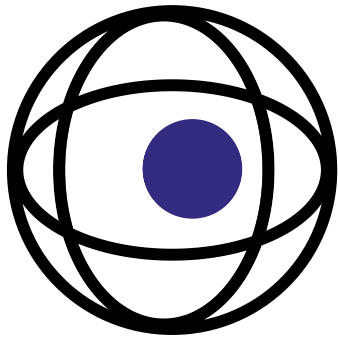

Insolvency Law: Back To The Future

Papers from the INSOL Europe Academic Forum Annual Conference
Dublin, Ireland 2-3 March 2022

Insolvency Law: Back to the future.

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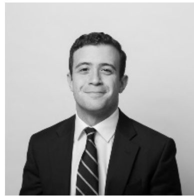

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Editorial Preface

When we last met in October 2019 in Copenhagen, we told each other 'Arrivederci a Napoli, in September 2020.' Little did we know that our plans would be cancelled because the COVID-19 pandemic which took over the world at the beginning of 2020. Unfortunately, the pandemic led us to cancel not one, but two, academic conferences.

To give our members the opportunity to meet in person before our "traditional" autumn conference, INSOL Europe organised an extraordinary conference in March 2022 in Dublin, Ireland. Located at the north-western edge of Europe, with its rich past and one of the most modern, developed service and financial sectors in Europe, Dublin was a fitting location for our first in-person conference following COVID-19. Despite the traumatic news of the events occurring on the border between Ukraine and the Russian Federation, INSOL Europe's Annual and Academic Forum conferences were invaluable opportunities to discuss insolvency and restructuring reforms, challenges, and opportunities across Europe.

The INSOL Europe Conference and Academic Forums were preceded by the Younger Academics Network of Insolvency Law (YANIL) Workshop. Now in its second iteration, the workshop was hosted by the Hotel Riu Plaza, The Gresham. The event was run in a hybrid manner. Dr Emilie Ghio (Edinburgh Napier University, UK) chaired the event, assisted by other YANIL board members, Dr David Ehmke (Willkie Farr & Gallagher LLP), Dr Jennifer L.L. Gant (University of Derby, UK), and Dr Eugenio Vaccari (Royal Holloway, University of London, UK). Gert-Jan Boon (chair of YANIL) and Dr Line Langkjaer joined virtually. The workshop was a real success, and the participants noted the very high quality of papers and discussions. Sadly, it was time to say goodbye to one of YANIL's founding members and previous chairperson, Jennifer Gant. She was succeeded by Dr Giulia Ballerini (University of Padova, Italy).

While the global impact of COVID-19 in the area of insolvency and restructuring was noted, the papers presented at the Academic Forum focused primarily on long-term issues, reflecting the variety of interests and expertise of the INSOL Europe members. The panels covered a range of topics and subjects, including cross-border insolvencies, the need to protect special categories of creditors and debtors, the challenges presented by crypto-assets and the 4th industrial revolution, and issues in consumer bankruptcy.

The memorial lecture in honour of late Prof Gabriel Moss was delivered by one of Ireland's leading academics and practitioners, Prof Irene Lynch Fannon. The discussion revolved around the topic of cross-border recognition of cross-border restructuring arrangements. This was particularly apt, seeing as this was one of the areas of insolvency law most frequently discussed by the late Prof Moss in his rich contribution to the academic and professional debate in insolvency.

The second day of the conference featured an equally exciting and varied a programme. For the first time in his history, the Academic Forum comprised a practitioners' forum, which featured a presentation by Prof Reinhard Bork (Hamburg University, Germany) and Prof Michael Veder (Radboud University, the Netherlands) on their recent book *The Harmonisation of Transactions Avoidance Laws* (Intersentia, 2022). This book is the result of a European-wide intensive research project, which involved an international working group with representatives from all Member States of the EU and the UK. Based on national reports and a principled-based approach, the book proposes a thorough, and highly qualitative analysis of national rules on the avoidance or nullification of legal acts which have been performed prior to the opening of insolvency proceedings. The presentation was followed by a conversation with leading practitioners in Europe on some of the most challenging aspects and innovative practices in cross-border recognition of insolvency and restructuring procedures.

This edition of the INSOL Europe Academic Forum series compiles a selection of the papers presented in Dublin in March 2022. If not otherwise stated by the contributors, the articles cover literature and

case law published before 1 June 2022. Before wishing you an enjoyable read of this collection of papers, we would like to commend the previous editor of these conference proceedings Dr Jennifer L.L. Gant; INSOL Europe Technical Research Co-Ordinator Dr Paul Omar; Secretariat staff members Caroline Taylor and Hannah Denney, as well as Technical Officers Emmanuelle Inacio and Myriam Mailly; and our Publisher, Paul Newson, for their support throughout the editing and publishing process.

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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, the largest Europe-wide association of academics, practitioners, and experts in insolvency. This event is regularly attended by academics, insolvency practitioners with recognised academic credentials, as well as those engaged in the research and study of insolvency.

The Academic Forum's primary mission is to provide a platform for INSOL Europe's members interested in insolvency law and research, to encourage and assist in the development of research initiatives in the insolvency field, and generally to affiliate with INSOL Europe's objectives and activities.

The Academic Forum meets annually, in conjunction with the main conference of INSOL Europe. It also organises half-yearly conferences around themes of interest to the practice and academic communities. Previous meetings have taken place in Prague (2004), Amsterdam (2005), Monaco (2007), Leiden and Barcelona (2008), Brighton and Stockholm (2009), Leiden and Vienna (2010), Milan, Venice and Jersey (2011), Nottingham and Brussels (2012), Trier and Paris (2013), Leiden and Istanbul (2014), Trier, Nottingham and Berlin (2015), Berlin and Lisbon (2016), Trier and Warsaw (2017), Athens (2018) and Copenhagen (2019). The COVID-19 pandemic led INSOL Europe to shift its activities to an online format in 2020 and 2021. In these years, INSOL Europe organised an online Academic Forum and full Conference in January-February 2021, and a Spring online Conference on 4 and 18 March 2021.A number of smaller events, including university seminars and colloquia, have also been co-hosted by the Academic Forum in partnership with other institutions across Europe.

In Copenhagen (2019), the chair of the Academic Forum was passed on from Prof Michael Veder (Radboud University, The Netherlands) to Tomáš Richter (Partner, Clifford Chance), while Dr Line Langkjaer (Aarhus University, Denmark) replaced Anthon Verweij (Sdu Publishers, the Netherlands) as secretary. In addition, the board of the INSOL Europe Academic Forum comprise Jessica Schmidt (University of Bayreuth, Germany), Gert-Jan Boon (Chair of the Young Academics' Network in Insolvency Law), Emmanuelle Inacio and Myriam Mailly (INSOL Europe Technical Officers), Rolef de Weijs (Amsterdam University, the Netherlands), Luigi Lai (Fellow of Ośrodek Przetwarzania Informacji, Warsaw), Francisco Garcimartin (Universidad Autónoma di Madrid, Spain) and Dr Jennifer L.L. Gant (University of Derby, UK).

Thanks to the generous sponsorship made available by Edwin Coe LLP (2007-2014; 2018- present) and Shakespeare Martineau (2015-2017), the Academic Forum has been able to offer young scholars travel grants to attend its conferences. The sponsorship has also supported the organisation of an annual lecture given by a scholar of international repute. These have included Prof Jay Westbrook (University of Texas, US), Prof Gabriel Moss QC (3/4 South Square, Gray's Inn, UK), the Hon Mr Justice Ian Kawaley (Supreme Court of Bermuda), Prof Karsten Schmidt (President of the Bucerius Law School, Germany), Prof Bob Wessels (Leiden Law School, the Netherlands), Prof Ian Fletcher QC (University College London, UK), Prof Rosalind Mason (Queensland University of Technology, Australia), Prof Axel Flessner (Humboldt University Berlin, Germany), HH Judge Ignacio Sancho (Spanish Supreme Court), Frank Verstijlen (Groningen, The Netherlands), Prof Ignacio Tirado (Secretary General of UNIDROIT/University of Madrid, Spain), and Prof Irene Lynch Fannon (Head of Knowledge Management at Matheson/University College Cork, Ireland).

These lectures, as well as many of the presentations at the Academic Forum conferences, have been collated and published in conference proceedings booklets. 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 technical publication series was inaugurated in 2009 by reports from the 2008 Leiden and Barcelona events. In the wake of the COVID-19 health crisis in 2020, the decision was taken by the INSOL Europe Council to publish the conference proceedings digitally.

The Academic Forum's next meeting is scheduled to take place on 5-6 October 2022 in Dubrovnik (Croatia). It will be preceded by the third YANIL workshop on 4 October, and followed by the INSOL Europe Conference on 6-9 October 2022. Details of these academic conferences and events will be posted on the INSOL Europe website when available (https://www.insol-europe.org/academic-forum-events). An on-line registration facility for academic conferences as well as further information about the work of the Academic Forum can also be obtained through the website, and alternatively, via a dedicated Facebook and LinkedIn page. Please follow INSOL Europe on Twitter @INSOLEurope.

We look forward to seeing you in Dubrovnik!

Drs Eugenio Vaccari and Emilie Ghio

Chapter 1

Preventive restructuring frameworks and the separate domain of cross-border restructuring law

Ioannis BAZINAS*

1. Introduction

The terms 'insolvency' and 'restructuring' are very frequently used together to refer to a single body of law that deals with the relationship between a debtor and its creditors in the context of financial distress. This view describes insolvency and restructuring law as merely different sides of the same coin. Both sets of legal rules deal with the problem of financial distress. However, unlike insolvency, which usually leads to the liquidation of the debtor's business, restructuring aims at enabling the debtor to continue trading as a going concern, by essentially selling the business back to its creditors.[1] This 'unitary' approach[2] has important implications for the treatment of restructuring proceedings from a private international law perspective. Since a restructuring is merely ancillary to formal insolvency, their cross-border aspects should be governed by existing international insolvency frameworks, such as the European Insolvency Regulation ('EIR').[3] This traditional view has been disrupted, most recently with the introduction of the European Preventive Restructuring Directive ('PRD').[4] The PRD requires member states to introduce 'preventive' restructuring frameworks, whose purpose is to facilitate the restructuring of the debtor's business before the onset of actual insolvency. These new preventive restructurings have initiated a lively debate about the proper contours of insolvency and restructuring law and, perhaps more interestingly, about the private international law implications of this distinction.

This article weighs in on the debate, by drawing a conceptual distinction between insolvency and restructuring law, using the tools of economic analysis. It argues for a novel conceptualization of the rules that govern cross-border aspects. This approach questions the soundness of the existing scholarship's attempts to identify the 'nature' of preventive restructuring frameworks, in order to determine how they should be treated in the cross-border context.[5] A proper comprehension of the distinction between insolvency and restructuring law as centering on the function of legal rules leads to the conclusion that preventive restructuring frameworks may give rise to cross-border insolvency or cross-border restructuring issues. This article proceeds on that basis and considers whether the EIR framework possesses the necessary infrastructure to accommodate the various cross-border issues that may be presented in the context of the new preventive restructuring frameworks.

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[1] T. Jackson, *The Logic and Limits of Bankruptcy Law* (Beard Books, 2001), p. 211; N. Tollenaar, 'The European Commission's Proposal for a Directive on Preventive Restructuring Proceedings' (2017) 30 *Insolvency Intelligence* 65, 71.

[2] This view is also reflected in the international best practice documents, such as the UNCITRAL Legislative Guide on Insolvency Law 2004 (United Nations, 2005): 'The first key objective of maximization of value is closely linked to the balance to be achieved in the insolvency law between liquidation and reorganization.'

[3] Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast) [2015] OJ 2 141/19.

[4] PRD (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending PRD (EU) 2017/1132 (PRD on restructuring and insolvency) [2019] OJ 2 172/18.

[5] I. Mevorach and A. Walters, 'The Characterization of Pre-Insolvency Proceedings in Private International Law' (2020) 21 *European Business Organization Law Review* 855.

2. The dichotomy of insolvency and restructuring law

2.1 Collective action problems and the origins of insolvency law

The most fundamental insolvency question is explaining the purpose of this area of law. In answering this question, economic analysis focuses on the problems of collective actions, which affect multiple creditors of a financially distressed debtor. The economic problem is conceptualised as a 'prisoners' dilemma'.[6] When multiple creditors are faced with the binary choice of whether to enforce their claims against the debtor's finite and insufficient assets, any creditor's optimal strategy is to enforce for fear that, if they wait, other creditors will be able to capture the assets for their own benefit.[7] This outcome generates significant costs, as creditors 'race to the courthouse' and expend valuable resources to satisfy their claims. Such a race also has *ex ante* costs. In fact, creditors, anticipating the destructive effect of a race of diligence, would be more reluctant to extend financing to the debtor in the first place. Even if they did, creditors would either place more onerous terms or spend additional resources in monitoring the debtor's conduct.[8] Thus, a debtor's inability to pay its multiple and diverse creditors creates a collective action problem that raises fundamentally different questions of principle than the conventional enforcement scenario in a typical bilateral debtor-creditor relationship. In the field of property law, similar collective action problems are usually described by the term 'tragedy of the commons'.[9] The same term can accurately describe the analogous insolvency scenario.

For this reason, it is argued that the function of insolvency law is to overcome collective action problems by realising the solution that the parties would reach in the absence of transaction costs. From an efficiency perspective, creditors would agree to minimise or eliminate the (*ex post* and *ex ante*) costs arising from a race of diligence by exchanging their private rights over the debtor's assets for a share in the proceeds arising from the liquidation of the common pool.[10] This would involve the suspension of creditors' private remedies and the vesting of the firm's assets with a third party, an insolvency trustee. Such trustee would be entrusted with liquidating the assets and distributing their proceeds to the various creditors, under a pre-determined distribution order. In short, the objective of insolvency law is to emulate the hypothetical bargain that the creditors would reach, if they could, in order to address the collective action concerns at the heart of the insolvency situation.[11]

The basic conclusion of the Creditors' Bargain Theory that insolvency exists primarily for the maximisation of distribution to beneficiaries, is widely considered a 'consensus goal' of any modern conception of insolvency law.[12] Naturally, this theory does not reveal exactly how insolvency laws should achieve this outcome. However, it is relatively straightforward to conclude that some of the most basic elements of any insolvency framework, such as the stay on creditor enforcement actions, the appointment of an insolvency trustee or transaction avoidance,[13] are specifically targeted at the common

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[6] For an alternative view, *see* R. McAdams, 'Beyond the Prisoner's Dilemma: Coordination, Game Theory, And Law' (2008) John M. Olin Law & Economics Working Paper No. 437. Available at: https://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=1087&context=law_and_economics (accessed: 12 August 2022).

[7] A. Rapoport, et al., *Prisoner's Dilemma: A Study in Conflict and Cooperation* (University of Michigan Press, 1965).

[8] Jackson (n 1), p. 16.

[9] G. Hardin, 'The tragedy of the commons' (1968) 162 Science 1242

[10] Jackson (n 1), p. 17. Such arrangements are called unitization arrangements, see G.D. Libecap and J.L. Smith, 'The Economic Evolution of Petroleum Property Rights in the United States' (2002) 31 *The Journal of Legal Studies* 589.

[11] T Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain' (1982) 91 *The Yale Law Journal* 857.

[12] J.L. Westbrook, 'The Control of Wealth in Bankruptcy' (2004) 82(4) *Texas Law Review* 798, 821. At the same time, some question the persuasiveness of this theory as a comprehensive theory of insolvency law, see R. Mokal, 'Contractarianism, Contractualism, and the Law of Corporate Insolvency' [2007] *Singapore Journal of Legal Studies* 51.

[13] R.J. de Weijs, 'Harmonisation of European Insolvency Law and the Need to Tackle Two Common Problems: Common Pool and Anticommons: Harmonisation of European Insolvency Law' (2012) 21 *International Insolvency Review* 67.

pool problem underlying insolvency scenarios.

2.2 Restructuring law and the limits of contractual bargaining

The hypothetical bargaining is not without critics when dealing with distressed yet viable firms. In such a scenario, a system of collective enforcement aimed at liquidating the assets of the firm is not the most efficient outcome. Instead, creditors would prefer if the firm were to continue operating and they retained a claim on its going concern value. Rescuing a firm can be accomplished either by a restructuring or a reorganisation. In a restructuring, creditors contribute a certain amount of resources in advance, usually in the form of a nominal reduction of their claims or new funds, so that the debtor may continue operating. These creditors retain an interest in the firm's going concern value (either in the form of debt or equity). Thus, if the firm has any going concern value, the hypothetical creditors bargain is radically different than the one suggested by the Creditor's Bargain Theory. Nevertheless, this conception does not assist us in determining how this form of hypothetical bargain is realised. In contrast to the insolvency scenario, the restructuring problem does not have a clear solution that can be determined *ex ante*. At the same time, the contracts between the debtor and its creditors are incomplete,[14] and so the parties would face insurmountable obstacles in setting out the process, by way of which a restructuring can be achieved.[15] The difficulties in determining a hypothetical restructuring bargain leave one alternative route, namely actual bargaining.[16]

However, multi-party bargaining under conditions of financial distress is not a simple task. As a matter of fact, contractual renegotiation can break down as a result of coordination failures within the creditor group.[17] In particular, multiple party bargaining is susceptible to the 'free rider problem'. This refers to the single creditor's preference to retain its own full claim against the firm, while other creditors bear the restructuring costs.[18] Creditors are essentially locked in a game of chicken,[19] where one party's gains are another party's losses. Furthermore, when a debtor negotiates with its creditors under incomplete information in a sequential bargaining setting, hold-out problems emerge. In such a scenario, the creditor who contributes first disseminates information about the debtor's financial situation.[20] Since consenting creditors effectively divert value to dissenting creditors by providing them with a bargaining advantage, each creditor, behaving strategically, has an incentive to withhold their consent until a later point in time and then bargain with the firm for a better deal.[21] Therefore, the function of restructuring law is to facilitate efficient bargaining in the face of coordination failures that cannot otherwise be addressed by contractual means. Restructuring law provides a collective procedure that enables effective bargaining between the debtor and its creditors under the supervision of a third-party, namely a court.[22] Such formal restructuring procedures contain a number of features that are specifically

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[14] On the definition of incomplete contracts, see: I. Ayres and R. Gertner, 'Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules' (1992) 101 *Yale Law Journal* 729, 729.

[15] A.J. Casey, 'Chapter 11's Renegotiations Framework and the Purpose of Corporate Bankruptcy' (2020) 120 *Columbia Law Review* 1709. Judicial gap-filling would also not work under conditions of financial distress, see Ayres and Gertner (n 14), 731.

[16] Casey (n 15), 1715.

[17] DG Baird and RC Picker, 'A Simple Noncooperative Bargaining Model of Corporate Reorganizations' (1991) 20 *The Journal of Legal Studies* 311.

[18] M.J. Roe, 'The Voting Prohibition in Bond Workouts' (1987) 97 *The Yale Law Journal* 232. However, Roe erroneously labels the problem as a prisoner's dilemma.

[19] R.J. de Weijs, 'Too Big to Fail as a Game of Chicken with the State: What Insolvency Law Theory Has to Say About TBTF and Vice Versa' (2013) 14 *European Business Organization Law Rev* 201.

[20] E. Rasmussen, *Games and Information* (Blackwell Publishing, 2007), p. 365.

[21] T.J. Miceli and K. Segerson, 'Land Assembly and the Holdout Problem Under Sequential Bargaining' (2012) 14 *American Law and Economics Review* 372.

[22] The involvement of the court separates the realm of restructuring law from out-of-court workouts, which are essentially contractual bargains and thus may suffer from bargaining breakdowns, in the form of hold-out and free-riding problems. Courts' involvement may range from direct involvement, in the form of the ratification of a plan that is agreed between the debtor and the qualified creditor majorities, to a more indirect involvement, such as the right of the creditors in a CVA to challenge the arrangement after it has become effective.

targeted at eliminating hold-out problems, most notably a majority decision rule that enables a debtor to agree on a binding restructuring plan with a qualified majority of its creditors.[23]

At the same time, this option also represents a real threat to minority creditors, who are exposed to hold up risk. This concept denotes the ability of a contracting party to strategically forfeit its contractual obligations and thereby deprive a creditor of its transaction-specific investment.[24] In the restructuring setting, if the majority power remains unrestrained, a firm's management can direct value away from minority creditors and deprive them of their contractual entitlements. Anticipating that they may be strong-armed into accepting unfavorable terms, creditors would be discouraged from extending credit or entering into contracts with the debtor *ex ante*.[25] In theory such concerns should not apply to sophisticated creditors, since they should have priced-in the risk of being coerced. [26] In reality, these inefficiencies cannot be fully subject to *ex ante* pricing.[27] As a result, if the majority decision-making features of restructuring law stood on their own, the law would merely have substituted one strategic behavior with another. In order to curtail the coercive power of creditor majorities, restructuring rules frequently limit majority powers. For instance, they mandate that creditors should be grouped into separate classes for voting purposes (so that a majority needs to be formed in each separate class) or, more importantly, that the plan should be examined and sanctioned by the court before it can be made binding on the dissenting minority. The sanctioning benchmark differs between jurisdictions.[28] Despite this, the common thread is that a court will need to assess whether the approved plan addresses genuine hold-out problems or whether it simply holds minority creditors up.[29] In short, restructuring law promotes efficient bargaining by addressing creditor coordination failures and balancing hold-out and hold-up risk.

2.3 A novel theory of the separate domains of insolvency and restructuring rules

The preceding analysis suggests an important distinction between insolvency and restructuring law. On the one hand, insolvency addresses primarily a common pool problem, where the pre-eminent consideration is asset preservation, in the face of a 'tragedy of the commons' scenario. On the other hand, restructuring rules deal with a scenario that is similar to the 'tragedy of the anticommons',[30] where

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[23] Majority decision-making eliminates the pitfalls of sequential bargaining with numerous parties. Majority voting with a continuum of creditors is essentially equivalent to a bilateral bargaining game between the debtor and the marginal creditor at the voting threshold. See A.G. Haldane et al., 'Analytics of sovereign debt restructuring' (2003) Bank of England Working Paper Series n. 203. Available at: https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2003/analytics-of-sovereign-debt-restructuring.pdf?la=en&hash=9CADAFF79AF4CF33BE2EB258CD4B30D64F50812E (accessed: 12 August 2022).

[24] The hold-up problem is essentially the reverse version of the hold-out problem: T.J. Miceli and K. Segerson, 'Holdups and holdouts: What do they have in common?' (2012) 117 *Economics Letters* 330.

[25] T.J. Miceli and K. Segerson, 'Opportunism in Sequential Investment Settings: On Strategies for Overcoming Holdups and Holdouts' (2014) University of Connecticut Working Papers. Available at: https://www.semanticscholar.org/paper/Opportunism-in-Sequential-Investment-Settings-%3A-On-Miceli-Segerson/ed621d8c644d4cd13862d1243f4697f0344c2d9f (accessed: 12 August 2022) .

[26] S Paterson, 'Debt Restructuring and Notions of Fairness: Debt Restructuring and Notions of Fairness' (2017) 80 *Modern Law Review* 600.

[27] This can be attributed to the general problem of contractual incompleteness, which is attenuated by the fact that, though financial distress may be a predicable (and thus, to some extent, quantifiable) risk, it is also largely idiosyncratic. On this, see Casey (n. 15), 1741.

[28] Under the US Bankruptcy Code for instance, the court may approve a plan if it is "fair and equitable", a requirement that has been associated with the need to provide dissenting creditors at least with the liquidation value of their claims and, in case the cramdown tool is employed, that their statutory priority is respected, and they are not unfairly discriminated [11 U.S.C. § 1129(b)(2)]. In an English scheme of arrangement, a court will consider whether the majority has been acting *bona fide* in deciding whether to exercise its jurisdiction to sanction a scheme. On this point, see: J. Payne, 'The Role of the Court in Debt Restructuring' (2018) 77 *Cambridge Law Journal* 124.

[29] S. Madaus, 'Leaving the Shadows of US Bankruptcy Law: A Proposal to Divide the Realms of Insolvency and Restructuring Law' (2018) 19 *European Business Organization Law Rev* 615, 636.

[30] M. Heller, 'The Tragedy of the Anticommons: Property in the Transition from Marx to Markets' (1998) 111 *Harvard*

the existence of multiple and diverse ownership interests creates problems of coordination that lead to the under-use of a common resource, the debtor's going concern value.[31] It follows that the rules of insolvency law, such as the stay on individual enforcement or transaction avoidance actions, are concerned with the problem of collective action over a scarce asset pool. However, the rules of restructuring law, such as majority decision making or court sanctioning requirements, aim at solving a non-cooperative bargaining problem, by addressing hold-up and hold-out problems in the context of contract renegotiation.[32]

This conclusion should not be construed to suggest that, since the underlying economic problems are different, the rules are also mutually exclusive. As already noted, financial distress can give rise to both types of situations. It is very common that a financially distressed firm may face both the challenge of asset preservation as well as consensus building and, therefore, require both asset protection measures as well as a mechanism to bind hold-out creditors to a collective arrangement. In fact, many collective proceedings, most notably the United States (US) Chapter 11, include both types of legal rules. Still, it should be emphasised that this doctrinal distinction exists at the level of legal rules. Collective proceedings, irrespective of their labels as insolvency or restructuring proceedings, frequently utilise both types of rules.[33]

At the same time, it is important to note that this dichotomy is not predicated on the assumption that restructurings are contractual solutions. In fact, as has been demonstrated, restructuring law exists precisely due to the inadequacy of bilateral contracting to deal with the free-rider and hold-out problems in the context of contractual renegotiation. From that perspective, restructuring law differs fundamentally from out-of-court workouts that employ exclusively contractual solutions, such as exchange offers or majority decision-making clauses in bond indentures.[34] Unlike exchange offers, which are fundamentally voluntary transactions, restructuring plans make an arrangement approved by the statutory majorities of creditors (and members) binding on the minority, irrespective of any form of consent on the part of the affected creditor constituency. Restructurings, therefore, are an exception to freedom of contract, which stems from the realisation that, in the context of financial distress, creditor autonomy may lead to inefficient outcomes, as a result of constraints of creditor coordination.[35] As a result, the dichotomy proposed in this paper differs both from the unitary approach as well as from the contractual approach.

Insolvency and restructuring are related fields since they both deal with problems in the context of a firm's financial distress. However, they differ in one significant respect; whereas insolvency rules are approached from the perspective of hypothetical bargaining, restructuring shifts the focus to actual bargaining.

3. Separate domains in private international law

3.1 Universalism and the collective action problem

The above-mentioned dichotomy is not only relevant for the analysis of substantive insolvency and

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[31] de Weijs (n 19).

[32] Casey (n. 15), 1733.

[33] As a matter of fact, modern financial restructurings frequently present minimal collective action concerns: S. Paterson, *Corporate Reorganization Law and Forces of Change* (Oxford University Press, 2020), p. 109.

[34] R. Gertner and D. Scharfstein, 'A Theory of Workouts and the Effects of Reorganization Law' (1991) 46 *Journal of Finance* 1189, 1202.

[35] The example of a party that has agreed to conclude a contract and, because of their unwillingness, is compelled by a court to conclude the final agreement, as used by Madaus (n 29) 626 is quite different. In that case, the party has already entered into a binding contractual arrangement to enter into an agreement and is unwilling to comply voluntarily, hence the compulsion. In the case of restructuring agreements however, a dissenting creditor has not entered into any voluntary agreement that could justify him being bound against his will.

restructuring law. It can also inform our understanding of the private international law rules of insolvency and restructuring procedures. The link between the function of substantive rules and the structure of private international law in the field of insolvency has been a long-recognized feature of cross-border insolvency law.[36] In reality, the preponderant function of insolvency law to solve collective action problems and ensure asset preservation can explain why a universalist approach[37] is generally considered the most appropriate and efficient in cross-border insolvency scenarios. The main argument in favor of a single universal proceeding taking place at the debtor's Centre of Main Interests ('COMI') has rested, at least implicitly, on efficiency claims. If insolvency proceedings were not universal, foreign creditors would not be affected and would be able to initiate a destructive race against the debtor's assets located abroad.[38] A universalist solution avoids this outcome and reduces the costs associated with resolving financial distress. Even if an insolvency proceeding were initiated in multiple jurisdiction based on the location of the debtor's assets,[39] universalism would still be the superior solution, as it would avoid the costs of parallel proceedings.[40] By providing a single forum and single law solution, universalism increases predictability for creditors and thereby promotes efficient *ex ante* allocation of capital.[41] This line of reasoning emphasises how a globally collective procedure and a single set of applicable rules can address collective action problems, irrespective of the location of assets and creditors, thereby reducing the costs associated with financial distress. While these arguments are often covered in a political economy vernacular,[42] there is in reality a close link between universalism and the objectives of insolvency law, as a mechanism that addresses a collective action problem.

The EIR is perhaps the closest practical manifestation of universalist principles in cross-border insolvency matters. It is a comprehensive legal framework of conflict of law rules that address the legal problems that arise in a cross-border insolvency scenario by providing solutions on the issues of jurisdiction, applicable law, recognition and enforcement and many other ancillary matters.[43] The most fundamental aspect of the EIR framework is the recognition principle. If a debtor has its COMI in a Member State, an insolvency proceeding in such Member State benefits from automatic recognition across the EU.[44] Recognition is automatic in the sense that no additional formalities, such as an *exequatur* proceeding, are required.[45] As a result, the consequences of insolvency in the debtor's home jurisdiction, most notably the stay on creditor enforcement actions, are extended throughout the EU.[46] The extension principle rule ensures that the debtor's assets are protected, under the terms of the *lex fori concursus,*[47] irrespective of where they are situated. It precludes a cross-border race between creditors that would destroy value. In addition, the appointed insolvency practitioner has authority to exercise all powers conferred by the *lex fori concursus,* including the removal of assets to the jurisdiction of the main proceeding. Although the EIR includes certain deviations from the universalist

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[36] Savigny for instance had noted that before examining the private international law of insolvency 'it is necessary to understand the peculiar nature of bankruptcy': F.C. von Savigny, *A Treatise on the Conflict of Laws and the Limits of their Operation in Respect of Place and Time,* (T&T Clark, 1869), p. 209

[37] This is the application of a single law, the law of the debtor's domicile, by a single court over the entire bankruptcy process. See, among others: J.L. Westbrook, 'A Global Solution to Multinational Default' (2000) 98 *Michigan Law Review* 2276.

[38] J.L. Westbrook, 'Theory and Pragmatism in Global Insolvencies: Choice of Law and Choice of Forum' (1991) 65 *American Bankruptcy Law Journal* 457.

[39] This approach is widely known as territorialism: J. Chung, 'The New Chapter 15 of the Bankruptcy Code: A Step Toward Erosion of National Sovereignty' (2007) 27 *Northwestern Journal of International Law and Business* 89.

[40] Ibid.

[41] L.A. Bebchuk and A.T. Guzman, 'An Economic Analysis of Transnational Bankruptcies' (1999) 42 *Journal of Law* and Economics 775; A.T. Guzman, 'In Defense of Universalism' (2000) 98 *Michigan Law Review* 2177.

[42] K.H. Nadelmann, 'An International Bankruptcy Code: New Thoughts on an Old Idea' (1961) 10 *International & Comparative Law Quarterly* 70. Westbrook (n 38) 2283.

[43] R. Bork, 'The European Insolvency Regulation and the UNCITRAL Model Law on Cross-Border Insolvency: EU and UNCITRAL Cross-Border Insolvency' (2017) 26 *International Insolvency Review* 246, 250.

[44] Article 19(1) EIR.

[45] R. Bork and K. van Zwieten, *Commentary on the European Insolvency Regulation* (Oxford University Press, 2016), p. 308.

[46] Article 20(1) EIR; Article 7(2)(f) EIR.

[47] Bork and van Zwieten (n 45), 317.

paradigm (such as the possibility of secondary and territorial proceedings), such deviations do not alter the function of the EIR framework. Such framework is primarily designed to solve a cross-border collective action problem and ensure that firm value is protected in the face of financial distress.

3.2 Addressing cross-border holdouts in the restructuring setting

Approaching the field of cross-border restructuring, the first observation that must be made is that foreign elements in the restructuring context can reintroduce or amplify the hold-out problem. If foreign creditors are able to evade the binding effect of a collective arrangement, they would essentially have a valid and enforceable 'exit option' from the bargaining process.[48] These creditors would be able to force the debtor to pay them in full. Anticipating this, all foreign creditors would engage in a similar behavior and the debtor's entire restructuring would unravel. Even if the number of foreign creditors were not large enough to 'sabotage' the entire restructuring, the diversion of value from domestic to foreign creditors would significantly diminish the domestic creditors' incentives to extend credit or engage in business with the debtor. To avoid this outcome, the debtor would need to commence a parallel restructuring proceeding. This would lead to parallel bargaining in every jurisdiction where they have assets. Overall, this would significantly increase costs and undermine the chances of business rescue. As a result, the potential for fragmentation of collective bargaining in the cross-border setting can substantially jeopardise the objectives of restructuring law. Considering the above, it seems incontrovertible that cross-border restructuring should facilitate the universal recognition of restructuring plans, irrespective of the law that governs the legal relationship between the debtor and the creditor. Recognition would essentially guarantee that a foreign plan has a preclusive effect on any claims by dissenting creditors against the debtor.

Nevertheless, while this approach is correct in principle, it is incomplete. As already noted, restructuring law tries to balance two countervailing considerations: facilitating business rescue by combating strategic hold-out behaviour while protecting minority creditors against the risk of hold ups. This latter aspect is even more important in a cross-border setting, where the possibility of hold ups is amplified not only because restructuring laws differ materially across jurisdictions but also due to the fact that courts in different jurisdictions may have varying degrees of institutional capacity to police hold-up behaviour.[49] As a result, creditors may be exposed to greater risks of being strong-armed into a plan that deprives them of their interests than in a purely domestic framework. This suggests that the basic structure of the cross-border restructuring framework should allow a court to refuse the recognition of foreign restructuring plans. As a result, a proper understanding of the function of restructuring law suggests that an efficient rule for cross-border restructurings should combine a basic rule of recognition, as a means of reinstating the collective bargaining process, with a defense to such recognition, in order to ensure some minimum measure of protection for dissenting minorities.

The EIR provides a recognition rule that can satisfy the above requirements. In particular, the EIR stipulates that judgments issued by the court of the debtor's COMI, such as those concerning the closure of proceedings or the approval of compositions between creditors, are entitled to automatic recognition.[50] As a result, a judgment approving a restructuring plan receives automatic recognition throughout the EU, as long as it is issued by the court of the debtor's COMI. The effect of recognition is that dissenting creditors are precluded from asserting their claims against the debtor, in contravention to the stipulations of the restructuring plan. In addition, the EIR provides that such judgments may be enforced in accordance with the provisions of the Brussels I Regulation.[51] The only defense to

[48] Baird and Picker (n 17).

[49] M.A. McGowan and D. Andrews, 'Design of Insolvency Regimes Across Countries' OECD Economics Department Working Papers No. 1504, p. 33. Available at: https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=ECO/WKP(2018)52&docLanguage=En (accessed: 12 August 2022); C. Bridge, 'Insolvency – a second chance?; (2013) *EBRD Law in Transition Journal* 23.

[50] Article 32 EIR.

[51] Ibid.

recognition is manifest contrast to public policy.[52]

One issue that remains not fully explored is how broadly the public policy defense can be construed when considering the recognition of a foreign restructuring plan under Article 32 EIR. In general, it is argued that the public policy exception should not be used to enable a revision of the merits of the foreign judgment but may only be resorted to in exceptional circumstances.[53] The way in which this problem can be manifested in cross-border restructurings was illustrated in an early French case from the 1940s. In the *Portuguese Railroads* case,[54] a French court was asked to recognise, in an *exequatur* procedure, a restructuring plan of the Portuguese Railroads corporation that had been approved by the courts of Lisbon and modified the claims of French bondholders. The French courts refused to recognise the plan arguing that, because each series of bondholders had not voted in a separate class, the judgment violated French public policy. The restrictive interpretation of public policy promoted by the EIR suggests that nowadays a similar case would be decided in a different way. Nevertheless, the EIR seems to provide an overall definitive answer to the issues presented in the context of cross-border restructurings.

3.3 Recognition of plans and recognition of proceedings

The difference between insolvency and restructuring law is reflected in the structure of their respective cross-border framework. In cross-border insolvencies, the central consideration is the universal recognition of proceedings. This is an issue of greater complexity than traditional judgment recognition. The recognition of an insolvency proceeding is important because it enables the extension of the immediate consequences of the opening order to a foreign jurisdiction, especially the stay on individual creditor enforcement actions. Moreover, it provides the insolvency practitioners with authority in the foreign jurisdiction to undertake all the subsequent steps that ensure the collective nature of the process, such as the marshalling of the assets and the verification of claims. In cross-border restructurings, the main issue is the recognition of the restructuring plan in a foreign jurisdiction. The main objective is to ensure that the provisions of the plan have preclusive effect against dissenting creditors, irrespective of their location or the law governing their claims. At the same time, an efficient cross-border restructuring framework also needs to specify the grounds for non-recognition of foreign plans, as a means to address the countervailing consideration of minority protection. Both of these aspects can be reflected in a traditional, albeit varied, judgment recognition framework. As a result, the dogmatic distinction between 'insolvency' and 'restructuring' can be conceptualised in the cross-border setting as a distinction between the recognition of proceedings and the recognition of plans.

It is again important to note that issues of recognition of insolvency proceedings and restructuring plans may arise concurrently. A firm, subject to formal restructuring proceedings in its COMI, but having assets and creditors in different jurisdictions, may in fact require both types of relief. The insolvency proceeding may need to be recognized in the foreign jurisdictions in order to protect the debtor's foreign assets. Following the successful adoption of a plan, that plan may need to be recognised, in order to bind foreign creditors and preclude them from bringing fresh actions against the debtor. As a matter of fact, the EIR framework is predicated on the assumption that both types of relief will be necessary to ensure a debtor's successful restructuring. Thus, under the EIR, a judgment approving a plan will be recognised under Article 32 EIR only if it is approved by a court, whose commencing judgment has already been recognized pursuant to Article 19 EIR.[55] This need not however be the case. Modern financial restructurings frequently raise only hold-out and hold-up concerns, meaning that the debtor is more concerned with making the collective arrangement effective against potential dissenting creditors,

[52] Art. 33 EIR.
[53] R. Bork and R. Mangano, *European Cross-Border Insolvency Law* (Oxford University Press, 2016), p. 186; 'Virgós–Schmit Report' (1996), para. 203.
[54] This case is examined in K.H. Nadelmann, 'Compositions: Reorganizations and Arrangements: In the Conflict of Laws' (1948) 61 *Harvard Law Review* 804.
[55] A similar recognition rule is provided in the German Insolvency Code (InsO); a foreign restructuring plan shall be recognized, if it implements or terminates a *recognized* insolvency proceeding section 343 InsO.

as opposed to preventing a race against the debtor's assets.[56] These developments highlight the distinction between questions of recognition of proceedings and recognition of plans are fundamentally different, even if they are frequently treated as being essentially similar.

4. The treatment of the new preventive restructuring proceedings under the EIR

4.1 Between asset preservation and hold-out resolution

On the basis of the above distinction, we can now try and consider the issues posed by introduction of preventive restructuring frameworks. As already noted, there seems to be no point in attempting to characterise a framework in its entirety, considering that it is possible for a single proceeding to combine elements of both insolvency and restructuring law. This is especially clear when it comes to preventive restructuring proceedings. As a general matter, they can be conceptualised as structured bargaining proceedings,[57] significantly influenced by the Chapter 11 of the US Bankruptcy Code,[58] whose objective is to achieve a restructuring of the debtor's business through the adoption of a restructuring plan. Still, they differ from traditional formal restructuring proceedings, as they are envisaged as flexible procedures with minimal court involvement. These procedures are made available before the onset of formal insolvency[59] and they lie somewhere in the middle between a pure contractual workout and a formal insolvency or rehabilitation proceeding.[60] Considering the general characteristics of preventive restructurings, the PRD centers, rather unsurprisingly, around elaborate rules of multi-party bargaining and decision-making. These rules include the formation and constitution of creditor classes [Articles 9(4)-(5) PRD], voting requirements [Article 9(6) PRD], the requirement for the plan to be approved by a court [Articles 10(1)-(2) PRD] as well as the substantive requirements for such approval [Article 10(3) PRD], including the option for plan approval over the objections of a creditor class (cross-class cramdown). Based on the above elements, the purpose and function of a preventive restructuring is to bind all parties, even dissenting creditors (Article 15 PRD), provided that certain requirements are met. The PRD's provisions ensure that 'dissenting creditors are well looked after'.[61] At the same time, the PRD includes important rules geared towards addressing collective action concerns. In particular, the PRD envisages a stay on individual enforcement actions, as a means to safeguard and support the negotiations between a debtor and its creditors (Article 6 PRD). These provisions can be viewed as complementing the collective bargaining and decision-making rules of the PRD, by ensuring that collective action concerns do not undermine the bargaining process. In short, preventive restructuring proceedings include provisions that fulfill both asset preservation as well as hold-out resolution functions.

The above analysis has some important implications for the cross-border effects of the PRD. On the one hand, since the objective of preventive frameworks is the adoption of a restructuring plan, the ability to recognize and enforce such plan in every Member State is of crucial importance. At the same time, the cross-border aspects of the new preventive restructuring frameworks are not utterly achieved through the recognition of the resulting restructuring plans. They need to include the recognition the commencement of proceedings in order to ensure that the stay envisaged in the PRD takes effect throughout the EU and thus that restructuring negotiations are safeguarded. In short, the introduction of the PRD is likely to raise two sets of issues, the recognition of the commencement of a preventive

[56] S. Paterson, 'Rethinking Corporate Bankruptcy Theory in the Twenty-First Century' (2016) 36 *Oxford J Legal Studies* 697.
[57] H. Eidenmüller, 'Contracting for a European Insolvency Regime' (2017) 18 *European Business Organization Law Review* 273.
[58] G. McCormack, *The European Restructuring Directive* (Edward Elgar Publishing, 2021), p. 28.
[59] Article 1(1)(a) PRD.
[60] Mevorach and Walters (n 5) 858.
[61] McCormack (n 58), p. 10.

restructuring proceeding as well as the issue of the recognition of the preventive restructuring plan. Still, it is perhaps safe to say that the aspect of plan recognition will be the most important one. Therefore, it is important to consider whether this can be addressed sufficiently in the context of the EIR.

4.2 The treatment of preventive restructurings under the EIR

Although, as already analysed, the EIR provides a solution to the question of plan recognition, it only does so in conjunction with the question of the recognition of proceedings. A judgment that approves a plan can be recognised and enforced only as long as the proceeding itself benefits from automatic recognition. But in order for a proceeding to benefit from such automatic recognition, it has to fall within the EIR's scope and thus under the definition of an 'insolvency proceeding' under art. 1 EIR. This can provide some justification of the reason that much of academic commentary has focused primarily on the question of whether the new preventive restructuring frameworks can qualify as insolvency proceedings within the meaning of the EIR.[62] This is considered the single (and perhaps easiest) avenue, by virtue of which the resulting plans may be recognised. However, this 'proceeding-centered' approach is predicated on a fallacious understanding of the objective of restructuring law and how the need for hold-out resolution may arise independently of an insolvency proceeding. As a result, there is an obvious imbalance between the basic assumptions underlying the EIR - namely that a plan may only be produced within the context of a formal insolvency proceeding - and the characteristics of preventive restructuring frameworks as rather informal, pre-insolvency interventions.

From a practical standpoint, this disparity may be of little relevance, as long as preventive restructuring frameworks may be classified as insolvency proceedings. Considering the dispositive nature of the EIR's Annex I,[63] it is clear that, if a Member State has introduced amendments to existing proceedings already listed in Annex I in light of the PRD, such proceedings, as well as the plans that are approved in their context, will be automatically recognised throughout Europe. If, on the other hand, Member States introduce new restructuring proceedings that fall outside the EIR's scope, such proceedings may be added to the Annex if they meet the criteria set out in the EIR. It would seem difficult to make such a determination, solely on the basis of the PRD, as it strives to provide Member States with flexibility in adopting its principles and provisions.[64] At the same time, the PRD underlines that its aim is for both instruments to be fully compatible.[65] In general, it is fair to assume that the majority of preventive restructuring proceedings will be 'public collective proceedings', within the meaning of the EIR.[66] In addition, preventive restructurings will generally be 'based on the laws relating to insolvency, for the purpose of rescue, adjustment of debt, reorganisation or liquidation'. Whether all preventive restructuring frameworks will meet one of the three additional criteria of Article 1(1) EIR is a more difficult question to answer. In general, preventive restructuring frameworks are envisaged as debtor-in-possession ('DIP') frameworks, where no insolvency practitioner is appointed and thus a debtor will not generally be divested of its assets, as required by Article 1(1)(a) EIR.[67] However, the fact that a court may lift the stay on individual creditor enforcement actions[68] could be considered sufficient to fulfill the requirement that the assets of the debtor are subject to court supervision under Article 1(1)(b) EIR. Finally, although the PRD envisions a stay, it does not provide that the expiry of the stay without the adoption of a plan constitutes, in itself, a reason to commence a formal liquidation.[69] Thus, meeting

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[62] Mevorach and Walters (n 5).

[63] Recital (9) EIR; R. Bork and R. Mangano, *European Cross-Border Insolvency Law* (Oxford University Press, 2016). In addition, courts of Member States may not second-guess the inclusion of a proceeding in the Annex, Bork and van Zwieten (n 4545), p. 76.

[64] Recital 16, EIR.

[65] Recital 13, EIR.

[66] D. Skauradszun and W. Nijnens, 'Brussels Ia or EIR Recast? The Allocation of Preventive Restructuring Frameworks' (2019) 16 *International Corporate Rescue* 193, 200.

[67] See however Article 5(3) PRD.

[68] Article 6(9) PRD.

[69] Article 7(7) PRD.

the requirements laid out in Article 1(1)(c) EIR may in reality be more complicated than it seems. Whereas most preventive restructuring proceedings will satisfy the requirements of Article 1(1) EIR and thus be eligible to be added to the Annex, it is not inconceivable that some may not due to their lack of conformity to the EIR's requirement or rather as a result of policy choice.[70]

What are the fallback options if the restructuring plans do not fall within the scope of the EIR? One obvious alternative would be to resort to the provisions of the Brussels I Regulation.[71] Considering that the recognition of plans is fundamentally an issue of judgment recognition, the provisions of the Brussels I Regulation could be applicable in these cases. This would ensure that plans benefit from automatic recognition across the EU. The problem with this approach is that it seems to run contrary to the Brussels I Regulation's exclusion of 'proceedings relating to compositions, judicial arrangements and analogous proceedings'.[72] Even if preventive restructuring frameworks are not composition proceedings, they are certainly analogous to compositions, as their objective is the restructuring of the debtor's business.[73] A further alternative that has been proposed would be to recognise the effects of restructuring plans pursuant to the provisions of the Rome I Regulation.[74] As already noted, this would presuppose that restructurings are creatures of contracts, a proposition that contradicts the purpose of restructuring law. The only remaining alternative would be to apply the national rules of Member States on the recognition of foreign judgments. This is not necessarily a bad outcome; after all, many jurisdictions adopt this approach in the recognition of plans originating outside the EU.[75] One issue that remains significant is the potential application of the public policy defense. Could the application of national rules lead to an outcome similar to the case of *Portuguese Railroads*, namely the rejection of recognition? As a matter of fact, refusal of recognition on the grounds of inadequate minority protection, should be an indispensable aspect of a cross-border restructuring framework. Nevertheless, the PRD establishes uniform rules on minority protection in the context of preventive restructurings. This means that it very unlikely that a preventive restructuring plan would be refused recognition in another EU Member State on the basis of public policy. As a result, even if EU private international law rules are not applicable, the harmonising effect of the PRD and its detailed provisions on the requirement and safeguards for the approval of restructuring plans should ensure that restructuring orders are recognised under the national rules of recognition of judgments.

5. Conclusion

The new preventive restructuring frameworks expose an imbalance in our contemporary thinking about cross-border restructurings. Traditionally, restructurings were only possible within the context of a formal proceeding, which necessitated, from a private international law perspective, the recognition of proceedings before any recognition of the restructuring plan *per se*. However, over the last decades, insolvency and restructuring law have become ever more separate from one another. As a result, the restructuring of a distressed firm may now be achieved before the onset of any formal insolvency, by virtue of a light-touch proceeding that approves a restructuring plan in a limited time span. In that context, the quintessential problem of cross-border insolvency, namely the recognition of proceedings in a foreign jurisdiction, may hold little relevance, where the primary objective of the commencement of such proceedings is not to take advantage of a stay on creditor enforcement actions but rather to bind

[70] Skauradszun and Nijnens (n 66), 199.
[71] Ibid, 195.
[72] Article 1(2) Brussels 1 Recast.
[73] It has been suggested that this exception has to be interpreted strictly in order to ensure the dovetailing between these two regulations, meaning that if a proceeding does not fall within the EIR's scope then it will be covered by Brussels I Recast see Bork and van Zwieten (n 45), p. 88.
[74] S. Madaus, 'The Cross- Border Effects of Restructurings' [2021]. Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4045334 (accessed: 12 August 2022); J. Windsor and P. Sidle, 'International Recognition of Schemes of Arrangement' (2010) 10 *Butterworths Journal of International Banking and Financial Law* 523.
[75] H. Eidenmüller, 'The Rise and Fall of Regulatory Competition in Corporate Insolvency Law in the European Union' (2019) 20 *European Business Organization Law Review* 547, 562.

dissenting creditors to a collective bargain. In that context, the recognition of restructuring plans, which has long treated as a mere corollary to the recognition of proceedings, is gaining new importance as a fundamental issue that is likely to be posed by the new preventive restructuring frameworks.

Under the EIR, this issue can largely be addressed by the operation of the principle of automatic recognition, provided that any resulting uncertainties as regards the EIR's scope will be addressed. Still, the harmonising effect of the PRD, especially as regards the rules governing the protection of dissenting minorities, suggests that the same effect can be achieved even if the recognition of preventive restructuring plans will need to be addressed through national rules of judgment recognition. This analysis suggests that the PRD is not important merely because of the practical challenges that it may pose in the cross-border setting. More conceptually, the PRD is an important development for an additional reason: it presents a unique opportunity to recognise the growing autonomy of cross-border restructuring law and consider the possible directions for a further development of this field.

Chapter 2

Insolvency law: quo vadis? About the regulatory protection of non-controlling unsecured creditors prior to and during insolvency proceedings

Dennis CARDINAELS*

1. Introduction

Although a lot of scholarly attention was dedicated to corporate governance topics in the aftermath of the financial crisis in 2007-2008, similar regulatory, economic and practical issues within insolvency governance have only been given scant attention.

Nonetheless, there is a stark similarity between corporate and insolvency governance. This analogy provides useful insight in insolvency governance, as it enables to re-examine the regulatory insolvency framework and, in particular, the protection of unsecured minority creditors.

This paper focuses on both reorganisation/restructuring and insolvency/bankruptcy procedures. It elaborates on the pitfalls of the current Belgian, English and EU regulatory frameworks as regards the more vulnerable creditors. The words weak, vulnerable, non-controlling and minority creditors will be used interchangeably throughout this paper to refer to these creditors. The paper provides suggestions to enhance the regulatory protection of vulnerable unsecured creditors.

2. Analogy between corporate governance and insolvency governance

As indicated above, there is a stark similarity between corporate and insolvency governance both in terms of the actors as well as in terms of the agency problems that could occur in these scenarios.

In terms of the actors, the debtor's unsecured creditors can, arguably from an economic perspective,[1] be compared to the company's shareholders as from the moment the company enters into financial difficulties[2] the unsecured creditors become the residual risk-bearers.[3] This is because, at that point, there are normally not enough assets to repay the creditors and grant a return to the shareholders who, therefore, are no longer the company's residual owners. If the company is liquidated, the monetary

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[1] This is based upon law and economics scholarship whereby it is asserted that the unsecured creditors replace the shareholders' position as residual risk-bearers once the company becomes financially insolvent. Surely (and as explained extensively below), this does not deny that some unsecured creditors such as for example utility companies or landlords may have a stronger position compared to other unsecured creditors who might be in a more vulnerable/weaker position.

[2] *BTI 2014 LLC v Sequana SA* [2019] EWCA Civ 112 where Richards LJ, however, declined to express a view other than when a company is actually insolvent.

[3] R. Kraakman et al., *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford University Press, 2009), p. 36; A. Keay and H. Zhang, 'Incomplete Contracts, Contingent Fiduciaries and a Director's Duty to Creditors' (2008) *Melbourne Law Review* 143.

equivalent of the residual assets will be distributed rateably amongst these unsecured creditors.[4]

Unless the company's directors remain in office during the procedure (i.e. during debtor-in-possession procedures), an office-holder (e.g. a liquidator) will be appointed to act as a fiduciary and agent of the financially distressed company in the interests of the latter company and for the benefit of all its creditors.[5] As this office-holder who is a qualified individual will be in control of the affairs of the company, their duties can, *mutatis mutandis,* be compared with the duties of the directors of the company.[6] Subsequently, once appointed, both the board of directors and the company's office-holder(s) act as agents of that company.[7]

Still on the topic of similarities between corporate and insolvency governance, although it is likely that the company will lack sufficient financial resources once it enters into a restructuring procedure, even a financially distressed company may well continue or enter into fresh contracts with third parties both before and after its commencement.[8] For instance, the debtor may need to continue paying the employees' wages.[9] From a *legal* perspective, these third parties will usually also be 'creditors'. However, due to their different *economic* relation to the debtor as their expertise is often needed to ensure a company can continue operating during rescue procedures, they would be granted a certain preferential position (in a liquidation scenario). This is why they can be distinguished from 'ordinary' unsecured creditors who rely on contracts/agreements entered into *before* the debtor became insolvent.

Having compared the 'roles' of the important actors in a financially distressed company with the actors in a solvent company, it can be observed that, economically, similar opportunistic agency problems may be identified in both scenarios.

First, similar to the agency conflict between shareholders and the board of directors within a solvent company, a conflict between the interests of the unsecured creditors and either the incumbent debtor company's management or the officeholder might arise. The fewer assets being available in the financially distressed company, the more risks unsecured creditors may want to take[10] provided they believe that by taking this risk the benefits will outweigh the costs of this risk and they are, if nothing is done, likely to get nothing in the distribution or restructuring phase.

Second, akin to the conflict that exists between the majority and minority shareholders, in insolvency situations one subset of unsecured creditors may be more able to influence the decision-making process than other unsecured creditors.[11] For instance, this would be the case if one unsecured creditor holds the majority of the votes needed to approve a plan whilst other unsecured creditors lack the ability to block a plan detrimental to their interests. The majority creditor may use their voting rights to act in their own self-interest even if this would be detrimental for the other unsecured creditor(s) or even to the company as a whole.

Third, there is also a potential issue between the debtor (managed in the interests of the unsecured creditors) and the third contracting parties. For instance, this is the case when the position of unsecured creditors would conflict with third parties such as legal professionals hired by the insolvency practitioner. Their fees are paid as administrative expenses prior to the unsecured creditors getting any dividend payment. Without elaborating further on this issue, it is this agency conflict which has been addressed quite extensively by Insolvency Code of Ethics by the Institute for Chartered Accountants of

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[4] A. Keay, 'Wrongful trading and the liability of company directors: a theoretical perspective' (2005) *Legal Studies* 433; T.H. Jackson, *The Logic and the Limits of Bankruptcy Law* (Beardbooks, 2001), p. 22.

[5] H. Anderson, *The Framework of Corporate Insolvency Law* (Oxford University Press, 2017), pp. 117-121.

[6] Jackson (n 4), p. 22.

[7] In relation to liquidation: *Knowles v Scott* [1891] 1 Ch 717 (Ch); in relation to administration: Sch. B1, para 69 Insolvency Act 1986 ('IA 1986'); in relation to CVA, this is meant to be determined in the terms of the CVA: Anderson (n 5), p. 121.

[8] A. Keay and P. Walton, *Insolvency Law: Corporate and Personal* (Jordan Publishing Limited, 2012), p. 516.

[9] Ibid, 516.

[10] J. Vananroye, 'Organisatierecht: werfbezoek aan een onvoltooide piramide', (2014) *Acta Falconis*, 30-33.

[11] Kraakman (n 3), p. 36.

England and Wales (ICAEW).[12]

All this can be summarised in the following table:[13]

Table 1. Opportunistic risks in active and financially distressed companies

	Solvent company		***Distressed company***
1	*Shareholders*	≅	*Unsecured creditors*
2	*Management*	≅	*Management or Office-holder*
3	*Third party constituents*	=	*Third party constituents*
	Opportunistic conflicts solvent company		***Opportunistic conflicts distressed company***
1	*Shareholders vs. management*	≅	*Unsecured creditors vs. incumbent management / office holder*
2	*Majority (controlling) shareholders vs. minority (non-controlling) shareholders*	≅	*Controlling unsecured creditors vs. non-controlling unsecured creditors*
3	*Company (particularly its shareholders) vs. third parties*	≅	*Company (particularly its unsecured creditors) vs. third parties*

The existence of similar opportunistic problems when the company becomes financially distressed can further be illustrated through various scenarios.

3. Agency conflicts between majority and minority unsecured creditors

A first example concerns the relatively recent English case *Gertner & Anor v CFL Finance Ltd*[14] whereby one of Mr. Gertner's creditors, Kaupthing Bank, had received a controlling position in the Individual Voluntary Arrangement ('IVA') of Mr Gertner which it had used to the detriment of the other unsecured creditors of Mr. Gertner. This was because Kaupthing Bank had used its strong position to enter into a hidden profit-sharing agreement with the debtor, thus giving Kaupthing not only a certain dividend under the IVA, but also a very large payment from the aforementioned arrangement.[15] Entering into this agreement which, at the time of the creditors' meeting, was not disclosed to other creditors was a precondition without which Kaupthing would have not voted in favour of the IVA. However, other unsecured creditors received a much lower dividend payment than Kaupthing, and no sound reason was given for this differential treatment.[16] Mr. Gertner agreed with this approach as he wanted to avoid a bankruptcy procedure. This case clearly shows that one of the unsecured creditors, Kaupthing Bank, acted to promote their own self-interest at the expense of the interests of unsecured creditors as a whole.

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[12] ICAEW Insolvency Code of Ethics, R2320.3 and R2320.4; L. Jacobs, 'Corporate Insolvency Practitioners, ethics and remuneration: Not a case of moral bankruptcy?' in INSOL International, *Special Report* (August 2020), pp. 60-61.
[13] Ibid. (fn. 9).
[14] *Gertner v CFL Finance Ltd* [2018] EWCA Civ 1781.
[15] Ibid.
[16] D. Cardinaels, 'Differentiation Between Groups of Unsecured Creditors: A Solution to Reduce Vulnerability?' (2019) 32 *Insolvency Intelligence* 118.

Other unsecured creditors would have received a more beneficial treatment under the IVA plan if no such hidden agreement had been concluded between Mr. Gertner and Kaupthing Bank. As a result of the material irregularity, the court held that the IVA was not valid.[17]

A second example concerns a Belgian case of 5 October 2012 of the Brussels Court of Appeal in which the majority creditors attempted to abuse their dominant position to the detriment of an employee who had been dismissed by the debtor and who, as the only creditor (without collateral), had voted against the plan. In addition to the material irregularities that had already affected the reorganization plan, and which would already have provided a sufficient basis for the refusal of the sanctioning of the plan, the Court stated, in an *obiter dictum*, that the reorganization plan also constituted an abuse by the majority creditors.

This finding resulted from the provisions of the reorganisation plan itself, which were very disadvantageous to the employee, in contrast to the advantageous treatment granted to the four other creditors, who were all also directors and shareholders of the company. In particular, the reorganisation plan proposed to repay all claims (both those to the employee and the four directors-shareholders) in full through a debt-to-equity swap. However, if a creditor refused to subscribe to this capital increase, that creditor would only be paid 5% of their claim. Although the employee's claim was ostensibly treated in the same way as the shareholders' claims, it cannot be denied that the employee, who had been made redundant, would have had no interest in becoming a minority shareholder in the financially distressed company. This contrasts sharply with the other creditors who were all already shareholders and who, through the debt-to-equity conversion proposed in the plan, would strengthen their position as shareholders within the company.

Consequently, in contrast to the material irregularities, this reorganisation plan, which treated the different creditors (i.e. the employee and the historic shareholders) equally and thus *de facto* only benefited the 4 existing shareholders but not the (dismissed) employee, could not be approved because of abuse of the majority creditors.

4. Overview of the regulatory framework

The aforementioned cases illustrate the risks faced by unsecured minority creditors[18] during a restructuring procedure. These risks are particularly present in Belgium as, pursuant to the current regulatory framework, no insolvency procedure exists whereby classes of creditors are created for voting purposes.[19] This is very different from England and Wales where, except for CVA[20] and IVA procedures, several restructuring procedures[21] allow creditors to vote in separate classes whereby each class is made up with creditors whose rights are not too dissimilar from one another.

Pursuant to current Belgian laws, categories of creditors can be created during a collective agreement.[22] However, this is only so for distribution purposes. In terms of voting rights, all creditors – secured or not – vote together in one group which allows minority creditors to be quite easily ‘crammed down’ if a large creditor and some other (smaller) creditors approve the plan. This is a direct consequence of the current requirements whereby a collective agreement is deemed approved if a majority in number of

[17] For the further evolution of this case see: D. Cardinaels, *Companies and creditors’ distress: how to untie the Gordian knot in the non-controlling unsecured creditors’ interests?* Doctoral Thesis, University of Leeds (2021), pp. 98-102. Available at: https://etheses.whiterose.ac.uk/30066/ (accessed: 12 August 2022).

[18] An unsecured minority creditor can be defined as a non-controlling unsecured creditor or a creditor who has not got the ability to influence the decision-making power of the debtor’s management prior to and/or during an insolvency procedure: see Cardinaels (n 17), p. 8.

[19] J. Dengler, ‘The Impact of the EU Restructuring Directive on the Belgian collective plan: To class or not to class’ in INSOL International, *A Collection of Short Papers by INSOL Early Research Academics (INSOL ERA)* (INSOL International, 2021), pp. 40; 48-49; F. De Leo, *Schuldeiser en behoorlijk insolventiebestuur* (Intersentia, 2021), p. 650.

[20] Company Voluntary Arrangement.

[21] See in this regard, the Schemes of Arrangement or Part 26A Restructuring Plans.

[22] Belgian Code of Economic Law, Article XX.73.

creditors representing at least 50%[23] of the total debt vote in favour of the collective agreement.[24] Cases whereby minority creditors are put in a disenfranchised position are not uncommon and could relatively easily occur if a bank who is often the largest creditor would vote together with some other creditors who might even be affiliated to the debtor[25] or who may have received generous treatment in result of the debtor's ability to differentiate between creditors for dividend purposes.[26]

Various protections have been built into Belgian law to mitigate the agency conflict that could occur between majority and minority creditors. In this regard, the court can refuse to sanction the collective agreement if the plan did not comply with the required formalities (e.g. not including all creditors on the creditors' list) or if it would be against the 'public order'.[27] Furthermore, if a plan had already been sanctioned, disenfranchised creditors can request the court to withdraw the collective agreement[28] and the debtor may even face criminal sanctions if some creditors were knowingly not included in the reorganisation plan or if the debtor's accounts (e.g. assets or liabilities) would not have shown a true and accurate overview of the total amount of assets or liabilities.[29] Nonetheless, the court has only marginal powers to assess whether a plan can be sanctioned, and this limits the effectiveness of the statutory provision. Furthermore, creditors - especially the weakest ones – do not usually take part to these procedures and may thus not exercise the rights at their disposal.[30] These creditors might fear that the transaction costs of getting involved in monitoring the debtor and initiating a claim may quite easily outweigh the dividends they are expected to receive, especially if their claim is quite small.[31]

However, whilst the current Belgian rules do not adequately tackle the risk of opportunism by the majority creditor(s), regulatory changes are imminent in light of the implementation of the EU Preventative Restructuring Directive 2019/1023 ('PRD').[32] One of the objectives of the PRD is to enhance the protection of vulnerable creditors. The tool used by the PRD for this is the technique of class formation. Article 9(4) PRD states that:

> Member States shall ensure that affected parties are treated in separate classes which reflect sufficient commonality of interest based on verifiable criteria, in accordance with national law. (…) Member States shall put in place appropriate measures to ensure that *class formation is done with a particular view to protecting vulnerable creditors such as small suppliers*. (Emphasis added)

Following the US and UK experience on the topic, it is indeed widely acknowledged that dividing creditors into uniform classes enhances the protections for more vulnerable creditors.[33] This can be illustrated through the following scenario. Imagine a debtor with a total amount of assets of EUR 50,000 with 5 creditors of which 2 secured creditors and 3 unsecured creditors each of them having a claim of EUR 15,000. Under the existing Belgian rules, all of the creditors would vote together, and a plan would be approved if the two secured creditors and one unsecured creditor voted in favour of it. This would be a majority in number of creditors (3 out of 5) and at least 50% of the total debt (i.e. EUR 45,000 out of a total debt of EUR 75,000). This would mean that a debtor could easily cram-down two unsecured

[23] 50% (and thus not 50% +1) is sufficient which is, in fact, not even a majority.
[24] Belgian Code of Economic Law, art. XX.78.
[25] Dengler (n 19), pp. 40, 48-49.
[26] Ibid.
[27] Belgian Code of Economic Law, Article XX.79.
[28] Ibid, Article XX.83.
[29] Belgian Penal Code, Article 490ter.
[30] Cardinaels (n 16); J. Dickfos, 'The Costs and Benefits of Regulating the Market for Corporate Insolvency Practitioner Remuneration' (2016) 25 *International Insolvency Review* 56, 70.
[31] V. Finch and D. Milman, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, 2017), p. 80.
[32] Although the PRD should have been transposed into Belgian law by 16th July 2021, the Belgian legislator made use of the one year-extension option meaning that the PRD should, in principle, be transposed into Belgian by 16 July 2022. As at the time of writing no bill has been published yet. It is expected that the Belgian legislator will not be able to meet the deadline.
[33] F. De Leo, 'Stemmen in categorieën als remedie voor minderheidsonderdrukking bij reorganisatieprocedures' (2022) 1 *TIBR* 32.

creditors by offering them 20% of their claim[34] (EUR 3,000 each) whilst the other unsecured creditor could be offered EUR 14,000 (93% of her claim) and the two secured creditors could be paid off entirely. However, if the two unsecured creditors who would be subject to differential treatment and would thus receive a considerable haircut would be placed in a separate class of unsecured creditors, that class (in which they would have a majority) would be able to vote against the plan.

Leaving aside situations whereby this differential treatment may be justified from a continuity perspective, class formation would enhance the controlling rights of unsecured creditors. This is because, according to article 9(6) PRD, 'a restructuring plan shall be adopted by affected parties, *provided that a majority in the amount of their claims or interests is obtained in each class* (emphasis added).' Consequently, if the two creditors who would receive an 80% haircut were placed in a separate class of unsecured creditors, the plan might not be approved if this class voted against the plan. In contrast, nowadays the plan would, in principle, be approved even if the two dissenting unsecured creditors voted against the plan. Courts may, as mentioned above, refuse to sanction a plan if there are irregularities or if the plan would be against the public order which would, arguably, be the case if the debtor, without proper justification, differentiates between the creditors. Also, even after the transposition of the PRD, dissenting class(es) of creditors may be bound by a plan if the court would make use of its cross-cramdown powers.[35] Nonetheless, the logic of the plan's approval would differ after the introduction of the PRD's class formation. The new law moves from a situation where plans are approved in principle *unless* the courts raise objections to a situation where classes of creditors can reject the plan *unless* the court would sanction it through a cross-class cramdown.

Nonetheless, although voting in classes could enhance the protection of vulnerable creditors, it does not give any guarantee that these group creditors will, in fact, be adequately protected. It is not even a silver bullet that would solve all potential regulatory and economic issues that could occur during insolvency governance from a creditors' perspective. It is in this regard that the PRD introduces an economic viability test which would grant courts more power to examine whether the plan (as proposed by the debtor) would be 'feasible' in practice. Whilst the current control by the Belgian courts is, in principle, rather 'marginal' and superficial, under the reformed law the courts would be entitled to assess whether the plan would be economically viable and thus enhance the debtor's survival chances. This more elaborate court control could be an opportunity for the courts to assess the terms and conditions of a proposed plan, which might again enhance the protection of more vulnerable creditors. In particular, courts will have to apply a 'best interests' test'[36]if requested by the dissenting creditor. Under this test, it must be assessed whether the dissenting creditor would receive as much under the reorganisation plan as they would receive in the relevant alternative which would usually be liquidation.[37] Furthermore, if a court wants to impose the plan on a dissenting class of creditors through a cross-class cramdown, such court will have to also examine if there are any additional reasons to refuse the sanctioning of a plan. In this situation, courts will have to analyse whether the classes of creditors have been duly formed and whether the debtor complied with the applicable *relative* or *absolute priority rule*.[38] If no restructuring specialist has been appointed, this specialist must then also be appointed.[39]

Nonetheless, the PRD, which only intends to create a minimum level of harmonisation across EU Member States, still leaves many questions unanswered.

First, whilst aiming to enhance the protection of vulnerable creditors, it does not properly define when a creditor can be considered as 'vulnerable'. In fact, by referring to 'workers or small suppliers', it suggests that vulnerability can be determined through the nature of one's claim (e.g. 'consumer claim' or 'employment claim'). This approach should be rejected for various reasons. First, it could lead to

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[34] This is the minimum that must be offered under current Belgian rules. However, it is expected that this minimum (dividend) threshold will disappear when the PRD will be transposed into Belgian law. This would offer more flexibility to the debtor (and creditors) when negotiating a restructuring plan.
[35] PRD, Article 11.
[36] PRD, Article 10.2.(d).
[37] PRD, Article 11; De Leo, (n 33), 33-34.
[38] PRD, Articles 11(1)(b); 11(1)(c); and 11(2).
[39] PRD, Article 5(al3)(b).

protecting creditors who may not need to be protected whilst other equally vulnerable creditors may not receive any protection at all. Imagine for example, a small supplier receiving 100% of its claim under a plan whilst a landlord would be subject to a haircut of 80%. Why should the landlord's claim be subject to such a considerable haircut in contrast to the small supplier who might be a one-off supplier? How is this justifiable? Furthermore, it seems to mix different interests. An employee may vote as a creditor (because there might be outstanding wages that have to be paid) but the employee may also vote because of other reasons (e.g. if they are a board director). Similarly, suppliers may vote as a creditor because the debtor may still have some outstanding debts, but they may also consider the benefits arising from the continuation of the debtor's business. By suggesting that classes of creditors should enhance the protection of vulnerable creditors such as 'small suppliers' or 'employees', the PRD unfortunately mixes up the different roles of the debtor's economic actors. This may well confuse the debtor when determining which creditors should be protected and risks, introducing differential treatments among equally vulnerable creditors.

In addition, the PRD determines that the national legislator may exclude small and medium enterprises (SMEs) from the requirement to form different classes of creditors. Despite the existence of different definitions of SME, more than 99% of the enterprises in Europe, are SMEs.[40] Therefore, this provision would significantly reduce the positive impact that class formation could have on the protection of vulnerable factions of creditors. It is not understandable why, for example, the same creditor would be entitled to receive better treatment (via class formation) dependent on the number of employees and the company results of the debtor.

Finally, the *relative priority rule*[41] proposed by the PRD creates the risk that in the vertical relation between secured creditors, unsecured creditors, subordinated creditors and equity holders, the latter actors (i.e. the subordinated creditors and equity holders) might be able to retain, as a percentage, much a higher proportion of their claim than unsecured creditors.[42] This is a direct result of Article 11(1)(c) PRD, according to which dissenting voting classes of affected creditors should be treated at least as favourably as any other class of the same rank and more favourably than any junior class. Consequently, this might mean that a plan could be approved if an unsecured creditor receives EUR 1 more than the subordinated creditors, even though the unsecured creditors would be subject to a considerable haircut in contrast to the subordinated creditors and/or equity holders whose position might not be affected. This would hardly enhance the protection of vulnerable unsecured creditors in spite of the PRD's intended goals. Furthermore, this risk could be exacerbated by equity holders attempting to influence the board of directors to engage in risky activities (as they have not got anything to lose under the plan)[43] or hidden agreements with senior creditors to disenfranchise junior (unsecured) creditors.[44]

5. Regulatory suggestions

The aforementioned cases illustrate the risks faced by unsecured minority creditors[45] during a restructuring procedure. These risks are particularly present in Belgium as, pursuant to the current regulatory framework, no insolvency procedure exists whereby classes of creditors are created for

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[40] PRD, Recital 17.

[41] The national legislator may however adopt an absolute priority rule (instead of a relative priority rule): see PRD, Article 11(2).

[42] R. De Weijs et al., 'The Imminent Distortion of European Insolvency Law: How the European Union Erodes the Basic Fabric of Private Law by Allowing 'Relative Priority' (RPR)' (2019) *TBH* 477; F. De Leo and S. Van Landuyt, 'De laatsten zullen de eersten zijn: over prioriteiten bij herstructurering' (2021) *TPR* 2021, 1695-1696.

[43] J. Seymour and S. Schwarcz, 'Corporate Restructuring under Relative and Absolute Priority Default Rules' (2019). Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3498611 (accessed: 12 August 2022).

[44] De Leo and Van Landuyt (n 42).1695-1696.

[45] An unsecured minority creditor can be defined as a non-controlling unsecured creditor or a creditor who has not got the ability to influence the decision-making power of the debtor's management prior to and/or during an insolvency procedure: see Cardinaels (n 17), p. 8.

voting purposes.[46] This is very different from England and Wales where, except for CVA[47] and IVA procedures, several restructuring procedures[48] allow creditors to vote in separate classes whereby each class is made up with creditors whose rights are not too dissimilar from one another.

Pursuant to current Belgian laws, categories of creditors can be created during a collective agreement.[49] However, this is only so for distribution purposes. In terms of voting rights, all creditors – secured or not – vote together in one group which allows minority creditors to be quite easily 'crammed down' if a large creditor and some other (smaller) creditors approve the plan. This is a direct consequence of the current requirements whereby a collective agreement is deemed approved if a majority in number of creditors representing at least 50%[50] of the total debt vote in favour of the collective agreement.[51] Cases whereby minority creditors are put in a disenfranchised position are not uncommon and could relatively easily occur if a bank who is often the largest creditor would vote together with some other creditors who might even be affiliated to the debtor[52] or who may have received generous treatment in result of the debtor's ability to differentiate between creditors for dividend purposes.[53]

Various protections have been built into Belgian law to mitigate the agency conflict that could occur between majority and minority creditors. In this regard, the court can refuse to sanction the collective agreement if the plan did not comply with the required formalities (e.g. not including all creditors on the creditors' list) or if it would be against the 'public order'.[54] Furthermore, if a plan had already been sanctioned, disenfranchised creditors can request the court to withdraw the collective agreement[55] and the debtor may even face criminal sanctions if some creditors were knowingly not included in the reorganisation plan or if the debtor's accounts (e.g. assets or liabilities) would not have shown a true and accurate overview of the total amount of assets or liabilities.[56] Nonetheless, the court has only marginal powers to assess whether a plan can be sanctioned, and this limits the effectiveness of the statutory provision. Furthermore, creditors - especially the weakest ones – do not usually take part to these procedures and may thus not exercise the rights at their disposal.[57] These creditors might fear that the transaction costs of getting involved in monitoring the debtor and initiating a claim may quite easily outweigh the dividends they are expected to receive, especially if their claim is quite small.[58]

However, whilst the current Belgian rules do not adequately tackle the risk of opportunism by the majority creditor(s), regulatory changes are imminent in light of the implementation of the EU Preventative Restructuring Directive 2019/1023 ('PRD').[59] One of the objectives of the PRD is to enhance the protection of vulnerable creditors. The tool used by the PRD for this is the technique of class formation. Article 9(4) PRD states that:

> Member States shall ensure that affected parties are treated in separate classes which reflect sufficient commonality of interest based on verifiable criteria, in accordance with national

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[46] J. Dengler, 'The Impact of the EU Restructuring Directive on the Belgian collective plan: To class or not to class' in INSOL International, *A Collection of Short Papers by INSOL Early Research Academics (INSOL ERA)* (INSOL International, 2021), pp. 40; 48-49; F. De Leo, *Schuldeiser en behoorlijk insolventiebestuur* (Intersentia, 2021), p. 650.
[47] Company Voluntary Arrangement.
[48] See in this regard, the Schemes of Arrangement or Part 26A Restructuring Plans.
[49] Belgian Code of Economic Law, Article XX.73.
[50] 50% (and thus not 50% +1) is sufficient which is, in fact, not even a majority.
[51] Belgian Code of Economic Law, Article XX.78.
[52] Dengler (n 19), pp. 40, 48-49.
[53] Ibid.
[54] Belgian Code of Economic Law, Article XX.79.
[55] Ibid, Article XX.83.
[56] Belgian Penal Code, Article 490ter.
[57] Cardinaels (n 16); J. Dickfos, 'The Costs and Benefits of Regulating the Market for Corporate Insolvency Practitioner Remuneration' (2016) 25 *International Insolvency Review* 56, 70.
[58] V. Finch and D. Milman, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, 2017), p. 80.
[59] Although the PRD should have been transposed into Belgian law by 16th July 2021, the Belgian legislator made use of the one year-extension option meaning that the PRD should, in principle, be transposed into Belgian by 16 July 2022. As at the time of writing no bill has been published yet. It is expected that the Belgian legislator will not be able to meet the deadline.

law. (…) Member States shall put in place appropriate measures to ensure that *class formation is done with a particular view to protecting vulnerable creditors such as small suppliers*. (Emphasis added)

Following the US and UK experience on the topic, it is indeed widely acknowledged that dividing creditors into uniform classes enhances the protections for more vulnerable creditors.[60] This can be illustrated through the following scenario. Imagine a debtor with a total amount of assets of EUR 50,000 with 5 creditors of which 2 secured creditors and 3 unsecured creditors each of them having a claim of EUR 15,000. Under the existing Belgian rules, all of the creditors would vote together, and a plan would be approved if the two secured creditors and one unsecured creditor voted in favour of it. This would be a majority in number of creditors (3 out of 5) and at least 50% of the total debt (i.e. EUR 45,000 out of a total debt of EUR 75,000). This would mean that a debtor could easily cram-down two unsecured creditors by offering them 20% of their claim[61] (EUR 3,000 each) whilst the other unsecured creditor could be offered EUR 14,000 (93% of her claim) and the two secured creditors could be paid off entirely. However, if the two unsecured creditors who would be subject to differential treatment and would thus receive a considerable haircut would be placed in a separate class of unsecured creditors, that class (in which they would have a majority) would be able to vote against the plan.

Leaving aside situations whereby this differential treatment may be justified from a continuity perspective, class formation would enhance the controlling rights of unsecured creditors. This is because, according to article 9(6) PRD, 'a restructuring plan shall be adopted by affected parties, *provided that a majority in the amount of their claims or interests is obtained in each class* (emphasis added)*.'* Consequently, if the two creditors who would receive an 80% haircut were placed in a separate class of unsecured creditors, the plan might not be approved if this class voted against the plan. In contrast, nowadays the plan would, in principle, be approved even if the two dissenting unsecured creditors voted against the plan. Courts may, as mentioned above, refuse to sanction a plan if there are irregularities or if the plan would be against the public order which would, arguably, be the case if the debtor, without proper justification, differentiates between the creditors. Also, even after the transposition of the PRD, dissenting class(es) of creditors may be bound by a plan if the court would make use of its cross-cramdown powers.[62] Nonetheless, the logic of the plan's approval would differ after the introduction of the PRD's class formation. The new law moves from a situation where plans are approved in principle *unless* the courts raise objections to a situation where classes of creditors can reject the plan *unless* the court would sanction it through a cross-class cramdown.

Nonetheless, although voting in classes could enhance the protection of vulnerable creditors, it does not give any guarantee that these group creditors will, in fact, be adequately protected. It is not even a silver bullet that would solve all potential regulatory and economic issues that could occur during insolvency governance from a creditors' perspective. It is in this regard that the PRD introduces an economic viability test which would grant courts more power to examine whether the plan (as proposed by the debtor) would be 'feasible' in practice. Whilst the current control by the Belgian courts is, in principle, rather 'marginal' and superficial, under the reformed law the courts would be entitled to assess whether the plan would be economically viable and thus enhance the debtor's survival chances. This more elaborate court control could be an opportunity for the courts to assess the terms and conditions of a proposed plan, which might again enhance the protection of more vulnerable creditors. In particular, courts will have to apply a 'best interests' test'[63] if requested by the dissenting creditor. Under this test, it must be assessed whether the dissenting creditor would receive as much under the reorganisation plan as they would receive in the relevant alternative which would usually be liquidation.[64] Furthermore, if

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[60] F. De Leo, 'Stemmen in categorieën als remedie voor minderheidsonderdrukking bij reorganisatieprocedures' (2022) 1 *TIBR* 32.

[61] This is the minimum that must be offered under current Belgian rules. However, it is expected that this minimum (dividend) threshold will disappear when the PRD will be transposed into Belgian law. This would offer more flexibility to the debtor (and creditors) when negotiating a restructuring plan.

[62] PRD, Article 11.

[63] PRD, Article 10(2)(d).

[64] PRD, Article 11; De Leo, (n 33), 33-34.

a court wants to impose the plan on a dissenting class of creditors through a cross-class cramdown, such court will have to also examine if there are any additional reasons to refuse the sanctioning of a plan. In this situation, courts will have to analyse whether the classes of creditors have been duly formed and whether the debtor complied with the applicable *relative* or *absolute priority rule*.[65] If no restructuring specialist has been appointed, this specialist must then also be appointed.[66]

Nonetheless, the PRD, which only intends to create a minimum level of harmonisation across EU Member States, still leaves many questions unanswered.

First, whilst aiming to enhance the protection of vulnerable creditors, it does not properly define when a creditor can be considered as 'vulnerable'. In fact, by referring to 'workers or small suppliers', it suggests that vulnerability can be determined through the nature of one's claim (e.g. 'consumer claim' or 'employment claim'). This approach should be rejected for various reasons. First, it could lead to protecting creditors who may not need to be protected whilst other equally vulnerable creditors may not receive any protection at all. Imagine for example, a small supplier receiving 100% of its claim under a plan whilst a landlord would be subject to a haircut of 80%. Why should the landlord's claim be subject to such a considerable haircut in contrast to the small supplier who might be a one-off supplier? How is this justifiable? Furthermore, it seems to mix different interests. An employee may vote as a creditor (because there might be outstanding wages that have to be paid) but the employee may also vote because of other reasons (e.g. if they are a board director). Similarly, suppliers may vote as a creditor because the debtor may still have some outstanding debts, but they may also consider the benefits arising from the continuation of the debtor's business. By suggesting that classes of creditors should enhance the protection of vulnerable creditors such as 'small suppliers' or 'employees', the PRD unfortunately mixes up the different roles of the debtor's economic actors. This may well confuse the debtor when determining which creditors should be protected and risks, introducing differential treatments among equally vulnerable creditors.

In addition, the PRD determines that the national legislator may exclude small and medium enterprises (SMEs) from the requirement to form different classes of creditors. Despite the existence of different definitions of SME, more than 99% of the enterprises in Europe, are SMEs.[67] Therefore, this provision would significantly reduce the positive impact that class formation could have on the protection of vulnerable factions of creditors. It is not understandable why, for example, the same creditor would be entitled to receive better treatment (via class formation) dependent on the number of employees and the company results of the debtor.

Finally, the *relative priority rule*[68] proposed by the PRD creates the risk that in the vertical relation between secured creditors, unsecured creditors, subordinated creditors and equity holders, the latter actors (i.e. the subordinated creditors and equity holders) might be able to retain, as a percentage, much a higher proportion of their claim than unsecured creditors.[69] This is a direct result of Article 11(1)(c) PRD, according to which dissenting voting classes of affected creditors should be treated at least as favourably as any other class of the same rank and more favourably than any junior class. Consequently, this might mean that a plan could be approved if an unsecured creditor receives EUR 1 more than the subordinated creditors, even though the unsecured creditors would be subject to a considerable haircut in contrast to the subordinated creditors and/or equity holders whose position might not be affected. This would hardly enhance the protection of vulnerable unsecured creditors in spite of the PRD's intended goals. Furthermore, this risk could be exacerbated by equity holders attempting to influence the board of directors to engage in risky activities (as they have not got anything to lose under the plan)[70]

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[65] PRD, Articles 11(1)(b); 11(1)(c); and 11(2).
[66] PRD, Article 5(al3)(b).
[67] PRD, Recital 17.
[68] The national legislator may however adopt an absolute priority rule (instead of a relative priority rule): see PRD, Article 11(2).
[69] R. De Weijs et al., 'The Imminent Distortion of European Insolvency Law: How the European Union Erodes the Basic Fabric of Private Law by Allowing 'Relative Priority' (RPR)' (2019) *TBH* 477; F. De Leo and S. Van Landuyt, 'De laatsten zullen de eersten zijn: over prioriteiten bij herstructurering' (2021) *TPR* 2021, pp. 1695-1696.
[70] J. Seymour and S. Schwarcz, 'Corporate Restructuring under Relative and Absolute Priority Default Rules' (2019).

or hidden agreements with senior creditors to disenfranchise junior (unsecured) creditors.[71]

5.1 Determination of creditors' vulnerability

First, it is necessary to define 'vulnerable creditors'. As noted above, rather than seeking to define vulnerability based upon the nature of a creditor's claim (e.g., an employment claim or a consumer claim), it is more appropriate to look at the practical circumstances and particularly at two sets of factors which determine to what extent the creditor(s) can influence the decision-making process during a restructuring and insolvency procedure.

On the one hand, some indicative factors which may suggest that a certain creditor might be more vulnerable than others. On the other hand, conclusive factors may allow the debtor to affirm or reconsider a certain creditor's vulnerability.

As set out in the table below, the nature of a creditor's claim (e.g. a consumer claim) is nothing more than an indicative factor. This may *indicate* whether a creditor could be expected to be more vulnerable. However, the actual attitude of the creditor prior to and during an insolvency procedure is more appropriate to determine the if a debtor is actually in a vulnerable position. Namely, if a consumer forms a coalition with fellow equally-ranking creditors and obtains a majority in the voting process, it could hardly be argued that the members of such group in that procedure are 'vulnerable' and in need for special protection. Nonetheless, as one may expect, if consumers do not use the power they have, do not exercise their voting rights (or are not able to form a coalition and cannot on their own influence the outcome of the insolvency procedure), it would be incumbent on the debtor to have more regard to the vulnerable position of that particular creditor as determined below.

Table 2. Opportunistic risks in active and financially distressed companies

Abstract factors		**Concrete/practical factors**
- *Size of the unsecured claim (and related percentage of voting rights)* - *Bargaining power of the unsecured creditor* - *Legal/financial knowledge and expertise of the unsecured creditor* - *Information (about the debtor) known to the unsecured creditor* - *Financial funds of the unsecured creditor* - *Nature of a creditor's claim (e.g. consumer claim)*	+	- *Attitude of the unsecured creditor during insolvency procedure (e.g. Coalitions built amongst unsecured creditors?)* - *Amount of votes of the unsecured creditors (dependent on the size of their claim and coalitions potentially built)* - *Actual exercising of voting rights*
Non-cumulative abstract factors INDICATIVE of potential non-controlling position of unsecured creditors		**Practical/concrete factors CONCLUSIVE of actual non-controlling (or controlling) position of unsecured creditors**

Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3498611 (accessed: 12 August 2022).

[71] De Leo and Van Landuyt (n 42), pp. 1695-1696.

The importance of having a clear idea as to which creditors might, in fact, be vulnerable cannot be underestimated for it would allow the debtor to better consider the interests of these creditors.

5.2 *Increased reporting requirements*

From a *governance* perspective, it is hereby advocated that directors should be subject to increased reporting requirements. Prior to the onset of the restructuring procedure, the board of directors of the debtor ought to assess which group of creditors (which might be just one creditor) could indicatively be more vulnerable. This would allow them, as in the *Kayford* case,[72] to set up a trust account for these creditors if this was deemed in the interests of both the entire group of creditors (including the more vulnerable faction of creditors) and the debtor's restructuring.

During a restructuring procedure, the debtor's management or a practitioner in possession[73] would be expected to accurately justify how business decisions that affect the statutory order of distribution affect vulnerable creditors, and the rationale for these decisions. For example, if the debtor proposes a restructuring plan where one group of creditors would be subject to a 80% haircut whilst other equally-ranking or lower-ranking creditors would be paid in full, it would seem advisable to require the directors to justify such course of action using a vulnerability approach. To enhance accountability during the insolvency process, information regarding the availability of remedies if creditors are dissatisfied with the plan's terms should be provided and, importantly, creditors should be offered an opportunity to propose alternative plans. These should be seriously considered by the debtor, provided that they would benefit not only the vulnerable creditors but also the rest of the creditors, and the plan would ensure the effective restructuring of the debtor.

Nonetheless, despite the merits of such increased reporting requirements imposed on directors (and officeholders) during an insolvency procedure, various concerns could be raised against this approach.

First, it could be argued that this would make directors more risk-averse, especially as it might be difficult for them (perhaps less so for office holders) to accurately determine which creditors are more vulnerable. Nonetheless, this argument is not persuasive as long as this increased reporting requirements are embedded in hard-law rather than soft-law guidance.[74] As both directors[75] and office-holders[76] are already subject to a fiduciary duty to the distressed company, the requirement to properly inform creditors would be judged as part of their fiduciary duty.[77] Nonetheless, the soft law would, arguably, contribute to enhancing good governance and provide the debtor's management with an appropriate tool to draft a restructuring plan whilst still being able to act in a flexible way, and thus allowing them to draft tailor-made restructuring agreements.

Second, it could be argued that the transaction costs imposed on directors regarding the closing of a restructuring agreement would increase by introducing these disclosure requirements. Nonetheless, it is expected that the benefits of giving more information to creditors outweigh any potential increase in transaction costs. This is because increased reporting requirement, as set out before, merely refine an already existing duty imposed on the debtor's directors. In other words, this increased reporting

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[72] *Re Kayford Ltd* [1975] 1 WLR 282

[73] This would be in an English administration procedure whereby the company is managed by an administrator in contrast to debtor-in-possession procedures such as CVAs, part 26A restructuring plans and schemes of arrangement.

[74] It could be argued that an Insolvency Governance Code may have to be enacted. See in a similar vein (but regarding creditors' committees): B. Wessels, 'Towards a European Code of Conduct for Creditors' Committees' (2021) 18 *International Corporate Rescue* 375.

[75] Companies Act 2006, s.172(3); *Liquidator of West Mercia Safetywear v Dodd* (1988) 4 BCC 30; *Re Pantone 485 Ltd* [2002] 1 BCLC 266; *Colin Gwyer v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch); *Re MDA Investment Management Ltd* [2003] EWHC 227 (Ch) as referred to by A. Keay, 'Financially distressed companies, restructuring and creditors' interests: what is a director to do?' [2019] *Lloyd's Maritime and Commercial Law Quarterly* 297, 298.

[76] Jacobs (n 12), pp. 12-20.

[77] A. Keay and J. Loughrey, 'The Concept of Business Judgment' (2019) *Legal Studies* 39.

requirement would merely steer directors into the 'right direction' by changing the focus of their directorial duty into a more creditor-friendly way. Directors would not need to focus on the entire group of creditors as one homogenous class. Acknowledging the practical realities, directors ought to have regard to non-controlling (i.e. more vulnerable) factions of unsecured creditors (without granting them privileges other unsecured creditors would not be entitled to). Furthermore, it could also enhance dialogue between the debtor and creditors and in doing so, it could reduce the amount of costly litigation (e.g. unfair prejudice procedures) that creditors would otherwise pursue to attack a restructuring plan. This is, arguably, in line with recent cases such as *House of Fraser*[78] or *Debenhams*,[79] where creditors who objected to a restructuring plan alleged that they would have wanted to receive more information and particularly a proper justification from the debtor as to why these restructuring terms were deemed the most beneficial to safeguarding the debtor's continuity. This was clearly set out by the High Court in the recent *All Scheme Ltd*[80] case, where the Court refused to sanction a scheme of arrangement stipulating that:

> [60] The reasonable creditor will also want to be provided with the necessary information to understand how any different groups of creditors and any other relevant stakeholders are treated under the scheme and in any wider restructuring in order that he can reach an informed view upon whether the losses which have been suffered and the available value are being appropriately allocated between stakeholder groups.
>
> [61] So, for example, if creditors which would rank equally in a formal insolvency are being differently treated under the scheme or are being left out of the scheme altogether so that they are not being required to accept a compromise of their claims at all, this should be fully disclosed and properly explained.
>
> (…)
>
> [138] I have therefore concluded that, *given the limited financial sophistication and literacy of the constituency of Redress Creditors*, the Explanatory Statement was *insufficient to inform them about the Scheme and the realistic alternatives to it*. Scheme Creditors were therefore not properly consulted for the purposes of the Creditors' Meeting. The information was not sufficiently full or accurate to enable the constituency of Scheme Creditors to form a reasonable judgment on whether or not the Scheme was in their interests.[81] (emphasis added)

Consequently, it is believed that, on balance, all stakeholders would benefit from increased reporting requirements on the debtor's management.

However, merely giving creditors more information would probably not sufficiently enhance the creditor's vulnerable or non-controlling position. Therefore, to stimulate creditors' activism and to reduce the rather passive attitude currently shown by creditors,[82] other measures are needed.

5.3 Derivative actions

In this regard, it is advocated that (unsecured) creditors should be provided with the opportunity to commence derivative actions on behalf of the debtor against directors and officeholders for alleged violations of their managerial duties as soon as the company becomes financially distressed (even if the company is not yet subject to a liquidation procedure). In contrast to the UK's position, both Singapore[83]

[78] *Re House of Fraser* [2018] EWHC 1906 (Ch).
[79] *Discovery (Northampton) Ltd v Debenhams Retail Ltd* [2019] EWHC 2441 (Ch).
[80] *Re All Scheme Ltd* [2021] EWHC 1401 (Ch).
[81] Ibid, paras. 60-61 and 138.
[82] Ibid (fn. 30).
[83] Singapore Companies Act 1967, s.216A(1)(c).

and Canada[84] allow creditors to file a derivative action once a company enters into financial difficulties because from that moment it is the creditors whose money is at stake. In these jurisdictions, unsecured creditors are considered the residual claimants, having taken over that position from the shareholders. This was clearly explained in the Canadian case *Peoples Department Stores Inc. (Trustee of) v. Wise,* whereby Major and Deschamps JJ both stipulated that 'the fact that creditors' interests increase in relevancy as a corporation's finances deteriorate is apt to be relevant to, inter alia, the exercise of discretion by a court in granting standing to a party as a "complainant" under s. 238(d) of the CBCA as a "proper person" to bring a derivative action in the name of the corporation under ss. 239 and 240 of the CBCA'.[85] Oddly, long-standing case-law in England and Wales recognises that creditors' interests become paramount once the debtor becomes financially distressed.[86] However, remedies such as being able to file a misfeasance claim against directors or office holders of the company are only available when the company is subject to a winding-up procedure.[87] Although this misfeasance procedure operates akin to derivative actions, the requirement that the company must be subject to a liquidation in order to be able to initiate such a misfeasance claim reduces the possibilities for the creditors to commence such procedure.

From a creditors' perspective, this is, arguably, even worse in Belgium as creditors are unable to file any liability claim against the directors except for one circumstance. This is when the directors' conduct that is alleged to constitute a considerably gross fault has contributed to the debtor's insolvency. In that case, the disenfranchised creditor can initiate a liability procedure provided that they give a one-month notice period to the liquidator to commence a procedure before starting a liability procedure themselves.[88]

5.4 Public trusts

Nonetheless, fears that controlling the debtor might lead to high economic costs which could outweigh the dividend the creditor is expecting (especially when the claim is rather small) in addition to the fact that the proceeds of a successful derivative claim may flow to the entire group of creditors[89] (rather than the creditor(s) who initiated the claim) may well reduce the creditors' willingness to commence a claim.

It is, therefore, argued that there are benefits in setting up a public trust which, subject to certain conditions such as the expected likelihood of success in a derivative claim[90], could co-finance the creditors' petitions. The public trust could be funded through the imposition of a small levy on new companies which are being incorporated. This may enhance creditors' involvement and, in doing so, it would also encourage good corporate governance.[91]

[84] Canada Business Corporations Act 1985, s.238.
[85] *Peoples Department Stores Inc. (Trustee of) v. Wise* [2004] SCC 68 at [49].
[86] *Liquidator of West Mercia Safetywear v Dodd* (1988) 4 BCC 30; *Facia Footwear Ltd (in administration) v Hinchliffe* [1998] 1 BCLC 218; *Re Pantone 485 Ltd* [2002] 1 BCLC 266; *Colin Gwyer v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch); *Re MDA Investment Management Ltd* [2003] EWHC 227 (Ch), as referred to by Keay (n 75), 298; Keay and Walton (n 8), 686-687.
[87] IA 1986, s.212.
[88] Belgian Code of Economic Law, Article XX.225.
[89] This is, however, not necessarily always the case in neither England nor Belgium. Whilst in England, the officeholder may assign a right of certain actions (e.g., wrongful or fraudulent trading actions), including the proceeds of that action, to the creditor commencing the claim on behalf of the insolvent estate, it would be possible for the officeholder in Belgium to grant a preferential position to the unsecured creditor commencing a derivative action. Nonetheless, as set out above, in Belgium creditors can currently only start a derivative claim in very limited circumstances. See IA 1986, s.246ZD (England and Wales); E. Hoogmartens, 'Interne aansprakelijkheidsvordering tegen de curator voor afgeleide schade' (2016-2017) *Jura Falconis*, 754, 798 (Belgium).
[90] Additionally, it must be avoided that creditors would use the opportunity to try to create a hold-out position whilst intending to rely on a trust funded by the public purse. See more in detail: Cardinaels (n 17), pp. 187-191.
[91] Ibid.

5.5 Public enforcement mechanisms

However, solely relying on private enforcement would, arguably, not appropriately address all the issues vulnerable creditors could be confronted with. Namely, even with more information being provided, creditors being able to file derivative claims for alleged breaches of directors' duties and a public trust contributing to financing these claims, some creditors may well remain passive. Even though this does not necessarily mean that they would not be interested in being repaid, such a passive attitude could well give a free pass to directors (or office holders) to try to avoid being held to account.

In addition to private enforcement, stronger public enforcement measures are needed. This could be achieved through the introduction of a public ombudsman such as ASIC in Australia which would be entitled to monitor the debtor's management and could impose civil sanctions if the debtor's directors would breach their duties.[92] Although an ombudsman would require large enough public support and concerns could be raised regarding the public costs, it would still be beneficial for various reasons. It would create a low-cost option if unsecured creditors express concerns regarding the debtor's management. Furthermore, the ombudsman would be able to act in situations whereby directors would not be held to account based on private enforcement (e.g., because creditors remain too passive, because derivative actions cannot be initiated after the shareholders' meeting would have approved or ratified the directors' decisions, potential free-rider problems or fears about the costs). This extra enforcement mechanism may also enhance managerial accountability standards which would protect various stakeholders and could enhance market trust. The latter arguments also debunk both the notion that insolvency law would solely be private law[93] or that the public purse should not be burdened.[94]

6. Conclusion

By comparing corporate governance of solvent companies with insolvency governance of financially distressed companies, it was shown that during insolvency governance three similar agency problems akin to the ones analysed within corporate governance could occur. Particular focus was hereby given to the agency relation between majority/controlling unsecured creditors and minority/non-controlling unsecured creditors (which, from an economic perspective, was argued to be similar to the potential majority-minority conflict between shareholders).

Whilst the current regulatory framework in England and Wales provides elaborate protection to vulnerable unsecured creditors via class formation, current Belgian laws do not allow the creation of classes for voting purposes.

Furthermore, even after the implementation of the PRD which would, arguably, improve the creditors' position, various concerns continue to exist. This is why additional governance and non-governance suggestions have been put forward in an attempt to drive the debate forward and to try to improve the regulatory protection of vulnerable unsecured creditors whilst having regard to debtors' and other stakeholders' interests too.

[92] Australian Corporations Act 2001, s.1317G.

[93] A similar argument was raised by Prof. Andrew Keay in relation to Company Law: 'The Public Enforcement of Directors' Duties: A Normative Inquiry' (2014) 43 *Common Law World Review* 89.

[94] Ibid.

Chapter 3

The Portuguese transposition of the Directive (EU) 2019/1023: Where it fell short regarding personal bankruptcy procedures

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1. General considerations

The discharge mechanism for insolvent individuals – the *exoneração do passivo restante* – rose to prominence in 2011, despite being present in the Portuguese Insolvency Code (CIRE)[1] since 2004. In that particular year, due the 2007-2008 global financial crisis and its negative impact on the Portuguese economy, the number of personal bankruptcies surpassed, for the first time, those of business insolvencies. This remains the case as of the time of writing.[2]

The *exoneração do passivo restante* mechanism was established by means of articles 235-248 of CIRE. It consists of three stages: a preliminary decision; a mandatory repayment period; and the final decision.[3] This mechanism is available to all individual bankruptcies, with or without liquidation of the debtors' assets.

The debtor usually requests the *exoneração do passivo restante* with the bankruptcy petition or by responding to a creditor's bankruptcy petition (Article 236(1) CIRE).[4] Creditors and the insolvency practitioner will then offer their inputs about the fulfillment of the legal requirements (Articles 236(4) and 238 CIRE). Legal requirements include different aspects regarding the debtors' behavior before and during bankruptcy proceedings. Generally, access to the procedure is granted to those who could demonstrate that they acted in good faith.[5]

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[1] Decreto-Lei 53/2004, 18 March 2004.
[2] In 2011, individual bankruptcies represented 52.8% of all of insolvency proceedings. The latest available statistics from December 2021 show that 77.7% of all proceedings are individual bankruptcy proceedings. Available at: https://estatisticas.justica.gov.pt/sites/siej/pt-pt/Destaques/20220429_D99_FalenciasInsolvencias_2021_T4.pdf (accessed: 12 August 2022). For more information on insolvency statistics, see: J.M. Branco, 'Uma abordagem estatística ao fenómeno da insolvência: evolução e tendências. Quem a pede e que respostas recebe do sistema judicial' (2017) *Revista de Direito da Insolvência* 245.
[3] See also J. Morais Carvalho and J.P. Pinto-Ferreira, 'Portugal' in T.K. Graziano et al. (eds) *A Guide to Consumer Insolvency Proceedings in Europe* (Edward Elgar Publishing, 2019) 802.
[4] The deadline, after which it will be rejected, is 60 days after the insolvency declaration or the date of the creditor's general assembly, determined by the court in the bankruptcy order: see Articles 236(1) and 238(1)(a) CIRE.
[5] The requirements are the following:

> b) the debtor, with intent or serious fault, has, within the three years prior to the date of the opening of bankruptcy proceedings, provided in writing false or incomplete information regarding their economic circumstances in order to obtain credit or subsidies from public institutions or in order to avoid payments to such institutions; (c) the debtor has already benefited from a discharge of remaining liabilities within 10 years prior to the date of the commencement of bankruptcy proceedings; (d) the debtor has failed to

The competent court will then issue a preliminary order. This includes the appointment of a specific trustee and a mandatory repayment period, which was fixed to five years (article 239 CIRE). In this mandatory period, debtors must fulfill some obligations, the main one being the repayment to the creditors, based on the available income.[6] This income is given to the trustee. The law does not prescribe any minimum payment threshold, meaning that potentially no money could be distributed as a result of the procedure if the debtor has no assets and no income. If debtors demonstrate a total inability to repay, based on their personal, family, and professional expenses, the creditors will not receive any return. This shows that, despite the lengthy repayment period, the procedure was largely ineffective.

The court issues a final decision at the end of the repayment period. If a debtor fulfilled of all their obligations, the competent court grants a discharge (Article 244 CIRE). Should the creditors or the trustee allege violations to the procedure or agreed plan during the repayment period, the court can deny the discharge even before the end of the repayment period (Article 243 CIRE). If these breaches become known after the final decision, a court may revoke the discharge in the year following such decision (Article 246 CIRE). The discharge does not apply to alimony, civil and criminal liability debts and tax claims, as stated in Article 245 CIRE.

The sudden spike in the number of personal insolvencies led to non-uniform decisions across the courts, partially due to their lack of specialization before the changes introduced in 2012. Some courts showed a rather conservative approach to the discharge rules, hampering the access to an effective fresh start.[7] Specifically, the courts adopted a very strict interpretation of the legal requirements and a mechanic approach to determine the income available for distribution during the five-year payment period. Moreover, the burden of proving the failure to comply with the legal requirements lies with the affected creditors and the trustee. This led to an abundance of litigation in the Portuguese higher courts, and this further affected the effectiveness of the discharge provisions. Insolvent debtors were faced with delays in obtaining the final discharge and a lack of predictable outcomes due to afore-mentioned varied approaches between courts.[8]

However, the discharge mechanism has affirmed itself as an essential solution for personal bankruptcies, which are far more popular among debtors than alternative solutions such as judicial payment plans or pre-insolvency proceedings (created in 2012[9], 2017[10], 2018[11] and 2020[12], during the

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comply with the duty to file for bankruptcy or, when not required to do so, has failed to do so within six months following the onset of the insolvency, with prejudice to the creditors in either case, and knowing, or being unable to ignore without serious fault, that there was no serious prospect of improvement in his economic situation; (e) there is evidence in the proceedings, or has been provided until the time of the decision, by the creditors or the insolvency administrator, that indicates in all probability the existence of the debtor's fault in the creation or aggravation of the insolvency situation, pursuant to article 186 CIRE(f) the debtor has been convicted by a final and conclusive decision of any of the crimes provided for and punished in Articles 227 to 229 of the Criminal Code within the 10 years prior to the date of filing for the declaration of insolvency or after that date; g) the debtor, with intent or serious fault, has violated the duties of information, presentation and collaboration incumbent upon him under this Code, during the bankruptcy proceeding.

[6] These include keeping or finding a job, not concealing income or other assets from the trustee and not spending money on unauthorised expenses.

[7] Especially regarding Article 238(1)(d) CIRE. See also: J.G. Ferreira, *A Exoneração do Passivo Restante* (Coimbra Editora, 2013) 49; G.G. Lobo, 'Exoneração do Passivo Restante e causas de indeferimento liminar' in C. Serra (ed), *I Colóquio da Insolvência de Santo Tirso* (Almedina, 2014) 257; L.M. Costa, *A Insolvência de Pessoas Singulares* (Almedina, 2021) 124.

[8] See also A.F. Conceição, 'A Jurisprudência Portuguesa dos Tribunais Superiores sobre a Exoneração do Passivo Restante' (2016) Julgar. Available at: http://julgar.pt/a-jurisprudencia-portuguesa-dos-tribunais-superiores-sobre-exoneracao-do-passivo-restante/ (accessed: 12 August 2022). See also C. Oliveira Martins, 'O Procedimento de Exoneração do Passivo Restante – controvérsias jurisprudenciais e alguns aspetos práticos' (2016) *Revista de Direito da Insolvência* 213.

[9] *Processo Especial de Revitalização* – Lei 16/2012, 20 April 2012 and *Sistema de Recuperação de Empresas por Via Extrajudicial* – Decreto-Lei 178/2012, 3 August 2012.

[10] *Processo Especial para Acordo de Pagamento* – Decreto-Lei 79/2017, 30 June 2017.

[11] *Regime Extrajudicial de Recuperação de Empresas* – Lei 8/2018, 2 March 2018.

[12] *Processo Extraordinário de Viabilização de Empresas* – Lei 75/2020, 27 november 2020, in force until 30 June

COVID-19 pandemic). The discharge mechanism accommodates all types of individual bankruptcies, such as consumers, entrepreneurs, self-employed professionals and personal guarantors (both from company debts or personal debts, mainly for mortgages payments). It has become an one-size- -fits- all solution, albeit the difficulties of access created by the courts interpretation, as said above.

In the absence of empirical studies or inquiries regarding the outcome of these procedures following the post-discharge period, some conclusions may be provisionally drawn from the observation of some available elements. Since individual bankruptcies mostly end with discharge, debtors are not able to keep their assets after the bankruptcy proceedings. In most bankruptcy proceedings in Portugal debtors do not have any assets to liquidate (NINA or LILA proceedings[13]), meaning that debtors file too late and are not able (or do not have the intention) to restructure their debts in order to keep their assets. Pre-insolvency proceedings in Portugal are abundant and redundant, since they compete with each other, creating confusion in the debtors. Finally, the five- year period of payment to the creditors was not efficient, as evidenced by the very low percentage of credit recovery.

Table 1. Evolution of the discharge decisions (Source: Portal CITIUS - Anúncios – as in 1November 2021)

	2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Preliminary Decision	4523	6295	5779	6780	7519	8433	8885	7962	6404	4742
Final decision	306	307	217	263	540	1459	2696	5909	6458	6590
Early Refusal	18	37	43	125	226	423	625	808	900	777
Discharge Refusal	-	-	-	-	-	-	362	216	489	459
Discharge Revocation	7	10	10	6	36	43	34	36	3	12

Looking at the numbers above, the increase in early discharge refusals shows that debtors face significant difficulties in maintaining the payment plan for a long period of time. At the same time, the relatively low number of (final) discharge refusals and revocations suggest that the discharge is granted to good faith debtors, who not only fulfill the access conditions, but also follow closely their obligations during the five-year repayment period.

2. Directive 2019/1023 and the minimum requirements for personal bankruptcy proceedings

The Directive 2019/1023 of the European Parliament and of the Council, of 20 June 2019 (PRD 2019)[14]

2023.

[13] See C. Frade and R. Jesus 'NINA/LILA debtors under the Portuguese Insolvency Act: A hidden problem in plain sight?' (2020) 29 *International Insolvency Review* 77.

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

establishes a very low degree of harmonisation of the rules and purposes governing individual bankruptcies. It incorporates the principles deemed essential by international guidelines[15], but the PRD 2019 is mainly focused on commercial insolvencies (although most Member States are extending preventive restructuring measures to include all types of debtors). These principles establish the need of two options for debtors: on the one hand, the debt restructuring, preferably extrajudicial and preventive; on the other hand, a discharge mechanism as an alternative, last-resort, and social insurance option for overindebted debtors.

The timid harmonization efforts do not allow the implementation of a unique model or solution across Member States. Moreover, it seems that the PRD 2019 does little to counteract forum shopping, since its rules do not prevent debtors from filing in other countries.

Despite these criticisms, after the transposition of the PRD 2019, it is to be acknowledged that all Member States will be equipped with a discharge mechanism, which was absent in some of them. This would allow more fragile and vulnerable debtors to obtain the desired second chance.

The PRD 2019 imposes the introduction in national laws of a discharge mechanism, with or without a repayment plan (Articles 20 and 21 PRD). The PRD 2019 does not mandate the liquidation of the debtor's assets to obtain the discharge. The maximum period before discharge can be granted is set to three years, but there is no obligation to use the petition date as the starting point of this period (Article 21(1) PRD). Finally, Member States can derogate from the three-year period when this is needed to protect creditors' rights and to ascertain that the discharge is only available to good-faith debtors and only for certain types of debts debt (Article 23 PRD 2019).

3. The (insufficient) new rules of discharge in Law 9/2022 from 11 January 2022

The Portuguese bankruptcy framework is considered tried and tested. Despite the flaws mentioned above, it has offered a safeguard for natural persons since 2004. Given this fact, the transposition of the PRD 2019 would not bring any serious challenges or changes to the existing legal framework. Nevertheless, practitioners and academics were expecting some degree of improvement over the existing system, namely regarding the procedure to discharge debts, the restructuring plan, the preventive insolvency framework and even the period of debt repayment. Law 9/2022 enacted on 11 January 2022 implements the PRD 2019 in Portuguese law, but it is widely regarded as falling short of the expectations, especially as Portugal made use of additional time to implement it. Part of the reason of such disappointing result is because the legislator did neither consult with specialized bodies nor launched any public consultation on the implementation of the PRD 2019. The results are therefore lacking depth and do not contribute to a more efficient personal bankruptcy system.

The Portuguese legislator opted for extending the measures to all debtors, and not only to entrepreneurs, as expressly stated by Article 1(4) of the PRD 2019.

However, the main changes were introduced to Articles 235 and 237(b) CIRE. The repayment period has been reduced from five to three years, starting from the date of closing of the bankruptcy proceeding. This article was problematic in its earlier drafts. In fact, these earlier drafts stated in one article that the discharge period would start from the judicial declaration of insolvency, while another article referred to the closing of bankruptcy proceedings. This inconsistency had been addressed in the final text.

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restructuring and insolvency) OJ L 172/18.

[15] World Bank, *Report on the Treatment of the Insolvency of Natural Persons* (2014). Available at: https://openknowledge.worldbank.org/handle/10986/17606 (accessed: 12 August 2022); UNCITRAL Legislative Guide on Insolvency Law (2005), recommendations 194-6. Available at: https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/05-80722_ebook.pdf (accessed: 12 August 2022).

The issue with the statutory choice of considering the closing date of the bankruptcy proceeding as the starting date for the discharge period is not entirely aligned with Article 21(1)(a) PRD 2019. The latter suggests that, in case of a repayment plan, the period should start at the latest from the opening of that repayment plan. Additionally, whenever the proceedings close without a bankruptcy order, the three-year period will start from the preliminary decision about the discharge, which may occur up to 55 days after the declaration of insolvency (Article 230(1)(e) CIRE). However, when the proceedings result in a bankruptcy order, they are only closed after the final payment following the liquidation of the debtor's assets (Article 230(1)(a) CIRE). In a nutshell, the legislator failed to address the issues highlighted in the implementation of the old law and it has created an unequal treatment between debtors with and without assets.

Another problem is a more profound one and can be put in the form of a question: What is the rationale for a repayment plan and what should be its acceptable duration?

Considering the fragile balance between creditors and debtors' interests, the existence of the repayment plan normally responds to economic, social, and legal demands and, particularly, to ethical reasons. Insolvency law is the answer to a generalized breach of contracts and to market failures. The risk of an undeserved debt forgiveness must be addressed, avoiding the moral hazard of forgiving bad faith debtors. Bankruptcy law must find an optimal match between the right to repay creditors and prevent the debtors' economic and social exclusion. It shall avoid the notion of immorality associated with the insolvency proceedings and the stigma normally imposed on bankrupt debtors.[16] The notion that the discharge is equivalent to a prize for good behavior, disregarding the specifics of the insolvent situation before the proceedings, must be avoided at all costs.

Additionally, long periods of repayment, such as the five-year period in the old Portuguese law, raise practical issues. Apart from the stigma brought to debtors and their families, debtors have difficulties in recovering from bankruptcy proceedings not only professionally, but also psychologically. A debtor in a long repayment plan is subject to continuous duties imposed by the court, can hardly change jobs, engage in training or educational programs, open new businesses, and similar activities. On a personal level, debtors tend to develop social and psychological issues and the risk of social exclusion is increased, for them and the members of their families. Due to the fact that the percentage of credit recovery is extremely low or irrelevant, one must question if the imbalance between the sacrifices of the debtor and the gains of creditors justifies the existence of a repayment period at all, especially when the expectations of repayment are inexistent.

The choice of the three-year period seems to address this need for a balance between opposing needs, but even three years may be too long if the likelihood of repayment for creditors are non-existent due to the poor economic and financial conditions of the petitioning debtor. In this case, the law should consider immediate discharge, as otherwise it is not possible to claim that debtors are given a second chance, since their lives are paused without giving any real benefit to the creditors. In our opinion, discharge should be offered where no repayment plan is needed, namely when assets are sold, we are before a NINA or LILA bankruptcy and, ultimately, when there is no opposition from the trustee or the creditors.

A final note about the choice of the Portuguese legislator regarding the deadline for the discharge. Earlier drafts suggested 30 months as an appropriate period and reduced the repayment plan period to 15 months. Unfortunately, the final text opted for the three-year minimum period. This extension lacks principled justification and reveals a lack of understanding of the discharge mechanism, since the credit recovery statistics demonstrate that six more months do not substantially benefit the creditors, but do impose unreasonable harm to debtors, without any social or economic justification.

The transposition law introduced some changes not triggered by the PRD 20149, including the need for a final court order regarding the classification and ranking of claims before granting payment to

[16] C. Frade and A.F. Conceição 'A reprodução do estigma na insolvência das famílias' (2013) 101 *Revista Crítica de Ciências Sociais*; N. Huls 'Overindebtedness and overlegalization: Consumer Bankruptcy as a Field for Alternative Dispute Resolution' (1997) 20 *Journal of Consumer Policy* 144.

creditors (Article 241(1)(d) CIRE); a new deadline for creditors to ask for the trustee's supervision of the debtors duties during the repayment period (Article 242(3) CIRE); a reduction, from one year to six months, of the creditors' right to ask for the termination of the repayment period due to the breach of duties (Article 243(3) CIRE).

With the new Article 241(A) CIRE, the transposition law allows for the court to order the debtor's liquidation after the conclusion of the discharge period, whenever the proceedings are closed in the absence of assets during bankruptcy proceedings. This introduces a moralizing and just measure to bankruptcy proceedings, since it allows creditors to benefit from new assets acquired by the debtor, although the occurrence of these situations will probably be scarce.

Additionally, in accordance with Article 23 PRD 2019, the Portuguese legislator also establishes a very ineffective approach to the breach of the debtor's duties during the repayment period. The debtor, the creditors or the trustee may ask the court for an extension of the repayment period for up to 36 more months, whenever the breach of the debtor's duties significantly affects the repayment scheme. The court, however, must restrict the extension to the exact measure of the damages, avoiding an excessive extension, without any benefit to the parties involved. This avoids the premature ending of the repayment plan, or non-awarding the discharge for breaches that can be addressed with an extension of the plan.

With the entry into force of the transposition law on 11 April 2022, the new rules apply to all pending bankruptcy proceedings. This is likely to cause some disruptions to ongoing procedures, as well as the early termination of some bankruptcy cases

4. Concluding remarks: what was left undone and what could have been done

Law 9/2022 is a missed opportunity for improving the Portuguese bankruptcy regime. Not only did the PRD 2019 urged for more profound reforms, but also the practical issues that have been identified in the last ten years allowed us to legitimately hope for more ambitious changes. Several improvements could have been made for the benefit of a truly fresh start solution.

The plethora of pre-insolvency procedures makes it difficult for the debtors to choose the most appropriate solution, one that preserves their social and economic value. Some of the existing mechanisms aim at restructuring all debts, while others only partially restructure either financial debts or non-financial and non-tax debts. Different mechanisms apply to entrepreneurs and consumers. Some of these mechanisms involve the use of mediators and conciliators, while others require the debtor to rely on legal practitioners. This is a very ineffective system, since there is a structural lack of information. Counseling is not available freely or easily, and debtors inevitably choose bankruptcy and discharge proceedings over debt restructuring, since they are more straightforward and simpler.

That is why the system could be significantly improved, and even more so after a decade and a half of experience. One of the key aspects to improve is access to information. The government should create dedicated websites and insolvency information services available in all courts or other public services to provide, in a plain language, a clear guidance for individuals on the available rules and solutions available to them. It could also implement a database of debt counselors, accessible both virtually and in person, taking advantage of the hundreds of regulated professionals operating on the market. Increasing debtors' access to reliable and transparent information and to adequate counselling will empower them to make more informed choices. It is also likely to benefit creditors, since debtors will be more likely to start debt restructuring or bankruptcy proceedings at an earlier stage.

Another area where improvements are needed relates to the repayment period that – under certain circumstances – should be eliminated to allow for an immediate discharge. The repayment plan should be retained as an option for those debtors who would like to keep all or part of their assets. With percentages of credit recovery below 10% on average, the repayment period seems unnecessary, punitive and obsolete as it does not operate for the benefit of the debtor's creditors.

Other amendments are worth considering. Tax claims should become dischargeable debt. There is no valid reason (not even in the PRD 2019) to justify their preferential treatment, which is also in breach of the international guidelines on these matters (for instance, the World Bank guidelines[17]). Since for many debtors taxes are a sizeable portion of their debts, if these debts are not forgiven, bankruptcy proceedings are unlikely to achieve any purpose.[18] Additionally, the treatment of mortgages for buying real estate properties should also be reconsidered, as they represent about 80% of the total amount of debts in personal bankruptcies. A uniform, joint proceeding for companies and their shareholders should be considered whenever there is a high proportion of personal guarantees in the company's debt. It is argued that the trustee functions should be extended to include debt counseling and trustees should be given more autonomy to authorize extraordinary expenses. Finally, personal bankruptcy proceedings should be free of charge whenever it is the debtor who starts the procedure to ensure that access to justice is not precluded by the lack of financial means. The currents rules for accessing legal aid are deemed too restrictive to be adequate in these cases.

[17] World Bank (n 15), p. 122.

[18] G. McCormack et al., *European Insolvency Law, Reform and Harmonization* (Edward Elgar Publishing, 2017), p. 103.

Chapter 4

Relativism and determination in restructuring frameworks. New and interim financing

Flavius MOTU* and Adreea DELIN**

1. Introduction

Traditionally, while looking into restructuring, financing is considered to be of the essence, hence it as a measuring unit of a restructuring's success.[1]

Furthermore, it is generally accepted that, if the debtor's business is eligible for financing from the perspective of a third party (considered, *per se*, objective),[2] then the debtor's business should be saved. Thus, financing becomes a desirable tool that leverages the debtor's business from precarious to stable.

This is precisely why, *ratio legis*, the legal protection that restructuring proceedings awards the interim and new financing enjoys the highest ranking in any subsequent insolvency proceeding and shields such financing from (most of the) avoidance actions.[3]

Yet, is financing a *sine qua non*, altogether beneficial instrument devised to save the debtor's business?

Our analysis is based on the assumption that, in case a debtor finds itself in financial distress, different interests arise.

The moment when the creditors' individual (and individualistic) interests necessarily become collective interests is the 'automatic stay'. However, since the debtor is not there yet, the restructuring proceedings

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[1] Ever since the UNCITRAL Legislative Guide on Insolvency Law (Part Two) was being elaborated, the authors insisted that the need for financing is 'highly desirable' – see in this respect para (95) of the Guide. Meanwhile, the researchers focusing on the restructuring proceedings have emphasised the essential role of rescue financing and have considered that the debtor's survival depends, at a structural level – on such financing. The Proposal for the Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU COM/2016/0723 final outlined that: (i) financing is 'essential in ensuring restructuring plans' success'; (ii) the protection of financing throughout restructuring should reinforce the funds providers' trust in 'a restructuring plan that can successfully be implemented'. For a recent analysis of the concerns around the compatibility of the rescue financing with the purpose and the end point of the restructuring, see A. Balsiukienė and R. Jokubauskas, 'Problems of New and Interim Financing in Restructuring Proceedings' (2021). Available at: https://dspace.rsu.lv/jspui/bitstream/123456789/6285/1/Socrates-20-2_10-Balsukiene-Jokubauskas_127-135.pdf (accessed: 12 August 2022).

[2] For the purposes of our analysis, a third party's perspective regarding the structure of the debtor's business and of their existing creditors is considered 'objective'. Hence, 'relativity' appears for the first time in the restructuring mechanisms. Certainly, a third party's review of the debtor's business in distress should be objective because it would require a realistic and thorough analysis of the constraints and restrictions and of the debtor's perspective, that sometimes can be too optimistic. However, as our analysis endeavours to prove it, such a review may be relatively 'objective' when the financier's interests go beyond the recovery of the extended financing, *i.e.* when the investor intends to take control of the debtor's business.

[3] The Proposal for the Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU COM/2016/0723 final, outlined that the Member States have disparate regulations as regards the priorities offered to rescue financing: 'The protection of new financing and interim financing […] also varies among Member States, ranging from minimum protection from avoidance actions to a form of priority over existing debt in subsequent insolvency procedures.' (p. 3)

allow for other particular interests to come into play, *i.e.* those of the financier – investor. The financier's interest is future-driven and has generally[4] no impact in terms of *ante-factum* protection, simply because the financier was not there in the past. The financier's 'individualistic' thinking and actions are of a different nature than the 'individualistic' interests of the pre-existing creditors. The financier's individual interest is more sophisticated and, therefore, more prone to vulnerability that the pre-existent creditors' individual interests.[5] While the debtor and its pre-existing creditors are already there, the financier steps in because it chooses to, although none of the former really wanted it to. Even if the financier is invited to the table by the debtor facing a financial distress, the debtor does so because it has to do so.

We have also assumed that the financier, while acting on their free will, does asses the risks and the opportunities of granting the financing.

On the one hand, the pre-existing creditors are presumed to have already lost something, and the risks they face, mathematically speaking, is to lose even more. On the other hand, the financier of the business in distress may be willing to invest precisely because the financing would bring a high leverage.

Any deviation from the principle 'financing is the safest and shortest way to save the debtor's business' may be considered, *prima facie*, atypical.

However, the same can be said about one of the universal principles of insolvency, *pari passu*. As legal scholars[6] have rightly argued and the practitioners have proved, few insolvency proceedings actually rely on the *pari passu* principle. The reality is that, in formal insolvency proceedings, the debtor's estate is exhausted way before the *pari passu* rule might be of any use. In other words, generally, no debtor gets to that point.

For the financing to be able to save the distressed business, it must be 'reasonable' and 'necessary'. What happens if the financing is only necessary, but not reasonable?

When its amount is either less or more than optimal, the financing may destroy the business even faster than initially estimated. Funds that are granted but in amount which proves insufficient to cover the debtor's restructuring needs may not be considered an effective remedy. The restructuring deal could collapse because of the insufficient financing.

The funds allocated to a debtor in distress are offered against certain collaterals. The debtor and its preexisting creditors are willing to risk their *status quo*. As soon as the debtor's business becomes distressed, taking further risks might be the debtor's better or only chance to save the business. Equally, this course of action enhances the opportunities for pre-insolvency creditors to recover what was originally owed to them. For a sophisticated investor, who is familiar with the debtor's business, the takeover of the encumbered assets and, in particular, of the core-business assets is appealing, since it is

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[4] Our analysis shall address further the situation of a financier that is not a creditor at the time it decides to invest. For a scenario where the financier is already a pre-existing creditor, converting a non-secured claim into a fully secured post-petition claim, see the *Colt* study case (*infra* at 5(b)).

[5] The protection offered to the financiers and the protection offered to the pre-existing secured creditors are clashing, as the Directive on restructuring frameworks allows a super-priority of the first over the second. The source of this super-priority is to be found in the US Code, Chapter 11, which it has two further features: the possibility of cramming-down the restructuring plan on the dissenting creditors and the implementation of a stay throughout the negotiations on the restructuring. For more details on the essential role of these three features, considered and applied in an integrated manner, see J. Payne, 'The role of the court in debt restructuring' (20 January 2017). Available at: https://www.law.ox.ac.uk/business-law-blog/blog/2018/02/role-court-debt-restructuring (accessed: 12 August 2022). In the Romanian national law, the super-priority of the financing extended during the observation period (*i.e.*, before a decision is made on the confirmation of a reorganization plan or, on the contrary, on the opening of the liquidation proceedings, as appropriate) was introduced by Law No. 85/2014, as a step-by-step structure: (i) financing must first be approved by the creditors' assembly; (ii) it is secured, firstly, by encumbering the unsecured assets in the debtor's estate and only exceptionally by encumbering the already secured assets, subject to the security holder's approval; (iii) if the unsecured assets are insufficient or the pre-secured creditor's approval is not obtained, than the securing of the new financing is created by operation of law on the already encumbered assets, *pro rata*, thus reducing the pre-existing securities proportionally.

[6] R. Mokal, 'Priority as Pathology, The Pari Passu Myth' (2001) 60 *Cambridge Law Journal* 581.s

precisely these assets that bring value to the debtor's business as a going concern. When in distress, neither the debtor enjoys an absolute contractual freedom,[7] nor do the preexisting creditors. The financial distress may quickly turn into insolvency, and insolvency means to these creditors a higher risk of not recovering their claims. Thus, the preexisting creditors may only decide freely their next moves if they are assured the debtor has no financial constraints to repay their claims and their claims are enforceable. Meanwhile, the financier can freely contract with the debtor and thus determine the rules of the game at will; it may even change these rules during the game.

Our analysis attempts at laying down the criteria that interim/new financing (hereinafter jointly referred to as 'rescue financing') must meet in the eyes of an objective observer. Certainly, there can be no rescue financing standard model, but one should bear in mind the fact that the rescue financing brings on the stage new, well experienced, actors, in the already complex and peculiar landscape of the restructuring. The new actors will attempt to manage the existing risks but, of course, to their own benefit. There can (should?) be no mutual planning between the financier and the pre-existing creditors because, just like the pre-existing creditors reject the idea of a permanent 'automatic stay', the financier rejects the idea of 'sharing' its position with the pre-existing creditors.

Moreover, the relativity of the 'next best alternative solution' (hereinafter referred to as 'NBAS') test is tempting enough for the financier, whose position is protected from the insolvency specific avoidance actions, to wish to be the only winner.

This is the point where the financing could cease being an instrument saving the distressed business of the debtor.

2. The institutions covered by the analysis: A theoretical (static) approach

2.1. *The rules governing rescue financing*

The Directive (EU) 2019/1023 lays down a rather sketchy legal framework in terms of rescue financing, founded on the basic principles of protecting and encouraging the financing:

As regards the interim financing, Recital 66 states the rationale behind such financing, making it altogether a (substantive?) *condition precedent* for the success of the future restructuring plan:

> The success of a restructuring plan often depends on whether financial assistance is extended to the debtor to support, firstly, the operation of the business during restructuring negotiations and, secondly, the implementation of the restructuring plan after its confirmation.

As regards the new financing, Recital 68 offers the possibility to 'naturally' convert the interim financing into a new financing:

> When interim financing is extended, the parties do not know whether the restructuring plan will be eventually confirmed or not. Therefore, Member States should not be required to limit the protection of interim finance to cases where the plan is adopted by creditors or confirmed by a judicial or administrative authority.

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[7] For a deeper analysis of the difference between the contractual agreement and the cram-down, see S. Madaus, 'Leaving the Shadows of US Bankruptcy Law: A Proposal to Divide the Realms of Insolvency and Restructuring Law' (2018) 19 *European Business Organization Law Review* 615, 616-18: 'The legislative frenzy has created "restructuring and insolvency law", a legal area that lacks normative foundations with clear lines between insolvency proceedings and (debt) restructuring […] Any solution that goes beyond the common pool requires an agreement between the debtor and (most of) his creditors (about future income). Such a solution is always a contractual solution and, consequently, any legal framework supporting the conclusion of such agreements (restructuring law) should be based on contract and company law principles instead of those of a liquidation (insolvency principles).'

Then, Recitals 48 and 68 bid the Member States to put in place controls over the granting of either one of the two types of financing, *i.e.* an *ex ante* control for interim financing and an *ex post* control for the purpose of implementation, for new financing:

> 68 [...] this Directive should not prevent Member States from introducing an ex ante control mechanism for interim financing.
>
> 48. Confirmation is particularly necessary where: […] the restructuring plan contains provisions on new financing; […]

According to Recital 68, both types of financing are subject to the same relative granting standard: the financing must be immediately necessary and reasonable.

> To avoid potential abuses, only financing that is reasonably and immediately necessary for the continued operation or survival of the debtor's business or the preservation or enhancement of the value of that business pending the confirmation of that plan should be protected.

The protection against avoidance actions is intended to offer stability to the long-term effects of such financing, to be correlated, though, to the *ex ante* or *ex post* controls.

According to Article 17(1)(a):

> Member States shall ensure that new financing and interim financing are adequately protected. As a minimum, in the case of any subsequent insolvency of the debtor: new financing and interim financing shall not be declared void, voidable or unenforceable.

The priority over other claims, in the undesirable event of insolvency, grants a higher degree of comfort to the financier, with a view to the risks the financier undertakes. Yet, the priority ranking of the rescue financing is to be determined by the Member States, since the Directive only points out to a minimal level.[8]

According to par. (68) of the Recitals:

> However, encouraging new lenders to take the enhanced risk of investing in a viable debtor in financial difficulties could require further incentives such as, for example, giving such financing priority at least over unsecured claims in subsequent insolvency procedures.

According to Article 17(4):

> Member States may provide that grantors of new or interim financing are entitled to receive payment with priority in the context of subsequent insolvency procedures in relation to other creditors that would otherwise have superior or equal claims.

2.2. The rules next-best-alternative scenario going rogue

Article 6(2) requires that the restructuring plan provides for an alternative scenario to the restructuring plan – the next-best-alternative scenario –. This is a mechanism to ensure creditor satisfaction anywhere between piecemeal liquidation and the expected outcome of the restructuring plan.[9]

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[8] For a deeper analysis of the rescue financing's priority, as embedded in the national laws of the Member States, where such financing is allowed, see European Law Institute, *Rescue of Business in Insolvency Law* (2017), pp. 216-217. Available at: https://www.europeanlawinstitute.eu/fileadmin/user_upload/p_eli/Publications/Instrument_INSOLVENCY.pdf (accessed: 12 August 2022).

[9] The legal doctrine offers an opinion on this matter, according to which the NBAS may be (more) reasonably explained if there are several competing plans. It has been considered that: 'The only reasonable way to read the Council's addition, in our perspective, is to consider that it refers to an alternative restructuring plan to the one under consideration. If such a comparison were to be systematic, however, the proceedings would be likely to become far too costly and complicated, as several competing plans would systematically have to be prepared and presented. It seems to us,

In case an interim financing is in place (that can be converted into a new financing at a later stage), the NBAS might be devised as a mechanism to enforce the collateral encumbered to secure the financing, resulting in the transfer of business to the financier (that, by definition, ensures a higher degree of creditor satisfaction than the liquidation of the debtor's business). This would only be natural, as the restructuring plan is the legal and economic support that has validated the financing and its implementation framework.

Where the NBAS does not allow for the debtor's restructuring, the adverse effect is the enforcement of the above-mentioned collateral.

2.3. Business core collateral, available for rescue funding, even if already encumbered

We discuss such collateral in detail as the respective assets are a part of the very fabric of the debtor's business.

Since they are essential to the operational core of the business, the liquidation scenario as a NBAS drastically reduces or neutralises their value. Their value can only be preserved to the extent that: (i) their use is continuous; and (ii) their acquirer runs a similar or a compatible business. Therefore, it would be both necessary and reasonable that the debtor offers then as security to the financier, even if they are already encumbered by pre-existent securities. At the same time, in order to preserve their value, the financier and, as the case may be, the pre-existent secured creditor would enforce them altogether (as opposed to piecemeal) in the NBAS.

3. Financing must be as reasonable as to prevent a gane of reversed chances

Undoubtedly, it is difficult to determine the best financing solution for a distressed business so that it meets both the standard of reasonability and the necessity to rebalance the business, while minimally affecting pre-existing creditors. Therefore, when assessing whether the rescue financing is reasonable, one must consider that:

(i) The individual interest of the financier may be of a different nature than the interests of pre-existing creditors

In the assessment of whether the financing is both 'immediately necessary' and of 'reasonable' standard, one must look first into the positions of the actors in the usual landscape of a restructuring.

Pre-existing creditors are already facing a risk and they are most likely to adopt a defensive position, attempting to deny the new financing, with a particular focus on any new costs. Their main concern is that the debtor's distress does not overly reduce the money available to satisfy their claims. It is, therefore, understandable that they tend to adopt a risk-adverse position.

Secured creditors, generally banks and credit institutions, realize that the liquidation would considerably reduce the value of their securities. They want to avoid an insolvent liquidation. Their prediction in this respect is, as realistic as it gets, gloomy and bleak. Furthermore, for the proper incentive, they may be willing to accept an exit strategy.

Debtors are also aware that they are a short time away from the moment the shortage of funds will destroy their business. Their position during the negotiations with the creditors grows weaker and

therefore, that the text should be understood as requiring that the stakeholder not be worse off than under a competing plan where such a plan exists.'; See also V. Rotaru, 'The Restructuring Directive: a functional law and economics analysis from a French law perspective' (2019). Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3461716 (accessed: 12 August 2022).

weaker every day.

The financier (investor) joins the game fully aware of the positions of the other parties. However, by reference to the risks already faced by the pre-existing creditors and the debtor, the investor may have the advantage of being the only one without a past involvement. In case the investor is a preexisting creditor, its interest is to obtain a better position than the one he already enjoys, in terms of claim recovery, and thus turn the risk taken into profit.[10] As the financier has the means to obtain a privileged position during the negotiations, it is able to set the rules and the limits of the restructuring game. Yet, in order to achieve just that, the financier is in need of a significant amount of information on the debtor's financial and commercial standing. There are certain situations in which the financier may already have such information.[11] This is the very reason why the financier can save the debtor's business but, at the same time, can take advantage of the debtor's vulnerabilities.

A well-balanced approach would take into account all players' interests.

(ii) Insufficient funds result in the useless sacrifice of the atypical, core-business guarantees

Insufficient funds have the potential to expedite the destruction of the business. Where the rescue financing is offered against securities over the core-business assets, the debtor's standing may turn from critical to dead-end. As the financier may leverage its position when requesting collateral, it may coerce the debtor into accepting to encumber its core-business assets to secure a rescue. However, if the financing secured in this way proves insufficient, the debtor would be forced to liquidate its assets in a piecemeal manner. In such a situation, the exhaustion of the core-business collateral was useless, because the financing was unable to maximize the use of core-business assets in order to reach the expected level of recovery. Such funding would prove a useless sacrifice.

(iii) Excessive financing: if the the costs of financing are not fairly backed by equivalent collateral, that collateral is not made at best use.

The same risks of insufficient financing occur in case of excessive financing not properly backed by the related costs and collaterals' structure. This may occur in situations such as where the financing may not, by itself, cover other needs of the distressed business, such as the loss of markets, clients or qualified licensing. In these scenarios, financing does nothing more than worsening the standing of core-business assets within the distressed business.

(iv) The fairness of rescue financing must be assessed by comparing it with: (i) a "forced" sale of the collateral; (ii) the profit margin of core-business collateral in place.

A financing that is necessary must fall between these two reference levels.[12]

An estimated return value in case of a "forced" sale of the collaterals equal to the financed value is the minimum standard the encumbered assets must meet in order to make the debtor eligible for funding. In other words, if the respective assets were isolated, segregated from the ongoing business, would their market value cover the financing?

At the other end stands the operational profit that may be obtained by setting these collaterals 'in

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[10] See 5(b) *infra*.

[11] According to the Romanian relevant case law, in one of the restructuring proceedings (*concordat*) of an aviation company, one of the debtor's competitors requested access to the case file and stated its interest arguing it was a post-petition creditor. After hearing the evidence and the parties' submissions, the competent judge eventually dismissed the request for access to information on the grounds that such a disclosure would have made the debtor vulnerable. The judge's reasoning revolved around the confidential nature of the information requested.

[12] Our assumption that the core assets, which have operational capacity, have a higher value than the pre-existing liabilities, is tackled within the comments under par. 3.2.8 (*New Financing)* of L. Stanghellini et al. (eds), *Best Practices in European Restructuring: Contractualised Distress Resolution in the Shadow of the Law* (Wolters Kluwer, 2018), p. 58: 'This would occur if the debtor's assets (if permitted to continue to operate as a going concern) have sufficient surplus value after meeting the liabilities that the debtor is envisaged as carrying in the restructuring plan upon the plan's approval.'

motion' within the ongoing business.[13]

Where the financing ranges anywhere between these two values, it should be considered reasonable, because it is backed by a true consideration. Outside these boundaries, the financing becomes non-reasonable because its consideration drifts away from the restructuring territory.

(v) Can there be a standard model of financing in the restructuring frameworks?

Most probably, a standard model is unlikely to exist. It is a *vexata quaestio*.

Yet it is reasonable to conduct a correlated analysis of the rescue financing in the context of all restructuring details of the case where it is destinated to interfere. Its interaction with the debtor's position is inseparable and, altogether, binding.[14] Most probably, the design of each financing can only be drawn after reviewing its underlying consideration in the specific restructuring.[15]

4. Rescue financing: From rescue to hostile takeover

Who may be interested in financing the distressed business undergoing restructuring?

When addressing the formal frameworks of insolvency, the UNCITRAL Legislative Guide has identified two categories of such interested persons and their respective causes of action:[16] (i) pre-existing creditors, who attempt at 'solidifying' (consolidating) their recovery; and (ii) sophisticated investors who expects high returns from such investment.

The portrait of the financier in the restructuring frameworks depicts a sophisticated investor who holds significant experience in the techniques of insolvency procedures.[17] To the same extent, a professional consultant may undertake this role, because it is capable of managing and strategically forecast the evolution of the concerned business, to the benefit of the holders of current interests in the distressed business.

Realistically speaking, the economic model used to examine a restructuring has two opposite outcomes: (i) a justified rescue; or (ii) failure. When assessing whether a distressed business is worthy of being

[13] For a deeper analysis of the grounds justifying the acceptance of the new financing in a restructuring proceeding, in order to enhance the value of the pre-existing securities, see A. Gurrea-Martínez, 'The Future of Reorganization Procedures in the Era of Pre-Insolvency Law' (12/2020). Available at: https://core.ac.uk/download/pdf/359403488.pdf (accessed: 12 August 2022). The author argues that 'from an economic perspective, these requirements seem to ensure that this new financing creates a Pareto improvement, or a situation in which, while generating some gains, nobody will be worse off. By doing so, the DIP financing regime can create ex post efficiencies without harming ex ante efficiency.'

[14] Relational interpretation concept, C. Rovelli Helgoland, *Cum să înțelegem teoria cuantică* (Making Sense of the Quantum Theory) (Humanitas Publishing House, 2020), p. 129: 'An isolated object, considered by itself, independent of any interaction, has no particular status. The most we can do is attribute to it some sort of probabilistic disposition to manifest itself in one way or the other. But this is just the anticipation of future phenomena and the reflection of past events, and it is always by reference to another object'.

[15] A preliminary legal construction can be found in Recommendation 3.9 of the Best Practices in European Restructuring Contractualised Distress Resolution in the Shadow of the Law, according to which:

> New financing - The law should exempt new financing from avoidance and provide for priority over unsecured creditors under court control, when new financing is necessary for the success of the plan. In some circumstances, applicable law may permit priority over existing secured creditors, if such creditors consent or else if the court can be satisfied that the interests of such creditors are adequately protected. The lender should be exempted from the associated risk of liability, provided that the new financing falls within the scope of one of the exemptions and is extended in good faith.

[16] See, in this respect, UNCITRAL Legislative Guide on Insolvency Law, Part two, Treatment of assets on commencement of insolvency proceedings, para (99).

[17] The survey drafted by the European Law Institute, *Rescue of Business in Insolvency Law* (n 8), mentions on p. 219 that the American Bankruptcy Institute Commission (ABI Commission) expressed its concerns about some potential risks of an abusive financing: 'In this regard the ABI Commission recognized, in particular, the risks of abusing such finance, especially with respect to roll-up provisions and cross-collateralization provisions. For example, where under such provisions finance is obtained from pre-commencement creditors which provides them with additional protection on their pre-commencement claims.'

rescued, state aid rules can be regarded as a reasonable benchmark for the quantification of the adequacy and of the amount of the financial support. In its Communication of September 2016 'Accelerating Reform: Guidelines on State aid for rescuing and restructuring non-financial undertakings in difficulty', the European Commission stressed the lower limit of state aid,[18] under which involution translates into disappearance, as a natural phenomenon in the economic evolution:[19]

> the successful sectors of the economy witness productivity growth not because all the undertakings present in the market gain in productivity, but rather because the more efficient and technologically advanced undertakings grow at the expense of those that are less efficient or have obsolete products. Exit of less efficient undertakings allows their more efficient competitors to grow and returns assets to the market, where they can be applied to more productive uses. By interfering with this process, rescue and restructuring aid may significantly slow economic growth in the sectors concerned.

Two analytical directions stem out: (i) what is 'obsolete' according to the market standards goes naturally into oblivion, if and because it does not evolve; (ii) where a business has the potential to grow but it does not, an investment 'booster' may exponentially enhance its growth.

Thus arises the opportunity to create a market for professional investors that will act as funds providers in the restructuring proceedings, but should operate according to rules that are clear, uniform, and verifiable by an unbiased, neutral observer.

5. The relativity of a successful restricturing: Is it a chance for the debtor or for the business?

Unbiasedly marketwise, the purpose of a restructuring should be the successful rescue of the business.[20] In other words, the market does not care whether the debtor survives or not, as long as the business survives.

However, just like relativity distorts space and time, the final purpose of the restructuring may be different, depending on the observer.

5.1. Rescue the business, terminate the debtor (inspired by Goodnab International)[21]

In financial markets, an investor may choose to take the short position. The financial markets witnessed many such a position, that bring about a significant leverage. In this case, the investor's gains equal the total losses of the other players who speculated on the growth thereof (played long).

What if the financing is not extended, *ab initio*, with the intent to rescue, but to accelerate the failure,

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[18] 'Rescue and restructuring aid are among the most distortive types of State aid. It is well established that successful sectors of the economy witness productivity growth not because all the undertakings present in the market gain in productivity, but rather because the more efficient and technologically advanced undertakings grow at the expense of those that are less efficient or have obsolete products. Exit of less efficient undertakings allows their more efficient competitors to grow and returns assets to the market, where they can be applied to more productive uses. By interfering with this process, rescue and restructuring aid may significantly slow economic growth in the sectors concerned.' Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A52014XC0731%2801%29 (accessed: 12 August 2022).

[19] An analogy can be made to R. Dawkins, *Selfish Gene* (Publica Publishing House, 2019), p. 45: 'As used by biologists, it is characteristic for the behavior to be rapid. In a convenient language, altruistic behavior and selfish behavior refer to the behavior of a human being towards another human being, perceived as two survival machines'.

[20] 'There are no two hills alike, but, in any place on Earth, the plane is the same': J.L. Borges, 'Utopia unui om ostenit (A Weary Man's Utopia)' in Editura Polirom, *Cartea de nisip (Book of Sand)* (Polirom Publishing, House 2011) 95.

[21] The evolution and the reimbursement of financing granted in *Goodman International* are presented in C. Paulus and R. Damman, *European Preventive Restructuring, Article-by-Article Commentary* (CH Beck, 2021), p. 73, fn 51.

thus to facilitate the way for a hostile takeover (*e.g.* lending with a debt/equity swap option)? In this scenario, the financier gets a viable business by realising the value business-core collateral. Their intention is either to obtain something for themselves or, as case may be, for a competitor interested to acquire the business at a lower price.

Should the debtor be 'naturally failing', it would only be an occurrence of the inevitable risk of business.

Yet, if the financing was not, *ab initio*, offered with an intent to remedy the distress, but to cause the failure of the debtor's business, it amounts to an attempt to facilitate the way for a hostile takeover.

Unlike the instruments specific to financial markets, the 'short' position in a restructuring is, unfortunately, invisible to any other participants, except for the option holder.

By way of analogy, should the insured person inflict the insured risk on themselves, such a situation would fall under an insurance coverage exemption. This exemption is of the essence of the insurance agreement. Everything that would allow the protection of the insured person in such a situation would prejudice the very *causa* of the insurance agreement.

Similar to the *causa remota* in insurance contracts, the financier's hidden agenda could be considered valid grounds for the avoidance of the financing if, to a neutral, unbiased, observer, it could have never been recovered under the offered terms (the same way the insurance does not cover self-inflicted risks). Testing the *causa remota* of the financing should allow for the verification of whether the rationale behind offering the funds was indeed a 'hostile takeover' of a distressed activity or, on the contrary, the allocation of funds in a risky situation for the financier as well.

In the case of the restructuring proceedings, the investor must act upon their intention to recover the investment and not aim at hostilely taking over a vulnerable, but still viable business.

5.2. Rolling up the pre-restructuring debt (inspired by Colt)[22]

Let's assume a pre-existent creditor decides to 'play along', with a twist: they shall extend the rescue financing to the debtor only if the pre-restructuring debt is rolled-up (included in the scope of the super-priority granted to the new financing provider). In such a case, the long position is visible, but inevitable. This creditor has a legitimate reason to offer the financing and, apparently, their purpose justifies the means employed to achieve it, including the security mechanism described above.

In terms of transactions avoidance, this situation would trigger the avoidance of the security only, at least when the security was created for guaranteeing the repayment of pre-restructuring debt. The financing would retain its validity, unlike the creation of the security. Thus, the debtor should repay the financier, but the financing would no longer enjoy the benefit of the super-priority in a subsequent distribution in the insolvency proceedings, at least for the pre-restructuring portion of the (aggregated) debt. This scenario also reveals another issue to be tackled, *i.e.* the relative (undetermined) protection awarded by the Directive to the financier from the avoidance actions, notwithstanding the conditions of the financing agreement.

The rescue financing's current legal regime allows for its avoidance in exceptional situations only, although the grounds for its avoidance are not limited. In Recital 67, the Directive lays down a non-exhaustive list:

> Such other grounds could include, among other things, fraud, bad faith, a certain type of relationship between the parties which could be associated with a conflict of interest, such as in the case of transactions between related parties or between shareholders and the

[22] The Colt case study envisages the problems occured at the moment of 'converting the DIP lender's (likely) undersecured pre-bankruptcy loan into a fully secured postpetition claim', as presented in J.C. Lipson, 'Bargaining Bankrupt: A Relational Theory of Contract in Bankruptcy' (2016) 6 *Harvard Business Law Review* 240, 252. The main question triggered by this case study, as the author himself underlined the issues, is the following: 'Was the ultimate financing the product of economic duress or bad faith?' (255).

> company, and transactions where a party received value or collateral without being entitled to it at the time of the transaction or in the manner performed.

Obviously, these provisions endeavour to sanction the fraudulent granting of rescue financing.[23] The Directive thus presumes that rescue financing extended to affiliates, where a conflict of interests is present, by way of creating an unfair security or where the rescue financier gains an unfair advantage is more likely to qualify for being avoided. Hence, the decision on whether the rescue financig is voidable would, most likely, result from a deductive reasoning.

The traditional type of insolvency avoidance actions reveals that their *genus proximum* is the *actio pauliana*, either fraud-based or based on the imbalance between the parties' respective performances, to the detriment of the (other) creditors. The commonality of the avoidance grounds, if any, is the debtor's (undue) preference of a certain creditor.

But, as a first paradox, the rescue financier's priority is (and must be) 'preferential' as an inducement.

It is hard to believe that the restructuring would be compatible with a 'financing bid' that would allow the debtor-in-possession or its creditors to select the best offer. In the restructuring proceedings, time is of the essence; such a bid is simply not feasible as the debtor' situation worsens as times goes by.

The second paradox consists in the statutory nature of the 'preference': the financier's security is created by operation of law. Such a security should stimulate the investors' appetite to join, from the outside, in a distressed business.

Hence, the benchmark the financier's statutory preference must be assessed against is its adequacy.

6. Conclusion

Coming back to our mathematicians sitting in that bistro in Paris, their conversation is surreal only in appearance. At the end of the day, when deciding whether a number or a value is positive or negative, one needs to take account of the inherent benchmark. While we habitually think that 'zero' is an absolute reference, our mathematicians have simply set a different benchmark. Therefore, their counting was accurate, they just had a different 'zero'.

No doubt, rescue financing is tremendously necessary in the restructuring frameworks. However, the mere enunciation of the financing's reasonableness in the Directive is not enough. It must be backed with adequate verification criteria, in order to ensure the predictability of a safe restructuring. In the absence of such criteria (benchmarks), the potential clashes between the pre-restructuring secured creditors or the debtor itself, on one hand, and the interim or new financier, on the other hand, would, most probably, end up in the 'victory' of the latter, thus denying the restructuring its very legitimacy. The Member States should adopt uniform and harmonised rules on the avoidance of such transactions, to prevent the preservation of 'safe-harbour'[24] jurisdictions in the EU. The financier's loan terms should be assessed in the light of the debtor's chances to revert to its pre-difficulty *status-quo*.

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[23] It has been considered that the option 'exempting approved new financing from avoidance actions except in the case of fraud' refers to 'the preferable option as it was contended that it provided the necessary incentives and support for restructuring plans to be successful, without unduly affecting the rights of existing creditors. It was felt that where the rights of creditors were impacted, these were proportionate of the alternative was to be the liquidation of the debtor' – Paulus and Damman (n 2121), p. 223.

[24] The different approaches to avoidance actions were considered to be a vulnerable feature of this European construction, although the common origin of *actio pauliana* is recognised:

> The traditionality of transactional avoidance provisions across the member states means that these can vary significantly. Many of these provisions represent the expression of embedded principles such as the civil law actio pauliana and the common law anti-deprivation rules. […] The likely application in rescue proceedings will accordingly also vary. This issue has been described as to whether or not a safe harbour for new or interim financing is provided in rescue frameworks. The terminology of safe harbour is however also used regarding the provision of finance in other contexts including mergers and acquisitions.

Paulus and Damman (n 21), p. 222, fn 4.

Chapter 5

Reconsidering fairness for vulnerable and involuntary stakeholders in insolvency and restructuring

Jennifer L.L. GANT[*]

1. Introduction

The intersecting areas of insolvency (wealth maximisation) and fairness (distribution) has ever been a value laden and complex balancing act. It is necessary to tread a line that attempts to balance two often conflicting areas of law and society: the need for a regulatory framework that allows businesses to thrive by attracting investment and another often-competing regulatory framework that provides a buffer for morevulnerable corporate stakeholders against the impact of unbridled self-interested capitalism.

The last couple of years have put the world's methods for dealing with acute and sudden financial distress under a microscope. Even at the time of writing, it is not entirely clear what the long-term impact of the economic shocks produced by the lockdowns of the COVID-19 pandemic will be once the world goes back to 'normal' and the result of the withdrawal of all temporary measures is fully felt. The effect that the pandemic has had on small businesses and individuals has been particularly acute. It could be that a turning point has been reached in terms of how achieving fairness should be approached in insolvency and restructuring, which may call for a new theoretical paradigm.

The stakeholder theory has been making the rounds for decades.[1] There have been many academic debates that pit the underlying principle of creditor wealth maximisation against the social impact of financial distress on involuntary and non-adjusting creditors. However, these debates still tend to start from the first principles of creditor wealth maximisation and a law and economics approach and then attempt to deviate from that original base line. Martha Fineman's vulnerability theory[2] provides an entirely new theoretical framework that starts from a fundamentally different underlying principle within which these conflicting areas can be viewed and balanced through a socio-legal lens.

This chapter will explore the potential that Fineman's vulnerability theory may have for reframing the way that policy makers and legislators (and academics) look at insolvency and restructuring frameworks with a view to opening the discourse to encourage a reconsideration the current approaches in line with the shifts occurring in the global economy today.

2. Revelations resulting from the COVID-19 pandemic

Between 2019 and 2022 there have been significant and rapid changes to the global economy. The whole market was revealed to be vulnerable to the pandemic and only a massive state response

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[1] See for example R.E. Freeman, *Strategic Management: A Stakeholder Approach* (Pitman, 1985); K. Goodpaster, 'Business Ethics and Stakeholder Analysis' (1991) 1 *Business Ethics Quarterly* 53; R.E. Freeman, 'The Politics of Stakeholder Theory: Some Future Directions' (1994) 4 *Business Ethics Quarterly* 409; A. L. Friedman and S. Miles, 'Developing Stakeholder Theory' (2002) 39 *Journal of Management Studies* 1; A. O. Laplume et al., 'Stakeholder Theory: Reviewing a Theory that Moves Us' (2008) 34 *Journal of Management* 1152; and R.E. Freeman et al., 'Tensions in Stakeholder Theory' (2018) 59 *Business & Society* 213.

[2] See for example M. Fineman, 'The Social Foundations of Law' (2005) 54 *Emory Law Journal* 201; 'The Vulnerable Subject: Anchoring Equality in the Human Condition' (2008) 20 *Yale Journal of Law and Feminism* 1; and 'Vulnerability and Inevitable Inequalty' (2017) 4 *Oslo Law Review* 133.

contained the damage. The COVID-19 pandemic has revealed many weaknesses in the approach to healthcare, social protection, and many other areas of society that can be affected by an economic shock. The financial difficulties faced by small and medium sized companies have been significant, not to mention the individual financial impact. Not only have individuals, companies, and institutions been forced to face their own vulnerabilities, but also the universal nature of vulnerability was shown by the impact of the pandemic through its effect on the fundamental pillars of societies and polities all over the world.

The ability to respond to vulnerability is the relative resilience of an individual or an institution to recover from adverse circumstances, which is often based on the power differential between different actors (known as 'stakeholders' in the corporate environment). Resilience is the key to understanding both the impacts of the pandemic and whether the insolvency and rescue system works adequately to deal fairly with the relative vulnerabilities of its various stakeholders. Modern insolvency law frameworks respond well to the vulnerability of secured creditors, as they give these stakeholders power in the process while also strongly supporting the recovery of their losses. However, this responsiveness is less impressive relative to other categories of less powerful stakeholders, such as employees, tort victims, and environmental claimants.

As noted in a conversation between this author and Graham Ferris,[3] an expert in the field of vulnerability theory, 'to treat major financial institution and individual creditors or employees or victims of corporate misfeasance "equally" is obviously absurd'. Financial institutions can secure their risks in lending contracts. Although the state does respond to some of the vulnerabilities of employees by assigning them preferential status, this can be inadequate protection in practice, particularly in a liquidation scenario which will leave customers, trade suppliers, and tort victims 'to the wolves'. Every insolvency stakeholder is vulnerable, but only some have their risk of harm adequately mitigated through the legal structures of insolvency law. Thus, although vulnerability is shared, the assets that support resilience, which include power, rights and control over processes, are most unequally distributed by the current system in that it gives first priority to the already powerful financial institutions. Such institutions are already more able to use their power to conclude favourable contracts and their efforts in both litigation and lobbying have been effective in maintaining a system that makes their resilience a first priority in the system itself.

The pandemic experience may introduce a challenge to the *status quo* in the way that financial distress resolution is viewed and potentially resolved. There have always been conflicting areas of interest in the intersection of corporate rescue and restructuring and the overall fairness in the way rights are managed and distributed. Whereas wealth maximisation tends to continue to underpin the overarching goals of collective procedures, whether they are rescue-oriented or not, the concept of fairness tends to indicate a broader interest among stakeholders who may not be contractually connected to the company, such as tortious and environmental claims. These categories of creditors tend to lack adequate resilience to the impact of insolvency and restructuring due to their lack of choice in being a part of such processes at all. In addition, there will also be some contractual creditors who suffer due to the power imbalance that is often present in a restructuring or rescue process, despite continued adjustments in many systems to account for and ring-fence distributive rights to redress some of that imbalance and often weaker resilience to financial impact. Employees remain perhaps the most significantly impacted group due to the far-reaching effects that loss of employment causes to individuals, families, and wider communities, as well as the draw it has on taxpayers due to social security costs.

During this time of shifting economies and rapid permanent or temporary regulatory changes, we may be at a turning point in considering how to approach fairness in insolvency and restructuring. This may call for a new theoretical paradigm that can balance the power differentials against the relative resilience

[3] My thanks to Graham Ferris for his expertise and advice in reviewing this editorial prior to publication. For publications in this area, see: G. Ferris, 'Undermining Resilience: How the Modern UK University Manufactures Heightened Vulnerability in Legal Academics and What Is to Be Done' (2021) 55 *The Law Teacher* 24; G. Ferris, 'Law-students Wellbeing and Vulnerability' (2022) 56 *The Law Teacher* 5; and G. et al., '"To Act Is to Be Committed, and to Be Committed Is to Be in Danger": the Vulnerability of the Young Lawyer in Ethical Crisis' (2022) *Legal Ethics* (forthcoming).

of more vulnerable stakeholders who will often have little choice in their involvement in the financial distress of a debtor.

3. Applying socio-legal methods to fairness in insolvency and corporate rescue

3.1. Consumer vulnerability in bankruptcy

Fineman's vulnerability theory has been proposed as an alternative to 'traditional equal protection analysis' and has been described as a 'post-identity' enquiry focused not on discrimination against defined groups, but rather 'concerned with privilege and favour conferred on limited segments of the population by the state and broader society through their institutions'.[4] Traditional approaches to equality have been associated with John Locke's liberal subject which is based on the well-known ideal that human beings are by their nature free and endowed with the same inalienable rights.[5] However, these rights are not always accessible to all individuals due to differences in position and circumstance which affects the ability of those individuals to make use of their inalienable rights and freedoms. They begin from a starting line, for lack of a better analogy, that is behind more privileged groups or individuals. They must, therefore, 'work harder' to arrive at the same level of socio-economic success in the same time period. This incidental (or intentional) privilege that is enjoyed by some groups of people (in the traditional equal rights perspective) makes it difficult to rise above the original circumstances in which some find themselves.

Given the individual basis of Fineman's vulnerability theory, it would seem more logically applied to *consumer* financial distress or personal bankruptcy, rather than corporate matters. Certainly, there is more socially oriented discourse around individuals in bankruptcy and there is an obvious and clear connection between consumer debt and the balancing act between vulnerability and resilience of debtors. For example, Crystin Ondersma applies socially sensitive ideals to the problem of the availability of debt solutions to the most vulnerable in society.[6] Although Ondersma does not specifically refer to vulnerability theory as a framework for her discussion of consumer issues in bankruptcy, her human rights approach to fairness in consumer bankruptcy situations broadly reflects similar underlying principles. The position of individuals in financial distress and facing bankruptcy tends to exacerbate their ability to recover (their resilience), which is the fundamental problem that vulnerability theory attempts to resolve.

In terms of how human rights principles should be considered in relation to consumer over indebtedness, Ondersma notes that this 'depends upon the nature and experience of indebtedness itself in any given context',[7] which clearly adopts an individualistic approach such as might be expected within a vulnerability framework. Fundamentally, Ondersma's message is that 'it is unjust and nonsensical to require impoverished debtors to undergo an expensive and burdensome process to obtain relief'. As such, relief that is legally available should also be actually available in order to ensure that individuals are not subjected to the indignities that may accompany a purely contractual remedy to financial distress.

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[4] M. Fineman, 'The Vulnerable Subject: Anchoring Equality in the Human Condition' (2008) 20 *Yale Journal of Law* and Feminism 1, 1.
[5] Ibid, 2.
[6] See for example C. Ondersma, 'A Human Rights Approach to Consumer Credit' (2015) 9 *Tulane Law Review* 373; 'Shadow Banking and financial Distress: the Treatment of Money Claims in Bankruptcy' (2013) 2013 *Columbia Business Law Review* 79; and with M. Gatti, 'Can a Broader Purpose Redress Inequality? The Stakeholder Approach Chimera' (2020) 46 *Journal of Corporate Law* 1.
[7] C. Ondersma, 'A Human Rights Framework for Debt Relief' (2014) 36 *University of Pennsylvania Journal of International Law* 269, 274.

Ondersma further advocates adopting a human rights framework to establish *baseline* protections for both debtors and creditors when dealing with consumer bankruptcy.[8] The concept of the *baseline* could be viewed as a similar approach insofar as it attempts to reflect the reality of human rights issues encountered in consumer bankruptcy in a similar way that Fineman advocates that law and policy should generally reflect the reality of human vulnerability.[9] Under both frameworks, this means starting with an individual's circumstances and assessing what that means in terms of their ability to recover and the vulnerabilities that have coalesced to create the unfortunate situation. Whereas the human rights approach will attempt to protect individuals from the infringement of their right to family life, dignity, and other human rights, vulnerability theory could go a step further in taking an individual approach that considers not just the hardship encountered, but how the circumstances of the individual created by society and the economy have affected their ability to recover from such situations which, in different and fairer circumstances, would not have been the case.

3.2. Vulnerability in the corporate rescue and insolvency context

Although a socio-legal approach to individual bankruptcy makes sense from a human perspective, a socio-legal approach is not necessarily new to the corporate insolvency and rescue discourse. Given the multi-layered and highly complex web of relationships in our global economies, there is some value in considering the wider impact of a corporate insolvency, and particularly in rescue and restructuring processes, in terms of the fairness of these processes for non-adjusting and involuntary creditors. This is in addition to employees, who have long been recognised as being in a weaker bargaining position and unique as not only being a creditor, but also a key stakeholder, for a company in financial distress.

Vanessa Finch provided an in-depth survey of the most commonly debated theoretical approaches to insolvency law in a prescient article in 1997. In it, she considered the viability of the current (at the time) measures of insolvency law, including the classical creditors' bargain theory;[10] the oft-cited broad-based contractarian approach;[11] a communitarian vision that has often been referred to as a traditionalist approach;[12] a forum vision;[13] an ethical vision; and a multiple values/eclectic vision.[14] Although an in-depth discission of each of these theoretical approaches is outside the scope of this paper, it is sufficient to note that despite the wealth of theoretical debate and discussion, a complete view of the appropriate measure of insolvency law still fails to emerge.[15] Further, although many of these theories do consider the social impact of insolvency and rescue, they continue to start from an economic standpoint deviating from that along fairly predictable lines.

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[8] Ibid, 276.

[9] M. Fineman, 'Vulnerability and Inevitable Inequality' (2017) 4 *Oslo Law Review* 133, 134.

[10] See T.H. Jackson, *The Logic and Limits of Bankruptcy Law* (Harvard University Press, 1986); D. Baird, 'The Uneasy Case for Corporate Reorganisations' (1986) 15 *Journal of Legal Studies* 127; T.H. Jackson and R.E. Scott, 'On the Nature of Bankruptcy: an Essay on Bankruptcy Sharing and the Creditors' Bargain' (1989) 75 *Virginia Law Review* 155; T.H. Jackson and D. Baird, 'Corporate Reorganisation and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy' (1984) 51 *University of Chicago Law Review* 97.

[11] See D.R. Korobkin, 'Contractarianism and the Normative Foundations of Bankruptcy Law (1993) 71 *Texas Law Review* 541; D.R. Korobkin, 'Rehabilitating Values: A Jurisprudence of Bankruptcy' (1991) 91 *Columbia Law Review* 717.

[12] See E. Warren, 'Bankruptcy Policy' (1987) 54 *University of Chicago Law Review* 775; E. Warren, 'Bankruptcy Policymaking in an Imperfect World' (1993) 92 *Michigan Law Review* 336; K. Gross, 'Taking Community Interests into Account in Bankruptcy' (1994) 72 *Washington University Law Quarterly* 1031; B. Adler, 'A World without Debt' (1994) 72 *Washington University Law Quarterly* 811.

[13] See A. Flessner, 'Philosophies of Business Bankruptcy Law: An International Overview' in J.S. Zeigel (ed), *Current Developments in International and Comparative Corporate Insolvency Law* (Clarendon Press, 1994) 20; P. Miller, 'Calculating Corporate Failure' in Y. Dezalay and D. Sugarman (eds), *Professional Competition and Professional Power: Lawyers, Accountants and the Social Construction of Markets* (Routledge 1995), 35; R.B. Stewart, 'The Reformation of American Administrative Law' (1975) 99 *Harvard Law Review* 1667.

[14] See P. Schuman, 'An Attempt at a "Philosophy of Bankruptcy"' (1973) 21 *UCLA Law Review* 403.

[15] V. Finch, 'The Measures of Insolvency Law' (1997) 17 *Oxford Journal of Legal Studies* 227, 242.

In the last few decades and in particular since the turn of the millennium, there has been a steady shift from an acceptance of liquidation as an inevitable outcome of corporate insolvency for most companies, to a policy and regulatory emphasis on a desire to rescue viable companies where possible. Justifying this shift has been discussed by many eminent academics, usually with a focus on not only the financial benefit of preserving value, but also the social benefits often associated with the preservation of corporate life. Donald Korobkin took this approach in 1994 in relation to small businesses.[16] Although he does not address vulnerability *per se*, he does raise a number of questions within the context of corporate insolvency that speaks to a more socio legal approach. He asks, 'to what extent should the law promote the survival of a financially distressed business as a going concern?'[17] In other words, what should be the 'survival standard' that defines and limits the role of the law in this regard? He builds on his original contractarian model[18] to answer this question:

> In the context of financial distress, creditors and non-creditors of a common debtor seek recognition of demands of various kinds--moral, personal, and social, as well as economic. The bankruptcy system must weigh, and ultimately select among, these competing demands.[19]

Though the theories mentioned herein certainly have their place and provide useful frameworks for analysing and measuring the complex issues raised by the circumstances of financial distress, they do not necessarily cater to the shift in emphasis from efficient liquidation to the rescue of viable business that drives insolvency law policy today. As such, there is a need for a new paradigm for measuring the fairness of insolvency and rescue procedures that considers not only an economic and legal approach but also attempts to balance the social and moral issues that are also at play. The concepts of resilience and vulnerability at its heart is worthy of development to meet the needs of the modern trends in the corporate distress industry.

4. A new theory responding to fairness⬩

A theoretical framework that considers the choices of all stakeholders affected by the decisions of a corporate entity is worth exploring given the somewhat recent shift from an emphasis on efficient liquidation outcomes to a preference for rescuing viable companies where possible. This shift raises a number of new issues that were not indicated in the collective processes used in traditional insolvency. Traditional approaches have tended to embrace the concept of creditor wealth maximisation, with fairness typically considered from a creditors' bargain perspective, which are generally drawn from a law and economics standpoint. However, law and economics considerations, and by extension the Jacksonian adherence to creditor wealth maximisation as the underpinning rational for insolvency procedures, is exclusionary, particularly in the more complex circumstances of business and company rescue.[20] It relies upon legal ties connected mostly to contract and property law. It typically does not allow for a balancing of the vulnerabilities caused by involuntary parties and information asymmetries inherent in processes instigated at the behest of a large or powerful creditors. A socio-legal perspective, however, allows for an analysis of current legal structures in a way that is directly linked with the social situation to which the law applies,[21] thereby allowing for a focus on the impact on stakeholders who

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[16] D.R. Korobkin, 'Vulnerability, Survival, and the Problem of Small Business Bankruptcy' (1994) 23 *Capital University Law Review* 413.

[17] Ibid.

[18] D.R. Korobkin (n 10); D.R. Korobkin, 'Rehabilitating Values: A Jurisprudence of Bankruptcy' (1991) 91 *Columbia Law Review*717.

[19] D.R. Korobkin (n 1616), 416.

⬩ Material from this section was drawn from J.L.L. Gant, 'Floating Charges and Moral Hazard: Finding Fairness for Involuntary and Vulnerable Stakeholders' in J. Hardman and A. McPherson (eds.), *Floating Charges in Scotland: New Perspectives on Current Issues* (Edinburgh University Press, 2022) 228; and J.L.L. Gant, 'Guest Editorial: Optimising Fairness in Insolvency and Restructuring: a Spotlight on Vulnerable Stakeholders' (2022) 31 *International Insolvency Review* 1.

[20] J.L.L. Gant, 'Floating Charges' (ibid), p. 241.

[21] D. Schiff, 'Socio-Legal Theory: Social Structure and Law' (1976) 39 *Modern Law Review* 287, 287.

wield less power or who may be involuntary parties to an insolvency and unable to adjust their level of risk accordingly. Such stakeholders may also be less resilient to the financial impact of an insolvency or restructuring due to socioeconomic dependencies resting on the debtor.

Martha Fineman's vulnerability theory provides a potential theoretical framework within which these conflicting areas can be viewed and balanced. Although Fineman's theory was constructed with human dependencies associated with social and cultural discrimination, with some adjustment it can also provide a new lens through which to view legitimately vulnerable stakeholders to a corporate insolvency or restructuring. Equality may even be an unjust measure when it is applied to 'situations of inescapable or inevitable inequality where differing levels of authority and power are appropriate',[22] such as in an employer/employee relationship or even the power imbalance between secured and unsecured creditors. A vulnerability approach applied to situations of financial distress may serve to recalibrate fairness between the clearly differential power structure among the various stakeholders due to rights attached to security and regulatory priorities. The resilience of a stakeholder will inevitably be linked to their ability to exercise power over a process which includes access to information, participation, and the notional ability to exercise control over their fate.

5. Equal treatment is not always fair treatment

One of the key underlying precepts of collective insolvency procedures is that of equal treatment,[23] although there are so many priority carveouts that it is arguable whether this remains the case.[24] Martha Fineman notes, in respect to equality of treatment between individuals, that, where equality is 'reduced to sameness of treatment or a prohibition on discrimination, this has proved an inadequate tool to resist or upset persistent forms of subordination or domination'.[25] Furthermore:

> [t]his version of equality is similarly weak in its ability to address and correct the disparities in economic and social wellbeing among various groups in our society. Formal equality leaves undisturbed - and may even serve to validate – existing institutional arrangements that privilege some and disadvantage others.[26]

Although the treatment of creditors already carries with it the obligations that were in place under a contract for the repayment of debts, the nature of debts for goods and services or for loans is different in nature from the obligations owed to employees under an employment contract or indeed the obligations owed to non-contractual, involuntary creditors, such as those who have suffered losses as a result of the company's activities. While there are certainly debts in terms of wages for work undertaken, the relationship is far more complex and far-reaching in terms of social implications, particularly when we consider the value of an employee's firm specific human capital contribution to the debtor company and the natural dependencies that employees have on their employment and job security. Equally, the damages owed to tort and environmental creditors tend to be treated as unsecured, so fall very low on the list of priorities.

With regards to environmental debts, the consequences of not paying out can be highly significant when the funds would be used to rectify certain environmental damage. The damage will still need to be rectified – in such circumstances who will ultimately pay? The obligation would likely fall upon society due to the necessity for governments to rectify the matter, which would inevitably have to be funded by the taxpayer.

Equal treatment in such circumstances is not necessarily fair treatment, given the varying degrees of

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[22] M. Fineman (n 9), 135.

[23] See A. Keay and P. Walton, 'The Preferential Debts Regime in Liquidation Law: In the Public Interest' (1999) *Company Finiancial and Insolvency Law Review* 84, 85; as cited in R.K. Mokal, 'Priority as Pathology: the Pari Passu Principle' (2001) 60 *Cambridge Law Journal* 581.

[24] For a full discussion on the realities of *pari passu* in the context of regulatory priorities, see Mokal, ibid.

[25] M. Fineman ('The Vulnerable Subject') (n 2), 3.

[26] Ibid.

power and resilience that different categories of stakeholders will have in an insolvency process, as well as the extensive impact that lack of funding can have on the wider society. This is also why so many carveouts already exist to this so-called fundamental principle, such as the categorisation of preferential debts that is often applied to employee claims.[27] These carveouts aim to some extent to redress the imbalance in power due to the greater vulnerability of less powerful stakeholders.

6. The concept of vulnerability in corporate insolvency

Fineman observes that the term 'vulnerable' can be used to describe:

> […] a universal, inevitable, enduring aspect of the human condition that must be at the heart of our concept of social and state responsibility. Vulnerability thus freed from its limited and negative associations is a powerful conceptual tool with the potential to define an obligation for the state to ensure a richer and more robust guarantee of equality than is currently afforded under the equal protection model.[28]

Fineman goes on to explain that 'the concept of vulnerability can act as a heuristic device, pulling us back to examine hidden assumptions and biases that shaped its original social and cultural meanings'.[29] Vulnerability can then provide a valuable context within which critical perspectives on political, societal, and legal institutions can be constructed.[30] A focus on vulnerability goes beyond the normative claims for equality generally, whether formal or substantive, and suggests the interrogation of what may be 'just and appropriate mechanisms to structure the terms and practices of inequality'.[31]

Currently, insolvency procedures continue to be guided by economic paradigms, principally due to their association with corporate law, which are shielded to some extent in the United Kingdom, and to a larger extent in the United States, by the continued reliance on the free market of Western capitalism.[32] However, given the social implications of corporate insolvency, an adjusted perspective that takes in these non-economic features is overdue.

By placing vulnerability and resilience at the centre of the social policies that have come to influence the preferences and entitlements for employees in insolvency law, it is possible to re-evaluate current approaches and also to consider the vulnerability and resilience of the institutions themselves. As has been evident in the age of COVID-19, some institutions will fail in the face of market fluctuations caused by sudden economic shocks such as lockdowns. By focusing on the ability for stakeholders to respond to a company's financial distress – their resilience - it may be possible to uncover the weaknesses of the institutions in place that were intended to respond to that vulnerability in terms of introducing and maintaining fairness according to the inherent needs of different stakeholders.[33]

7. Conclusion

Although Fineman generally refers to equality between individuals in her work, given the differences between powerful creditors, vulnerable stakeholders such as employees, and those who are involuntary creditors, a rethinking of the equalities ascribed to insolvency and restructuring procedures is worth undertaking. The next stage in the evolution of insolvency theory is on the horizon. It will require significant theoretical research as well as an exploration into the categories of vulnerable, non-adjusting, and involuntary creditors to a company's insolvency in order to establish a means of measuring their relative vulnerability so that a new fairness paradigm can be applied. A balance needs to be struck

[27] A. Keay and P. Walton (n 23), 584.
[28] M Fineman ('The Vulnerable Subject') (n 2), 8–9.
[29] Ibid, 9.
[30] Ibid.
[31] M. Fineman (n 9), 134.
[32] M. Fineman ('The Vulnerable Subject') (n 2), 5.
[33] Ibid, 12–13.

between the many competing values that intersect when a company enters into a rescue process, whether that is formal or otherwise.

Vulnerability theory provides a different perspective from which the treatment of employees and other vulnerable and involuntary creditors can be viewed. It facilitates the consideration of broader social implications of these players in society and the impact upon this that an insolvency of their employer may have, along with how resilient they may to the exercise of rights held by more powerful stakeholders. Although commentators and scholars of corporate and insolvency law often prefer to avoid the determination of social value in a corporate or commercial context, there can be no denying that the social impact remains and should therefore at least be considered in the context of achieving fairness in the balance of relative resilience between social and business interests when faced by a company's financial distress. These circumstances have only become more complex over time due to the shift from a relatively straightforward insolvent liquidation outcome in which traditional collective approaches still works relatively well, to the variety of solutions available under the guise of 'rescue'. As noted by Fineman: '[as] law should recognise, respond to, and, perhaps, redirect unjustified inequality, the critical issue must be whether the balance of power struck by the law was warranted.'[34] The question to be answered going forward is: are the current systems under which rescue processes occur achieving true fairness between the competing interests of various stakeholders, contractual and otherwise? The answer at the moment must be: watch this space.

[34] M. Fineman (n 9), 142.

Chapter 6

A new cross-border framework for restructuring proceedings

Stephan MADAUS[*]

1. Introduction

The 2019 Directive on Restructuring and Insolvency requires all European Union (EU) Member States to implement a preventive restructuring framework with all the features specified in Title II of the Directive ('Restructuring Directive').[1] The Directive marked the end of a European legislative initiative that intended to improve the national laws and procedures in Member States. The justification of the Directive, in its recitals, demonstrates that it aimed to harmonise national laws to increase access to certain court-assisted restructuring tools available across the EU.[2] However, this idea was compromised in the European legislative process where many Member States insisted on the optional nature of many provisions in the Directive, which effectively enabled them to adjust the preventive restructuring framework to their pre-exiting laws. This resulted in a minimum harmonisation instrument, and close to a hundred options for Member States in the Directive. Thus, while Member States were bound to provide for a preventive restructuring framework and its features, they were also given ample leeway in shaping the conditions and scope of restructuring assistance.

This environment obviously led to legislative competition. The United Kingdom (UK) and the Netherlands were the first to discuss specific features of the new EU framework with a view to positioning their jurisdictions as European, or even global, restructuring hubs. The EU legislator envisioned new preventive restructuring options to be 'fully compatible with, and complementary to, [the European Insolvency] Regulation',[3] which had only just widened its scope to include such proceedings in 2015. The European Insolvency Regulation ('EIR 2015')[4] contains answers to relevant questions of international jurisdiction, applicable law and recognition with regard to preventive restructuring proceedings. Dutch restructuring practice quickly realised that the rules of the EIR 2015 included a rather strict regime on international jurisdiction and applicable law compared to the ability to access the competing English restructuring hub based on a mere sufficient connection to England.[5] This led to the idea of providing two types of court proceedings with identical tools: a public procedure and a non-public one. The former would be listed in Annex A and thus enable parties to secure cross-border effects under the EIR 2015, while the latter would not be listed in Annex A and thus not fall within the scope of the EIR 2015. As Recital 13 of the Restructuring Directive also admitted that 'this Directive does not require that procedures within its scope fulfil all the conditions for notification under that Annex', a choice between available cross-border restructuring regimes appeared to be a viable solution. This idea of choosing the better-fitting cross-border regime has been attractive to lawmakers. It led to the addition of a Part 26A restructuring plan option[6] next to the traditional scheme of

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

[2] See Recitals 1-4, in particular recital 1 stating that the Directive aims to ensure that 'viable enterprises and entrepreneurs that are in financial difficulties have access to effective national preventive restructuring frameworks.'

[3] Recital 13 of the Restructuring Directive.

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

[5] See L. Payne, *Schemes of Arrangement, Theory, Structure and Operation* (Cambridge University Press, 2021), pp. 347-352.

[6] As introduced by the Corporate Insolvency and Governance Act 2020.

arrangement in the UK and to the adoption of a public/non-public preventive restructuring framework option in both the Netherlands[7] and Germany.[8] This article will illustrate that this choice does not provide European insolvency practice with efficient tools to secure the cross-border effects needed in a preventive restructuring.

Section 2 explains why the mere application of the EIR 2015 to preventive restructuring procedures is not considered appropriate in a preventive restructuring case. It also explores why the solution to the problems identified cannot be found in the simple option to avoid the scope of the EIR 2015 in non-public proceedings. Section 3 builds on these insights and identifies the principles that should inform a new cross-border framework for restructuring assistance. Section 4 finally explains how this new framework relates to the cross-border regime for insolvency proceedings and other matters.

2. What is missing in today's cross-border frameworks for preventive restructurings?

The conclusion in this analytical section is best illustrated by introducing a test case. Imagine a German start-up company registered in Germany with a head office in Berlin. The company sells products produced in Asia online across Europe. Particular success in France and Austria has prompted the company to operate warehouses in those countries. In 2021, product liability claims against the company arose across Europe from a bad charge of products produced in Asia. In addition, poor tax advice has resulted in tax claims for 2020 from tax authorities in France, Switzerland, Austria and Germany. The shareholder-manager-entrepreneurs believe in the success of the business but are likely unable to finance the payment of all claims. In order to avoid insolvency proceedings, a preventive restructuring is considered.

2.1. Restructuring proceedings listed in Annex A of the EIR 2015

The preventive restructuring framework of the Restructuring Directive is meant to facilitate the restructuring of viable businesses and to prevent insolvency with its additional costs and losses.[9] The German instrument implementing the Directive, the StaRUG, has been effective since 1 January 2021 with the public restructuring framework listed in Annex A EIR 2015 available since 17 July 2022. Under this legal framework, debtors with a German centre of main interests ('COMI') are able to initiate public restructuring proceedings for the court to sanction a restructuring plan that would modify pre-existing claims of selected creditor classes based on a 75 per cent majority of claims in each class accepting the plan. A cross-class cramdown option is also available if the plan is not accepted by the required majority. The process can be supported by a moratorium and by the appointment of a restructuring professional.[10] The German StaRUG would principally allow for the modification of both product liability and tax claims while leaving all other classes of creditors and shareholders unimpaired provided that, amongst other conditions, a majority of classes of impaired creditors actually accepts the plan. Therefore, a public restructuring process would seem to be a promising path to recovery.

Leaving the technicalities of the German provisions aside, the success of the restructuring critically depends on the ability of the German restructuring plan (possibly supported by a moratorium) to affect creditors and their rights abroad. Under the EIR 2015, recognition of main insolvency proceedings is

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[7] Wet Homologatie Onderhands Akkoord (WHOA).
[8] Gesetz über den Stabilisierungs- und Restrukturierungsrahmen für Unternehmen (hereinafter: 'StaRUG').
[9] Recital 2 of the Restructuring Directive.
[10] For a more detailed description, see among others T. Pogoda and C. Thole, 'The new German "Stabilisation and Restructuring Framework for Businesses"' EIRJ 2021-6; J. Ponseck and A. Swierczok, 'The New German Restructuring Regime' (2021) 18 *International Corporate Rescue* 7.

automatic pursuant to Articles 19(1), 20(1) and 32(1) but limited to countries within the Regulation's territorial scope. Hence, the EIR 2015 does not offer any support for the plan with regard to third countries, such as Switzerland, Denmark and the UK.

Within its territorial scope, the EIR 2015 requires the plan to be drafted within the debtor's main insolvency proceedings, which causes the need to find the debtor's COMI in jurisdiction of the restructuring proceedings pursuant to Article 3(1). A mere sufficient connection to this jurisdiction would only be enough if the facts relevant to establish such a connection also allow that the court finds the debtor's place of administration there.

Article 7(1) EIR 2015 would enable the *lex fori concursus* to govern any aspect of the proceedings, including the ability of creditors to collect on behalf of their claims and the ability of a plan to modify creditor rights. However, there are relevant exceptions to be considered in Articles 8-18 EIR 2015. These include the protection of rights of secured creditors to collect assets of the debtor in jurisdictions other than the COMI jurisdiction (Article 8(1) EIR 2015) or the protection of contracts relating to immovable property (Article 11 EIR 2015).

In the case of establishments in other jurisdictions, there is a risk that secondary proceedings be opened. This is critical since secondary proceedings protect all assets located in these jurisdictions from the direct effects of the main proceedings, pursuant to Articles 34-35 EIR 2015. The second sentence in Article 34 EIR 2015 even facilitates the opening of secondary proceedings by stating that '[w]here the main insolvency proceedings required that the debtor be insolvent, the debtor's insolvency shall not be re-examined in the Member State in which secondary insolvency proceedings may be opened.' Where, under national law, the threshold to open a procedure listed in Annex A as an insolvency proceeding is defined by the terms of a 'likely insolvency' or 'financial difficulty', this threshold may qualify as an 'insolvency test' under Article 34 EIR 2015 and thus enable the opening of secondary proceedings in any jurisdiction with an establishment. This would even include the option to open liquidation proceedings. The CJEU stated in the *Bank Handlowy* decision[11] that the clearly torpedoing effect of such secondary liquidation proceedings to main restructuring proceedings would not hinder the opening of such secondary proceedings and may only be mitigated by the need to cooperate and coordinate pursuant to Articles 41-44 EIR 2015.

Preventive restructuring proceedings are not only in danger of being torpedoed by secondary proceedings; they also face the threat of mandatory provisions in the EIR 2015 that stem from traditional, fully collective, insolvency proceedings which hardly work in a mere soft-touch debt restructuring setting. Article 23(1) EIR 2015, for instance, requires any creditor to return what was received on behalf of a claim against the debtor after the opening of insolvency proceedings in order to preserve the *pari passu* principle.[12] This strict (hotchpotch) rule does not work well in preventive proceedings, which aim at avoiding any interference with the day-to-day business of the debtor, in particular by allowing for payments and deliveries made in the course on behalf of pre-petition claims. Article 24(2) EIR 2015 provides a list of mandatory information to be published in the insolvency registers. Many of the items listed are not applicable to preventive proceedings, especially those concerning the lodging and verification of claims. As any claim verification process is absorbed by the plan acceptance procedure, it is also impossible to guarantee the right of foreign creditors to lodge their claim pursuant to Article 53 EIR 2015 and to be informed of the relevant process according to Article 54 EIR 2015. It is an open legal question whether such substantive rules may simply remain ignored in insolvency proceedings due to the fact that they do not fit their purpose.

Finally, the recognition of a judgment confirming a restructuring plan may be refused pursuant to

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[11] CJEU, 22 November 2012, *Bank Handlowy w Warszawie SA and PPHU 'ADAX'/Ryszard Adamiak v Christianapol sp. z o.o.*, C-116/11, ECLI:CU:C:2012:739, para. 57.
[12] C. Thole, in Moritz Brinkmann (ed.), *European Insolvency Regulation – Commentary* (Hart Publishing, 2019), Article 21(1).

Article 33 EIR 2015 ‘where the effects of such recognition or enforcement would be manifestly contrary to that State's public policy, in particular its fundamental principles or the constitutional rights and liberties of the individual.’ This may not present much of an issue in cases where the modification of substantive creditor or shareholder rights in a court-confirmed plan is readily available also in the host jurisdiction. It is a well-established principle that the mere ability to achieve a facilitated restructuring abroad is not as such sufficient to trigger the *ultima ratio* of a public policy objection.[13] However, if a modification of rights does circumvent a clear policy choice in the host jurisdiction, which aims to protect certain local rights from any modification without full and actual consent based on social or fiscal concerns, any foreign plan carrying such a modification will probably meet a public policy objection.[14] Relevant policy choices may take different shapes: from straight-forward prohibitions (see e.g. § 4 StaRUG) to effective value guarantees based priority ranks (e.g. for tax claims) and the best interest test. Thus, if tax claims or pension claims of employees were specifically exempted from the scope of a restructuring under local law, or could only be modified with consent based on priority ranking, the foreign plan would not only facilitate a rescue solution, but also enable a very different burden sharing to that end, contrary to local law. The host jurisdiction would probably be inclined to refuse to recognise the plan based on public policy concerns.[15]

Overall, the application of the EIR 2015 to preventive restructuring proceedings is possible and it is capable of achieving automatic recognition and thus, EU-wide effect, of plan provisions. However, there are pitfalls for which to watch out. The proceedings must be main proceedings and thus can only be commenced in the COMI jurisdiction. The ability of a plan to modify substantive rights under the *lex fori concursus* is limited by applicable exceptions to the *lex fori* (Articles 8-18 EIR 2015), as well as potential public policy concerns, and it is contingent on the prevention of secondary proceedings. Finally, rules such as Article 23(1) EIR 2015 may also complicate the daily operation of the business. Considering these impediments, the fact that lawmakers in the Netherlands, Germany or the UK have made efforts to avoid the scope of the EIR 2015 should not come as a surprise.

2.2. Restructuring proceedings and the Judgment Regulation

If the aim of EU Member State lawmakers was to avoid the scope of the EIR 2015 by introducing a new preventive restructuring proceeding, they must take a closer look at the definition of the scope of the EIR 2015 in its Article 1(1) and Recitals 9 to 17. Of course, the EIR 2015 does not apply to proceedings that are not listed in Annex A, regardless of their characteristics.[16] The fact that proceedings fulfil all requirements of insolvency proceedings as defined in Article 1(1) EIR 2015 may nonetheless suffice to bar access to the alternative legal framework for the recognition of commercial judgments.

It is interesting to note that the legislators in the Netherlands, Germany and the UK used different strategies in handling Article 1(1) EIR 2015. The UK lawmakers duplicated the scheme of arrangement provisions in a new Part 26A of the Companies Act 2006 before adding the specific feature of a cross-class cramdown and the access threshold of financial difficulties.[17] The traditional Part 26 scheme of

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[13] See even Bundesfinanzhof, 27.1.2016, NZI 2016, 929 para. 23 for an English law discharge of German tax claims.

[14] The prerogative of overriding mandatory provisions safeguarding local interests is a principle of EU cross-border law and clearly stated in Article 9 of the Rome I Regulation [Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations].

[15] See also P. Mankowski, ‘Auswirkungen ausländischer Insolvenzverfahren auf deutsche Steuerforderungen (Teil II)’ (2019) *DStR* 1979, 1982, who describes such limitation as a structural limit to any cross-border effect.

[16] See the last sentence of Article 1(1) EIR 2015 (‘The proceedings referred to in this paragraph are listed in Annex A’) and the last sentence of Recital 9 (‘National insolvency procedures not listed in Annex A should not be covered by this Regulation’).

[17] For a more detailed description of the new Part 26A plan, see among others S. Frisby, ‘Of rights and rescue: a curious confluence?’ (2020) 20 *Journal of Corporate Law Studies* 39; R. Mokal, ‘The difficulties with “financial difficulties”: the threshold conditions for the new Pt 26A process’ (2020) *Butterworths Journal of International Banking and Financial Law* 662.

arrangement remains unaltered and can, therefore, still be characterised as a procedure based on general company law, which is not designed exclusively for insolvency situations. The second sentence in Recital 16 of the EIR 2015 ('However, proceedings that are based on general company law not designed exclusively for insolvency situations should not be considered to be based on laws relating to insolvency.') would apply and lead to the conclusion that the scheme is not an insolvency proceeding as defined in Article 1(1) EIR 2015. Whether this conclusion is also justified for the new Part 26A proceedings is less clear[18] but requires no discussion since the UK left the EU and the territorial scope of the EIR 2015.

Lawmakers in the Netherlands and Germany both designed their preventive restructuring schemes with debtors in financial difficulties or on the verge of a likely insolvency in mind. Hence, they did not even consider following the UK strategy for avoiding the substantive scope of the EIR 2015. Instead, they based their threshold on the need for insolvency proceedings to be public,[19] which excludes confidential proceedings from the scope of the EIR 2015,[20] even if such proceedings offer all or most of the debt restructuring tools of public (debt restructuring) insolvency proceedings. Consequently, both Dutch and German schemes are now available in a public or in a confidential format.[21] Confidential proceedings are not listed in Annex A.

Confidential schemes as well as UK-style general company law schemes in EU Member States laws are not insolvency proceedings as defined by Article 1(1) EIR 2015 and could therefore fall within the scope of the Brussels Ibis or Judgment Regulation ('JR').[22] This would give restructuring practice access to a mechanism of automatic recognition pursuant to Article 36(1) JR and a more flexible framework of international jurisdiction in Articles 4-28 JR in other EU Member States. However, at the moment, the conclusion that confidential proceedings are covered by the JR is widely debated.

Authors favouring a functional approach argue that restructuring proceedings cannot be characterised as commercial or civil law matters since they modify commercial or civil law claims. Instead, they must be characterised independently and, as they are used for the purpose of avoiding the insolvency of the debtor through a debt restructuring, can only be understood as insolvency law tools even if they do not fulfil the definition of Article 1(1) EIR 2015. The bankruptcy exception of Article 1(2)(b) JR would apply and deny access to the legal framework for commercial judgments.[23]

Other authors favour a more systematic approach to the scope of the relevant EU regulations. They point at Recital 7 EIR 2015, stating that the interpretation of the scope provisions 'should as much as possible avoid regulatory loopholes between the two instruments.' While the mere fact that a procedure is not listed in Annex A does not call for the application of the JR pursuant to the last sentence of Recital 7, the fact that it also does not meet the requirements listed in Article 1(1) EIR 2015 should mandate the application of the JR as the EIR 2015 cannot apply and loopholes shall be avoided.[24]

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[18] Mr Justice Zaccaroli held that the new Restructuring Plan is an insolvency proceeding in the sense that it would trigger that bankruptcy exception of the 2007 Lugano Convention; see *Re Gategroup Guarantee Limited* [2021] EWHC 304 (Ch). See also K. Stephenson, 'Gategroup: UK Restructuring Plans Are lnsolvency Proceedings; Classes Split' (2021) 18 *International Corporate Rescue* 98.

[19] See the first sentence of Article 1(1) EIR 2015 ('This Regulation shall apply to public collective proceedings […]'). See also Recital 12 mandating publicity as a safeguard for collective effects of proceedings.

[20] See Recital 13.

[21] See Article 369(6) of the Dutch Bankruptcy Act and § 84 of the German StaRUG.

[22] Regulation (EU) No 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters.

[23] See among others *Gategroup* (n 18) paras. 57-137; C. Paulus et al., 'Konzernweite Restrukturierungen – Hilft das StaRUG?', (2021) ZIP 1085, 1089-1090; C. Thole, 'Vertrauliche Restrukturierungsverfahren: Internationale Zuständigkeit, anwendbares Recht und Anerkennung' (2021) ZIP 2153, 2154.

[24] See among others D. Skauradszun and W. Nijnens, 'Brussels Ia or EIR Recast? The Allocation of Preventive Restructuring Frameworks' (2019) 16 *International Corporate Rescue* 193, 197, and 'The Toolbox for Cross-Border Restructurings Post-Brexit – Why, What & Where?' (2019) 7 *NIBLeJ* 1, 14; J. Schmidt, 'Präventiver Restrukturierungsrahmen: Internationale Zuständigkeit, Anerkennung und anwendbares Recht' (2021) ZInsO 654, 657.

Even if the CJEU were to one day support a binding interpretation of the scope provisions favouring the application of the JR, its mechanisms do not seem to cater smoothly for a debt restructuring procedure. The framework of the JR is geared towards a civil or commercial litigation that produces one final judgment in need for cross-border circulation. Provisional, including protective, measures are possible and covered in Article 35, but are not at the heart of the framework. The law applicable to the substantive decision of the judgment is not governed by the JR but is left to general private international law rules. The specific type of substantive law dispute is only partially reflected in specific jurisdiction rules. In contrast, insolvency law frameworks focus on the opening decision and assume a procedure in which several judgments are issued. The variety of substantive rights affected by these decisions justifies overriding the law specifically applicable to them by the *lex fori concursus* in principle. Modern preventive debt restructuring proceedings are often caught in the crossfire of these traditional approaches. They leave the debtor in possession of the business and thereby avoid many of the effects of an opening decision to creditor rights, especially when a stay or moratorium is not automatic or limited to certain creditors or a subset of their enforcement rights. The number of judgments issued may be limited to one (the plan confirmation) or two (the decision to convene a meeting for plan acceptance). At the same time, the content of the plan may affect a variety of rights governed by different laws, or only a subgroup of creditors with claims governed by local law. Therefore, the need for a dominant *lex fori* is present but limited.

The provisions of the JR can work well in cases in which the debt restructuring affects only a small subgroup of creditors with claims or rights governed by local laws. Even provisions on international jurisdiction with a strong connection to the law governing the rights of the dispute, such as rights concerning immovable property (Article 24(1) JR) or company law rights (Article 24(2) JR), but also insurance or consumer claims (Articles 10-19 JR), may cause less concern in such cases. The ability to agree on a jurisdiction under Article 25 JR may even be seen as very useful where the debt restructuring is limited to creditors bound by such an agreement, such as bond or syndicated loan creditors.

For more comprehensive debt restructurings, the provisions of the JR present a number of obstacles and uncertainties. Who is the claimant and who is the defendant in such cases? Is it correct to assume that only the debtor can be understood as the claimant based on the fact that restructuring proceedings begin with the motion of the debtor? Would this lead to the conclusion that all other affected parties are defendants even if they support the plan and vote to accept it? Would such an interpretation not enable the debtor to file for confidential restructuring proceedings in any EU jurisdiction where at least one of the affected creditors is domiciled pursuant to Article 8(1) JR? These open questions are relevant and should be answered based on a substantive understanding of the dispute litigated in restructuring cases where the dividing line is drawn by dissent to the plan proposal.

Obstacles arise from the differentiated jurisdiction rules of the JR. Where different types of claims or rights are to be impaired by the plan or a stay, special rules for insurance or consumer rights or rights on immovable property or rights under company law may require the debtor to file for several parallel proceedings in multiple jurisdictions. [25] In test case, product liability claims of consumers would need to be restructured in the courts of the Member State in which the consumer is domiciled pursuant to Articles 18(2), 17(1)(c) JR. The restructuring of tax claims could fall outside the scope of the JR according to the second sentence of its Article 1(1) ('It shall not extend, in particular, to revenue, customs or administrative matters or to the liability of the State for acts and omissions in the exercise of State authority (*acta iure imperii*)'). If a court ignores these limitations, the recognition of a judgment cannot be secured under Article 36(1) JR (for claims outside its scope) or can be refused pursuant to Article 45(1)(e) JR. Such complications could only be avoided if the matter in a restructuring case were not defined by the modified claims or rights but by the restructuring tool applied to them. At least the German Bundesgerichtshof would need to amend existing case law in order to adopt this interpretation.

[25] For an English scheme of arrangements impairing German insurance claims, see Bundesgerichtshof, 15.2.2012 – *Equitable Life*, NZI 2012, 425 para. 27.

The ability of the JR to protect the preventive restructuring proceedings from parallel proceedings in other Member States depends on the interpretation of Article 29(1) JR. This provision grants a *lis pendens* protection provided that the parallel proceedings involve the same cause of action and the same parties. A strict interpretation of these requirements would not prevent creditors from filing a competing plan in another jurisdiction where they are allowed to file and where they include a slightly different set of creditors.

Finally, the territorial scope of the JR is limited to EU Member States. The framework is not able to secure any recognition in third countries such as Switzerland and the UK. Recognition in these jurisdictions would be governed, where applicable, by the Lugano Convention (Norway, Switzerland, Island) or – someday – by the Hague Convention on Judgments.[26]

2.3. Restructuring proceedings and local cross-border laws

Preventive restructuring plans are only able to extend effects into third countries based on bilateral or multilateral treaties or local rules on cross-border recognition of proceedings or judgments. The same is true for EU Member States if the CJEU were to hold that preventive restructuring procedures meet the scope of the bankruptcy exemption of the JR and the respective procedures were not listed in Annex A of the EIR 2015.

Unfortunately, the relevant cross-border rules are far from uniform, or even in place in many countries.[27] Countries with a statutory cross-border insolvency framework, especially those with a framework modelled after the UNCITRAL Model Law on Cross-Border Insolvency, would need to decide whether confidential and only partially collective proceedings are covered by the scope of these frameworks. If so, recognition of restructuring plans would depend on a review of the debtor's COMI and a public policy test including a review of adequate protection for local creditors. Some countries are rather recognition-friendly in their interpretation, most prominently the United States of America (US),[28] while some are rather hostile to plans modifying claims governed by local law, most prominently those applying the *Gibbs* rule such as English courts.[29]

In countries with no existing or applicable cross-border insolvency framework, statutory rules for the recognition of civil or commercial judgments may exist and cover judgments ordering a temporary moratorium or confirming a restructuring plan. Again, the grounds to grant and refuse recognition may vary and commonly include indirect jurisdiction and public policy tests but also the need to show reciprocity and a precedence for local judgments in the same matter.[30]

In our test case presented above, the German StaRUG restructuring plan would certainly become effective in Germany. In Austria, recognition outside the scope of EU law would be available under § 240 of the Austrian Insolvency Code if confidential StaRUG proceedings qualified as insolvency proceedings under Austrian law. Otherwise, judgment recognition under the Austrian Enforcement Act would need to be sought, provided that this statute even applies to judgments modifying Austrian tax claims.[31] In France, the recognition of foreign insolvency proceedings is governed by case law

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[26] See the Hague Convention of 2 July 2019 on the Recognition and Enforcement of Foreign Judgments in Civil or Commercial Matters.
[27] See, for instance, the findings of INSOL Europe and LexisPSL Joint Project on 'How EU Member States recognise insolvency and restructuring proceedings of a third country' (January 2022).
[28] See *In re Agrokor,* 591 B.R. 163 (Bankr. S.D.N.Y. 2018).
[29] See *Bakhshiyeva v Sberbank of Russia & Ors* [2018] EWHC 59 (Ch); *OJSC Int Bank of Azerbaidjan* [2018] EWCA Civ 2802.
[30] See § 328 ZPO (German Code of Civil Procedure).
[31] For Austria, see the report in INSOL Europe and LexisPSL Joint Project on 'How EU Member States recognise

(exequatur) and would need to be tested. Even if these rules were not applicable directly, judgment recognition seems to depend on similar conditions under established case law, which include a sufficient connection review and a public policy test.[32] In Switzerland, recognition could be achieved under Articles 175 and 166 of the Private International Law Act (PILA) if the StaRUG scheme were deemed to qualify as a foreign insolvency plan confirmed in foreign insolvency proceedings. Otherwise, it could be recognised as a foreign commercial judgment (Article 25 PILA).

2.4. Conclusion

Harmonised rules on preventive restructurings provide some rather limited assistance to financially troubled businesses if any cross-border effect requires special investigation into the nature of the cross-border effect, the regulatory framework available and applicable in the relevant country and, potentially, parallel procedures there if assets abroad are to be protected or foreign law governed rights are to be modified. The current legal landscape does not provide any fitting solution for modern preventive restructuring plans or stays encompassing all assets and debt. Even the EIR 2015 shows significant inconsistencies and pitfalls for debt-oriented procedures. Especially in smaller cases as illustrated in our example, costs for legal advice on cross-border efficacy and parallel procedures effectively hinder the restructuring of viable businesses.

3. How to approach a fresh cross-border restructuring framework

A solution to this situation requires legislative action and relevant law reform should be guided by certain benchmarks.

3.1. Minimum content and possible design

Law reform should consider all three relevant matters of private international law legislation: international jurisdiction, applicable law and cross-border recognition.

The design of the cross-border framework could be procedure-oriented, as is traditionally found in cross-border insolvency laws.[33] The procedure itself would be allocated and recognised abroad by circulating its opening decision. Subsequent decisions would be effective abroad based on this recognition and supported abroad unless their specific effects, e.g. on substantive rights on local creditors, justified another review. Parallel proceedings should, however, be avoided if possible. This condition may also favour a design closer to the one familiar in the recognition of commercial judgments. Here, the first judgment in a matter has global effects provided that it is recognised globally.[34] Such a design also seems better adapted to a preventive restructuring framework, which is not characterised by a dominating opening decision, but instead follows a more modular approach where the debtor may select the court support needed in a specific case. In Germany and the Netherlands, for instance, a stay is as optional as a confirmation order. A cross-border framework that enables such orders to circulate rather than the mere initiation of a procedure appears more fitting.

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insolvency and restructuring proceedings of a third country' (January 2022), 13-17.

[32] For France, ibid, 37-39.

[33] See the design of the EIR 2015, but also the design if the UNCITRAL Model Law on Cross-Border Insolvency.

[34] See the design of the Hague Convention of 2 July 2019 on the Recognition and Enforcement of Foreign Judgments in Civil or Commercial Matters.

3.2. Guiding principles

The cross-border framework for restructurings must be guided by fundamental principles stemming from best practice in restructurings.

First, the principle of universalism is key. While assets of the debtor may be located across the globe and justify local procedures for their administration and realisation in coordinated insolvency proceedings, in the real world (modified universalism),[35] a debt only exists once. Debt is defined by the parties, the content of the obligation and the law governing it. Debt can only be modified once. It is either modified or not under a stay or a plan. Considering the same claim as modified in one and unaltered in another jurisdiction only makes sense with regards to currently available assets and their distribution on behalf of the claim.[36] However, it makes no sense with regard to the future business activity of the parties. Hence, any framework focusing on debt restructurings should return to the principle of general private international law that a right is modified with global recognition under the one law applicable to the modification as identified under private international law rules.

This discussion already touches upon the second insight. The cross-border framework should be drafted with the clear understanding that the process to be allocated and the outcomes to be recognised are debt-oriented. In clear contrast to traditional insolvency proceedings, debt restructurings are commonly debtor in possession proceedings with the impetus of interrupting the ordinary course of business as little as possible. Assets are neither meant to be realised, nor seized. This does not mean that such orders cannot be made if necessary for a restructuring effort. However, the clear focus of any restructuring proceeding is the restructuring of a certain pile of debt. Any framework made for them should reflect this peculiarity.

Finally, the cross-border effects of a debt restructuring must be predictable. The cost and effort of a preventive restructuring is only justified if the outcome – the debt modification under a plan – is predictably, if not certainly, effective. Any cross-border effect should therefore be governed by a set of rules that provides a predictable threshold to stakeholders.

3.3. An approach differentiating a closest and a mere sufficient connection

To start with, any modification of a right should be governed by the law of the country with which it is most closely connected. A restructuring is not different. If a restructuring is characterised by a coordinated, not necessarily (fully) collective debt modification, such modification should still be governed by the law of the country with the closest connection. This is, in principle, the law of the country governing the modified debt. Hence, any contractual claims governed by English law is to be modified by English law, including modification options under English contract law (e.g. termination rights), company law (e.g. a scheme of arrangement), and insolvency law (e.g. a company voluntary arrangement). As long as the case remains purely domestic, these principles should be commonly understood and accepted.

In a cross-border case, foreign elements are added. Creditors may be domiciled abroad; the debtor may be registered or have the COMI abroad; the law governing the claim may be foreign. The closest connection principle nonetheless applies. Which country provides the closest connection?

If the parties agree that the law of a certain country shall modify the claim, such a choice of law would be able to identify the country.[37] The same reasoning would probably apply to a choice of law clause identified the law applicable to the original debt as such a clause would typically include the wish to see this law govern the ways to modify or discharge debt.[38] If the parties to the debt contract,

[35] For a detailed discussion, see I. Mevorach, *The Future of Cross-border Insolvency* (Oxford University Press, 2018), pp. 12-48.
[36] See Article 47(2) EIR 2015.
[37] This assumption is underlying, for instance, Article 3 Rome I Regulation.
[38] See Article 12 Rome I Regulation.

restructuring agreement, or plan did not identify a country, the closest connection may also be found in other circumstances.[39] If all of the restructured debt is governed by the law of the same country, a closest connection of any debt restructuring to this country seems obvious.

If cases are less uniform and involve a variety of claims and stakeholders from different jurisdictions, it may be less and less convincing to identify a single country with the closest connection. Where the debt restructuring involves claims governed by several laws and creditors domiciled in several jurisdiction, as in our example, the closest connection can be particularly difficult to find. The only fact connecting all claims is the debtor. In a debt-oriented framework, the debtor is a relevant figure but, as well-established rules of private international law demonstrate, not at all sufficient to establish a closest connection. More importance is given to other circumstances, in particular the underlying legal relationship of a contract or a property right, or the wish to protect a vulnerable party of the legal relationship, such as an employee, a consumer or franchisee.[40] Circumstances like, for instance, the domicile of the majority of affected creditors, the same law applicable to the majority of restructured debt or the COMI of the debtor may, however, establish a sufficient connection to one country, which again allows for cross-border aspiration.[41]

The difference between applying the law of the country with the closest connection and the law of a country with a sufficient connection should be reflected in the framework. The difference is commonly visible when rules on international jurisdiction refer to a sufficient connection as a way to identify a forum while rules on applicable law would insist on identifying the country with the closest connection. However, the underlying rational that courts are perfectly capable of applying foreign law is impossible to extend to debt restructuring tools where the modification of rights follows from a court-supported agreement (a plan) and from supporting orders (stays). The substantive effects are so intermingled with the procedure and the rules enabling them are so geared towards the specific role of the court in a country that they are impossible to apply by a foreign court. It is simply not intended and difficult to imagine that, for instance, a Dutch restructuring court with international jurisdiction merely based on a sufficient connection would apply German restructuring law (StaRUG) when confirming a plan modifying German debt of a Dutch company. A framework for court-based restructuring tools must reflect this nexus between the forum and the applicable restructuring law at least as long as it is present in respective laws. As long as a (restructuring) court is only meant to be able to apply the restructuring tools of the law of the forum, the allocation of procedures and the law applicable is a task for the rules on international jurisdiction only, while the choice of law mostly is largely determined by the forum allocation.

3.4. The basic outline

The new cross-border restructuring framework would need to provide for all types of cases, the uniform as well as the international ones.

Where the parties to the restructuring proceedings have agreed on a jurisdiction (choice of court or law) in a restructuring support agreement or in the choice of court/law agreement of the restructured debt (bonds, syndicated loans), the identified country is the one with the closest connection. The courts of this country have international jurisdiction for restructuring proceedings and, based on this connection, the local restructuring laws are applied. The closest connection approach also justifies the expectation that the outcomes of the process – the debt modification under the plan or a stay supporting it – are globally effective and thus recognised automatically; any review abroad would be limited to public policy concerns (due process, manifest conflict with local policy decisions).[42] In short, the restructuring of debt in the country with the closest connection to this debt should be globally effective.

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[39] See Article 4 Rome I Regulation.
[40] See Articles 4(1), 6 and 8 Rome I Regulation.
[41] See for the sufficient connection test required by English courts for scheme jurisdiction J. Payne, *Schemes of Arrangement* (Cambridge University Press, 2021), pp. 348-352.
[42] For mandatory provisions of local law reflecting such decisions, see Article 9 Rome I Regulation.

Where the country of restructuring proceedings is able to find a sufficient connection of the restructuring case, e.g. based on the debtor's COMI, the majority of debt governed by local law or the majority of creditors domiciled locally, the courts of the country shall have international jurisdiction to decide the case. Based in the nexus identified above, local restructuring law would be applied. However, the recognition of the outcomes of the process abroad is not self-evident in these cases. Instead, any country with a closer connection to some of the affected debt, for instance a country whose law governs some of the modified debt, would be entitled to review the fair treatment of legitimate expectations of (non-consenting) creditors in the application of their laws under the plan. Upon a request by affected parties, recognition could be refused if the plan modified claims that are immutable without consent under local law or if the alteration of claims without consent would have required a significantly higher compensation under local laws.[43]

Finally, the courts of a country with no sufficient connection to the restructuring case shall have no jurisdiction and, if the local law provides for exorbitant jurisdiction to restructure foreign companies' debt, cannot expect recognition abroad.

Overall, the rules guiding international jurisdiction would include jurisdiction for restructuring proceedings based on the closest, but also on a sufficient connection. They should also identify relevant criteria, one of which (only) would be the debtor's COMI. Rules on applicable law would only refer to the law of the forum due to the nexus between forum and debt restructuring tools. Rules on recognition would review the jurisdiction of the foreign court (indirect jurisdiction test). Where it is found that the debt restructuring originated in the country of the closest connection, recognition is granted unless the foreign procedure or outcome raises manifest public policy concerns. Where a sufficient connection is found, recognition shall be granted unless an objection by the affected non-consenting party is raised stating that the plan modified claims that are immutable without their consent under local law or that the alteration of claims without their consent would have required a significantly higher compensation under local laws. Where no sufficient connection is found, recognition is refused.

4. Conclusion

The 2019 Directive on Restructuring and Insolvency has initiated the creation, and approximation, of local preventive restructuring proceedings in the Common Market. However, the Directive does not provide for a cross-border framework that sufficiently reflects the characteristics of these new proceedings. The EIR 2015 is geared towards asset-oriented insolvency proceedings and several Member States have enacted preventive restructuring proceedings to deliberately avoid its scope. The Judgment Regulation was made with a view to regulate commercial litigation and it is significantly uncertain whether it will apply to preventive restructuring proceedings at all and, if so, whether the restructuring is a matter to be identified separate from the underlying debt when applying its rules. National law rules on cross-border restructurings do not exist. Whether new procedures are sufficiently covered by existing rules on cross-border insolvency or rules on the recognition of foreign commercial judgments is unclear.

The analysis reveals that there is an urgent need for legislative action. Law reform at both EU and Member State level should find orientation in the principle design described in this paper. Cross-border efficacy shall be safeguarded and facilitated whenever the restructuring proceedings are pursued in the country with the closest connection to the modified debt. Restructuring proceedings in countries with a sufficient connection shall also receive support provided that their outcome does not conflict with relevant rules of the *lex causae*.

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[43] Similar ideas for a limited ground for refusal were advanced by E. Janger, 'Virtual Territoriality' (2010) 48 *Columbia Journal of Transnational Law* 401, 432.

Chapter 7

Directors' duty to promote negotiation in times of crisis: Some reflections in light of Directive (EU) 2019/1023

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1. Introduction

The recent economic and financial crises, those that erupted in the second decade of the present millennium, have shown that companies play an important role within society. It is now clear that saving a company is much more than protecting the interests of its owners. Viable companies that face economic and financial difficulties should have access to effective preventive restructuring frameworks, to help them to continue operating, in whole or in part. Consequently, the job losses, the loss of know-how and skills, and the build-up of non-performing loans are avoided or, at least, can be substantially limited. It helps to maximise the total value to creditors and companies' owners, in comparison to what they would receive in the event of the next-best-alternative scenario and contributes, also, in promoting the growth of the economy. Obviously, the earlier those frameworks are triggered, the more effective and successful the restructuring will be for all affected parties and for the economy and society as a whole.[1]

All these concerns are deeply reflected in the Directive (EU) 2019/1023 on restructuring and insolvency.[2] Instead of forcing the Member States to implement a specific and rigid preventive restructuring framework, the European legislator preferred to establish a minimum set of rules, designed to facilitate the negotiation of an agreement between parties. Throughout the Directive, two main objectives stand out. The European legislator takes care of both private interests of affected parties and public interest inherent to the restructuring of viable companies. On the one hand, it seems clear that the European legislator wants to promote negotiation between the parties,[3] which must follow the general principles of private autonomy and good faith. For this purpose, debtors accessing preventive

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[1] On the economic and social role of preventive restructuring frameworks see, *inter alia*, J. L.L. Gant, 'The role of social policy in corporate rescue and restructuring: a messy business' in P. Omar and J. L.L. Gant (eds.), *Research Handbook on Corporate Restructuring* (Edward Elgar, 2021) 476.

[2] About Directive 2019/1023/UE, see, *inter alia*, D. Ehmke et al., 'The European Union preventive restructuring framework: A hole in one?' (2019) 28 *International Insolvency Review* 184; A. Gurrea-Martínez, 'The future of reorganization procedures in the era of pre-insolvency law' (2020) 21 *European Business Organization Law Review* 829; C. Serra, 'Direito da insolvência em movimento: a reestruturação de empresas entre as coordenadas da legislação nacional e as perspetivas do Direito europeu' (2017) *Revista de Direito Comercial* 99; *Lições de Direito da Insolvência*, (Edições Almedina, 2021) 554; C. Paulus, 'Introduction' in C. Paulus and R. Dammann (eds.), *European Preventive Restructuring, Directive (EU) 2019/1023, Article-by-Article Commentary* (C. H. Beck, 2021) 4; D. Zhang, 'Preventive Restructuring Frameworks: A Possible Solution for Financially Distressed Multinational Corporate Groups in the EU' (2019) 20 *European Business Organization Law Review* 289; J. Pulgar Ezquerra, 'Marcos de reestructuración preventiva y segunda oportunidad en la Directiva UE 2019/1023' (2019) *Diario La Ley*; N. Tollenaar, 'The European Commission's Proposal for a Directive on preventive restructuring proceedings' (2017) 30 *Insolvency Intelligence* 65; R. Dammann, 'Article 1 – Subject matter and scope' in C. Paulus and R. Dammann (eds.), *European Preventive Restructuring, Directive (EU) 2019/1023, Article-by-Article Commentary,* (C. H. Beck, 2021) 35; S. Madaus and B. Wessels, 'Restructuring reform with pre-insolvency proceedings – where is the EU heading to?' in *Harmonisation of European Insolvency Law* (INSOL Europe, 2017) 201; 'Business rescue in insolvency law in Europe: Introducing the ELI Business Rescue Report' (2018) 27 *International Insolvency Review* 255.

restructuring procedures shall remain totally, or at least partially, in control of their assets and the day-to-day operation of their business, and rescue finance (new financing and interim financing) and restructuring related transactions have to be protected.[4] On the other hand, the European legislator suggests that these general principles cannot be fully relied upon as problems often arise when creditors seek to disrupt the negotiations by exercising hold up rights or by seeking to enforce their claims. To deal with the hold out problems, the law can assist with some mechanisms, such as imposing some form of moratorium (stay of individual enforcement actions),[5] and ensuring that a restructuring plan can be confirmed by a judicial or administrative authority and become binding upon dissenting creditors or classes of creditors where the restructuring plan fulfils at some conditions.[6] This why the European legislator adopted a hybrid system that manages both carrots and stick approaches.[7] That means that the law is called upon to play an important role through a system of incentives to negotiate an agreement that reasonably and fairly protects the private and public interests at stake, and through a mandatory and punitive system that sanctions fraudulent conducts, in opposition to those principles and interests.

The above-mentioned approach is clearly contained in Article 19 of the Directive and in the explanation given in Recitals 70 and 71.[8] Under these legal provisions,

> where there is a likelihood of insolvency (or pre-insolvency *status*), directors "[shall] have due regard, as a minimum, to the following: (a) the interests of creditors, equity holders and other stakeholders; (b) the need to take steps to avoid insolvency; and (c) the need to avoid deliberate or grossly negligent conduct that threatens the viability of the business.[9]

Such conduct expresses what directors have to do (conduct of positive content or *facere* conduct) and what directors have to avoid (conduct of negative content or *non facere* conduct). Regarding what directors have to do, we can see that the European legislator was inspired by the English wrongful trading regime when it is explained that directors 'should take steps to minimise losses and to avoid insolvency', including professional advice, early warning tools, and holding negotiations with creditors and entering preventive restructuring procedures, if appropriate.[10] This is 'important to ensure that directors are not dissuaded from exercising reasonable business judgment or taking reasonable commercial risks, particularly where to do so would improve the chances of a restructuring of potentially viable businesses.'[11] Regarding what directors have to avoid, the European legislator, inspired by the German insolvency law, says that directors need to 'avoid deliberate or grossly negligent conduct that threatens the viability of the business'. It is 'important to protect the legitimate interests of creditors from management decisions that may have an impact on the constitution of the debtor's estate, in particular where those decisions could have the effect of further diminishing the value of the estate available for restructuring efforts or for distribution to creditors'.[12] In both situations, directors have to

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[4] Articles 17 and 18 of Directive (EU) 2019/1023.
[5] Article 6 and 7 of Directive (EU) 2019/1023.
[6] Articles 8 to 16 of Directive (EU) 2019/1023.
[7] See J. Cepec and M. Kovac, 'Carrots and sticks as incentive mechanisms for the optimal initiation of insolvency proceedings' (2016) 7 *Law and Economics Review* 79.
[8] On the implications of this rule in the Portuguese legal system, see A. de Soveral Martins, *Administração de sociedades anónimas e responsabilidade dos administradores* (Edições Almedina, 2020) 339; C. Serra, 'The impact of the Directive on shareholders, companies' directors and workers' *Eurofenix* (Summer 2017) 28; 'O dever de prevenção da insolvência na perspectiva dos deveres fundamentais dos administradores (a crescente encruzilhada do Direito das Sociedades e do Direito da Insolvência)' in R. Costa et al. (eds), *Diálogos com Coutinho de Abreu, Estudos oferecidos no Aniversário do Professor* (Edições Almedina, 2020) 167; C. Serra and J. Gonçalves Machado, 'Para uma harmonização mínima do direito da insolvência - Primeira abordagem à Proposta de Directiva de 22.11.2016, com especial atenção ao seu impacto no direito das sociedades comerciais' (2017) 17 *Direito das Sociedades em revista* 161; J. Coutinho de Abreu, 'Administradores e (novo?) dever geral de prevenção da insolvência' in C. Serra (ed.), *V Congresso de Direito da Insolvência* (Edições Almedina, 2019) 229; and N. Pinto Oliveira, 'Responsabilidade civil dos administradores pela violação do dever de apresentação à insolvência' (2018) *Revista de Direito Comercial* 609.
[9] Article 19 of Directive (EU) 2019/1023.
[10] Recital 70 of Directive (EU) 2019/1023.
[11] Recital 70 and Article 19(b) of Directive (EU) 2019/1023.
[12] Recital 71 and Article 19(c) of Directive (EU) 2019/1023.

look at (having 'due regard' to) the pre-insolvent company's equity holders, creditors, workers and other stakeholders, whose interests need to be given due regard according to circumstances.[13]

2. How to deal with conflicts of interests in times of crisis?

Where the company experiences financial difficulties, it is likely that there exists the potential for conflict of interests to arise among the different parties: pre-insolvent company's creditors, equity holders, workers and other stakeholders.[14] The directors' conduct can oscillate between an atomistic or individual approach, more focused on protecting the interests of one party or group, and a pluralistic approach, more focused on conciliating all different interests at stake, where we can include the enlightened shareholderism doctrine and the stakeholderism doctrine.[15] In the first approach, the balancing of interests seems to be clear when the company is solvent or insolvent. This can be defined as a black or white approach. There is no 'twilight zone'. When a company is solvent, the equity holders' interests are prevalent, and creditors will benefit indirectly from the company success. There is no need to put the creditors' interests first. However, if the company becomes insolvent, the equity holders' interest is residual because all creditors will be paid before them. As result, the directors have an obligation to prioritise creditors' interests. Accordingly, they have to protect the assets of the insolvent company, refraining from any kind of voidable transaction and excessive risk-taking.[16]

However, what if the company is merely within the vicinity of insolvency, where there is a mere likelihood of insolvency? In this scenario whether a company is close to insolvency or not is an imprecise concept. It is unclear which interest should prevail, even if the law establishes a hierarchy and defines the meaning that is given to pre-insolvency *status*. That means that the decision-making processes becomes more difficult under the atomistic or individual approach. In some jurisdictions, such as Australia, the United Kingdom, and the United States, there are significant jurisprudence and doctrine defending a shift in the nature of directors' duties, in favour of creditors, when their company is in the 'twilight zone', moving from solvency *status* towards insolvency *status*.[17] However, it remains unclear when directors' duties shift. Under the pluralistic approach, this does not create issues because in this case there is no need for a deep or sudden shift of duties; all interests must be continually measured, balanced and protect by directors according to circumstances. The protection of the corporate interest (*maximise* its viability and sustainability) remains at the top of the interest list to have due regard to, and this primordial position works as reference and orientation for the harmonisation of other interests, including equity holders' and creditors' (short, medium and long term) interests. Once the company is in the vicinity of insolvency and it is not clear when the 'moment of truth'[18] arises, from which the creditors duties shift, there will be a natural tendency to harmonise all interests involved according to the circumstances. It does not mean that directors are free to do whatever they like, yet they are not merely obliged to accept or follow internal and external influences. In contrast, it entails enough managerial discretion to analyse circumstances and make reasonable and rational decisions. It

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[13] Recital 71 and Article 19(1) of Directive (EU) 2019/1023

[14] See K. Schmidt, 'Conflictos de interés entre socios, acreedores y administradores en la proximidad de la insolvência: reflexiones introdutórias en el contexto de la Directiva (EU) 2019/1023' in J. Pulgar Ezquerra and E. Recamán Graña (eds.), *Reestructuración y Gobierno Corporativo en la proximidade de la insolvência* (Wolters Kluwer, 2020) 43; J. Megías Lópeza, 'Noción de gobierno corporativo y su papel en la crisis empresarial' in J. Pulgar Ezquerra and E. Recamán Graña (eds.), *Reestructuración y Gobierno Corporativo en la proximidade de la insolvência* (Wolters Kluwer, 2020) 129.

[15] D. Baird, 'Bankruptcy's uncontested axioms' (1998) 108 *The Yale Law Journal* 573.

[16] A. Keay, 'The Shifting of Directors' Duties in the Vicinity of Insolvency' (2015) 24 *International Insolvency Review* 140..

[17] Ibid.

[18] K. Schmidt, 'Interaction of corporate law and insolvency law: German experience and international background' in *International Insolvency Law: Future Perspectives* (INSOL Europe, 2015) 129.

is commonly said, in line with the wrongful trading regime[19] and deepening insolvency doctrine,[20] that directors should take all necessary and appropriate steps to avoid insolvency and to minimise losses, in order to maximise the company's value and avoid loss of key assets. So, if directors know or ought to conclude that there is no reasonable prospect of the company avoiding going into insolvent liquidation, they shall take every step to minimise the potential loss to creditors. In a similar way, if directors know or ought to conclude that there is a reasonable and realistic prospect of implementing a restructuring plan, they shall not ignore holding negotiations with creditors and entering preventive restructuring procedures as a response to avoiding insolvency. In this kind of approach, it is obvious that the company must be managed in harmony with the plurality of interests at stake, duly ordered according to the primordial interest of the pre-insolvent company, which includes everything that contributes to its viability and sustainability or, if not possible, all steps to minimise losses.[21]

This discussion has been addressed in many European jurisdictions after Article 19 of the Directive came into force. Nonetheless, the Portuguese doctrine seems to be divided. Some authors[22] consider that during the pre-insolvency period, directors are obliged to act solely in the interest of the company and its owners. The corporate interest would be perfectly aligned with equity holders' interests so that before the insolvency *status,* they own fiduciary duties to equity holders, not to creditors. In contrast, the majority of the Portuguese doctrine[23] argues that, where there is a likelihood of insolvency, directors are obliged to take all necessary and appropriate steps in order to minimise losses to all affected parties (equity holders and creditors), entering into a preventive restructuring procedure in order to negotiate a restructuring plan, or, if there is no prospect of doing so, non-viable businesses should be liquidated as soon as possible. Regardless of the path followed, directors would have to explain why the option chosen (restructuring or liquidation) is the most appropriate solution to maximise the company's value for its benefit and for stakeholders as a whole. This understanding, as it is based on broader and more flexible criteria, is the one that, in our view, is best in line with the wrongful trading regime which, admittedly, forms the basis of the aforementioned Article 19 of the Directive.[24]

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[19] Section 214 of the UK's Insolvency Act 1986. See C. Gerner-Beuerle and E-P. Schuster, 'The evolving structure of directors' duties in Europe' (2014) 15 *European Business Organization Law Review* 226; H. Eidenmüller, 'Trading in times of crisis: formal insolvency proceedings, workouts and the incentives for shareholders/managers' (2006) 7 *European Business Organization Law Review* 252; K. van Zwieten, 'Director liability in insolvency and its vicinity: West Mercia Safetywear Ltd v Dodd revisited' (2018) 38 *Oxford Journal of Legal Studies* 382; P. Davies, 'Director's Creditor-regarding duties in respect of trading decisions taken in the vicinity of insolvency' (2006) 7 *European Business Organization Law Review* 319; R. Sahyan, 'The myth of the zone of insolvency: Production Resources Group v. NCT Group' (2006) 3 *Hasting Business Law Review* 181; and S. Madaus, 'Reconsidering the shareholder's role in corporate reorganisations under Insolvency Law' (2013) 22 *International Insolvency Review* 106.

[20] See N. Santoro, 'Deeping Insolvency: A cause of action, a tool of measuring damages, or nothing at all?' (2015) 7 *St. John's Bankruptcy Research Library*; N. Abbott et al., 'A Deeper Look at Deepening Insolvency' (2006) 4 *DePaul Business and Commercial Law Journal* 529; and R. Millner et al., 'Potential Liability for Deepening Insolvency and Breach of Fiduciary Duty to Creditors' (April 2007) *ABA Section of Litigation Annual Conference* 1.

[21] See R. Goosens, 'The European Initiative on the Harmonisation of Directors' Duties in the Vicinity of Insolvency' (2017) 5 *Nottingham Insolvency and Business Law e-Journal*.

[22] A. de Soveral Martins, '"Em casa onde não há pão, toda a gente ralha e ninguém tem razão". A propósito do dever de apresentação à insolvência e do (?) dever de evitar a insolvência' (2021) 5 *Revista de Direito da Insolvência* 56; e M. Carneiro da Frada, 'A responsabilidade dos administradores perante os credores entre o Direitos das Sociedades e o da Insolvência' in C. Serra (ed.), *IV Congresso de Direito da Insolvência* (Edições Almedina, 2017) 200.

[23] See, *inter alia*, C. Serra, 'O dever de prevenção da insolvência na perspectiva dos deveres fundamentais dos administradores (a crescente encruzilhada do Direito das Sociedades e do Direito da Insolvência)' in R. Costa et al. (eds), *Diálogos com Coutinho de Abreu, Estudos oferecidos no Aniversário do Professor* (Edições Almedina, 2020) 167, pp. 175-180; J. Coutinho de Abreu, 'Administradores e (novo?) dever geral,' 229-234; Nuno Pinto Oliveira, 'Responsabilidade civil dos administradores,' 609-615.

[24] C. Serra, C. Serra, 'The impact of the Directive on shareholders, companies' directors and workers' *Eurofenix* (Summer 2017) 28, 29; C. Serra and J. Gonçalves Machado, 'Para uma harmonização mínima do direito da insolvência - Primeira abordagem à Proposta de Directiva de 22.11.2016, com especial atenção ao seu impacto no direito das sociedades comerciais' (2017) 17 *Direito das Sociedades em revista* 161; G. Balp, 'Early Warning Tools at the Crossroads of Insolvency Law and Company Law' (2018) *Bocconi Legal Studies Research Paper,* no. 3010300, pp. 25-30; N. Pinto Oliveira, 'Responsabilidade civil dos administradores pela violação do dever de apresentação à insolvência' (2018) *Revista de Direito Comercial* 609.

3. Criteria to implement a consensual and non-consensual restructuring plan

Inspired by the Reorganization regime, enshrined in Chapter 11 of U.S. Bankruptcy Code, Directive (EU) 2019/1023 encourages 'consensual' as well as 'non-consensual' restructuring plans, whenever the affected parties must be treated in separate classes, which correspond to the class formation criteria under national law (nonetheless reflecting a sufficient commonality of interest).[25] A plan is consensual when it is accepted by all classes. A plan is non-consensual when it is not accepted by all classes. A plan accepted by all classes can gather the support of all (unanimously) or only of a certain majority. The higher the majority, the higher the legitimacy of the restructuring plan. If all affected parties agree on the plan, there is a unanimous plan. Apart from this situation, consensual plans will nonetheless bind some parties (the minority in each class) who reject the plan. At first glance we might assume that a consensual plan is reasonable and fair. [26] The democratic approval in each category justifies, by itself, that consensual plans could or should bind all dissenting minorities. If this premise is valid, it does not matter what is contained in the restructuring plan. The democratic rule only cares about votes and the consensus is merely a result of a voting procedure. If it is not valid, there must be a justification for biding dissenting affected parties in each class, to justify the exception to the *pacta sunt servanda* principle.[27] The need for a justification is even more obvious when the plan is non-consensual because in that case the democratic rule does not in that sense.

According to Directive (EU) 2019/1023, the restructuring plan must fulfil some procedural and substantial requirements, such as (i) 'the debtor's assets and liabilities at the time of submission of the restructuring plan, including a value for the assets, a description of the economic situation of the debtor and the position of workers, and a description of the causes and the extent of the difficulties of the debtor'; and 'a statement of reasons which explains why the restructuring plan has a reasonable prospect of preventing the insolvency of the debtor and ensuring the viability of the business, including the necessary pre-conditions for the success of the plan' (that can 'be made or validated either by an external expert or by the practitioner in the field of restructuring if such a practitioner is appointed').[28] Assuming that affected parties have prior and full access to all relevant information when they are called to vote on the adoption of a restructuring plan,[29] we can reasonably assume that all votes reflect the creditors assessment on the fulfilment of the procedural rules and on the content of the plan. If a certain majority approves the content of a restructuring plan according to the procedural rules, and if all affected parties vote rationally, there is no plausible reason to consider that plan unfair to creditors. However, for the European legislator, this justification is not enough.

Under the Article 10(1) of Directive (EU) 2019/1023, restructuring plans are binding on dissenting affected parties only if they are confirmed by a judicial or administrative authority[30] that will control, at least, the following conditions:

> (a) the restructuring plan has been adopted in accordance with Article 9 [regarding the voting rules]; (b) creditors with sufficient commonality of interest in the same class are treated equally, and in a manner proportionate to their claim; (c) notification of the restructuring plan has been given in accordance with national law to all affected parties;

[25] Recitals (44) e (45) and Article 9 of Directive (EU) 2019/1023.

[26] See N. Tollenaar, *Pre-Insolvency Proceedings*: *A Normative Foundation and Framework* (Oxford University Press, 2019), p. 61; F. Garcimartin , 'Article 4 – Availability of preventive restructuring frameworks' in C. Paulus and R. Dammann (eds.), *European Preventive Restructuring Directive (EU) 2019/1023, Article-by-Article Commentary* (C.H. Beck, 2021) 93.

[27] R. Dammann, 'Article 9 – Adoptions of restructuring plans' in C. Paulus and R. Dammann (eds.), *European Preventive Restructuring Directive (EU) 2019/1023, Article-by-Article Commentary* (C.H. Beck, 2021) 64.

[28] Article 8 of Directive (EU) 2019/1023.

[29] Article 10(2)(c) of Directive (EU) 2019/1023.

[30] Article 10(1)(a) of Directive (EU) 2019/1023.

(d) where there are dissenting creditors, the restructuring plan satisfies the best-interest-of-creditors test; (e) where applicable, any new financing is necessary to implement the restructuring plan and does not unfairly prejudice the interests of creditors.

Further, 'judicial or administrative authorities are able to refuse to confirm a restructuring plan where that plan would not have a reasonable prospect of preventing the insolvency of the debtor or ensuring the viability of the business.'[31]

This means two things: on the one hand, however legitimate the 'binding of dissenting affected parties,' judicial or administrative power is required to confirm the plan and the will of a certain majority is not sufficient on its own. On the other hand, judicial or administrative authorities cannot decide according to free criteria, fixed on a case-by-case basis. There are legal requirements that must be verified and confirmed by judicial or administrative authorities, considering the content of the plan and the fulfilment of certain procedural rules. For that reason, the justification we are looking for must be based also on those legal requirements. In fact, the negotiation of restructuring plan takes place in the shadow of (modern) insolvency law that combines the common tools of traditional insolvency law with the common tools of out-of-court procedures, in order to facilitate a restructuring agreement.[32]

In light of the foregoing, we can distinguish two different types of justifications: first, the judicial or administrative power; second, the fulfilment of substantial and procedural rules. Among these rules, it is crucial to pass the best-interest-of-creditors test. This test, also known as the no creditor worse off principle,

> is satisfied if no dissenting creditor would be worse off under a restructuring plan than such a creditor would be if the normal ranking of liquidation priorities under national law were applied, either in the event of liquidation, whether piecemeal or by sale as a going concern, or in the event of the next-best-alternative scenario if the restructuring plan were not confirmed.[33]

If the plan is not-consensual, it may still be confirmed through a cross-class cram-down mechanism.[34] The lack of consent in all classes is replaced by one of the following rules: (i) it has been approved by a majority of the voting classes of affected parties, provided that at least one of those classes is a secured creditors class or is senior to the ordinary unsecured creditors class; or, failing that, (ii) it has been approved by at least one of the voting classes of affected parties or where so provided under national law, impaired parties, other than an equity-holders class or any other class which, upon a valuation of the debtor as a going concern, would not receive any payment or keep any interest, or, where so provided under national law, which could be reasonably presumed not to receive any payment or keep any interest, if the normal ranking of liquidation priorities were applied under national law.[35] This limitation to the democratic rule can be understood against the idea that if classes had veto rights, it would be highly unlikely for the restructuring agreement to come into force due to hold-out positions that, not rarely, are used to extract value for the benefit of some classes at the expense of other classes.[36]

In addition to this minimum support test, a non-consensual plan may only bind dissenting classes of affected parties if the fairness test is met, which consists of two elements: (i) respect for priority rights of classes; (ii) and do not distribute more than the full amount of claims or interests of classe(s) of affected parties. Regarding the first element, the European legislator provides two options: the relative

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[31] Article 10(3) of Directive (EU) 2019/1023.

[32] See J. Payne, 'The role of the court in debt restructuring' (2018) 77 *Cambridge Law Journal* 124, 126-129; and S. Madaus, 'Leaving the Shadows of US Bankruptcy Law: A Proposal to Divide the Realms of Insolvency and Restructuring Law' (2018) 19 *European Business Organization Law Review* 615.

[33] Article 2(1) of Directive (EU) 2019/1023.

[34] See K. Klee, 'All You Ever Wanted to Know About Cram Down Under Chapter 11 of the New BankruptcyCode' (1979) 53 *American Bankruptcy Law Journal* 133; P. Coogan, 'Confirmation of a Plan Under the Bankruptcy Code' (1982) 32 *Case Western Reserve Law Review* 301; R. Broude, 'Cram Down and Chapter 11 of the Bankruptcy Code: The Settlement Imperative' (1984) 39 *The Business Lawyer* 441.

[35] Article 11(1)(b) of Directive (EU) 2019/1023

[36] M. Veder, 'Article 11– Cross-class cram-down' in C. Paulus and R. Dammann (eds.), *European Preventive Restructuring Directive (EU) 2019/1023, Article-by-Article Commentary* (C. H. Beck, 2021) 178.

priority rule and, as an alternative, the absolute priority rule.[37] The relative priority rule 'ensures that dissenting voting classes of affected creditors are treated at least as favourably as any other class of the same rank and more favourably than any junior class.'[38] The absolute priority rule entails that 'the claims of affected creditors in a dissenting voting class are satisfied in full by the same or equivalent means where a more junior class is to receive any payment or keep any interest under the restructuring plan.' [39] With regard to the second element, the European legislator explains that 'no class of affected parties can, under the restructuring plan, receive or keep more than the full amount of its claims or interests.'[40] These two elements are expression of the 'no unfair discrimination principle', [41] which try to ensure that a good chance at restructuring is not lost if the reduction of the rights or interests of dissenting classes of affected parties are treated at least as favourably as any other class of the same rank and if they have access to a reasonable and fair plan which is, according to the circumstances, the best possible solution.

In light of forementioned, we conclude that judicial or administrative authorities play an important and essential role in the field of restructuring pre-insolvent companies, especially by controlling the procedural and substantial requirements for the adoption of a restructuring plan. What seems to be clear is that, even though the restructuring of pre-insolvent companies can be carried out by purely contractual means, judicial (or administrative) intervention may be necessary and indispensable to promote a fair agreement between affected parties, namely when some of them, by their misconduct and without any rational reason, try to avoid the success of the conclusion of a restructuring plan. In this sense, it cannot be said that judicial intervention aims to exclude the negotiation autonomy and/or the contractual nature of the reorganisation agreement. Instead, it aims to safeguard the contractual balance in the light of the principles of private autonomy, good faith and the public interest in the restructuring of pre-insolvent and viable companies. In other words, through judicial (or administrative) intervention, the parties affected by the plan, supporters or dissenters can, and must, trust that the approved agreement will meet in a fair and balanced way, the particular interests of each of the affected parties or classes and the public interest in the restructuring of pre-insolvent companies. This trust is the foundation of negotiation in good faith and, consequently, the reason of the duty to cooperate which bind all parties involved in negotiations.[42]

4. Duty to promote negotiations in times of crisis

In times of crisis, directors are called upon to manage the company and defend interests that are not their own. Instead, they must protect the corporate interest and the interests of others. By their personal conduct and their decisions, directors externalise and bind the conduct of their company. In this sense, they also know (or should not ignore) that it is up to them to promote or support the negotiation of a possible restructuring plan. Even though they are not parties to the negotiation procedure, the pre-insolvency restructuring of companies will mainly depend on the decisions of the directors, both as managers of debtor companies and as managers of creditor companies. The conduct of directors conditions, limits, and binds their company (as debtors or creditors) and their conducts contains procedural elements and substantial elements.

With regard to procedural elements, it will be said that it is up to managers to provide and/or respect the procedural rules that are necessary for the parties to communicate with each other in an appropriate manner for the purpose of the negotiations. We can think about conditions or limits regarding the

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[37] See S. Madaus, 'Is the Relative Priority Rule Right for Your Jurisdiction: A simples guide to RPR' (2020) *Working Paper*. Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3827696 (accessed: 12 August 2022).
[38] Article 11(1)(c) of Directive (EU) 2019/1023.
[39] Article 11(2) of Directive (EU) 2019/1023.
[40] Article 11(1)(d)) of Directive (EU) 2019/1023.
[41] M. Veder, 'Article 11– Cross-class cram-down' in C. Paulus and R. Dammann (eds.), *European Preventive Restructuring Directive (EU) 2019/1023, Article-by-Article Commentary* (C. H. Beck, 2021) 178, pp. 184-185.
[42] For an in-depth analysis of the theory of trust and its impact on civil liability, see M. Carneiro da Frada, *Teoria da Confiança e Responsabilidade Civil* (Almedina, 2021).

individual and collective action of the parties involved in the negotiations, namely stay of individual enforcement actions, sharing relevant information, formation of classes, notification of the restructuring plan to all affected parties, voting rights and fulfilment of deadlines. In some cases, these procedural rules may be established by law or, if not, they may result from an agreement between the parties involved or from the imposition made by the judicial or administrative authority responsible for supervising the negotiation procedure. With regard to substantial elements, managers are required to contribute, fundamentally, to the presentation of proposals or counterproposals, for the adoption of restructuring plan. Basically, both procedural and substantial elements represent two sides of the same coin that helps to better understand the conduct of directors in the context of preventive restructuring frameworks.

The procedural elements differ depending on the legal regime of preventive restructuring frameworks,[43] but the substantial elements tend to remain the same across jurisdictions, in the sense that all restructuring plans should represent a reasonable prospect of preventing the insolvency of the debtor and ensuring the viability of the business in a fair manner and more beneficial (in terms of economic value) to all affected parties. That means that directors' managerial discretion can be limited not only by procedural rules, depending on preventive restructuring framework, but also by substantial reasons. If there is a realistic and reasonable chance of implementing a restructuring plan, under the terms and conditions mentioned above, directors are bound to act in order not to lose or threaten it. They are not free to act in the opposite direction, adopting unreasonable and unjustified conduct that threatens or harms such a chance. Thus, there must be some coordination between the duties provided for in Article 19 of Directive (EU) 2019/1023 and the other legal provisions that contribute, procedurally or substantially, to the negotiation of a restructuring plan.[44]

Regarding the substantive part of the negotiation, the decision to present or not present certain contributions or proposals that may form part of the possible agreement has to be made, as well as the expression of support or opposition to it. In terms of its content, a mere debt restructuring may be at stake, in the sense of reducing or allowing a moratorium, reducing the value of instalments and extending payment periods, but also granting financial support (new or interim financing):[45] a debt-to-equity swap is also possible measure. Basically, all contributions or proposals that are intended to recover and keep the pre-insolvent company operating are admissible. Naturally, such proposals comply with basic general requirements. In general, they must be serious, necessary, adequate, reasonable and fair proposals. As a result, proposals or counter-proposals containing false information or with a merely misleading intention must not be submitted. Proposals or counter-proposals that are clearly careless and inappropriate to the specific situation and/or that abusively aim to benefit or harm one or more parties are also not admissible, compared to the situation in which they would be in the absence of agreement and leave them in a situation less favourable than other parties with claims of the same nature and rank or lower rank.

Promoting the negotiation of a restructuring plan is, certainly, a management decision, which can be

[43] For example: under the terms of the Portuguese Special Revitalization Process ('*Processo Especial de Revitalização'*), negotiations are, ab initio, conditioned by the possibility of participation of all creditors who are notified to claim their credits and, if they wish, to participate in the negotiations. In addition, the conduct of the parties involved in the negotiation is limited by a set of procedural and substantial effects that automatically arise from the opening of the process. On the other hand, the extrajudicial recovery of companies' regime ('Regime Extrajudicial de Recuperação de Empresas') allows the negotiation to involve only selected parties, who are responsible, by agreement, to define some conditions and effects regarding their individual and collective action. Ultimately, the choice of the appropriate negotiating instrument is, in itself, a management decision that aims to promote negotiations in a certain way, within certain limits and conditions, pre-established and or to be defined by mutual agreement within legal limits.

[44] See G. Corno, 'Article 19 – Duties of Directors' in C. Paulus and R. Dammann (eds.) *European Preventive Restructuring, Directive (EU) 2019/1023, Article-by-Article Commentary* (C. H. Beck, 2021) 238, pp. 240-241.

[45] Under Article 2(1)(7) of Directive (EU) 2019/1023 'new financing' means any new financial assistance provided by an existing or a new creditor in order to implement a restructuring plan and that is included in that restructuring plan. Under Article 2(1)(8) of Directive (EU) 2019/1023 'interim financing' means any new financial assistance, provided by an existing or a new creditor, that includes, as a minimum, financial assistance during the stay of individual enforcement actions, and that is reasonable and immediately necessary for the debtor's business to continue operating, or to preserve or enhance the value of that business.

more or less conditioned or limited depending on the circumstances that point in a certain direction, or even limited or excluded by any previously existing binding agreement or legal imposition. However, the question remains what the *ratio* or foundation of such a duty is. If its *raison d'être* concerns exclusively the directors-companies' contractual relationship, its scope will be limited to that relationship and, consequently, the directors will only be liable to the company. If the *ratio* is also linked to the protection of third parties, there is no justification to put aside a system of directors' liability in relation to third parties, namely, due to a legal or contractual provision specially designed to protect third parties, or due to a special relation that arises in certain circumstances between the directors and third parties. Thus, asking about the existence and scope of the general duty to promote the negotiation of a pre-insolvency recovery agreement is important to understand the consequences of its violation, within the scope of the internal relationship (towards the managed company itself) and, eventually, in the context of external relations (to third parties). In this sense, understanding the legal foundation of the general duty of directors to promote the negotiation of a restructuring plan is important in order to find an answer to the extent of the due conduct and the consequences of its violation, both within the scope of the internal relationship (manager-company) as well as in the scope of external relations (manager-third parties).

One possible reason can be found in the shift of fiduciary duties theory in the vicinity of insolvency.[46] In light of this conception, the pre-insolvency situation causes a shift in fiduciary duties in the sense that directors must guide their conduct mainly in defence of creditors' rights and interests. The explanation for the shift is simple: if the company is in the vicinity of insolvency, the directors are playing with the creditors' money because the equity holders rights are subordinated, and all creditors will be paid before them in the event of insolvency. That means that when a company is close to insolvency, creditors have more to lose than equity holders whose interests are of marginal value. The pre-insolvency *status* must represent a realistic likelihood of insolvency, which is normally assessed according to the balance sheet or cash flow tests.[47] That period cannot be too far in time, otherwise it is a mere speculation. It cannot be too close in time either, otherwise there is no objective information to come to a realistic and reasonable conclusion. At some reasonable time prior to insolvency, directors know or ought to know that there is a realistic prospect of the company going into insolvency if they do nothing to avoid it. In that case, directors should take steps to protect the creditors' interests. Hence, the shift in directors' duties is a form of creditor protection.[48] Such protection is essential because it enhances certainty in respect of transactions with pre-insolvent companies and tend to reduce the fear of creditors and investors that company value will transfer to equity holders' or to highly risky transactions (which will benefit third parties) that put creditors' interests at stake. Continuing to trade in these circumstances puts directors under a duty to take account of the creditors' interests.

It turns out that the rationale behind the duty to promote the negotiation of a restructuring plan is not exactly the defence of the creditors' interests, but the best (reasonable and fair) satisfaction of the interests of all affected parties and the public interest in restructuring pre-insolvent and viable companies. Above the interest of creditors and equity holders will certainly be the corporate interest itself, which may not exactly coincide with those interests. The corporate interest is, of course, the continuity and sustainability of the company. Creditors and equity holders also benefit from it. We believe this understanding is the one that best fits with Article 19 of Directive (EU) 2019/1023 and, to some extent, it is reflected, in section 172 of the UK Companies Act 2006,[49] §§ 76, (1) e (2) e 93, (1)

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[46] This theory started from the judgment of the High Court of Australia in *Walker v Wimborne* ((1976) 137 CLR 1; (1976) 3 ACLR 529. This position was quickly spread by the English courts, with special emphasis on the case *West Mercia Safetwear Ltd v Dodd*, in which the Court ruled that directors should take into account the interests of creditors in the vicinity of insolvency). Thanks to this decision, the *shift of fiduciary duties theory* during in pre-insolvency began to assume a role more and more recognized by jurisprudence and doctrine, including in the United States, through the *deepening insolvency theory* (see above, n 20).

[47] V. Finch, *Corporate Insolvency Law, Perspectives and Principles* (Cambridge University Press, 2009), pp. 146-149.

[48] A. Keay, 'The Shifting of Directors' Duties in the Vicinity of Insolvency' (2015) 24 *International Insolvency Review* 140, 163-164.

[49] See A. Keay, 'Having Regard for Stakeholders in Practising Enlightened Shareholder Value' (2019) 19 *Oxford University Commonwealth Law Journal* 118.

AktG and §§ 32. (1), 43. (1) e 57 of the Germany StaRUG,[50], and Article 64.º, 1 CSC, in light of Article 186.º, 1 CIRE of the Portuguese Law.[51] Therefore, the shift of fiduciary duties theory does not seem to be fully adequate to justify the duty under analysis. At least, it seems that it would need to be, in some way, cut and reoriented to the specific context and objective of preventive restructuring frameworks. Instead of proposing a shift in directors' fiduciary duties, we defend an adaptation of their duties to the specific (and special) context of pre-insolvency, to promote a balanced approach, having due regard to all interests involved according to the circumstances.

Another alternative or competing reason to explain the *ratio* of the duty under analysis can be found in the theory of trust or special close relationships. Based on traditional foundation of *culpa in contrahendo*, it is known as a *tertium genus* of liability, located between contractual and tortious liability, and has developed in case law and German doctrine.[52] During the negotiations to conclude a contract, and because of the good-faith principle, a special relation arises without primary duties of performance, but rather, certain duties of information and clarification, loyalty, care and consideration for the interests of the counterparty (the so-called '*Schutzpflichten*').[53] These protective obligations (understood as accessory duties of conduct), could result from a legal or contractual stipulation intended to protect the interests of others or from the specific context of the negotiation of a contract, due to the exposure of their interests to the others sphere of influence, due to a relationship of special connection and trust between the parties, or due to mutual trust as a result of contacts maintained and developments and compromises made during the negotiations. Karl Larenz[54] and Klaus Hopt[55], following the Kurt Ballerstedt teachings,[56] say that this can also be valid to assert an autonomous responsibility of the directors and representatives of the companies towards third parties when, in the course of the negotiations, they used their professional and personal qualities as differentiating factors and worthy of trust or had a relevant economic interest in the conclusion of the contract to be entered into between the managed company and third parties. From this point of view, the decisive factor to uncover a direct (civil) liability of directors to third parties would be the specific and conclusive behaviour from which a legitimate expectation to third parties arises. As result, directors would be bound to compensate third parties if they breached those duties. However, we cannot forget that the restructuring plan normally aims to modify previously existing contractual conditions. Creditors are negotiating with a common debtor due to a contractual bond previously formed. In these cases, we are dealing with contractual or post-contractual relationships and not with pre-contractual relationships. This may limit the application of the third way of liability, but it does not exclude its main foundation which is the general principle of good faith and the secondary duties of information, loyalty, and cooperation.

Thirdly, taking into account the Hans Würdinger doctrine,[57] the so-called 'community of interests', and admitting that preventive restructuring frameworks can generate a need for protection of several parties exposed to a common danger, threatening their rights and interests (provoked by the imminent insolvency), there will be a community of interests among them (reflecting a sufficient commonality of interest) that would justify a coordinated and collective action in order to maximise a common goal in protecting the assets of the pre-insolvent company so as to maximise value and avoid loss of key assets. Horst Eidenmüller[58] invokes a common interest comparable to the common interest of shareholders,

[50] S. Korch, ‚Sanierungsverantwortung von Geschäftsleitern: Krisenpflichten im Lichte des Art. 19 der Restrukturierungsrichtlinie' (2019) 48 *Zeitschrift für Unternehmens- und Gesellschaftsrecht* 1051.

[51] C. Serra, 'Revitalização – a designação e o misterioso objeto designado: o processo homónimo (PER) e as suas ligações com a insolvência (situação e processo) e com o SIREVE' in C. Serra (ed.), *I Congresso de Direito da Insolvência* (Edições Almedina, 2013) 90.

[52] Up to the 2002 reform, this doctrine was reflected in § 242 BGB, similar to Article 227.º of the Portuguese Civil Code.

[53] D. Moura Vicente, *Comparative Law of Obligation* (Edward Elgar Publishing, 2021), p. 60.

[54] K. Larenz, 'Bemerkungen zur Haftung für ‚culpa in contrahendo' in W. Flume et al. (eds), *Beiträge zum Zivil- und Wirtschftsrecht: Festschrift für Kurt Ballerstedt zum 70. Geburstag am 24. Dezember 1975* (FS Ballerstedt, 1975) 397.

[55] K. Hopt, 'Nichtvertragliche Haftung außerhalb von Schadens- und Bereicherungsausgleich: Zur Theorie und Dogmatik des Berufsrechts und der Berufshaftung' (1983) *Archiv für die civilistische Praxis* no. 4/5 608, pp. 699-701.

[56] K. Ballerstedt, '*Zur Haftung für culpa in contrahendo bei. Geschäftsabschluss durch Stellvertreter*' (1950) *Archiv für die civilistische Praxis* no. 6 501.

[57] H. Wurdinger, *Theorie der schlichten Interessengemeinschaften* (Ferdinand Enke Verlag, 1934), pp. 12-78.

[58] H. Eidenmuller, *Unternehmenssanierung zwischen Markt und Gesetz: Mechanismen der*

from which reciprocal duties of cooperation and loyalty would arise. It tends to be a relationship like the shareholders relationship because all those involved have a common interest in ensuring that the restructuring plan is implemented in order do to maximise going-concern value.[59] From this perspective, we admit that the preventive restructuring frameworks aim at the composition of a common (economic) interest, comparable to the shareholders' interest. The companies' directors involved effectively in the negotiations are obliged to defend this common interest, actively promoting cooperation between parties. If the company is not yet insolvency and viable, directors have to hold negotiations with company creditors, enter preventive restructuring procedure, and make necessary, appropriate and reasonable proposals or counterproposals, in order to promote and facilitate the negotiation of a restructuring plan and not lose a chance at restructuring the company. In other words, directors are prohibited from adopting opportunistic strategies and unjustifiably breaking negotiations.

The theoretical-practical scope of these three approaches tends, however, to be limited if there is no third-party protection norm that clearly supports the attribution of responsibility of directors directly to third parties. Article 19 of Directive (EU) 2019/1023 seems to point to the need for Member States to implement in their legal systems a rule for the protection of third parties in the event of breach of the duties provided for therein. In the Portuguese legal system, a combined interpretation between Article 64.º, 1 of CSC[60] and article 186.º, 1 of CIRE[61] does not seem to exclude such a possibility. However, it would be convenient for the Portuguese legislator to say so clearly. Nuno Pinto Oliveira[62] and Catarina Serra[63] defended the need to expressly enshrine a general duty to prevent insolvency and other related duties, such as those found in Recital 70 of Directive (EU) 2019/1023. In Germany, Philipp Scholz[64] describes § 43 (1) of StaURG (which replaced § 45 (1) in the draft law of this diploma) as a protective rule within the meaning of § 823 (2) of BGB. Essentially, the breach of the duty to provide information regarding the occurrence of insolvency during the course of the negotiation process can occur, but other situations are possible in order to protect creditors from directors' misconduct.

In light of the above, it is time to question which of the three approaches presented, i.e. the shift of

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*Untemehmensreorganisation und Kooperationspflichten im Reorganisationsrecht (*Otto Schnnidt, 1999), pp. 608-619.

[59] Ibid.

[60] Supporting this understanding, see A. Menezes Leitão, 'Responsabilidade dos administradores para com a sociedade e os credores sociais' (2009) *Revista de Direito das Sociedades* 674; L. Menezes Leitão, *Pressupostos da exclusão* de sócio nas sociedades comerciais (AAFDL, 1988), pp. 37-39; M. Carneiro da Frada, 'A business judgement rule no quadro dos deveres gerais dos administradores' in A. Menezes Cordeiro and P. Câmara (eds.), *A Reforma dos Código das Sociedades Comerciais: Jornadas em Homenagem ao Professor Doutor Raúl Ventura* (Edições Almedina, 2007) 78; P. Caetano Nunes, *Dever de gestão dos administradores de sociedades anónimas* (Edições Almedina, 2012) 495; T. Meireles da Cunha, *Da Responsabilidade dos Gestores de Sociedades perante os Credores Sociais* (Edições Almedina, 2009), p. 66. Against this understanding, see A. Menezes Cordeiro, *Direito das Sociedades* (Edições Almedina, 2020), p. 1000; A. Fernandes de Oliveira, 'Responsabilidade civil dos administradores' in *Código das Sociedades Comerciais e Governo das Sociedades* (Edições Almedina, 2008), pp. 315-316; M. E. Ramos, *O Seguro de Responsabilidade Civil dos Administradores* (Edições Almedina, 2010), p. 118.

[61] See C. Serra, 'Covid-19 (II)/ Lei n.º 4-A/2020, de 6 de Abril, insolvência e reestruturação de empresas' (2020) *Observatório Almedina*; J. Coutinho de Abreu, 'Direito das Sociedades e Direito da Insolvência: interacções' in C. Serra (ed.), *IV Congresso de Direito da Insolvência* (Edições Almedina, 2017) 181, pp. 189-190; M. Carneiro da Frada, 'A responsabilidade civil dos administradores na insolvência' in A. Menezes Cordeiro and P. Câmara (eds.), *A Reforma dos Código das Sociedades Comerciais: Jornadas em Homenagem ao Professor Doutor Raúl Ventura* 935; N. Pinto Oliveira, *Responsabilidade civil dos administradores: entre o Direito Civil, Direito das Sociedades e Direito da Insolvência* (Coimbra Editora, 2015), pp. 211-215; R. Costa, 'Gestão das Sociedades em Contexto de "Crise da Empresa"' in P. Pais de Vasconcelos et al. (eds.), *V Congresso de Direito das Sociedades em Revista* (Edições Almedina, 2018) 193.

[62] N. Pinto Oliveira, 'Responsabilidade civil dos administradores pela violação do dever de apresentação à insolvência' (2018) *Revista de Direitor Comercial* 533, 622-624.

[63] C. Serra, 'O dever de prevenção da insolvência na perspectiva dos deveres fundamentais dos administradores (a crescente encruzilhada do Direito das Sociedades e do Direito da Insolvência)' in R. Costa et al. (eds), *Diálogos com Coutinho de Abreu, Estudos oferecidos no Aniversário do Professor* (Edições Almedina, 2020) 167, p. 185.

[64] P. Scholz, 'Die Krisenpflichten von Geschäftsleitern nach Inkrafttreten des StaRUG' (2021) 5 *Zeitschrift für Wirtschaftsrecht* 226. In the same vein, M. Brinkmann, 'Die Haftung der Geschäftsleiter in der Krise nach dem Gesetz zur Fortentwicklung des Sanierungs- und Insolvenzrechts (SanInsFoG)' (2020) 4 *Zeitschrift für Wirtschaftsrecht* 2361, 2364-2368.

fiduciary duties, the theory of trust, or the common interest is best suited to the duty to promote the negotiation of a restructuring plan. We recognize that all of them have their merits and, together, help to better understand the *raison d'être* and scope of that duty. Therefore, we would say that we should not definitively abandon any of those perspectives. Each of them advances a fundamental understanding of the same problem, which, in fact, may justify the reunion of different approaches to the civil liability of directors for the violation of the duty to promote negotiation, under Article 19 of Directive 2019/1023/EU and its Recitals 70 and 71. In fact, the reasons that underlie the shift of fiduciary duties, the theory of trust, and the common interest, are somehow implicit in that legal provision and in those recitals. Where there is a likelihood of insolvency, directors must have due regard to the interests of creditors, equity holders, and other stakeholders and must take steps to avoid insolvency and minimise losses. Negotiating with creditors and entering preventive restructuring procedures meet these requirements. In other words, in times of crises, directors have to promote the negotiation of a restructuring plan in good faith if the debtor company is potentially viable.

5. Conclusion

Pre-insolvency status represents a serious chance to avoid unnecessary liquidation and the closure of viable companies, to avoid considerable loss of jobs, to prevent significant non-performing loans, and to avoid the deterioration of the economy and of social welfare in general. Such an opportunity can only be properly safeguarded if those who manage the company adopt the necessary and adequate measures to protect those interests, which, in many situations, will entail promoting, procedurally and substantially, the negotiation of a restructuring plan. It is, on a procedural level, a matter of contributing to the protection and facilitation of negotiations. On a substantial level, it is about considering reasonable and fair proposals or counterproposals or, at least, about not opposing them without any valid reason. For this purpose, it is important to ensure that directors are clearly obliged to take decisions that promote the restructuring of pre-solvent companies, which must always occur when the plan is necessary, adequate, reasonable and fair. It is necessary if the debtor company is pre-insolvent and economic and financially viable; it is adequate if it ensures an additional value to all, when compared to other alternative options; it is reasonable and fair if it ensures that affected creditors are treated at least as favourably as any other of the same rank and more favourably than any junior class.

Considering the strong incentives inherent in preventive restructuring frameworks, as presented in Directive (EU) 2019/1023, the managers' discretion is, in a way, limited, since they can only block the negotiation of a restructuring plan if they have a more advantageous and suitable alternative. To come to that conclusion, directors must have due regard to all options. In other words, they cannot simply ignore or abandon any restructuring chance without first properly evaluating and weighing its advantages and disadvantages. If directors do not act accordingly, they are, and rightly should be, held liable for damages caused not only to the company, but also to third parties. This last premise finds its roots in Article 19 of Directive (EU) 2019/1023, which can be better understood in light of shift of fiduciary duties, of trust, and of common interest theories. Nevertheless, as far as legal certain goes, it is important to implement a general duty of preventing insolvency and more specifically, a duty to promote negotiation of restructuring plan.

Chapter 8

Implementation of the 2019/1023 Directive in French pre-insolvency and insolvency law: The debtor-creditor juggle

Sarah POPLE*

1. Introduction

When considering whether a jurisdiction's insolvency framework can be described as pro-creditor or pro-debtor on the international scene, there can be many points of reference: whether a debtor can rebound or bounce back quickly, whether a debtor has any form of legal protection under insolvency proceedings, as well as the public policy orientation of a State as to the aims of insolvency proceedings, notably prioritising either business turnaround or creditor satisfaction.[1]

In the case of French insolvency law, it appears that a negation of one of the criteria cited above suffices in determining its leaning. Indeed, since Badinter's law of 1985,[2] French legal doctrine has globally considered the system debtor friendly, despite the fact that several characteristics of a debtor friendly system were introduced relatively late into French insolvency law compared to neighbouring States.

A good example to illustrate this is the right to bounce back, introduced into French law in 1985,[3] a principle that is legally consecrated today, but, in reality, does not translate into practice. Although theoretically a director is not supposed to have any negative repercussions on their capacity to rebound and start anew after insolvency proceedings are closed and a discharge given, it is common knowledge that a French director, post insolvency proceedings, will be allowed very little access to banking services. This means that the director would be refused access to credit or loans of any sort, or if not refused, would be subjected to harsher contractual terms than a director having never been through insolvency proceedings. If a director of a company manages one failed business and several other successful ones, the opening of insolvency proceeding against the distressed one can sometimes suffice to impact the other business' access to credit. France may be geographically one of the nearest European countries to the United States, yet it seems to be far removed from the American logic that directors are believed to have learned from the experience of insolvency and been battered by it.

Despite French insolvency law lacking certain of the classic pro-debtor criteria, it also cannot be described as pro-creditor. First, French insolvency proceedings are strongly entrenched in public policy, especially in the legal and social culture around employee rights and security. Therefore, business rescue (and job preservation) is preferred over creditor satisfaction. On an international comparative basis, it could be argued that French creditors are treated harshly. For example, French law provides an automatic stay for up to 18 months[4] without the debtor having to demonstrate its ability to propose a plan; a plan can propose to progressively pay all the debts over a ten-year period;[5] the first term of said plan is most commonly payable a year after the end of the 18-month automatic stay[6] and often

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[1] These examples do not constitute an exhaustive list.
[2] Law n.84-148 of 1 March 1984 and Law n.85-98 of 25 January 1985.
[3] Inspired from the American discharge, the Law of 25 January 1985 adopted a measure to paralyse litigation or measures aiming at forced claim recovery if a liquidation process was ended with deficient funds.
[4] Commercial Code, Article L. 622-13.
[5] Commercial Code, Article L.626-12.
[6] Before the reform of 15 September 2021, this was only possible in safeguard proceedings, as per Commercial Code, Article L. 621-3. This is now only possible in rehabilitation proceedings, as per Commercial Code, Article L. 631-7.

representing less than 5% of a creditors' claim.[7] Furthermore, in a payment plan configuration (*plan de sauvegarde* or *plan de redressement*, as opposed to a liquidation configuration such as selling the business as a going concern or a direct liquidation), a secured creditor is not immune to the collective treatment of creditors. Indeed, they are treated the same as any unsecured creditor, sometimes even more harshly, as the debtor disposes of a legal capacity to pay 'strategic creditors' (under certain conditions and the sanctioning of the assigned insolvency judge),[8] who are often suppliers of the business. Even when business turnaround is ultimately deemed impossible, secured creditors are still subject to this collective treatment and therefore, their right to recover claims, pursue litigation, and automatically terminate contractual agreements remain limited.[9]

Therefore, it seems fair to say that creditors suffer insolvency proceedings (or pre-insolvency proceedings of a judicial and collective nature such as the safeguard procedure (*sauvegarde)*),[10] instead of playing an active part in their debtors' turnaround. It is perhaps not surprising that certain pro-debtor measures introduced into French insolvency law, such as the right to rebound or bounce back, were ultimately destined to fail. Ultimately, creditors are reduced to just that: a creditor, without consideration as a partner (financial or economic) of the distressed business.

Thankfully, preventive and pre-insolvency procedures mitigate this picture. Based on consensual negotiations and trust, French preventive procedures, such as the ad hoc mandate (*mandat ad hoc*)[11] and conciliation (*conciliation*),[12] have proved their efficiency, boasting a national success rate of 70%-80%.[13] As for the judicial collective proceedings, i.e. safeguard and rehabilitation (*redressement judiciaire*),[14] the success rate diminishes according to the degree of distress that motivates the opening of either procedure (about 60 % for safeguard proceedings,[15] considered a preventive procedure, and only 27% for rehabilitation proceedings).[16] Indeed, to open safeguard proceedings, the debtor must not be cash insolvent (the expression *'cessation des paiements'* is used in French law, which roughly translates as 'suspension of payments' and means the inability to cover current liabilities that have fallen due with available liquid assets).[17] For rehabilitation proceedings to be opened, the debtor must

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[7] Commercial Code, Article L.626-18.
[8] Commercial Code, Article L.622-7.
[9] For information on the general rules of liquidation proceedings, see Commercial Code, Articles L.640-1 et seq.
[10] For information on the general rules of the safeguard procedure, see Commercial Code, Articles L.620-1 et seq.
[11] Commercial Code, Article L. 611-3.
[12] Commercial Code, Article L. 611-4.
[13] Centre d'Information sur la Prévention des Difficultés d'Entreprise. See https://www.cip-national.fr/prevention-des-difficultes-des-entreprises/outils-et-solutions-difficultes-entreprise/faq/#:~:text=2%2FQuel%20est%2C%20d%27,int%C3%A9r%C3%AAt%20d%27anticiper%20les%20difficult%C3%A9s (accessed: 12 August 2022). According to Mr. President J.-B. Drummen 'we know that the success rate of these measures (ad hoc mandates, conciliations and safeguards) is of around 70%'; for the President of the Lyon Commercial Court, Mr. Y. Chavent 'these amicable procedures (ad hoc mandate and conciliation) are the most effective (compared to collective procedures) since 75% of the companies that benefit from them continue their activity', Colloque de Lyon, 25 June 2012, Le droit des entreprises en difficulté à l'épreuve de la crise économique, Bull. Joly Entreprises en difficulté, Sept.-Oct. 2012, p. 306, spec p. 308; adde : F. Pérochon, A propos des chiffres de la sauvegarde, Droit et Patrimoine, n°223, March 2013, p.46, spec. p.52.

> *(Monsieur le Président J.-B. Drummen 'l'on sait que le taux de succès de ces mesures (mandats ad hoc, conciliations et sauvegardes) est de l'ordre de 70 %' ; pour le président du tribunal de commerce de Lyon, Monsieur Y. Chavent 'ces procédures amiables (mandat ad hoc et conciliation) sont les plus efficaces (par rapport aux procédures collectives) puisque 75 % des entreprises qui en bénéficient poursuivent leur activité', Colloque de Lyon, 25 juin 2012, Le droit des entreprises en difficulté à l'épreuve de la crise économique, Bull. Joly Entreprises en difficulté, sept.-oct. 2012, p. 306, spéc. p. 308 ; adde : F. Pérochon, A propos des chiffres de la sauvegarde, Droit et Patrimoine, n°223, mars 2013, p.46, spéc. p.52.)*

[14] For information on the general rules of the rehabilitation procedure, see Commercial Code, Articles L. 631-1 et seq.
[15] A. Epaulard and C. Zapha 'Entreprises en difficulté: quelle efficacité des procédures préventives? (February 2020), France Stratégie – La note d'analyse n.84. Available at: https://www.strategie.gouv.fr/sites/strategie.gouv.fr/files/atoms/files/fs-2020-na84-procedures-preventives-fevrier.pdf (accessed: 12 August 2022).
[16] Ibid.
[17] Commercial Code, Article L.631-4.

be cash flow insolvent.

It can therefore be reasonably deduced from these statistics that two main things govern the likelihood of successful business turnaround: early detection and treatment of business distress ('prevention is better than cure')[18] and preserving healthy business relationships with the partners and creditors (that a distressed business will call on to accompany them in their turnaround).

Therefore, the EU Directive 2019/1023[19] hit the mark on several points lacking in French restructuring frameworks, especially in relation to the role played by creditors in these procedures, but also about how their role can differ according to their security and, more importantly, whether creditors are 'in the money' or not. Creditors are also further incentivised to contribute to debtor turnaround, at any stage of that turnaround, including post insolvency plan.

The Directive also aims at reducing the impact of insolvency proceedings on creditor rights, especially where creditors were disadvantaged by long procedural delays or debt heavy plans. It is worth mentioning that the Ordinance of 15 September 2021 which implemented the Directive[20] was accompanied by a second text on the same day which reformed security law[21] in France, notably the legal interactions between insolvency proceedings and their effect on creditor security.

The implementation of the Directive, as well as the influence of the aforementioned reform of security law, highlighted the need to find a balance between debtor and creditor rights within restructuring frameworks that is the most efficient for all confluent interests, whilst providing legal certainty for all parties, but especially those susceptible to finance a business, before or during business distress.

The newly introduced reforms seem to have given creditors more ground in judicial, collective proceedings, be they pre-insolvency or insolvency-based proceedings (Section 3), while only tweaking the existing preventive framework in France (Section 2), as the latter had, per the statistics mentioned above, already demonstrated its efficiency.

2. The tweaking of French preventive frameworks by the European Directive: Still (mostly) the debtor's playground

To truly understand the changes brough about by the Directive (2.2), it is important to expose certain main principles of French preventive, out of court frameworks, that explain why the debtor may be having some advantage (2.1).

2.1. Recalling the main principles of French preventive out-of-court frameworks

First, in French law, a preventive pre-insolvency procedure can only be opened at the initiative of the debtor's directors.[22] A creditor, or any other party, cannot force the hand of a debtor company to open a pre-insolvency procedure. It should also be noted that the debtor chooses the judicial administrator that will orchestrate the procedure. The administrator will be either an ad hoc administrator (*mandataire ad hoc*) or a conciliator (*conciliateur*) depending on the procedure opened. During the entire course of pre-insolvency proceedings, the debtor can decide, for almost any reason, to change the judicial

[18] The phrase 'prevention is better than cure' is attributed to the Dutch philosopher Desiderius Erasmus (circa. 1500), but its origins remain debated.
[19] Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132.
[20] Ordinnance n.2021-1193 of 15 September 2021.
[21] Ordinnance n.2021-1192 of 15 September 2021.
[22] Commercial Code, Article L. 620-1.

administrator[23] or to end the procedure (even though in practice these legal possibilities are rarely used or necessary). Therefore, it is clear that the debtor remains captain of their ship during a pre-insolvency procedure.

Second, the legal conditions to open an ad hoc mandate or a conciliation are similar. The debtor must not be in a state of cash flow insolvency at the time of filing (or can be so but for no more than 45 days for the conciliation procedure).[24] A parallel is often made by commentators and insolvency professionals between business distress and the illness of a natural person: in general, the sooner you detect the illness, the more chance you have of finding a cure and getting better.

Third, pre-insolvency procedures function on a consensual basis. The director has brought their company to the negotiating table, to which the creditors are invited. They are theoretically free to refuse to negotiate in the first place, or free to listen to the debtor and refuse propositions made to them. Quite obviously, certain realities might force the hand of creditors, notably the impact that the collapse of their debtor would have on them if their financial distress was not deal with, resulting in possible impecunious liquidation proceedings. The restructuring toolbox also offers tools which can be used to incentivise creditors to enter negotiations. The threat of using judicial collective insolvency proceedings to treat business distress instead of pre-insolvency preventive procedures can often persuade a creditor to find an agreement with the debtor, as will be discussed in sub-section 2.

Lastly, and perhaps most importantly, trust and confidentiality often dictate whether a pre-insolvency workout can be reached. Trust is important between the debtor and its creditors (or partners). The creditors need to believe in the capacity for a debtor company to turn around a business loyally and realistically. The debtor needs to believe that the creditors are going to honour their obligations and concessions in good faith and continue supporting the distressed business during turnaround. It is perhaps opportune to suggest here that the earlier a director decides to initiate pre-insolvency proceedings, the easier it is to establish or nurture a trustful relationship between a distressed business and its partners.

Confidentiality is a legal requirement[25] which serves all parties, during the procedure and during the execution of an agreement. Indeed, confidentiality supports the debtor from a business point of view: the information of business distress can be worrisome to clients and partners not called upon in the preventive procedure, something competing businesses may use in order to gain a competitive advantage over a distressed business. According to the contents of a workout, it is also important to note that its confidentiality can avoid the debtor company being awarded a lower credit rating. Absence of confidentiality could throw a debtor's business plan into disarray, by the harsh reduction of credit-insurance and the subsequential increase of the distressed business's need for working capital, impacting the debtor's possibility to respect obligations and execute the workout agreement. In this regard, creditors benefit from confidentiality as well. Creditors also benefit from confidentiality in respect of setting precedent with their other clients, notably financial institutions. Indeed, what may be consented in one pre-insolvency procedure must not be seen as automatically accessible in another.

These main principles, amongst others, guarantee the efficiency of French pre-insolvency preventive frameworks. Therefore, it is not surprising that the EU Directive has only very lightly impacted them. The consensual nature of negotiations has nonetheless been strengthened, providing more efficient tools to force a creditors hand.

2.2. The changes brought about by the implementation of the EU Directive

The two main changes brought about by recent reforms in French pre-insolvency law are the introduction of 'classes of affected parties', as per the EU Directive 2019, as well as the merging of

[23] Commercial Code, Article L. 611-6.
[24] Commercial Code, Article L.611-4.
[25] Commercial Code, Article L. 611-15

financial accelerated safeguard proceedings and accelerated safeguard proceedings.

First, before the reform of September 2021, French law provided for two different 'hybrid' procedures, which served as a dissuasive tool for debtors to use against recalcitrant creditors. Indeed, if a debtor managed to obtain a consensus of more than two thirds of its creditors (in number) on a restructuring plan but could not get the last recalcitrant creditors to yield, they had the possibility to file for accelerated safeguard proceedings (*sauvegarde accélérée*[26] or for financial accelerated safeguard proceedings (*sauvegarde financière accélérée*).[27] Both legal instruments, introduced respectively in 2014[28] and 2010,[29] while efficient, were sparsely used in practice. One reason was that certain criteria (notably concerning turnover, totals of balance sheet and number of employees)[30] restricted their use. Another reason was that these tools played an important role in persuading creditors to find an agreement in preventive out of court frameworks (in order to avoid a public proceeding that would have for effect to impose a largely consensual workout already on the table), meaning that the threat of using one of the hybrid procedures would normally be sufficient to avoid it, and find a consensual workout.

When implementing the EU Directive and with a view to simplifying the already varied and well-stocked restructuring toolbox, the French legislator saw fit to merge these procedures into one, i.e. the accelerated safeguard procedure. .As a solution to the sparse use of its predecessors, the previous criteria (turnover, balance sheet or employee numbers)[31] have now been discarded and it is now possible for *any* debtor to benefit from the accelerated safeguard procedure. Therefore, its use could be now more widespread and democratic, giving smaller debtor companies the possibility to benefit from it. Debtors engaged in conciliation proceedings that cannot get a unanimous agreement on a plan can now open accelerated safeguard proceedings, no matter the size of the company.[32] Therefore, the conciliation procedure has, in some way, become the antechamber of the accelerated safeguard procedure.

Second, the crux of the reforms was the introduction of classes of affected parties (CPA used for short in France).[33] In reality, this notion is not a creation in French restructuring framework, but rather, an adaptation. Indeed, French law provided for 'creditor committees' before the reform. However, the criterium that sorted the creditors into committees were based on somewhat superficial notions: it sufficed to belong to a category by name, for example as a secured creditor, without consideration of whether that creditor was in the money or if the security was enforceable or of any value. The introduction of CPA and how they are constituted is provided for in the French Commercial Code in article L. 626-30, but essentially leaves a lot of leeway to the judicial administrator. The French legislator adopted a rough translation of the Directive, in that the judicial administrator must, by objectively verifiable criteria, sort the creditors into classes that represent a sufficient community of economic interests. At the very least, there must be a class representing secured creditors and another representing unsecured creditors. If there are shareholders or equity holders affected by the restructuring plan, they must also constitute one or several classes.

The main change in French law however is the fact that the judicial administrator must take into account subordination agreements that pre-existed the preventive procedure. This is of particular important seeing as although not being a concept textually consecrated specifically, one seminal principle in French restructuring is the 'equal' treatment of creditors.

This principle features heavily in the French regime. Objective equality prevails in collective judicial

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[26] Commercial Code, Article L. 628-1, repealed since the implementation of EU Directive 2019/1023 into French law.

[27] Commercial Code, Article L. 628-9, repealed since the implementation of EU Directive 2019/1023.

[28] Ordinnance n.2014-326 of 12 March 2014.

[29] Law n.2010-1249 of 22 October 2010.

[30] Before 2014, the criteria were: (i) at least 150 employees or; (ii) an annual turnover exceeding 20 million euros before tax. After the creation of the accelerated safeguard in 2014, the criteria were relaxed for: (i) any company that certified their accounts by an accountant; (ii), had more than 20 employees; (iii) an annual turnover of 3 million euros and; (iv) a total balance sheet of 1,5 million euros.

[31] The criteria are: (i) 250 employees; (ii) 20 million euros of annual turnover; (iii) or 40 million euros of annual turnover if the employee criterion is not met.

[32] For information on other legal conditions, see Commercial Code, Articles L. 628-1 et seq.

[33] Commercial Code, Article L. 626-30.

proceedings which rely on a system of individual consultation of creditors on a plan. Whatever the answer given by the creditor, the court is able to force a moratorium of up to ten years on creditors, no matter their rank or the nature of the claim. Creditors can be treated differently if they accept to be. In general, they can only be treated differently in a less favourable manner if they agree, and not in a more favourable manner. Subjective equality can be seen in other configurations. There is a general consensus in preventive procedures that, whilst parties are free to agree to any terms they wish, any efforts made by creditors should be shared amongst them, based on a number of factors in a case. These are often their nature, risk and amount (it is useful to note here that logic often dictated observance of subordination agreements in preventive out of court negotiated workouts). However, CPA must be constituted in consideration of subordination. It could be argued that the collective secular treatment of creditors has been upturned by this reform. This statement, i.e. the fact that the judicial administrator must take into account subordination agreements that pre-existed the preventive procedure, could be further supported with the introduction of the technique of cross class cram down into the safeguard accelerated procedure, which, until the reform, did not exist. However, this position can be nuanced, by arguing that the financial safeguard procedure already had modified the principle of equal collective treatment, by providing for a procedure that included only creditors of a financial nature in the procedure.

The aim behind this (semi) upturn is twofold. First, it blends the economic and financial implication of certain creditors with their role and say in the debtor's business. This consideration does not seem illogical at all; on the contrary, why should a secured creditor that is out of the money have the same say as a secured creditor that is in the money ? Second, the reforms are rooted in public policy with a view to redeeming France's reputation on an international scale with financial creditors and investors, by offering more legal security and trying to make French pre-insolvency and insolvency procedures more attractive.

In the accelerated safeguard procedure, the debtor has the monopoly of presenting a plan.[34] However, if the plan is not approved by the creditors, and the Court does cram-down creditors,[35] a risk exists that the proceedings be converted into rehabilitation proceedings. In this case, the classes that have been set up remain for the subsequent procedure.[36] In this hypothesis, a class that is considered in the money can propose a concurrent plan. This not only gives a more active role to creditors, but also merits reflexion on the part of the debtor as to the use or not of the accelerated safeguard procedure. Circling back to the principles presented in the previous sub-section, especially the guarantee for a director to remain in control of the procedure, a director could technically lose the monopoly of decision on a restructuring plan. In the case where a director is also present in the share capital of the company or an equity holder, it is not impossible to imagine a hypothetical situation where a particularly strong secured creditor that is in the money could present a concurrent plan that provides for reducing the nominal capital of the debtor company, to squeeze out the current shareholders, providing for a subsequent increase in capital for new investors or by conversion of their claim into equity, in order to take control of a company.

While the risk mentioned above is, in reality, relatively minimal or is apprehended before the opening of the procedure and CPA constitution, there remains a way for the debtor to incentivise creditors to accept the plan. Before the Ordinance of September 2021, if a creditor sent a demand letter[37] to a debtor company during a conciliation procedure, the conciliator and the debtor could ask the President of the Commercial Court to apply grace delays to the claim, for up to 24 months.[38] This regime aimed at imposing a stay or payment delays on a singular recalcitrant creditor amongst many other consenting creditors to the plan. However, the limit to this tool was that the demand letter had to be addressed by the creditor to the debtor. If the recalcitrant creditor stayed silent, that creditor could wait until the end of the conciliation proceedings to try and forcefully recover their claim. If creditors did not apply for

[34] Commercial Code, Article L.626-30-2.
[35] Commercial Code, Article L. 626-32.
[36] Commercial Code, Article L. 622-10.
[37] A formal notice demanding that the recipient perform a legal obligation to avoid being taken to court, e.g. pay a sum of money or perform an obligation under a contract.
[38] Commercial Code, Article L. 611-10-1.

such grace periods, their claims could only be recovered once the conciliation proceedings had ended. Occasionally, the silence of one creditor could dissuade other creditors to find an agreement on the principle of legal security and equal efforts by all creditors. The law has now been amended.[39] If the conciliator writes to a creditor to request a voluntary stay or payment delays, and the creditor either refuses or simply does not respond, passed a certain delay, the conciliator can file a petition to the President of the Commercial Court requesting that the creditor comply. Therefore, it is no longer necessary to await a demand letter by the creditor. Additionally, if the creditor does not agree to the plan, the same mechanism can be used to obtain grace delays for up to 24 months.

The reform of September 2021 has only slightly tweaked the balance between debtor and creditor rights, by both strengthening the consensual nature of French preventive restructuring procedures and giving the Conciliator more efficient tools to force a recalcitrant creditors hand. The accelerated safeguard procedure has integrated some of the legal techniques missing in French law to give a voice to creditors that are in the money. This change will benefit both creditors and debtors when adopting a plan. However, the possibility for a 'strong' creditor to present a concurrent plan should not be taken lightly, and perhaps diminishes, in some specific cases, the dissuasive nature of the hybrid procedure for creditors.

If the debrief is quite balanced in terms of give and take for debtor and creditor rights in the reform prompted by the EU directive in preventive framework, the same cannot be said in collective judicial proceedings, where the majority of measures introduced try to help creditor rights gain ground.

3. How the aim of harmonisation of the EU Directive has inevitably helped creditors gain ground in French collective judicial proceedings

Creditors rights gained ground in collective judicial proceedings in two ways as a result of the implementation of the EU Directive. First, a boost was given to creditor security (3.1), and second, certain procedural aspects have been modified in favour of creditors (3.2).

3.1. Creditor security

Creditor security has been reinforced by the implementation of the EU Directive in many ways, but three points will be mentioned to illustrate the positive impact of the reform on creditor security.

First, one of the most welcomed changes in this area has been the reversal of a controversial decision of the French Commercial High Court from 2019.[40] The decision was evaluating the effects of the resolution of a pre-insolvency workout for non-respect by one or several parties to the agreement. The French commercial Code[41] indicated that if the agreement were not correctly executed, it would become null and void. However, these agreements often serve as the contractual base for the creation of new creditor security that can be granted in exchange for new money to finance a debtor's turnaround. In the 2019 decision, the High Court decided that the entire agreement was null, including the dispositions and articles that aimed to organise the effects of the resolution of the agreement, notably the clauses relating to new creditor security. This meant that the creditors in preventive procedures who had taken the risk to finance a distressed business (and were guaranteed with new security and a legal privilege of new money) would actually find themselves ranking as unsecured creditors on the sums brought forward in case of subsequent insolvency proceedings.

Evidently, this situation was more than regrettable, as there would be no incentive for creditors to help

[39] Commercial Code, Article L. 611-10-1.
[40] Cass. Com. 25 September 2019, *Société Générale x H. and A.*, case number 18-15.655.
[41] Commercial Code, Article L. 611-10-4 (pre-reform).

finance the turnaround of a debtor's business. Furthermore, the decision seemed to go against the logic behind the creation of the new money privilege, which would only be useful to the creditor if the debtor defaulted or opened subsequent insolvency proceedings. Therefore, the reform amended the 2019 decision, providing that if an agreement is to become null or void, for whatever reason, the clauses relating to eventual subsequent judicial collective proceedings remain valid, including the clauses (and legal existence) on creditor security.[42]

Second, when judicial collective proceedings are opened, creditors have, as a general rule, two months to file a claim with the insolvency practitioner (*mandataire judiciaire*).[43] This declaration must be made by the debtor within eight days[44] and if the creditor does not confirm the claim, the debtor is reputed having filed the claim for the creditor. It is now provided that the debtor, as well as providing the basic details as to the identity of the creditor and their claim, must specifically mention whether the creditor is secured, and indicate the nature and the scope of the security.

Lastly, in order to incite creditors, or new partners, to contribute to business turnaround at all stages of the business's distress, a new version of the privilege of post money has been introduced (it is referred in this paper as the privilege of 'post-post money', but can also be referred to as the post plan privilege). As a reminder, a new money or conciliation privilege is given to creditors that put forward new money in conciliation proceedings. In case of subsequential judicial collective proceedings, the repayment of sums benefitting from the privilege cannot be forced into the payment plan, the original contractual terms remaining despite the opening of proceedings. The 'PACTE' law[45] consecrated a post money privilege, meaning that a creditor that financed a distressed business in the observation period of judicial collective proceedings the period between the moment the procedure is opened by the court and a plan is adopted) would also benefit from a legal privilege, and therefore a preferential payment rank in case of liquidation. In liquidation proceedings, the new money privilege ranks before the post money privilege,[46] with a view to rewarding creditors for their early intervention in financing a distressed business.

A common difficulty for debtors that had successfully started to repay their payment plan and needed new financing during the ten-year plan period, for example, for cyclic investments and to remain competitive, was to find a financial partner to back them, solely because they were currently executing a payment plan sanctioned in judicial collective proceedings. Not only would a debtor company therefore have the plan to repay, they would also have to face becoming obsolete in the face of their competitors, not being able to invest excess cash flow into the company due to having to deal with the payment plan. The 'post-post money' privilege, or post plan privilege, aims to answer this difficulty, by granting a privilege to a financial partner that finances a debtor currently executing a payment plan. In a liquidation estate, the 'post-post money' privilege ranks behind the new money privilege and at the same rank as the post money privilege.[47]

3.2. *Procedural measures in favour of creditors*

Certain procedural aspects of collective judicial proceedings have been modified, these modifications being favourable to creditors.

First, it is important to recall the creation of CPA (see Section 1, Sub-section 2), that implies a more active role of creditors in insolvency proceedings. As well as being applicable in the accelerated safeguard procedure, this system is obligatory in the 'classic' safeguard procedure and rehabilitation proceedings, if certain levels of turnover and employee numbers are exceeded.[48] Unlike the old

[42] Commercial Code, Article L. 611-10-4.
[43] Commercial Code, Article L. 622-6.
[44] Law n.2019-486 of 22 May 2019.
[45] PACTE Law 2019 (Loi n° 2019-486 du 22 mai 2019 relative à la croissance et la transformation des entreprises (1))
[46] Commercial Code, Article L. 611-11 making reference to Commercial Code, Articles L. 622-17 and L. 641-13.
[47] Commercial Code, Article L. 643-8.
[48] The criteria are: (i) 250 employees; (ii) 20 million euros of annual turnover or: (iii) 40 million euros of annual turnover

accelerated safeguard procedure or the financial accelerated safeguard procedure, if a debtor does not meet the aforementioned thresholds, they can now choose to opt for proceedings including CPA.[49] This stands in stark contrast to the 'classic' approach of individual creditor consultation, which remains the principal modality of imposing a plan on creditors. As mentioned above, this system allows the insolvency court to impose payment plan delays on all creditors. Since the introduction of the reforms in September 2021, commentators have debated the procedural consequences of failure to agree a plan if the debtor opts for CPA. It is generally agreed that the individual consultation system would come into play as a subsidiary way to sanction a plan (this solution however is not as evident in the new accelerated safeguard procedure). Therefore, this measure can be viewed as inviting creditors to take an active part in the drafting of the plan and in agreeing to it in good faith, but ultimately the principle of business rescue at all costs resurfaces if the debtor and creditors cannot agree.

On top of CPA, there have been two other main procedural changes, that are linked to the celerity of the collective judicial proceeding.

The first concerns the length of the 'observation period' in the safeguard procedure, that has been limited to 12 months, instead of the previous 18 months.[50] This has now created a distinction with the rehabilitation procedure, which seems to be rooted in the fact that to open safeguard proceedings, a debtor must not be in a suspension of payment situation (see Introduction).[51] It is therefore a choice for the debtor to open safeguard proceedings, as opposed to a legal obligation. Rehabilitation proceedings, on the other hand *must* be opened within 45 days of a suspension of payment situation. The legislator here seems to follow the logic that voluntarily placing a debtor under the Courts' protection does not imply the same need for protection as a debtor who is already in a suspension of payment state.

While this reasoning can seem logical, it does prompt the question as to whether the safeguard procedure is still worth using. When the procedure was created in 2005,[52] in order to encourage directors to anticipate the treatment of business distress, several benefits were granted to them and their company during safeguard proceedings that did not exist in the rehabilitation procedure, even though most of the substantial rules were in fact the same in both procedures. For example, a natural person (notably a director) who had guaranteed some of the debtor company's obligations personally could benefit from a moratorium and plan delays and would not see their guarantee activated during a plan at the issue of a safeguard. While this was true for the observation period in rehabilitation procedure, once the plan was sanctioned, the director could be called to answer the guarantee they had given and would be subrogated in the rights of the creditor that had been satisfied by the guarantor. Another example was that director gratification was automatically granted in the safeguard procedure while in rehabilitation proceedings, the insolvency judge had to sanction the director's gratification.

These differences have now been removed, with a view to simplifying insolvency proceedings and removing stigma and stress for directors of debtor companies in rehabilitation proceedings. The only differences now that remain are that the State wage insurance company (*l'Association pour la gestion du régime de Garantie des créances des Salariés*)[53] does not intervene in safeguard proceedings (as a general rule), but does in rehabilitation proceedings, giving the latter a cash flow advantage when the procedure opens.[54] Perhaps the safeguard procedure has indeed lost its interest with the successive reforms that have come into play since its creation in 2005.

The second procedural change aims at fighting debt heavy, unrealistic, and overly progressive payment plans, that have little to no chance, of being honoured until the end of the payment plan period. Before the reforms, the only rule concerning the percentage that each annual payment had to represent was that, from year three, the debtor had to pay at least 5% of the total debt in the plan. Technically, in doing

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if the employee criterion is not met.

[49] Commercial Code, Article L. 626-29.

[50] Commercial Code, Article L.621-3.

[51] Commercial Code, Article L.620-1.

[52] Law n.2005-845 of 26 July 2005.

[53] For more information, see: https://www.ags-garantie-salaires.org/accueil.html (accessed: 12 August 2022).

[54] Labour Code, Articles L3253-6 to L3253-21.

the strict legal minimum, a debtor could leave the tenth and last annuity of the plan at 63% of the total debt, paying 1% for the first two years and five percent through years three to nine. Now, from the fifth year, the annuity must represent at least 10% of the total debt in the plan.

4. Conclusion

The implementation of the EU Directive has helped the French legislator to establish a greater balance between debtor and creditor rights. Despite the reform, French pre-insolvency and judicial collective frameworks remain essentially pro-debtor, with creditors still getting a worst deal in France than compared to other neighbouring States. The strong culture around employee rights and job security remains very present in public policy.

Preventive frameworks have not been altered much, and the additional protection gained by creditors seems justified, while also counter-balanced by new measures of efficiency for debtors against recalcitrant creditors or creditors acting in bad faith. The equilibrium of these procedures is based on trust and consensual negotiations, meaning that debtor and creditor rights tend to balance themselves out by pragmatic discussions in search of a rapid and confidential solution for the debtor company.

It could be argued that the real advantage of this reform is that by reinforcing creditor rights in judicial collective procedures, the legislator is pushing the debtor to anticipate difficulties and business distress, being the only means by which the debtor can keep the upper hand on the debtor's future. If this is one of the aims, and indeed if time shows this to be one of the results of the reform, French insolvency statistics will be positively impacted, as the efficiency of preventive framework compared to judicial collective framework has already been amply proven.

Chapter 9

Recognition of Schemes and Restructuring Plans in Switzerland and under the Lugano/Brussels instruments

Rodrigo RODRIGUEZ*

1. Introduction

The purpose of this paper is to analyse the nature of both the United Kingdom (UK) Scheme of Arrangement ('Scheme') and the (new) UK Restructuring Plan ('Restructuring Plan') under Part 26A of the Companies Act 2006 in light of continental European instruments for recognition of judgments. The objective is to assess the chances of recognition of restructurings using such tools in continental Europe, especially in Switzerland and – particularly for UK lawyers – to help draw conclusions as to the tools to use in a restructuring case with a cross-border element.

2. The sources of recognition in continental Europe: The example of Switzerland

2.1. The 2007 Lugano Convention

2.1.1. General scope

The Lugano Convention has been fully applicable in Switzerland since 2011, while in the UK, it continued to apply for some time under the Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community[1] ('Withdrawal Agreement'). Article 129.1 of the Withdrawal Agreement provided for a continued application of the Lugano Convention until the end of the transition period, i.e. 31. December 2020.[2] Since then, the UK has formally requested to re-accede to the Lugano Convention as an independent party and the European Free Trade Association States have agreed.[3] However, the EU has refused to give its (necessary) consent to that accession. The re-accession of the UK will likely be part of broader political discussions over the next few years. In any event, the UK has ceased to be subject to the Lugano Convention as of 1st January 2021.

The Lugano Convention is conceived as a parallel instrument to the Brussels Convention of 1968

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1 2019/C 384 I/01, O.J. C 3841.

2 By its Article 129, the UK remains subject to the international agreements concluded by the EU (including the Lugano Convention) until the end of the transition period, as 'Union law' (Article 2(a)(iv)) is defined in Article 2(a)(iv) of the Withdrawal Agreement as including 'the international agreements to which the Union is party and the international agreements concluded by the Member States acting on behalf of the Union.'

3 Upon leaving the EU on 31 January 2020, the UK has stated its interest in re-joining the 2007 Lugano Convention as a separate contracting party in the course of the transition period. See https://www.gov.uk/government/news/support-for-the-uks-intent-to-accede-to-the-lugano-convention-2007 (accessed: 12 August 2022).

originally,[4] and later to the Brussels I Regulation of 2000.[5] The last recast of the latter (Brussels Ia Regulation[6], 'Brussels Regulation') introduced a new numbering and some minor changes in the text, but a subsequent 'update' of the Lugano Convention has however not taken place. Therefore, the vast majority of the key provisions are still identical in both instruments. Reference is made, in particular, to the effects of Protocol 2 on the uniform interpretation of the (Lugano) Convention and on the Standing Committee. In practice, the obligation to pay "due account" under said protocol is applied by the Swiss Federal Court as a de facto obligation to follow the ECJ jurisprudence where no important reasons advise otherwise.

2.1.2. Recognition situation after 31 December 2020

The Swiss Federal Court has recently confirmed that the Lugano Convention remains applicable in Switzerland to the recognition of decisions issued before the end of the transition period.[7]

In the (yet undecided) situation where a decision is made in the UK after 31 December 2020 – but initiated before that date, a statement of the Swiss Federal Office of Justice argues that "[t]he same [i.e. the recognition under the Lugano Convention] must also apply to judgments pronounced after the date of withdrawal if the underlying proceedings began before the date of withdrawal".[8] This is supported by the wording of Article 63(1) Lugano Convention, which states that it is applicable to proceedings 'instituted' at the relevant time.

2.1.3. Application of the 1998 Lugano Convention?

'Lugexit' raises the question of the 're-emerging' of agreements concluded directly between Switzerland and the UK. This includes the Lugano Convention of 16 September 1988 on jurisdiction and the enforcement of judgments in civil and commercial matters (the predecessor of the Lugano Convention – together: Lugano Conventions).

The 1988 Lugano Convention was 'superseded' by superseded by the 2007 Lugano Convention as no further acts of rescission were agreed between the parties, by virtue of Article 65 of the Lugano Convention.. As the latter would cease to be applicable, that could automatically lead to the 1998 Lugano Convention being applicable again. In this case, the application of the 1988 Lugano Convention would lead to the same result as the application of the Lugano Convention, which would favour recognition of Schemes beyond 31 December 2020, but would most likely not be relevant for Restructuring Plans (see below at 2.2.1).

The 1988 Lugano Convention is not cited in Annex VII of the 2007 Lugano Convention, which lists the agreements superseded pursuant to Article of the Convention. In Switzerland, which follows a monist approach to treaties, courts should again apply the 1988 Lugano Convention. However, since the UK follows a dualist approach, one must also consider its national law. Article 3A of the Civil Jurisdiction and Judgments Act 1982, giving force to the 1988 Lugano Convention, has been repealed. The courts of the UK might therefore refuse to apply the provisions of the treaty, despite the UK still

[4] Convention on jurisdiction and the enforcement of judgments in civil and commercial matters of 27 September 1968, O.J. L 299.
[5] Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, O.J. L 12.
[6] Regulation (EU) No 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, O.J. L 351.
[7] Swiss Federal Court, Decision 5A_697/2020 of 23.3.2021.
[8] See on the consequences of 'Brexit' on the Lugano Convention the general official information provided under https://www.bj.admin.ch/bj/en/home/wirtschaft/privatrecht/lugue-2007/brexit-auswirkungen.html (accessed: 12 August 2022).

(or again) being bound fowolling this argument. Consequently – and possibly wrongly – courts have so far ignored the 1988 Lugano Convention and a majority of doctrinal views refuse its applicability as well

2.2. The Swiss Private International Law Act

2.2.1. General scope

In cases where no multilateral or bilateral agreements apply, recognition and enforcement of foreign decisions in Switzerland are subject to the provisions of the Swiss Private International Law Act ('SPILA').[9] The SPILA contains provisions on jurisdiction, applicable law and recognition and enforcement in all fields of private law as well as in insolvency law.

It is worth noting that, unlike in the field of commercial matters, there is no such thing as a parallel convention to EU Regulation 2015/848 ('Recast Insolvency Regulation')[10] applicable for Switzerland (or any other non-EU country). There also is no bilateral agreement to which Switzerland and the UK are party which covers the field of insolvency.

2.2.2. Commercial matters outside the Lugano Convention

Articles 25 *et seq.* and Article 149 SPILA concern the recognition of foreign decisions in matters of 'obligations' (under contract and tort law), while Articles 166 *et seq.* concern the recognition of foreign 'insolvency decrees', 'composition agreements' and 'insolvency related decisions'. While Articles 25-27 SPILA contain the general conditions applicable to the recognition of all foreign decisions (grounds for refusal for improper service of the summons, violation of procedural and substantive ordre public, *res iudicata* and *lis alibi pendens exceptions*, see below at 4.2.3), the qualification of the decision as either a contractual one or an insolvency decree within the meaning of SPILA determines which provisions on indirect competence (accepted grounds for a personal jurisdiction) are applicable.[11]

Articles 25-27 and 149 SPILA are applicable where the Swiss recognising court considers the decision to be recognised as a 'civil and commercial matter'. It is noteworthy that, unlike the Lugano Convention, Article 149 SPILA provides grounds for refusal on the basis of a lack of indirect competence. This means that a foreign decision, for example the sanctioning of a UK Scheme, would qualify as falling under that section. Where the Lugano Convention did not apply the *ratione temporis* principle, the foreign decision would not be recognised if the Swiss court considers that the foreign court based its jurisdiction on a ground inconsistent with Articles 26 or 149 of the SPILA. Instead, if the court were to qualify a decision, for example the sanctioning of a UK Restructuring Plan, as an 'insolvency decree' or a 'composition agreement', it would be likely to apply the provisions of the SPILA.[12]

2.2.3. Recognition as insolvency decree or composition agreement

Where a foreign decision is considered an 'insolvency decree' or a 'composition or analogous agreement', Articles 166-175 of the SPILA apply, which are the provisions containing Switzerland's international insolvency law, notably regarding the conditions for and consequences of the recognition

[9] Federal Act on Private International Law (SPILA) of 18 December 1987 (RS 291).
[10] Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings, O.J. L 141.
[11] See Article 149 and 166(1) SPILA.
[12] Articles 175 and 166 *et seq.* SPILA.

of foreing proceedings. Articles 166-175 of the SPILA follow the principle of passive territoriality, which means that in the absence of a formal recognition by the competent Swiss court, foreign insolvency proceedings generally have no effect in Switzerland. Arguably, where a composition agreement is limited to changing contractual terms and does not affect the rights over assets located in Switzerland, a recognition order will not be required.[13] The same applies where parties voluntarily apply the terms of the composition agreement. In all other cases, Swiss law not only requires the formal recognition of the foreign insolvency order by the competent Swiss court, it also subjects such recognition to certain conditions. A recent revision of the relevant provisions, which entered into force on 1 January 2019, has retained the fundamental recognition requirement, yet loosened its conditions,[14] first, by abolishing the controversial proof of reciprocity and second, by extending the indirect competence to the debtor's centre of main interest (COMI), which is now considered – together with the place of incorporation, formerly the sole criterion – a proper ground for indirect competence. Other recognition requirements have remained unaltered. In summary, under the current provisions of SPILA, recognition is granted to a foreign 'insolvency decree' if:

(i) the decree is enforceable in the state in which it was rendered;[15]

(ii) there is no ground to deny recognition for reasons of violation of the Swiss ordre public;[16]

(iii) the foreign insolvency order was rendered in the state of the debtor's domicile (under Swiss law, only the registered office), or in the state of the debtor's COMI under the condition that the debtor was not domiciled in Swizterland at the time of the opening of the foreign insolvency proceedings.[17]

The last condition excludes recognition in Switzerland of a foreign proceeding opened in respect of any company formally incorporated in Switzerland, even if its COMI is located in a foreign country. However, it allows for the recognition of a proceeding opened in the jurisdiction where the COMI (e.g. the UK) is distinct from its place of registration as long as the latter is also in a third country.

The provision dealing with foreign restructuring proceedings is Article 175 SPILA, according to which 'a composition or a similar proceeding in a foreign jurisdiction be recognized in Switzerland. Articles 166 to 170 shall be applicable by analogy […]' Consequently, the recognition of any foreign proceedings falling under the (wide) definition of a 'composition or a similar proceeding' is subject to the conditions applicable to bankruptcy proceedings under articles 166 SPILA (see discussion below in section 5).

3. The qualification game

3.1. Questions to be answered

The present assessment of the recognition in Szitwerland of both a UK Scheme of Arrangement and a Restructuring Plan determines whether the court order sanctioning the Scheme or Plan falls into the scope of 'civil and commercial matters' for the purposes of the Lugano Convention or under the

[13] See the case law on article 175: BGE 137 III 138; on Article 166:140 III379, cited in BSK IPRG-Volken/Rodriguez N 3. See also article 167 SPILA on the venue of the recognition proceedings.

[14] See further R. Rodriguez, 'Das revidierte internationale Konkursrecht des IPRG' (14 January 2019) Jusletter. Available at: https://jusletter.weblaw.ch/fr/dam/publicationsystem/articles/jusletter/2019/963/das-revidierte-inter_6e9bfd0267/Jusletter_das-revidierte-inter_6e9bfd0267_fr.pdf (accessed: 12 August 2022); R. Rodriguez, 'Is Swiss international insolvency law finally embracing the Model Law?' in *Mélanges en l'honneur de Jean-Luc Vallens* (Joly éditions, 2017) 449.

[15] Article 166(1)(a) SPILA.

[16] Articles 166(1)(b) and 27(1) SPILA.

[17] Article 166(1)(c) SPILA.

exception of its Article 1(2)(b) if it is, in turn, qualified as an insolvency, a composition, or a similar proceeding under SPILA.

It is worth noting that, while the qualification of the proceeding by the originating court can be an important element, it is formally not binding upon the recognising court.

The present assessment focuses on qualification and recognition. Accordingly, the following description of the main features of both Scheme and Plan is a succint and simplified one.

3.2. Main features of a Part 26 Scheme of Arrangement

For purposes of this paper, a Scheme is understood as being a compromise or arrangement between a company and its members or creditors (or any class of them) under Part 26 Companies Act 2006 (sections 895 to 901). It can be used to effect a solvent reorganisation of a company or group structure, as well as to effect insolvent restructurings such as by a debt for equity swap or by a wide variety of other debt-reduction strategies. A scheme requires approval by at least 75% in value of each class of the members or creditors who vote on the scheme, being also at least a majority in number of each class. If the scheme includes a reduction in the company's share capital, a separate special resolution of the company's members (requiring a 75% majority of those voting) is also necessary. A UK court's permission is needed to convene the meetings of members and creditors to vote on the scheme. The court will, at this point, review whether any division of the members and creditors into classes for voting purposes is appropriate. If the relevant members and creditors approve the scheme, the court will decide at a further hearing whether to sanction the scheme, and will look at whether the approved scheme is fair. If the court sanctions the scheme, the scheme is binding on all affected members, creditors and the company.

An English court will accept jurisdiction to sanction a Scheme in respect of a foreign-incorporated company if it is satisfied that there is a 'sufficient connection' with England. It is well established that a company will have such a 'sufficient connection' if:

(i) it has substantial assets in England;
(ii) its COMI is in England; or
(iii) the liabilities subject to the scheme are governed by English law (whether or not coupled with an English jurisdiction clause). [18]

3.3. Main features of a Restructuring Plan

A Part 26A restructuring plan ('Restructuring Plan') is an arrangement which may be proposed under Part 26A of the Companies Act in relation to a company which 'has encountered, or is likely to encounter, financial difficulties that are affecting, or will or may affect, its ability to carry on business as a going concern.'[19] Part 26A was introduced in 2020 by the Corporate Insolvency And Governance Act.

In addition to this specific scope, the following particularity differentiates it from the pre-existing Part 26 Scheme of Arrangement ('Scheme'). A Scheme requires approval of more than 50% in number constituting at least 75% in value of each relevant class of creditors or members, as the case may be, present and voting either in person or by proxy in favour of the Scheme for it to be sanctioned by the court. A Restructuring Plan, in turn, allows the court discretion to sanction a a plan where a number representing 75% in value of the creditors or members, as the case may be, of at least one class present

18 J. Watson, 'Forging the connection: Foreign companies & English schemes of arrangement' (Eurofenix 2015) 23.
[19] Section 901A(2) Companies Act 2006.

and voting either in person or by proxy in favour of the Restructuring Plan. A Plan may be sanctioned even where there is a dissenting class (or classes) (which therefore binds that dissenting class (or classes) to the Restructuring Plan (*i.e.* a 'cram down')), provided that:

(i) no members of the dissenting class are any worse off under the 'relevant alternative'[20] to the Restructuring Plan; and
(ii) at least one of the classes that has voted in favour of the Restructuring Plan received payment, or has a genuine economic interest in the company if the relevant alternative were implemented.

There is not yet much case law referring to a Restructuring Plan. The first Restructuring Plan was sanctioned on 4 August 2020 by the High Court of Justice of England and Wales in the matter of Virgin Atlantic Airways Ltd.[21] That decision was recognised by the bankruptcy court of the Southern district of New York on 12 November 2020 under Chapter 15 of the United States Bankruyptcy Code, the United States (US) implementation of the UNCITRAL Model Law on Cross-Border Insolvency 1997.

3.4. The scope of the relevant instruments

3.4.1. The scope of the Lugano Convention and the Brussels Regulation

The key question to examine is whether the Scheme of Arrangement or the Restructuring Plan fall under the exception of article 1(2)(ƀ) Lugano Convention referring to 'bankruptcy, proceedings relating to the winding-up of insolvent companies or other legal persons, judicial arrangements, compositions and analogous proceedings.'

Due to the parallelism between the Brussels Regulation and the Lugano Convention and to the mechanisms for a unified interpretation, case law concerning the Brussels Regulation and its relationship with the Recast Insolvency Regulation is also relevant for the interpretation of the Lugano Convention. However, legal writing and case law in Switzerland are scarce on this matter.The author is not aware of any Swiss case law as to a Plan or a Scheme. Particularly, when interpreting the Lugano Convention, Swiss law draws some inspiration from German legal practice and legal writing, being more abundant. In Germany, while a majority of scholars favour the qualification of a Scheme as a court decision falling under the Brussels Regulation[22] (corresponding to the Lugano Convention) some views advocate for those proceedings to be subject to the Recast Insolvency Regulation.[23] In the EU context, the EU Restructuring Directive adds an additional layer of complexity (as a subsequent instrument it is irrelevant, however, in the Lugano/Brussels context, see the discussion below at 3.4.1 and 3.4.2.1).

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[20] The relevant alternative will be whatever the court considers most likely to occur if the Restructuring Plan is not sanctioned by the court (e.g. this might be an administration or liquidation or, potentially, could be an alternative Restructuring Plan).

[21] [2020] EWHC 2191 (Ch). The case has subsequently been followed in other Part 26A cases, but the principles in the *Virgin Atlantic* case remain the guiding principles.

[22] See R. Rodriguez and P. Gubler, 'Recognition of a UK Solvent Scheme of Arrangement in Switzerland and under the Lugano Conventions' (2020) 40 *Praxis des Internationalen Privat- und Zivilverfahrensrecht* (IPRax) 372; D. Schulz, 'Grenzen der Anerkennung des Scheme of Arrangement nach Änderung der Rechtswahlklausel' (2015) 40 *Zeitschrift für Wirtschaftsrecht* (ZIP) 1912; D. Sax and A. Swierczok, 'Recognition of the English Scheme of Arrangement post Brexit' (2016) 41 *Zeitschrift für Wirtschaftsrecht* (ZIP) 601.

[23] M.L. Graf-Schlicker and A. Bornemann, 'Art. 1 N 2' in J. Kropholler and J. von Hein (eds.), *Europäisches Zivilprozessrecht, Kommentar zur EuGVO, Lugano*-Übereinkommen, EuVTVO, EuMVVO und EuGFVO (Deutscher Fachverlag, 2011).

3.4.2. The scope of the Recast Insolvency Regulation

3.4.2.1. Relevance

Article 1(2)(b) Lugano Convention and its parallel provision in the Brussels Regulation cannot be read isolated without having regard to the wider features of the EU legislative landscape. In particular, it is well established that the Recast Insolvency Regulation and the Brussels Regulation should dovetail without leaving any gaps.[24]

3.4.2.2. Definitions

The instrument devoted to fill the gap created by the exception to the Scope of the Brussels Regulations of Article 1(2)(b) was Regulation 1346/2000 on insolvency proceedings.[25] ('EuInsReg'). According to Article 1, the Regulation is applicable to 'collective insolvency proceedings which entail the partial or total divestment of a debtor and the appointment of a liquidator.'

Article 1 of the Recast Insolvency Regulation[26] has widened the definition. The Regulation shall now apply to

> public collective proceedings, including interim proceedings, which are based on laws relating to insolvency and in which, for the purpose of rescue, adjustment of debt, reorganisation or liquidation:
>
> a) a debtor is totally or partially divested of its assets and an insolvency practitioner is appointed;
>
> b) the assets and affairs of a debtor are subject to control or supervision by a court; or
>
> c) a temporary stay of individual enforcement proceedings is granted by a court or by operation of law, in order to allow for negotiations between the debtor and its creditors, provided that the proceedings in which the stay is granted provide for suitable measures to protect the general body of creditors, and, where no agreement is reached, are preliminary to one of the proceedings referred to in point (a) or (b).

3.4.2.3. What are 'collective proceedings'?

A question arises as to whether both the Scheme and the Restructuring Plan qualify as 'collective proceeding', as only a selected set of creditors and borrowers, whose composition is determined by pre-existing contracts, are bound by the Scheme or Restructuring Plan.[27] However, even 'traditional' insolvency and restructuring proceedings often exclude certain classes, such as privileged creditors under Swiss law.[28]

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[24] See e.g. Case C-157/13, *Nickel & Goeldner Spedition GmbH v "Kintra"* (2014).

[25] Council Regulation (EC) No 1346/2000 of 29 May on insolvency proceedings, O.J. L 160.

[26] Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings, OJ L 141.

[27] See on German law also C Paulus, 'Das englische Scheme of Arrangement – ein neues Angebot auf den europäischen Markt für außergerichtlie Restrukturierungen' (2011) *Zeitschrift für Wirtschaftsrecht* (ZIP) 1077, 1080.

[28] See Articles 305(2) and 306(1) Swiss Debt Enforcement and Bankruptcy Act of 1 August 1889 (Classified Compilation 281.1).

The Recast Insolvency Regulation has expanded the definition of 'collective proceedings' to include proceedings covering 'all or a significant part of a debtor's creditors.'[29] Though modifications introduced in the Recast Insolvency Regulation are of only limited relevance for the interpretation of the 2007 Lugano Convention (an EU/EFTA instrument negotiated in 2007, and formally not covered by the parallelism mechanisms of Protocol 2 to the 2007 Lugano Convention), they may have an influence on the interpretation of both the Lugano Convention and SPILA insofar as they reflect general legislative developments.

3.4.2.4. In a law 'related to insolvency'?

One of the key elements of an insolvency proceeding is that it is contained in a 'a law relating to insolvency,' as evidenced in Article 1(1) of the Recast Insolvency Regulation, but also under the 1997 UNCITRAL Model Law on Cross-Border Insolvency, whose Article 2(a) requires the proceedings to be 'pursuant to a law relating to insolvency.'

Unlike a Scheme, the Plan fulfils this requirement since an actual or imminent financial distress (see above at 3.3) is defined in the law as a requisite for its applicability.

3.4.2.5. Irrelevance of Annex A of the EIR (including the recast)

The question as to the inclusion of a Plan in Annex A of the Insolvency Regulations has not arisen, beacuse at the time of the enactment of those provisions the UK had already ceased to be a member of the EU. Accordingly, no inferences can be drawn from a Schme or a Plan not being included in Annex A.

3.4.2.6. Further elements of insolvency proceedings

As shown above, the definitions of 'insolvency proceeding' contains further elements (stay, debtor divestment, court control or supervision, purpose of rescue, adjustment of debt, reorganisation or liquidation) that deserve consideration as well. However, it is important to note that the conjunction 'or' means that an insolvency proceeding needs not satisfy the requirements of each of these limbs.

3.5. Conclusion as to the qualification

3.5.1. UK instruments in light of the definitions

While a Scheme shares with the definitions of insolvency prodeedings cited above a series of elements (the purpose of restructuring of debts, court supervision, overvoting of dissenting creditors), it also fails to fulfil a series of key elements, such as encompassing all of the debtor's creditors; providing for an automatic stay of individual enforcement against the debtor;[30] and being in a law relating to insolveny as well as requiring financial distress of the debtor.

A Plan, in contrast, differs from a Scheme in a few – but essential – elements. Its purpose is the 'rescue, adjustment of debt, reorganisation' and it is only applicable where 'the company has encountered, or is likely to encounter, financial difficulties that are affecting, or will or may affect, its ability to carry on business as a going concern.' The possibility of a 'cross-class cram down' (see 3.3) in the new Part 26A

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[29] See Article 2(1) of the Recast Insolvency Regulation.
[30] It is also a defining element under Swiss law, see above as to the 'typical elements'.

Restructuring Plan (unlike the Part 26 Scheme of Arrangement) adds a heavily non-consensual element that is characteristic of (only) insolvency proceedings.[31]

While some of these elements have evolved over time, some have remained constant. These include (i) the requirement of a context of financial distress; and (ii) the purpose of the restructuring of debts. Unlike a Scheme, a Plan proceeding cumulatively fulfils those requirements.

3.5.2. The plans as 'composition or a similar proceeding'?

As stated under 2.1, the Lugano Convention of 2007 is not applicable to the UK since 2021. Therefore, any UK Scheme or Plan initiated after that 31 december 2020 falls outside the scope of that Convention (on the 1988 Convention, see above at 2.1.3). The consequence is that the national SPILA applies in Switzerland and in other countries, their respective rules on recogntion of foreign decisions.The key determination to be made in the context of the SPILA is wether provisions on the recognition of 'insolvency decrees' (Article 166 SPILA) as well as on 'composition and similar proceedings' (Article 175 SPILA) apply – or the general provisions of commercial matters.

In its leading caseon the scope of article 166 SPILA,[32] the Swis Federl Court ruled that a foreign insolvency decree has to deploy a set of minimal insolvency-typical effects to be subject to the provisions of Articles 166 et seq. SPILA.

The conclusions in respect of the Lugano Convention and the Recast Insolvency Regulation are also relevant for the qualification under SPILA. The SFSC has consistently sought to interpret Artilce 1(2)(b) Lugano Convention and Articles 166 and 175 SPILA in a coordinated manner in accordance with ECJ jurisprudence on art. 1(2)(b) Brussels Regulation.[33] Consequently, there is a strong argument that a proceeding that is considered to be excluded from the scope of the Lugano Convention by virtue of its art. 1(2)(b) is subject to either Article 166 or Article 175 SPILA.

The author is not aware of jurisprudence or doctrine in Switzerland as to the qualification of a Restructuring Plan. The few scholarly views that can be found on the qualification of the Scheme of Arrangement[34] heavily rely on the criterion of the legal instrument having its basis 'in a law relating to insolvency', an element lacking in the Scheme. Accordingly, they conclude that a Scheme of Arrangement is to be excluded from the scope of the insolvency law provisions of SPILA, arguing that any proceeding falling under those provisions should have its basis in a law relating to insolvency or at least share with such provisions the purpose of avoiding a potentially existential financial distress of the debtor.

Following that conclusive line of argument, a Plan must, in turn, be subject to Articles 175 and 166 et seq. SPILA as it has its basis in a law relating to insolvency (see below at section 5).

3.5.3. Conclusions

Based on these sources the author has identified a series of elements required for a proceeding to qualify as an 'insolvency proceeding' or an 'insolvency decree' including 'compositions or similar

[31] See Article 11 of Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132, O.J. L 172.

[32] Swiss Federal Court Decision 2C_303/2010 of 24.10.2011 ('Bashkirian').

[33] See Swiss Federal Court Decision 133 III 386, 135 III 127, 140 III 320 and 141 III 382. In particular, its latest decision established a tight link between ECJ jurisprudence and the relevant interpretation of an insolvency proceeding for Swiss courts both under the Lugano Convention and SPILA.

[34] Supra n 22.

proceedings'. These elements include:

(i) having their basis in a law relating to insolvency (*i.e.* in a law addressing financial distress and the rights of creditors);
(ii) requiring, explicitly or implicitly, a state of financial distress which is an existential threat to the debtor, or would become one if not addressed;
(iii) having, as their purpose, the liquidation or restructuring of the debts of the debtor;
(iv) the agreement sanctioned by the court/authority having a binding effect on dissenting creditors.

All these elements can be found in a Restructuring Plan. Most relevant, the Restructuring Plan requires financial distress as a necessary requirement for its applicability. Furthermore, its 'cram down' possibilities are typical tool of insolvency proceedings. Finally, even though regulated by company law, it was introduced in that statute as part of an insolvency legislation package. These important elements differenciate it from the Scheme, and justify a different qualification of the Restructuring Plan from the Scheme. The latter, in turn, lacks the just cited essential elements and therefore is more likely to be qualified as a 'commercial matter' (under the Lugano/Brussels instruments) or as a decision relating to 'obligations' (of contractual or non-contractual nature) under Article 149 SPILA.

4. Recognition of a Scheme as a 'commercial matter' under Article 149 SPILA

4.1. No recognition and enforcement under the Lugano Convention

As set out in section 2.1.3, one of the consequences of the UK not being a party since 2021 to the Lugano Convention is that the sources of national law are applicable, the SPILA in the case of Switzerland. On the hypothesis that the Lugano Convention's predecessor, the 1988 Lugano Convention, might be re-applicable (see above sec. 2.1.1).

4.2. Recognition and enforcement under the SPILA

4.2.1. Qualification as a judgment

There are no reasonable grounds to question that the court sanctioning the schemes is a 'court' in the sense of Article 25 of the 1988 Lugano Convention (Article 32 of the 2007 Lugano Convention), i.e. a court of law acting in full independence and acting within proceedings that grant the parties bound by the decision the possibility to be heard, i.e. a proceeding that is 'offering guarantees of independence and impartiality and in compliance with the principle of audi alteram partem.'[35] Even if the decision were to be considered a court-approved settlement, Article 51 of the 1988 Lugano Convention (Article 58 of the 2007 Lugano Convention) provides for court-approved settlements to be treated – for the purposes of recognition and enforcement – in the same manner as judgements.

4.2.2. Qualification as a matter of commercial (but not corporate) law

Schemes will generall alter the rights of all creditors party to it out of, or in connection with, facilities, indentures or notes subject to the Scheme. The decisions confirming the Schemes thus fall within the scope of commercial civil matters under both the SPILA (Articles 25-27 and 149) and/or the

[35] Case C-551/15, *Pula Parking d.o.o. v Sven Klaus Tederahn* (2017), para. 54.

Brussels/Lugano-Conventions.

Generally, a Scheme will not have 'as [its] object the validity of the constitution, the nullity or the dissolution of companies or other legal persons or associations of natural or legal persons, or of the validity of the decisions of their organs', as per Article 16.2 of the 1988 Lugano Convention and Article 22.2 of the 2007 Convention. A similar provision can be found in Article 165 of the SPILA. They also lack the *erga omnes* effect that defines the rational and the narrow scope of those provisions.

4.2.3. General requirements

Articles 25–27 and 149 SPILA contain the requirements for recognition and enforcement of foreign decisions in civil and commercial matters, being that:

1. the decision is enforceable in the state of origin;
2. the decision is not manifestly contrary to Switzerland's ordre public;
3. no lis pendens (same matter pending) or res iudicata (same matter already decided) objections exist ;
4. the proceedings did not violate basic procedural rights of the parties bound by it, in particular the right to be heard;
5. the parties have participated in the proceedings or have at least been duly summoned to participate in accordance with applicable treaties and regulations; and
6. the proceedings took place based on a ground for jurisdiction accepted under SPILA (indirece competence).

As to the first condition (enforceability), it is assumed that an order sanctioning the Schemes would be enforceable under UK law and could not be appealed against by means of an appeal having an automatic suspensive effect at the time its recognition and enforcement is sought.[36]

As to the ground of refusal of lis alibi pendens (point 3), it is assumed that no other proceedings regarding the same parties and the same matter would have been initiated in any other jurisdiction and no prior decision concerning the same matter and the same parties exists.

As to the ground of refusal of violation of (basic) procedural rights (point 4), it is further assumed that a court sanctioning the Schemes will have granted all affected parties the procedural right to be heard (in writing or in a hearing) before the decision is taken, including the right to present evidence to support their statements (see, however, below sec. 4.2.5).

On the most relevant ground for refusal, the lack of indirect jurisdiction, see below section 4.2.6.

4.2.4. Ordre public violation

Article 27 SPILA (like Article 34 of the Lugano Convention) provides for a ground for refusal of recognition where the decision 'manifestly' violates both procedural or substantial 'ordre public.'

It is assumed that the proceedings to confirm the Schemes will raise no procedural issues amounting to a procedural ordre public violation, particularly that the rights of the parties affected to be heard will be respected.

However, a party willing to oppose the enforcement of Schemes in Switzerland could argue that the latter do violate substantial 'ordre public' on the basis that the Schemes disregard the principle of party autonomy by providing for a mechanism to disregard a party's necessary consent as to a contract change

[36] For a discussion regarding the ground for refusal based on ordre public violation and lack of proper service of the summons (points 2 and 5), see below sections 4.2.4 and 4.2.5.

– and particularly by doing so outside the context of an insolvency. This can be interpreted as contradicting basic principles of party autonomy and contract law theory. So saying, such argument is nontheless unconvincing on several grounds:

Fist, a Scheme is a well-known feature of English law, especially to the law firms advising debtors and creditors with respect to contracts like the ones relevant here. The parties reasonably had to be, and most certainly were, aware of the possibility of a Scheme being applied to the relevant agreements. Respecting the principle of party autonomy precisely calls for this choice and its consequences to be respected – at least where the choice of (English) law was made or was made possible by the agreement terms themselves.

Second, the possibility of modifying a contract or its effects against the will of a party is atypical, but not fully unknown under Swiss law. In fact, legal theory does not always consider a contract to be 'unchangeable'. The *clausula rebus sic stantibus* is a general principle of law, which has notably been raised in the context of the COVID-10 pandemic.

Thid, majority decisions of creditors that override dissenting creditors are a common feature of insolvency law – and most Schemes generally relate to a context o financial distresse. The fact that UK company law permits variations to contractual rights through a Scheme as distinct from its insolvency proceedings is exceptional, but would most likely not be considered as 'manifestly' violating 'ordre public', particularly in view of newer legal developments towards 'hybrid' insolvency instruments between commercial and insolvency.

This conclusion is underlined by the fact that Swiss courts – like most courts of the European continent - apply a strict standard to the application of the 'ordre public' clause. Furthermore, Swiss courts require the result or consequence of the decision to be a manifest violation of 'ordre public': generally, the most likely alternative to restructuring is insolvency, which would generally result in worse recoveries for creditors compared to the implementation of a rescue plan. This leads to the conclusion that – outside very particular situations – an argument of violation of ordre publice through a Scheme has little chances of success.

4.2.5. Proper service of the summons

The fifth condition (proper notice) applies to any judgement made in respect of a party that did not participate in the proceedings (in absentiam judgements). Where this is the case, the non-participating party can oppose recognition alleging that it was not 'duly summoned'. Concerning this ground for refusal, it must be noted that the requirements for 'due summoning' under Article 27 SPILA are stricter than under the Lugano Convention (Article 34(2), see also the Brussels Ia Regulation Article 45(1)(a)). Under the SPILA, full compliance with the applicable provisions on cross-border service of the summons is required, at least for the document instituting the proceedings. To that point it is essential that parties within the UK (or having agreed to be served there) and subject to the Scheme, are served or informed in accordance with the law of the forum and, in the case of cross-border notifications, in accordance with applicable treaties, so far as applicable.

Scheme creditors must have been notified of the proceedings in accordance with applicable UK law. If such creditors are abroad, the notification would have to fulfil the requirements of applicable treaties, so far as applicable as a matter of English law (in the case of Switzerland and many other states, the Hague Service Convention of 15 November 1965). However, the ground for refusal of non-compliance with such provision would only be available to a creditor of a Scheme (abroad) that would not have participated voluntarily in the proceedings (e.g. in the meetings).

4.2.6. Indirect competence in particular

The last cited refusal ground is the lack of so-called 'indirect competence', i.e. a lack of a proper ground for jurisdiction of the foreign courts out of the recognizing jurisdictions point of view. Unlike under the Lugano Conventions (Article 28.3/35.3), the recognising court may under SPILA examine the proper assertion of jurisdiction by the originating court.

Where parties bound by a Schemes would have validly submitted to the jurisdiction of the courts of England and Wales, Articles 5 and 26(c) SPILA provide for the indirect jurisdiction to be UK courts and therefore for recognition of the decision under that aspect.

Subsidiarily, further grounds for jurisdiction (Article 2, 6(1) Lugano Convention, referred to – as art. 2, 8 Brussels Regulation) would justify the UK court's jurisdiction. But even then, the SPILA would not grant such a court decision recognition if this jurisdiction contradicts an exclusive choice of court in favour of a different jurisdiction (from the UK) or an exclusive arbitration clause. In such cases, parties opposing recognition (and not having submitted to the proceedings) will stand good chances of opposing recogntion of the Scheme it such Scheme were to be raised as a defence in a claim against a Scheme debtor.

5. Recognition of a Plan as a 'composition agreement or analogous matter' (Articles 175 and 166 SPILA)

5.1. The requirements of Article 166 SPILA

The conditions for recognising a 'composition agreement or analogous matter' (as opposed to commecial matters) are found in chapter 11 of the SPILA. Article 175 SPILA refers to Articles 166 and 27 SPILA's conditions for recognition, these being that:

1. the decision is enforceable in the state of origin;
2. no *lis pendens* (same matter pending) or res iudicata (same matter already decided) objections exist;
3. the proceedings did not violate the basic procedural rights of the parties bound by it, in particular the right to be heard;
4. the parties have participated in the proceedings or have at least been duly summoned to participate in accordance with applicable treaties and regulations;
5. the decision to be recognized was issued by a court in the country of either the registered seat or the COMI of the debtor – provided the debtor is not registered in Switzerland ('indirect competence') and
6. the decision is not manifestly contrary to Swiss ordre public.

As to the first condition, it is assumed that a decision sanctioning a Plan would be enforceable under English law and would not appealed against by means of an appeal having an automatic suspensive effect at the time at which its recognition and enforcement in Switzerland is sought.

As to the second condition it is further assumed that no other proceedings regarding the same parties and the same matter would have been initiated in any other jurisdiction and no prior decision concerning the same matter and the same parties exists.

As to the third condition, it is also be assumed that the court sanctioning the Plan will have granted all affected persons the procedural right to be heard before the decision is taken, including the right to present evidence to support their statements.

The fourth condition applies to any judgement made in respect of a party that did not participate in the proceedings (in absentiam judgements). Where this is the case, the non-participating party can oppose

recognition alleging that he or she was not 'duly summoned'. The requirements for 'due summoning' under the relevant Article 27 SPILA are stricter than under the Lugano Convention (Article 34(2), see also Article 45(1) (a) Brussels Regulation). While, as a general rule under SPILA, full compliance with the applicable provisions on cross-border service of the summons is required, at least for the document instituting the proceedings, in the context of insolvency proceedings (Articles 166 *et seq*. SPILA) creditors are not subject to the same notification rules as formal parties to a proceeding. In any event, voluntary submission to the proceedings, or e.g. participation in the hearing, heals any possible formal defect in the notifications.

5.2. Indirect competence and ordre public in particular

The fifth ground for refusal is the lack of so-called 'indirect competence'. i.e. of a proper ground for jurisdiction of the foreign courts in the eyes of the recognizing jurisdiction. Unlike under Article 35(3) of the Lugano Convention, the recognizing court may under the SPILA examine the proper assertion of jurisdiction by the originating court. Since the reform of 2019, Article 166 SPILA allows for recognition of a decision (Plan sanctioning) issued either in the state of the registered seat or of the debtor's COMI (in the case at hand the company or companies proposing the plan). No recognition is possible in respect of a debtor company that had its registered seat in Switzerland at the time of the issuing of the decisions.

The last ground for refusal (Point 6) is the 'manifest' violation of ordre public. The reservations elaborated unter section 4.1.4 are applicable mutatis mutandis to the recogntion of a Plan. Given that the Plan is recognised as an insolvency proceeding, it appears even more unlikely that typical consequences of the Plan (like overvoting of creditors) is considered in any way a ordre public-violation of , as these consequences are outright typical of an insolvency proceeding, also under Swiss law. There is established case law (at least regarding the Lugano Convention) under which the violation of jurisdictional rules does not amount to a breach of ordre public but will only be examined with the test for indirect competence. As seen above, insolvency proceedings are to be opened in accordance with Article 166(1) SPILA.

5.3. Extent of the recognition

The recognition of the Restructuring Plan in Switzerland is not mandatory if parties voluntarily respect the terms of the modified agreements. However, recognition becomes necessary if a party decides to enforce a claim against another party subject to the Plan and argues, that the Plan should not affect its claim, if this claim is 'located' or affects assets in Switzerland. In such situation, the recognition decision (which generally has to be obtained in a separate proceeding) will have to be raised as a defense.

6. Conclusions

According to the findings of this paper, a Restructuring Plan is likely to be considered (by a Swiss court, or, in this view, by most continental European courts) a 'composition or similar proceeding' falling under Article 1(2)(b) of the Lugano/Brussels instruments (and consequently also under Articles 166–175 SPILA) and thus not a commercial matter falling under the substantial scope of the Lugano Convention (or Articles 25-26 and 149 of the SPILA).

The consequential applicability of national law provisions on the recognition of insolvency proceedings would, in Switzerland, lead to a Restructuring Plan being recognised and enforced (upon application to the Swiss court) under Articles 166–175 SPILA – provided that the the SPILA conditions are fulfilled, namely that the Plan company (provided it be the material debtor) had its registered seat or COMI in

the UK.

In turn, a Scheme is more likely to be qualified as a ‘commercial matter’. If proceedings had been initiated in England before 31 December 2020, but decided afterwards, recognition proceedings would still benefit from the Lugano Convention when recognition is sought in Switzerland. For Scheme proceedings initiated after that date, recognition proceedings would be subject to the conditions in Articles 25–27 and 149 SPILA. These provisions would require that parties bound by the Scheme have validly submitted to the jurisdiction of the UK courts.

As a result, UK law provides for two restructuring tools that are similar, but different in aspects that are key to their qualificaiton in terms of recognition. This opens the possibility for an UK counsel to choose the restruncturing tool also (or even mainly) on the basis of the chances of recognition abroad. Where the parties subject to a (potential) Scheme would validly submit (or have submitted) to the jurisdiction of UK courts, a Scheme stands good chances of recognition, despite the Lugano Convention being most likely not applicable. However, where this condition is not met, a Plan may be the better option, provided that the Plan company (or any material debtor under the Plan) has its COMI in the UK.

Chapter 10

Harmonising restructuring frameworks: Top-down, bottom-up, or both?

Eugenio VACCARI[*] and David C. EHMKE[**]

1. Introduction

This paper focuses on the harmonisation narrative of the European insolvency law.[1] It provides an analysis of alternative approaches, notably top-down regulation and bottom-up competition, geared towards supporting the convergence of insolvency and restructuring laws across the Member States.

The harmonisation of insolvency and restructuring frameworks has become increasingly important since 2000. While transnational insolvency law (conflict of law rules) has been regulated since 2000 on a European level (EIR 2000,[2] EIR Recast 2015[3]), the European Union (EU) institutions relied on soft law mechanisms such as recommendations[4] for the substantial harmonisation of restructuring laws until the enactment of the Preventive Restructuring Directive (PRD) in 2019.[5] The PRD was designed as a top-down mechanism to address a key flaw in many continental European insolvency frameworks. This was the absence of flexible and effective restructuring mechanisms like the US Chapter 11 procedure (and, to a lesser extent, the English schemes). In the European legislator's mind, such procedure should include provisions for a cross-class cram-down plan on a comprehensive restructuring of debt and equity claims. The PRD made it mandatory for the EU Member States to offer a preventive restructuring framework for companies experiencing financial difficulties. The restructuring framework should provide debtors with a breathing space to negotiate a restructuring plan with their creditors, suspend the obligation to file for insolvency, override termination clauses, and include cross-class cram-down provisions on dissenting classes of creditors.

The PRD gives Member States a high degree of flexibility when implementing its rules. It sets minimum standards and leaves important definitions, such as 'likelihood of insolvency', to the EU Member States' discretion. This flexibility may be perceived as detracting from the original purpose of having a harmonised restructuring framework across EU Member States. It may result in arbitrage between the Member States, a risk further enhanced by the state-specific measures introduced in the wake of the COVID-19 pandemic. However, while this flexibility could have led many European countries with a

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[1] For a literature on the concept of 'harmonisation' see (among others): A. Platsas, *The Harmonisation of National Legal Systems. Strategic Models and Factors* (Edward Elgar Publishing, 2017); S. Weatherill,'Why Harmonise?' in T. Tridimas and P. Nebbia (eds), *EU Law for the Twenty-First Century: Rethinking the New Legal Order* (Hart Publishing, 2004) 11.

[2] Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings O.J. L 160.

[3] Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings O.J. L 141.

[4] Commission Recommendation of 12 March 2014 on a new approach to business failure and insolvency O.J. L 74.

[5] Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency) [2019] O.J. L 172.

rather traditional insolvency framework to thwart their reform efforts, a preliminary state-by-state comparison suggests that most the EU Member States have fully embraced the restructuring-friendly culture postulated by the PRD.[6]

Flexibility in the harmonisation process is, therefore, a prudent approach in view of the highly diverse nature of domestic restructuring and insolvency proceedings, as well as of the different stages of development of insolvency regimes throughout the EU Member States. Such flexibility allows for bottom-up competition. This leads to a multi-prong harmonised approach based on competition and, possibly, the try and err of different solutions.

This paper builds on collaborative research carried out by us and the other members of the YANIL board[7] to assess how the idea of harmonisation by top-down regulation interlinks with bottom-up national solutions and how possibly the COVID-19 pandemic might have influenced such development. To showcase its findings, the research focuses on the reforms introduced in Germany (SanInsFoG/StaRUG) and the United Kingdom (Corporate Insolvency and Governance Act 2020 or CIGA 2020). While the UK is no longer compelled to follow the EU harmonisation agenda, it is a proper comparator especially for the influence of bottom-up convergence. The UK legislator is certainly influenced by the desire to provide a restructuring framework that competes with the corresponding laws applicable in the EU, as the UK has been the model state for flexible and market-oriented restructuring solutions in Europe for a long period of time.

The conference presentation on which this paper is based assessed the degree of uniformity and harmonisation achieved in Germany and the UK with reference to selected key innovations of the PRD. These are: (i) revised entry criteria; (ii) creditors and shareholder's involvement in the procedure; (iii) automatic stay on executory actions; (iv) treatment of executory contracts; (v) voting thresholds; and (vi) cross-class cram-down provisions. In this paper, we only focus on the treatment of executory contracts in insolvency as well as on cram-down provisions to ensure an adequate level of analysis of these arguments given the limited space for this contribution.

2. Executory contracts in insolvency procedures

It is frequently accepted that to maximize the chances of rescuing insolvent but viable debtors, it is necessary that executory contracts that are essential for the debtor's survival are neither terminated (automatically) nor that the counterparty is entitled to modify the contract to the disadvantage of the debtor (for instance, by charging a risk-premium because of the debtor's insolvency or restructuring procedure). To achieve this goal, the PRD adopted a pro-debtor stance by significantly restricting the creditor's possibility to terminate or modify contracts by means of *ipso facto* clauses.

Pursuant to the PRD, *ipso facto* clauses triggered solely by reason of the company's insolvency or restructuring procedure (i.e., the request, opening, or use of the procedure's instruments) are void or unenforceable.[8] The European legislator gives Member States the flexibility to opt out of such ban in regards to limited contracts, such as netting arrangements in financial, energy and commodity markets.

At the time of the enactment of the PRD, the UK had notably been one of the few remaining jurisdictions in the world to feature limited restrictions to the enforceability of *ipso facto* clauses in insolvency and restructuring procedures. At that time, the relevant provisions in the Insolvency Act 1986 (IA 1986) offered some protection to essential supplies in relevant insolvency procedures. Broadly speaking, contracts for the supply of gas, water, electricity and communication services were considered 'essential' under the law.[9]

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[6] E. Ghio and others, 'Harmonising insolvency law in the EU: New thoughts on old ideas in the wake of the COVID-19 pandemic' (2021) 30 *International Insolvency Review* 427.
[7] Ibid.
[8] PRD, Recital 40.
[9] Ss.233-233A IA 1986.

The first provision (s.233 IA 1986) applied and still applies to debtors in administrative receivership, company voluntary arrangement (CVA), administration or liquidation. As a rule, the commencement of such procedures does not automatically invalidate *ipso facto* clauses included in executory contracts. On the contrary, such clauses are in principle enforceable, unless and until the office holder requests the continuation of these contracts. Even where the supplier is allowed to terminate existing contracts, the supply of gas and electricity to the debtor's premises is ensured by contracts deemed to arise under the Gas Act 1986 and the Electricity Act 1989 respectively.[10] Finally, if the office holder requests the continuation of the contract despite the *ipso facto* clause and the creditor's intention of relying on it, the supplier could make it a condition that further supplies are personally guaranteed by the office holder themselves.[11]

This provision was supplemented by s.233A IA 1986, introduced by the Small Business, Enterprise and Employment Act 2015 (SBEEA 2015). The new provision applies to the same contracts for the supply of goods and services covered by s.233 IA 1986. However, it is only relevant where the debtor enters into a CVA or administration.[12] Additionally, it applies to clauses that not only terminate, but also cause "any other thing" to happen to existing contracts, such as increase supply prices or variate payment terms.[13] Further to that, s.233A 1986 reversed the approach to the treatment of such contracts by introducing a general ban on the enforceability of termination clauses,[14] which could only be superseded in limited circumstances.[15]

CIGA 2020 fundamentally changed the existing law with the introduction of a new section[16] to the IA 1986. This section has the effect of introducing a general ban to *ipso facto* clauses. After these amendments, which apply to any insolvency and restructuring procedure except for Pt 26 schemes of arrangement,[17] the prohibition to rely on these clauses extends to any contracts for the supply of goods and services,[18] subject to only limited exceptions.[19]

It would, therefore, seem that the English legislator was prompted to introduce such changes by the provisions in the PRD. While it is not possible to claim that this is an example of top-down harmonisation (as by the time the PRD had to be implemented, the UK was no longer an EU Member State), this closely resembles such type of harmonisation. The general rules on the treatment of executory contracts are changed by a higher-ranking institution (in this case, a regional organisation such as the EU), and legal convergence resulted from the directions provided by such organisation.

A closer analysis to the process, which led to the adoption of the revised rules on the treatment of executory contracts may suggest a different conclusion. Despite having been quickly enacted through Parliament, the reforms in the CIGA 2020 did not come out-of-the-blue. A broader scope for a special treatment for certain types of contracts was first advocated by the Cork Report in 1982.[20] More recently, changes to the treatment of executory contracts and *ipso facto* clauses were first discussed as a result of a consultation in 2016.[21] In the regulatory reform process, the legislator seems to have considered the

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[10] As observed in *Laverty v British Gas Trading Ltd* [2014] EWHC 2721 (Ch), which dealt with the treatment of the charges for these deemed contracts in the insolvency procedure.
[11] S.233(2) IA 1986.
[12] S.233A(1) IA 1986.
[13] S.233A(2) IA 1986.
[14] S.233A(1) IA 1986.
[15] S.233A(4)-(5) IA 1986.
[16] S.233B IA 1986. For an analysis, see (among others): P. Wood, 'Corporate Insolvency and Governance Act 2020 – Freezes on Contract Terminations' (2020) 5 *Corporate Rescue and Insolvency* 167; L. Hotton and J. Norris, 'UK Corporate Insolvency and Governance Act: Effects on *ipso facto* Clauses' (2020) 35 *Butterworths Journal of International Banking and Financial Law* 550; N. Cooper, 'Termination Rights in the Event of Insolvency: Where Are We now with *ipso facto* Clauses? Are They still a Potent Weapon in a Creditor's Armoury?' (2021) 18 *International Corporate Rescue* 190.
[17] S.233B(2) IA 1986.
[18] S.233B(3) IA 1986.
[19] S.233B(4)-(5) IA 1986.
[20] *Report of the Review Committee on Insolvency Law and Practice* (Cmnd 8558, 1982), Ch. 33, para 1453.
[21] The Insolvency Service, *A Review of the Corporate Insolvency Framework. A Consultation on Options for Reform*

arguments against the introduction of sweeping changes to the law,[22] as well as the general unease in the insolvency community to adopt a US-style ban to the enforceability to termination clauses.[23] In the Government's words, it recognized that some of their proposals were 'too weighted in favour of the debtor company and open to abuse'.[24]

In fact, it is to be noted that the UK legislator built on the existing legal tradition, thus giving evidence of not ignoring a flourishing scholarly debate[25] on the opportunity to introduce a general ban on the enforceability of *ipso facto* clauses. The ban in s.233B IA 1986 excludes several types of suppliers and contracts (e.g., contracts for the supply of goods or services from banks, insurers, and financial providers, intellectual property contracts and contracts for the lease of land).[26] Additionally, it 'does not cover a series of contracts that achieve the same goals as executory long-term supply contracts but are structured on an *ad hoc* basis by reason of the nature of the goods or services supplied, or to give more flexibility to the parties involved in the contract'.[27]

All these elements, therefore, suggest that the top-down approach has been mitigated by several bottom-up elements, thus giving rise to a varied and flexible example of legal convergence. What top-down harmonisation could not achieve here is a change in the long-established legal approach of English judges to prioritise and preserve to the highest possible extent the principles of party autonomy and freedom of contract. However, the quasi-binding effect of the PRD together with the persuasive nature of the World Bank principles on effective insolvency frameworks[28] had the effect of deviating from this long-established legal approach to the treatment of termination clauses in insolvency.

While the introduction of a rather broadly applicable prohibition of *ipso facto* clauses marked a quite fundamental policy shift in the UK, the German Federal Court of Justice had already ruled in 2012 that *ipso facto* clauses which would allow for the termination of a contract solely because of an insolvency-related reason are void.[29] Up until this decision, it was debated among judiciary and academics whether *ipso facto* clauses were in fact void or permissible as expression of the general principle of freedom of

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(May 2016), chapter 8. Available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/525523/A_Review_of_the_Corporate_Insolvency_Framework.pdf (accessed: 12 August 2022).

[22] F. Toube, 'A Brave New World? Should the UK Ban *ipso facto* Clauses in Non-executory Contracts?' (2018) 31 *Insolvency Intelligence* 78 (arguing that a general ban would sit at odds with the established principles of anti-deprivation, *pari passu* treatment of creditors and freedom of contact, that underpin the English corporate insolvency framework).

[23] This is mainly because such ban would have conflicted with the principle of freedom of contract, which represents one of the pillars of the English legal system. On this point, see (among others): *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd* [2011] UKSC 38, [103] per Collins LJ.

[24] Department for Business, Energy and Industrial Strategy, *Insolvency and Corporate Governance. Government response* (26 August 2018), at [5.90]. Available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/736163/ICG_-_Government_response_doc_-_24_Aug_clean_version__with_Minister_s_photo_and_signature__AC.pdf (accessed: 12 August 2022). The Government followed the approach recommended by the respondents to the consultation in some areas, such as the treatment of licenses and the exemptions for financial contracts. The Government did not believe in the need to extend the requirement for personal guarantees from the office holders or debtors to ensure that suppliers were not unduly affected.

[25] S. Menon et al., '*Ipso facto* Protection: as Dead as the Language and Rightfully So?' (2019) 34(6) *Butterworths Journal of International Banking and Financial Law* 370; E. Vaccari, 'Executory Contracts in Insolvency: The English Perspective' in J Chuah and E Vaccari (eds), *Executory Contracts in Insolvency Law: A Global Guide* (Edward Elgar Publishing, 2022).

[26] Pt 2 (paras 3-10) and Pts 3-4, Sch. 4ZZA IA 1986. For an outline, see (among others): Wood (n 16), 167-168; A. Goldthorp and N. Grandage, 'The Impact of the Corporate Insolvency and Governance Act 2020 on Credit Insurers and Suppliers' (2021) 36 *Butterworths Journal of International Banking and Financial Law* 508.

[27] E. Vaccari, 'A Modular Approach to Restructuring and Insolvency Law: Executory Contracts and Onerous Property in England and Italy' (forthcoming).

[28] World Bank Group, *Principles for Effective Insolvency and Creditor/Debtor Regimes* (April 2021), at C10. Available at: https://openknowledge.worldbank.org/bitstream/handle/10986/35506/Principles-for-Effective-Insolvency-and-Creditor-and-Debtor-Regimes.pdf?sequence=1&isAllowed=y (accessed: 12 August 2022).

[29] German Federal Court of Justice, decision of 15.11.2012 – IX ZR 169/11.

contract.[30] Although there is no rule in the German Insolvency Code 1999 (InsO) that explicitly declares *ipso facto* clauses void, the German Federal Court of Justice found that *ipso facto* clauses breach the key principle of German insolvency law in s.103 InsO that the insolvency administrator or debtor should exercise a right to perform or reject performance of executory contracts.

Currently, under German insolvency law, the enforcement of executory contracts is suspended[31] by the opening of the insolvency procedure until the insolvency administrator decides whether to perform a contract, demand performance or reject it.[32] In a debtor-in-possession procedure, the debtors themselves decide on these issues.[33] Because s.119 InsO states that any contractual clause which contradicts ss.103-118 InsO is void, the German Federal Court of Justice concluded that a clause which triggers the termination of a contract solely because of an insolvency-related event would effectively breach the statutory privilege granted to insolvency administrators to decide the outcome of executory contracts.

Should the insolvency administrator or debtor choose to assume an executory contract, the claim of the other party to the debtor's consideration is elevated to the ranking of obligation incumbent on the assets of the insolvent estate. Therefore, this claim would rank above ordinary insolvency creditor's claims,[34] meaning that it has to be satisfied in full before ordinary insolvency creditors can demand (partial) satisfaction of their claims. In case the other party's performance (of goods and services etc.) is partible, outstanding payments before the opening of the insolvency procedure rank as ordinary insolvency claims, while the performance requested after the opening of the insolvency procedure would be considered a preferential claim.[35]

The other party, eventually, remains entitled to terminate the contract for a breach of contract that is not related to an insolvency-event. Importantly, should the law entitle the other party to terminate the contract under certain circumstances, and may such circumstances typically coincide with the debtor's insolvency, the other party's right to (extraordinarily) terminate the contract remains valid. Sec.490(1) of the German Civil Code (BGB), for instance, provides the lender under a loan agreement with the right to terminate the contract for future pay-outs should the financial situation of the borrower decline in a way that the repayment of future pay-outs is threatened. An *ipso facto* termination of a loan agreement, therefore, is not captured by the ban on such clauses described above. Exceptions from the debtors' right to choose performance, moreover, apply for certain qualified transactions, such as for instance fixed transactions and close-out netting arrangements.[36]

The right to choose performance, enforced by a prohibition of *ipso facto* clauses, as well as the elevation of claims arising from such contracts after the opening of the insolvency procedure are essential for the successful continuation of the business in insolvency. If the enforceability of *ipso facto* clauses was not restricted, the debtor would often be required to re-negotiate executory contracts that are essential for the continuation of the business in a distressed situation. While a debtor may even lose valuable contracts, they would also be confronted with the other party's request for a risk premium. Both can be disastrous in an already precarious situation.

While the prohibition of *ipso facto* clauses in German insolvency law follows from an interpretation of s.119 InsO by the judiciary with the intention to enforce the insolvency administrator's or debtor's right to choose performance, the German Restructuring Law (StaRUG) implementing the PRD contains an explicit prohibition to enforce *ipso facto* clauses in s.44 StaRUG. It remains to be seen if the explicit prohibition of enforcing *ipso facto* clauses through the implementation of the PRD 2019 might also result in a more rigid interpretation of the less explicit insolvency law rules on the prohibition of *ipso facto* clauses. The *ipso facto* prohibition in restructuring procedures applies automatically in every

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[30] On this debate: J. Sarra et al., 'The promise and perils of regulating *ipso facto* clauses' (2002) 31(1) *International Insolvency Review* 45, 59–62.
[31] On the 'suspension theory': German Federal Court of Justice, decision of 25.04.2002 – IX ZR 313/99.
[32] The insolvency administrator is required to decide in due course should the counterparty request a decision, according to s.103(2) InsO.
[33] The decision should be made in agreement with the trustee appointed to supervise the debtor: see s.279 InsO.
[34] S.55(1)(2) InsO.
[35] S.105 InsO.
[36] S.104 InsO.

restructuring procedure, while the creditor remains entitled to terminate the contract for the past non-performance of the debtor, including for delays in payments. Should the debtor, however, request a stay, the creditor's/counterparty's right to terminate a contract or withhold future performance because of a delay in payments before the stay has been requested is additionally prohibited by s.55 StaRUG.

Differently from the insolvency law, the German restructuring law does not entitle the debtor to choose non-performance of an executory contract. Moreover, the restructuring of future obligations from executory contracts is explicitly ruled out by s.3(2) StaRUG. The question as to whether the restructuring procedure should affect executory contracts sparked a lively debate during the discussions on the new restructuring law. Especially the choice to exempt future liabilities from executory contracts from the restructuring plan creates a hardly justifiable privilege for creditors of executory contracts when compared to financial creditors.[37]

It is, therefore, possible to conclude that Germany and the UK have followed different paths in the harmonisation of provisions dealing with executory contracts in insolvency. Where in the UK the reform process had been heavily influenced by local reform proposals and the existing judicial culture, the Germany legislator certainly added some clarity for the restructuring procedure by an explicit prohibition of enforcing *ipso facto* clauses when implementing the PRD. This development, however, also consequently follows an evolutionary path in the interpretation of German insolvency law emerged with a decision by the German Federal Court of Justice in 2012.

3. Cross-class cram-down provisions

To restructure a business, several parties need to work together towards a common goal. It is frequently the case, however, that not everyone agrees as to the best course of action to rescue or restructure a debtor. Certain parties may gamble for a higher satisfaction quota should they holdout. To avoid these undesirable outcomes,[38] every restructuring framework includes some mechanisms to bind dissenting creditors.

These mechanisms are usually part of formal insolvency or restructuring procedures. Under English insolvency law, for instance, administration procedures can only go ahead if the creditors approve the administrator's proposal, usually within 10 weeks of a company entering into administration.[39] An administrator shall manage the company in accordance with the approved plan, but secured and preferential creditors shall not vote on the plan unless their rights are impaired.

Equally, in CVAs creditors who represent 75% by value of debt shall vote in favour of the plan, provided that the majority of them are not connected to the debtor.[40] However, the arrangement cannot either prevent secured creditors from enforcing their collateral or modify their proprietary rights. Finally, in Pt 26 schemes of arrangement, a restructuring plan is submitted to the creditors. Creditors are divided into classes (if their rights are dissimilar) and vote on the plan. Each meeting must approve the Pt 26 scheme with a majority of 75% in value of the creditors and members present and voting.[41]

Up until the enactment of the PRD, there was no debtor-in-possession mechanism under English law capable of binding dissenting classes of creditors in restructuring procedures, despite recommendations

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[37] For an analysis of this debate see S. Madaus and D. Ehmke, 'Germany: Still Waiting for the Revolution in Restructuring to Come?' HERO (June 2022), section 4.8. Available at: https://www.online-hero.nl/art/4351/special-issue-preventive-restructuring-4-germany-still-waiting-for-the-revolution-in-restructuring-to-come (accessed: 12 August 2022).

[38] A 'holdout' in the insolvency context is typically a creditor that either delays or does not participate in proceedings to leverage a higher recovery for itself than other similarly situated creditors: V. Sachdev, 'Choice of Law in Insolvency Proceedings: How English Courts' Continued Reliance on the Gibbs Principle Threatens Universalism' (2019) 93 *American Bankruptcy Law Journal* 343, 349.

[39] Para. 51(2), Sch. B1 IA 1986.

[40] S.4 IA 1986.

[41] S.899(1) CA 2006.

to the contrary from international institutions such as the World Bank[42] and UNCITRAL.[43] This forced debtors to either undertake individual negotiations with secured creditors to ensure their support – thus significantly increasing the cost, complexity and duration of the restructuring process – or to combine more flexible procedures such as Pt 26 schemes with binding ones such as administration. The 2016 consultation explored the possibility of introducing in the English restructuring framework a cross-class cram-down mechanism. Under that proposal, a restructuring plan could be 'imposed on dissenting classes of junior creditors, on the condition that they would not be worse off under the restructuring than if the business went into liquidation'.[44]

The PRD suggested the adoption of a similar mechanism. Pursuant to recital 54 of the PRD:

> [i]t should be possible that, where a majority of voting classes does not support the restructuring plan, the plan can nevertheless be confirmed if it is supported by at least one affected or impaired class of creditors which, upon a valuation of the debtor as a going concern, receive payment or keep any interest, or, where so provided under national law, can reasonably be presumed to receive payment or keep any interest, if the normal ranking of liquidation priorities is applied under national law.

The PRD went on to dictate that the 'best-interest-of-creditors' test was satisfied were either "no dissenting creditor is worse off under a restructuring plan than it would be either in the case of liquidation, whether piecemeal liquidation or sale of the business as a going concern, or in the event of the next-best-alternative scenario if the restructuring plan were not to be confirmed".[45]

The new Pt 26A restructuring plan procedure was introduced into the English corporate insolvency framework by CIGA 2020 to align the UK to these international trends on the treatment of dissenting classes of creditors. The Pt 26A restructuring plan is a powerful and flexible court-supervised restructuring procedure. This debtor-in-possession procedure allows struggling companies, their creditors, and their members to propose a restructuring plan to pursue various goals. These include the rescue of a company or part of its business, enabling complex debt arrangements to be restructured, and the support of the injection of new rescue finance.

Courts have the jurisdiction to make a convening order in respect of a company that is liable to be wound up under IA 1986.[46] As with Pt 26 schemes, court involvement is limited to two hearings. In the first hearing, a court is asked to convene the meeting(s) and examine the proposed class composition. Those creditors or shareholders who do not have a genuine economic interest in the company will not need to participate in the meeting(s).[47] Once an order to convene the meeting is made, the prohibition on the enforceability of *ipso facto* clauses applies, and suppliers cannot terminate their contracts.

The innovative aspect of Pt 26A plans is, as mentioned, its cross-class cram-down provisions. The EU's position on this matter has been noted before. With reference to the UK Government, in their response they argued for the introduction of cross-class cram-down provisions on classes of both secured and unsecured creditors.[48] In the same response, they argued to use the majority thresholds applicable to CVAs[49] and wanted to subject the cross-class cram-down provisions to a modified absolute priority rule.

The use of the absolute priority rule was recommended by the PRD.[50] Eventually, the UK Government opted for a more flexible mechanism than the absolute priority rule, designed to ensure that affected

[42] World Bank Group (n 28) at C14.5.
[43] UN Commission of Int'l Trade Law, *Legislative Guide on Insolvency Law. Parts 1 and 2* (2005), [54]-[55]. Available at: https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/05-80722_ebook.pdf (accessed: 12 August 2022).
[44] Insolvency Service (n 21), at [9.8].
[45] PRD 2019, Recital 52.
[46] S.901A(4)(b) CA 2006.
[47] S.901C(4) CA 2006.
[48] Department for Business, Energy and Industrial Strategy (n 24), at [5.123].
[49] Ibid, at [5.155].
[50] PRD 2019, recitals 55-56.

creditors are not unfairly prejudiced. Under the current law, two conditions need to be met for the cross-class cram-down to be ordered:

a) [condition 'A'] firstly, a court must be satisfied that, if the compromise or arrangement were to be sanctioned, none of the members of the dissenting class would be any worse off than they would be in the event of the relevant alternative. The relevant alternative is whatever a court considers would be most likely to occur in relation to the company if the compromise or arrangement were not sanctioned ('no worse off' test).[51]

b) [condition 'B'] secondly, the plan must receive the consent of at least one class of creditors who would receive a payment or have a genuine economic interest in the company in the event of the relevant alternative ('economic interest' test).[52]

Unsurprisingly, there have been cases where cross-class cram-down provisions were approved even if the proposed plan was not in compliance with the absolute priority rule. In *DeepOcean*, the Court noted that the Pt 26A plan may provide differential treatment for some creditors that are 'out of the money', provided that such differential treatment is justified. The Court stated in this instance that finding the relevant alternative is analogous to establishing a suitable comparator for class purposes in the context of a Pt 26 scheme.[53] It is also comparable to the analysis that a court may be asked to perform when applying a 'vertical' comparison for an unfair prejudice challenge to a CVA.[54] Additionally in *Virgin Active*,[55] it was ruled that shareholders could receive some value in the new company because they provided new money under the plan, whilst more senior-ranking creditors (landlords) had their obligations compromised and were crammed-down. In particular, in this judgment the Court held that a dissenting class of 'out of the money' creditors could not be granted a veto power on the outcome of such procedures. Finally, the more recent case of *Amicus Finance* further facilitated the use of cross-class cram-down mechanisms by holding that that the debtor had to demonstrate on the balance of probabilities that the dissenting creditors are no worse off than in the relevant alternative ('condition A'), rather than that there was no real prospect or no realistic possibility of such an outcome.[56]

Once again, the flexibility granted in this top-down harmonisation exercise has resulted in regulatory competition among EU Member States. It has prompted the UK to devise solutions that are tailored to their legal tradition and build on the experience and expertise of its judiciary.

The German Insolvency Code (InsO), modelled after US chapter 11, provides a cross-class cram-down option since 1999. Most of the classes of creditors need to vote in favour of the plan to effect a cross-class cram-down.[57] A single class is considered to have approved the plan if a simple majority in number (headcount test) of creditors or shareholders voting in this class and a simple majority in value has consented to the plan.[58] While individual creditors can always object the plan for proper cause (for instance, if they are worse-off by the plan than in the alternative scenario, such as liquidation),[59] the court will have to review *ex officio* for a cross-class cram-down if the plan does not disadvantage creditors[60] and if it does not violate the absolute priority rule. The absolute priority rule states that lower-

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[51] S.901G(3) and (4) CA 2006. This is not necessarily liquidation, thus marking a significant difference from the previous proposals.

[52] S.901G(5) CA 2006. This is not the absolute priority test, thus further departing from the original Government response.

[53] *Re DeepOcean 1 UK Ltd* [2021] EWHC 138 (Ch) [29]. See also: *Re Telewest Telecommunications Plc* [2004] B.C.C. 342, 351; *Re British Aviation Insurance Co Ltd* [2006] B.C.C. 14 [82], [88]; and *Re ColourOz Investment 2 LLC* [2020] EWHC 1864 (Ch) [74].

[54] *DeepOcean* (n 53) [30].

[55] *Re Virgin Active Holdings Ltd* [2021] EWHC 1246 (Ch). For a comment, see: L. Linklater, 'Virgin Active and New Look: a new dawn for the rescue culture?' (2021) 34 *Insolvency Intelligence* 55; Cooper (n 16); A. Cohen et al., 'Imposing a restructuring plan: a sign of times?' (2021) 32(5) *PLC Mag*. 4; and C. Lamont, 'A new look at leasehold restructuring' (2021) 25(5) *Landlord and Tenant Law Review* 192.

[56] *Re Amicus Finance Plc* [2021] EWHC 3036 (Ch) [55].

[57] S.245(1)(3) InsO.

[58] S.244 InsO

[59] S.251 InsO.

[60] S.245(1)(1) InsO.

ranking (classes of) creditors cannot receive any value if higher-ranking (classes of) creditors have not been paid in full. A corollary of this rule is that no preferences can be made in the treatment of creditors belonging to the same class.[61] With a recent reform package to implement the PRD and establish a new restructuring procedure, the provision for cross-class cram-down in the German Insolvency Code had been updated. These updates allow for limited deviations from the absolute priority principle so that (managing) shareholders can receive a share in the restructured debtor or its assets based on the value of their future commitment to the debtor.[62]

With the insolvency plan, the insolvency administrator or debtor can affect a wide variety of amendments to rights of (secured) creditors and shareholders. These include waivers and postponements of debt, amendments to rights in collateral - even if provided as side-, down-, or upstream collateral by a connected company (with adequate compensation), debt-for-equity swaps, or transfer of (equity) claims. The opportunity to include and amend equity claims as part of a restructuring plan was introduced in 2012 (Law to Further Facilitate the Restructuring of Companies, ESUG). For the first time, this law enabled the transfer of ownership interests not only through a sale but also through a restructuring of the debtor's financial obligations. These reforms had the effect of facilitating the debtor's fresh start with a new ownership structure.[63]

With the enactment of the German Restructuring Law, debtors expected to become unable to pay their debts within the next 24 month (i.e., in so-called imminent insolvency) but typically still able to meet their financial obligations for the upcoming 12 month can voluntarily choose to initiate a restructuring procedure and restructure their financial obligations through a restructuring plan.[64] Basically, the restructuring plan allows for the same amendment to rights of (secured) creditors and shareholders as the insolvency plan, with some unique characteristics.

The restructuring plan, differently from the insolvency plan, can modify non-payment terms of multi-party agreements.[65] Additionally, the debtor has greater flexibility for a balanced financial restructuring targeted to the specific needs of the debtor. In fact, the debtor can select who shall be affected by the plan and treat creditors, principally equally-ranking ones, differently. Differential treatments are only possible if the debtor provides sound economic justifications for the unequal treatment.[66] While these differences set the restructuring plan ahead of the insolvency plan in terms of flexibility for the debtors, the procedure may play against the use of such mechanism. While the insolvency administrator can reject executory contracts so that the other party can only claim damages from the insolvent estate which in turn are subject to modification by the plan, this option has been explicitly ruled out for the restructuring procedure. The restructuring plan is, therefore, limited in scope to financial obligations.

Differently from the insolvency plan, the required majority to approve a plan is 75% in value with no headcount test.[67] A cross-class cram-down, moreover, requires the approval of the plan by the majority of classes[68] and compliance with a the less stringent absolute priority rule, that allows for the different

[61] S.245(1)(3) and s. 245(2) InsO.
[62] S.245(2) InsO.
[63] For an evaluation of the ESUG-reforms see F. et al., 'Evaluierung – Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen (ESUG) vom 7. Dezember 2011', BT-Drs. 19/4880. Available at : https://dserver.bundestag.de/btd/19/048/1904880.pdf (accessed: 12 August 2022).
[64] There are three grounds upon which an insolvency procedure may be opened: the debtor's inability to pay its debts when they fall due (s.17 InsO), the debtor's prospective insolvency (s.18 InsO), and the debtor's over-indebtedness (s.19 InsO). Prospective insolvency entitles only the debtor to voluntarily apply for insolvency while inability to pay debts and over-indebtedness are grounds for the mandatory opening of an insolvency procedure. Over-indebtedness requires: (i) that the debtor is expected to become unable to pay its debts within the next 12 month; and (ii) that the debtor's liability exceed the debtor's assets.
[65] S.2(2) StaRUG.
[66] Ss.8, 28 StaRUG. See District Court of Hamburg, decision of 12 April 2021 – 61a RES 1/21 = NZI 2021, 544 on the different treatment of creditors.
[67] S.25 StaRUG.
[68] Should only two classes vote on the proposal, the approval of one class suffices unless this is a class of shareholders or subordinated creditors: s.26(3) StaRUG.

treatment of creditors of otherwise equal rank with sound economic justification.[69] The plan may also be refused if parties affected can show that they are worse-off with plan than in an alternative scenario.[70]

Both in Germany and the UK, debtors now have the possibility to choose between different restructuring options. The German restructuring procedure offers flexibility to tailor the restructuring plan to the debtor's needs, for instance by selecting the participating creditors and opting for their different treatment. The German insolvency procedure allows the debtor to adjust their business strategy, reject unprofitable contracts and restructure liabilities arising from such contracts, with distinct majority requirements for approval within a class. The UK Pt 26 schemes allow solvent or distressed debtors the possibility to restructure their financial obligations or compromise their debts with a class-strategy vote requiring a 75% majority and headcount test for all impaired creditors. CVAs only feature a one-class simple-majority mechanism for impaired creditors. The UK Pt 26A restructuring plan adds a new option with a cross-class cram-down that is only available for debtors in distress.

4. Concluding remarks

This paper and the more comprehensive analysis shown in the presentation at the INSOL Europe 2022 Academic Forum, as well as in the collaborative project mentioned in the introduction,[71] show that top-down regulation and bottom-up convergence work smoothly towards the goal of having a more harmonized but still flexibly evolving set of restructuring options across Europe. Flexibility in the harmonization process resulted in being a prudent and sensible approach, in view of the highly diverse nature of domestic restructuring and insolvency proceedings, and the different stages of development of insolvency regimes throughout the EU Member States.

This work shows that the EU's harmonisation language is inadequate insofar as it concentrates on top-down regulation. This paper proved that the EU's harmonisation strategy should acknowledge and embrace the reality of harmonisation, with a combined (top-down and bottom-up) approach. This would result in maximising the opportunities arising from varied approaches to harmonisation and would uncover the role of EU Member States and relevant players as drivers of the harmonisation and convergence process. The UK, not formally bound by EU top-down regulation but certainly concerned with providing a competitive restructuring option, is the best example for the interplay of top-down initiatives and bottom-up regulation that feature similar results across Europe in the pursuit of a market-sought restructuring framework. Germany, on the other hand, is a certainly bound by top-down harmonisation in the EU. The great flexibility offered by the PRD, however, allowed for significant adjustments at the national level. The German restructuring law shows that the bottom-up implementation process was certainly inspired by the PRD's initiative and the spirt of rescue culture echoed by the proposal. It also shows an original desire to offer debtors a competitive restructuring mechanism, which eventually resulted in a legislative product fairly similar to the UK Restructuring Plan.

[69] S.63 StaRUG in connection to ss.26-8 StaRUG.
[70] S.64 StaRUG. On the best-interest-test cf. Higher Regional Court of Dresden, decision of 1 July 2021 – 5 T 363/21 = ZIP 2021, 2596.
[71] Ghio (n 6).

Chapter 11

Natural person ltd.: towards a unified discharge regime for entrepreneurs and consumers

Gauthier VANDENBOSSCHE[*]

1. Introduction

Over the last few decades, the significant growth[1] of – and many negative consequences caused by – over-indebted and insolvent[2] individual entrepreneurs and consumers[3] has created a challenge for legislators in developing an efficient and fair system to deal with personal insolvency. The continual inability to pay off outstanding debts, apart from negative social effects, undermines the initiative that individuals – suffering under a debt-burden – take and, consequently, their productive capacity and the productivity in the wider community. This has a significant impact on the economy through reduced entrepreneurship, purchasing power and consumer spending.[4]

Where over-indebtedness cannot be avoided, it is important to ensure that natural persons can be relieved from an overwhelming debt burden, so that the aforementioned negative effects are mitigated. One way to tackle these challenges are personal insolvency procedures[5] – regulating the insolvency of entrepreneurs and/or consumers – that provide the possibility of a discharge of debts (as a form of debt relief). As debt discharge permanently releases the individual from an obligation at the end of the relevant period, it allows debtors a fresh start[6] and therefore a second chance.[7]

The focus in this paper is on personal insolvency procedures in Europe. In regulating the insolvency of

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[1] See also International Monetary Fund, 'World Economic Outlook: War Sets Back the Global Recovery' (April 2022). Available at: https://www.imf.org/en/Publications/WEO/Issues/2022/04/19/world-economic-outlook-april-2022 (accessed: 12 August 2022).

[2] In this paper, both 'insolvency' and 'over-indebtedness' will be used synonymously to denote severe debt problems and financial distress as well as their psychosocial effects on natural persons. A person is considered to be "insolvent" when they are unable to pay their debts on time. The concept of insolvency could take the form of over-indebtedness: see Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 [2019] O.J. L 172, Recital 73. See also Insolvency and Creditor/Debtor Regimes Task Force, *Report on the Treatment of the Insolvency of Natural Persons* (World Bank, 2014), p. 13. Available at: https://openknowledge.worldbank.org/handle/10986/17606 (accessed: 12 August 2022). Over the years, there have been several attempts at EU-level to define 'over-indebtedness': see e.g. F. Ferretti and D. Vandone, *Personal Debt in Europe: The EU Financial Market and Consumer Insolvency* (Cambridge University Press, 2019), pp. 52-55. See also J-O. Heuer, 'Consumer insolvency proceedings in Europe: an introduction to consumer over-indebtedness and debt relief' in T. Kadner Graziano et al. (eds), *A guide to consumer insolvency proceedings in Europe* (Edward Elgar Publishing, 2019) 2, p. 4.

[3] In this paper, 'consumers', 'non-entrepreneurs' and 'private individuals' (i.e. natural persons not engaged in business activities) will be used interchangeably, with no intended difference in meaning, to differentiate this distinct category of natural persons from entrepreneurs. Where reference is made to entrepreneurs and consumers *together*, 'natural persons' shall be used.

[4] World Bank Report (n 2), pp. 127-128.

[5] In this paper the label 'personal insolvency' encompasses the insolvency of entrepreneurs and consumers.

[6] See N. Huls, 'American Influences on European Consumer Bankruptcy Law' (1992) 15 *Journal of Consumer Policy* 125, 127.

[7] For the purposes of this paper, 'second chance policy' should be understood as the possibility to benefit from a full discharge of debt after a maximum period of three years, as outlined in Directive 2019/1023.

natural persons, some EU Member States distinguish 'commercial' and 'consumer' insolvency proceedings. Commercial insolvency procedures regulate the situation of corporate entities and non-incorporated entrepreneurs (or traders/merchants, *i.e.* natural persons engaged in business activities). In contrast to business insolvency, consumer insolvency did not, at least until the nineties,[8] attract such sustained political and legal attention. At first, discharge provisions were only applicable to companies and entrepreneurs.[9] Later, their scope was extended to consumers, or specific parallel regimes for consumers were introduced.[10] Only in recent years have many Member States adopted or reformed national laws on consumer insolvency, thereby recognising the importance of enabling consumers to be discharged of non-business debts and obtain a second chance.[11]

Whether Member States should run separate systems of discharge of debts for entrepreneurs and consumers, and whether this is justified in relation to the purpose of promoting second chance opportunities, is a complicated question.[12] The premise on which this paper is based is that maintaining distinct discharge provisions between entrepreneurs and non-entrepreneurs is not justified for the purpose of second chance. Focusing on natural persons in an insolvency context, this paper advocates that the purposes of providing a fresh start and second chance, by promoting debt discharge, is as relevant to consumer debtors, as it is to entrepreneurs. It is time to expand the second chance policy and discharge concept beyond the (mere) possibility for entrepreneurs to restart in terms of entrepreneurial activities. Unjustifiably limiting the personal scope of application of (generous) second chance provisions to entrepreneurs excludes other natural persons who face unlimited liability for debts.[13] It is precisely their unlimited personal liability for incurred debts that makes these individual entrepreneurs and consumers face similar issues, in many respects, as natural persons. As a result, it is argued that a similar (discharge) treatment for individuals who are similarly situated, is needed. This creates the need for a unified discharge regime available to all natural persons, that releases the individual debtor, totally or partly from personal liability. This should increase the opportunities for natural persons to be given a fresh start and enable them to recover from over-indebtedness, so that they can contribute to the overall economy.[14]

The remainder of the paper is structured as follows: section 2 will outline Directive 2019/1023, which is the starting point of this Paper. Then, in section 3 the existing insolvency procedures of (some) EU-Member States will be divided into a typology; on the one hand, on the basis of the prevalent procedures (3.1), on the other hand, on the basis of the type of debtors (3.2). In section 4, I will make a case for a unified discharge regime for natural persons on the basis of two main reasons (4.1 and 4.2). A general conclusion will be given in section 5.

2. Directive 2019/1023: Discharge of debt for entrepreneurs

2.1. Directive (EU) 2019/1023

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[8] World Bank Report (n 2), p. 51.
[9] See also I. Ramsay, 'Towards An International Paradigm Of Personal Insolvency Law? A Critical View' (2017) 17 *QUT Law Review* 15, 18.
[10] V. Sajadova, 'Consumer insolvency proceedings: comparative legal aspects' in T. Kadner Graziano et al. (eds), *A guide to consumer insolvency proceedings in Europe* (Edward Elgar Publishing, 2019) 14.
[11] Ferretti and Vandone (n 2), p. 212.
[12] See also T. Richter, 'Art. 24' in C Paulus and R Dammann (eds), *European Preventive Restructuring. Article-by-Article Commentary* (C.H. Beck, 2021) 269, p. 270.
[13] See also F. Javier Arias Varona et al., 'Discharge and entrepreneurship in the preventive restructuring directive' (2020) 29 *International Insolvency Review* 8, 10.
[14] European Commission, Directorate-General for Justice and Consumers, 'Study on a new approach to business failure and insolvency: comparative legal analysis of the Member States' relevant provisions and practices' (2016). Available at: https://op.europa.eu/en/publication-detail/-/publication/3eb2f832-47f3-11e6-9c64-01aa75ed71a1/language-en (accessed: 12 August 2022).

The Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 deals with various aspects of restructuring and insolvency. One of the main elements of the Directive are the provisions on second chance (or fresh start) for *entrepreneurs*. An important part thereof are the rules on procedures leading to a discharge of debt incurred by insolvent entrepreneurs, mentioned in art. 1(1)(b) and further regulated in Title III of the Directive, which requires Member States to ensure that honest insolvent entrepreneurs have access to a procedure that can lead to an automatic,[15] full discharge of debt[16] after a period that does not exceed three years.[17] The latter is considered to be a reasonable period of time by the EU for honest insolvent entrepreneurs to be fully discharged of debt.[18]

2.2. Optional extension to non-entrepreneurs

The minimum provisions contained in Title III of the Directive on discharge of debt are, in principle, restricted to entrepreneurs. However, at the same time, the Directive explicitly states that Member States *may extend* the application of the debt discharge procedures to insolvent natural persons who are not entrepreneurs, i.e. consumers and, in accordance with national law, managers and directors of companies.[19] Recital 21 acknowledges that consumer over-indebtedness is a matter of great economic and social concern which is closely related to the reduction of debt overhang. Therefore, according to the recital, it would be advisable for Member States to extend provisions of the Directive concerning discharge of debt to consumers, *at the earliest opportunity*. While the Directive does not require that discharge be extended to other natural persons than entrepreneurs, the recitals strongly encourage Member States to enlarge the scope of discharge principles to consumers, thereby applying the same regime to entrepreneurs and consumers.

This approach is not new and it had been put forward by the 2014 Commission Recommendation on a new approach to business failure and insolvency. Although consumer over-indebtedness and consumer bankruptcy were not covered by the scope of the Recommendation, Member States were invited to explore the possibility of applying the recommendations also to consumers.[20]

2.3. Cautious approach

Binding rules on discharge for non-entrepreneurs remain outside the mandatory scope of the Directive. However, the 2016 Impact Assessment uncovered that several Member States are already treating the discharge and second chance for natural persons in the same way (i.e. under the same insolvency regime), irrespective of whether the indebted person is a consumer or entrepreneur, and have common rules for entrepreneurs and consumers. Therefore, given the fact that Member States are required to regulate a discharge period for entrepreneurs in line with the minimum requirements of the Directive, it is argued that even non-binding provisions on the extension of that provision to consumers could have a tangible impact on the ground over and above the 2014 Recommendation on a new approach to business failure and insolvency in the future.[21] In other words, promoting entrepreneurialism by drafting

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[15] See Directive 2019/1023, Article 21(2).
[16] See Directive 2019/1023, Article 2(1)(10). See also SWD(2016) 357 final, 154.
[17] Directive 2019/1023, Article 23 allows Member States to make derogations from these principles in a number of circumstances. See also Directive 2019/1023, Recital 78.
[18] See Directive 2019/1023, Recital 1. See also European Commission, 'Entrepreneurship 2020 Action Plan' COM(2012) 795 final.
[19] Directive 2019/1023, Article 1(4).
[20] Commission Recommendation 2014/135/EU of 12 March 2014 on a new approach to business failure and insolvency [2014] OJ L 74, Recital 15.
[21] SWD(2016) 357 final, 55-56 and 86. See also J. Niemi-Kiesiläinen, 'Consumer Bankruptcy in Comparison: Do we cure a market failure or a social problem?' (1999) 37 *Osgoode Hall Law* J 473, 475.

generous discharge rules in a system where to same personal insolvency procedure is open to entrepreneurs as well as non-entrepreneurs (and thus modifying existing personal insolvency procedures for all natural persons), should cause a side-effect of increased access to discharge for consumers.[22]

While Directive 2019/1023 aimed to foster entrepreneurship, it will not necessarily affect the situation of consumers.[23] This will be especially true in jurisdictions that have separate insolvency proceedings for entrepreneurs ('commercial insolvency procedures') and non-entrepreneurs ('consumer insolvency procedures'). Indeed, several Member States treat entrepreneurs and consumers completely different in terms of discharge (see 3.2). In those jurisdictions who distinguish between commercial and consumer insolvency proceedings, the choice for a non-binding, 'soft law', rather than binding, legislation on second chance for consumers could lead to Member States having stricter consumer discharge rules than those mandated by Title III of the Directive. When Member States decide not to extend the principles of the Directive to non-entrepreneurs, the latter could namely be subject to longer discharge periods and face tougher second chance frameworks compared to non-entrepreneurs in Member States that have implemented the principles.[24] This is particularly true seeing as the average discharge period for consumers in Member States is currently five years[25] since (court-imposed) discharge for consumers is typically strictly conditioned on the fulfilment of a multi-year payment plan,[26] while the discharge period under the Directive is of maximum three years.

3. Typology of insolvency procedures

At this stage, the mere *possibility* to include consumers within the scope of the discharge mechanism provided for by Directive 2019/1023 needs to be considered against existing national insolvency frameworks for natural persons. Here, two types of access-restrictions are relevant to apply for insolvency procedures: (i) restrictions that depend on the type of procedures and; (ii) restrictions that depend on the type of debtor.[27]

3.1. Typology of procedures

Insolvent natural persons may have access to different insolvency procedures and the available range of options open to debtors varies between Member States. Discharge of debt can either be a straight discharge, where unconditional freedom from debt is given as a result of a bankruptcy procedure, or a conditional discharge dependent on a payment plan in a debt settlement procedure.[28] Both types are recognised by Directive 2019/1023, which states that a discharge of debt should be available in procedures that include a realisation of assets ('bankruptcy' or 'liquidation procedures'), a repayment plan[29] ('debt settlement' or 'restructuring procedures'), or a combination of both.[30] Indeed, in all countries where discharge is possible, it is dependent either on liquidation of the debtor's assets and/or on compliance with a payment plan. As a result, in some Member States entrepreneurs and/or consumers may have access to both bankruptcy and debt settlement procedures, while in others, they

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[22] See also I. Ramsay, 'A Tale of Two Debtors: Responding to the Shock of Over-Indebtedness in France and England – a Story from the Trente Piteuses' [2012] 75 *Modern Law Review* 212, 212-215 and 240.
[23] See also J-O Heuer (n 2) 7.
[24] Richter (n 12), p. 270.
[25] See J. Kilborn, 'Expert Recommendations and the Evolution of European Best Practices for the Treatment of Overindebtedness, 1984-2010' (2010). Available at: https://www.iiiglobal.org/sites/default/files/19036368v1%20-%20Expert%20Recommendations%20and%20the%20Evolution%20of%20European%20Best%20Practices%20%28Jason%20Kilborn%29.PDF (accessed: 12 August 2022).
[26] Sajadova (n 1010), p. 35.
[27] Sajadova (n10), p. 21.
[28] European Commission (n 14), pp.290; 312; 358.
[29] See Directive 2019/1023, Article 2(1)(11).
[30] See Directive 2019/1023, Recital 75.

only have access to bankruptcy procedures or debt settlement procedures. The difference between these bankruptcy and debt settlement procedures essentially lies in how quickly or easy discharge will be achieved.[31] Both bankruptcy and debt settlement procedures have advantages and disadvantages.

3.2. *Typology of debtors*

3.2.1. Entrepreneurs, consumers, natural persons

Personal insolvency procedures may exist for all natural persons, but access may depend on whether the debtor is an entrepreneur or a consumer. The classification of natural persons within the insolvency framework, and thus the typology of insolvency procedures according to the type of debtors, primarily depends on how the entrepreneur is classified.[32] This, in turn, has an influence on how the consumer is classified in the insolvency framework (see Table 1). This aspect of divergence may cause concern, particularly when entrepreneurs do not have access to suitable procedures. Outdated categorisations[33] may also lead to consumers not having access to suitable procedures.

Table 1. Typology of type of debtors. The categorisation of debtors dictatesto which procedures the debtor is subject or is entitled to access.

In respect of insolvency proceedings, entrepreneurs may – broadly speaking – be placed in three main categories[34]:	**classification of the entrepreneur**	**classification of the non-entrepreneur**
option (i)	all debtors regardless of their legal status (*i.e.* any legal entity or natural person, including natural persons who have become indebted in their private, non-business capacity)	
option (ii)	any other business (*i.e.* traders, artisans, self-employed professionals and legal entities, whereas other natural persons may be excluded from these procedures) ‘commercial insolvency procedures’	insolvency procedures provided for non-entrepreneurs take place as discrete provision for consumers only ‘consumer insolvency procedures’
option (iii)	natural persons (*i.e.* grouped together with and treated the same as consumers)	

[31] European Commission (n 1414), p. 310.
[32] Ibid, pp. 289; 300.
[33] See also 4.1.
[34] Entrepreneurs may also be regarded as a separate category.

	‘natural person procedures’

Thus, concerning the types of debtors, personal insolvency procedures exist on a continuum, ranging from insolvency proceedings that are open to any natural person (‘natural person procedures’), to entrepreneurs (‘commercial insolvency procedures’) and to non-entrepreneurs (‘consumer insolvency procedures’).

3.2.2. Natural person procedures

Some jurisdictions have historically not distinguished between individual entrepreneur (or trader) and consumer insolvency.[35] In other words, in the countries, insolvency procedures are open to *any* natural person. This is for example the case in England and Wales, the Netherlands, and Germany.[36] A 2016 report by the University of Leeds uncovered that in 43% of the Member States, entrepreneurs have access to consumer procedures *as a natural person*, and in 18%, entrepreneurs have access to these procedures yet with some restrictions,[37] based either on the size of the enterprise or type of proceedings available. This means that there are several jurisdictions where there is one single regime for discharging debt, regardless of whether the debtor is an entrepreneur or a consumer. In those jurisdictions that simply allow any natural person to enter the procedure (as long as they fulfil the other access criteria), there is little difference in treatment between the entrepreneur and consumer.[38]

3.2.3. Commercial insolvency procedures vs. consumer insolvency procedures

Although the 2016 Proposal for Directive 2019/1023 stated that consumers largely have the same (discharge) treatment as entrepreneurs under national insolvency laws[39] and the Impact Assessment accompanying the Directive mentioned that, in the majority of the Member States, there is no distinction between consumers and other natural persons and there are no special procedures or mechanisms for consumer insolvency (since the personal bankruptcy/insolvency proceedings are also available to them), this is not the case in all Member States.[40]

In the past decades, countries which did not provide insolvency procedures inclusive of debt discharge for non-business debtors introduced consumer insolvency provisions as a (separate) new legal instrument.[41] Consumer insolvency procedures exist, for example, in Belgium, France, and Poland. In those jurisdictions, the approach to consumer insolvency entails (long-term[42]) repayment plans, whereby a consumer is committed to repaying a portion of outstanding debt over a period of time.[43] Indeed, in many Member States there is no access to discharge for consumers other than through a debt settlement procedure involving a payment plan, coupled with some type of oversight over economic activity and circumstances.[44]

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[35] Ramsay (n 22) 215.
[36] Sajadova (n10), p. 20.
[37] Some Member States only allow entrepreneurs with lower value business to access procedures available to natural persons.
[38] European Commission (n 14), p. 340.
[39] COM(2016) 723 final, 4.
[40] SWD(2016) 357 final, 209.
[41] J-O. Heuer, ‘Social Inclusion and Exclusion in European Consumer Bankruptcy Systems’ (2013), 2. Available at: https://www.academia.edu/3992692/Social_Exclusion_in_European_Consumer_Bankruptcy_Systems (accessed: 12 August 2022).
[42] See J. Kilborn, ‘La Responsabilisation De L'Economie: What the United States Can Learn from the New French Law on Consumer Overindebtedness’ (2005) 26 *Michigan Journal of International Law* 619, 622.
[43] See J. Niemi, ‘Consumer Insolvency in the European Legal Context’ (2012) 35 *Journal of Consumer Policy* 443, 445.
[44] European Commission (n 14), p. 360.

4. The case for a unified discharge regime for natural persons

The main thesis of this paper is that it should be recognised that insolvent entrepreneurs – particularly those who are sole traders with no or very few employees – suffer similar detriment and vulnerabilities to over-indebted non-entrepreneurs[45] and, that therefore, they should be subject to the same discharge regime. In other words, jurisdictions where entrepreneurs are treated in the same way as other natural persons should be considered as a best practise. This section makes the case for a unified discharge regime for *all* natural persons on the basis of two main reasons. First, placing entrepreneurs within 'commercial insolvency procedures' and, conversely, non-entrepreneurs within 'consumer insolvency procedures' causes problems of (arbitrary) delineation (see 4.1). Second, a unified discharge regime for natural persons offers a better opportunity to reflect the common, special needs of insolvent individuals (*i.e.* rehabilitation of the debtor and the social good) – as opposed to companies (see 4.2).

4.1. Reason 1: problems of delineation

Directive 2019/1023 focuses on regulating the concerns of a natural person in its capacity as an entrepreneur.[46] Yet, as natural persons engage in a wide variety of activities questions arise as to the distinction between entrepreneurs and non-entrepreneurs in the context of debts and indebtedness.[47] The World Bank Report on the Treatment of the Insolvency of Natural Persons rightly indicates that persons who engage in small-scale business activity in their own name often find themselves in a similar situation as wage-earning debtors who have become insolvent.[48] Therefore, the promotion of entrepreneurialism based on the second chance approach, exacerbates the difficulty of defining 'entrepreneurs'.[49] It is becoming increasingly difficult to draw a meaningful distinction between the entrepreneur (who is engaged in business) and non-entrepreneur (or 'pure' consumer). The same can be said about the distinction between consumers and non-consumers.

The situation of company directors is a first example of the difficulties in defining the concept of 'entrepreneur'. The concept of entrepreneur within the meaning of Directive 2019/1023 should, according to Recital 73, have no bearing on the position of managers or directors of a company, which should be treated in accordance with national law. In other words, the Directive does not regulate the position (and second chance) of persons who are merely managers or directors of a company. In Belgium, there is currently a debate on whether natural persons exercising the mandate of director in a company can be qualified as 'enterprise', i.e. persons exercising a professional activity independently. Established case law has established that natural persons who are company directors can be qualified as 'enterprise', provided that some conditions are met, and can accordingly be subject to bankruptcy.[50] However, the Cour de Cassation ruled on 18 March 2022 that a natural person is an enterprise, only when he or she constitutes an organisation consisting of an arrangement of material, financial or human resources with a view to exercising a professional activity on an independent basis. A company director who exercises his or her mandate without any organisation would thus not be an enterprise.[51]

Another example that creates difficulties for the entrepreneur-concept are platform workers and the accompanying changes in the labour market. In many sectors of the economy, new ways of organising work have evolved. The transformation of the labour market during the past few decades has turned

[45] Ibid, p. 301.
[46] For the purposes of the Directive an 'entrepreneur' is a natural person exercising a trade, business, craft or profession: see Article 2(1)(9).
[47] World Bank Report (n 2), p. 10.
[48] Ibid, p. 16.
[49] G. McCormack, *The European Restructuring Directive* (Edward Elgar Publishing, 2021), p. 205.
[50] See D. Bruloot et al., 'Het faillissement van bestuurders van rechtspersonen en onbeperkt aansprakelijke vennoten: licht aan het einde van de tunnel' (2021) 62 TIBR RS-19.
[51] Cass. 18 March 2022, C.21.0006.F.

many providers of low-skill services from employees into self-employed service providers.[52] As a result, the line between entrepreneurship and salaried work is weakening when self-employed professionals work by themselves for a few clients and each contractual relationship resembles an employment relationship without the benefits of salaried work.[53]

4.2. Reason 2: entrepreneurs and consumers face the same concerns in an insolvency situation

Similar issues: A fundamental reason for a unified discharge framework for all natural persons is that natural persons face shared key issues, whether or not business activity is a part of the context of the insolvency.[54] Indeed, individual entrepreneurs will in many respects face similar issues to those of consumers. For individual entrepreneurs, there is no legal distinction between them as an individual and the business.[55] Hence, the rationale for treating entrepreneurs (*mutatis mutandis* consumers) the same as other natural persons is presumed to be that these debtors suffer the same detriments and vulnerabilities as an individual in a private capacity (*mutatis mutandis* entrepreneurs).[56] In other words, the rationale of discharge regimes is equally pertinent to all debtors, whether entrepreneurs or consumers.[57]

Risk-taking: The regulation of personal insolvency has an influence on how individuals, both entrepreneurs and consumers, deal with risks in their economic activity.[58] The traditional hypothesis is that entrepreneurs generally face a higher risk of financial failure as compared to wage earners and, hence, a second chance policy provides a necessary cushion to accommodate their increased financial vulnerability.[59] Any entrepreneur exercising a trade, business, craft or independent, self-employed profession can run the risk of becoming insolvent.[60] Therefore, entrepreneurship inherently includes the risk of (business) failure, which is part of a dynamic, healthy market.[61] Here, discharging debt after the failure of a business may mitigate the risk involved in entrepreneurship and stimulate the willingness to opt for self-employment.[62] Discharge is said to provide a liability safety net to encourage entrepreneurial individuals to take commercial risks for the benefit of society[63] and to protect entrepreneurs from the potentially devastating consequences of unlimited liability. It is argued that the scope of the second chance policy is plausibly a product of a country's predisposition towards entrepreneurship, because of a relationship between the availability of debt discharge in an insolvency regime and the extent to which the government wishes to foster entrepreneurial-risk taking in the society.[64] In short, the encouragement of commercial risk-taking is at the heart of second chance policy.[65]

Yet, for consumers, simply engaging in modern economic life is also a sort of entrepreneurial risk.[66] First of all, the current economic model encourages consumers to use debt to finance consumption.[67]

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[52] World Bank Report (n 2), p. 16.
[53] J. Arias Varona (n 13), pp. 14-15.
[54] World Bank Report (n 2), p. 15.
[55] J Kilborn, 'The Personal Side of Harmonizing European Insolvency Law' (2016), 25. Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2816618 (accessed: 12 August 2022).
[56] European Commission (n 14), p. 301.
[57] Ibid, p. 333.
[58] SWD(2016) 357 final, 82.
[59] R. Efrat, 'Global Trends in Personal Bankruptcy' (2002) 76 *American Bankruptcy Law Journal* 81, 81.
[60] Directive 2019/1023, Recital 72. See also Heuer (n 2), p. 10.
[61] SWD(2016) 357 final, 40. .
[62] J. Arias Varona (n 13), p. 15.
[63] J. Kilborn, 'Mercy, Rehabilitation, and Quid Pro Quo: A Radical Reassessment of Individual Bankruptcy' (2003) 64 *Ohio State Law Journal* 855, 864.
[64] Efrat (n 59), 98.
[65] See also Ramsay (n 22), 240.
[66] World Bank Report (n 2), pp. 39-40.
[67] Ferretti and Vandone (n 2), p. 1.

Indeed, international competitiveness calls for nations to encourage individuals to take reasonable risks in smoothing consumption through credit transactions.[68] Since consumer lending and borrowing benefit both the general quality of consumer life and the overall economy, many policymakers around the world today ascribe significant value to individual borrowing from future income with a view to smoothing and optimising consumption patterns over time.[69] As a result, consumers are, like businesses, encouraged to be responsible risk-takers and to behave like responsible credit users, investing in education or training, and managing their financial future in an increasingly financialised culture, making appropriate use of credit markets.[70] The increased debt problems of private households – and, as a consequence, the adoption of second chance policy in consumer insolvency – caused by the growth of consumer credit are traditionally justified by the deregulation of countries' consumer credit market which has taken place since the late 1970s and early 1980s, causing greater affordability of, and ultimately greater access to, consumer credit.[71] A credit-based economy means that individuals sustain considerable levels of debt, and this results in higher rates of personal over-indebtedness – and thus personal insolvency.[72] Here, debt discharge could be said to resolve the tensions between a consumerist-oriented credit driven society and the inevitable problems of non-repayment that this causes for certain individuals.[73]

The view that only the uncertainties of business justify a second chance, or more generous discharge provisions, is outdated. Accordingly, the difference between the risk-taking entrepreneur – for whom the second chance policy would exist – and other natural persons can be questioned. Failure and over-indebtedness are situations that affect all natural persons, whether entrepreneurs or consumers. The idea behind a second chance policy can be applied to both entrepreneurs and consumers, with a view to supporting those who suffer detriment through no fault of their own, beyond normal circumstances.[74] In addition to focusing on the risks that cause insolvency, emphasis should also be put on rehabilitation within a reasonable time period once the risk has occurred. The absence of adequate second chance provisions hampers economic activities and therefore, a full discharge of debts – subject to certain conditions – should be offered to both entrepreneurs and consumers (provided that they are 'honest' debtors).[75]

Economic and social concerns: The World Bank Personal Insolvency Report, in its discussion of insolvency of natural persons, highlights the distinction between the all-encompassing economic concerns of a business insolvency, and that of a natural person, where there will also be an inherent (important) 'social' (or 'human') factor[76] in any insolvency case involving a natural person as debtor.[77]

Economic rationale: The rationale of providing a second chance for natural persons, apart from humanitarian goals, involves a powerful element of economic concerns.[78] Allowing honest entrepreneurs to benefit from a second chance after overcoming bankruptcy is crucial for ensuring a dynamic business environment and promoting innovation. Second chance, in its narrow sense, means

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[68] World Bank Report (n 2), pp. 39-40.
[69] Kilborn (n 42), p. 666.
[70] Ramsay (n 9), 21. See also Niemi-Kiesiläinen (n 21), 476.
[71] Heuer (n 41), p. 2.
[72] J.M. Garrido, 'The Role Of Personal Insolvency Law in Economic Development' (2014) 111 *World Bank Law Review* 111, 113.
[73] McCormack (n 4949), pp. 219-220. See also Kilborn (n 63), 885.
[74] European Commission (n 14), p. 320. See also World Bank Report (n 2), p.18; 35; Kilborn (n 42), 666; Sajadova (n 10), pp. 10-11.
[75] SWD(2016) 357 final, 27.
[76] The most important social reason for a second chance is that natural persons – both consumers and entrepreneurs – and their families could avoid being caught in a debt-trap for life, with all the precarious social consequences that this situation may cause to individuals and their families. In particular, excessively long discharge periods for natural persons result in continuing poverty and exclusion of these individuals. In this context, the importance of human rights of natural persons in an insolvency context can also be highlighted. See SWD(2016) 357 final, 11; SWD(2016) 357, 41. See also Heuer (n 2), p. 10; J. Arias Varona (n 13), 11.
[77] European Commission (n 14), p. 283.
[78] World Bank Report (n 2), p. 17. See also Garrido (n 72), 117.

offering the opportunity to entrepreneurs to start again in terms of entrepreneurial activity[79] and evidence shows that entrepreneurs who have become insolvent have more chances of being successful the next time[80]. In particular, discharge of debt under reasonable conditions, received after a period which is not excessively long – long discharge periods can create a significant disincentive to entrepreneurial activity – forms an integral element to fresh start and achieve the goal of promoting a second chance for those who wish to learn from their mistakes and restart a business. Since inefficient second chance frameworks result in entrepreneurs being locked into debt-traps or driven to the black economy, discharge within a reasonable time period should ensure that the debtor is liberated from a debt overhang which otherwise might cause him either to stop working at all or to submerge into a shadow economy.[81] As a result, effective second chance provisions may have a positive influence upon entrepreneurship[82] and employment, because second chance is an important incentive for honest but bankrupt entrepreneurs to re-enter the jobs market and the productive economy.[83] In summary, facilitating a discharge of debt for entrepreneurs would help to avoid their exclusion from the labour market and enable them to restart entrepreneurial activities, drawing lessons from past experience.[84]

The second chance policy also has an economic rationale for consumers. Over-indebtedness is a macroeconomic issue, because a significant number of over-indebted individuals creates a debt overhang and acts as a drag on economic growth.[85] Remaining in a debt-trap has detrimental consequences both for the indebted consumer and for society, because these natural persons do not contribute to economic growth for different reasons, including reduced consumption and hence aggregate demand,[86] withdrawal from labour market, and lower potential for entrepreneurship. Instead of returning to economically productive life, they may rely on social services support, which results in increased costs for Member States' social security schemes.[87] Easing consumption by freeing up future income for present consumption is an important goal of a personal insolvency regime.[88] In particular, consumers discharged of debts can start buying services and products and therefore contribute to the rise of GDP. Evidence shows that shorter debt discharge periods for individuals have a positive impact on consumers, as they are quicker to re-enter the cycle of consumption and able to come back to normal professional and personal life when they are freed from debt, which ultimately leads to economic growth.[89] Therefore, helping consumers back into the economic spending cycle is an important part of good functioning markets and retail financial services.[90]

It should be clear that the impossibility of repayment and difficult conditions of discharge cause both entrepreneurs and consumers to fall in a debt trap, which may lead them to plunge into the 'black economy'. Although there is a difference in the finality of the economic rationale between offering entrepreneurs and consumers a second chance, the underlying foundation of encouraging entrepreneurship and encouraging consumption is essentially the same, namely deleveraging to maximise economic activity. Therefore, there is no need to distinguish between entrepreneurs and consumers in terms of discharge periods: the same arguments linked to re-integration into the economic

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[79] SWD(2016) 357 final, 4, 11.
[80] Directive 2019/1023, Recital 72. See also SWD(2016) 357 final, 200-201.
[81] C. Paulus, 'Art. 20' in C. Paulus and R. Dammann (eds), *European Preventive Restructuring. Article-by-Article Commentary* (C.H.Beck, 2021) 249, 250; McCormack (n 49), p. 209.
[82] See Recommendation 2014/135/EU Recital (12); Commission staff working document, 'Impact assessment accompanying the document Commission Recommendation on a New Approach to Business Failure and Insolvency' SWD(2014) 61 final, 21. See also J. Armour and D. Cumming, 'Bankruptcy Law And Entrepreneurship' [2018] 10 *American Law and Economics Review* 303, 303-304.
[83] SWD(2016) 357 final, 168.
[84] See Directive 2019/1023/EU, Recital (16).
[85] Ramsay (n 9), 19.
[86] See also L. Laeven and T. Laryea, 'Principles of Household Debt Restructuring' (2009) IMF Staff Position Note. Available at: https://www.imf.org/external/pubs/ft/spn/2009/spn0915.pdf (accessed: 12 August 2022).
[87] See also Niemi-Kiesiläinen (n 2121), p. 480. SWD(2016) 357 final, 27. See also World Bank Report (n 2), p. 13.
[88] Kilborn (n 55), 18.
[89] COM(2016) 723 final, 4.
[90] Ibid, 14.

life play out for both.[91] Although it could be argued that, historically, discharge provisions have been indented to rehabilitate the once owner of a failed and liquidated business,[92] increased legislative concerns should be given to extending the discharge provisions in the Directive beyond individual entrepreneurs and, instead, include all natural persons.[93] This should facilitate the return of debtors to entrepreneurship and consumption with the all-encompassing, underlying goal of offering incentives to engage in (any) income-producing activity – and the most prominent, fundamental, and effective way to do this is by offering discharge of unpaid debts.[94]

5. Conclusion

It is time to extend second chance policy beyond the mere opportunity to start again in terms of entrepreneurial activity. In the radically changed legal, social and economic environment of today (introducing an increasingly generous second chance policy for entrepreneurs in insolvency procedures, with the European Commission pressing for a three-year maximum discharge period), imposing tougher second chance frameworks – with stricter conditions for discharge – on consumers (or their debts) makes no sense anymore. Maintaining distinct discharge provisions between entrepreneurs and non-entrepreneurs is not justified for the purpose of second chance. There is no apparent reason why consumers should have a different discharge regime than entrepreneurs: in both cases what is at stake is the personal liability of the debtor, and thus the rehabilitation of the debtor.[95] There is a need for efficient and effective personal insolvency procedures for deleveraging over-indebted individuals and re-integrating them into economic society, either as entrepreneurs or consumers.[96] As a result, the personal scope of second chance frameworks, with a focus on a timely discharge, after no more than three years, should be extended to cover *all* natural persons, including consumers, so that the opportunity for honest individuals to obtain a discharge is given to both consumers and entrepreneurs under the same conditions – with the underlying general goal of rehabilitation of insolvent natural persons in mind.

[91] SWD(2016) 357 final, 83.
[92] McCormack (n 49), p. 222.
[93] See also C. Paulus, 'Art. 20' in CG Paulus and R Dammann (eds), *European Preventive Restructuring. Article-by-Article Commentary* (C.H. Beck, 2021) 249, 250.
[94] World Bank Report (n 2), p. 92.
[95] SWD(2016) 357 final, 55.
[96] Kilborn (n 55), 8.