all institutions that are considered to be financial institutions. According to this Law, bankruptcy and liquidation proceedings are initiated by a decision of a competent commercial court, where the decision is based on the previous decision of the People's Bank of Serbia (Serbia's central bank/"NBS"). In case of bankruptcy, simultaneously with the making the decision that the preconditions for initiating bankruptcy proceedings have been met, NBS revokes the license of the bank in question. Interested parties can initiate a proceeding for reassessment of the legality of the decision of NBS before the Administrative court. In that proceeding, the Administrative court can only decide that the decision was not legal, annul it and send it back to NBS to repeat the proceeding, but the court cannot decide alone in the matter, in full jurisdiction.⁶

The organs of bankruptcy proceedings are the court, bankruptcy administrator and the board of creditors. The Deposit Insurance Agency⁷ ("DIA") acts as bankruptcy administrator in every case *ex lege*. DIA immediately pays the deposits in the amount in which they are insured by the law, which currently stands at EUR 50,000 per individual depositor. The court publishes the decision to initiate a

4 A. Anic, M. Malovic and V. Mistic, "Macroeconomic Environment and NPLS: Evidence from Serbia and the Czech Republic" (205) XXXIX *Teme* 175.

5 Law on Bankruptcy and Liquidation of Banks and Insurance Companies, Official Gazette of the Republic of Serbia, N°14/2015. See also N. Jovanovic, "Novi zakonodavni „mućak“ Srbije u MiFID okruženju" in *Uskladjivanje poslovnog prava Srbije sa pravom Evropske unije* (2011, Pravni fakultet Univerziteta u Beogradu, Beograd), at 228-304.

6 Law on Bankruptcy and Liquidation of Banks and Insurance Companies, Official Gazette of the Republic of Serbia, N°14/2015.

7 Deposit Insurance Agency of Serbia: <http://www.aod.rs>.

bankruptcy proceeding, in which it determines the deadline for submitting claims of the creditors of the bank in bankruptcy proceeding, which could be in between 30 and 90 days.

DIA makes a list of assets and obligations of the bank, its significant contracts in power, deals done in the last 180 days, etc., as well as the initial bankruptcy balance sheets. During the proceeding, deals that were made by the bank in the last six months before the proceedings initiation could be disputed before the court if some creditors were brought in favorable position by such deals. If the deals were made with connected persons, they can be disputed if they were made in the last year. Compensation of one's debts with the debts of the bank toward that person can be made before the decision on final distribution of assets. In the bankruptcy proceeding, selling off a debtor bank as a legal entity is not permitted.

DIA determines the validity of creditors' claims within six months after the deadline for submitting the claims. Within 60 days after that, a court hearing is held where the final list of claims is made.

A liquidation proceeding is similar to the bankruptcy proceeding, with the exception that no board of creditors is formed (since the bank in question is solvent, hence the creditors have no need for that kind of protection). Organs of the proceeding are the court and the liquidation administrator, which is again the DIA.

The Law on Bankruptcy and Liquidation of Banks and Insurance Companies provides a relatively small number of regulations, directing instead to the rules of bankruptcy proceedings for regular (non-financial) companies for matters not specially regulated by this Law.⁸

However, a wide variety of measures that could be undertaken in the period before the initiation of bankruptcy or liquidation proceedings is regulated by the Law on Banks.⁹ The Law on Banks was significantly amended in 2015, among other under the influence of BRRD. One of the most significant changes has been the introduction of the reorganisation procedures, which are regulated in some detail. The competent national authority for restructuring banks is NBS – the central bank. All in all, with the amended Law on Banks, NBS has a much more active role in following the day-to-day doing business of the banks, with the aim of being able to intervene in a timely and adequate manner, with as little damage to

8 M. Vasiljevic, *Kompanijsko pravo* (2012, Sluzbeni glasnik RS, Beograd). Dj. Djuric, "Serbian Insolvency Law and its relation to EU Insolvency Standardization and the US Bankruptcy Code", Chapter 12 in: R. Parry (ed), *Substantive Harmonisation and Convergence of Laws in Europe* (2012, INSOL Europe, Nottingham), at 159-171.

9 Law on Banks, "Official Gazette of Republic of Serbia", No. 107/2005, 91/2010 and 14/2015. More on the official site of the National Bank of Serbia: <http://www.nbs.rs>.

overall financial stability and other market participants as possible. This kind of legislative change is completely in line with the changes in EU regulations that are the consequence of the financial crisis.

For example, banks are obliged to compile a Recovery plan, which is to be applied in the case of significant worsening of their financial status. Those Recovery plans are delivered to NBS on a yearly basis, or more often if necessary (if requested by NBS). Therefore, the provisions about Recovery plans are in line with the provisions of BRRD. The provisions on the supervisory role of NBS in analyzing auditor's reports of the banks are also made stricter. As we have already pointed out, NBS has a much greater role and competence in following the banks, including some measures that did exist in Serbian law until these latest amendments to the Law on Banks. Also, a stricter system of responsibilities has been established to be in place inside the banks themselves.

Restructuring of a bank has been established as a special procedure to be applied when the need exists to secure the maintaining of the critical functions of the banks, protecting the stability of the financial system as a whole, protecting state funds, depositors, investors and clients of the bank and their assets. The main principles of the restructuring process are: the first ones to bear the losses are the shareholders of the bank (a clear statement that the public funds are to be spared and not be used to cover the losses in the private financial sector); next ones to bear the losses are the creditors of the bank, but in the same order as if the bankruptcy or liquidation proceeding were initiated; deposits insured by law will be paid in full; members of the management of the bank will be dismissed, but will be obliged to assist in the restructuring process and also be held legally responsible for the damage they may have caused by their actions to the bank and its creditors.

Measures like those brought by the presented laws reflect not only the need to adjust Serbian law to EU regulations in this field, but also the fact that Serbia has had several cases of failed banks in recent years, with one speciality: those banks were already (at the moment that failure became apparent and imminent) almost entirely owned by the State. Therefore, Serbian taxpayers are already familiar with the situation when the losses of financial institutions fall ultimately and directly to the state budget. That is exactly the situation with the EU regulations, as well as with Serbian regulations, aimed to be avoided in the future.

3. Regulations in Montenegro

Bankruptcy and liquidation proceedings for banks in Montenegro are regulated in the Bank Bankruptcy and Liquidation Law.¹⁰ The main characteristic of both proceedings is that they are conducted exclusively by the Central Bank of Montenegro (“CBM”). CBM initiates the proceedings, appoints the bankruptcy or liquidation administrator and the members of bankruptcy board and decides on closing the bankruptcy or liquidation proceedings. Bankruptcy or liquidation administrator is a natural person that meets the criteria set in the Law. The Law contains detailed regulations of the proceedings, in which the bankruptcy (or liquidation) administrator has the main role, but is ultimately responsible to the bankruptcy board and the CBM. Unlike the bankruptcy proceedings for regular companies in Montenegro, courts do not participate in bankruptcy proceedings for banks, except in the case of lawsuits filed against administrative acts of CBM in the bankruptcy proceeding.

The Law on Banks¹¹ regulates several measures that can be undertaken by the CBM in the event that supervision determines that the bank has done business in an illegal or not solid manner, especially in relation to risk management. Those measures include various orders and bans (that effectively mean interfering in doing day-to-day business of the bank), ordering the bank to create a plan for improving the state of affairs of the bank, introducing a temporary administration to the bank, or even revoking the bank’s license. In case of introducing temporary administration, CBM appoints a temporary administrator that takes over the management of the bank and is responsible to the CBM. Temporary administrator can order the emission of new shares of the bank (emission to existing shareholders only, which is the primary way, except in the case of already failed recapitalisation), or selling the shares of existing shareholders to raise new capital, or even transferring the bank’s assets and/or liabilities to another bank, without the consent of shareholders, creditors or debtors. These actions can be compared to those introduced by BRRD, although they are definitely not caused by BRRD, since the last amendments to the Law on Banks were adopted in 2011.¹²

10 Bank Bankruptcy and Liquidation Law, “Official Gazette of Montenegro”, Nos. 47/2001, 62/2008 and 44/2010. More on the official page of the Central Bank of Montenegro: <http://www.cbmn.org>.

11 Law on Banks, “Official Gazette of Montenegro”, Nos. 17/2008, 44/2010 and 40/2011.

12 Ministry of Foreign Affairs and European Integrations of Montenegro, Report on Analytical Survey of Harmonisation of Legislation of the Republic of Montenegro, Chapter 9 – Financial Services, available at: <http://www.mvpei.gov.me> (last viewed 14 September 2015).

4. Regulations in Former Yugoslav Republic of Macedonia

Banking Law of Macedonia¹³ contains regulations concerning bankruptcy and liquidation proceedings for banks, as well as a wide array of measures that can be undertaken before initiating such proceedings, when banks run into difficulties during their business operations. While the bankruptcy proceeding can be initiated by the Governor of the National Bank of The Republic of Macedonia, liquidations proceeding can be initiated either by the bank itself or by the Governor of the National Bank. The bankruptcy proceeding is initiated by the Governor of the National Bank, who after passing the decision that the requirements for initiating bankruptcy proceeding are fulfilled, files a proposal for opening the proceeding to the court. The bankruptcy proceeding is conducted by the court, which appoints a bankruptcy administrator, after receiving the opinion of the Governor of the National Bank for this appointment. Bankruptcy administrator must be a (natural) person that meets the legal requirements for being a member of the management of the bank. The court also appoints a board of creditors. The National Bank is also involved in the proceeding, since the bankruptcy administrator compiles a report on all the claims and liabilities of the bank and sends the report to the National Bank, which sends it to the bankruptcy court after inspecting the received documents. Not all the bankruptcy proceeding rules are contained in the Banking Law, since this law often directs to the provisions of the Bankruptcy Law, which regulates the bankruptcy proceeding for regular companies.

Macedonian Banking Law contains a whole chapter dedicated to branches of banks from EU member states, which means that the Macedonian law grants the banks stemming from EU states a special status, simplifying their access to the Macedonian banking market through branches.¹⁴ Namely, Macedonian Banking Law contains a different set of rules for foreign banks, which are not from EU member states. Banking Law also prescribes that the only competent authority for deciding on opening bankruptcy or liquidation procedures against a bank, including its branches in Macedonia, is the competent authority of the home country. This, as well as the other provisions of the Banking Law, is harmonised with the provisions of the Directive 2001/24/EC on the reorganisation and winding up of credit institutions.

13 Banking Law of Macedonia, "Official Gazette of Republic of Macedonia" Nos. 67/2007, 90/2009, 67/2010, 26/2013 and 15/2015. More on the official page of the National Bank of FYRO Macedonia: <http://www.nbrm.mk>.

14 M. Malovic and S. Paunovic, "Flow of Funds in Balkan Banks: Narrow Banking or Narrow Escape?" in P. Teixeira *et al.* (eds), *European Integration Process in Western Balkan Countries* (2012, University of Coimbra Press, Coimbra), at 564-588.

Banking Law also provides the Governor of the National Bank, as the competent authority, with a wide set of measures that could be undertaken in the case of observed irregularities in the functioning of the bank, including introducing administration or appointing new members of administration of the bank that is facing difficulties.

Conclusion

The analysis of the state of legislation in the selected EU candidate countries shows a general trend of adapting to the post-crisis conditions of the banking markets, which is also somewhat influenced by the changes in EU regulations in this field. While it can be said that Serbia has responded in the most direct manner to new EU regulations, such as BRRD, it is clear that other countries are also preparing their respective markets for the challenges of EU accession negotiations. For example, FYR Macedonia has already introduced a special treatment for banks that originate from EU states into legislation, which facilitates their access to Macedonian market.

However, the future of banking regulations of candidate countries is still uncertain, and it must be said that the outcome is not entirely dependent on the quality of their laws and their implementation. Political and economic circumstances have put other topics to the agenda lately (immigration crisis, Greek crisis, Ukrainian crisis, slow economic growth in many EU member states), which means that EU enlargement is currently not under serious consideration. Also, it is still to be determined how the EU regulations themselves, which are to be used as a model for the candidate countries, would perform in case of a new financial crisis. The process of testing and evaluation of legislation of candidate countries is a process that will certainly take years.

Chapter 10

The Cost of Bank Insolvencies: A Socio-Economic Rights Analysis

Jennifer Gant

Introduction

High risk banking practices were a central factor of the financial crisis of 2007-2008 and the world is still feeling the aftershocks. Sovereign debt, austerity, and the degradation of social benefits, employee rights, and even the democratic framework of sovereign nations have been only some of the negative results. Given the complicated nature of modern financial markets, complex and remote financial instruments, and the banking industry, it is uncertain as to whether the current banking regulation and reforms can provide an effective safety net to avoid the social costs associated with future financial crises. It could be that it is time for a paradigm shift in the way in which banking and lending are approached from a philosophical perspective, taking into account a renewed understanding of the purpose and character of debt and lending, particularly when dealing with those debt transactions affecting individuals. Considering the juxtaposition of wealth maximisation, a fundamental aim of banking and finance, to the potential social costs when profit focussed activities go wrong, it could be possible that a neo-liberal and economically focussed approach to banking regulation and reform may need to be shifted to reflect the actual social costs of capitalism.

The purpose of this paper is to examine the fundamental underpinnings of the UK's approach to banking and lending with a focus on the apparent theoretical or philosophical approach to banking and regulation within the economy with reference to Coase's "The Problem of Social Costs"¹ and whether or not his framework of analysis is relevant to the regulation of today's financial markets. The origins of the financial crisis in irresponsible banking and lending practices will be explored as well as the social costs the financial crisis and the specific impact of lending practices on the consumer. Historic views on debt will be presented with a view to tracing how those views have changed in the modern age, particularly in consideration of the banking industry's approach to debt selling.

1 R. Coase, "The Problem of Social Costs" (1960) 3 *Journal of Law and Economics* 1.

There will also be brief look at some of the post crisis regulatory reforms that have occurred and a critical analysis of the neo-liberal economic approach in this area, followed by a conclusion that will comment on whether or not the current approach and underpinning theoretical framework can be adequate to circumvent the social costs of irresponsible banking practices in the future.

Origins of Financial Crisis

It is fairly well known that the most recent global recession was triggered by a subprime mortgage crisis in the United States in 2007, which then led to a global liquidity crisis due to the interconnectedness of many financial institutions, both banks and non-banks, which were affected by the “credit crunch”.² It was common to transfer certain repackaged debt obligations to increase liquidity, thereby giving creditors a means of trading debt obligations on the market. Without debt instruments to facilitate trading, debt remains an obligation from one party to another. When debt instruments are used as a means of facilitating debt trading, debt obligations can be removed from one party and given to another quickly and efficiently. Complex debt relationships have evolved among the financial institutions of the world, thus when mistakes are made by one, whether through negligence or mismanagement or simply overly risky behaviour, all institutions are affected, or perhaps *infected* as a result.³ Thus when banks ceased to function in the provision of credit on the scale to which the world economy had become accustomed, states often intervened in order to protect the national economies from complete collapse.⁴

Once confidence was shaken in Lehman Brothers in 2008, fewer market participants were willing to purchase securities from them as the trust that the company would eventually be able to repurchase them at a higher price had been lost.⁵ Its collapse and bankruptcy led to great market uncertainty and, failing to secure a government rescue package, revealed a fundamental cause of the crisis: excessive risk-taking. The loss of confidence in the financial system caused by the collapse of Lehman led to a global market collapse, which frightened many

2 S. Lubben and S. Woo, “Reconceptualising Lehman” (2014) 49 *Texas International Law Journal* 297; T. Jiang *et al.*, “Dynamics in Bank Crisis Model” [2015] *Mathematical Problems in Engineering*, available at: <http://dx.doi.org/10.1155/2015/378463> (last viewed 15 September 2015); G. Walker, “Financial Crisis – UK Policy and Regulatory Response” (2010) 44(2) *International Lawyer* 751.

3 Jiang *et al.*, above note 2.

4 D. Singh, “UK Approach to Financial Crisis Management” (2013) 19 *Transnational Law and Contemporary Problems* 869.

5 This refers to a repo-agreement in which securities are sold with an agreement for the seller to buy them back at a later date and normally at a higher price.

governments into action to try to avoid additional bank collapses by providing bail outs to many banking institutions. It impacted not just banks, but a number of financial type institutions, such as the insurance group AIG, which had linked itself to complex mortgage backed securities market, providing guarantees for collateralised debt obligations without making adequate provision in capital for any claims that could arise.⁶ The complex financial instruments to which the risks were attached lured considerable interest due to promised high returns, leading to additional repackaging and securitising and rapid growth in this market due to the perceived efficiency and high returns on investment. Eventually the demand for these kinds of products overwhelmed the need for due diligence regarding their product quality, which fuelled demand for the securitisation of lower forms of assets, such as subprime mortgages.⁷

While massive bank collapses were viewed as an imminent threat to the global economy, there remained a question of moral hazard as to whether it could be justified for governments to intervene with taxpayer's money to rescue banks from collapse when essentially the primary cause of their distress was mismanagement.⁸ Essentially, governments would be taking money from the people they were trying to protect from the effects of banking collapses caused by mismanagement of the very debt that belonged to the people governments were trying to protect! Of course, the banking industry also has an intimate connection to the lives of ordinary people as it is to the banks that people turn in order to acquire loans for housing, entrepreneurial business activities, and pensions to see them through to the end of their days. Thus when the banking industry suffers, regardless if the taxpayer is forced to bail them out, the ordinary man will also suffer due to difficulties in attaining credit.

The financial crisis exposed existing problems in the financial markets and the banking industry in terms of financial supervision, theory and practice. In addition, the intangible nature of debt securities and credit derivatives calls into question the value that can be placed on a promise when it has passed through numerous "hands" and has been split, combined, and amalgamated subject to additional promises that rely on all previous promises being met, until the original "promise" is no longer recognisable. This sounds more like fantasy than any real transaction between financial entities and/or individuals.

6 Singh, above note 4, at 873-874.

7 Ibid., at 875-876.

8 Ibid., at 871-872.

Modern Views on Debt⁹

Debt used to have an intrinsic moral dimension tied to the human condition. While early banks could only lend against the deposits held within the bank, this is no longer banking norm. Today dispensing with debt has become a financial decision as institutions tend to treat individual debt obligations as profit-making and capital freeing instruments. Granted, in order for banks to lend to individuals, they must first have capital to provide to borrowers and capital can only be freed if banks can also free themselves from the debt of their borrowers, often by selling it on through the complex securitization transactions, such as those that were at least partially indicted by assessments of the financial crisis. However, the extent to which debts can now be separated from the individual who owes them is reflective of fundamental changes in how debt is perceived in the modern financial context, particularly when compared to the anthropological origins of debt as a concept.

Debt and credit have an extraordinarily long history lying well outside their current financial aspects. It has been said that the origin of modern debt and credit lies in a sense of human community, mutual obligations, and morality.¹⁰ It has been viewed as a product of humanity's existential condition owed by virtue of the natural mutual protections afforded by living in a society or, from a religious standpoint, the existential debt owed to a supreme being.¹¹ Those living proper and moral lives are obliged to constantly repay the existential debts owed to one another. This evolved into a social obligation over time related to a reputation for honesty and charity,¹² something that can be traced to the early developments of social contract theory as well.

In principle, debt requires a relationship between individuals who do not consider each other fundamentally different and who are potentially equals. The balance of debt and credit addresses this equality in the sense that the urge to repay a debt is also the need to reinstate the equality between the debtor and creditor. If one is then unable to reinstate that equality, the person who is in debt must be at fault. Thus a debt is an exchange between individuals that has not yet been reciprocated.¹³ Given the association of creditworthiness with reputation for honesty and integrity,

9 The research in this section has also contributed to the author's PhD thesis, "Rescue before a Fall: an Anglo-French Analysis of the Balance between Corporate Rescue and Employment Protection" (submitted in January 2016).

10 D. Graeber, *Debt: the First 5000 Years* (2011, Melville House Publishing, Brooklyn NY), at 1-19.

11 This is a primordial debt "owed by the living to the continuity and durability of the society that secures their individual existence": G. Ingham, *The Nature of Money* (2004, Polity Press, Maldon MA), at 90.

12 Graeber, above note 10; J. Munro, "The Medieval Origins of the Financial Revolution: Usury, Rentes and Negotiability" (2003) 25(3) *The International History Review* 505, at 506.

13 Graeber, above note 10, at 120-121.

financial debt obligations eventually became indistinguishable from moral obligations.¹⁴ Hence the development of laws prohibiting usurious lending which was viewed as a type of theft as the charging of interest had no representation in goods. As money was meant to be only to be a representation of value in goods and services, interest was equated to taking money from an individual for nothing in return.¹⁵

The growth of capitalism precipitated the gradual collapse of economic reliance upon traditional communities due to the growing power of an impersonal market. There was a gradual transformation of moral networks by the intrusion of impersonal market rules and the powers of the state. The legalisation of interest led to the evolution of signed legal bonds agreeing terms of loans, which in turn required the evolution of a court system that could deal with the influx of commercial claims.¹⁶ While today debts and credits have taken on an impersonal and purely financial character within a specific legal framework, their derivation is in good faith, socially acceptable behaviour and reputation that create the “credit” of an individual in society.¹⁷

Whether or not the origins of debt can truly be said to be in this ideal of human community and the obligations owed to one another for the safety of living in society, it can certainly be agreed that debt was once a personal obligation that most individuals would seek to escape as soon as possible. This could be due to the feeling of being subordinated to another human being due to what is owed, or perhaps just the consequences of not repaying. Today, however, it is rare to find an individual who does not live in a perpetual state of financial debt: it is the accepted status quo of the human condition, which has essentially commoditised the value of debt into something that has been separated from its moral roots. It has become abstracted from any proprietary interest that a debtor may have had over it; banks do not ask a mortgagor if they can sell their “IOU” on to hedge funds, insurance companies, or other financial institutions, despite that by all appearances, debt has a proprietary nature.

While it could be that banks are exchanging funding now for money later as the debt is repaid, the question remains as to how if debt is an obligation, how can it be sold free from consent? It is admitted that this is a highly controversial assertion,

14 W. Hunt, *The Puritan Moment: the Coming of Revolution in an English County* (1983, Harvard University Press, Harvard MA), at 146.

15 Graeber, above note 10, at 289.

16 *Ibid.*, at 332-333.

17 *Ibid.*, at 56-57; according to Munro, above note 12, at 506, usury is defined as the exaction of interest or of any specified return beyond the principal value of a loan.

given that these transactions have been going on for centuries, essentially in a sense like a bookmaker laying off large bets to other book makers in order to reduce their exposure. Applying the analogy, these transactions can effectively spread the risk across the financial market rather than solely impact on the entity lending.

Social Costs of Financial Crisis

The banking origins of the financial crisis fed into the sovereign debt problems in Europe, which led to a severe economic slowdown and eventually a crisis of the Euro in 2010. This crisis was due in part to differentials in macroeconomic development between the member states in the Euro, with the previously more expensive and developed countries becoming balanced with those states that used to benefit from their less expensive production environment. Thus the economic advantages of states like Greece, Portugal, Spain and Italy that could benefit from the imbalance in competitiveness prior to the introduction of the Euro, lost their edge. This combined with mounting current account deficits, led to the sovereign debt crisis.¹⁸ The situation in Europe in 2010 has been described as a twin sovereign and banking crisis that mutually feed each other, resulting in a gradual contagion to more countries and more asset classes. Government bailouts of national banks further added to the public debt and as private debt became public debt, sovereign debt became critical.¹⁹

Since the financial crisis and following the sovereign debt crisis there have been massive changes in national approaches to the regulation of aspects of national and supranational economies and social policies. This is particularly evident in the changes that have occurred throughout the EU in its reduced emphasis on social protections, in favour instead of a more neo-liberal approach designed to support its weakened economic status. Member State reforms under these revised EU policies as well as the austerity measures required in those States that are party to Memoranda of Understanding²⁰ in return for financial support have seen the steady erosion of workers' rights generally, while the "rescue culture"²¹ has been steadily infused into Member State legal systems. While the presence of good rescue mechanisms may mitigate to some extent the loss of social protection, it is questionable whether or not such reforms are capable of going far enough to

18 B. Moro, "Lessons from the European Economic and Financial Great Crisis: A Survey" (2013) 34 *European Journal of Political Economy* s9.

19 *Ibid.*, at s11.

20 Hereafter referred to as "MoU".

21 An economic policy emphasising the priority of rehabilitating viable companies in financial distress for the purposes of preserving their economic value as well as the livelihood and well-being of those dependent upon an enterprise, including unsecured creditors, employees, communities and other stakeholders.

protect the most vulnerable of those EU citizens affected by the financial crisis.²² There has thus been a fundamental shift in welfare state politics with austerity becoming a key measure to combat growing budget deficits. While a number of economists have now discredited the economic research that allegedly supported the push toward austerity, it remains a central feature of the recovery efforts that continue to exist, particularly in those countries whose sovereign debt spiralled to the point of needing or nearly needing supranationally supported loans to avoid insolvency.²³ This in turn has created a democratic deficit due to the requirements of these loans to reform the affected countries' legal systems, regardless of whether or not the government has been elected on an austerity platform or otherwise.

Beyond the impact on employment and business failure, the financial and sovereign debt crises have also affected individual borrowers seeking to finance business ventures or to purchase family homes. Repossessions became a common claim due to the inability to repay mortgages as a result of the fall in housing prices. Social benefits have been cut back everywhere as a part of austerity measures. This has often had the most severe effects on the most vulnerable individuals in society: the elderly and the disabled. Suicides among those vulnerable members of society who have been put through the rigours of defending their need to receive certain benefits have risen due to the stress and hopelessness that changes to benefit to which changes in applications have led. While public support for the welfare state has not changed, rather indications are that it has become even more beloved due to the fact that it shields people from losing their jobs and protects income in case of unemployment, there has been a steady erosion of social rights and benefits.²⁴ It has been argued that a number of countries had gone too far in their social protections, causing some of their debt related problems by failing to balance social policy with the requirements of capital. However, the social impact on individuals due to the instigation of austerity is manifest.

22 A full exploration of the impacts of the sovereign debt and financial crises on employment protection and corporate rescue was explored at the IEAF Conference in Istanbul in 2014 in a paper titled "The Road to Recovery: A Comparative Analysis of the Impact of the Financial Crisis on the Rights of Workers in Greece, Portugal, France and the United Kingdom and their Insolvency Legal Systems" written with Dr Alexandra Kastrinou.

23 For an exploration of the economic arguments against austerity, see P. Krugman, "The Austerity Delusion" (*The Guardian*, 29 April 2015), available at: <http://www.theguardian.com/business/ng-interactive/2015/apr/29/the-austerity-delusion> (last viewed 30 April 2015).

24 B. Vis *et al.*, "To What Extent Did the Financial Crisis Intensify the Pressure to Reform the Welfare State?" (2011) 45(4) *Social Policy & Administration* 338, at 342.

A Legal Economic Analysis of Debt Instruments

The financial sector has long benefitted from a neo-liberal economic approach to its regulation. This has allowed innovation in investment and profit-making, creating new and different debt instruments and ways of selling and packaging them in order to increase bank liquidity, permitting more and greater lending to individuals and businesses. However, the roots of the crisis in high risk debt trading have shown that such an approach does not afford the social benefit that highly liquid financial markets were meant to provide. Rather, it has required input from tax-payers to make sure the economy did not implode entirely. It must be queried, then, if a purely economic approach to regulation of the financial market is adequate, particularly given the distance that has evolved between debt and the human element of it and the ease of which it is now disposed.

The principles of Law and Economics provide an analytical framework within which a balance between social and commercial interests is sought. The basis of an economic approach to legal rules assumes that the people involved in a legal system will act rationally to maximise their own satisfaction.²⁵ In an economic analysis of the law, if two opposing sides of an issue behave rationally, they will find a balance that maximises the benefits/happiness of each side when an outcome is uncertain at the outset.²⁶ Rational maximisation within a legal system suggests that by putting a conceptual price on legal rights and remedies, it will be possible to create legal rules that maximise effectiveness by finding the perfect balance of economic efficiency between competing aims.²⁷

Law and economics defines a good legal system as one that keeps the profitability of businesses and the welfare of people aligned, so that the pursuit of profit also benefits the public. This is somewhat reflective of the ideals of utilitarianism, a fairly hedonistic and secular political theory that places the overall pleasure or perhaps satisfaction of humanity as the defining characteristic of what is “right” for humanity in terms of political and legal structure.²⁸ However, while classical utilitarianism seeks to maximise the sum of all individuals’ functions in terms of utility, law and economics aims to try to maximise social wealth rather than social utility. Goods should be awarded to those individuals who are willing to pay the most, not to those for whom those goods will have the highest utility. Fines and

25 R. Posner, “Utilitarianism, Economics and Legal Theory” (1979) 8(1) *Journal of Legal Studies* 103, at 104.

26 R. Posner, “Observation: The Economic Approach to Law” (1974) 53 *Texas Law Review* 761.

27 *Ibid.*, at 764.

28 M. Freeman, *Lloyd’s Introduction to Jurisprudence* (9th ed) (2014, Sweet & Maxwell, London), in Chapters 2 and 3; B. Bix, *Jurisprudence: Theory and Context* (6th ed) (2012, Sweet & Maxwell, London), in Chapter 3.

sanctions then become a deterrent if they are set at a level that people are unwilling to “pay the price” for doing the unwanted behaviour. The trick is to set the price at a level that deters the behaviour, but does not deter one from engaging in some risk, particularly if applied to economic activity.²⁹ While true that sanctions may prevent unwanted and costly behaviour, it would be economically inefficient in terms of regulating the financial market to set those sanctions at such a level that no one would want to lend, invest, or follow entrepreneurial ideas. Thus a balance needs to be struck in order to find the point that deters enough behaviour to retain some order in the market, while not discouraging some risk in the market.

One problem with the law and economics theoretical framework is that it has been perceived as being of a specifically free-market, capitalistic ideology and even an apology for conservatism. While it is not intended to paint capitalism as “evil”, it must also be acknowledged that it does not often consider those elements of society that fall outside of the markets and profit. If economic efficiency depends on what people are willing to pay, then by association, a person’s willingness to pay is directly connected to what they are able to afford. Thus the more wealth one has, the more likely it is that it can be increased in a system built on models of pure economic efficiency. Its precept tends to support unequal income distribution, which tends to be a highly political subject.

Ronald Coase’s theory, developed in the 1960s, on social costs posits that in circumstances where two activities conflict, the costs should be assessed as the combination of both activities. The classic example used was a scenario where a train travels through a farmer’s field and causes crop fires on occasion due to flying sparks. While many would view it as axiomatic that the farmer should be compensated for the losses incurred, Coase’s view was that it was not merely the case that without the railway there would have been no fire, but that if the farmer had not planted crops so close to the railroad tracks, there would similarly have been no fire. This approach has allowed the application elements of supply and demand on how damage may be allocated. The economic analysis of law has an underlying capitalistic foundation and the fault-based approach would require far more government regulation than a profit driven society could accept.

The train in Coase’s example had a social benefit. It provides transportation of the very crops that the farmers grow. It allowed for quicker access between cities and represents a kind of progress that has effectively benefitted all. There is an argument to be made for ensuring that the damage caused by trains, were a fault

29 U. Gneezy and A. Rustichini, “A Fine is a Price” (2000) 29(1) *Journal of Legal Studies* 1.

based approach applied, might lead to changes and limitations in rail travel that could reduce its overall usefulness to society. As such, a balanced approach that allocates the costs to both farmers and railways can allow for both to continue to co-exist and provide their benefits to society as a whole.

Fast-forward to the modern day and apply Coase's theory to the prospect of financial regulation. The railway and the farmers' crops both provide a social benefit that has the potential to enrich all of society in one way or another. While the ability to sell debt allows for increased liquidity and releases capital for lending, does the current system effectively put capital in the right places so that all of society can benefit from these transactions, rather than those who do the buying and selling? Regulation has been created to control industrial pollution, noise and other noxious or anti-social effects of industry, but complicated financial transactions and particularly those involving complex, repackaged, depersonalised debt instruments present an entirely different social cost that regulators should probably take into account. If debt is an obligation or promise, what happens when that promise is mixed with other promises, amalgamated, divided, sold and dispersed to the point that it is no longer identifiable? Granted, debt is itself only a concept having no true physical existence, at least not since the un-pegging of major currencies from the gold standard, and even then money only represented a promise to pay something else of equivalent value, accepted only because it is assumed that others will also accept it as valuable in exchange.³⁰ That said, if debt is to remain a promise, surely the person who made that promise should remain connected to it in some way.

Conclusion

Following the crisis of 2007/2008 reform in banking and finance was firmly on the agenda of many of the most affected countries throughout the world. The United States passed the Dodd Frank Wall Street Reform and Consumer Protection Act, which was a compendium of financial regulations affecting financial institutions and their customers, passed in an attempt to prevent the recurrence of events that caused the 2008 financial crisis. The UK passed the Banking Act in 2009 following the Turner Review which was the regulatory response to the global banking crisis, the Banking Reform Act in 2013, and set up the Prudential Regulation Authority that can hold banks to account for the way they separate their retail and investment activities. The EU has issued the *De Larosière* Report, which has provided some foundation for reform, though it does not have binding force, while there have also

30 Graeber, above note 10, at 47.

been changes to the institutions dealing with banking by introducing the European Banking Authority and the European Securities and Markets Authority. Many of these reforms have been fundamentally reactive in nature, though they have certainly gone further than any reforms that have come before. That said, it must be queried whether these reforms are treating the symptoms, or the disease, and if the latter, what is the disease?

It has been said that there is nothing inherently “wrong” with the complex financial instruments that were central to the crash of confidence in debt markets that precipitated the financial crisis. It is the people who use them and manage the relevant debt. It would seem that enough people have used them inappropriately that it was possible to provide a part of the cause of the second worst financial crisis of living memory. If the ethics guidelines were not followed then, who is to say that changes to guidelines and ethics will prevent the bad behaviour in the future. It is necessary therefore to find a way to better “enforce” the guidelines, or essentially, in the style of Coase, to make the “price” of breaking the rules too high for bankers or other financiers to be willing to pay. Compare it for example to the arguments about gun laws in the United States. The gun lobbyists and the NRA say it is not the guns; it is the people who use them. With that logic it would seem that given the increase in senseless gun crime in the US over the last several decades, it is clear that the people cannot be controlled with the rules that are in place now. Perhaps then something should be done about access to the guns themselves. They are fine and useful tools if used properly by well trained, sane and appropriate people – but that means making sure that we put our guns – and our money – in those right hands.

While the reasons for the crisis cannot be laid solely at the feet of the banking industry, the way that debt is handled is at least one small aspect that can be reconsidered, perhaps leading to improved institutions for handling debt that could prevent its level of contribution to future problems in the global economy. The complex, interconnected, and dependent structure of financial institutions require an international approach to financial distress amongst financial institutions. Although UNCITRAL provides model laws and promotes the noble goal of coordination among the courts of the world that hear insolvency cases, it has been viewed as being inadequate to the nature of financial institutions as they tend to fail to address the structural dependency inherent in them.³¹ A paradigm shift in the way that debt is perceived could lead to a better handling of future economic risks, potentially avoiding a financial crisis having the catastrophic impact of the last one.

31 Lubben and Woo, above note 2, at 300.

A more transparent system of banking may also lend itself to a better coordination on the international stage as well. Given the interconnectedness of our economies, better cooperation could only improve the resolution of debt.

Chapter 11

Prepacks: No Evil is Without Good

Alexandra Kastrinou and Stef Vullings

Introduction

Prepackaged insolvency proceedings have been with us for some time now, but in the last decade or so the number of prepackaged proceedings has increased dramatically across many jurisdictions in the European Union. From a debtor's perspective prepacks can be attractive for a wide range of reasons, for instance the process is quick, secret and inexpensive. On the other hand, from an apprehensive creditor's perspective, a variety of concerns arise primarily due to the lack of transparency of the process. However, notwithstanding the criticisms and concerns prepacks have repeatedly received support and ultimately validation as a helpful rescue tool.

In light of prepacks having been widely adopted by a number of European jurisdictions as a rescue tool, the aim of this paper is to provide a comparative analysis of the approach towards prepacks. The paper will consider the different approach adopted in the very creditor-friendly UK and compare it with the approach taken in the Netherlands. Particular emphasis will be placed on the role of secured creditors in the prepack process, banks in particular.

Moreover, the paper will briefly examine whether prepacks are proving to be a useful social policy tool. With particular regard to the UK, it could be argued that the preservation of employment and as a result the greater social prosperity is the explanation behind the support of prepacks. A comparison will then be drawn with the Dutch prepack regime and the paper shall assess whether or not preservation of employment is also a driving force behind the increased endorsement of the prepack practice.

The Rise of Prepacks in the United Kingdom

In the United Kingdom prepacks fall within the context of administration proceedings. A prepack administration involves a pre-arranged sale of the distressed business, which will be executed immediately after the formal appointment of the administrator.

The Enterprise Act 2002 (“EA 2002”)¹ strengthened the rescue ethos of the United Kingdom by streamlining the administration procedure, first introduced in the Insolvency Act 1986 (“IA 1986”), and effectively making it a key restructuring tool. In particular, the EA 2002 introduced revolutionary changes to what was previously a time-consuming, expensive and complex administration procedure. The EA 2002 contains a series of reforms designed to make administration an attractive restructuring device.

However, it is important to note that the EA 2002 does not make specific reference to prepacks. Instead prepacks developed as a market technique to promote corporate rescue, but no legislation is directly applicable to them. A prepack typically involves a sale of a distressed business, seamlessly prepared outside of formal administration proceedings, which is executed immediately after the formal appointment of an administrator.

As previously stated, a prepack sale, albeit not expressly regulated by the relevant legislation, nevertheless falls within the context of administration proceedings. It is therefore important at this stage to provide a brief analysis of the applicable law.

The Law regulating Prepack Administration Proceedings

A significant change introduced by the EA 2002 is the fact that it makes provision for two “out of court” routes to administration. Under the old law, an administrator could only be appointed by an order of the court, on a petition by the company, its directors or any creditors.² However, under the EA 2002, a company is able to enter administration not only by means of a court order but also by:

- (a) an appointment by a floating charge holder; or
- (b) an appointment by the company or its directors.

The EA 2002 enables the holder of a floating charge to appoint an administrator, provided that their security has become enforceable³ and that their security interest relates to the whole or substantially the whole of the company’s property.⁴ The power to make an appointment must be specified by the instrument creating their security.⁵ The second gateway to administration is by virtue of an appointment by

1 Pursuant to the EA 2002, Part II of the IA 1986 has been replaced and a new Part II was inserted in its place, which gives effect to an additional Schedule B1.

2 Section 9(1), IA 1986.

3 *Ibid.*, paragraph 16, Schedule B1.

4 *Ibid.*, paragraph 14(3).

5 *Ibid.*, paragraph 14(2).

the company or its directors. It could be argued that, although directors can often be held responsible for the company's difficulties, nonetheless, the rationale for granting them expedited appointment rights is to provide incentives (in the form of "sticks and carrots") for them to take drastic action, when the company is in crisis.⁶ It is noteworthy that, although the floating charge holder does not initiate this process, he is still given the opportunity to appoint his own administrator, unless the court thinks otherwise.⁷ In addition, the floating charge holder must receive at least five days' notice of the company's intention to appoint an administrator⁸ and no appointment may be made until the notice period has expired or until the floating charge holder gives his written permission.⁹

A remarkable change introduced by the EA 2002 is with regards to the purpose of administration.¹⁰ The administrator must hierarchically perform his functions with the objective of:

- "a) rescuing the company as a going concern;
- b) achieving a better result for the company's creditors as a whole than would be likely if the company were wound up; or
- c) realizing property in order to make a distribution to one or more secured or preferential creditors."¹¹

Additionally, the administrator must perform his functions "in the interests of the company's creditors as a whole"¹² and as "quickly and efficiently as is reasonably practicable".¹³ In exercising his functions, the administrator acts as the company's agent.¹⁴ Upon his appointment, the administrator has the power to do anything necessary or expedient in relation to the management of the affairs, business or property of the company.¹⁵ For instance, he may challenge undervalue transactions, preferences, extortionate credit transactions and certain floating charges.¹⁶

6 J. Armour and R. Mokal, "Reforming the Governance of Corporate Rescue: The Enterprise Act 2002" (2005) *Lloyd's Maritime and Commercial Law Quarterly* 28, at 32.

7 Paragraph 36, Schedule B1, IA 1986.

8 *Ibid.*, paragraph 26(1).

9 *Ibid.*, paragraph 28.

10 Phillips and Goldring argue that "this provision makes it expressly clear that administration is first and foremost about rescuing the corporate entity": M. Phillips and J. Goldring, "Rescue and Reconstruction" (2002) 15(10) *Insolvency Intelligence* 75, at 76.

11 Paragraph 3(1) a-c, Schedule B1, IA 1986.

12 *Ibid.*, paragraph 3(2).

13 *Ibid.*, paragraph 4.

14 *Ibid.*, paragraph 69.

15 *Ibid.*, paragraph 59(1).

16 See sections 238, 239, 244 and 245, IA 1986, respectively.

Further, the EA 2002 affords creditors enhanced participation in the administration proceedings. The EA 2002 requires the administrator to submit a statement of proposals for achieving the purpose of administration,¹⁷ which must be accompanied by an invitation to an initial creditors' meeting.¹⁸ However, no such meeting is necessary where the administrator believes that:

- (a) the company has sufficient property for each creditor to be paid in full;¹⁹
- (b) that the company has insufficient property to enable a distribution to be made to unsecured creditors other than by virtue of the statutory ring-fencing of fund for unsecured creditors;²⁰ or
- (c) that none of the objectives for which the administration process was initiated can be achieved.²¹

Upon consideration of the proposals, the creditors can either approve or reject them. Additionally, the creditors may approve the proposals with modifications. However, the administrator must consent to each modification.²² Subsequently, if the administrator approves the proposed modifications and believes that they are substantial, he must call for a further meeting, where he will present the revised proposals or report any decisions to the creditors, and then report the matter to the court.²³ It should be pointed out that the requirement for administrators to set out proposals, which are in turn to be approved by the creditors at the creditors' meeting, is designed to enhance creditor participation in the re-organisation process. However, the objective of this requirement is arguably undermined by prepackaged administrations, as, where such proceedings are involved, it is possible for the administrator to effect a prepack disposal of the company's business, or a substantial part of it, prior to a creditors' meeting.²⁴

Furthermore, although the administrator will consult with the company's secured creditors prior to a prepack (in fact it is impossible to give effect to a prepack sale without the bank's support), it could be argued that the rights of less powerful creditors will be overridden. Frisby identifies that creditors' rights of participation

17 Paragraphs 49(1), (3)-(5), IA 1986, which state that a copy of the proposals must be sent to all the members it applies to, no later than the end of 8 weeks from the commencement of administration.

18 *Ibid.*, paragraph 51(1). Paragraph 51(2) states that the meeting must be held as soon as is reasonably practicable but not later than the end of 10 weeks from the commencement of the administration process.

19 *Ibid.*, paragraph 52(1)(a).

20 *Ibid.*, paragraph 52(1)(b).

21 *Ibid.*, paragraph 52(1)(c).

22 *Ibid.*, paragraph 51(3).

23 *Ibid.*, paragraph 54.

24 A more detailed analysis of the prepackaged administration technique and criticism over its use is offered below.

are subjugated to commercial considerations in a prepack situation, and acknowledges that there is a strong possibility that the commercial advantages of a prepack, in the form of enhanced consideration for the business and a reduction in the costs of selling it, will probably not inure to the advantage of those creditors who are excluded from the decision-making process.²⁵

As mentioned earlier, the prepack is a restructuring method, whereby a sale is seamlessly prepared outside of formal insolvency proceedings, with a primary aim to preserve value. However, although the popularity of prepack has risen dramatically, the use of the procedure has not been free from criticism. In particular, it could be said that a significant criticism of the prepack process relates to the extent of control exerted by secured creditors, which arguably is not in line with the objectives of the EA 2002. An analysis of some of the key criticisms is offered below.

Prepacks and The Role of Secured Creditors in the Process

One of the key changes introduced by the EA 2002 is the virtual abolition of the administrative receivership procedure, with the objective of replacing a somewhat “selfish” proceeding with a somewhat more collective administration procedure. In other words it is no longer possible for a floating charge holder to appoint a receiver, who would primarily act in the interests of his appointor. Instead, following the reforms introduced by the EA 2002, the aim of which is to promote a more collective approach towards insolvency, the floating charge holder has an option to make an out of court appointment of an administrator,²⁶ whose statutory duty to perform his functions in the interests of the company’s creditors as a whole.²⁷

It could be argued that although the legislature’s intention was to promote a more collective insolvency procedure than administrative receivership, the manner in which prepack administration operates in practice is such that it closely resembles the administrative receivership procedure, effectively reviving the abolished procedure. In particular, some critics argue that prepacks have effectively replaced administrative receivership, as the procedure of choice for the secured lender as appointor.²⁸

25 S. Frisby, “Report on Insolvency Outcomes” (2006), at 72, available at: <http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/research/corpdocs/InsolvencyOutcomes.pdf>.

26 Paragraph 14(1), Schedule B1, IA 1986.

27 *Ibid.*, paragraph 3(2).

28 S. Davies, “Prepack” (2006) *Recovery* (Summer) 16.

The aim of the EA 2002 to promote corporate rescue and a collective approach towards insolvency is clearly reflected in paragraph 3 of Schedule B1 IA 1986, where it is stated that “the administrator of a company must perform his functions hierarchically with the objective of –

- (a) rescuing the company as a going concern, or
- (b) achieving a better result for the company’s creditors as a whole than would be likely if the company were wound up (without first being in administration), or
- (c) realising property in order to make a distribution to one or more secured or preferential creditors.”

Therefore, with particular regard to the statutory purpose of administration, it could be argued that prepacks defy the intentions of the EA 2002, as with a prepack the emphasis is no longer on rescuing the company as a going concern. Instead, since as part of a prepack sale an agreement to sell the business is concluded prior to the administrator’s formal appointment, it could be argued that a prepack fails to achieve the primary objective of administration. It is therefore apparent that the prepack is designed to achieve either the second or third objective of administration, where the emphasis shifts to the protection of the secured creditors’ interests.

Although it appears that prepacks undermine the statutory objectives of administration in practice and that the significant control exercised by secured lenders is retained post EA 2002, one could nevertheless argue that prepacks could in the right circumstances constitute the most appropriate course of action. For instance, in circumstances where an insolvent company cannot be sold as a going concern, the prepack constitutes a great “value-preservation” tool, as it facilitates a discreet and quick sale of the business.²⁹ In particular, the prepack could prove to be a very valuable tool where a business has a strong brand or intellectual property, the value of which could decrease dramatically by even a hint of a formal insolvency.³⁰ Furthermore, a prepack minimises the erosion of customer confidence, reduces any damage to relationships with key employees, especially in service based companies.³¹

Whilst there is a clear advantage to be gained from concealing the troubles of a company from the general public, where a prepack sale is involved, looking at the

29 The sale is negotiated and prepared prior to entering into formal administration proceedings and is executed immediately after the appointment of the practitioner. Therefore the process is quick and confidential and as a result the value of the business assets is preserved.

30 M. Ellis, “The Thin Line in the Sand: Prepacks and Phoenixes” (2006) *Recovery* (Spring) 3.

31 Davies, above note 28.

process from an apprehensive unsecured creditor's perspective, it could be said that the lack of transparency within the prepack process makes it very difficult to determine how a deal was struck (arguably, the prepack-sceptic unsecured creditor is predisposed to believe that secrecy translates into a willy-nilly arrangement to benefit the secured creditors) and whether the administrator has properly conducted all the necessary enquiries as well as complied with his statutory duties.³² Furthermore, whilst unsecured creditors would be kept in the dark, a prepack cannot be completed without the involvement of the secured creditors, often banks or other financial institutions. The debtor needs the secured creditor to provide a release on the encumbered assets or else they cannot be sold. The creditors on the other hand need the administration procedure to take recourse on their secured assets. Therefore, the secured creditors are always involved in the process, whereas unsecured creditors are not.

However, it is submitted that banks benefit from successful prepack proceedings and have interest to ensure that there has not been an abuse of process. In addition, although safeguards (such as the Statement of Insolvency Practice 16 ("SIP 16")) are in place, so as to ensure that insolvency practitioners act in accordance with their duties, it is rather unlikely that an administrator would willingly jeopardise his reputation (and hence his livelihood) and risk losing his licence, so as to benefit a particular creditor.

Furthermore, although prepacks appear to be a "controlled way forward" for banks, one could argue that banks are very well-placed, due to their experience and vast range of resources, to provide advice on the viability of a rescue business plan and to positively influence the outcomes of a prepack administration proceeding.³³ It is submitted that banks benefit from successful prepack proceedings and have interest to ensure that there has not been an abuse of process.

The lack of transparency which surrounds prepack administration gives rise to further criticisms relating particularly to the marketing and the valuation of the business prior to a sale. It could be argued that a proposed prepack sale is not subjected to the competitive forces of the market, which ultimately is likely to lead to the business or assets within the business being sold at a value significantly lower than it would, had it been properly exposed to the market for an appropriate period. With particular regard to instances where the sale of the business is to a connected party, even where the deal offered by the connected party is the best

³² Importantly, the administrator must perform his functions in the interests of the company's creditors as a whole and as quickly and efficiently as is reasonably practicable.

³³ In particular the London Approach suggests an influence on restructurings dating back to the 1970s.

one available in all the circumstances, unsecured creditors in particular perceive the sale to be inherently unfair.

The Graham Report,³⁴ which offered an overview of the criticised prepack elements and proposed reforms to improve the procedure, suggested that the creation of a “pool of independent experts”³⁵ would effectively address problems raised by the limited marketing of the business and would provide extra checks and balances to the process. The Graham report recommends that in connected sales, the connected party should voluntarily take the opportunity to present outline of the deal, together with the reasons why it is necessary to proceed in a particular way to an independent member of the “pool” prior to administration.

This would create independent scrutiny of the sale, whilst retaining the much desired secrecy before the event. Nevertheless, it could be argued that the creation of a pool of experts only partly addresses the issue of limited marketing of a business, as it only applies to the case of a sale to a connected party. In addition, in the case of connected sales, it remains to be seen as to whether or not the creation of a pool of experts will operate effectively or instead add to the existing “comply or explain” bureaucracy insolvency practitioners are faced with. Finally, one has to question whether the Graham report recommendation will serve its genuine purpose or simply amount to a mechanism that alleviates insolvency practitioners from liability.

The Dutch Prepack: An Alternative on the Rise?

As part of the revision of the Dutch Insolvency Act, the Dutch have introduced a legislative framework for their prepack practice in the *Wet Continuïteit Ondernemingen I*.³⁶ The Dutch prepack derives from English practice, but is different on many levels.

In the Netherlands the prepack falls within the context of the “faillissements” procedure (“liquidation”), which focuses on the winding up of the company. However, in practice the liquidation procedure is also used as the most important instrument for the reorganisation and continuation of businesses in financial difficulties.³⁷ A big advantage of this procedure can be found in the rules governing employment contracts. Importantly, since the liquidation procedure is aimed at the

34 T. Graham, “Graham Review into Prepack Administration June 2014”, Report to the Honourable Vince Cable MP.

35 The “pool of experts” became operational on 2 November 2015.

36 *Kamerstukken II* 2014/15, 34 218, 2.

37 N. Faber *et al.* (eds), *Commencement of Insolvency Proceedings* (2012, Oxford University Press, Oxford), at 427.

winding up of the company, the Acquired Rights Directive (“ARD”)³⁸ excludes the automatic transfer of employment contracts upon the transfer of the business.³⁹

Though at first sight the Dutch Insolvency Act (“DIA”) does not seem very rescue-orientated, the liquidation procedure can be used quite effectively for restructuring purposes. The liquidation procedure gives two possible routes for the continuation of the business or company. First there is an option for liquidation compositions. The liquidation composition must be offered to all ordinary creditors who can adopt the proposal by a simple majority that together represent at least half of the debts.⁴⁰ The proposal often consists of an offer to partially pay the debts after which the total amount of these debts will be discharged.⁴¹ A major advantage of this procedure is the court approval and the binding on a dissenting minority of ordinary creditors. After the court approval the liquidation procedure comes to an end without liquidating the company (Article 161 DIA). Therefore, the liquidation composition gives the possibility to restructure the debts within the same legal entity.⁴² However, these liquidation procedures are used very rarely in practice. The fact that the composition only works against the unsecured creditors is a major drawback.⁴³

The second route involves the asset transaction in liquidation, also known as “restarts”. The Dutch prepack derives from such restarts. As part of a restart the assets of a company are sold followed by the liquidation of the corporate entity as an “empty shell”.⁴⁴ The big advantages of this asset sale by the trustee are the speed of the procedure and the privacy of the sale.⁴⁵ In contrast to the composition plan, the asset sale does not require public voting at a creditors’ meeting. The consent of the supervisory judge is required and so is the permission of key secured creditors to sell the encumbered assets which are secured by their security rights.⁴⁶ Most restarts of business are based upon these asset transactions followed by liquidation.

The lack of transparency that surrounds the prepack process is often criticised both in the UK and the Netherlands. Particularly, the concerns in the UK are focussed

38 2001/23/EC of 12 March 2001.

39 Article 5(1), ARD; Article 7:666 section 1, Dutch Civil Code (“DCC”).

40 Articles 138 and 145 DIA; an exception can be made under the conditions mentioned in Article 146, DIA.

41 J. Groenewegen and J. Van Buren-Dee, *Tekst & Commentaar Insolventierecht* (2014, Kluwer, Deventer), art. 138 DIA, aant. 4.

42 J. Adriaanse, *Restructuring in the Shadow of the Law: Informal Reorganisation in the Netherlands* (2005, Kluwer, Deventer), at 16.

43 *Idem*.

44 *Idem*.

45 L. Kortmann, “Improved Prepacks: Going Dutch” (2012) *Corporate Rescue and Insolvency* 225.

46 *Ibid.*, at 226.

on “connected party sales”, the potential conflict of interest of an insolvency practitioner, as well as the lack of involvement of the unsecured creditors. Instead, in the Netherlands the main concern has been the applicability of the ARD.

As part of the proposed Dutch prepack, a debtor who approaches insolvency, but is not yet insolvent,⁴⁷ can request the court to appoint an intended trustee. This intended trustee is an insolvency practitioner who is likely to be appointed as trustee in case of impending liquidation proceedings.⁴⁸ Following the debtor’s request, it must be proven that the appointment of the intended trustee will provide “added value”. Added value can be shown in at least two cases: when the debtor can show that the preparation by an intended trustee can limit the damage for the stakeholders in the case of a potential liquidation procedure, or when he can show that the preparation in secrecy can increase the value and job preservation to such an extent that this preservation outweighs the fact that the preparation is conducted in secrecy and lacks certain aspects of transparency.⁴⁹ Where the court is convinced that added value is present, an intended trustee can be appointed for a maximum of two weeks.⁵⁰ Furthermore, the court can make the appointment of the intended trustee subject to certain conditions, such as the involvement of the representatives of the employees or the unions.⁵¹

The Role of Unsecured Creditors in Prepacks

In most prepacks unsecured creditors are “out of the money” and receive very little, if anything at all, from the empty shell distributions.⁵² The statutory priority of claims in respect of distributions in insolvency places the unsecured creditors almost at the bottom of the list both in the UK and the Netherlands.

In the Netherlands the intended trustee and the intended supervisory judge are involved in the process to supervise the debtor and ensure that the interests of the unsecured creditors and employees are not neglected.⁵³ Since most of the creditors are not involved in the preparation process, the responsibility on the intended

47 Proposed article 363 sub 1, DIA; The debtor may not yet be insolvent since he has to be able to pay the salary of the intended trustee as well as the debts that fall due in short term.

48 Proposed article 363 sub 1 first sentence, DIA.

49 Proposed article 363 sub 1 third sentence, DIA.

50 Proposed article 363 sub 3, DIA. For the extension of the period the debtor has to prove once again that the appointment will have added value. Before the extension of the period, the court will hear the intended trustee and the intended supervisory judge.

51 Proposed article 363 sub 4, DIA; *Kamerstukken II 2014/15*, 34 218, 3, at 14 (MvT).

52 “Out of the money” meaning that after the expenses and return to the preferential and secured creditors, there will be no return for the unsecured creditors.

53 *Kamerstukken II 2014/15*, 34 218, 3, at 7 (MvT).

trustee and intended supervisory judge is even greater than would be in the event of an “ordinary” liquidation procedure.⁵⁴ The intended trustee and intended supervisory judge must ensure that the interests of all affected parties are taken into account and this is very significant as unsecured creditors and employees are not involved in the process. In addition to the interests of creditors as a whole, the intended trustee should keep in mind the “interest of the society as a whole”, which could include preservation of employment knowledge and the productivity.⁵⁵

The Role of Secured Creditors in Prepacks

Secured creditors have a very significant role to play in the prepack process both in the UK and the Netherlands. However, neither the Graham Report nor the Dutch proposed legislation explicitly examine the role that might be played by secured creditors in a prepack.⁵⁶

It has been argued that it is the degree of certainty and control for the secured creditors in a prepack that makes the procedure so attractive and successful.⁵⁷ It could be argued that, as long as key lenders, such as the banks, do not suffer too much from the insolvency of the company, they are quite keen on keeping the lending in place for the NewCo.⁵⁸ It stands out that most of the critical literature is focused on the lack of transparency or the role of the unsecured creditors and it seems that the role played by the secured creditors is relatively untouched.

Contrary to the position in the UK, an out of court appointment of an intended trustee is not possible in the Netherlands. This could indicate that there might be less influence of the secured creditors on the insolvency practitioner. Moreover, the Dutch proposed prepack cannot be commenced by any party other than the debtor himself.⁵⁹ However, this does not necessarily mean that the banks will not have influence in the process. The banks in the Netherlands that have security rights on the assets of the debtor will have a position as a “*separatist*” in liquidation procedures.⁶⁰ This essentially means that, at any moment of default, either during or outside liquidation, the pledgees and mortgagees may exercise their rights as if it there was no liquidation procedure.⁶¹ They may exercise these foreclosure rights

54 *Idem*.

55 *Ibid.*, at 18.

56 “Secured creditors” and “banks” will be used as exchangeable terms from here on.

57 S. Harris, “The Decision to Pre-Pack” (2004) *Recovery* (Winter) 27.

58 W. Moojen, “Banken ook bij prepack bepalend voor uitkomst” *FD* 18 September 2014.

59 It is of course possible that banks will exercise pressure on the debtor to start a procedure.

60 Article 57, DIA.

61 Articles 3:248; 3:268, DCC; Article 57 DIA.

without having to obtain a court approved enforcement order. This provides the secured creditor with a very strong bargaining position, since the debtor and trustee will always have the threat of the secured creditor taking recourse at the assets when the debtor is in default. The secured creditor thereby has the possibility to block the going concern sale of the business.⁶² Moreover, post-petition financing shall only be provided by these banks if they are optimistic about the continuation of the business. Therefore, it can be argued that there is in fact little power in the hands of the debtor or the trustee.⁶³ It should be noted that the banks are within the group that have expressed their support in the development of the Dutch prepack.⁶⁴

It has been stated that the reason that banks have so much influence is that the Dutch as well as the English businesses are often over-collateralised.⁶⁵ The process of over-collateralisation essentially entails the posting of more collateral than is needed to obtain or secure financing. Therefore, the banks will have security on (almost) everything owned by the debtor and when the insolvency of a debtor occurs, it is the secured creditor who obtains almost everything and very little, if any, is left for the unsecured creditors. Banks often prefer to provide the NewCo with credit when this offers perspective that their full loan will be repaid in the future. With the intensive care departments of banks, permanent control is kept on the loans and finance of the debtors. It can be questioned what the consequences of these high stakes and over-collateralisation are for the influence of the banks in the prepack.

An essential part of the prepack in both the UK and the Netherlands is the continuation of finance after the liquidation or administration procedure has started. It seems that, as long as the banks receive (almost) all of their outstanding credit out of the business sale, they are willing to continue financing in the NewCo.⁶⁶ Without this new credit from either the secured creditor or a new investor, the NewCo will be doomed to fail. It has been argued that, because the banks are willing to continue the financing as long as their debts are fulfilled, the purchaser will be able to buy the assets at “rock-bottom” value and nothing will be left for

62 J. Hummelen, “Het verkoopproces in een prepackaged activatransactie” (2015) 2 *TvI* 14.

63 J. Timmermans, “De curator en het boedelkrediet” in J. Princen and A. van der Schee (eds), *De ondernemende curator* (2011, Kluwer, Deventer), at 68.

64 M. van Vught, “De Nederlandse prepack: time-out, please!” (2014) 1 *FIP* 26, at 26.

65 Moojen, above note 58.

66 C. Mallon and S. Waisman (eds), *The Law and Practice of Restructuring in the UK and US* (2011, Oxford University Press, Oxford), at 237-238.

the unsecured creditors.⁶⁷ As long as a purchaser is found and the secured creditor is satisfied, it is likely that insolvency practitioner will agree with the sale.⁶⁸

If one compares the position of the separatist in the Netherlands to the floating charge holder's in the UK, it can be argued that the Dutch secured creditors have a more powerful position. The Dutch secured creditors may simply ignore the liquidation procedure and enforce their foreclosure right without using the court or a formal insolvency procedure.⁶⁹ However, there is the possibility of a moratorium for the maximum period of four months ordered by the supervisory judge.⁷⁰ In this period the secured creditors will not be allowed to take recourse to the assets of the debtor without the approval of the supervisory judge. In neither of the jurisdictions the prepack can be executed without the release of the banks. In the UK, the enforcement of the floating charge has to be executed via the administration procedure, giving the banks a major degree of leverage in both jurisdictions. One could say that the banks in the UK have a major influence on the prepack since an out of court administrator is often appointed at the prompting of the banks. However, the banks strive to avoid being directly associated with a failed company. Therefore, it will most likely be the company or directors that appoint the administrator, *albeit* at the prompting of the banks.

In the Netherlands on the other hand, the banks have a very strong position and a lot of influence in the process as separatist. However, the court, intended supervisory judge and intended trustee are involved in the procedure to provide the necessary checks and balances. However, in general, the blessing of the banks is required in both jurisdictions since the secured creditors have to release their assets for the sale. Therefore, a prepack seems to be impossible in the UK as well as the Netherlands without the blessing of the secured creditors.

It has been argued that the fact that under the proposed Dutch legislation it is the debtor, and no one else who can request for the appointment of an intended trustee, can be seen as an advantage over the English procedure.⁷¹ Where the English out of court appointed administrator might create the perception of a bias towards the secured creditors or management, the Dutch intended trustee is court appointed and subject to control of the intended supervisory judge. This difference in manner of appointment and the degree of court control can create the perception that the

67 Moojen, above note 58.

68 *Idem*.

69 Article 57, DIA.

70 *Ibid.*, Article 63a.

71 P. Frölich, "Redding en sanering: monomaan of modern paradigma? Over de prepack en dergelijke" (2015) *AA* 192, at 197.

Dutch intended trustee is less biased. However, the secured creditor will always be at the table together with the debtor, purchaser and insolvency practitioner.⁷²

Neither in the UK nor in the Netherlands is the position of the secured creditor subject to much discussion at the moment. The qualified floating charge holder in the UK has an important role to play through the out of court appointment of the administrator and the post-petition financing of the debtor. The Dutch secured creditors will always be involved at a certain stage of the process since they have the possibility to take recourse on the assets at any moment of default. Without the consent of the banks, there is no way the debtor will be able to sell the assets, let alone the business in a prepack. The first and far most reason being that in both jurisdictions the secured creditor has to provide a release in respect of the assets being sold.⁷³ In combination with the over-collateralisation, this means that the bank will have to provide a release on (almost) all assets of the debtor. Therefore, the banks will always be involved in the process.

It seems that it is in fact “he who pays the piper that calls the tune”.⁷⁴ The prepack provides the banks with an assured return and a high level of influence in the procedure.⁷⁵ It can be argued that banks exert significant control over prepack sales and it is highly unlikely that a sale could be given effect in the absence of the secured creditors’ support.⁷⁶ Nevertheless, as argued above, although banks have a vested interest to ensure that a prepack sale is successfully completed; at the same time it is in their best interests to ensure that there is no abuse of process and that the legality of the prepack process shall not be questioned.

A Comparison of the Anglo-Dutch Prepack

The economic crisis has prompted a move towards a more debtor friendly oriented insolvency regime in the European Union. The concept of rescue itself is being revisited⁷⁷ and business rescue is ranked at the top of the European insolvency law related agenda. The European Commission published a recommendation on a new approach to business failure and insolvency “to encourage Member States to put in place a framework that enables the efficient restructuring of viable enterprises

72 Hummelen, above note 62.

73 Mallon and Waisman, above note 66, at 232.

74 Davies, above note 28.

75 A. Kastrinou, “An Analysis of the Prepack Technique and Recent Developments in the Area” (2008) *Company Lawyer* 262.

76 P. Walton, “Prepackaged Administrations – Trick or Treat?” (2006) 19(8) *Insolvency Intelligence* 121.

77 P. Omar, “Upstreaming Rescue: Pre-insolvency Proceedings and the European Insolvency Regulation” (2014) 25(1) *International Company & Commercial Law Review* 20.

in financial difficulty” and to “give honest entrepreneurs a second chance”.⁷⁸ The Dutch have followed this route set out by the European Union and are moving their insolvency regime from the traditional “pay what you owe” towards “business rescue” by introducing the prepack in their insolvency regime.⁷⁹ With the prepack, the Dutch are introducing a procedure that is already heavily criticised in the country of origin.

A prepack procedure in the UK cannot be completed without the involvement of the secured creditors, often banks or other financial institutions. The debtor needs the secured creditor to provide a release on the encumbered assets or else they cannot be sold. The creditors on the other hand need the administration procedure to take recourse on their secured assets. Therefore, the secured creditors are always involved in the process. A “prepack pool” comprised of independent experts, as recommended in the Graham Report, might provide extra checks and balances to the process.⁸⁰

The Dutch prepack is essentially an adapted version of the asset transaction in liquidation, also known as a “restart”. In the practice of an ordinary restart, the debtor will prepare the sale of the business, together with his own advisors, before filing for “faillissement”. In the proposed prepack, the debtor has the opportunity to formally involve an intended trustee and an intended supervisory judge in the process of preparing the business sale.⁸¹ Since the intended trustee and intended supervisory judge are involved early in the preparation, they will not be confronted with a prepared asset transaction at the moment of the formal appointment as trustee and supervisory judge in liquidation.

The Dutch intended trustee is court appointed and therefore it can be argued that his independence is guaranteed.⁸² The appearance of a biased trustee might therefore not, or at least to a lesser degree than in the UK, be part of the Dutch procedure. However, the Dutch secured creditors do have a powerful position in the prepack because of their position as *separatist*. The secured creditors in the Netherlands can take recourse to their encumbered assets as if there is no liquidation procedure. To protect the intended trustee and the debtor from the powerful secured creditors,

78 All the EU member states were invited to implement the principles of the recommendation. In the evaluation of this recommendation of the 30 September 2015 the Member States were asked to communicate to the Commission, on a yearly basis, data concerning the insolvency procedures. This evaluation can be found at: http://ec.europa.eu/justice/civil/files/evaluation_recommendation_final.pdf (last viewed 22 March 2016).

79 Frölich, above note 71, at 193.

80 L. Conway, House of Commons Briefing Paper (January 2016), at 3.

81 *Kamerstukken II* 2014/15, 34 218, 3, at 7 (MvT).

82 Frölich, above note 71, at 197.

the Dutch intended trustees are appointed by the court and the secured creditors do not have influence on the appointment itself or on the person who is going to be assigned as intended trustee. The intended trustee is supervised by the intended supervisory judge from the moment of appointment and his appointment can be made subject to certain conditions.

Finally, a key difference between the Dutch and the UK prepack is in relation to the protection of employment contracts and in particular, the application of the ARD.⁸³ Although it could be argued that it is difficult to facilitate corporate rescue through a prepack and at the same time protect the employees' interests, one of the main justifications in favour of the prepack in the UK is the fact that it often results in the preservation of jobs. In fact, SIP 16 statements cite the preservation of jobs as one of the primary reasons to prepack. Furthermore, in the early case of *DKLL*,⁸⁴ the court expressed its support, or at least accepted that there is a legal justification for the prepack process, primarily because of its effect on preservation of employment. Furthermore, the Graham report⁸⁵ found that in most cases (almost) all jobs are preserved after the use of a prepack.

Although, the prospect of administration or liquidation is rarely well conceived by the employees, it might nevertheless be comforting for English employees that the prepacks do not constitute insolvency proceedings within the meaning of the ARD, effectively meaning that the protection afforded to employment protection rights under the ARD, applies to the prepacks.⁸⁶

The Dutch on the other hand, have taken a different view with regard to the applicability of the ARD on their procedure. Although the best practice rules of Insolad⁸⁷ and the explanatory memorandum also point out the possible preservation of jobs as a justification for the prepack,⁸⁸ the applicability of the ARD was subject to a lot of discussion in the period of drafting the Dutch legislation. It has been argued that the ARD provisions do not apply to the prepack.⁸⁹ Since what will happen to the undertaking (i.e. continuation or dissolution) only becomes apparent *after* the company entered into the liquidation procedure in a prepack procedure,

83 Above note 38.

84 *DKLL Solicitors v Revenue and Customs Commissioners* [2007] EWHC 2067 (Ch); [2007] BCC 908 (Ch D).

85 Above note 34.

86 The ARD was implemented in the UK by means of the Transfer of Undertakings (Protection of Employment) Regulations 2006 (SI 2006 246).

87 Insolad is the Association of Dutch insolvency lawyers.

88 *Kamerstukken II* 2014/15, 34 218, 3, at 27-30 (MvT).

89 *Ibid.*, at 34-37 (MvT).

Articles 7:662-7:666 DCC implementing the ARD do not apply to the proposed prepack procedure.⁹⁰

A decision has to be reached in the Netherlands as to whether the procedure is aimed at liquidation *or* at the continuation of the business.⁹¹ In the English administration procedure this distinction only becomes apparent when the administrator declares what statutory objects he is following. Since the outcome only becomes apparent when the proposals are filed, the Court has opted for an “absolute” rather than a “fact based” approach in order to increase the legal certainty and ensure the easy approach of the procedure. It was held in *OTG*⁹² that the line between the procedures aimed at liquidation and at continuation in the UK is a less clear cut than the difference between liquidation and suspension of payments in the Netherlands.⁹³

The UK court chose the “absolute” approach because it is otherwise too difficult to take a “fact based” approach in determining the outcome of every different case. One could argue that such an absolute approach should also be applied in the Netherlands and that therefore the ARD should not apply to any case of liquidation. However, when one looks at the Dutch liquidation procedure, the “fact based” result will be different from the formal goal of the liquidation procedure in many cases, especially prepacks. Looking at the Dutch practice and the possibilities for a trustee, most of the time the liquidation procedure is the only possibility, within the insolvency laws, to truly achieve corporate rescue. The suspension of payment procedure has not proven to be a successful restructuring mechanism. This does not mean that every time the liquidation procedure is used, it is used to restart the company. It is however not uncommon that the liquidation of the company (the corporate shell) is the result, but the procedure was in fact aimed at the rescue of the business and not the liquidation of the company.

Conclusion

In light of the significantly different treatment of employees’ rights in insolvency in the two creditor-friendly jurisdictions, one cannot fail but to consider the possibility of whether or not such critical differences shall put the Netherlands on the map as a worthy competitor of the traditionally attractive and successful UK

90 *Idem*.

91 *Idem*.

92 *OTG Ltd v Barke* [2011] BCC 608.

93 *Ibid.*, at [8.4], where the court refers to the *Abels*-case, where the Dutch suspension of payments structure was held to be aimed at the continuation, but the Dutch liquidation procedure was not.

prepack regime⁹⁴ and whether the inapplicability of the ARD in the Netherlands will result into more restructurings taking place in the Netherlands and in an increase of insolvent companies shifting their centre of main interests there. Arguably, it remains to be seen whether or not the Dutch prepack will prove to be a key competitor of the UK prepack. Without a doubt, the UK has been proven to be a very attractive restructuring destination in the past, so it remains to be seen whether the fact that the Dutch prepack enables the debtor to evade the protection rights afforded to employees under the ARD, will make the Dutch model even more attractive.

94 See for instance Hellas Telecommunications, which resulted in the UK's biggest prepack administration. Interestingly, the forum shopping of big enterprises towards the UK has been identified by the Graham report as a source of "inward investment" and, according to Graham, should be perceived as a positive advantage to the economy.

Chapter 12

Companies with Virtual Headquarters – One Step to the Insolvency?

Jan Plaček

1. Introduction: The Issue of Virtual Headquarters

Intense public and professional debate has been taking place in the Czech economic environment for many years now on two issues, which are markedly connected to the problem of enforcing receivables and especially to the area of insolvency proceedings. The theme of insolvency mafias and that of so-called bullying proposals are at issue. There is, however, yet another theme which deserves more careful research, and that is the previously overlooked issue of virtual addresses. Yet as we shall prove, there are very serious indices here according to which virtual addresses are a clear risk that an entrepreneurial subject will enter into insolvency proceedings.

The very concept of the virtual address seems modern and is essentially perceived by a clearly inexperienced ear as positive or at least neutral. Yet it would in fact be possible to speak equally well of fictive addresses, which would in many cases depict reality incomparably more precisely. In terms of value, however, it would most certainly shift the entire term to the negative part of the spectrum.

A virtual address is the headquarters of a firm where a given company or entrepreneurial subject does not in fact perform any real activity, although it is an address recorded in the commercial or trade register. Theoretically, there should be a company or tradesman available for “enquiry”. It should be possible to arrange a meeting with the firm’s representatives at the headquarters thereof and the entrepreneurial subject should accept postal correspondence here (even if it were merely in the form of resending it to another address). On this principle, numerous projects also utilise a virtual address service (a virtual address is sometimes also used). It is, however, often the case that this is the provision of an address intended solely for the purpose of making it impossible to seek out the entrepreneurial subject.

Needless to say, the whole concept of virtual addresses is not specific to the Czech Republic. In fact, most of the countries do not place any special emphasis in their

legislation on entrepreneurial subject headquarters. This stems from the fact that, given the amount of market participants of various sizes and significances, it is impossible in market economies to force abidance of a law which would prescribe that company headquarters be identical with the place of its real operation (which does not necessarily refer to the place where a service is provided or the place where production is carried out, but the place of administration of a legal or entrepreneurial person).

Moreover, in accordance with the reality of modern cooperative connections, it is assumed that numerous companies exist, for various reasons, merely in the role of “vehicles”, i.e. special purpose firms which do not perform any real activity or perform it only occasionally, or serve as mediators, accounting units and so forth. In such companies, the place where activities (albeit understood as the place where such an entrepreneurial person is managed) are performed is thoroughly suspicious.

The first virtual addresses were offered in the United States as early as in the 1990s by Ralph Gregory in the project Intelligent Office (Colorado). The original principle was the offer of a lucrative address, but at reasonable rates. This model assumes provision of certain services, hiring of conference rooms for negotiation, arranging company postal correspondence and numerous others. The aim was to enable the acquisition of headquarters in a trustworthy place even for such companies which could not rent real office spaces in expensive areas or for which company headquarters are in principle unnecessary (a classic case could be a provider of financial services).

Legislative Circumstances in the Czech Republic

The unenforceability of a real company headquarters address was among the reasons why the Czech legislation implemented changes in 2009 to the civil code in force at the time, which enabled the separation of firm headquarters from the place where a firm actually performs its activities or where its bodies are situated. Act No. 40/1964 Coll. Civil Code underwent significant changes with the abolition of what was then Section 19c paragraph 2, which enjoined legal entities to select as their company headquarters spaces in which the administration of the legal entity is performed and in which contact between the public and the legal entity could take place.

Contrariwise, another change effective as of the beginning of 2015 in the VAT Act (Act No. 235/2004 Coll. on value added tax) took place. “Real” headquarters were defined here. The place where the company management meets, and especially where fundamental decisions influencing the management of the firm are accepted,

is considered to be the real headquarters of the company. If entrepreneurs (natural persons) do not have another place of business listed, their place of residence is considered to be their headquarters. This is a harmonisation of the perspectives on this problem with the European Union Legislation (Directive 2006/112/EC on the common system of value added tax and especially (EU) Council Implementing Regulation No. 282/2011 on the VAT directive). It states that among persons required to tax, the mere existence of a postal address cannot suffice for the definition of its headquarters (from the perspective of tax obligations and local competence to value added tax). In other words, it is inclined towards the real headquarters being a place from which the administration of the entrepreneurial subject is performed.

Tax laws (generally) expect that a tax audit can be carried out at the company headquarters and that an entrepreneur has to be able to present the necessary documents to the tax authority at the company headquarters. Now, a requirement has been added that the tax administrator has to be able to seek out and have ready access to a person required to tax at the place of its headquarters. Yet the act does not attempt to limit the existence of a virtual address; it does, however, require that if the headquarters of an entrepreneurial subject is different from the company's place of administration, the obliged person is to notify the tax authority (tax administrator) in the prescribed manner. This attacks one of the main reasons why entrepreneurial subjects in the Czech environment utilise virtual addresses – to relocate the company into areas where there is a lower probability of conducting a tax audit. This is connected to the fact that in the city of Prague, for instance, the probability of a tax audit taking place is almost zero or at least very low in spite of the enormous amount of tax subjects.

The Definition of a Virtual Address

There is a certain problem as to how exactly one can define, or more precisely, detect a virtual address, for there is no “list” or “register” available of such addresses. In fact, such a register would not make even the slightest sense. To put it simply, the headquarters of an entrepreneurial subject could be any space where the owner has given its authorisation for this. At the same time, one can hardly limit the rights of owners to a property in the sense that they could lease it solely for the purposes “real physical usage” and could not implement “virtual lease”. However, we would then be able to determine with difficulty whether a certain address where several dozens of firms may be registered is an office property in which these firms truly perform their administration, which means that the firm is actually based there and is managed from this place or whether it is a property whose owner

merely enables entries into pertinent registers. Moreover, it applies that numerous companies, which establish and then sell ready-made trading companies, use their own headquarters as the first address of headquarters – in this case it can then occur that a truly significant number of firms are registered at such an address. Therefore, for the purposes of the survey to follow, we selected an approach in which we ranked in the survey such addresses where at least one hundred entrepreneurial subjects listed were based in the commercial register. Elimination of addresses of business persons with ready-made companies was ensured by random checks according to public sources.

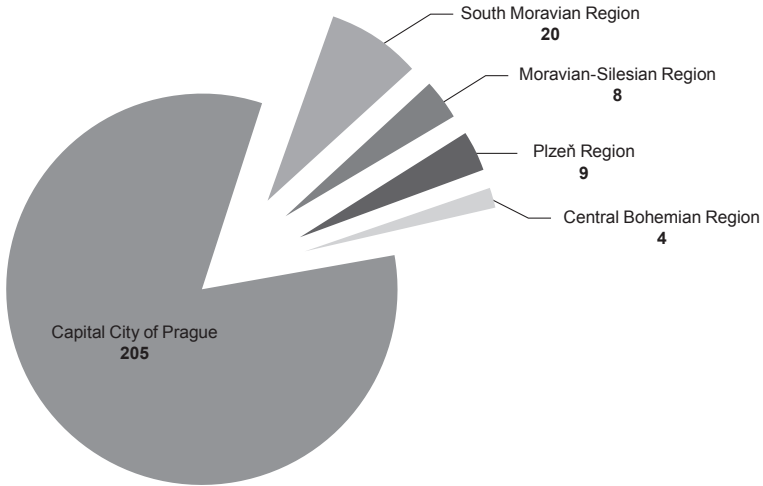
In Table 12.1, one is naturally immediately struck by the dramatic dominance of the capital city of the Czech Republic in the number of addresses with more than one hundred entrepreneurial subjects who state it as their headquarters. As is visible from the data, both in the number of addresses and in the number of companies registered at these addresses, Prague reaches a share of more than eighty percent, by which the economic influence of the centre clearly surpasses that of individual regions. Contrariwise, virtual addresses are entirely absent in certain regions (or the use thereof is so small that approximately less than one hundred companies are concentrated there, so they do not exceed the limit set for this survey).

Table 12.1: The number of virtual addresses according to regions and the proportion of the region to the whole of the Czech Republic

Region	Number of addresses	Proportion of the CR (%)	Number of firms	Proportion of the CR (%)	Average number of firms per address
Prague	205	82.0	49,363	84.5	241
South Moravia	20	8.0	4,436	7.6	222
Hradec Králové	1	0.4	193	0.3	193
Moravia-Silesia	8	3.2	1,535	2.6	192
Olomouc	1	0.4	109	0.2	109
Pardubice	1	0.4	131	0.2	131
Plzeň	9	3.6	2,005	3.4	223
Central Bohemia	4	1.6	515	0.9	129
Ústí nad Labem	1	0.4	148	0.3	148
Total	250	100.0	58,435	100.0	234

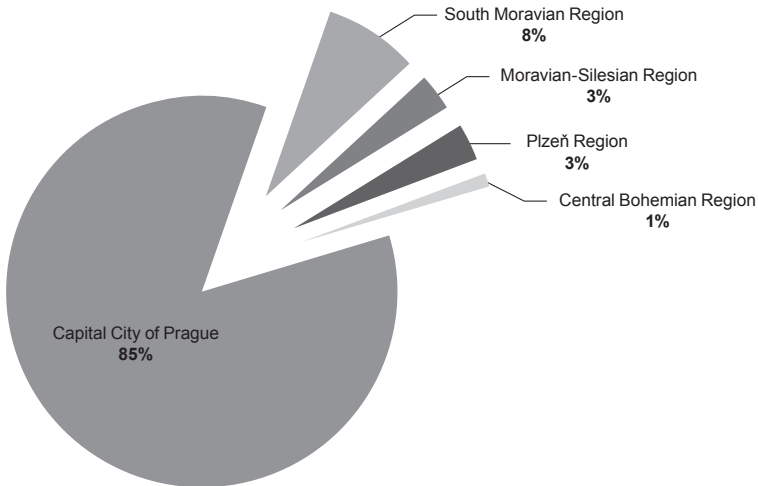
Source: own calculation (the data “number of addresses” refers to the number of such addresses in individual regions which are stated in the commercial register as headquarters for at least one hundred firms; the first column “proportion of the CR” refers to the percentage from the entirety of virtual addresses in the Czech Republic apportioned to a given region; the data “number of firms” describes the number of companies with headquarters at addresses from the first column, and the second column “proportion of the CR” gives the proportion of such firms to the total number of firms with virtual addresses in the Czech Republic).

Image 12.2: The number of virtual addresses according to regions



Source: own calculation

Image 12.3: The number of virtual addresses according to regions and the proportion of the region to the whole of the Czech Republic



Source: own calculation

Expression of Hypothesis and the Aim of the Survey

The main theme of the survey of virtual addresses which took place at the University of Economics in Prague was not an assertion of the fact that this method of firm registration really exists, but to ascertain the influence of whether the fact of an entrepreneurial subject's virtual headquarters has an influence on the probability of whether insolvency proceedings will be conducted against it, and if this probability exists, also to ascertain the influence of the fact of virtual headquarters on the standard satisfaction of creditors in the context of such proceedings.

The survey was based on the hypothesis that the location of a firm at a virtual address increases the probability of insolvency proceedings (company bankruptcy in the given context) and at the same time decreases the probability of creditor satisfaction in such proceedings. The results of statistical surveys conducted by the Insolvency Research scientific team¹ were used for the purposes of comparing the course of insolvency proceedings among standard firms with insolvency proceedings among firms with a virtual address.

Virtual Addresses lead to a Greater Degree of Insolvency

It was first necessary to ascertain which companies from the “virtual address” group appear in the sample of 3,222 entrepreneurial subjects included in the statistical outputs of the Insolvency Research team. In this regard, it is necessary to define the utilised survey, at least in basic terms. The Insolvency Research team surveyed the above-mentioned cases of insolvency proceedings, which took place in the Czech Republic during 2008–2015, whilst these were always entrepreneurial subjects, always cases which were bindingly closed (or where proceedings were at least bindingly closed in the practical sense of the word and only administrative motions remained until formal closure) by the end of 2015 at the latest. The survey took place in 2012–2014, extending into 2015, and the above-mentioned sample of 3,222 cases contained roughly 20 percent of all insolvency proceedings, which corresponded to the definition at the given time. It can therefore be said that certain values can – with the awareness of significant simplification – be calculated into the whole with a simple multiplication by five.

In Table 12.4, we see the number of insolvency proposals against firms with virtual addresses, and further, the “bankruptcy index” (labelled “proposals/firms”), which states how many firms from one thousand registered at virtual addresses were confronted by insolvency proposals in 2014 and 2015 (regardless of whether

1 Smrčka *et al.* 2015, Smrčka *et al.* 2014, complete data available online at: www.vyzkuminsolvence.cz.

creditor or debtor). To compare data, the number of insolvency proposals in a given region per thousand companies regardless of their address, i.e. the “standard” state in the given region, is in the last column. This is the methodology used by Creditreform in the Czech Republic.

Table 12.4: Insolvency of firms with a virtual address according to regions in 2014 and 2015

Region	Number of Proposals 2014	Number of Proposals 2015	Regist'd Firms	Proposals/ Firms 2014	Proposals/ Firms 2015	Proposals/ Firms (total)
Prague	348	339	49,363	7.05	6.87	1.33
South Moravia	34	35	4,436	7.66	7.89	1.00
Moravia-Silesia	9	18	1,535	5.86	11.73	0.93
Pardubice	2	0	131	10.27	0.00	0.89
Olomouc	1	2	109	9.06	18.35	0.88
Central Bohemia	0	0	515	N/A	0.00	0.88
South-Bohemia	N/A	N/A	0	N/A	N/A	0.82
Liberec	N/A	N/A	0	N/A	N/A	0.79
Ústí nad Labem	9	1	148	60.81	6.76	0.77
Karlovy Vary	N/A	N/A	0	N/A	N/A	0.76
Zlín	N/A	N/A	0	N/A	N/A	0.73
Hradec Králové	0	3	193	0.00	15.54	0.69
Plzeň	4	3	2,005	2.00	1.50	0.67
Vysočina	N/A	N/A	0	N/A	N/A	0.56

Source: own calculation; Creditreform²

The difference between the last two columns is visible at first glance, and it can be labelled as rather extreme. In any event, and with the awareness of the exceptional nature of the situation in the Central Bohemian Region, one can express the conclusion that in places where subjects headquartered at a virtual address appear, the standard probability of conducting insolvency proceedings against these firms is roughly twice to twenty times higher than with firms with standard headquarters at the place where the entrepreneurial subject’s administration is performed. But

2 Creditreform, *Development of Insolvency in the Czech Republic in 2015*, available at: http://www.creditreform.cz/fileadmin/user_upload/CR-International/local_documents/cz/Presseartikel/Vyvoj_insolvenci_v_Ceske_republice_v_roce_2015.pdf.

the most frequent range is a five to ten times probability of insolvency of a subject with a virtual address as against other subjects.

In the next survey, we ascertained whether the results of insolvency proceeding also differed, i.e. whether it is possible to find differences between:

- The number of cases in which insolvency proceedings are closed prior to declaration of bankruptcy and the number of proceedings in which bankruptcy is actually declared and a settlement is reached (always using the bankruptcy method in this case); and
- The satisfaction that is usually gained by creditors in cases of bankruptcy of companies with a standard address and bankruptcy of companies headquartered at virtual addresses.

In the sample surveyed by the Insolvency Research team (3,222 cases making up 20 percent of the whole at the given time) a total of 256 cases of entrepreneurial subjects with a virtual address were found, which is almost eight percent of the entire number of surveyed cases. This is truly a significant number and thus confirms the previous expectation that insolvency proceedings are truly generally more probable among entrepreneurial subjects with a virtual address than they are among subjects with a standard address.

Table 12.5: Proceedings with and without bankruptcy among subjects with a virtual and with a standard address (comparison with Table 12.1)

Proceedings with and without bankruptcy	“Virtual” address values		“Standard” address values	
	Number of rulings	%	Number of rulings	%
With bankruptcy	79	30.9	1,750	54.3
Without bankruptcy	177	69.1	1,472	45.7
Total	256	100.0	3,222	100.0

Source: www.vyzkuminsolvemnce.cz; own calculations

The Probability of Proceedings without Bankruptcy

As we can therefore see, it is substantially more probable that bankruptcy will not be declared whatsoever among entrepreneurial subjects that have a virtual address recorded as their headquarters. In the environment of the Czech Republic, this state usually means that continuing proceedings is pointless, for the given entrepreneurial subject does not even have such assets that would enable rational insolvency proceedings in which it would be possible to expect at least payment

of the costs of the proceedings (in this context it is primarily receivables beyond property that are at issue, i.e. the standard insolvency administrator’s fee and the defrayal of his or her expenses). One can therefore express the conclusion that creditors have a lower probability of satisfying their receivables where debtors headquartered at virtual address are concerned, even in the sense that only among a third of debtors with a virtual address will it even make sense to conduct insolvency proceedings against them and attempt to monetise their assets. Yet in the case of debtors headquartered at a standard address, barely a half of insolvency proceedings are suspended. In order to confirm this conclusion, it is possible also to survey the reasons that lead to the fact that insolvency proceedings do not take place.

Table 12.6: Reasons why a debtor bankruptcy was not declared

	Standard address			Virtual address		
	Rulings	%		Rulings	%	
Number of surveyed proceedings with bankruptcy	1,750	54.3		79	30.9	
Number of surveyed proceedings without bankruptcy	1,472	45.7		177	69.1	
Total sum	3,222	100.0		256	100.0	
In proceedings without bankruptcy		% of the whole	% without bankruptcy		% of the whole	% without bankruptcy
- proposal rejected according to Section 144 (for lack of debtor property)	600	18.6	40.8	56	21.9	31.6
- proposal rejected for flaws according to Section 128	485	15.1	33.0	73	28.5	41.2
- proceedings suspended according to Section 108 (non-payment of deposit for insolvency proceedings)	149	4.6	10.1	11	4.3	6.2
- proceedings suspended according to Section 129 and Section 130 – retraction of proposal	121	3.8	8.2	15	5.9	8.5
- proposal rejected according to Section 143 (legally set requirements were not fulfilled)	79	2.5	5.4	15	5.9	8.5
- other	29	0.9	2.0	6	2.3	3.4
- proceedings suspended according to Section 107 (other proceedings regarding the same matter were in progress)	9	0.3	0.6	1	0.4	0.6

Source: www.vyzkuminsolvemnce.cz; own calculations

As we see in Table 12.6, the reasons why proceedings against entrepreneurial subjects headquartered at virtual addresses are closed differs slightly in comparison with the data for the whole sample (standard address), whilst this divergence is given by a change of the positions between rejection for lack of debtor property and rejection due to flaws. Rejection for flaws is frequent among debtor proposals where the debtor pointedly files an insolvency proposal against itself, yet does not truly aim to carry out insolvency proceedings.

Differences in Satisfaction of Creditors

Nevertheless, the result of the process, i.e. satisfaction of creditors where declaration of bankruptcy occurs, is a decisive argument for the evaluation of the influence of the existence of a virtual address on the circumstances of insolvency proceedings. Here, we must declare that the expectation according to which a virtual address decreases the probability that the creditor will be satisfied, truly applies; or more precisely, there is a clear expectation here that satisfaction will be lower.

Table 12.7: Results of insolvency proceedings among subjects with a virtual address and subjects with a standard address

	Standard address			Virtual address		
	Registered (CZK M)	Satisfaction CZK M)	Satisfied %	Registered (CZK M)	Satisfaction CZK M)	Satisfied %
Secured	5,130.6	1,445.7	28.2	52.7	9.9	18.9
Non-secured	24,229.2	907.2	3.7	863.9	7.9	0.9
Beyond property	1,003.8	859.7	85.7	9.2	5.2	56.9
On a par	765.3	346.4	45.3	6.1	1.8	30.1

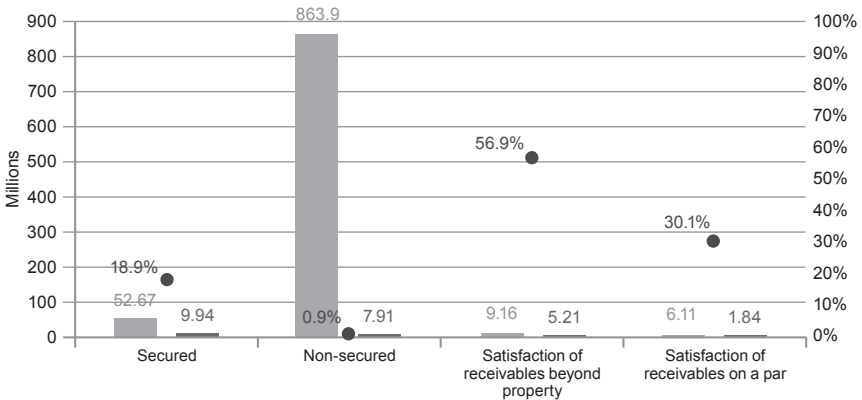
Source: www.vyzkuminsolvemnce.cz; own calculations

Table 12.7 gives a clear answer as to whether the hopes of creditors for satisfaction is influenced by the fact of a debtor's virtual address (virtual headquarters) – we can consider this expectation to be founded and proved. Among secured creditors, the difference is ten percentage points; among non-secured creditors, the yield is only a quarter as against those cases where a debtor is headquartered at a standard address, i.e. at an address where company administration is truly performed. We also see a significant difference among receivables beyond the property, where satisfaction clearly occurs only in the administrators' fees and their expenses, which are items that always have to be defrayed (even if at the court's expense).

Unfortunately, in the present state of research, it is not possible to answer the question of the degree to which precisely court (state) funds have participated in

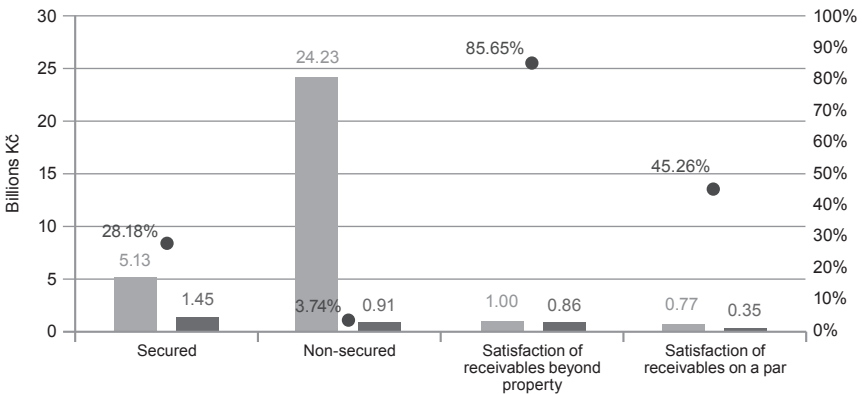
covering the costs of these cases, but it can be expected that this state will not be entirely exceptional. This occurs relatively standardly also in proceedings against debtors headquartered at standard addresses; where debtors at virtual addresses are at issue, one can expect a higher frequency of such situations. This is connected to the clearly poorer state of their assets. A highly marked visual comparison is offered by Image 12.8 and Image 12.9.

Image 12.8: Satisfaction of individual creditors and groups of receivables in proceedings against debtors with a virtual address



Source: www.vyzkuminsolvemnce.cz, own calculations

Image 12.9: Satisfaction of individual creditors and groups of receivables in proceedings against debtors with a virtual address



Source: www.vyzkuminsolvemnce.cz, own calculations

Summary

This part of the survey of insolvency proceedings can thus be closed given the confirmation of the expectation according to which the relocation of entrepreneurial subjects to a so-called virtual address is a step which increases the probability for the creditor that its business partner will be confronted with an insolvency proposal, and further, the probability that these proceedings will be settled without debtor bankruptcy, for its lack of property will transpire, and finally, the certainty that even in the event that the proceedings do take place, fulfilment for the creditor will be lower than normal. These insights will be important for economic practice, for this is a mechanism by which it will be possible to detect certain risks stemming from the realisation of corporate connections with entrepreneurial subjects with headquarters at virtual addresses.

Chapter 13

Use of Cross-Border Insolvency Protocols in the Banking and Financial Sector

Giulia Vallar

Introductory Remarks

It is widely known that one of the major insolvencies of all the times in the banking/financial sector has been that of the Lehman Brothers group, occurred in 2008. It is also widely known that a considerable part of said insolvency has been faced through the conclusion of a cross-border insolvency protocol,¹ a tool that had been abundantly used, starting from the earlier Nineties, in corporate insolvencies and, in particular, with regard to multinational groups of companies.² As far as multinational groups of banks and of financial institutions are concerned, there can be recalled at least two cases prior to the Lehman Brothers' one, in which what would nowadays be called a protocol was adopted.

In a mere chronological order, the first is a very old one, as it dates back to 1908, and relates to the saga concerning Mr. Patrick Macfadyen and the Arbuthnot bank, whereby an agreement on the handling of the proceedings had been entered into between the English and the Indian insolvency representatives.³ The second, way more recent in comparison, is that concerning the Bank of Credit and Commerce International, whose protocol was entered into in 1991, and that, at that time, was operating in more than 71 States.⁴ In addition, a further insolvency case that can be recalled, as it somehow pertains to the “financial sector”, and that has been

- 1 Cross-Border Insolvency Protocol for the Lehman Brothers Group of Companies (12 May 2009), available at: <http://www.iiglobal.org/component/jdownloads/finish/573/4339.html>. All websites, unless otherwise specified, were last viewed on 27 January 2016.
- 2 The huge diffusion of the use of protocols commenced on 15 January 1992 with the one entered into in relation to the Maxwell Communication Corporation insolvency. From then on, several protocols have been entered into: the website of the International Insolvency Institute used to have a section with around 45 published protocols. A database of protocols can be found on the webpage of the “Leiden-Protocol Project”: <http://www.tri-leiden.eu/project/categories/insolvency-protocols-project/>.
- 3 *Re P. MacFadyen & Co, ex parte Vizianagaram Company Limited* [1908] 1 KB 675. See also the UNCITRAL Practice Guide on Cross-Border Insolvency Cooperation, 2009, at 125, available at: http://www.uncitral.org/pdf/english/texts/insolven/Practice_Guide_Ebook_eng.pdf.
- 4 See the Global Report on the Liquidation of the BCCI group (1991 – 2012) (16 March 2012), which was available at: http://www.bcci.info/pdf/bcci_global_report.pdf (last viewed 6 January 2014). Quite interestingly, within this Report the term “protocol” is never mentioned.

resolved through a cross-border insolvency protocol is the one concerning the group of investment companies set up by Bernard Madoff, namely Bernard L. Madoff Investment Securities and Madoff Securities International Limited, whose liquidation commenced in December 2008.⁵

The present chapter is divided into four parts. The first will investigate whether there are any differences between protocols entered into in cases of financial insolvencies and protocols entered into in cases of commercial insolvencies. The second and the third parts will discuss two issues, on which there is no uniform view among scholars and that concern protocols in general and that therefore are pertinent also for protocols related to financial institutions. The one will deal with what can be defined as the “legal nature” of protocols. The other concerns what can be referred to as the “legal basis” of protocols. I will then conclude this chapter restricting again its scope only to financial insolvencies, making an hypothesis of what role will protocols play, as far as this subject matter is concerned, within the EU legal order, where two hard law instruments addressing the insolvency of financial institutions and investment firms have recently been adopted.⁶

1. Do Cross-border Insolvency Protocols for Financial Institutions have a Specific Content?

The first issue that needs to be addressed in this chapter concerns whether there are any differences between protocols addressing banking and other financial institutions insolvencies on the one hand and protocols addressing corporate insolvencies on the other hand. This question needs to be answered for two main reasons. First of all, because this is the paper of a presentation that has been delivered at a conference specifically devoted to insolvency of banks and other financial institutions. Second, because in many legal orders, both national and supranational, financial insolvencies are addressed to by specific legislative

5 Available at: <http://www.iiiglobal.org/sites/default/files/media/MadoffSecuritiesCrossBorderInsolvencyProtocolOrder.pdf>.

6 Reference is made to Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No. 1093/2010 and (EU) No. 648/2012, of the European Parliament and of the Council (so called “BRRD”) and to Regulation (EU) No. 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No. 1093/2010 (so called “SRM Regulation”).

instruments, different from those addressing corporate insolvencies.⁷ Therefore, it could be argued, by analogy, that also protocols related to banks insolvencies need to have their own specific characteristics that would make them easily distinguishable from those related to corporate insolvencies.

The question at hand should be answered in the negative: being protocols single purpose arrangements solutions, it is clear that no specific characteristics of protocols concerning banks – if compared to commercial enterprises insolvency protocols – can be identified.⁸ Each protocol will have its own specificities and its drafters will take into account, from time to time, the specific needs that are to be addressed in each case.⁹

2. The Legal Nature of Protocols

By “legal nature” of cross-border insolvency cooperation agreements or protocols reference is made to the operation consisting in the characterization or qualification of protocols, namely in placing them into an existing legal category.

First of all, cross-border insolvency protocols are certainly to be qualified as one of the possible realizations of the concept called “judicial dialogue”.¹⁰ Recent legal scholarship has paid much attention to such a concept, which is, nevertheless, still young:

“[i]l y a quelques années, l'idée d'un dialogue entre juges transgressant les frontières aurait été considérée impossible: on aurait abordé le dialogue entre le juge et les parties – le fameux *Rechtsgespräch*, mais un dialogue entre juges (en dehors des délibérations) paraissait plus ou moins impossible: la Cour ne discute que par ses jugements...”¹¹

7 If we consider, for example, the European Union, we would notice the coexistence, within its boundaries, of, on the one side, Regulation (EC) No. 1346/2000 (that will be replaced by the new Regulation (EU) No. 2015/848) and, on the other side, of Directives 2001/24/EC and 2014/59/EU and Regulation (EU) No. 806/2014.

8 Nevertheless a scholar has identified specific trends in protocol drafting, thereby including a self-standing group of protocols related to multinational financial companies: see M. Maltese, “Court-to-Court Protocols in Cross-border Bankruptcy Proceedings: Differing Approaches between Civil Law and Common Law Legal Systems” (2013), at 17, available at: http://www.iiiglobal.org/sites/default/files/media/maltese_michele%20submission.pdf.

9 For example, in the Cross-border insolvency protocol for the Bernard Madoff group of companies, the specific “nature of the business” is expressly taken into account: see paragraph C.

10 On the preferential use of terms such as “cooperation”, “coordination” or “communication” instead of “dialogue”, when relations between private parties, instead of relations between legal orders, are at stake, see S. Menétrey, “Dialogues et communications entre juges: pour un pluralisme dialogal” in S. Menétrey and B. Hess (eds), *Les dialogues des juges en Europe* (2014, Larcier, Bruxelles), at 119.

11 B. Hess, “Avant-propos” in Menétrey and Hess (eds), above note 10, at 10.

Judicial dialogue, in the form of a direct communication between courts involved in insolvency proceedings concerning the same debtor, represents the “culmination of judicial co-operation”¹², “*le degré supérieur de la coordination des justices étatiques*”¹³.

As to the effects of cross-border insolvency protocols, they enact what has been called a “joint transborder case management”¹⁴,

“une intégration informelle [...] des procédures nationales au sein d’une espèce de procédure supranationale qui en réaliserait la synthèse”¹⁵,

designing a sort of transnational insolvency norm that otherwise was missing.

From the point of view of the instrument in which protocols are embodied, there is no doubt that we are dealing with a kind of agreement.¹⁶ Scholars, however, have not reached a common position on what kind of agreement is at stake. According to some, protocols are *ad hoc* private international insolvency law treaties,¹⁷ “court-created treaties”¹⁸ or “mini-treat[ies]” concluded by courts of different States, “regarding each side’s role in resolving the dispute”.¹⁹ According to some others, cross-border insolvency agreements are the “Lex Mercatoria in international insolvency cases”,²⁰ “customary law of international commercial transactions (or

12 P. Schlosser, “Jurisdiction and International Judicial and Administrative Cooperation” (2000) 284 *Recueil des Cours de l’Académie de droit international de La Haye* 9, at 396. In the same sense, see also M. Laazouzi, “Nature juridique des communications entre juges” in Menétrey and Hess (eds), above note 10, 104-105.

13 Laazouzi, above note 12, at 86. On coordination between legal orders see P. Mayer, “La notion de coordination et le conflit de juridictions” in E. Pataut *et al.* (eds), *Les nouvelles formes de coordination des justices étatiques* (2013, IRJS, Paris), at 3 ff., in particular at 9.

14 Schlosser, above note 12, at 396.

15 L. d’Avout, “De l’entraide judiciaire internationale au contentieux civil intégré” in Pataut *et al.* (eds), above note 13, at 117; see also at 140.

16 Even if, as it has been noted, “[i]n European continental ears the latter words (*i.e.* “cross-border agreement”) indicate a rather more binding character than many of these “agreements” promise”: B. Wessels, “Cross-border Insolvency Agreements: What are they and are they here to stay?” in D. Faber *et al.* (eds), *Insolventie en Overeenkomst* (2012, Wolters Kluwer, Nijmegen).

17 E. Flaschen and R. Silverman, “Cross-border Insolvency Cooperation Protocols” (1998) 33 *Texas International Law Journal* 587, at 589; “Maxwell Communication Corporation plc: The Importance of Comity and Co-operation in Resolving International Insolvencies” in E. Leonard and C. Besant (eds), *Current Issues in Cross-border Insolvency and Reorganizations* (1994, Graham and Trotman and International Bar Association, London), at 44.

18 S. Dargan, “The Emergence of Mechanisms for Cross-border Insolvencies in Canadian Law” (2001-2002) 17 *Connecticut Journal of International Law* 107, at 124.

19 A.-M. Slaughter, “A Global Community of Courts” (2003) 44 *Harvard International Law Journal* 191, at 193.

20 B. Wessels, *Judicial Coordination of Cross-border Insolvency Cases, Inaugural Lecture, University of Leiden Law School, 6 June 2008* (2008, Kluwer, Deventer), at 44, who is also critical of the idea of considering protocols as customary international law.

law merchant).²¹ A further voice has explained protocols as contracts entered into by the parties involved in an insolvency proceedings that – as always happens with contracts exceeding ordinary administration and that are entered into after the opening of an insolvency proceedings – must be approved by the competent court.²² In this same direction, even if in a broader perspective, a prominent scholar has talked about “unedited forms of ‘contractualization’ of the settlement of international litigation”, realizing a model of cooperative process.²³

As far as public international law treaties are concerned,²⁴ it is submitted that comparing them with protocols would certainly highlight more differences than analogies. First, because treaties are entered into by public international law actors – States or international organizations – through persons normally authorized to represent them in the negotiation or adoption of a treaty, among which liquidators or courts are not, generally, included. Second, from the point of view of the subject matter of the agreement: protocols do not regulate rights and duties governed by public international law.

Also with respect to the *lex mercatoria*, it is submitted that there exist more differences than analogies. First, protocols are *ad hoc* agreements, while the *lex mercatoria* is supposed to be a set of standard norms, *lex generalis*, to be applied to any pertinent situations. Second, a breach of the *lex mercatoria* is supposed to be sanctioned by a competent court or adjudicatory body, while it seems that the same cannot be said as far as an hypothetical breach of a protocol is concerned.

The comparison between protocols and contracts entered into by private parties seems to be more convincing. No particular concerns seem to arise as far as the subject matter is concerned. It is true that, in principle, a contract governs private patrimonial relationships among the parties, while protocols deal, *prima facie*,

21 R. Mason, “Cross-border Insolvency and Legal Transnationalisation” (2012) 21 *International Insolvency Review* 105, at 122.

22 A. Sexton, “Current Problems and Trends in the Administration of Transnational Insolvencies involving Enterprise Groups: The Mixed Record of Protocols, the UNCITRAL Model Insolvency Law, and the EU Insolvency Regulation” (2012) 12 *Chicago Journal of International Law* 811, at 818. The author criticizes in particular Flaschen and Silverman’s view (see above note 17), holding that protocols cannot be deemed to be treaties because: (i) they are not binding; (ii) any actor in the insolvency proceedings can refuse to take part to them.

23 L. Cadiet, “Inaugural lecture, Towards a New Model of Judicial Cooperation in the European Union”, available at: http://www.mpi.lu/fileadmin/mpi/medien/institute/Cadiet_Inaugural_lecture.pdf; “Conclusion d’un processualiste” in Pataut *et al.* (eds), above note 13, at 225-226.

24 The Oxford English Dictionary gives another possible – though obsolete – definition of “treaty” as “[a] settlement or arrangement arrived at by treating or negotiation; an agreement, covenant, compact, contract.” In this case, nothing would change with respect to what will be said with regard to contracts. Curiously enough, the Debtors’ motion in the Lehman Brothers case (above note 1) states that the Protocol is a “privately negotiated treaty” and that it “is not a legally binding document”, but just “a statement of intentions and guidelines” (see § 18).

mainly with procedural issues. However, the ultimate aim of such a procedural coordination is a substantive one, namely the maximization of the value of assets.²⁵

More concerns, on the contrary, seem to arise with regard to the parties that enter into, respectively, a contract and a protocol: courts are organs of a given State and liquidators are – together with the courts – organs of the insolvency procedure. It is submitted that they do not have much in common with private parties that enter into a contract, even thinking of a third-party beneficiary contract. One last reflection, strictly linked to this latter point, pertains to the uncertainty related to the consequences of an hypothetical breach of a protocol. As a matter of fact, it is not clear either by who (Liquidators? Courts? Creditors?) and to whom a complaint should be addressed or what legal sanctions could follow such a breach.

Another possibility would be to consider protocols as non-binding instruments, a kind of gentlemen's agreement. If we consider, for example, the Lehman Brothers' protocol, we read a number of clauses that allow us to share this view. At paragraphs 1.1 and 1.2. respectively we find the following statements:

“[t]he parties acknowledge that this Protocol represents a statement of intentions and guidelines”; and

“[t]his Protocol shall be no legally enforceable nor impose any duties or obligations.”

In this same direction, one of the English administrators for the Lehman Brothers Inc. Europe declared in an interview that, even if the protocol did not create “a legal obligation, it created a moral one”.²⁶ It is true that paragraph 14.1 of the Protocol reads as follows:

“[n]othing herein shall create a right for any entity that is not a party to the Protocol, and a party hereto shall not be bound by this Protocol in its dealings with any entity that is not a party hereto.”

However, it seems that “having a right under the protocol” should not be construed as if referring to a legal right but just to the concrete chance of doing something. Further, the idea can be put forward that protocols represent a *tertium genus*, an unprecedented category of binding agreements not yet governed by any source of law. Such a position has certainly to deal with the circumstances that the formation of unprecedented legal categories is not that common in the modern era, it being

²⁵ See, in this sense, Cadiet, above note 23, at 226. This leads, according to the author, to reconsidering the traditional distinction between substance and procedure.

²⁶ See Wessels, above note 20, who quotes the interview, as it appears in (2010) 23 *Insolvency Intelligence* 32.

rather more frequent that a legislator regulates new species of an already known category, in order to face a new praxis that came into existence within the human experience. This happens, for example, when a legislator introduces a new crime or a new type of contract.

3. The Legal Basis of Protocols

Coming to the third part of this presentation, the question that needs to be answered is on which basis protocols are concluded. In other words, it is to be investigated whether a legal norm exists that authorizes the conclusion of protocols.²⁷

Some legal orders can be said to have provided for an explicit legal basis for cross-border insolvency protocols. A first, notable example concerns those countries that have enacted the UNCITRAL Model Law and, in particular, its Article 27(d). Among these countries, the United States can be recalled, whose Code, at Title 11, Chapter 15 explicitly states that:

“[c]ooperation referred to in sections 1525 and 1526 may be implemented by any appropriate means, including — *d*) approval or implementation of agreements concerning the coordination of proceedings.”

A further example concerns the European Union legal order and, consequently, the legal orders of its Member States. With reference to commercial insolvencies, the EIR implicitly allows the conclusion of cross-border insolvency protocols to enact that cooperation prescribed by Article 31. This possibility has then been expressly foreseen by the European Communication and Cooperation Guidelines for Cross-border Insolvency Cooperation.²⁸ Subsequently, the EIR Recast itself, in its Recital 49 and Articles 41, 42, 56 and 57, contains the word “protocols”.

What about those legal orders where, or those subject matters for which, no explicit legal authorization for concluding a protocol is foreseen? First of all, it can with no doubts be excluded that the conclusion of protocols could be related

27 With a slightly different approach to the issue at hand, see also Laazouzi, above note 12, at 106. The Author considers whether protocols (“*accords de communication directe*”) themselves could be deemed to represent the legal basis for judicial communications, concluding in the negative. As a matter of fact, according to Laazouzi, either courts can communicate between each other irrespective of a protocol authorizing them thereto or, if the involved legal orders do not allow such a communication to take place, a protocol will not be a useful tool to bypass such an obstacle. See in particular at 105-106.

28 *European Communication and Cooperation Guidelines for Cross-border Insolvency Developed under the aegis of the Academic Wing of INSOL Europe* by Professor Bob Wessels and Professor Miguel Virgós (July 2007), available at: <http://www.insol.org/INSOLfaculty/pdfs/BasicReading/Session%205/European%20Communication%20and%20Cooperation%20Guidelines%20for%20Cross-border%20Insolvency%20.pdf>.

to the existence of a duty contained in a customary international law norm, at least because the requisite consisting in the belief that a given practice is legally compelled (the so called “*opinio iuris ac necessitatis*”) is lacking. Three other hypothesis could be considered. It can be argued, first of all, that protocols might have an implied basis, in the sense that their source should be found in an inherent power of the liquidators and of the judges, within the spectrum of their freedom and of their procedural initiative aimed at administering justice and at assuring a smooth development of the proceedings. Second, it has been argued that a “legislative basis” or simply a “basis” for cross-border insolvency protocols are those non-binding, soft law instruments drafted by international organizations or academic associations, such as, just to mention the oldest one, the 1995 Cross-border insolvency concordat.²⁹ Third, it can also be put forward that the legal basis for protocols is comity³⁰. However, the three hypothesis just mentioned are only partially satisfactory. They might be acceptable for common law legal orders, while they do not solve anything from a civil law point of view. The reason being that they recall abstract principles or soft law instruments, which would not generally be accepted as a legal basis in civil law countries.

It follows that, in the absence of an (explicit – tangible – hard law) legal basis for protocols, it might not be so easily conceivable for a legal order of a civil law tradition to accept that liquidators enter into protocols with foreign colleagues and that courts approve them.³¹ This could explain why, as it has already been mentioned, civil law countries are, in general, more reluctant than common law ones toward the conclusion of protocols. Bearing in mind that, in some cases, such

29 Committee J, Section on Business Law, International Bar Association, Cross-Border Insolvency Concordat, 17 September 1995, available at: <http://www.iiiglobal.org/component/jdownloads/finish/396/1522.html>. See, in the sense above, A. Kamalnath, “Cross-border Insolvency Protocols: A Success Story?” (2013) *International Journal of Legal Studies and Research* 172, at 176; J. Farley *et al.*, “Coordination and Cooperation in Cross-border Insolvency Cases, First Annual Insolvency Review Conference” (6 February 2004), at 6; P. Zumbro, “Cross-border Insolvencies and International Protocols – An Imperfect but Effective Tool” (2010) 11 *Business Law International* 157, at 165.

30 See F. Dialti, “Cooperazione tra curatori e corti in diritto internazionale fallimentare: un’analisi comparata” (2005) *Il diritto fallimentare e delle società commerciali* 1010, at 1015; UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment, at §175; UNCITRAL Practice Guide on Cross-Border Insolvency Cooperation, at 38. See, also for further references, holding that comity is “the principle ... which justifies the enactment of protocols”: E. Canuel, “United States – Canadian Insolvencies: Reviewing Conflicting Legal Mechanisms, Challenges and Opportunities for Cross-Border Cooperation” (2005) *Journal of International Business and Law* 8, at 15; Kamalnath, above note 29, at 176. In the sense that comity is not a sufficient basis for the conclusion of protocols, see Dargan, above note 18, at 120. In the sense that comity cannot be taken as the basis for protocols, see A. Briggs, “The Principle of Comity in Private International Law” (2011) 354 *Recueil des Cours de l’Académie de Droit International de la Haye* 65, at 69 ff.; E. Warren and J. Westbrook, “Court-to-court Negotiation” (2003) *American Bankruptcy Institute Journal* 28, at 28 and in note 3; J. Westbrook, “International Judicial Negotiation” (2003) *Texas International Law Journal* 567, at 569.

31 In this sense, see for example Zumbro, above note 29, at 158 (note 3). For the opposite attitude of common law countries, see *e.g.* Farley *et al.*, above note 29, at 7: “the working philosophy in those jurisdictions was that if something was not forbidden and it made sense to do it, then it was judicially permitted.”

a reluctance could turn into a real impediment for relevant courts and liquidators to enter into such protocols, it is believed that providing a proper legal basis for the conclusion of protocols could facilitate their use even in those countries where no judicial initiative could be undertaken outside the boundaries of what is stated by relevant norms.

More in general, it is believed that another concern which is often put forward in the pertinent scholarship regarding protocols could be usefully addressed through the provision of a legal basis for them. Notwithstanding the fact that the initiative undertaken by liquidators and judges, in order to find a way to bypass territorialism inconveniences, is, without doubt, to be appreciated, also considering that the ultimate benefit will be for the creditors of the insolvent group, it could be useful to investigate whether there are and, if so, what are the limits for courts and liquidators to create *ad hoc* (international) procedural norms, even if they act in the exclusive interest of creditors. In particular, reference is made here to the need to protect, within insolvency proceedings coordinated through the use of a protocol, fundamental rights of the parties and, most of all, that to a fair process.³² It is submitted that a legal basis could help in assessing these limits and ensuring their protection.³³

In the light of the above, it would be without doubts advisable to promulgate legislation that expressly authorizes the adoption of protocols.

32 See S. Jackson and R. Mason, "Developments In Court To Court Communications in International Insolvency Cases", (2014) 37 *UNSW Law Journal* 507, at 519 ff., referring to an address of Justice R. I. Barret of the Supreme Court of New South Wales delivered at the 22nd Banking and Financial Services Law Association Annual Conference, Cairns, 6-7 August 2005. See also Dargan, above note 18, at 124, raising the issue of whether a protocol would stand up to scrutiny by the US Supreme Court in case it would be challenged by some dissatisfied creditors for an alleged violation of the US Constitution. On the protection of human rights and of procedural rights of the parties within proceedings that have a cross-border dimension and that are jointly administered by the involved judicial authorities, see also B. Hess, "Justizielle Kooperation/Judicial Cooperation" in P. Gottwald and B. Hess (eds), *Procedural Justice. XIV. IAPL World Congress/XIVème Congès mondial de l'AIDP. Heidelberg 2011* (2014, Giesking-Verlag, Bielefeld), at 431 ff.; C. Kessedjian, "L'avenir de la coopération judiciaire transfrontalière" in Menétrey and Hess (eds), above note 10, at 353.

33 On cooperation and conclusion of protocols in international insolvency cases see further S. Bufford, "Coordination of Insolvency Cases for International Enterprise Groups: A Proposal" (2012) 86 *American Bankruptcy Law Journal* 685; I. Fletcher and B. Wessels, "Shaping Rules for Cooperation in International Corporate Insolvency Cases through Dialogue" (2010) *European Company Law* 149; B. Leonard, "Managing Default by a Multinational Venture: Cooperation in Cross-Border Insolvencies" (1998) 33 *Texas International Law Journal* 543; "The Developing Use of Protocols in Major Cross-border Filings" (1999) 18 *American Bankruptcy Institute Journal* 12; "The Way Ahead: Protocols in International Insolvency Cases" (1998) 17 *American Bankruptcy Institute Journal* 12; P. Omar, "Cross-border Assistance in the Common Law and International Insolvency Texts: An Update" (2009) 20 *International Company and Commercial Law Review* 379; B. Wessels, "EU promotes Judicial Cooperation in Cross-Border Insolvency Cases" (1 July 2013), available at: <http://leidenlawblog.nl/articles/eu-promotes-judicial-cooperation-in-cross-border-insolvency-cases>; J. Westbrook, "The Duty to Seek Cooperation in Multinational Insolvency Cases" (2004) *Annual Review of Insolvency Law* 6.

4. The Role played by Protocols within the New EU instruments regulating Banking and Financial Insolvencies

The last part of this presentation considers whether cross-border insolvency protocols will continue to play a role in the future within the insolvencies covered by the two new instruments enacted by the European Union in the banking and financial fields, namely Directive 2014/59/EU and Regulation (EU) No. 806/2014.

While, as already recalled, the recently adopted EIR Recast (Regulation (EU) No. 2015/848) explicitly mentions protocols in Recital 49 and Articles 41 and 42, as far as the coordination between main and secondary insolvency proceedings is concerned, and in Articles 56 and 57, as far as the coordination of more proceedings related to more members of a same group is concerned, the same cannot be said with regard to the regulation and the directive recalled above dealing with the resolution of credit institutions and investment firms. It is submitted that this silence derives from the fact that, under the directive and the regulation, there is apparently no need for entering into cross-border insolvency protocols.

The two legislative instruments foresee institutionalized cooperation fora, respectively the resolution colleges and the Board, where group level resolution authorities and national resolution authorities in the first scenario and representatives of national resolution authorities and the other members of the Board in the second scenario are supposed to cooperate to achieve a successful resolution of the pertinent insolvent group. On the one side, resolution authorities shall be, according to Article 3(2) of Directive 2014/59/EU, public administrative authorities entrusted with public administrative powers and, on the other side, the Board is, according to Article 42(1) of Regulation (EU) No. 806/2014, “a Union agency”. Therefore, even if it cannot be excluded that, within said bodies, cooperation could be enacted through the drafting of formal agreements that could even be named “protocols”, said agreements would anyway be different from the cross-border insolvency protocols which we are used to, at least under the point of view of the actors that are called upon to enter into them.

Therefore it seems that a minor, if not any, role could be played by cross-border insolvency protocols under the recently enacted directive and regulation.

PART III
THE SHAKESPEARE
MARTINEAU LECTURE

Chapter 14

Insolvency Law and Investment Protection Treaties – A Conflict of Laws and Jurisdictions to be Addressed

Axel Flessner

I. Introduction

Insolvency law is concerned with protection of investments and investors – of creditors having contributed money to businesses, and of business owners having put money into their own business. The protective feature of insolvency law is to collectivize the enforcement of claims and the disposition of the debtor's assets. Originally, the protection was meant to serve only the creditors – by preserving and enhancing the overall value of the property available for the satisfaction of their claims. Nowadays, with rescue proceedings forming a normal part of insolvency law, the protection includes the investment of the owners of the business.

During the last 50 years or so, investment protection has become the subject also of international treaties, mostly bilateral ones between individual states. It is a different kind of investment protection. While insolvency law is to protect investors at the instance of debtors' economic difficulties, the aim of the treaties is to protect investors against governmental action in the foreign country where the investment has been made. Originally, the investment protection treaties had been invented for developing countries wishing to attract foreign capital without having a reliable domestic legal system to protect foreign investors against expropriation and other unwelcome political action.

Meanwhile, investment protection treaties have been concluded, or are about to be concluded, between states with legal systems beyond reproach, that is, with systems that can be trusted to protect the expectations of investors, domestic and

foreign.¹ The most prominent ones of this kind are the envisaged treaties between the European Union and the United States of America (called *Transatlantic Trade and Investment Partnership* – “TTIP”) and between the EU and Canada (called *Comprehensive Economic Trade Agreement* – “CETA”).

Insolvency law is about owners and creditors, both being investors, the international treaties are about investors and governments. Where, then, is the conflict to be addressed? The conflict emerges from the ambition in the treaties to protect foreign investors comprehensively, that is: against governmental action of any kind – legislation, executive and administrative action, judicial action, and thus also against insolvency laws and proceedings. The conduct and the results of an insolvency proceeding may be questioned by individual investors invoking the protection promised by the treaty. That is the conflict to be explained here.

First, the typical investment protection treaty and its possible impact on insolvency law and practice will be described. The conflict will then be illustrated by three prominent insolvency cases, with the lesson we can draw from them. Finally, an assessment of the treaties will be given with an outlook on what stand the insolvency and restructuring law profession can take towards the investment protection treaties oncoming in Europe – TTIP and CETA.²

II. Investment Treaties and their Impact

The typical investment treaty traditionally provided investors of the contracting states with free access to their domestic markets and with an assurance of equal treatment with the nationals of the respective state. Modern investment treaties, however, go further. They give a promise of the treaty state to the protected foreign investors of *generally* not to disturb the investment indecently. The promise is usually framed as an express obligation to accord investors of the other state “fair and equitable treatment” and further by a provision against expropriation of the investment unless it is made for a public purpose, under due process of law, in a non-discriminatory manner and against prompt compensation.

- 1 Major works on the field in English: M. Bungenberg *et al.* (eds), *International Investment Law* (2015, Nomos, Baden-Baden); R. Dolzer and C. Schreuer, *Principles of International Investment Law* (2nd ed) (2012, OUP, Oxford); H. Muchlinski *et al.* (eds), *The Oxford Handbook on International Investment Law* (2008, OUP, Oxford); M. Sornarajah, *The International Law on Foreign Investment*, (3rd ed) (2010, CUP, Cambridge); in German: J. Griebel, *Internationales Investitionsrecht* (2008, Beck, München); M. Krajewski, *Wirtschaftsvölkerrecht* (3rd ed) (2012, C.F.Müller, Heidelberg); A. Reinisch, “Internationales Investitionsschutzrecht” and “Die Beilegung von Investitionsstreitigkeiten”, §§ 8 and 18 in C. Tietje (ed), *Internationales Wirtschaftsrecht* (2nd ed) (2015, de Gruyter, Berlin/Boston).
- 2 The negotiated English draft of CETA is available at: www.trade.ec.europa.eu/doclib/docs/2014/september/tradoc_152806.pdf. It is now being revised and translated into all official EU languages and is likely to be submitted for ratification in 2016.

In modern treaties like CETA, the cases of unfair and inequitable treatment are exclusively listed in the treaty. In CETA, these cases are:

- 1) Denial of justice;
- 2) Fundamental breach of due process;
- 3) Manifest arbitrariness;
- 4) Targeted discrimination on manifestly wrongful grounds, such as gender, race or religious belief;
- 5) Abusive treatment of investors such as coercion, duress and harassment; or
- 6) any other treatment the contracting parties may have later agreed under the treaty to constitute such unfair and inequitable treatment.³

The salient feature of the treaties is that impairment of an investment by measures of the host state not compatible with the treaty entitles the investor directly, not only the other contracting state, to claim damages or compensation against the host state at an arbitration tribunal set up for the case under the treaty rules; the decision of the tribunal is then binding on the defendant state and it is enforceable internationally. In other words: The treaty places the enforcement of its investment protection into the hands of the investors themselves providing them with readily enforceable money claims against the state in breach. Complaints can be made against any governmental “measure”,⁴ whether the measure is one of the legislature, of the executive branch or the judicial branch of government. Measures of the judicial branch include, of course, insolvency proceedings. They can be challenged and given a price tag by binding awards of money compensation to complaining investors.

III. Illustration

The working of such treaties is here illustrated by three prominent insolvency cases, partly real, partly hypothetical.

1. *Suhrkamp*

The first case is the *Suhrkamp* insolvency. *Suhrkamp* is one of the most prestigious book publishing houses in Germany. It publishes highbrow literature and has been called a pillar of literary and intellectual life in the German speaking world.

³ The typical contents of such treaties are described in the general works cited above note 1.

⁴ CETA, Chapter 10 Article 3 – *measure*.

With its program it has for long times been at the head of intellectual moods and developments.

Suhrkamp was owned and run by a limited partnership of two, the one partner being a foundation with a 60% share of the capital and the votes, the other partner being a Swiss holding company, with 40%.⁵ In truth, the actors in the drama were two natural persons. On the side of the foundation, there was the widow of the former majority owner of the business who had left his share to the foundation and made his widow, a former theatre actress, the foundation's president. On the Swiss side stood a German art dealer, grandson of a famous German sculptor, who had bought his minority share from a Swiss family who had been on friendly terms with the business which they had wanted to support by investing and taking that minority share. The widow and the art dealer soon got into a permanent and bitter war over management and policy. Over the years, they fought against each other in numerous law suits.

The war escalated when one year the parties argued about the distribution of profits which the minority partner wanted to be distributed and the majority partner to be retained in the business. The minority partner sued the partnership for her share and got a judgment in her favour. The majority partner thereupon had the managers of the partnership file for a restructuring proceeding in the insolvency court, the petition alleging that the partnership lacked the liquidity to satisfy the enforceable judgment and that insolvency was consequently imminent.

The insolvency court opened the proceeding, in which then the debtor partnership presented a reorganization plan (in German *Insolvenzplan*), which provided for full satisfaction of the creditor claims and for the conversion of the partnership into a stock company in which the existing partners would be shareholders of, again, 60 and 40% respectively, but with a restriction on the transfer of shares and with a bar to a subscription of new shares at an envisaged increase of share capital. In other words: While partners under general commercial law have a voice also in the management of the business and while, in this case, the minority partner had by separate agreement had secured to herself special co-management rights, the partners by the plan were now going to be made mere shareholders in a company, the minority shareholder thus losing any influence on the management and facing the risk of her shares being watered down by a future increase of capital and with no right to freely sell the shares allotted to her by the plan.

5 To be precise: it was a limited partnership with the general partner being a private company limited by shares (a *GmbH*), such limited partnerships (*GmbH & Co KG*) being a legal construct in wide use, originally for tax reasons. In this case, the limited partners were also the shareholders in the *GmbH*, their general partner.

The plan was approved in the creditor groups and by the majority partner, and the insolvency court confirmed it. The minority partner, the Swiss company, had fiercely opposed the plan and twice appealed against its confirmation up to the Federal Supreme Court (*Bundesgerichtshof*). It alleged an abuse of the insolvency proceeding as such and particularly of the insolvency plan provisions of the Insolvency Act, because, in her view, they were used not for a restructuring of debt at an insolvency – the debts were indeed to be satisfied in full – but solely for fettering, annoying and eventually squeezing out a tiresome partner in the business without a showing of real insolvency.

On the first appeal, the Supreme Court remanded the case to the appeal court below for procedural reasons,⁶ on the second appeal the Supreme Court denied further review on the ground that the court below had now based its decision on a special provision in the Insolvency Act (§ 254 para. 4) the application of which, in the eyes of the Supreme Court, was not subject to appeals.⁷ The Swiss company has now lodged a complaint with the Federal Constitutional Court (*Bundesverfassungsgericht*) alleging abuse of proceedings, denial of justice, unlawful expropriation and violation of the freedom of association.⁸

The case is pending. It touches upon an investment made. To make it illustrate international investment protection, it is now made a hypothetical one. Assuming the investor to be not a Swiss company but a company coming from Canada, the case would come within the scope of CETA, the investment treaty between the European Union and Canada which is awaiting ratification. And further assuming that the Constitutional Court dismisses the complaint, in other words: approves of the insolvency proceeding and its results. Can the Canadian company then invoke CETA to make Germany or the EU liable in damages for this proceeding?

It is clear from the outset that insolvency proceedings, as any other governmental activity, are covered by the treaty – which attaches a possible financial state liability on any “measure”.⁹ There is no exemption for the judicial branch of government in any investment treaty. Indeed, the very gist of those investment treaties is a general distrust towards national judges and their treatment of foreign investors. So, in the supposed case, we have to look to the standards CETA is going to establish for the EU and Canada.

6 BGH 7 July 2014 – IX ZB 13/14, Zeitschrift für Wirtschaftsrecht – ZIP 2014, 1442.

7 BGH 17 Sept 2014 – IX ZB 26/14, ZIP 2014, 2040.

8 BVerfG, file number (*Aktenzeichen*) 2 BvR 1978/13. The proceeding as of December 2014 has been extensively reported and commented upon in various law review articles; ZIP 2015, 83, ZIP 2015, 1208; *Deutsche Zeitschrift für Wirtschafts- und Insolvenzrecht (DZWIR)* 2014, 331, 440, 577; 2015, 1, 125; *Der Betrieb (DB)* 2015, 538.

9 CETA, Chapter 10 Article 3 – m.

Is there a risk of the Suhrkamp proceeding to be regarded as unfair and inequitable or as an unjustified expropriation under CETA? When we look at the catalogue of instances of such behaviour mentioned in the beginning¹⁰ we find exactly those charges that have been addressed by the minority shareholder company to the German courts – denial of justice, lack of due process, abusive treatment of an investor, expropriation. To be sure, all German courts, in the assumed case, have held the charges to be unfounded. But the three arbitrators far away in Washington DC or somewhere else might think differently and may thus impose financial liability on Germany or the EU for what the arbitrators think to be a misbehaviour of the German courts – and that would be the final word in this case. The possible conflict between German insolvency law, as applied by the German courts, and the treaty standards, as applied by the arbitrators, would be obvious, it is a conflict of laws and of jurisdictions.

This is not the place to comment on this hypothetical conflict or on the actual Suhrkamp case. The next illustration is the case of the Austrian *Hypo Alpe Adria Bank*.

2. *Hypo Alpe Adria*

With a daring strategy since the nineties of last century, this bank grew from a small state-owned mortgage bank in Carinthia, a state in the Austrian federal system of government, into one of the 5 or 6 big banks in Austria, benefitting from close links to party politics. After the opening of the East of Europe, it expanded heavily in South Eastern Europe. Beginning with the financial crisis of 2008 and later, it got into troubles with many of its investments and loans that decreased sharply in value or failed altogether. In 2009, the Austrian government felt the need to come to help. They bought all the shares in the company, among them a majority of 70% held by the Bavarian State Bank, they invested a good EUR 5 billion into the bank over the next five years, and then concluded in 2014 that the prospects were hopeless, the business untenable. They could have sent the bank into a normal insolvency proceeding, but for various economic and political reasons, the government decided to liquidate the business by their own hands. The bank was renamed and converted into a winding up institution (what one often calls a “bad bank”), and legislation was passed to liquidate its assets smoothly and slowly and with support of the liquidation process by government funds.

One of the government’s concerns was to protect the winding up institution against insolvency until it had assembled liquidity sufficient to satisfy claims when falling

¹⁰ Above notes 1 and 3.

due. They thought that roughly five years of liquidating would be needed to yield the funds necessary for regularly serving claims on maturity. So, provisions were enacted in 2014 that declared lower ranking claims to be extinguished which would fall due before a fixed date in 2019, that is: 5 years later. The bank had incurred in its former business a good number of lower ranking liabilities within its total debt of about EUR 10 billion. The lower ranking claims hit by this law made up about EUR 800 million.

The whole legislative winding up scheme was attacked in the Austrian Constitutional Court (*Verfassungsgerichtshof*) by a group of dissenting members of Parliament big enough to have standing in the court, and by a regional civil court of first instance (*Landesgericht*) in Carinthia where an insurance company tried to recover under bonds that were subject to that special law. On 29 July 2015, the Constitutional Court rendered its decision.¹¹ It held that the purported extinction of those claims was an arbitrary expropriation of the creditors, being incompatible with the property guaranty in the Austrian Constitution, and the Court consequently invalidated the whole legislative scheme. It expressly acknowledged the power of the legislature to impose sacrifices on creditors of a bank of systemic relevance, and it particularly noted that in any ordinary liquidation at insolvency the junior creditors like the ones affected here carried a special risk of being wiped out because of their lower rank. The Court did not, however, accept that within the lower ranking class the law could make a difference between claims according to their date of maturity, with no regard to the nature and origin of the claims but with the intent only of getting the liquidation under way.¹²

When we look at the scheme, it was an insolvency proceeding for all intents and purposes, to be sure not under general or banking insolvency law, but having all the ingredients of a legal insolvency measure, that is: an insolvent debtor and its creditors, with no hope of the debtor's survival, a statutory mandate for its liquidation – albeit a slow and smooth one – and a cutting off of creditor claims to help the process achieve its aims. And the Constitutional Court intervened with classical insolvency law arguments, although dressed in constitutional terms, by pointing to creditor ranks deserving respect and to the equality of creditors within a given rank.

If we now look to whether the affected creditors could have been protected under a given investment treaty, the Constitutional Court in this case, to be sure, has

11 Available at: www.vfgh.gv.at under "Ausgewählte Entscheidungen" > G 239/2014. The facts stated here and the decision are taken directly from the judgment. A press release in English is available at the website under "Medien".

12 Ibid. at paragraphs 249-296.

rendered the treaty irrelevant by providing by itself the looked for protection. But what if it had decided otherwise? The arguments of the Austrian government for imposing that sacrifice were by no means far-fetched or utterly mistaken.¹³ In case they had persuaded the Constitutional Court to dismiss the complaint, the arbitration tribunal under the investment treaty could be seized and the Republic of Austria would again had to defend itself against the arguments that had been rejected previously in its constitutional court. Again, the potential conflict between the statutory insolvency treatment and the investment protection mechanism is coming into sight here.

In Austria, the conflict is actually not even safely averted in the Hypo case. Austria has meanwhile enacted a new Bank Reorganization and Resolution Act in accordance with European Union prescriptions.¹⁴ Under the new Act, the lower ranking creditors in this case – this time all of them – have been set under a moratorium until 2016. This moratorium, of course, is also open to an attack under the constitution or under the assumed investment treaty. Whether it would stand constitutional or – alternatively – investment treaty attacks is by no means certain.

3. *Yukos*

The last illustration case is the *Yukos* saga. Unlike Suhrkamp and Hypo Alpe Adria, the conflict between the investment treaty and insolvency law is here not hypothetical but has been very real. The case has been widely covered by the media, but mostly with regard to the criminal proceedings in Russia against the controlling shareholder of Yukos, Mikhail Khodorkovsky, who was roughly treated by the authorities and was twice sent to jail for a number of years. But part of the story was an insolvency proceeding through which Yukos was eventually dissolved and which subsequently resulted in an investment protection claim against Russia in an arbitration organized by the Permanent International Court of Arbitration at The Hague in the Netherlands. The arbitrators have rendered their judgment on 14 July 2014. The report here of the case is taken exclusively, no media in between, from the facts stated in that judgment, and will focus on the proceedings against Yukos, not on the criminal charges against Khodorkovsky.

Yukos was formed as a joint stock company by the Russian government after the dissolution of the Soviet Union. It was to run a number of the formerly state-owned oil and gas fields. In the mid-nineties, under President Yeltsin, large parts of the economy were privatised, and so were the shares in Yukos. They were sold by

¹³ *Ibid.*, at paragraphs 128-146.

¹⁴ Directive of Council and Parliament No. 59/2014 of 15 May 2014 on Bank Recovery and Resolution (“BRRD”).

auction, Khodorkovsky and some associates acquired about 70% of the shares. He had been a high ranking leader in a communist youth organisation in Soviet times, later he became vice-minister in a government under President Yeltsin. This background may have enabled him to marshal the funds needed for the successful bid at the auction. Under the management of Khodorkovsky, Yukos flourished. By the turn of the century it had become the biggest Russian oil company, also a worldwide player with an estimated market capitalization of USD 33 billion, it was engaged in negotiations with Exxon and ChevronTexaco for a merger or other form of combination.

In 2003, the Russian authorities held a field tax audit at Yukos. They discovered what the aforementioned arbitrators later called a huge tax evasion scheme with taxes of hundreds of millions of Dollars withheld, what Yukos called a tax optimization scheme, and the Russian authorities simply called wilful and persistent tax fraud. Russia had established in the nineties a number of low tax areas where investments were to be especially encouraged. Yukos used mailbox firms in those territories and also a subsidiary in the republic of Cyprus, with which Russia had a double tax agreement, to avoid taxes by clever in-group selling and pricing, the technique so familiar to many in the corporate world. Khodorkovsky was arrested and twice convicted for long prison terms, and the tax authorities reassessed Yukos for the years 2000 to 2004 with taxes and interest amounting to a total of USD 16 billion. They added fines for the tax fraud in the amount of USD 8 billion, so that in 2006, when the last assessment had been made, Yukos had a tax liability of USD 24 billion. Yukos appealed against the assessments up to the highest court, but without success. When the assessments were not paid, the authorities enforced them very quickly with freezing assets and then seizing and selling by auction the core production facilities of Yukos for USD 9 billion. The asset basis of Yukos was thereby reduced to 40% of the previous level.

Now, at last, comes the insolvency proceeding. Yukos had, in 2003, taken up a loan of USD 1 billion from a syndicate of Western banks. After the aforementioned auction of the greater part of its assets, Yukos failed to serve the loan. The syndicate obtained a judgment against Yukos in the High Court in London and they tried to enforce it in the Netherlands where Yukos held its foreign assets. The enforcement failed because the assets had been rashly placed in two newly formed Dutch foundations that held them for the controlling shareholders of Yukos. The syndicate then achieved recognition of the London judgment in Russia and eventually petitioned for an insolvency proceeding which was opened in 2006. In the proceeding, the tax liabilities left over after the previous auction made up 70% of the admitted claims. Yukos offered a restructuring plan, it was rejected in

the creditors' meeting, and liquidation of the remaining assets followed in several steps with a total yield of USD 31 billion, USD 9 billion in taxes remaining unpaid. In 2007, Yukos was struck from the company register.

Already in 2005, the controlling shareholders of Yukos sought investment protection against the Russian Federation by starting mediation and then arbitration under the Energy Charter Treaty. That treaty is a consequence of the dissolution of the Soviet Union and of the political opening of Eastern Europe. Governments were now concerned about the continuance of oil and gas supplies from the former Soviet territory, the successor states were concerned about the flow of money from the export of oil and gas and they wanted to attract western capital to modernize and expand their production. So, a treaty, called the Energy Charter Treaty ("ECT"), was concluded in 1994, came into force in 1998 and has been ratified meanwhile by 51 countries, mainly European, and by the European Union. Russia has signed the treaty, but has not ratified it, and has meanwhile formally declared to be no longer willing to ratify.¹⁵

Because of its aim to foster capital export to energy producing countries, the treaty has also an investment protection chapter. It is modelled after the many other investment treaties, that is, it obliges the treaty states to fair and equitable treatment of investors from other treaty states and it prohibits unjustified expropriation. Violation of these provisions entitles the investor to seek compensation, enforceable against the guilty treaty state by arbitration.

This investment protection was sought against Russia by three shareholders of Yukos, that is, two holding companies in the Republic of Cyprus and one on the Isle of Man. Together they were holding about 70% of the Yukos shares, and each was under the control of Khodorkovsky and his associates through a sophisticated chain of holdings and trusts leading to Gibraltar and the Channel Islands. They claimed that all the legal measures of the Federation of Russia against Yukos were not simply measures of tax assessment and judicial enforcement, but were all part of an overarching strategy of the Russian government to destroy Yukos, to get back into the hands of the state its extensive oil and gas facilities, and to get rid of Mikhail Khodorkovsky – he was allegedly suspected to become a dangerous political opponent to President Putin.

15 The facts on the ECT are taken from Wikipedia, "Energy Charter Treaty", and from the judgment cited below notes 16 and 17. See also T. Roe and M. Happold, *Settlement of Investment Disputes under the Energy Charter Treaty* (2011, CUP, Cambridge) and, with regard on the special relationship of the EU and Russia, S. Pritzkow, *Das völkerrechtliche Verhältnis zwischen der EU und Russland im Energiesektor* (2011, Springer, Berlin/Heidelberg).

A giant arbitration proceeding developed before a panel of arbitrators formed with the services of the Permanent International Court of Arbitration. The three arbitrators were a renowned judge and advisor in international law disputes from the United States, *Stephen M. Schwebel*, an *Avocat* from Geneva, *Dr. Charles Poncet*, and a professor and practitioner from Canada, *The Hon Yves Portier*, the chairman. They called themselves “The Arbitration Tribunal”.

The tribunal had first to decide on its jurisdiction, after Russia has not ratified the treaty. In 2009, in an interim judgment of 200 pages, they decided against Russia, on the basis of Russia having signed the treaty without objecting to its provisional application which the treaty expressly declares to follow from such signature.¹⁶ After a busy further five years, the tribunal gave its final judgment on 14 July 2014. The judgment, an impressive document of more than 600 pages, holds the Federation of Russia liable for a violation of the Energy Charter Treaty and orders it to pay the claimants a compensation of USD 50 billion.¹⁷

For our subject, two aspects are remarkable:

The tribunal did not deny the measures taken by the Russian authorities to have been permissible under Russian law, and it did not dispute the compatibility of the laws applied with the treaty. It emphasized, instead, the harsh and rash procedures against Khodorkovsky personally and against Yukos and it concluded from this “big picture”¹⁸ and all the circumstances that the claimants had proven their allegation, that is: that the Russian government under President Putin had conceived a plan to destroy Yukos and to appropriate its assets to the state in the first place, and that it exploited the tax evasion scheme as a welcome trigger for the execution of that plan. In the tribunal’s view, the insolvency proceeding was only the concluding part of an ongoing, carefully orchestrated expropriation, lasting from the tax audits in 2003 to the elimination of Yukos from the company register in 2007.

The other remarkable aspect is how the tribunal arrived at the amount of USD 50 billion of compensation.¹⁹ It had assessed the losses suffered by the claimants at about USD 70 billion. It then held the claimants and their shareholders liable for contributory fault because of their extensively practised tax evasion system

16 The judgment is available at the website of the Permanent Court of Arbitration: www.pca-cpa.org, under “Recent Activities > more > Final Awards Issued in 3 Arbitrations between Former Shareholders of Yukos and the Russian Federation > Hulley Express (and others) v. The Russian Federation > Interim Award on Jurisdiction and Admissibility of 30 November 2009”.

17 *Ibid.*, substituting as the final link > “Final Award of 18 July 2014”.

18 *Ibid.* at 366 (paragraph 1144).

19 *Ibid.*, at 500-509.

that had made them, in the view of the tribunal, vulnerable and had opened the way to the eventual destruction of Yukos. The tribunal claimed wide discretion in weighing the parts played by both sides and in attributing the shares to be taken, and it came to the conclusion that 25% of the loss should be borne by the claimants themselves, which makes for about USD 50 billion left for their compensation.

IV. The Lesson

It would be useless here to comment on the judgment. We must rather take it, and the other illustration cases, as an indication of the potential of judicial review of insolvency proceedings the investment treaties hold in store. What do investment treaties like TTIP and CETA mean to insolvency law? It appears that the review potential is enormous. The treaties allow judicial imposition of state liability to individual investors caught in insolvencies on the basis of circumstances far back in time and high up in politics, brought together under some guiding idea, and they allow the arbitrators wide discretion in comparing and evaluating the behaviour of the participants involved. As to the range of circumstances possibly to be considered, the treaties are “comprehensive” in the widest possible sense. No such reaching out into the factual and legal surroundings would be allowed, let alone be possible, in a normal national insolvency court. This discrepancy of what an insolvency court and what the investment protectors are allowed and able to consider, is the primary source of the potential conflict between the fields.

But the conflict will not be limited to spectacular instances like the aforementioned cases; it can rather eat itself into quite normal issues of insolvency practice. In a case reported only recently, the Republic of Hungary was held liable, under an investment treaty with Portugal, for its insolvency court denying a Portuguese investor a hearing on a debt restructuring proposal in an ongoing liquidation proceeding over its insolvent Hungarian subsidiary. The court had demanded additional supporting documents and, when they were not forthcoming, allowed and encouraged the appointed liquidator to proceed with the sale of the subsidiary’s production plant. The arbitrators under the treaty found that Hungarian case law and doctrine allow the courts to demand, if “necessary”, information and documents additional to those expressly required in the bankruptcy statute, but they thought that the court’s demand was unwarranted by the facts and unreasonable under the circumstances, and they branded it as a violation of the rescue chance the plaintiff under treaty standards should have had in the insolvency proceeding.²⁰

20 The judgment of 24 August 2015 in the case of *Dan Cake (Portugal) SA and Hungary* is available at the website of the International Center for Settlement of Investment Disputes (ICSID) at the World Bank: <https://icsid.worldbank.org>, under “Cases > ICSID Case No. ARB/12/9”, with the reasoning of the court at 24-48.

We can conclude from these cases that an investment treaty is apt to control and censure insolvency practice in cases whether high or low, sensational or inconspicuous, and that it may lead the arbitrators to penetrate deeply even into the fact findings of an insolvency court, to examine closely its legal conclusions and set them aside. This means that in every country bound by an investment protection treaty, the insolvency statute automatically carries a general reservation saying: “This law is subject to full legal review under an applicable investment treaty.” Practically, the reservation can be invoked in every case where the investment concerned is worth the costs of the arbitration under the treaty. That is the lesson.

V. Legal and Policy Assessment

The proponents of investment protection in the business world, in governments and in the European Commission praise it with the well-known arguments for free trade generally, that is that investment protection by treaties, too, will enhance further economic growth. Politically, the driving motive is a protectionist one. Governments, often driven by their economic “constituency”, strive to shield foreign investments of their home industries against unwelcome foreign state action. However, whether economic welfare optimists, stakeholders or governments: It is obvious that for their treaty projects they are demanding a price.

The *constitutional* price is increasingly debated in Europe²¹ – it is the impairment of democracy, the surrender of governmental sovereignty, the evasion of existing state liability rules, the interference with the power of Parliament over the budget, the outsourcing of judicial power to para-state instances. There is also a price in terms of *international law* – the sovereign states are to accept private investors as legal equals, equipped with enforceable compensation claims, in the structuring and management of international relations.²²

The focus here is on the contribution demanded of *insolvency law*. It is to yield on three central issues. The first issue is firmness of means and results. Insolvency proceedings are there to sort out with the strong hand of the state a troubled economic situation and thereby to put investors – debtors and creditors – on a

21 See A. Flessner, “Investitionsschutz durch völkerrechtliche Verträge wie TTIP und CETA – ein Fall für das Verfassungsrecht!” (2015) *Recht und Politik (RuP)* 149; J. Kleinheisterkamp, “Financial Responsibility in European International Investment Policy” (2014) 63 *International and Comparative Law Quarterly* 449; L. Ankersmit and K. Hill, “Legality of Investor-State Dispute Settlement (ISDS) under EU law – Legal Study” (22 October 2015) with ample further references at 4 (note 5), available at: www.ClientEarth.org using links > Publications > Publications Archive > 19.10.2015.

22 Leading critique: G. van Harten, *Investment Treaty Arbitration and Public Law* (2006, OUP, Oxford); see also J. Kleinheisterkamp, “Investment Treaty Law and the Fear for Sovereignty: Transnational Challenges and Solutions” (2015) 78 *Modern Law Review* 793 with further references.

new and firm legal footing, by liquidation of assets, restructuring of debt, or both. The results of an insolvency proceeding should be final, but they are not when they can be later challenged, if indirectly, by any unhappy investor with a claim for compensation.

The second issue is equality. Insolvency must respect ranks but it must not make a difference within ranks, equality insofar is one of its hallmarks. The investment treaties allow inequality, they benefit only the investors of the other treaty state, not domestic investors and not the foreign investors of other than treaty states. To be sure, the compensation to protect investors is available only after the conclusion of the insolvency proceeding, but the hope for, or apprehension of, such compensation will of course influence the participants and courts before.

Thirdly, *international* insolvency law can be disturbed. The ideal attitude in this field is to give international recognition and assistance to an insolvency proceeding that has been conducted in an appropriate forum in an appropriate manner. This liberal attitude is a concern of many international instruments, for instance of the UNCITRAL Model Law.²³ Where recognition, however, threatens to bring the recognition state into a conflict with its obligations under an investment protection treaty, we can no longer safely expect it to follow the internationally accepted ideal.

And then, we have a special problem here on the *European level*. The Insolvency Regulation requires the member states to give legal effect to insolvency proceedings opened and conducted wherever in the Union.²⁴ So, if the Union would make an investment treaty like TTIP and CETA, all the member states, not only the one with the proceeding, but all the others where its effects are realized, may become liable to Canadian or American investors under the respective treaty. Was the Union really empowered to make an insolvency regulation with member state liability to North-American investors automatically attached? Or, to put it reversely, would a member state be entitled to deny recognition under the Insolvency Regulation if such recognition might trigger such a liability? We can see here, that even in insolvency law investment treaties like TTIP and CETA can raise European constitutional questions. Such questions have apparently not been addressed by the negotiating teams of the European Commission.

23 See R. Mason, "Cross-Border Insolvency Law: Where Private International Law and Insolvency Meet", Chapter 2 in P. Omar (ed), *International Insolvency Law: Themes and Perspectives* (2008, Ashgate, Aldershot) at 27-60.

24 Regulation No. 1346/2000 of 29 May 2000 on Insolvency Procedures ("EIR").

VI. Embrace, Tolerate or Oppose?

All in all, the contribution asked of insolvency law for the envisaged investment protection treaties is substantial. The insolvency law community ought to consider whether to oppose the projects or to subscribe to them or just to take them easy. To be sure, investment protection under such treaties opens a field for legal services with ample rewards – although not for everybody; the arbitrations are highly demanding in manpower and time so that only big players in the legal profession can confidently manage them. But the price, in insolvency law currency, appears to be very high. Representatives of the insolvency profession would do well in their homelands to approach their governments with the problem, make them aware of the built-in threat to their insolvency procedures and ask them how they are going to sustain them against the treaty obligation. And INSOL Europe should give the problem close attention and place questions to the European Commission, particularly to its directorate in charge of European insolvency law. It seems that the negotiators for the Commission have as yet not seen the full legal and institutional implications of their treaty projects.

PART IV
VALEDICTORY ADDRESS

Chapter 15

An Insolvency Trajectory

Paul Omar

Address

Dear Friends, Colleagues and Guests,

I am not here for praise from others, as kind as the words at this conference have been, nor am I here to sing my own praises. I shall let my works speak for themselves. What I will do though is to thank all those whose help has enabled me to do my job well and who have contributed to my standing here today.

In first place, a word for our sponsors, Shakespeare Martineau, whose sponsorship has enabled the holding of the annual lecture that we have just heard, by Professor Flessner, on an intriguing and original topic, very inspiring indeed. That sponsorship has, more importantly, enabled a number of younger academics, both early career researchers as well as doctoral students, attend and present at this conference. This is exceedingly important, given that they are the lifeblood and promise for the future of this organisation.

Next, some words of thanks for INSOL Europe, our parent body, and particularly for Marc Udink, whose idea it was to begin an Academic Wing in 2004, later the Academic Forum we know now, and to have asked Bob Wessels and me in 2007 to relaunch it, leading to the organisation it now is. I thank also the superb organisation team behind the conferences, most particularly Caroline Taylor and her team (Wendy Cooper, Florica Sincu, Paul Newson and others), without whom the conferences simply would not happen and whose hard work and dedication have considerably lightened my task as Secretary.

In this light, a word of appreciation also for the Technical Officers, Emmanuelle Inacio and Myriam Mailly. Myriam is on secondment to Brussels, though she is much missed and I hope she will soon return. Both Emmanuelle and Myriam have been stalwarts of the Academic Forum, first attending conference in Monaco 2007, the first event I helped organise after taking up the role of Secretary. Without them, none of the essential administration of the conference would happen. Also to be thanked are the “invisible”, but essential staff, the audio-visual guys, who assist at

the INSOL Europe and INSOL International events, following us around the world and, of course, the hotel conference and catering staff, without whom conferences would not be as comfortable as they are.

I would like to thank the panel chairs and speakers for making things run smoothly and for delivering some inspiring and amazing papers. A special mention goes to the Young Academics' Network in Insolvency Law (YANIL), both its old guard: Emmanuelle Inacio, Myriam Mailly, Rolef de Weijjs, Giulia Vallar and Anthon Verweij, as well as the new generation: Jenny Gant and Jochem Hummelen, for the part they have played in the running of the dedicated YANIL session as well as their contribution to the general programme.

Of course, I could not leave without mentioning the audience, without whom there would be no point in being here. Many have come from afar: Australia (Rosalind Mason, Anil Hargovan) and South Africa (Anneli Loubser, Kathleen van der Linde, Juanitta Calitz, Leonie Stander, Adam Harris). Perhaps from not as far, but also deserving of mention, is Waiswa Abudu Sallam from Uganda, the 2015 Richard Turton prize winner and student on the LLM (Distance Learning) at the Nottingham Law School.

Ladies and gentlemen, friends and colleagues, in coming to the end of my term as Secretary, I am minded of the debt I owe the many people who along the way helped guide my "insolvency trajectory" to bring me to the place I am now.

Pride of place goes to Harry Rajak, now Professor Emeritus at Sussex, who asked a callow and young LLM student whether he would be interested in pursuing a PhD and whose guidance has been invaluable throughout my academic career. Next comes Anker Sorensen, then of Borloo Saigne, now of Reed Smith, who invited me to Paris to help him write a book and who helped found my continuing interest in French insolvency law.

I would also like to mention Ian Fletcher, former Chair of the INSOL International Academics' Group, and Rosalind Mason, his more than worthy successor, for the parts they played in giving me my first academic conference outings in 2005 in Sydney and Brisbane respectively. I am minded also that they were also instrumental in offering me some of my earliest publication opportunities in the journals they respectively edited: the *International Insolvency Review* and the (Australian) *Insolvency Law Journal*.

It was at the Brisbane conference that Bob Wessels first appeared, as the proverbial Dutchman coming in from the rain. His words at that event inspired the "Brisbane Initiative", which has led to many international collaborations, not least the INSOL

International Global Insolvency Practice Course (or “Fellowship”) on which quite a few of us teach. I have had many occasions over the years to work with Bob, from the CoCo Guidelines in 2006 to the most recent JudgeCo Principles in 2014. His influence has been instrumental in many a career here, not least through his idea to found the YAN (later YANIL) group in 2009.

Bob’s words have also led indirectly to the cooperation between the Nijmegen and Nottingham Law Schools that has seen the establishment of a “Dual LLM” programme, one of whose first cohort, Stef Vullings, has presented at this conference jointly with Alexandra Kastrinou on work arising from his LLM dissertation supervised by her. The calibre of the students on this programme has been of the highest and we are justifiably proud of their achievements. Thanks also to Michael Veder, who has not only been a fellow Management Board member in the Academic Forum, but more importantly is Joint Course Leader of this inspiring programme.

It is to work that we will all return after this conference. I would like to mention, at the Nottingham Law School, my colleagues David Burdette, Rebecca Parry, Adrian Walters (on secondment in Chicago), Paula Moffatt, Alexandra Kastrinou and Jenny Gant, the last three of whom have presented here in Berlin. Jenny Gant is, of course, the new YANIL Chair, but her real distinction is in having been the best doctoral student I have ever had. At the Nottingham Law School, not only are they all dear colleagues, but also good friends, and it is a real pleasure to be able to go to work each day in such good company. It is a little like having a work-family, as well as a home-family.

The Academic Forum has also been such a family, with many of you here not just colleagues, but also friends of long standing. The Academic Forum has been fortunate in being guided by its Chairs: Bas Kortmann (2004-2007), Bob Wessels (2007-2010), Stefania Bariatti (2010-2013) and Christoph Paulus (2013-present). My fervent wish is that it continue to benefit from such excellent leadership and that long may it flourish. *Floreat! Floreat! Floreat!*

In handing over to my successor, Anthon Verweij, I am minded of the words of Paul Valéry (1871-1945), the French poet and author. As paraphrased by Auden:

“A [work] is never finished, it is merely abandoned.”

In this work, that is the life of the Academic Forum, I have written my chapter. I now leave it to you, the audience, to take it and to write your own chapters in this story.

Over to you, Anthon.

