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Options for Troubled Enterprises

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CHAPTER ONE:

Restructuring Processes

A new breed of bankruptcy

BY JONATHAN CARSON

A new breed of corporate bankruptcy is taking centre stage in today's global economic picture. As distressed US companies continue to seek Chapter 11 as a strategic alternative to resolve their financial and operational issues, they follow new paradigms to navigate the procedural and financial hurdles within the corporate bankruptcy process. The automakers' new twist on Chapter 11 provides one example of how the face of corporate bankruptcy is evolving as a strategic alternative. In addition, the widespread occurrence of Section 363 asset sales, prepackaged and pre-arranged bankruptcies represents renewed models of bankruptcy that companies rely upon to salvage and preserve value. Unlike previous recessions, we see that traditional, 'free-fall' restructurings have become the exception in the US, rather than the norm.

A number of driving factors contribute to the changing face of bankruptcy. Companies undergoing Chapter 11 today must contend with formidable restrictions on the process, as well as on the timeline allotted for a successful restructuring. Limited financing options, restrictions imposed by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) and the increased complexity of capital structures create the need for a more consensual, accelerated bankruptcy process. But in spite of these challenges, troubled companies continue to adapt to the steep demands of the current economic recession by extracting value from the Chapter 11 process in innovative ways.

The auto industry's Chapter 11 'hybrid'

As we look to the current restructuring cycle, the recent spate of automaker Chapter 11 filings highlight one new direction for corporate bankruptcy. The Chrysler and GM filings spawned a Chapter 11 'hybrid' with unprecedented government involvement, setting the stage for other companies that may be considered 'too large to fail'. The government's role as both the financier for the Chapter 11 proceedings as well as the predominant stakeholder following the companies' emergence from bankruptcy played a critical role in these restructurings.

In addition, Section 363 of the US Bankruptcy Code significantly contributed to the accelerated pace of the proceedings by allowing the automakers to shed underperforming assets free and clear of liens. Indeed, the Second Circuit Court of Appeal's decision on 5 August 2009 to uphold the sale of Chrysler, despite numerous objections from its creditors, foretells the growing prevalence and acceptance of Section 363 asset sales in the course of bankruptcy. Industry analysts expect that this Second Court of Appeals decision will reinforce the ability for businesses to argue the need for expeditious asset sales to avoid a 'melting ice cube' syndrome.

So despite the challenges that remain ahead for the automakers, their Chapter 11 proceedings provide a historic example of the potential for corporate bankruptcy to create new pathways for corporate renewal. As we see other industries and companies that present potential systemic risk to the US and global economy, the automaker bankruptcies will serve as one roadmap to mitigate complex issues.

New paradigms gain prominence

Looking beyond the automakers' Chapter 11 filings, we see that the majority of today's bankruptcies rely on new paradigms as alternatives to the traditional Chapter 11 bankruptcy. Across all industries, distressed companies employ Section 363 of the US Bankruptcy Code as a more effective mechanism for selling assets than through traditional state foreclosure laws. As a result, Section 363 asset sales increasingly occurred across publicly-traded Chapter 11 cases that filed so far this year, including Lyondell Chemical Company, Nortel Networks and Midway Games, among many others.

In addition, prepackaged and pre-arranged bankruptcies play a prominent role in today's restructuring environment. The recent prepackaged Chapter 11 filing of publishing giant Reader's Digest highlights this growing trend. These bankruptcies provide an accelerated course through bankruptcy by allowing the debtor to handle its negotiations with major stakeholders prior to filing the petition for Chapter 11. Indeed, according to a report issued by Standard & Poor's earlier this year, the number of pre-packaged bankruptcies reached an eight-year high in Q1 2009, and this trend is likely to continue as the rating agency predicts that the junk bond default rate will hit 14.3 percent by March 2010.

In other instances, we see other companies using Chapter 11 as a platform for M&A transactions. Printing companies Vertis and American Color Graphics successfully used Chapter 11 to merge into one entity following their respective, individual pre-packaged bankruptcies. Noted by Vertis' lawyers as the "first large (or maybe first ever) 'double-prepack-merger," this case shows the potential for distressed companies to use Chapter 11 bankruptcy to find original solutions to their financial and operational issues.

Navigating the evolving bankruptcy process

Today's corporate bankruptcies are more complex than ever. Many companies that undergo Chapter 11 bankruptcy on a faster timeframe find an expeditious bankruptcy to be a productive approach. However, it is important that they follow the guidance of seasoned professionals, and take the time they need in order to maximise the benefits that corporate bankruptcy has to offer.

To start with, companies navigating the 'new breed' of

bankruptcy can look to the following guiding principles to emerge successfully. Firstly, be prepared – key company information should be accessible to help expedite the process and easily locate required records. Data and other information needed during the process can include financial statements, vendor listings, employee/retiree listings, contracts, real-estate leases, etc. Secondly, be transparent – develop a strategic communications strategy to disclose forward progress to relevant constituencies during the restructuring process– from employees and vendors to financial institutions and the media. It is critical that you know what to say, when and how to say it. Finally, be sensitive – when dealing with financial matters of this scale, emotions can run rampant. Be sensitive to the needs of stakeholders and provide reassurance that their matter is one of significance and is being addressed.

While the bankruptcy game may be changing, it continues to offer a strategic alternative for companies seeking to remain profitable and competitive. Companies that approach the process strategically and expeditiously stand to gain much, despite the unique procedural and financial challenges presented by the current recession. Regardless of the exit strategy that corporate debtors use in navigating Chapter 11, distressed enterprises can continue to maximise value from the US Bankruptcy Code as it evolves to meet the needs and demands of the current economic environment.

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Ultra Stores success in the Chapter 11 fast lane

BY JOSHUA J. ANGEL

A wise old attorney once said that any fool lawyer with a form book and a fountain pen can file a Chapter 11 petition for a client, but emerging from Chapter 11 with the client's skin intact is another matter entirely. This is the story of how one company found its way in and out of bankruptcy with its skin intact, when others in the same industry had failed.

Ultra Stores Inc. was incorporated and opened its first retail jewellery store in 1991. By December 2008, its footprint consisted of 105 outlet stores, 57 jewellery departments in three department store chains, three airport stores, and 16 other stores in various locations. Revenues for the three most recent fiscal years were in the $150m range, and EBITDA went from $17m in 2007 to $12.5m in 2008 and $8m in 2009. Ultra's capital structure included a $35m asset-based revolving credit agreement provided by Bank of America (BoA), and a junior secured term loan of $15m provided by Crystal Capital Fund.

By the end of 2008, borrowing under the revolving credit facility had reached about $16m, with the loan – then current – secured by a first lien on substantially all of Ultra's assets. The amount Ultra could borrow from BoA was determined by a formula that multiplied Ultra's inventory and accounts receivable by a fixed factor of their respective net values minus certain reserves as BoA reasonably mandated. Over the previous year, BoA had severely limited the amount Ultra could borrow, plunging the company into a full-fledged liquidity crisis.

When it made the pre-petition term loan, Crystal entered into an intercreditor agreement with BoA that required that Crystal provide BoA with 45 days' notice before invoking a default. In December 2008, the BoA loan was current, meaning that Crystal's loan could not be called into default until 45 days after the expected covenant-busting date of 31 January 2009. That gave Ultra a window of less than three months to organise its team, evaluate its options, and negotiate and put into effect a plan for the company's rehabilitation.

Ultra's business model

Ultra obtained its merchandise in two ways: vendor credit purchases and consignment or 'memo' purchases. Generally speaking, with credit purchases, goods are acquired from vendors on open account, with title passing on receipt and payment due at some later date. Title to consigned merchandise typically remains with the consigner, pending its sale by the consignee, and consignments must be perfected in accordance with the Uniform Commercial Code to receive full faith and credit in bankruptcy proceedings. Ultra's consignment arrangements generally required that Ultra report periodically the sale of consigned jewellery to the consigner and pay for the sold jewellery within two weeks of a reported sale. The arrangements gave Ultra the right to return jewellery that didn't sell, and allowed Ultra to delay payments until after merchandise sold. Because the consigned merchandise was not owned by Ultra, it could not be used as collateral for loans from its secured lenders. Ultra's major vendors supplied goods on both credit and consignment terms, and the continued trust and support of those vendors would ultimately prove critical for its reorganisation.

On 31 December 2008, Ultra owed its merchandise vendors $11m for open account credit purchases, and the value of its owned inventory was $50m. At that time, the company inventory, together with substantially all of Ultra's other owned assets, served as collateral for Ultra's $31m secured debt obligations to its institutional lenders, with the value of consigned merchandise at about $50m. In formulating a plan for Ultra's reorganisation, insolvency counsel – after assuring itself that nearly all Ultra's consignment vendors had

perfected their liens – advised Ultra to continue its consigned merchandise program and immediately communicate that decision to the consignment vendors to enlist them as reorganisation allies.

The plan

Counsel determined that Ultra would best be served by employing a pre-arranged bankruptcy plan in which it would seek to resolve consensually its major issues, by informal agreement with the creditors, before seeking Chapter 11 relief. Counsel then instructed Ultra to revisit its business plan and generate a series of new business plan projections employing a variety of assumptions for fiscal 2010. The plan would include debt forgiveness, flat sales, declining sales, no credit on open account, and various permutations of store closings. The new projections led to several conclusions being drafted.

Firstly, Ultra had to obtain immediate, significant rent concessions from nearly all its landlords, or immediately reduce its store count by liquidating the stores where concessions could not be obtained. Secondly, the value of Ultra's business had deteriorated so badly that Ultra's common stock was worthless, wiping out unsecured creditors in liquidation. Also, Crystal's pre-petition term loan was deeply under-collateralised, while BoA remained fully collateralised on its loan and would likely come out whole in an Ultra liquidation. It was suggested that Ultra could survive for at least three months beyond Christmas 2008 without receiving significant new merchandise, provided it made minimal cash purchases and redeployed inventory from underperforming, to-be-closed stores to the remaining viable stores. By freezing payments to its landlords and vendors and putting the Crystal term loan on payment in kind (PIK) status effective 1 January 2009, Ultra would have sufficient cash to remain viable for several months, allowing it to make timely payments of interest to its senior secured BoA loan. Ultra also would be able to continue to pay consignment vendors as consigned merchandise was sold.

Having forged an early alliance with consignment vendors, Ultra knew that those vendors who also supplied merchandise on open account would be intent on protecting the $50m of consignment merchandise held by Ultra, and would not be overly militant in negotiating terms for the settlement of their unsecured claims. Because liquidation would undoubtedly result in no distribution to unsecured creditors, it was not difficult for Ultra to convince vendor creditors to agree to settle their unsecured claims of approximately $11m for a pro-rata distribution of 18 percent of Ultra's post-reorganisation common stock and a $3m unsecured 7.5 percent payment in kind note maturing in 2013.

Ultra first met with its senior secured lender BoA in early January 2009. At that meeting, Ultra apprised BoA of its decisions to PIK pay the Crystal debt effective 1 January 2009 and freeze unsecured vendor and landlord cash payments. BoA agreed to Ultra's request that it adopt a short-term neutral stance while Ultra sought agreements for debt relief from its junior secured lender, Crystal, and its unsecured vendor and lease creditors.

Immediately following the BoA meeting, insolvency counsel – together with Ultra's senior management – stressed to Crystal that its term loan was under-collateralised. They opined that Crystal would be best served by converting a portion of the loan to equity and restructuring the payment terms on the remaining portion of the loan rather than force liquidation. Crystal's fear of loss in a forced liquidation was not the determining factor in convincing it to convert its junior secured loan into a combination of equity and a financial covenant-free PIK replacement note. It was the compelling case for future profit that Ultra and counsel put forth that ultimately convinced Crystal to think reorganisation rather than liquidation. The argument for future profitability was based on the premise that at recession's end, a leaner Ultra – featuring trimmed overhead, trade support, a manageable debt load, and a superior management team – provided an attractive investment case far more compelling than a liquidated estate.

Crystal recognised that its interests would be best served by a switch from junior secured lender to vulture investor, as sanity, commitment and the prospect of outsized future profit triumphed over fear. Crystal became Ultra's most vocal and ardent reorganisation ally, allowing for agreement regarding Crystal's debt, albeit after complicated and contentious negotiations. In general terms, the Crystal/Ultra agreement provided for the $15m pre-petition loan to be split in two, with half being a financial-covenant-free secured PIK note maturing in 2013, and the other half a debt-for-equity swap that gave Crystal 56 percent ownership interest in reorganised Ultra.

Simultaneously, Ultra successfully negotiated with virtually all its landlords rent-relief agreements conditioned upon Ultra successfully confirming the pre-arranged bankruptcy, with landlords preferring diminished rent from viable tenants to empty stores. The bankruptcy plan also provided for Ultra's post-petition management to receive 26 percent of Ultra's common stock as sweat equity, vesting over four years. The logic behind the equity grant was Ultra's need to secure the ongoing commitment of senior management as the final, indispensable ingredient for financial redemption.

With those agreements in place, BoA agreed to provide Ultra with a debtor-in-possession loan that would replace the revolving credit facility once Ultra filed its bankruptcy petition. In addition, BoA agreed that it would provide exit financing for the reorganised company, provided Ultra confirmed the bankruptcy plan before 30 July 2009.

Ultra formally filed for Chapter 11 bankruptcy relief on 9 April 2009. On July 28, Ultra confirmed its bankruptcy plan. Against a landscape of failed reorganisation attempts by Fortunoff, Friedman's, Whitehall and Christian Bernard, why was Ultra able to reorganise? Ultra built consensus and convinced its lenders, landlords and vendors to analyse, plan and execute a reorganisation before Ultra formally dove into the bankruptcy pool.

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Restructuring agreements in the Italian insolvency law

BY GIORGIO CHERUBINI

The duration of Italian bankruptcy proceedings was one of the longest in the European Union, lasting several years when the Royal Decree of March 16, 1942 no. 267 became effective. The Decree was permeated with the general outlook of the period in which it was conceived, when insolvency was considered to be an offense to the economy.

According to data available, more than half of bankruptcy proceedings ended with a liquidation and creditors recovering only a small percentage of their debt, in addition to high costs related to procedures, which exhausted a relevant share of the assets. Also, in most cases, unsecured creditors were left with nothing. A change was necessary and the Italian bankruptcy law has been significantly amended in recent years through the enactment of the Law 80 of 2005, Legislative Decree 5 of 2006, and Legislative Decree 169 of 2007, in order to provide a more efficient and effective insolvency regime.

The reform was difficult due to the fact that bankruptcy is a complex process and the changes required time and support. However, in insolvency and restructuring, practitioners and entrepreneurs widely understood that the regime required substantial modernisation and, in this regard, amendments to extraordinary administration law for 'large' and 'very large' companies served as forerunners of legal frameworks favouring business restructuring rather than liquidation.

The recent changes are aimed at balancing the needs of companies facing financial difficulties to recover through more flexible arrangements with those of the creditors requiring adequate protection. As a result, Italy's legal framework has finally moved towards corporate reorganisation, and failed businesses are no longer considered out of the business community. They are instead given the opportunity for a 'fresh start'.

As a consequence of the influence of the British and US models, specifically the US Chapter 11 regime, the core of the matter was identified with the opportunity to save the value of the company (i.e., the capacity to produce goods and services), and the possibility for arrangements between debtors and creditors similar to pre-packaged reorganisations under US bankruptcy law.

The partial satisfaction of the secured claims represents a significant innovation in the Italian insolvency regime. It is also in line with the provisions of the bankruptcy law concerning the ranking of claims since, in some situations, a deviation from the absolute priority rule is required to find a solution with the majority of the creditor classes, also recently introduced.

Italy's legal framework has finally moved towards corporate reorganisation, and failed businesses are no longer considered out of the business community.

A quick examination of available alternatives to bankruptcy starts with debt restructuring agreements *(accordi di ristrutturazione dei debiti)*, which are out-of-court procedures constituted by an arrangement reached between the debtor in financial difficulties and the creditors representing at least 60 percent of the company's liabilities, with a subsequent control by the judiciary.

The agreement must be published in the companies' register and becomes effective after its publication; it must be homologated by the Court within a stay period of 60 days from the publication, necessary to allow the debtor to negotiate with the creditors. This procedure is not binding on creditors which have not agreed to the restructuring plan and allows the troubled company to file a petition with the Court for the ratification and enforcement of a debt restructuring agreement, previously agreed to by the creditors.

A debt restructuring agreement may also include a settlement between the debtor and tax authorities concerning the debtor's tax liabilities, which represents another important novelty of this procedure.

The reform has also deeply modified and simplified the procedure for the composition with creditors *(concordato preventivo)*, with the aim of making existing regulations better adapted to the business community needs, preserving the insolvent business as a going concern and granting a stronger guarantee for creditors through the business restructuring.

Such a procedure is available to companies in distressed conditions facing a 'state of crisis', and is supervised by bankruptcy courts. In the past, this was only available to insolvent companies, i.e., those that found it permanently impossible to regularly meet their obligations.

From a procedural point of view, the debtor – through a Court application accompanied by a report drafted by a professional – enters into an agreement with its creditors for settling his/her outstanding debts through available assets.

The reform has also lowered the mandatory requirement needed in such procedure. Previously, the debtor was requested to guarantee the payment of at least 40 percent of the unsecured claims and 100 percent of the secured claims, within a six months period, starting from the approval of the composition by the competent bankruptcy Court.

Under the new provisions, the debtor is now allowed to pay the secured creditors less than in full, albeit under specific circumstances and tests. They also allow more resources to be

The availability of capital and management in troubled situations is creating new opportunities, along with the decreasing clawback risk.

directed to unsecured creditors and offer a broader range of means to restructure debt, both from a financial and legal point of view: from the assumption of debt by any means (including asset transfers, assumption of liabilities, or a transfer of some or all of the company's assets to a third party *'assuntore'*), to mergers or other corporate transactions such as, for instance, the allocation to creditors or classes of creditors (differentiated by legal status or priority) of stocks, quotas or bonds, including convertible bonds, or other financial instruments.

Not all companies can or should be saved, and the liquidation plan prepared by the court-appointed practitioner must now comply with a given timeline and must include appropriate details regarding the approach selected to realise the assets. This approach indirectly helps the creditors, or third party, to evaluate and propose alternative solutions that may entail keeping or restoring part of the business operations.

Upon filing of the motion, enforcement proceedings against the company are 'frozen', and interests cease to accrue on the company's debt. Also, from the date of filing of the petition up to the homologation, the debtor is granted an automatic stay regarding existing creditors.

Throughout the procedure, all pending agreements entered into by the company continue to be effective and enforceable; the company is still under the management of its directors, although under the control of the Court and of a special commissioner appointed by the same Court.

The creditors will vote upon the composition proposal within the terms established by the Court, which is then approved if voted by creditors representing the majority, in value, of claims admitted to vote and, in case of more classes, by the majority of creditors in each class. Afterwards, the Court will ratify the proposal, which becomes binding on all the creditors, and will act as the final arbiter retaining the power to approve a composition despite the existence of one or more dissenting classes, as long as the composition satisfies certain statutory requirements similar to the Chapter 11 'cram-down' standards contained in the US Bankruptcy Code.

Another change with a strong practical impact is the reduction of the obligation to advance in cash the whole amount of procedural expenses within 15 days following the acceptance of the application filing. With the reform, the advance must now cover only half of the estimated procedure costs and the Court can further reduce the amount to be advanced by up to 20 percent.

Another novelty of the insolvency system are the restructuring plans *(piani di risanamento)*, which do not require a judicial control or approval, nor the consent of a specific majority of all outstanding claims. Also, the creditors are not required to receive the same treatment, known in the past as *'par conditio creditorum'*. If a company's economic results improve due to the continuation of the activity, the company's reorganisation must be planned and, as a consequence of the restructuring efforts, the protection of the creditors' interests has to be taken into consideration.

Some substantial changes have also been introduced to the regime of arrangements with creditors, leading to the definition of the bankruptcy procedure and to the end of bankruptcy *'concordato fallimentare'*. In particular, creditors' position has been improved, so as to develop a consensual approach based on arrangements and cooperation between them and the insolvent company, and to create significant opportunities. The *concordato fallimentare* is not an autonomous insolvency proceeding, it is, on the contrary, a device within the proceedings aimed at closing the bankruptcy process early and, therefore, ensuring quicker and more effective proceedings. It also may involve creditors in the insolvency management.

The procedure is based on a plan proposed to the creditors, according to their positions, classes, and economic interests; furthermore, the debt restructuring and satisfaction of creditors' claims may take place through any technical or legal means, including assumption of debts, mergers or other corporate transactions. Where the requested majority of creditors votes in favour, the Court shall approve the composition proposal, which is binding on all creditors, including dissenting and non-voting creditors.

Concordato fallimentare is clearly aimed at fostering settlements for insolvent companies in Italy and providing a new role with more opportunities for the creditors, which are much more involved in the process than in the past. It may also prove essential when a high number of pending bankruptcy proceedings needs to be closed very quickly.

Under this legislative scenario that offers many alternatives to bankruptcy, the declaration of bankruptcy should really be the last choice.

The availability of capital and management in troubled situations is creating new opportunities, along with the decreasing clawback risk.

Certainly, some cultural barriers still have to be overcome. However, with the recent changes in Italy's bankruptcy law, all players (practitioners, bankruptcy judges, entrepreneurs, banks, and other specialised investors) now have the chance to change the outcome of many situations, by achieving better results for key stakeholders, saving business activity, and avoiding bankruptcy proceedings. Therefore, distressed Italian companies have greater flexibility when addressing their financial problems, by means of court-approved creditor compositions or debt restructuring agreements.

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Bankruptcy and restructuring in Finland – procedures and current issues

BY PAULIINA TENHUNEN AND ANNA-KAISA NENONEN

Finland's corporate insolvency proceedings for restructuring enterprises are governed by the Restructuring of Enterprises Act (25.1.1993/47). Bankruptcy situations are governed by the Bankruptcy Act (20.2.2004/120).

Bankruptcy proceedings have been the most commonly used procedure for enterprises facing critical financial difficulties. Troubled companies usually start to take necessary measures too late, which leaves no room for other options. The number of bankruptcies increased tremendously during the recession of the 1990s, and the proceedings for some of the biggest bankruptcy estates at the time are still ongoing.

The number of bankruptcy petitions had diminished steadily since the first half of the 1990s – until 2008 when they started growing again. There were 37 percent more bankruptcy petitions filed during January-July 2009 than the year before. Bankruptcies have increased most in the construction industry, although these bankruptcy estates are usually quite small.

The Finnish restructuring proceedings are undertaken in order to rehabilitate a distressed debtor's viable business, to ensure its continued operations and to achieve debt arrangements. As mentioned above, enterprises in financial trouble usually act too late, which makes bankruptcy proceedings more common than restructurings, since meeting the prerequisites for a restructuring is difficult at a late stage. Furthermore, in practice, large companies are more eligible for restructuring than smaller companies; they have more rehabilitation measures available and thus the restructuring proceedings are more likely to succeed. There are also some industry-specific differences. For example, companies engaged in retail sales are simpler to restructure than project businesses, since the field of business may offer more restructuring possibilities.

The need for restructuring proceedings in Finland became topical when the recession of the 1990s began, and the Restructuring of Enterprises Act was enacted in 1993. Restructuring proceedings were widely used in the beginning of 1990s but since then the number of initiated proceedings steadily diminished – until in January-July 2009 when the number of restructuring proceedings grew substantially. Notably, when a creditor files a bankruptcy petition against a debtor, it is quite common for the debtor to respond by filing a restructuring petition and attempting to rescue the company through restructuring. Thus, many restructuring petitions are not made by companies that are necessarily eligible for restructuring.

It is also worth pointing out that voluntary restructuring has become more popular and many companies seek to solve their financial troubles by reorganising debts without official insolvency procedures. Voluntary restructuring, like formal restructuring, can also be used, for example, to reorganise a company's business branches, capital structure, etc. Voluntary restructuring usually only works if the creditors have confidence in the company's viability.

Restructuring of enterprises

The scope of application of restructuring proceedings is regulated in the Restructuring of Enterprises Act. Its scope is quite extensive as restructuring may apply to private entrepreneurs, commercial farmers and fishermen, general partnerships, limited partnership companies, limited companies, co-operative societies, housing companies as well as to associations whose activities are economic in nature. However, deposit banks, credit institutions, insurance companies and pension institutions are excluded from the possibility of restructuring. Nonetheless, as regards insolvency proceedings of insurance companies and credit institutions, Directive 2001/17/EC on the reorganisation and winding-up of insurance undertakings and Directive 2001/24/EC on the reorganisation and winding up of credit institutions have been implemented in Finland.

A petition for restructuring under the Restructuring Act may be presented by the debtor or a creditor (or several creditors together, excluding any creditors whose claim is contested as to its basis or to its essential amount or otherwise unclear) or a party for whom the debtor's insolvency would likely cause financial loss based on their right to a claim for reasons other than partnership or shareholding with the debtor (a probable creditor).

There are certain prerequisites for commencing the restructuring proceedings. Firstly, the proceedings may be commenced if at least two creditors, whose aggregate claims represent at least one-fifth of the known claims against the debtor, file a joint petition with the debtor or declare that they support the debtor's application. Secondly, if the debtor faces imminent insolvency, the proceedings may be commenced. A third prerequisite for commencing the proceedings is that the debtor is insolvent. In this case, however, the insolvency of the debtor may not be such that the restructuring program could not remedy the insolvency. The court will review the petition and may also dismiss it on certain other grounds, *inter alia*, if it is probable that the debtor's assets are not sufficient to cover the costs of the restructuring proceedings.

An administrator is appointed to supervise the day-to-day activities and interests of the creditors. During the restructuring procedure, the management of the debtor remains in control of and continues to operate the business in the usual way

but under the supervision of the administrator who assesses the debtor's financial situation and safeguards the interests of creditors.

The administrator prepares and submits a proposal to the court for a restructuring plan in collaboration with the debtor and the creditors. The plan shall specify the measures and arrangements designed to improve the debtor's activities. After the proposal for a restructuring plan is submitted to the court, the court will provide creditors with the opportunity to comment on the proposal. The restructuring plan can be confirmed with the consent of all creditors or once the plan is accepted, by a majority of each of the creditor groups.

The restructuring proceedings end when the debtor fulfils the terms of the plan or enters into bankruptcy proceedings. Restructuring proceedings involving the court normally take 8-11 months depending on the complexity of the matter. The duration of the restructuring plan is generally 5-10 years.

Bankruptcy

Bankruptcy proceedings are a form of general enforcement of creditors' claims against the property of the debtor company. At the commencement of the bankruptcy proceedings, the debtor company forfeits control of its assets. The company's estate is managed by a court-appointed administrator, who realises the assets and uses them to pay the bankruptcy creditors in accordance with the applicable priority rules.

Bankruptcy proceedings can be initiated by the company itself or by its creditors with a written petition. The petition is filed and the proceedings take place in the district court of the city where the company's main administration is located. A creditor can file for bankruptcy if it has an enforceable court judgment or decision against the debtor, or if the creditor's claim against the company is based on a written commitment signed by the debtor and the company has not contested the claim on validity grounds, or if the creditor's claim is so clear that its validity cannot justifiably be doubted.

Insolvency is a general precondition for both the debtor's and the creditor's petition. If the debtor itself files for bankruptcy, the precondition of insolvency is usually taken for granted. The requirement of insolvency means that the company must be otherwise than temporarily unable to repay its debts. However, the creditors are able to invoke insolvency assumptions as provided for in the Bankruptcy Act. This means that unless proven otherwise, insolvency is presumed if: (i) the company has discontinued its payments; (ii) enforcement proceedings have taken place in the preceding six months and by those proceedings it has been determined that the company's assets do not cover the outstanding debts in full; or (iii) having received the creditor's request for payment, the company has not paid a valid and due debt within a week.

The court will appoint an administrator to take over the management and control of the debtor's business, since as a result of the bankruptcy the debtor will lose its authority over its assets. The administrator's main duties are to draw up an inventory of the debtor's assets and liabilities and a report regarding the debtor's actions preceding the bankruptcy. The administrator will also set a fixed date for claims and draft a disbursement list. By realising the bankruptcy estate's assets, the administrator aims to get as good dividends as possible to the creditors. Finally, the administrator pays the dividends in accordance with the disbursement list approved by the court.

The length of a bankruptcy depends primarily on the size of the bankrupt estate. The procedure usually takes several months even in a small bankruptcy estate and there is no maximum duration issued to the proceeding. It is not uncommon for very large estates to remain unclosed after 10 years, even if the proceedings are inactive. On average, bankruptcy proceedings tend to take one to five years.

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Recovery of assets in Finnish insolvency situations

BY PAULIINA TENHUNEN AND ANNA-KAISA NENONEN

The Act on the Recovery of Assets to a Bankruptcy Estate (758/1991) sets out the main rules for recovery in insolvency situations. Even though the name of the Act might indicate that the Act is only applied to recovery situations in bankruptcy, the Act is, however, applied to all insolvency situations, including recovery in the restructuring of enterprises.

Pursuant to the Recovery Act, a transaction concluded prior to the commencement of the bankruptcy proceedings may be recovered to the bankruptcy estate. The definition of the transaction is subject to an expansive interpretation and, therefore, any kind of proceedings, arrangements or measures taken, may be recovered if the conditions set out in the Recovery Act are met.

On the basis of the Recovery Act, in bankruptcy both the estate administrator and the creditors who have secured their claims in bankruptcy or whose claims have been taken into account otherwise in the disbursement list may seek to recover assets of the debtor. In restructuring, the administrator and a creditor may bring an action for recovery. However, a creditor who wishes to seek recovery shall notify the administrator of the same. The creditor may bring an action if the administrator does not undertake to do so.

In bankruptcy, an action for recovery must be filed within six months from the lodgement date. If the grounds for recovery appear after this six-month period, an action may be filed later if it is filed within three months from the date when the grounds for such action became, or should have become, apparent to the bankruptcy estate. In restructuring, an action for recovery must be filed within six months from the commencement of the proceedings. Also, in restructuring the same additional three-month period applies to grounds that the administrator has noticed later, i.e., the action may be brought within three months from the date the administrator noticed, or should have noticed, the grounds for recovery.

General grounds for recovery

Pursuant to the general recovery rule set out in the Recovery Act, the transaction shall be recovered if: (i) such transaction alone or together with other measures taken was deemed to improperly favour a single creditor at other creditors' expense; (ii) the asset item(s) has been transferred out of reach of the creditors; or (iii) the liabilities have been increased with prejudice to the creditors. The precondition for the recovery is the insolvency of the debtor on the date the transaction was concluded, or that the debtor became insolvent due to the concluded transaction.

Furthermore, the recovery claim under the general rule requires that the other party subject to the transaction knew or should have known of the insolvency or excessive indebtedness of the debtor or of the significance of such transaction on the financial standing of the debtor and those facts based on which the transaction is deemed improper. If the other party subject to the transaction was in close relationship with the debtor, the other party is deemed to be aware of the circumstances specified above. The fixed date for the recovery claim is five years from the date the bankruptcy petition was filed.

The Recovery Act's general rule for recovery has been evaluated in court praxis several times. For example, the Supreme Court's decision 2000:125 notes that if a company closes down its business and at that time pays its debt to one creditor, it is in the interest of the creditor to sort out the position of possible other creditors and their debts in order to avoid recovery. If the company later is declared bankrupt, and the creditor knew about the closing down of the business, the payment can be recovered to the bankruptcy estate even though the bankruptcy took place as late as 1.5 years after the payment.

Special grounds for recovery

In certain situations recovery is possible even though the counterparty has been in good faith, i.e., was not aware of the debtor's insolvency or excessive indebtedness.

With regard to the recovery of payment of debts, any debt paid later than three months prior to the date when the bankruptcy or restructuring petition is filed with the court may be recovered if: (i) unusual means of payment have been used; (ii) the payment was premature; or (iii) the amount of payment was considerable in comparison to the assets of the bankruptcy estate. Approximately an amount of 10 percent of the estate's assets is deemed to be considerable. In the event that the beneficiary is a person close to the debtor, the payment may be recovered if it was paid later than two years prior to the date the petition was filed. It is noteworthy that the Finnish Supreme court decisions have verified that group companies are considered to be close to each other in the meaning referred to in the Recovery Act. Notwithstanding the abovementioned, the payment shall not be recovered if the payment is considered to be customary in the specific circumstances.

A gift may be recovered, if it has been completed later than a year prior to the date when the petition for bankruptcy or restructuring is filed with the court. A gift, which has been completed before this but later than three years before the aforementioned date, may be recovered if it has been given to a person close to the debtor and it is not shown that the debtor was not excessively indebted or did not become excessively indebted due to the gift. With regard to recovery of a gift, it is noteworthy that certain contributions, etc., between group companies may easily be recovered if one group company is declared bankrupt or restructuring proceedings begin, since every group company is treated individually in Finnish insolvency situations.

Security given later than three months prior to the date when the petition for bankruptcy or restructuring is filed with the court may be recovered if: (i) the parties had not agreed upon the security in connection with the granting of the credit; (ii) the possession of the security had not been transferred; or (iii) any similar act effecting the security had not been taken without undue delay from the granting of the credit. If the beneficiary is a person close to the debtor, the fixed date for the recovery claim is two years from the filing of the petition. It is noteworthy that if debts are restructured and a security is given out of old debt, this security may be recovered.

Effects of recovery

If a transaction is recovered, the property received from the debtor shall be returned to the bankruptcy estate. The bankruptcy estate must also return the compensation paid for the property. However, no obligation to return the compensation exists if the compensation was concealed from the creditors and the party who paid the compensation knew or ought to have known that this was the intention of the debtor.

If the property which shall be returned no longer exist or otherwise is not returnable, its value shall be reimbursed. Furthermore, if the value of the property to be recovered has significantly depreciated due to wear and tear or damage, the party liable for returning the property shall compensate for the value of depreciation of such property.

The party liable for returning the property shall surrender

the proceeds from the property earned during the period following the presentation of the claim for the recovery of the transaction, or compensate for its value, respectively. Furthermore, the party liable for returning the property shall be entitled to receive compensation for the incurred necessary costs relating to the property and also for other costs which may be deemed reasonable.

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Compromise under the Estonian Bankruptcy Act

BY PAUL VARUL, TARMO PETERSON AND PEETER VIIRSALU

At the end of 2008, a new Rehabilitation Act (Saneerimisseadus) entered into force in Estonia. Before that, the Bankruptcy Act (Pankrotiseadus) was the only act regulating insolvency in Estonia – except for credit institutions, which are subject to sector-specific regulations. Before the enactment of the Rehabilitation Act, the only viable option for rehabilitating a company under Estonian law was through a compromise between debtor and creditors within the bankruptcy proceedings (the act recognises the rehabilitation of a debtor's enterprise within the bankruptcy proceedings, but its practical efficiency is virtually nonexistent – it has been applied only in very few cases). The new Rehabilitation Act gives companies an opportunity for rehabilitation outside bankruptcy proceedings. Nevertheless, the rehabilitation process under the Rehabilitation Act may turn out to be unsuccessful, bringing forth a potential bankruptcy. In a situation where a company has been declared bankrupt by a court, it is still possible to rehabilitate the company within the bankruptcy proceedings in order to avoid liquidation.

The object of this article is to give an overview of the main aspects of compromise under the Estonian Bankruptcy Act.

Reaching a compromise in bankruptcy proceedings

The act defines compromise as an agreement between a debtor and its creditors concerning the payment of debts, and involves the reduction of debts or extension of their term of payment. A compromise can be made in the bankruptcy proceedings only on proposal of the debtor or the trustee after the declaration of bankruptcy. It should set out to what extent and by which date the debtor is to pay the debts. It must also be substantiated in the compromise proposal that the debtor is able to pay the debts to the extent and by the date indicated. If the compromise concerns a company, a rehabilitation plan should be annexed to the proposal. Such a proposal of compromise may be filed until approval of the first distribution proposal by the court.

This compromise proposal must be accepted by the creditors. Therefore, it can only be made at a general meeting of creditors, and requires at least half of them to be present and their claims to represent at least two-thirds of the total amount of all claims to be voted. However, only defended claims give the right to vote.

A compromise is presented for approval to the court, which rules on the proposal within 15 days following the submission. The creditors, debtor and trustee may file appeals against a ruling in which the court approved or rejected the compromise. A court ruling approving a compromise terminates the bankruptcy proceedings and the compromise enters into force.

Consequences of the compromise

The main consequence of the compromise is that the bankruptcy proceedings are terminated. Once the court has approved the compromise, the debtor recovers the right to administer its assets and the sale of the assets must be terminated. Money received from the sale of assets, which has not been transferred to creditors, must be transferred to the debtor. The obligation to perform the consolidated obligations and pay the costs of the bankruptcy proceedings is transferred to the debtor. Though the bankruptcy proceedings are terminated and the debtor regains its right to administer its assets, the trustee or the members of the bankruptcy committee shall not be released and they shall be administering supervision over performance of the compromise. It can be concluded that, after the approval of the compromise, the debtor can continue its normal business with the exception that it must follow the terms of the compromise and be subject to supervision by trustee and bankruptcy committee.

As a consequence, during the term of validity of a compromise, bankruptcy petitions cannot be filed against the debtor on the basis of the claims covered by the compromise. Nevertheless, as the debtor can continue its business after the approval of the compromise, new claims against the debtor may arise. This means that a situation may occur where a bankruptcy petition is filed against the debtor on the basis of a claim against which the compromise does not apply. In this case a court must establish whether there are grounds for bankruptcy. If the court so establishes, it shall annul the compromise and reopen the bankruptcy proceedings.

Pledgees' position in case of compromise

The pledgees' position in case of a compromise is different to the position of other creditors. Firstly, only a creditor whose claim is not secured by a pledge should normally have the right to vote on a compromise. In such case, the claim of the

pledgee can be taken into account only to the extent that the claim would not be satisfied by the proceeds of the sale of the pledged object. In the event of a dispute, the size of the secured part of the claim shall be determined by the trustee. In practice, this usually means that a pledgee is not able to vote on a compromise as the pledgees normally take precautions to ensure that the pledge would secure their claim, even in cases when the claim increases. However, if invocation of pledged claim is to be precluded for more than 90 days, the claim shall be fully taken into account in voting. Secondly, the pledgees' rights are restricted when, according to the compromise, the pledged object is needed for continuing the activities of the debtor company. In this case, the claim secured by the pledge shall not be invoked during the term determined by the compromise which, however, should not exceed one year.

Supervision over the performance of the compromise and annulment of the compromise

A trustee and the bankruptcy committee shall exercise supervision over the performance of a compromise. A trustee is obliged to submit a report on his/her activities and on the fulfilment of the compromise to the court and the bankruptcy committee once a year. The trustee must indeed continuously observe whether the debtor is able to meet the requirements of the compromise. If the trustee establishes that the debtor is unable to do so, the trustee is under obligation to immediately notify the court and the bankruptcy committee thereof.

To annul the compromise, the trustee or a creditor bound by the compromise must turn to a court. A court shall annul a compromise if the debtor is convicted of a bankruptcy offence or a criminal offence relating to the execution procedure (the debtor fails to perform the duties arising from the compromise or upon expiry of at least one-half of the term of validity of the compromise if it is evident that the he/she is unable to meet the requirements of the compromise). If these circumstances become evident, the trustee is under an obligation to submit a request for the annulment of the compromise to the court. The consequence of the annulment of the compromise is that the bankruptcy proceedings shall be reopened.

Conclusion

The main problem with a compromise within bankruptcy proceedings is that, in a situation where bankruptcy has already been declared and bankruptcy proceedings are being conducted, it is extremely difficult for the debtor to find additional sources of financing. After all, bankruptcy is, first of all, a shortage of means of payment. And the only way this can be overcome is by finding and involving new sources of financing. However, once bankruptcy proceedings have been initiated, there are no grounds to expect shareholders to invest additional equity capital in the enterprise. Needless to say, if they had wished to do that, they would have already invested this capital in the company before the declaration of bankruptcy. Therefore, inclusion of borrowed capital could be seen as an alternative. Getting a loan after bankruptcy is declared, however, is almost impossible. This is the main reason why most bankruptcy proceedings in Estonia end up in the liquidation of the company and not rehabilitation.

The legislature has tried to make it easier to obtain a loan for continuation of economic activities if rehabilitation is done through a compromise. It is also stipulated in act that the claims of persons who have granted credit to the debtor in order to enable the debtor to continue the business activities shall be given priority over the claims of the other creditors in the bankruptcy proceedings if the compromise is annulled. Even though rehabilitation with a compromise seems like a rather good solution for the debtor, compromises, particularly successful compromises, are not common in practice. The main reason for this is that insolvency has usually developed too far and parties concerned are not interested in providing new sources of financing needed to execute the rehabilitation plan.

Still, despite the fact that the practice concerning compromise has not been very successful, the possibility for compromise, and therefore rehabilitation after a company's bankruptcy has been declared, should not be disregarded altogether. For example, in cases where a company's rehabilitation has, for some reason, failed under the new Rehabilitation Act, there may still be chances for a successful rehabilitation within the bankruptcy proceedings with respect to the work done during the failed rehabilitation proceedings.

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Reorganisation in Estonia – useful tool or just stretching out the inevitable?

BY KLEN LAUS AND LIINA JENTS

In a broader sense, reorganisation of an undertaking means all kinds of activities taken to rehabilitate the enterprise. Reorganisation does not have to be conducted by a court and can be done simply by agreements with creditors. However, if agreements with creditors cannot be achieved, but solvency problems of the enterprise are temporary and there is a wish to reorganise the enterprise along with prospects for sustainable management, it could mean that court interference

is necessary.

Until this year solutions for such insolvency problems were solved through bankruptcy proceedings which usually meant liquidation of the enterprise. According to the Estonian Bankruptcy Act rehabilitation of an enterprise was possible through application of measures which enabled satisfaction of the claims of the creditors through continuation of the business activities of the debtor. Unfortunately during the ongoing bankruptcy proceedings, finding new sources of financing or investors was quite impossible due to the nature of bankruptcy.

In 2006 the Estonian activity plan to improve the international competitiveness of the legal environment of enterprises stated that, Estonian insolvency legislation needs an alternative to liquidating bankruptcy proceedings. According to the key standpoint of the activity plan if an enterprise is facing solvency problems which are not permanent, the only option should not be finding solutions through bankruptcy proceedings. As a result, development of a new reorganisation regulation was started.

The Reorganisation Act came into force on 26 December 2008 when signs of the worldwide economic crisis were already present. According to the Act, the reorganisation of an enterprise means the application of a set of measures in order for an enterprise to overcome economic difficulties, to restore its liquidity, improve its profitability and to ensure its sustainable management. Finally there was a prerequisite for an alternative that was not targeted to liquidation – although its effectiveness is yet to be seen.

Taking into account the experiences of countries with similar legal order to Estonia, the expected number of rehabilitation cases in the first three years was 5-10 cases per year. In reality, during the first six months of validity of the Reorganisation Act, as many as 50 applications were filed. Most of them have not come to a happy ending. The reasons for such a difference in number can lie of course in the global economic crises, the depth and seriousness of which was not taken into account to its full when the Act was developed. But in addition, the overall meaning and idea behind the reorganisation procedure seems to have been lost during these difficult times.

One of the main reasons for many failures in the first reorganisation processes (only two of the 50 applications reached the confirmation of the reorganisation plan) is that in the current economic climate, reorganisation is seen as the last straw. Undertakings often fail to realise that reorganisation is no magic wand, but requires in-depth preliminary work and rushing into the process is destined to fail from the very beginning. As the first cases show, it is often forgotten that a recognisable enterprise in a reorganisation process is the kind where the solvency is reconstituted through structural changes. The solvency has to be in fact restorable and it cannot simply depend on a sudden growth of the market or other external factors that cannot be influenced by the debtor. Also, the purpose of the measure is not to provide temporary shelter from the storm but to enable the undertaking to adapt to the new economic circumstances.

Therefore, before plunging into the reorganisation procedure one should make sure that the enterprise is eligible for reorganisation. And of course, before filing a reorganisation application, extrajudicial reorganisation should be considered. Only after it is clear that agreements with creditors outside the courtroom walls cannot be achieved, should formal steps be taken.

First of all, a valuation of the *status quo* of the enterprise should be performed. If the accounting value of the net assets is positive but there are expected solvency problems, there is a good chance for reorganising the enterprise. This of course does not automatically mean that the enterprise is fit for reorganisation, but if the accounting value of the net assets were negative it would obviously be more difficult to reorganise due to liquidity issues. Secondly, valuation of the possibilities to overcome the insolvency issues should be done (are there any investments or supplementary contributions on the horizon, by shareholders, new investors or sales of assets?). Thirdly, it should be determined if the enterprise is worth saving.

If the valuation results indicate that reorganisation is the best solution for saving the enterprise, the undertaking should submit to the court an application for the reorganisation. Although a bankruptcy petition can also be filed by a creditor, the reorganisation proceeding can only be instituted by the undertaking itself. This makes sense when taking into account that filing a bankruptcy petition requires only arrears by the debtor in a stipulated amount which might give the creditor reasonable doubt to question the permanent insolvency of the debtor. Reorganisation proceedings, however, require in depth valuation of the enterprise which cannot be done by a creditor.

In the reorganisation application, the undertaking will have to present an explanation for the economic difficulties of the enterprise, substantiate that the undertaking is likely to become insolvent in the future, the enterprise requires reorganisation and that sustainable management of the enterprise is likely after the reorganisation. Consequently, initiating the proceedings is quite easy. Authors of the Reorganisation Act have stated that they intentionally made the threshold low. The reason for such an approach lies in the fact that usually a reorganisation is unsuccessful because the proceeding is initiated too late – only after the debt load is high and the means necessary to continue activities of the enterprise have been pledged – so continuing the economic activities and reorganising becomes quite impossible. A low threshold gives the undertaking the chance to take the necessary actions once the first indications of danger have appeared. An easy starting point is also good because a neutral person – a reorganisation adviser – shall be involved. With the help of a professional adviser a permanent insolvency and therefore unavoidable bankruptcy is tracked at an earlier stage.

The critique for such a simplified procedure is that applications are easily filed for enterprises which have no actual prerequisites for succeeding. Although the aims of the reorganisation regulation were noble it seems to be often used as means of straining the bankruptcy proceeding and providing the enterprise the possibility to make necessary arrangements and 'save' as much as possible until facing the inevitable – bankruptcy. Since such a measure is still new and unproved, judges and reorganisation advisers require more

experience to sieve out such undertakings.

If the enterprise is acknowledged fit for reorganisation, the court initiates the reorganisation proceeding, sets a term for acceptance of the reorganisation plan and appoints a reorganisation adviser. The duty of a reorganisation adviser is to inform the creditors and the court of the economic situation and reorganisation possibilities of the enterprise in an impartial and competent manner, to advise and assist the undertaking in the course of the reorganisation proceedings and to verify the lawfulness of the claims of the creditors and the purposefulness of the transactions of the undertaking.

After the commencement of reorganisation proceedings, a reorganisation adviser shall prepare in the name of the undertaking a reorganisation plan, which *inter alia* shall: set out the description of the economic position of the enterprise as at the commencement of reorganisation proceedings and the analysis of the reasons which have brought about the need to reorganise the enterprise; the expected economic position of the enterprise after reorganisation; the term for compliance with the reorganisation plan; the description of the reorganisation measures to be implemented and the analysis of their purposefulness, including the description of and justification for the transformation of a claim of an oblige and the impact of the reorganisation plan on the employees of the enterprise.

The creditors shall accept the reorganisation plan by way of voting. The number of the votes of each creditor is proportional to the amount of the creditor's principal claim ascertained during the reorganisation proceeding. The creditors with similar interests must cooperate as the reorganisation plan is accepted if at least one-half of all the creditors who hold at least two-thirds of all the votes vote in favour. Although the creditors get to vote on the acceptance of the reorganisation plan, the court also has to approve the respective reorganisation plan within 30 days after the receipt thereof. The Reorganisation Act also presents the possibility to approve an unaccepted reorganisation plan if two court appointed experts provide a positive opinion of the plan.

A valid reorganisation plan gives the undertaking the time to reorganise the enterprise without the pressure of the creditors as it is an enforcement document in respect of a claim transformed by the reorganisation plan. The approved reorganisation plan, however, does not release a person who bears liability for obligation solidarity with the undertaking from the performance of his or her obligation. Also, a reorganisation plan does not apply to a creditor who is not aware of the conduct of reorganisation proceedings. If the undertaking fails to fulfil its obligations, the court has the right to revoke a reorganisation plan and the consequences of commencement of reorganisation proceedings retroactively cease to exist.

Although the first experience shows that reorganisation is often rushed into as initiating the proceeding is so easy, it is still a very useful and necessary measure for an undertaking with solvency problems. Once the judges and reorganisation advisers gain more experience, fewer enterprises unfit for reorganisation will get over the threshold to initiate the reorganisation proceeding and even fewer will make it to composing the reorganisation plan. According to the authors of the draft legislation, the Reorganisation Act is a success if, through reorganisation, around 10 companies a year survive and overcome their solvency issues. Hopefully their vision of a useful measure for temporarily insolvent undertakings will justify itself.

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Recent trends in practice of restructuring proceedings in Lithuania

BY MANTAS PETKEVICIUS AND INA BUDELINAITE

Lithuanian laws distinguish between two types of procedures – bankruptcy and restructuring – that can be attributed to insolvency proceedings in a broad sense. While both procedures grant enterprises certain protection from their creditors, the procedures are different and their purpose is different. This paper will focus on restructurings.

Restructuring of a company is a court procedure aimed at creating facilities for the company (which meets certain criteria) to preserve and develop its activities, repay debts, restore solvency and avoid bankruptcy. The criteria for a company to be eligible for restructuring are: (i) temporary financial difficulties (i.e., payments to the creditors are due for at least three months); (ii) continued commercial activities; and (iii) no bankruptcy proceedings initiated against the company.

The Law on Restructuring of Enterprises is the main document which regulates restructuring process and has been in force for more than eight years. Procedures similar to restructuring were known before the adoption of the Law on Restructuring. Despite that, until 2009 the restructuring proceedings were not popular in Lithuania at all. In fact, you can count all restructuring procedures successfully completed during 2001-2008 on one hand. To compare, during the same period bankruptcy proceedings were started for nearly 6000 companies. The difference is more than obvious.

While restructuring and bankruptcy are two different procedures, which aim at different results, at least some

companies which eventually became bankrupt had a chance to enter restructuring proceedings. Thus, one may question the reasons for such a dramatic difference between the popularity of restructuring and bankruptcy proceedings. And there number of them. While one can say that it is unfair to blame mainly the imperfect Law on Restructuring, it seems this is a major obstacle.

First of all, the restructuring process is not regulated thoroughly, and is rather unclear. Further, the initiation of the restructuring case is rather cumbersome and requires double consent of the creditors (creditors must firstly approve the initiation of the case and later the restructuring plan). In addition, the Law on Restructuring is not completely harmonised with the Law on Bankruptcy of Enterprises. For example: debtors using the looseness of the Law on Bankruptcy may continue their activities during the bankruptcy process and 'restructure' activities by 'silently' moving business (contracts, clients) to related companies. While lawfulness and rightness of such restructurings through bankruptcies might be questioned, such practices exist.

Another example is the absence of limitations to file repeated applications to initiate restructuring procedures. This allows companies to unfairly avoid bankruptcy proceedings by filing a new application for initiation of restructuring proceedings (provided that a corporation may influence main creditors, e.g., in case of intra-group financing) after the previous one has been rejected. A court will suspend the hearing of an application for initiation of bankruptcy proceedings as long as it has an application to initiate a restructuring process to handle, because, according to the law, restructuring has priority over bankruptcy.

There are also several problems indirectly related to the Law on Restructuring of Enterprises. For example, unclear regulation (as well as previous practice) creates fears that the restructuring process would be used only in order to postpone (or prepare for) bankruptcy. In addition, there exist no schemes for provision of state aid, which leads to a situation where large restructuring cases are to be notified to the European Commission. Taking into account that timing in restructuring is one of the most important attributes, this may result in a rather significant obstacle.

Lastly, established procedure does not benefit secured creditors; even more, it seems that secured creditors are better protected in bankruptcy proceedings than in restructuring.

During the spring of 2009, several different proposals to fundamentally amend the Law on Restructuring were raised by different institutions. The Ministry of Economy, among other things, proposed to entrust restructuring administrators with more powers, to allow restructuring of only those enterprises, which were established no less than three years ago and provided that no less than 10 years have passed after the decision of the court to complete or suspend the restructuring proceedings. According to the proposals of the members of Parliament, the court should have a right to initiate restructuring proceedings and/or to confirm a restructuring plan without the consent of creditors. Besides, if the proposals were accepted, the secured creditors would be excluded from the concept of 'main creditor', i.e., they would be barred from initiation of the restructuring proceedings and voting for the restructuring plan. According to another proposal, the number of creditors' votes required for approval of the restructuring plan would be reduced from three-quarters to two-thirds.

Evidently, there is quite a range of proposed amendments to the Law that aim to make it practically applicable. However, it is rather difficult to predict when and which amendments will be adopted. Further, neither of the proposals cover the full spectrum of current problems. In the summer of 2009, discussions regarding changes in the Law on Restructuring slowed down and some of the proposals to amend the law were withdrawn.

While we were waiting for legislative changes, the global economic crisis crept into Lithuania and began mowing down companies. Hopefully, the autumn session of the Parliament will remember the need to make amendments and the newly enacted law will solve at least some of the problematic issues that are currently obstructing the restructuring processes in Lithuania.

On the other hand, even without legislative changes, we see some movement in practice. Since 2009, the number of new restructuring proceedings increased significantly. The first nine months of 2009 yielded 39 new restructuring cases (compared to only four restructuring cases initiated in 2008 and three in 2007). Hopefully, the recently initiated restructuring proceedings of well-known companies (including major Lithuanian construction company Ranga IV and the publicly listed company Agrowill Group, which is a biggest holding of agriculture companies in Lithuania) will be effectively completed. Successful examples may bring positive repercussions concerning the use of restructuring proceedings, and may encourage other companies in distress to follow. On the other hand, failure may destroy the last seeds of belief in such proceedings.

Further, it might be noted that while the laws do not provide for out-of-court restructuring procedures, obviously companies may try to solve their problems out-of-court. Indeed, in practice many debt restructurings arise from informal agreements with creditors, and are conducted outside of any formal bankruptcy or restructuring regime. Companies facing financial difficulties may use different techniques to improve their financial standing, such as sale of assets or business, reduction in the number of employees, turn to idle time, etc. There are methods that resemble restructuring procedures – for instance, debtors may try to agree with creditors on postponement of performance of their obligations, a reduction of debts or may try to reach a standstill agreement, which would ensure that creditors do not bring enforcement proceedings. Obviously, as long as the Law on Restructuring is not adjusted for proper practical use, such informal restructuring procedures will prevail over the official restructuring proceedings. However, such informal restructurings might not serve as an effective remedy for many companies going that way. In particular, informal restructurings would not protect the company from hostile creditors, so the risk of bankruptcy proceedings would be much higher for such companies.

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CHAPTER TWO:

Financial Restructurings

The strange case of the shifting rescue funding

BY NICK HOOD

Amid the carnage of this self-inflicted global recession, much has been changed in the financial world, but one reality remains. Successful business rescue and restructuring outcomes depend above all else on one essential ingredient: cash. Broadly speaking, no money means no rescue.

Way back before subprime and excess leverage destroyed the foundations of the financial system and before the Lehman collapse finally made the world realise how serious the situation was, the provision of rescue funding came from the banks, with a modicum of involvement by vulture funds keen to turn rather more than a penny from the misfortunes of others.

Recent developments suggest the levers of this vital, commercial life-giving mechanism have passed into the hands of new players, and unexpected ones at that. Suddenly, the debtor in possession (DIP) finance for a whole series of major restructurings has come not from banks, but from private equity.

The cavalry riding to the rescue in the Lyondell Chemical Chapter 11 earlier this year, which needed $6bn in DIP funding, featured a number of major private equity players, including KKR, Apollo and Ares Management. Two recent auto industry restructurings – of car seat manufacturers Lear Corp and wheel makers Hayes Lemmerz – confirmed this trend with strong private equity involvement in the lender group. In the media sector, Readers Digest is another example.

The factors driving this sea change in funding practice are themselves the children of the recession. At the root of it is the lack of liquidity in the banking system and the severe risk aversion of traditional lenders. Not only are the banks unwilling, or in some cases unable to lend to distressed businesses, but they have also stopped funding the leveraged deals for healthier corporations, which were the lifeblood of strong private equity returns. Lending for LBOs is down 91 percent from 2007 levels.

So what is the private equity sector to do with the $600bn of capital it raised before the credit markets froze? It seems that the answer is to adapt the old 'loan to own' strategy to modern times. For sure, there are decent returns in providing DIP funding, but not at the levels needed to satisfy private equity investors. Factor in the ability to convert into substantial equity positions and suddenly the sums add up.

Typically, investors in these new loan-to-own deals can earn up to an 18 percent annual return and convert their position into a substantial equity piece, by comparison with typical returns of around 12 percent on straight DIP finance transactions.

The scope for these types of transactions is obvious. Already this year over 150 US companies have been bought out of bankruptcy, some 60 percent up on the equivalent period in 2008 and three times the number in 2007. Corporate defaults will inevitably continue to rise, despite early signs of recovery. Worldwide more than 200 companies with bonds and loans have missed interest payments in 2009, up by over 50 percent on 2008. A recent Standard & Poor's prediction suggests that US speculative grade defaults will surge to 13.9 percent in July 2010, an increase from 10.2 percent in August 2009.

The last loan-to-own peak was back in 2003, when the value of debt for equity conversions came out at around $52bn. It is too soon to know if this record will be beaten this year or next, but the trend is clear.

With the banks unlikely to be active in this market any time soon, the private equity dominance is likely to continue. And it may even address another feature of the current crisis. Restructuring professionals worldwide, whether they operate in the US, the UK, Hong Kong or any other developed economy, are commenting on the lack of activity at a time when the correction has wreaked commercial havoc across the board. Surely they say, whole swathes of enterprises must need an urgent dose of turnaround skills, so why is the workload so patchy?

The speculation is that both banks and private equity are in denial, unwilling to bring themselves to admit to all of the damage to their portfolios, despite the opportunity in this bad news environment to drag these decomposing commercial cadavers from the cupboard and see whether there might be a miracle restructuring cure.

There is a real concern that by the time the mood changes and reality re-asserts itself, some of these companies may be beyond resuscitation, or certainly much more damaged than they might have been with earlier remedial treatment.

One clue to what is happening is a sudden and unprecedented surge in demand for cash management specialists, who are being forced on management teams by anxious investors and lenders. This is not just caused by the usual pre-insolvency mantras: 'cash is king' or 'manage your cash like your life depends on it'. It also reflects the thought that if cash calls can be avoided, then perhaps an impairment may not have to be recognised.

The desire to keep heads firmly buried in the sand is also driven by savage levels of discounts in the secondary distressed debt market. Average discounts to par have risen in the first half of 2009 to figures well north of 50 percent, making it much less attractive to walk away from an exposure by selling it on, as was the practice for some years prior to the start of the recession.

Another problem is the lack of turnaround talent available to provide the boots on the ground in restructurings,

especially operational work out specialists, as opposed to the financial engineers. One leading restructuring expert recently complained that it was ironic that despite relatively low levels of activity, it was still difficult to find the right people for assignments. The trouble is, he commented, that the market is full of retrenched executives, but very few of the management stars from the era of headlong growth are any good at shrinking businesses.

One final worry haunts the restructuring market. With private equity houses burning their way through the cash pile from before the recession in pursuit of higher returns, what happens if they run into trouble raising new capital, as some believe they may? Where then will the DIP funding come from, assuming that the banks are still busy and sensibly repairing their balance sheets rather than growing their lending?

For management teams and minority equity participants in private equity sponsored rescues there is another concern. No doubt the situation is better than a balance sheet with hedge funds and vulture investors prowling all over it, but how long term will the PE involvement really be as performance and exit prospects improve?

No matter what shape the recovery may turn out to be, or its timeframe, all players in the restructuring market are in for an interesting and bumpy ride. Nothing is the same as it was, with no certainty about how normality will look in the future. Flexibility and creativity will need to be our core skills and at least some successful outcomes will owe as much to good luck as they will to good judgment.

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Financial restructuring in Germany

BY THOMAS ZIEGLER AND DR SANDRA HOFMANN

Under German law, businesses which are over-indebted or unable to meet their payment obligations are under a statutory obligation to file for insolvency. As a consequence, prevention and elimination of over-indebtedness and illiquidity are the main objectives in any financial restructuring.

Over-indebtedness, illiquidity. In principle, a business is 'over-indebted' if its liabilities are not covered by its assets. Too many businesses would fail this test since the financial crisis has hit the markets, and for that reason the relevant law has been amended for the time period ending on 31 December 2013, to the effect that such over-indebtedness shall not be deemed to be given if there is a positive outlook for the continuation of the business, i.e., a probability of more than 50 percent that the respective business can be continued and the assets will cover the liabilities in the medium-term. For the assessment of over-indebtedness a balance sheet of the company is to be drawn, whereby equity, capital reserves and qualifiedly subordinated liabilities are not to be taken into consideration on the liabilities side. Assets are to be booked at liquidation value, unless (applicable after 31 December 2013) there is a positive outlook for the continuation of the business in which case they are to be booked at going concern value.

A business is considered 'illiquid' if it is not able to meet its payment obligations as they fall due. Temporary payment delays are irrelevant as long as the business is able to meet 90 percent or more of its payment obligations becoming due within a time period of three weeks to come.

Cash management. Cash management measures can improve the company's liquidity, but not its balance sheet status. For instance, factoring, sale-and-lease-back and cash-pooling provide for additional liquidity, but none of these measures is fit to remedy imbalances on the company's balance sheet, because they either result only in changes within the asset side (factoring increases the cash position at the cost of the receivables position, sale-and-lease back at the cost of the fixed-asset position) or an increase on the asset side goes along with a corresponding increase of the liabilities, as is the case with cash-pooling which increases the cash position at the cost of an increase of the liabilities.

Consequently, all of these measures are an adequate remedy for liquidity problems, but no remedy against over-indebtedness.

Deferral of payment, *waiver of payment.* Deferral of payment postpones payment obligations, and therefore has a positive effect on liquidity. Since the respective liability remains on the balance sheet it is not a remedy against over-indebtedness.

Waiver of payment. Waiver of payment does not improve the company's cash position, but removes part of the payment obligations, and therefore has a positive effect on liquidity. Because liabilities are eliminated it is also an adequate means for the prevention or elimination of over-indebtedness.

Increase of equity. Equity can be increased by way of share capital increase, payment into the capital reserve and mezzanine finance instruments, such as atypical silent partnership, jouissance rights and profit participating loans, structured to the effect that the funds will be qualified as equity, which is the case if the funds are granted long-term, subordinated to all other creditors, with profit-related compensation and with participation in loss of the company. Any such equity funding results in an increase of the assets (cash), but not in an increase of the liabilities, because equity positions are not taken into consideration for the assessment of over-indebtedness. Consequently, the increase of equity is, from an accounting perspective, the most suitable instrument

to prevent or eliminate illiquidity and over-indebtedness.

Non-subordinated debt finance, bank finance to distressed borrowers. Non-subordinated debt finance, such as typical bank loans, regular shareholder loans, typical silent partnerships and mezzanine finance instruments which do not qualify as equity, are the most common means to provide businesses with cash. They are appropriate for the elimination of illiquidity. However, the increase of cash on the asset side of the balance sheet is mirrored by an increase of the liabilities, and consequently non-subordinated debt finance is not a remedy against over-indebtedness.

Bank finance to distressed borrowers can involve particular problems if there are no prospects for the long-term rescue of the distressed borrower. In particular, the bank could be held liable for undue retardation of the insolvency. Therefore, in practice the granting of such funds is subject to submission of an expert report on the status of the borrower, together with an opinion on the prospects of the long-term continuation of the business. Further problems can arise if the bank exercises undue controlling rights, e.g., if loan covenants or other finance terms result in effective control of the bank over the business of the borrower. As a consequence of such controlling position the bank debt can suffer a subordination of rank in case of the insolvency of the borrower. Therefore, compared to common law finance practice German law finance documents are rather restrictive with respect to the bank's rights to control the borrower's business. In the alternative, where necessary, German banks rather request for transfer of the distressed business to a trust, with both the bank and the shareholders of the borrower as beneficiaries. In such cases the trustee administers the business in accordance with the provisions as agreed under the trust agreement, which for example could provide for the sale of the business if certain business targets are not achieved, and distribution of the sales proceeds to the beneficiaries in accordance with certain waterfall rules.

Subordinated debt finance. Liabilities which are subordinated to the effect that they have rank subordinated to all other (subordinated and non-subordinated) creditors are not to be taken into consideration for the assessment of over-indebtedness. Therefore, such subordinated debt finance is an appropriate remedy against both illiquidity and over-indebtedness. In practice, a typical means for the financial restructuring of over-indebted businesses would be to provide for subordination of shareholder loans and, if necessary and possible, third party debt as well.

Debt-equity-swap. A debt-equity-swap can be effected by way of waiver of debt in connection with a share capital increase, by way of contribution of debt into the capital reserves or by way of debt-buy-back by the company or its shareholder, in connection with share capital increase and debt waiver or contribution of debt into the capital reserve, as applicable. Usually, the appropriate structure will be driven by tax reasons. A debt-equity-swap does not provide for additional cash and therefore is no remedy against *illiquidity*. However, it results in a decrease of the liabilities against an increase of equity or capital reserves, both of which are not to be taken into consideration for the assessment of over-indebtedness. Therefore, debt-equity-swap is an appropriate means against over-indebtedness.

Conclusion. The above measures have different effects on the financial status of a distressed company, at the cost of different parties. Consequently, financial restructuring is usually carried out by way of a combination of measures, which typically comprise subordination of existing shareholder loans and intercompany debt, provision of additional bank finance and, as available, additional shareholder funds, by way of subordinated shareholder loan or capital increase, granted by existing shareholders and/or new investors.

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Advantages of the APE: Argentina's prepackaged debt restructuring agreement

BY RICARDO W. BELLER

This article describes the benefits that the Acuerdo Preventivo Extrajudicial Procedure (APE) has provided with regards to the facilitation of debt restructurings in Argentina since the 2001 crisis.

Background

As of December 2001, Argentina suffered a tremendous financial, political and social crisis. Among other major events, the country declared the default of its sovereign debt, restricted the transfer of funds abroad and the withdrawal of deposits from financial entities, and the Argentine peso, which had been pegged to the US dollar for more than 10 years, was devalued. The devaluation was especially prejudicial to companies that had issued bonds and obtained cross-border loans in the international markets, as these debts were owed in their original US dollar or other foreign currency in which they were denominated, but could not be paid with the devalued Argentine peso income of these companies.

Consequently, many laws and decrees were passed during the first half 2002 to alleviate the crisis. Among these, the Argentine Congress passed an amendment to the Argentine Bankruptcy Law 24,522 (ABL), that among other changes, made

the '*Acuerdo Preventivo Judicial*' or 'APE' enforceable against all the unsecured creditors provided certain conditions were met.

Acuerdo Preventivo Extrajudicial

The APE is a procedure by which a debt restructuring agreement that is entered into by a debtor with a certain majority of its unsecured creditors becomes enforceable against all the unsecured creditors, including those that did not consent or voted against it. The enforceability of the APE against all unsecured creditors is the key feature that makes the APE an extremely useful tool to achieve a successful debt restructuring.

To become enforceable against all unsecured creditors, two basic requirements need to be complied with: (i) the APE debt restructuring agreement must be consented to by the majority of creditors provided by the ABL (as described below); and (ii) the court must endorse or validate the agreement – this court ruling is denominated an *homologación*, which basically consists of a judicial confirmation that the ABL legal requirements have been complied with.

Any company can enter into an APE, with a few exceptions related to certain activities that are regulated by special insolvency rules (e.g., banks and insurance companies).

Debt restructuring implementation

We describe below the typical mechanics for the implementation of a debt restructuring using the APE procedure. These descriptions are based on the analysis of several of the 2001 crisis debt restructuring experiences.

First stage: preparation of the proposal. The debt restructuring procedure is generally commenced by the debtor proposing debt restructuring terms to its unsecured creditors. The ABL provides freedom of content of the debt restructuring agreement. The debtor company and its unsecured creditors may agree to any or all of the following: amendments, waivers, 'haircuts' and/or deferral of principal or interest payments, exchange of notes for new notes and/or equity, new guarantees, payments in cash or in kind, or others. The creditors may conduct negotiations through a steering committee, although the ABL does not require such a committee to be constituted. Generally the debtor prefers to negotiate the proposal with a steering committee, to ensure a minimum of consents will be obtained. The creditors also prefer to be members of the steering committee, to ensure that the proposal addresses their particular interests. Otherwise, an agreement negotiated by other creditors may be 'crammed down' on them under the APE procedure. During this period the debtor will generally request a standstill agreement from the creditors. Obtaining this protection is important for the debtor, as the ABL does not provide any standstill protection prior to the APE being filed in Court.

Second stage: *consent period.* Once the debtor and the committee of creditors agree on the terms of the debt restructuring agreement, the debtor proceeds to launch the restructuring proposal in order to obtain the consent of a majority of the unsecured creditors. To obtain court endorsement of the agreement under an APE procedure, the consent of creditors that represent: (i) the absolute majority (more than 50 percent) of all unsecured creditors, determined on a per capita basis, each individual creditor being computed as one unit, regardless of the amount of their credit; plus (ii) at least two thirds of the aggregate principal amount of such unsecured creditors (the 'APE Majorities'), is required.

In several of the 2001 debt restructuring proposals, the debtor offered different implementation alternatives to the creditors which depended on the amount of consents obtained, as follows:

Direct exchange. If the agreement was consented by a significant number of the creditors (e.g., creditors representing 95 percent or more of the unsecured debt), then the debtor would enter into a direct exchange with the consenting creditors. In this scenario, the benefit of enforcing the restructuring agreement against the 'holdouts' was outweighed by the time and cost required to obtain court approval under an APE procedure, and the debtor would be able to pay the small portion of the debt that was not restructured.

APE procedure. If the agreement was approved by creditors that represented at least the APE Majorities, but less than the majorities required for a direct exchange, then the debtor proceeded to file the debt restructuring with the Court under the APE procedure in order to make the debt restructuring agreement enforceable against all the unsecured creditors.

Failure of the proposal. If the APE Majorities were not reached, the debtor had the option to improve the terms of the debt restructuring and launch a new consent period with the aim of obtaining the consent of the required APE Majorities, or file a concurso if the debtor considers that the APE Majorities will not be reached or is under too much judicial pressure of creditors requesting its bankruptcy.

These majority requirements created various incentives that facilitated the debt restructuring process. Firstly, the creditors became less concerned if other creditors would obtain better restructuring terms, and therefore were less reluctant to grant their consent. They reasoned that if the APE Majorities were reached, the APE procedure would be followed and the agreement would become enforceable against all creditors. If on the other hand the APE Majorities were not reached, then the conditions precedent would not be complied with and the agreement they had consented to would not become enforceable.

Furthermore, if the proposal did not obtain the consent of the APE Majorities, the debtor might be forced to enter into a concurso preventivo proceeding (similar to US Chapter 11). As the concurso is more complicated, costly and time consuming than an APE procedure, this creates an incentive for creditors to grant their consent. Lastly, the holdouts often speculate that they will be paid their credits under the original terms. This is only possible if the debtor obtains a sufficient amount of consents that allow it to enter into a direct exchange (e.g., at least 95 percent). Therefore the holdouts also have the incentive to support the debtor in obtaining the required consents.

Third stage: implementation

In the case of a direct exchange, the debtor and the creditors proceed to implement directly the debt restructuring under the terms of the agreement. The debtor would then need to deal with the holdouts, but it is not obliged to pay them immediately and could continue negotiating with them under the terms of their outstanding credits.

To implement an APE Procedure, the executed debt restructuring agreement is filed with the Court together with a dossier of documentation that mainly refers to the financial situation of the debtor. The filing of the APE before the relevant court has the effect of staying all actions to enforce unsecured claims against the debtor. However, it does not suspend the accrual of interest on outstanding debt. The Court will conduct a review of the compliance of the APE Majorities and other formal requirements, and a limited review of the substantive terms of the APE. For example, a review to determine that basic standards of Argentine law have not been breached, such as compliance of public order regulations, non existence of fraud, etc. or that the proposal does not discriminate creditors on unreasonable grounds. The Court will subsequently order the publication of notices of the filing of the APE. Non-consenting creditors may then contest the APE on very limited grounds, such as omissions or exaggerations of the assets or liabilities, non-compliance of the APE Majorities, or non compliance of the other formal or substantive requirements mentioned in the prior paragraph. Once the oppositions, if any, have been resolved, and the compliance of the APE Majorities and other legal requirements are verified, the court should endorse the APE. Upon court endorsement, the APE becomes effective against all unsecured creditors, including those that did not consent to the APE.

APE case law

Several of the 2001 debt restructurings resulted in proceedings being initiated before several courts. Of these it is worth mentioning the following: (i) the New York courts ruled in several cases that the debt restructuring agreements approved under an APE proceeding were enforceable in the USA under the terms of Section 304 (currently Chapter 15) of the US Bankruptcy Law (In re: Telecom, Multicanal, and Cablevisión, among others); and (ii) the Argentine Supreme Court recently confirmed the validity of the APE procedure in a case in which its constitutionality was being challenged (in re: Cablevisión).

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CHAPTER THREE:

Bankruptcy-Related M&A

General Motors and Chrysler bankruptcies: should we treat them as precedent or aberrations?

BY DOUGLAS C. BERNSTEIN

The landscape of bankruptcy law in the United States changed dramatically in 2009 as a result of the filing of Chapter 11 petitions for relief by Chrysler, LLC, General Motors Corporation, and various affiliates.

The proceedings took on characteristics unlike other bankruptcies because, in each instance, the United States Department of Treasury provided debtor-in-possession financing. The Treasury largely dictated how the restructuring of each company would play out, subject to the appropriate orders of the bankruptcy court.

The term '363 sale', coined as a result of the corresponding section of the US Bankruptcy Code, no longer was referred to only in pleadings and arguments in bankruptcy courts throughout the US, but remarkably became a frequent part of news reports in mainstream publications and in radio and television programs describing the proceedings. The use of this bankruptcy code provision served as the springboard to facilitate the start of one of the most important restructurings of an industry ever undertaken in the United States.

After most of the dust had settled, however, bankruptcy practitioners were left to ponder the question of whether the same rules apply to other bankruptcy proceedings where the federal government does not provide the debtor-in-possession financing and has not devised the plan of reorganisation.

Some of the underlying facts are essential to understand the challenges faced by the automakers, the US government, the courts hearing the matters, and other bankruptcy professionals.

In December 2008, the United States, through the Department of Treasury, agreed to throw a lifeline to General Motors and Chrysler, each of whom had been suffering from low sales volumes, high pension and employee benefit costs, and other effects of the global credit crunch. In exchange for the temporary relief, which was at the time referred to as 'loans', Chrysler and General Motors were required to make radical changes to their business model, by bringing their cost structures in line with those of Toyota, Honda and Nissan factories in the United States. The Treasury also mandated that the affected automakers would have to negotiate a significant discount of their bondholder debt, and that both General Motors and Chrysler would have to submit plans in February 2009, demonstrating their future viability.

The plan submitted by Chrysler was roundly criticised, ultimately resulting in the Treasury and President Barack Obama concluding that there was no option but to effectively sell its assets to Fiat, with a tight deadline established to accomplish the transfer. The Treasury, in another startling and unprecedented move, required General Motors to replace its chief executive officer, as a condition for obtaining further assistance.

While the Chrysler bankruptcy had a purchaser in waiting for most of its assets, General Motors took a slightly different tact, by separating the 'good' assets from the 'bad', shedding Saab, Saturn and Hummer, and announcing plans to discontinue manufacturing the Pontiac brand.

In both cases, howls of protest, perhaps more vigorous with respect to Chrysler, came from various classes of creditors, who asserted that their interests were being improperly compromised by the Treasury's plan, in contravention of the US Bankruptcy Code. In some instances, those protests were even publicly denounced by President Obama, as being contrary to the 'good' of America. A closer look at the facts and circumstances would seem to indicate that those protests had some legitimacy, which may have produced slightly different results but for the short deadlines set for completion of the Fiat transaction.

Both Chrysler and General Motors, immediately upon filing their petitions, shuttered manufacturing operations, as a means for conserving cash. While the plants were closed, many of their suppliers, who were already struggling under the burden of price concessions extracted by the manufacturers, slowed payments and volumes far below those which were anticipated, teetered on the brink of their own demise. Thus, an even greater sense of urgency for completing these sales was created.

First Chrysler, and then General Motors, sought to carry out the plans designed for them by the Department of Treasury, by filing motions in reliance upon Section 363 of the bankruptcy code, which governs the sale of a debtor's property outside of the ordinary course of its business.

Mechanically, a 363 sale requires the prior approval of the process to be used by the bankruptcy court. Typically, potential bidders at the sale will have to be 'qualified' under the terms of the sales procedures order issued by the court. Once the sale is held, the debtor will determine which bid is, in its view, the highest and best which, in turn, must be confirmed by the bankruptcy court.

The court has a key role in 363 sales, as the applicable procedures must be fair, with no undue advantage given to any potential bidder, in order to maximise the sale price and, ultimately, for the return to be paid to the creditors. The court will typically inquire about how, to whom, and for how long the assets have been marketed. If there is a so-called 'stalking horse bidder' (i.e., a pre-qualified offer), the court may authorise a breakup fee to be paid if that party is not successful in acquiring the assets. Fiat filled the role of the stalking horse bidder in the Chrysler bankruptcy.

Given the apparent liberties taken with the bankruptcy code, one can only wonder when and if we will ever be able to use these cases as precedent.

Contrary to the vast majority of bankruptcy cases, no good faith deposit was required from Fiat; however, any potential competing bidder was required to post a deposit of $20m. Further, the proposed sale was to take place merely a few days after the hearing, seeking approval of the procedures to be used, thus making it virtually impossible for a competing bidder to perform any meaningful due diligence in the interim. Finally, the United Auto Workers (UAW), which otherwise would have had the same status for the purpose of receiving distributions as other unsecured creditors, found itself arguably significantly improving its position, apparently in contravention of the provisions in the bankruptcy code.

Despite the vigorous protests of a segment of the creditors, led by a group of Indiana pension funds, Bankruptcy Judge Arthur Gonzalez approved the proposed procedures and sale, as requested by Chrysler, Fiat and the Treasury. Significant to the ruling were that there appeared to be no other prospective purchaser of those assets on the horizon; Fiat, under the terms of its purchase offer, could walk away from the transaction if it was not closed by the end of June and, perhaps most importantly, absent approval of the sale, there would be no apparent alternative but to have Chrysler liquidated.

The Chrysler proceedings seemed to be a dress rehearsal for the General Motors bankruptcy, which followed shortly thereafter. General Motors, which had serious and difficult negotiations with its bondholders before finally reaching a last minute agreement, seemingly had a much easier time in having its sale approved than did Chrysler. Neither of the presiding bankruptcy judges agreed to delay the sales, pending appeals, as had been requested by certain objecting parties. Also, the US Supreme Court refused to review Judge Gonzalez's approval of the sale of Chrysler's assets to Fiat.

The bankruptcy proceedings had other unpopular consequences, which impacted even those who favoured government assistance for the industry.

First, using the powers afforded by the bankruptcy code, Chrysler was able to terminate franchise agreements with a significant portion of its dealership network, addressing the belief that the marketplace was oversaturated. These contract rejections caused protests throughout the country, as small businesses which, in many cases, had been an important part of their communities for decades, were suddenly having their stores closed without compensation or other available recourse. The uproar even precipitated the introduction of legislation which sought to unwind the dealership closures. General Motors, taking note of the adverse publicity received by Chrysler, followed a somewhat different course, allowing some of its dealers to brace for their eventual closing by announcing that certain franchise agreements would not be renewed upon their expiration.

Another serious public relations problem was that the filing of the bankruptcy petitions stayed the pursuit of product liability and personal injury claims against Chrysler and General Motors that arose prior to the filing, potentially leaving the seemingly innocent victims without any recourse or compensation for their damages.

Chrysler and General Motors have now begun their new lives, looking much different than before. Although the restructured companies are beginning to take shape, questions remain about what precedential value, if any, these two cases have or should have.

Virtually no one believed that the 363 sales for Chrysler and General Motors could be accomplished within 60 days of the date of filing of their respective bankruptcy petitions; certainly, most bankruptcies involving companies a fraction of their size did not have 363 sales approved or consummated within such a short time frame. Thus, can we expect that the process in other cases will be accelerated in the same manner?

Additionally, will any other bankruptcy court approve a potential purchaser as a stalking horse bidder without posting a deposit or other evidence of a financial stake in the transaction?

Furthermore, what became of the exclusivity period described in the bankruptcy code, whereby only the debtor has the right to submit a plan of reorganisation in the first 120 days of the proceedings, which time period may be extended by the court? Were the plans drawn up for Chrysler and General Motors in fact nothing more than the work of the Department of Treasury, which the debtors had no discretion to reject or to modify?

And, how could the priority of the claims of the UAW become higher than that of other unsecured creditors, thus allowing the union to enjoy a greater recovery, seemingly in contravention of the provisions of the bankruptcy code?

Certainly, there is no preamble in the bankruptcy code which states that, "in the event debtor-in-possession financing is provided by the Department of Treasury, some of these provisions may not apply."

Only time will tell whether the plans set forth by the Department of Treasury will ultimately work to allow Chrysler and General Motors to survive. Given the apparent liberties taken with the bankruptcy code, one can only wonder when and if we will ever be able to use these cases as precedent.

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Section 363 sales: the other side of the coin for secured lenders

BY JONATHAN N. HELFAT

Over the last several years, companies operating under Chapter 11 of the US Bankruptcy Code have increasingly used Section 363 of the Bankruptcy Code to consummate a sale of their business and, in doing so, have made Section 363 the most common Chapter 11 reorganisation tool for the secured lender. The increased use of Section 363 is due in great part to the capital structures of the companies filing for Chapter 11 relief. Most companies (or 'debtors' as they are referred to under the Bankruptcy Code) entering Chapter 11 have multiple layers of secured debt, the amount of which exceeds the value of its assets. As the value of the debtor's assets is usually insufficient to fully repay its secured debt, the debtor's secured lenders have little appetite for funding a traditional reorganisation process (and risking an even greater loss). Instead, secured lenders have turned to the 363 sale as a faster and more efficient strategy.

Without question, 363 sales have many advantages, including speed and efficiency (363 sales can occur within the first month of the case), the secured lender's ability to credit bid and, perhaps most importantly, the debtor's ability to sell assets free and clear of liens and claims. However, 363 sales are not always the secured lenders' panacea, as 363 sales have various potential pitfalls of which secured lenders should be aware.

First, if the 363 sale will leave the debtor's estate with little or no assets after the repayment (in whole or in part) of the secured lenders' claims, then in most cases the Chapter 11 debtor's estate will be administratively insolvent. A Chapter 11 estate is administratively insolvent when the Chapter 11 debtor does not have sufficient funds to pay the operating expenses it has incurred during the Chapter 11, including expenses incurred in furtherance of the 363 sale.

In an effort to ensure that a Chapter 11 debtor will have sufficient funds to pay these administrative expenses, the secured lender in many instances is required by the Bankruptcy Court (usually at the urging of the Creditors Committee) to 'carve-out' from the 363 sale proceeds a sum necessary to fund the expenses. Depending on the nature of the business and its financial circumstances, the administrative expenses may be substantial. Alternatively, the debtor could require the 363 purchaser to pay the outstanding administrative costs as a condition to the sale or for receiving the benefits typically afforded to a 'stalking horse bidder'. When evaluating the merits of a potential 363 sale, the secured lender should consider the extent and means of funding these administrative costs.

Second, as with the Chapter 11 confirmation process, the payment of 'cure costs' is normally a condition of a 363 sale. These costs arise when the 363 purchaser wants the assignment to it of one or more of the debtor's contracts under which the debtor is in default. Section 365 of the Bankruptcy Code permits a debtor to assume and assign its executory contracts if the debtor (or the 363 purchaser on behalf of the debtor) cures defaults under the contract and provides adequate assurance of future performance under the contract. So, for example, if the 363 purchaser wants to purchase the debtor's rights to leased equipment used in the business but the debtor is not current on its lease payments, the past due lease payments will generally need to be paid in order for the debtor to assign the lease to the 363 purchaser.

Obviously, depending on how many contracts will be assigned in a 363 sale and the past due amount under these contracts, the aggregate 'cure costs' of a 363 sale can be significant. The question of who is responsible to pay 'cure costs' is negotiated between the debtor and the 363 purchaser. However, regardless of whether the debtor agrees to pay the 'cure costs' from the sale proceeds or the 363 purchaser receives a credit against the purchase price for any 'cure costs' it pays, the secured lender ultimately ends up with less of the sale proceeds than it might have anticipated because in either case the cure costs reduce the amount of net proceeds generated from the sale. Thus, secured lenders should be mindful of 'cure costs' when evaluating a proposed 363 sale transaction.

Third, it is not unusual for a 363 sale to include trademark licences under which the debtor is the licensee. As discussed above, the Bankruptcy Code permits a debtor to assume and assign executory contracts, such as licence agreements, after certain conditions are satisfied. However, Section 365(c)(1) of the Bankruptcy Code contains an exception to this general rule, which courts have interpreted to mean that a licensee debtor cannot assign a trademark licence without the consent of the licensor. This clearly is a 'trap' for the unwary buyer, or worse, a deal killer for the sale.

Frequently, however, the licensor is willing to consent if it is paid a fee or receives some other consideration. Thus, when a proposed 363 sale contemplates the assignment of a trademark licence under which the debtor is the licensee, consideration should be given to the likelihood of obtaining the consent of the licensor, the cost to obtain such consent and who will pay such cost.

Fourth, it is not unusual for the debtor's business to deteriorate during the weeks leading up to the 363 sale. This concern is often a primary rationale for the use of the 363 sale given the speed with which it may be achieved relative to a plan of reorganisation. The deterioration of the business erodes the value of the secured lenders' collateral as the collateral is used to fund operating expenses necessary to enable the business to continue from the commencement of the Chapter 11 case until the closing of the 363 sale. Of course, no matter how efficient the 363 sale process is conducted, 363 sales take

some length of time to close, and during this period, the debtor will continue to lose money and suffer asset deterioration. These losses are colloquially referred to in US bankruptcy circles as the 'melt'.

Obviously, any 'melt' will need to be funded to close the 363 sale. Otherwise, the debtor may not have sufficient funds to remain operational pending the closing of the sale, and as a consequence will be forced to liquidate its assets. A secured lender might be reluctant to fund the 'melt' due to the risk that it does so, thereby increasing its exposure, only to have the 363 sale fall apart before closing. If this were to occur, the secured lender might be in a worse position than if the debtor had liquidated its assets at the outset of the case. For this reason, the 363 purchaser may be required to provide funding proportionate to any 'melt' before the secured lender will commit to the 363 sale process. The potential for a 'melt' in the debtor's business also puts a premium on obtaining an accounting of the debtor's assets as soon as possible.

As discussed above, when evaluating the proposed merits of a 363 sale, secured lenders should be mindful of any anticipated administrative costs, 'cure costs', trademark licensing issues and continuing 'melt' of the debtor's business. If these issues are not addressed until the 363 sale process is already underway, the secured lenders may find themselves without any leverage to negotiate a better result, and may ultimately be forced to fund additional amounts in order to preserve any remaining value in its collateral. Thus, secured lenders should make every effort to identify and negotiate these issues before they commit to the 363 sale process.

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Acquisition of distressed assets in Germany – how to avoid the pitfalls

BY THOMAS ZIEGLER AND DR SANDRA HOFMANN

An increasing number of fire sales create interesting investment opportunities. However, the investment in distressed businesses or the acquisition of assets from distressed sellers involves a number of legal risks, the most important of which are outlined in this article, together with possible ways to cope with them.

Transactions with distressed sellers. Typically, a number of risks involved in a transaction are hedged by way of representations and warranties to be used for recourse against the counterparty if such risks materialise. This does not provide adequate coverage where the credit-standing of the counterparty is doubtful. In this case, adequate due diligence is becoming more important for the assessment of possible risks. To the extent due diligence cannot exclude risks, it is vital to ensure that claims under representations and warranties can effectively be enforced, irrespective of the seller's possible insolvency. The most common means are (i) escrow deposit and (ii) third-party guarantee. Alternative instruments would be (iii) payment of purchase price in instalments, together with the right of retention and set-off if risks materialise. Further, certain risks could be hedged by way of (iv) insurance which however is rarely used due to the significant impact on transaction costs. Finally, to the extent risks cannot be adequately secured, they may need to be reflected in the (v) amount of purchase price. Numbers (i) and (iii) could trigger the risk of avoidance by the insolvency administrator, as set out in more detail below. Consequently, the other instruments, in particular a recoverable third-party guarantee (which might be backed by part of the purchase price in deposit or other security) will be the preferred route for the purchaser in such transaction.

Transfer of liabilities. In share deals, all of the liabilities created in the business remain unaffected by the transaction, i.e., they remain with the company. In principle, liabilities do not transfer in asset deals, and therefore this kind of deal structure is a further possibility to reduce risks. However, under German law this does not apply to all liabilities and therefore even for an asset deal the purchaser incurs the risk of transfer of certain liabilities. This applies in particular to employment agreements relating to the purchased business, irrespective whether they have been disclosed to the purchaser or not. Unless the employee objects within one month after due notification, the employment agreement transfers to the purchaser by operation of law and the purchaser becomes liable for all liabilities of the employer created thereunder, including pension commitments. Further, this applies to all tax liabilities created by the business operation in the time period starting at the beginning of the calendar year preceding the acquisition, and declared or assessed within one year since notification of the business acquisition to the tax authorities. Furthermore, this applies to certain regulatory obligations (e.g., decontamination obligations in relation to contaminated real property) and could apply in relation to the restitution of subsidies which can become due if subsidies have been granted to the business and the transfer of the business is not in compliance with the underlying subsidy regulation. Finally, liabilities created in a business transfer in total to the purchaser of such business if the purchaser continues to use the firm (name) of the business, unless seller and purchaser have excluded transfer of liabilities, and such non-transfer of liabilities has been notified to the respective creditor or entered into the commercial register.

Since the transfer of the above liabilities cannot be ruled out by way of deal structure or other agreement, thorough due

diligence in relation to such risks and adequate security for recourse claims as set out above are essential when dealing with a distressed seller.

Insolvency offences. If a managing director misuses the power to dispose of assets of the company (e.g., by unreasonable sale of assets of the company far below fair market price to the detriment of the company) that managing director is subject to criminal prosecution. The mere participation of a purchaser in the transaction does not result in criminal liability of the purchaser. However, if the purchaser is aware of the misuse of power by the managing director and induces or encourages the managing director to harm the company's interest (e.g., by exercise of undue pressure on the managing director or by grant of undue incentives) the purchaser would also be subject to criminal liability. Corresponding risks arise if a distressed seller carries out transactions grossly contrary to regular business standards and diminishes its assets to the detriment of the company's creditors. If any such risks cannot be excluded otherwise, it will be appropriate for the parties to produce adequate evidence that the transaction is in the interest of the company, by way of respective shareholder resolutions and expert opinion. Finally, it may be considered to avoid any such risk by way of carrying out the transaction not with the distressed seller prior to the commencement of insolvency proceedings, but with the seller's insolvency administrator after opening of the insolvency.

Avoidance of transaction. If assets are purchased from a distressed seller, irrespective of conclusion of such acquisition and proper payment of purchase price, it cannot be excluded that subsequent to the transaction the seller becomes subject to an insolvency proceeding. In such an insolvency procedure, the insolvency administrator is entitled to review transactions executed prior to the insolvency procedure, and under certain circumstances is entitled to rescind such transactions. This applies in particular to transactions carried out not earlier than three months prior to the filing for insolvency, if: (i) the seller was at the time of the transaction illiquid; (ii) the purchaser knew about that illiquidity; and (iii) the transaction is to the detriment of the other creditors of the distressed seller (e.g., a higher purchase price for the assets could be obtained). For the purchaser the negative effect of such avoidance could go far beyond the mere cancellation of the acquisition. Whereas in principle the purchaser has to return the purchased assets against restitution of the purchase price by the insolvency administrator, the claim for restitution of the purchase price would not have a preferred rank if the funds are not segregated from the other assets and if the insolvent seller is not enriched anymore. In this case the claim for restitution of purchase price is treated like an ordinary claim against the insolvent debtor, to be filed for under the insolvency procedure and in rank equal to the claims of all other non-subordinated unsecured creditors – with a correspondingly low chance of satisfaction.

Consequently, in transactions with distressed sellers, purchasers should – if applicable and possible – produce evidence on the seller's ability to meet its payment obligations, and otherwise request that the purchase price be paid to and, to the extent possible, kept on a special account of the seller, segregated from any other monies. In the alternative, any of the above risks could be avoided by way of entering into the insolvency procedure and conclusion of the transaction with the seller's insolvency administrator.

Even if assets are acquired at fair market price, transactions carried out not earlier than three months prior to the filing for insolvency can be avoided by the insolvency administrator, if: (i) the seller was at the time of the transaction illiquid; (ii) the purchaser knew about that illiquidity; and (iii) a significant delay occurred between complete exchange of purchase price and acquired assets. Consequently, in distressed asset deals it is key to ensure exchange in full in a timely manner. This would not be the case where all or part of the purchase price is retained or paid to an escrow account.

Advance payments in distressed asset transactions are particularly risky. If the distressed seller has not yet fulfilled all of its obligations under a pre-insolvency sales agreement, the insolvency administrator will not fulfil these obligations, and the purchaser will not have any other right than to file its claims for breach of contract under the insolvency procedure, which will be in rank equal to all other non-subordinated unsecured creditors – with low prospects of satisfaction.

Conclusion. Distressed asset transactions may open interesting commercial opportunities but they involve particular legal risks. Thorough structuring and execution of the transaction can eliminate most, if not all such risks. To the extent such risks cannot be eliminated otherwise, entering into an insolvency process and execution of the transaction with the insolvency administrator could be an appropriate solution.

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M&A with the insolvency administrator in Germany

BY DR RALF MORSHÄUSER AND DR TOBIAS FALKNER

Over the last few months there has been a substantial number of insolvencies in Germany involving even well-known companies (e.g., numerous automotive suppliers, department stores). The market for M&A transactions from insolvency proceedings has grown significantly. Further transactions with an insolvency focus are expected in the coming months.

Transactions with the insolvency administrator follow 'special rules' compared with normal M&A transactions and require a specific approach.

Overview of insolvency proceedings

German insolvency proceedings are run by an insolvency administrator who is appointed by the insolvency court. The insolvency administrator is usually a lawyer and often a member of a specialised law firm.

The opening of insolvency proceedings is usually applied for by the management of the company but may also be applied for by creditors (usually social security or tax authorities). Once the application has been filed, the court appoints a so-called 'preliminary insolvency administrator' to secure the assets of the company. It usually takes up to three months from the appointment of the preliminary insolvency administrator for the (final) insolvency proceedings to be opened. During this time, the wages of the company are paid by the state authorities.

Acquisitions from a preliminary insolvency administrator are very rare because of serious risks for the investor. The time period until the opening of the (final) insolvency proceedings may, however, be used for due diligence and negotiations with the preliminary insolvency administrator (who generally will be identical with the final insolvency administrator). The purchase agreement is then signed after the (final) insolvency proceedings have been opened.

Legal framework for transactions with the insolvency administrator

After opening of the (final) insolvency proceedings, the insolvency administrator has full authority to continue the business and to dispose of the assets of the company. The insolvency court only plays a minor role in the proceedings. The interests of the creditors are usually safeguarded by the creditors' committee consisting of representatives of the major creditor groups, which has to approve the transaction prior to completion. The insolvency administrator could validly dispose of the assets without such approval but would then face liability risks. If no creditors' committee is established, the creditors' assembly (consisting of all creditors) assumes this function.

Transactions from insolvency are usually structured as an asset deal. The insolvency administrator disposes of (ideally all) assets of the insolvent company including shares in non-insolvent domestic and foreign subsidiaries held by the insolvent company. A share deal is only possible in connection with a so-called 'insolvency plan proceeding' (Insolvenzplanverfahren) which is somewhat similar to US Chapter 11 proceedings. A share deal is also possible if the insolvency administrator transfers the assets of the company to a new entity whose shares are then sold.

Foreign investors need to be aware that insolvency administrators usually request that all transaction documents are executed in the German language. Sometimes translations of the first draft are provided by the insolvency administrator. The remaining translation work needs to be handled by the investor. The quality of transaction documents cannot be predicted. While insolvency administrators in larger proceedings involve renowned advisers, the drafts in smaller proceedings may be of rather poor quality and far from 'market standard'. However, due to the time pressure it will often only be possible to address the most important issues.

Major differences from normal M&A transactions

There are important differences between acquisitions from an insolvency administrator and normal M&A transactions.

Transactions with an insolvency administrator are conducted under extreme time pressure because of the insolvency situation. Often there are only a few weeks to carry out due diligence and to finalise negotiations.

The investor usually determines the purchase price according to the company's enterprise value. Therefore, in the case of loss-making companies the purchase price may be low or even negative. The insolvency administrator determines his 'minimum purchase price' according to the potential proceeds from a sale of the individual assets. The reason is that the insolvency administrator has to achieve the best revenue for the creditors. If this cannot be achieved by selling the business as a whole the insolvency administrator may consider disposing of the assets individually.

When signing the purchase agreement the insolvency administrator requires certainty concerning the final purchase price. He usually requests a fixed purchase price without adjustments (except for those relating to the actual inventory or receivables sold). The insolvency administrator furthermore has to avoid a negative purchase price for certain assets (e.g., shares in subsidiaries) as such negative purchase price would be to the detriment of certain creditors.

In general, the insolvency administrator does not accept representations and warranties or indemnification risks for the insolvency estate. This means that – despite the high time pressure and often unsatisfactory data rooms – the investor needs to identify potential risks in the due diligence to reflect them in the purchase price. If the offered purchase price is high enough, certain limited representations and warranties may be negotiable (e.g., regarding title to key assets or certain environmental risks). In this case, the insolvency administrator will request that part of the purchase price be paid to an escrow account, this being the sole remedy for potential claims of the investor. The time limitations will be much shorter than in normal M&A transactions. Six to twelve months are not unusual even regarding environmental risks. The investor needs to be familiar with these specifics. Investors requesting standard representations are unlikely to succeed in the sales process. To a certain extent, sufficient protection can be achieved by means of the Insolvency Code. For example, the insolvency administrator is entitled by law to dispose of moveable assets, disregarding pledges or transfers by security. Other risks may be covered by closing conditions.

Transaction security is highly important to the insolvency administrator. He has only 'one shot' to sell the company.

Therefore, most insolvency administrators request that the merger control risk be borne entirely by the purchaser, e.g., by an obligation to accept conditions or commitments requested by the authorities. Additionally, the insolvency administrators tend to accept only closing conditions which are in their control. Furthermore, investors are often asked to submit financing confirmations by a bank at a relatively early stage of the sales process. A bank guarantee of a renowned (German) bank or even payment of the purchase price to an escrow account already upon signing is often requested. This may appear odd to foreign investors but can be regarded as market standard, at least in larger M&A transactions with the insolvency administrator.

Potential for restructuring

An acquisition from the insolvency administrator may be used for substantive restructuring of the company. In particular, insolvency proceedings offer interesting possibilities to restructure the workforce with the help of the insolvency administrator.

Generally, in the case of an asset deal, all employment relationships of the target transfer to the purchaser by operation of law as they are on the closing date. It is prohibited to terminate such employment relationships because of the transfer of the business. This general rule may, to a certain extent, be circumvented in an acquisition from insolvency. The insolvency administrator can terminate any employment relationship with a maximum notice period of three months. Longer notice periods are disregarded. The investor may provide the insolvency administrator with his restructuring concept *(Erwerberkonzept)*. The insolvency administrator will then terminate the employment relationships in view of the restructuring concept. This allows the investor to have the number and structure of the workforce adjusted to its requirement. However, the investor cannot choose individual employees to be dismissed. Social factors have to be taken into account. It is also not possible to change the terms and conditions of the employment contracts of the employees that transfer to the investor by law.

Alternatively, the insolvency administrator may set up a so-called 'transfer company' *(Transfergesellschaft)* into which the employees of the insolvent company transfer prior to the consummation of the transaction. The transfer company allows the investor to choose which individual employees from the transfer company he wishes to re-hire without being bound to social selection criteria. Additionally, the employees may be offered new employment conditions. However, the employees are free to decide whether to transfer into the transfer company or not. The success of this model, therefore, depends on the attractiveness of the conditions offered by the transfer company (e.g., salary, trainings offered to the employees, etc.). Additionally, there are several legal pit falls which need to be avoided.

The insolvency proceedings may further be used to restructure and renegotiate other contractual relationships of the company. The insolvency administrator is entitled to reject the performance of contracts which are not entirely fulfilled. This gives him the opportunity to retain and then terminate disadvantageous, e.g., loss-making, contracts upon request of the investor. The investor himself can use this pressure on customers or suppliers to renegotiate the contracts. The contract partner may be willing to accept the investor's proposals given the risk of the company's liquidation.

Of course, it is necessary for an investor to inform the insolvency administrator about any assistance required from him in this respect.

Conclusion

M&A transactions with the insolvency administrator are a special kind of transaction following specific rules. Only an investor familiar with such specific rules has the chance to make a good deal with the insolvency administrator and to make use of the restructuring opportunities. Therefore, advisers who are experienced in transactions with the insolvency administrator should already be involved at an early stage.

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Potential opportunities for distressed transactions in Brazil in view of the Brazilian Judicial Recovery Act

BY RACHEL MARTINS

The Brazilian market has experienced an important increase in M&A transactions, joint ventures and foreign equity investment during recent years. A constant and solid development resulted in a dynamic scenario for investments, despite the negative effects of the world crisis. Brazil's corporate market has developed strategic areas in which investors from all over the world are increasingly interested in business and cross-border transactions. This increase has been motivated for several reasons, including the effectiveness of the Federal Law # 11.101/2005, also known as the Brazilian Judicial Recovery Act, which has an important role in restructuring companies in critical economic situation. This Act has updated the laws regarding companies' bankruptcy and financial recovery in Brazil. It provides for the suspension of existing lawsuits

against companies and the drafting of a Judicial Recovery Plan intended to help companies recuperate from financial loss. It intends to offer to the company in distress an opportunity to recover from collapse and maintain its operations, employees' jobs and creditors' interests. In this way it preserves the company and its social function and encourages the development of economic activities in Brazil.

Numerous Brazilian companies have been severely affected by the world crisis, although the impact was not as substantial in all sectors as in other countries. According to Brazilian Central Bank reports, the two sectors in Brazil most affected by the crisis were automotive and financial. The crisis was felt particularly deeply by Brazilian companies which exported to the international market, rather than those supplying products to the internal market. In this scenario, several opportunities for deals have arisen; it is worth mentioning the incorporation of a new company named 'Brasil Foods', which resulted from the merger of Sadia and Perdigão, the two largest companies in the food processing business in Brazil.

Judicial recovery process

Certain Brazilian companies that could not obtain credit or renegotiate debts to keep operating were forced to apply for a Judicial Recovery Process, a type of arrangement with creditors, regulated by Federal Law # 11.101/2005. The Brazilian Judicial Recovery Act has updated the laws regarding companies' bankruptcy and financial recovery in Brazil.

Although Law # 11.101 dates from 2005, its application by Brazilian Courts increased after 2008 due to the impact of the world economic crisis. According to research conducted by Brazilian Company Serasa, between January and June 2009, a total of 391 Judicial Recovery requests were filed before Brazilian Courts based on the rules of Law # 11.101/2005. This represents an increase of 185 percent compared to the first semester of 2008, when 137 Judicial Recovery requests were filed before Brazilian Courts.

Serasa advisers believe that the increase in the number of requests is due to mainly to the effects of the world crisis, which include: (i) reduced availability of domestic and international credit; (ii) a decrease in business activity and; (iii) the recession of highly developed economies. Among the 391 Judicial Recovery requests filed, there were 256 requests accepted in the first semester of 2009, which happens when the company requests the suspension of the Collection Lawsuits in order to plan its recovery from crisis. Also, in the first semester of 2009 there were 43 Judicial Recoveries conceded, which happens when the plan developed by the company is approved by the creditors and duly ratified by the Justice. This is a significant increase considering that in the same period of 2008 only six Judicial Recoveries were conceded.

Furthermore, the following persons may apply for a Judicial Recovery Plan in Brazil: (i) an individual businessman; (ii) companies incorporated under the laws of Brazil; and (iii) foreign companies with proper authorisation to operate in Brazil.

The debtor may only apply for a Judicial Recovery Plan in the event it cumulatively fulfils the following requirements: (i) the company develops its business activity for more than two years; (ii) the company was not in the process of bankruptcy; (iii) the company was not part of a Judicial recovery in the past five years; (iv) the company was not part of a Judicial recovery in the past eight years (in the case of smaller companies); (v) none of the officers or shareholders of the company were considered guilty on bankruptcy crime suits. In addition, article 50, II, of the Judicial Recovery Law sets forth mergers and acquisitions of companies and the assignment of the shares held by the debtor as possible methods of recovery, among others.

In addition, prerequisites for a company to apply for a Judicial Recovery are set forth in article 282 of the Brazilian Civil Process Code and Article # 51 of Act # 11.101/2005. These prerequisites are: (i) an explanation of the real causes of the current financial situation of the debtor and the reasons behind its critical economic and financial situation; (ii) presentation of the company's accounts for the previous three financial years; (iii) presentation of financial statements specially drafted for documenting the request of Judicial Recovery; (iv) a list of the names of the creditors and details of each debt (value, origin, etc); (v) a list of employees and their respective enrolments; (vi) a clearance certificate of the company issued by the registry of companies with the Articles of Incorporation and appointment of officers; (vii) a list of particular assets of controlling shareholders and officers of the debtor (which is criticised by the doctrine); (viii) bank extracts; (ix) clearance certificates issued by the notary; and (x) a list of all judicial claims to which the company is a party, along with an estimate of the amounts demanded.

Considering the changes in the Brazilian Judicial Recovery legislation and the main government initiatives for the development of business in Brazil, the current circumstances can present an advantageous platform to investment funds which may apply in direct acquisition of shares of Brazilian companies by means of private equity and venture capital, especially considering the post crisis phase. A recent study by Deloitte Touche Tohmatsu revealed that globalisation of the venture capital industry will intensify in the coming years, creating opportunities for emerging markets such as Brazil. Moreover, a PricewaterhouseCoopers report asserts that private equity is growing stronger in the current scenario and is a good alternative for resources achievement. So far in 2009, private equity investors participated in 24 percent of transactions in Brazil. They were particularly active the food and beverage, education, construction, logistics, entertainment, retail, electric energy, technology and finance sectors.

It is important to emphasize that Law # 11.101/2005 is considered flexible as it allows companies to use several structures to recover their business. For this reason, companies in the process of judicial recovery present an opportunity for M&A transactions and foreign investments. According to the Judicial Recovery Act, a company in debt needs to present a detailed plan of recovery establishing the means it intends to follow for the purposes of recovering and paying its creditors. The plan of recovery may include, among other items, opportunities for M&A operations or assignment of the

company's shares at a lower price. By means of a recovery plan, companies in the Judicial Recovery Process are able to decide on selling parts of their assets to investors excluding eventual debts, for example. A Recovery Plan also provides that the company's current lawsuits are temporarily suspended for 180 days.

In summary, the world crisis has brought not only losses but also new opportunities for investments. Along with this scenario, the Brazilian Judicial Recovery Act has created grounds for investments – especially for small and medium sized companies – by private equity and venture capital funds, as well as strategic buyers.

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CHAPTER FOUR:

Creditor Issues

Preference and fraudulent conveyance litigation: a primer and some recent case law developments in the second (New York) and third (Delaware) circuits regarding defences

BY JOHN S. MAIRO AND KELLY D. CURTIN

In 2003, Enron initiated a lawsuit in its New York bankruptcy proceedings to avoid and recover over $1bn paid to a total of 98 creditors during the weeks preceding its December 2001 Chapter 11 bankruptcy filing. The Enron Commercial Paper Litigation involved two common causes of action brought against creditors in US bankruptcy proceedings: preference and fraudulent conveyance. In addition to highlighting those common bankruptcy causes of action, the Enron Commercial Paper Litigation shows how such lawsuits can ensnare creditors from around the globe in complex, expensive litigation. Indeed, while the majority of defendants have settled with Enron, three defendants are continuing to expend resources to litigate nearly six years after the initiation of the lawsuit.

This article will address the elements of a preference and fraudulent conveyance cause of action, as well as discuss some recent case law developments from the New York and Delaware jurisdictions relating to defences available to creditors. The New York and Delaware jurisdictions are being focused upon because these venues have been where the largest US bankruptcies have been filed. Lehman Brothers, Lyondell Chemical, Washington Mutual, Primus Telecommunications and, more recently, the automobile industry giants Chrysler and General Motors, all filed for bankruptcy protection in either New York or Delaware. Because preference and fraudulent conveyance lawsuits typically need to be brought within two years of a bankruptcy filing, these large US bankruptcy cases will undoubtedly have a substantial international impact for the years to come, as the debtor companies begin to institute lawsuits to avoid and recover preferential and fraudulent conveyances made to their creditors.

In brief, fraudulent conveyance and preference lawsuits are causes of action in the US Bankruptcy Code which allow a debtor to seek the return of funds paid or interests transferred to creditors before the debtor's bankruptcy filing. These suits can be unexpected, complex, involve significant dollars and, oftentimes, name defendants covering the globe. The amount of money at stake in these lawsuits can be alarming. In light of the recent big cases filed, and the likelihood that both foreign and American creditors alike will soon be confronted with bankruptcy avoidance litigation, knowledge of the elements of preference and fraudulent conveyance lawsuits and the common defences is indispensable. Additionally, understanding the defences and preserving the financial records to establish a defence is smart business practice because the burden of establishing a defence is on the defendant in bankruptcy avoidance litigation.

Preference lawsuits

Generally, to establish that a particular transfer constitutes an avoidable and recoverable preference, the debtor must show that the debtor made the transfer, while insolvent, to or for the benefit of a creditor on an account of antecedent debt during the 90 days prior to the debtor's bankruptcy filing – and that such a transfer allowed the transferee to receive more than it otherwise would in a liquidation. The standard of whether a transfer is a preference is harshly objective. Intent, hardship, or good faith on the part of either party is totally irrelevant. The typical effect of these requirements is that nearly all transfers made by the debtor within the 90 days prior to bankruptcy filing date are recoverable unless the creditor establishes a defence.

Fortunately for creditors, there are defences available. In fact, the US Bankruptcy Code provides for three commonly used statutory defences: (i) 'Contemporaneous Exchange for New Value' defence; (ii) 'Subsequent New Value' defence; and (iii) 'Ordinary Course Of Business' defence. The 'Contemporaneous Exchange for New Value' defence acts as a complete bar to recovery so long as the transfer was both intended to be made, and substantially was made in a contemporaneous exchange for new value given to the debtor. The intent element is critical, and whether it is evident in a given transfer is almost always debatable. In In re: Hechinger Investment Company of Delaware, the debtor sought to recover alleged preference payments made to a creditor, who had provided the debtor with an open line of credit. The lower courts determined that the Contemporaneous Exchange for New Value could not be applied where there is a credit relationship because it did not evidence the requisite intent to be contemporaneous exchanges. To the relief of many creditors, the Third Circuit reversed the lower courts' decisions and concluded that transfers made under 'credit' terms are not categorically excluded from utilising the Contemporaneous Exchange for New Value defence. The Third Circuit determined that a 'credit' relationship can be consistent with the intent required to establish the defence and that there can be an intent to have a contemporaneous exchange of new value even when there is a delay between when the debt arises and payment of the obligation.

Under the 'Subsequent New Value' defence, a debtor may not avoid and recover a transfer to the extent that after such transfer, the creditor gave to or for the benefit of the debtor 'new value' that was not secured. Importantly, such new value must be provided subsequent to the transfer. In determining whether new value is provided before or after receipt of

a preferential transfer, most courts hold that payments by cheque are considered transferred when the cheque is received, not when the cheque is honoured by the bank. One issue that has arisen is whether the new value provided must remain unpaid in order to qualify as a defence. Unfortunately, the courts are split and the conclusion is dependent on the jurisdiction of the bankruptcy.

Additionally, a transfer cannot be recovered if it was made in the 'Ordinary Course of Business' as conducted by the debtor and the transferee or by the industry generally. Although commonly asserted as a defence, a creditor seeking to establish that a payment was made in the ordinary course between the debtor and creditor must demonstrate that the payment at issue was paid within an established 'payment range' consistent with the parties' history. Any deviation from that range weakens the strength of this defence.

Fraudulent conveyance lawsuits

Aside from the threat of a preference lawsuit, creditors also face the risk of having a prepetition transfer received from a debtor avoided as fraudulent. Unlike preferences, fraudulent conveyances are governed by both federal and state law. Although maintaining similar standards, a state's fraudulent conveyance laws may allow for a longer look-back period. For example, by utilising New York fraudulent conveyance law, a debtor may recover a fraudulent conveyance made by the debtor up to six years prior to its bankruptcy filing.

There are two types of fraudulent conveyances – those involving actual fraud, where the transfer was made with the intent to hinder, delay or defraud creditors, and those involving constructive fraud. Unlike actual fraud, constructive fraud does not require any intent, but rather focuses on the financial condition of the debtor immediately before and after the conveyance was made. Usually, two elements must be proven to establish constructive fraud: (i) a showing that the debtor received less than reasonably equivalent value in exchange for the transfer; and (ii) a showing that the debtor was insolvent, possessed unreasonably small capital, or that the transfer left the debtor with debts beyond its ability to pay.

The Bankruptcy Code provides a limited 'Good Faith' defence to the assertion that a transfer was fraudulent, but only to the extent that the transferee gave value to the debtor in exchange for the transfer. and received the transfer in good faith. A recent case within the Second Circuit, *In re: Bayou Group LLC*, provides a definition of 'Good Faith', and demonstrates the effectiveness of the defence. In *In re: Bayou Group LLC*, the debtors were improperly managed hedge funds which filed for Chapter 11 protection and, thereafter, sought the avoidance and return of alleged fraudulent conveyances made to investors. Prior to filing Chapter 11, the debtors were operating a Ponzi scheme by bringing in investors while fraudulently overstating the hedge funds' assets and failing to disclose their losses. Based on this, the debtors claimed that investors who redeemed all or part of their investment in the year prior to the bankruptcy filing had received an avoidable fraudulent conveyance. This claim was based on actual and constructive fraud. In analysing the Good Faith defence, the Bayou Group court concluded that by establishing the defence a defendant/investor limits the debtors' recovery to only the fictitious profits paid to the investor, thus, the defendant/investor is able to retain the amount constituting the reasonably equivalent value of their original investments. Thereafter, the Court evaluated the facts unique to each defendant's individual redemption and ruled that conveyances could be recovered from some, but not all, of the investors. The investors who successfully established the Good Faith defence to protect the amounts 'invested', as opposed to any 'profits' received, usually had objectively adequate support demonstrating that they did not know, nor had reason to know of the fictitious profits, or that at the time of the conveyance they had conducted diligent investigation that failed to uncover any reason to question the fictitious profits. The Good Faith defence will undoubtedly be raised by investors in the Bernard Madoff multi-billion dollar Ponzi scheme; the Madoff investors are likely to be sued by the bankruptcy trustee for receiving fraudulent transfers.

Aside from the above mentioned defences for preference and fraudulent conveyance lawsuits, creditors involved with a securities transaction with a debtor must be aware of the 'Settlement Payment' defence, which can be a complete defence in a lawsuit seeking to recover an alleged preference payment or constructively fraudulent transfer. A Settlement Payment is an industry term of art defined as a payment to discharge a settlement obligation. The defence is intended to protect financial markets, brokers, clearing agencies, and customers from the instability that would result with the reversal of settled securities transactions. This defence has been the subject of several decisions in the Enron case and it is likely that it will be raised in the Lehman Brothers case because many of Lehman's transfers to counterparties/creditors may be viewed as settlement payments. Recently, the Court presiding over the Enron Commercial Paper Litigation issued an opinion recognising the Settlement Payment defence as possibly applicable, but determined a trial was necessary to establish whether the subject transfers constituted settlement payments protected from avoidance and recovery.

In sum, foreign and American entities which had a relationship with US debtors should not be surprised if they are targeted in preference and fraudulent conveyance lawsuits arising in the bankruptcy proceedings of those debtors. These entities may or may not be substantial creditors actively involved in the bankruptcy proceedings. Regardless, those entities which had relationships with US debtors would be wise to maintain their business records relating to these debtors so that, if sued for a preference or fraudulent conveyance, they have the backup necessary to potentially establish a complete or partial defence. By maintaining such business records, defendants give themselves the best chance to establish a defence that will lead to either a complete defence or form the basis for a reasonable settlement, which in turn will avoid the expense of protracted preference/fraudulent conveyance litigation.

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Australian schemes of arrangement effecting third party releases

BY JAMES MARSHALL

Since the introduction of the deed of company arrangement (DOCA) procedure, the creditors' schemes of arrangement procedure in Australia has fallen into relative disuse. This is largely for the reason that DOCA's were thought to be able to achieve everything that a creditors' scheme could achieve, requiring only a simple majority of creditors in number and value to be approved without the need for court approval or the separation of creditors into classes where they have different interests (in order for a creditors' scheme to be validly constituted, the scheme must be approved by the Court together with 75 percent in value and 50 percent in number of each relevant class of creditors).

However, following the decision of the Federal court in *In the matter of Opes Prime Stockbroking Limited* [2009] 258 ALR 362 to approve an innovative creditors' scheme of arrangement, the creditors' scheme mechanism is likely to become more popular in Australia again for the reason that, unlike DOCA's, schemes of arrangement have the ability to bind creditors to provide releases to both the company and third parties in certain situations. The ability of schemes to effect third party releases is consistent with authorities in Canada, Singapore and the United Kingdom and can be utilised to finally resolve class or multiple claimant disputes involving a range of different parties.

The orders approving the schemes were delivered on 4 August 2009 by Justice Finkelstein, after the substantive judgment having been handed down a day earlier. The judgement at first instance was the subject of an appeal to the Full Federal court which was unsuccessful *(Fowler v Lindholm, in the matter of Opes Prime Stockbroking Limited [2009] FCA 125)*. This is a landmark decision, as it is the first time where an Australian court has approved a scheme of arrangement under Part 5.1 of the Corporations Act 2001 (Act) which, not only releases the company from claims brought by its own creditors, but also releases third party financiers from claims by the scheme company's unsecured creditors. Without those releases, third party financiers would not have agreed to have contributed funds to resolve the matter.

The inability of DOCAs to effect third party releases was recently confirmed by the Full Federal Court in *City of Swan v Lehman Brothers Australia Ltd [2009] FCAFC 130*.

Background to the Opes Schemes

The four scheme companies included Opes Prime Stockbroking Limited (OPSL), which engaged in providing securities lending and equity financing services to institutional and retail clients. OPSL was financed by two principal banks that advanced money to OPSL upon delivery of securities to them.

When global stock markets collapsed in 2008, some of OPSL's margin lending clients demanded their securities back from OPSL, placing significant financial pressure upon OPSL. In most of these cases, OPSL failed to redeliver the securities which were the subject of stock loans to the banks. Voluntary administrators were subsequently appointed to OPSL in March of 2009.

Following the appointment of administrators to OPSL, a spate of legal proceedings (some of which were funded by litigation funders) were brought against the Opes companies for misleading and deceptive conduct, breach of trust and breach of contract. The banks were also sought to be held accountable for having allegedly received property (securities) from OPSL knowing that the transfer was in breach of trust or constituted a wrongful disposal of OPSL's clients' property, as well as for their alleged knowing involvement in OPSL's misleading and deceptive conduct. The key allegation made by the OPSL clients was that OPSL had represented to them that they retained an equitable interest in the securities and had an equity of redemption which entitled them to the return of the securities upon repayment of the client loans.

The schemes

Against the background of a growing number of claims, the liquidators and the financiers entered into mediation which eventually resulted in a settlement to be effected through the proposal by the liquidator of a scheme of arrangement.

The key terms of the proposed scheme include that: (i) the banks contribute $226m in cash towards a scheme fund, which together with other money, will be distributed among Opes' creditors; and (ii) the receivers and the banks to release certain assets of the scheme companies to the liquidators for distribution among the creditors, which have an estimated realisable value of $27m.

In return, the banks and the Opes companies will be released from all Opes related claims and proceedings that are presently ongoing as well as any foreshadowed claims by the creditors and the liquidators of the Opes companies. Other key terms of the scheme include: (i) $11.5m to be used to pay two litigation funders' costs and other plaintiffs' legal costs in actions brought against the Opes companies and the banks; (ii) the liquidators to become the scheme administrators to realise and distribute pooled assets in accordance with the provisions of the scheme; and (iii) a panel of three experts to rule on any dispute between a creditor and the scheme administrators concerning the existence and value of any creditor's claim.

The court decided that the scheme creditors fell into two

separate classes. Class 1 largely comprised the former clients of OPSL who asserted claims against the banks, referred to as 'client creditors'. Class 2, loosely referred to as the 'trade creditors', consisted of unsecured creditors who do not assert any claim against the banks.

Pursuant to the orders made by Justice Finkelstein on 1 July 2009, creditors meetings were convened on 24 July 2009 at which the creditors resolved, through a 92 percent majority in Class 1, to adopt the proposed scheme with the requisite majorities of each class of creditors. The scheme became effective on 4 August 2009 with the delivery of the Federal court's orders approving them without amendment. A subsequent appeal to the Full Federal court by a creditor was unsuccessful.

The judgment

What distinguishes this decision is that Finkelstein J held that the scheme represented a valid "compromise or arrangement between a company and its creditors or any class of them" pursuant to s 411(1) of the Act, notwithstanding that they contain provisions purporting to bar claims against third parties.

Two distinct questions were considered by the court. Firstly, whether the proposed scheme could be characterised as a 'compromise' or an 'arrangement' under s 411(1). Secondly, if so characterised, whether the compromise or arrangement is one that is solely between the company and its creditors. At the heart of the second point is the issue whether a s 411 scheme of arrangement can validly require the company's creditors to release the company and third parties.

Compromise or arrangement

In relation to the first question, the Court rejected the submission that the release of the creditors' choices in action against the banks amounted to a confiscation of their property and found that the proposed scheme represented "a true compromises of the claims against the banks", as the creditors are receiving a benefit in return for giving up certain rights.

In reaching this conclusion, Finkelstein J said that "the words 'compromise' or 'arrangement' must be construed liberally". His Honour made the comment that "from a business point of view, the banks are putting a very large sum of money into the schemes to be rid of claim by the liquidators and the creditors". The fact that the funds have not yet been apportioned between the claims and that this exercise will be a difficult process does not make the scheme a confiscation of the creditors' property.

Whether a compromise can bar the creditors from claims against third parties

The second question was given much deliberation by the court. Finkelstein J analysed a series of cases from other common law jurisdictions in which the courts approved schemes of arrangement made under equivalent provisions to s 411 of the Act, which provided for the release of third parties from liability. Consistent with these decisions of the English High court, the court of Appeal of Ontario and the court of Appeal of Singapore was the approach that "the scheme of arrangement provisions are intended to be a flexible instrument and it is that flexibility which gives the provisions their efficacy." Finkelstein J went on to say that "When first enacted in England as ss 159 – 161 of the Companies Act 1862 (25 & 26 Vict, c 89), the provisions were intended to facilitate compromises and arrangements between insolvent companies and their members and creditors as an alternative to liquidation. Now they have a much wider purpose, including allowing businesses to restructure or reorganise their affairs to enable them to go forward in a better condition, or to amalgamate their business so as to reduce expenses and compete with greater effect."

Further support for a broad construction of s 411 was found in a series of cases in the United States where a third party release was approved by the courts in a bankruptcy reorganisation under Chapter 11 of the bankruptcy Code. However, the case of Re Buildmat Pty Ltd and the Companies Act (1981) 5 ACLR 689, the only Australian case directly in point, was arguably inconsistent with the more flexible approach. In that case, Needham J of the Supreme court of New South Wales held that, a scheme of arrangement discharging a creditor's debt did not release the liability to the creditor of a surety, as a "scheme of arrangement between a company and its creditors affects those creditors only in their capacity as creditors of the company".

In light of the numerous overseas foreign decisions that consistently favoured a broad construction and flexible application of the scheme of arrangement regime, Finkelstein J declined to follow the anti-release approach adopted in Re Buildmat and held that: "Provided that there is a sufficient nexus between a release (of a claim against a third party) and the relationship between the creditor and the scheme company, the scheme can validly incorporate the release".

Applying this test to the factual circumstances at hand, the court found that a sufficient nexus has been established for, among other reasons, "the creditors' claims against the Opes companies and their claims against the banks largely (and in many cases completely) overlap, the schemes are in settlement of interlocking claims and, in the absence of the release, none of the claims would be compromised."

Acquisition on unjust terms

Finkelstein J rejected the argument that the third party release proposed under the scheme, being the extinguishment of a common law right, amounted to an acquisition of property on unjust terms and thereby was in contravention of s 51 of the Constitution. Firstly, neither the scheme, nor the statute which gave it effect (i.e., s 411 of the Act), could be characterised as "dealing with, or with respect to, the acquisition of property for purposes of s 51", as the acquisition of property under such an arrangement as proposed under the scheme, if it could be characterised as an "acquisition of property" at all, is "merely an incident of the regulation of conduct that is in the common interest".

Secondly, the purported acquisition would not be on unjust terms in any event. The court stated that the "acquisition of property" under the scheme was necessarily on just terms, as the scheme procedure "only permits the court to approve a scheme of arrangement, and thereby bind dissentients, if the scheme is fair and reasonable."

Classes of creditors

With respect to the determination of classes of creditors for the purposes of voting on the proposed scheme, Finkelstein J adopted earlier authorities and emphasised the distinction between a creditor's interest and his or her rights. His Honour remarked that, "it is the difference in rights, not interests that are relevant to determining whether or not separate classes exist, and it is the extent of the difference that will determine whether separate classes are required."

The application of the test was said to require "a comparison of the rights creditors have in the absence of the scheme and any new rights that are established under the scheme". When assessing the differences identified, Finkelstein J noted the following considerations: (i) when creditors are broken up into classes, each class is given power to veto the scheme and that is a process that undermines the basic approach of decision by majority; (ii) it is necessary to ensure that there is no oppression by the minority as a built-in safeguard against majority oppression already exists through the court is not bound by the decision of the creditors' meeting; (iii) practical considerations are relevant as schemes of arrangement are ultimately propounded in a business context. The judge should adopt a practical business-like approach to the issue, as would the creditors if they were to decide the matter.

Taking this practical approach, Finkelstein J rejected both the liquidators' argument for a single class of creditors and the objecting creditors' demands to form a series of separate classes for a variety of reasons. Emphasising the difference in the rights of the creditors and not their interests, the court concluded that only the client creditors (whose right to pursue causes of action against the Opes companies and the banks would be affected by the proposed scheme) and the trade creditors (who will not be deprived of any right under the proposed scheme), constitute groups which "do not have sufficient rights in common" as to be able to consult together to reach a view on their common interest.

The implications

The decision of the Federal court to approve the Opes Prime scheme provides significant additional flexibility to companies and their advisers to resolve complex multi-party disputes in a constructive and sensible way. It is clear from the decision of the Full Federal Court in Lehmans that DOCAs can produce the same degree of flexibility and so the use of creditors' schemes is likely to increase in Australia. In this decision the Court held that the provisions governing the operation of DOCAs could not be construed so as to effect third party releases.

The number of creditor and shareholder class actions has escalated in Australia in recent years, particularly in the wake of the global financial crisis. However, the cost and uncertainty of litigation means that it does not always achieve the best outcome for the creditors. As Finkelstein J said in the judgment dated 4 August: "If the schemes are not approved, the 13 or so actions which have been commenced by former Opes clients against an Opes company or the banks, and which at the moment are on hold, will be revived. No doubt more actions will be commenced. The cost involved in taking them to trial will amount to many millions of dollars. Moreover, if the creditors are forced to litigate to get back some of the money which they have lost, they will be embarking upon a very hazardous venture. Most litigation is a gamble. The clients here have gambled and lost on the stock market. They may not wish to gamble any more. If, on the other hand, the schemes are approved, the creditors will be able to put this entire affair behind them."

The regulators' attitude towards the scheme was evident from Media Release AD 09-135 dated 4 August in which, ASIC stated that it "welcomed the court approval of the creditors schemes", saying it made "commercial sense" and "avoided the need for costly litigation by the liquidators and clients of Opes Prime".

The Opes decision is consistent with a broad and flexible application of the schemes regime under the Act and has brought Australia into line with authorities in other common law jurisdictions including England, Canada and Singapore. While the power might exist, going forward it can be expected that Australian courts will only exercise their discretion to approve such schemes if there are very good reasons for imposing releases upon creditors of their rights against third parties.

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BVI corporate insolvency – does the sun always shine on creditors?

BY RICHARD EVANS

There is a real risk in labelling a jurisdiction as 'pro-creditor' or 'pro-debtor'. It is a risk of peculiar application to practitioners based in the jurisdiction in question. Such a label is quite capable of conjuring up, in the eyes of outside parties – and prospective clients – the fear that should you be in the other camp, for example a creditor in the land of debtors, then at

best you may receive a rough ride, and at worst, there may be no point in even setting foot in the jurisdiction (figuratively speaking) for fear of having no prospect whatever of achieving a desirable outcome.

Such conjecture is wholly unplaced so far as insolvency litigation is concerned in the BVI. The aim of this article is to seek to develop the theme that the BVI insolvency regime, both through its legislative design, and also the judicial application of that regime, is one that is particularly focused toward the needs of creditors. Debtors have nothing to fear from this, if they bear the essential premise in mind, and obey strictly the rules of the game.

A clear example of the approach of the jurisdiction may be found at the first stage of the corporate insolvency process. Under the Insolvency Act 2003, a creditor may serve a statutory demand on a debtor. This is not a necessary step, although it is usually a highly desirable course for a creditor to follow. Non-compliance with a statutory demand that has not been set aside triggers section 8 (2)(a) of the Act, such that the debtor company is deemed to be insolvent. Thereafter, an application can be filed for the appointment of a liquidator. While such a provision is not unusual within corporate insolvency regimes, what sets the BVI scheme apart is that the period afforded to a debtor to set aside a statutory demand is limited to just 14 days (Section 156(2) of the Act) and even more striking is the fact that under the statute, this period is incapable of extension (Section 156(3)). Viewed in the round, the statutory regime can plainly be seen to be one that favours the creditor – a swift and clear (if draconian) consequence can readily befall a BVI company that receives (but does not deal promptly with) a statutory demand.

The BVI High Court has followed this strictness of approach in its treatment of statutory demands. Following careful consideration of both English and Australian authorities (each jurisdiction's legislation representing the principal parentage of the BVI Act) it determined that a company that permitted a statutory demand to stand, without challenge, may not later (at the stage of the hearing of an application to appoint a liquidator) raise challenges that were available to it at the earlier stage; see *Metalloyd Ltd. v Burwill Resources Ltd* BVIHCV 2006/0083. Accordingly, it is not open to such a company to assert that either the debt upon which the application to appoint a liquidator is founded is disputed, or that it is not insolvent. There is no doubting that the Metalloyd decision is a firm one – it shows no quarter to a BVI company that chooses to disregard the mechanism available to it to challenge the statutory demand. Also, it must be recorded that it has undergone various degrees of first instance challenge (most recently in *Fogerty v Island Point Properties* SA BVIHCV 2008/0259, in which the Court held that it still retained a discretion notwithstanding *Metalloyd,* although the scope of this discretion (if this decision is correct) has yet to be defined), the Court of Appeal of the Eastern Caribbean Supreme Court has, however, yet to be invited to overrule the earlier decision.

Remaining on the topic of statutory demands, the newly established Commercial Court in the BVI has shown itself capable of taking a robust line against debtor companies who seek to challenge statutory demands on the grounds of disputed debt. The fact that the company asserts on oath in an affidavit the fact of a dispute will not avail it if the contemporaneous correspondence tells a different story: see *China Alarm Holdings Limited v. China Alarm Holdings Acquisitions LLC*, BVIHCV 2008/00385. Moreover, even if a company can produce purported contemporaneous evidence (for example, a memorandum evidencing a resolution to suspend redemptions in its fund) if, in its totality, its account is incredible the demand will not be set aside: see *Professional Offshore Opportunity Fund Limited v. Daiwa Securities Trust And Banking* BVI HCV 0006 of 2009.

A further example of the legislative scheme in the BVI arguably adopting a pro-credit stance is to be found in Section 168 (1) of the Insolvency Act 2003. It provides that an application for the appointment of a liquidator must be determined within six months, failing which, it stands dismissed. Although this period is capable of extension (See section 168(2)) it may only be extended for periods of three months at a time, and then only if 'special circumstances' are found to exist and the application made within the prescribed time limit. This provision can be regarded as pro-creditor since it creates a statutory requirement that the process of appointing a liquidator should be a swift one. Debtors cannot seek solace in delay tactics, since a creditor can legitimately claim prejudice on the grounds that its application is subject to a strict time limit, and the matter must progress. It is only fair to note, however, that the provision is a two edged sword. A creditor who misses the six month expiry without applying for an extension readily finds themselves with a dismissed application – and the BVI Court is equally strict when the tables are turned: see *Asiacorp Development Ltd. V. Green Salt Group Ltd et al* BVIHCV2005/0242 *and Citco Global Custody NV v. Y2K Finance Inc* BVIHCV2008/0146.

Administration, debtor in possession, and other such procedures, are the flagship mechanisms in their respective jurisdictions for the recovery process within formal insolvency schemes. They can be highly effective in achieving the objective of rescuing a failing, but salvageable, enterprise. Their successful deployment invariably requires compromise on the part of all stakeholders, creditors (even secured creditors) included. It may therefore be regarded as surprising given the above discussion to learn that BVI has enacted its own form of rescue mechanism in Part III of the Insolvency Act. It is administration, and is largely based on the English model, as it stood before the reforms introduced in the Enterprise Act 2002.

However, before the entire premise of this article erodes, one vital piece of the jigsaw must be borne in mind. The BVI administration provisions have not been brought into force. Nor, as at the time of writing, now six years since the Act was passed, is there any indication as to when (or, indeed, whether) they will be. As a consequence, a creditor of a BVI company does not have to fear to what extent, and for what period it rights of enforcement will be suspended; those rights remain inalienable under BVI law. So, what better evidence is there that

the BVI regime is pro-creditor – the jurisdiction has enacted, but not activated, the single most potent pro-recovery/debtor mechanism arguably available? The only footnote to this discussion is an argument that the BVI Court may be permitted to make the equivalent of an administration order (that is, specific orders in respect of a BVI company that have the same effect) at the behest of an overseas insolvency practitioner pursuant to its foreign assistance powers under Part XIX of the Insolvency Act. This is as yet untested in the BVI, and the approach that the Court chooses to adopt is eagerly awaited.

At this point, it is useful to pause and reflect why, if I am correct, the above state of affairs exists. The answer is as simple as it is inoffensive to commercial common sense. BVI companies are invariably used as asset holding vessels, either alone, or as part of a larger asset holding structure. They very rarely are engaged in trading. (Indeed, there is a misconception as to the ability of a BVI company to trade. There is no statutory prohibition, nor is one usually found in the memorandum or articles of association. The former governing statute, the International Business Companies 1984, contained a prohibition on a BVI company doing business with anyone resident in the BVI, but not upon doing business per se.) Accordingly, as a matter of policy, it makes real commercial sense for a modern insolvency regime in the BVI to direct itself to the demands of creditors and debtors in the context of the purpose for which BVI companies exist. Given that assets are what the jurisdiction is all about (so far as its registered companies are concerned, and there are around 800,000 of them), ready and certain access to them via a modern insolvency regime is a commercial necessity. In this, the BVI succeeds admirably.

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Effect of creditors on the restructuring process seen from a Danish perspective

BY ANNE BIRGITTE GAMMELJORD

As in many other countries, the worldwide financial crisis in the last year has resulted in a steep increase in the number of entities experiencing financial difficulties in Denmark. This article describes the basic principles of the Danish bankruptcy law on the reconstruction of distressed companies with an emphasis on creditor influence during the process. It also addresses the applicability of the rules in real life situations and the need for reform.

The present reconstruction rules – a short introduction

The present Danish Bankruptcy Act of 8 June 1977, with later amendments, provides for rules governing suspension of payments and compulsory composition of debts. Voluntary (contractual) debt schemes fall outside the Act and the scope of this article.

Suspension of payments

In Denmark, suspension of payments can only be initiated by the debtor. When a debtor is unable to fulfil its obligations it may give notice to the bankruptcy court that it has suspended its payments. Such notification must include the debtor's suggestion as to whom should be appointed supervisor in the suspension period. Normally the supervisor appointed will be a practising lawyer, although this is not a legal requirement. The court will normally appoint the supervisor suggested by the debtor.

The functions of the supervisor according to the Act are limited, although it is set out in the Act that all major business transactions must be approved by the supervisor. Only in exceptional circumstances must such transactions also be submitted to creditors for approval. In practice, the supervisor will require that the debtor reports all major business transactions to him before a decision is made.

Accordingly, at the outset, the debtor retains the power to conduct the business and may legally enter into any valid and binding agreement during the period of suspension without the approval of the supervisor. However, transactions approved by the supervisor have rights of preferential payment if the debtor is later declared bankrupt, and normally such transactions cannot be set aside later if the debtor is declared bankrupt.

Although appointed by the court, the supervisor has no responsibility to report to the court unless: (i) the suspension of payments was commenced for unfair purposes; (ii) the debtor does not co-operate; or (iii) satisfactory efforts are not made to reach a solution with the creditors.

The suspension period normally last three months, but can, upon the request of the debtor and with the approval of the supervisor, be extended for further periods. However, the suspension period cannot exceed 12 months.

Usually, a distressed entity will try to file a petition for suspension of payments in order to try to buy time to see if it is possible to come to an arrangement with the creditors, e.g., if a compulsory composition of debts can be made.

Compulsory composition of debts

A compulsory composition of debts is a procedure in which a prescribed majority of the creditors may force the remaining creditors to reduce their non-secured claim.

The compulsory composition of debts may involve the realisation of all the debtor's assets or simply allow the debtor a postponement of the payments of debt or both. The procedure

may give the debtor relief from the part of his debts remaining unpaid, whereas bankruptcy proceedings would not unless the debtor is a limited company.

Only the debtor can file a petition for a compulsory composition of debts. The petition must be supported by: (i) details of the composition proposal; (ii) a statutory declaration by the debtor stating that all assets and liabilities are included; (iii) declarations by at least 40 percent of the unsecured creditors by both number and value indicating that they will be prepared to accept the proposal of the debtor; and (iv) a joint report by a professional accountant and a recognised expert in the business or profession of the debtor which finds that, among other things, the proposal of the debtor is fair to the creditors as well as to the debtor.

If the bankruptcy court accepts the debtor's petition, a meeting of creditors is scheduled for the consideration of the proposal. At the meeting the proposal will be put to the vote of the creditors attending the meeting. In general the proposal must be approved by at least 60 percent of the creditors. If the proposal is to pay less than 40 percent of the creditors' claims, the percentage of approving creditors is increased to the percentage that the proposed dividend falls short of 100 percent. A proposal for payment of less than 10 percent is not possible except in very special circumstances.

As the procedure is very burdensome and inflexible, the number of compulsory composition schemes unfortunately has generally been very low.

Practicability and proposed amendments

It is a fact that the Danish applicable rules on reconstruction of distressed entities rarely result in the survival of such entities.

Many reasons may explain this, including the fact that entities in financial difficulty recognise the extent of their problems too late, and hence that necessary initiatives are begun too late to ensure survival. Another reason may stem from a periodic contraction of the banks' willingness to provide further loans and the extent of existing credits.

Irrespective of the fact that the low success rate may result from more general factors, lawyers and accountants have pointed out that the present rules on reconstruction (suspension of payments and compulsory composition of debts) only to a limited extend support the continuance of entities that in principle should be capable of surviving.

As regards the rules on suspension of payments, several possible solutions have been highlighted. First, the creditors (with the debtor's consent) should be authorised to initiate the suspension of payments procedure and have the right to ask the court to appoint an expert to assist the supervisor. Second, the creditors' ongoing insight with the reconstruction process should be increased – also with a view to providing the creditors with a better basis for establishing if they should object to a prolongation of the suspension period. Third, the pace of the suspension of payments procedure should be increased by tightening up conditions for having the suspension period prolonged. Fourth, under certain conditions it should be possible to dispose of pledged assets without the consent of the pledges. Finally it should be possible to apply the bankruptcy rules concerning existing contracts, whereby contracts containing burdensome provisions and long termination notices should not unnecessarily impeded a reconstruction (reference is made to the mandate of the Bankruptcy Council *(Konkursraadet)* of 12 September 2000).

With respect to the rules on compulsory composition of debts, it has been pointed out that the rules contain the in-built weakness that entities in financial difficulty have to initiate a number of cost-consuming initiatives involving, for example, engagement of an expert without any assurance as to whether or not the creditors are in favour of the composition proposal. Consequently, many entities in financial difficulty run a great risk by paying often substantial costs to expert assistance, etc., because it may turn out that the costs were paid in vain. In addition the tight voting rules make it difficult to have the composition proposal approved (reference is made to the mandate of the Bankruptcy Council *(Konkursraadet)* of 12 September 2000).

From our point of view, much of the criticism of the present system seems to be well-founded. Hence it is our experience that nine out of ten entities which suspend their payments end up facing bankruptcy proceedings soon after filing the petition. Also, very few entities file a petition for a compulsory composition of debts, and if they do, generally do not survive.

The Bankruptcy Council, a body under the Danish Ministry of Justice, is expected to submit a proposal for amending the rules on the reconstruction of distressed companies. It is expected that the Council will submit a number of proposals with a view to eliminating some of the (justified) criticism of the existing rules. Hopefully, the amendments will also entail more creditor involvement in the reconstruction process.

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Secured creditors in bankruptcy proceedings – present and future developments

BY HOLGER TILK

The issue of secured creditors is of special importance in the context of economic recession, which has lead to a threefold increase in the number of bankruptcies among commercial entities in Estonia. According to official statistics of 31 July

2009, released by Bank of Estonia, credit institutions in Estonia have issued loans to commercial entities worth €7.3bn, most of these having been issued on a secured basis If the commercial entity then fails, credit institutions must generally start bankruptcy proceedings in order to receive payment, making it necessary to analyse how secured creditors are treated in bankruptcy proceedings. When legal regulations do not adequately protect secured creditors' interests, the impact on credit terms, and eventually on the economy, would be immense. Indeed, the lack of certainty would increase the price of credit, cause stricter credit terms, and would reduce the availability of the credit, which might otherwise act as an impulse for general economic growth.

There are a variety of ways to secure contractual obligations, but only creditors with real security will obtain the status of secured creditor in bankruptcy proceedings. As a rule, all secured creditors must participate in a bankruptcy in order to receive payments. However when debtors' obligation in default has been secured by a third party, whose bankruptcy has been declared, the secured creditor may realise its claim outside third persons' bankruptcy proceedings. This is due to the secured creditors' claim being right in rem, and not a monetarily determinable claim necessary for participating in bankruptcy proceedings. Although the current legal situation offers, on the one hand, secured creditors the possibility to potentially realise their claims quicker than in bankruptcy proceedings, it decreases, on another hand, the payments executed to creditors participating in bankruptcy proceedings. This is due to the reason that the pledged object is excluded from the bankruptcy estate, which significantly decreases the pool of resources from which the costs are covered. Hence, each bankruptcy creditor incurs greater share of the bankruptcy and related costs. Current regulation and the Draft currently being discussed in Parliament do not regulate the question of the right of security, when third party pledger goes into bankruptcy before the claim against debtor becomes due. As the Bankruptcy Act excludes the possibility for the secured creditor to submit their claim in the bankruptcy proceedings of the third party pledger, the only possible consequence is the loss of right of security at the sale of the pledged object, and the formerly secured creditor must demand new security from the debtor.

Since bankruptcy proceedings are not necessary for secured creditors to satisfy their claims, the lawmaker has deprived secured creditors of the right to submit a bankruptcy petition when the claim is fully secured. When obligation is only partially secured, the unsecured fraction must exceed at least €12,782 against public limited companies, €2,556 against private limited companies and €639 against physical persons. This regulation requires the court to appraise the value of the pledged object prior to commencing bankruptcy proceedings. The Supreme Court has found that the value of the pledged object must be appraised according to the value of realisation at the moment of filing a bankruptcy petition. However, it has failed to specify which method of realisation is meant; the values of realisation at public auction, as part of the set of assets or under market conditions, tend to differ. Courts, in spite of their right to gather necessary evidence, have been subjected to tight schedules, and mostly rely on the evidence submitted by secured creditors. Nevertheless, when the court refuses to commence bankruptcy proceedings on the basis of evidence submitted by a secured creditor, the latter will incur all the related procedural costs.

Estonian bankruptcy law consists of a two-tier system, First, the commencement of bankruptcy proceedings, where the question of insolvency will be determined and secondly, declaration of bankruptcy. The Draft equalises the commencement of bankruptcy proceedings with the declaration of bankruptcy to avoid unnecessary harm to companies subjected to first-tier proceedings, which may not be insolvent at all. The Bankruptcy Act currently includes regulations that require courts to refrain from declaring the bankruptcy, in spite of the debtor's established insolvency, when the bankruptcy proceedings were not duly commenced – for example, when the court falsely appraises the value of the pledged object to be less than the value of the claim. At first glimpse, this solution might seem favourable to secured creditors, who would attain their right to an individual realisation. However, the members of the insolvent entity's board are obliged, in order to avoid criminal punishment, to submit a bankruptcy petition within 20 days of the establishment of insolvency, which would eventually result in the repetition of the same procedure, causing an unreasonable delay. The Draft discards current approach and provides expressis verbis that establishing the debtor's insolvency is the only criterion necessary for declaration of bankruptcy, which ultimately makes bankruptcy proceedings more effective by removing unnecessary time and resource costs.

The Bankruptcy Act creates uniquely harsh consequence for secured creditors, who have been properly informed of bankruptcy (having received the bankruptcy trustees' written notice), who have failed to submit their claims on time and whose term for submitting claims has not been restored by the general meeting of creditors. Under the given circumstances, a secured creditor will lose their right of security; however, when the monetary claim has been defended at the meeting for defence of claim the creditor's claim would be satisfied in the last order just before payments to owners. The purpose of the restriction has been to make bankruptcy proceedings more effective, by disciplining the properly informed secured creditors to submit their claims on time. Therefore, this regulation should only affect secured creditors, who have received trustees notice. But according to the main counterargument presented in legal literature, secured creditors are already materially interested in submitting claims on time to assure the fastest realisation of pledged objects and to avoid the termination of right of security at the sale of the pledged object. Hence, the goals of the current regulation are attainable without imposing given restrictions.

The same pattern of thought has been followed in the Draft, which abolishes the regulation discarding the right of security. Further, the position of secured creditors is strengthened

by the abolishment of the regulation, which requires a general meeting to decide over the restoration of the term, when secured creditors have delayed the submission of the secured claim. Therefore, the secured claims must only be acknowledged at the meeting for the defence of the claim. However, the right of security, which has been confirmed by court ruling or arbitral award, or has been entered into a land or ship register, commercial pledge register or Estonian Central Register of Securities, is automatically acknowledged. Then, only a monetary claim can then be challenged, unless the claim has also been confirmed by court ruling or arbitral award. If a monetary claim has conclusively not been acknowledged, entries in the pledge registers automatically become incorrect and the bankruptcy trustee may demand their termination.

But the Draft does not specify what happens to a monetary claim when the secured claim has been submitted in delay – the right of security (i.e., rights as pledged objects, possessory pledge) and the monetary claim must both be separately recognised, and the right of security would not be acknowledged. As the restoration of the term was not necessary beforehand, would the monetary claim be considered as a delayed submission, and therefore capable of receiving payments just before the owners, even though there might have been good reasons for restoring the term? If yes, the given solution would hinder the attainment of the goal of strengthening the overall position of secured creditors, as they might start avoiding pledges not capable of being registered.

The right of security, whether movable or immovable, will generally be terminated at the sale of the pledged object. As an exception, the mortgage will remain when the immovable has not been sold at public auction and the secured creditor has refused to grant consent for termination of the right of security. After the pledged object has been sold and the right of security terminated, the secured creditor obtains preferential right for the result of the pledged object after relevant costs have been deducted. Although some bankruptcy laws (e.g., the US Bankruptcy Code) recognise secured creditors' absolute preferential right for the result of the realisation, the Bankruptcy Act brings forth several rights related to bankruptcy proceedings, which are preferred to claims of all the creditors – i.e., costs of bankruptcy proceedings. However, secured creditors are only obliged to incur aforementioned costs to a maximum amount of 15 percent of the realisation value. The given approach is to comply, on one hand, with the principle of maximising payments to creditors as a group, and on the other hand, to mostly preserve secured creditors' pre-bankruptcy rights. When the claim of the secured creditor cannot be fully satisfied from the realisation of the pledged object, they will compete for additional payments with unsecured creditors, who have submitted their claims on time.

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Main elements and risks for creditors under the new Estonian Restructuring Act

BY KARIN MADISSON AND RISTO AGUR

The new Estonian Restructuring Act is a long-awaited revolution in the regulation of corporate insolvencies in Estonia. The Restructuring Act was adopted on 4 December 2008 and entered into force on 26 December 2008 with the aim of avoiding unnecessary bankruptcies and giving an alternative solution for distressed corporations. The law established a completely new legal procedure enabling distressed corporations on the verge of insolvency to reorganise themselves operationally, restructure their debt, and apply other measures to regain financial health and restore profitability. The restructuring procedure is designed as an alternative to bankruptcy, similar to the US Chapter 11, the German Insolvenzordnung, and the Finnish Saneerauslaki.

Background stats and interest groups

Estonian court practice during the first 9 months of 2009 shows that s surprising number of entrepreneurs have entered into restructuring proceedings – over 70 applications have been filed and there are around 40 restructuring proceedings ongoing. Several restructuring plans have been left unconfirmed and proceedings have been terminated. There are only a few proceedings that can be considered successful where the restructuring plan has been confirmed by the creditors and by the court.

Apart from debtors, the Restructuring Act is also intended to be beneficial for creditors, large and small, secured or unsecured, who are provided a clear nonbankruptcy means of maximising the amount they are able to collect from their corporate debtor.

The new law is also appealing to turnaround investors and venture capitalists whose business is acquiring debt or equity in troubled corporations for a fraction of their face value, injecting new capital, improving management, and adding other value in order to restore the target's profitability. The new Restructuring Act has already dragged to the marketplace a number of distressed corporations that may be of interest to turnaround investors.

Overview of the proceedings

A precondition to opening the restructuring proceedings is that the debtor corporation files an application to court giving proof that the corporation is likely to become insolvent

in the future, the corporation requires restructuring and the sustainable management of the corporation is likely after the restructuring. The list of debts and financial reports of the corporation have to be appended to the application.

If the court decides to satisfy the filing, then the enforcement proceedings against the corporation and the calculation of a fine for delay or a contractual penalty on claims against the corporation are suspended. A suspension also applies to the deciding on commencement of bankruptcy proceedings. Additionally, there's the possibility to terminate court proceedings regarding a financial claim against the corporation. This is intended to give the corporation time to work out its problems through the automatic stay of collection attempts against it, while still continuing to run its business.

If the court opens the restructuring proceedings, it also appoints a restructuring adviser who will advise the debtor in preparing the restructuring plan. Among other duties, the adviser also has to monitor the solvency of the debtor and the purposefulness of the transactions the debtor enters into as well as check the legality of the claims brought into the restructuring estate.

The entrepreneur has 60 days to prepare and file the restructuring plan to the court. In order for the restructuring plan to become effective, the plan must be accepted by creditors and confirmed by the court. The plan is accepted by the creditors if at least half of all the creditors are in favour and at least two-thirds of all the votes are in favour. The court shall approve a restructuring plan if the creditors have received notice of the amount of their claim and the restructuring plan and if the plan complies with legal requirements. In certain circumstances the court can even confirm a plan that has not been approved by the creditors. This is subject to, among others, two additional experts confirming that the restructuring of the entrepreneur is likely to be successful and that the entrepreneur is a significant employer.

Risks for creditors

It is clear that given the current state of the economy, some businesses are more viable than others. Also, it seems that in many restructuring proceedings there may have occurred abuse of the restructuring proceedings by way of these proceedings being initiated by corporations that do not have a realistic perspective of making a successful turnaround. In other cases, there appear to have occurred violations of creditor rights. However, it is likely that additional court practice and implementation of certain changes to the existing restructuring law will solve these problems. There are many problematic and unclear clauses in the current language of the Restructuring Act that are difficult to overcome by way of interpretation. Proposals for amending and improving the current Restructuring Act are under way and will hopefully reach the Parliament within a couple of months.

Some of the dangers and risks to creditors under the current regulation are listed below.

Restructuring procedure is initiated with respect to corporations whose business is not sustainable and whose insolvency may be permanent. This may result in a situation where a creditor's claim is not satisfied to the same extent as it would have been if bankruptcy proceedings had been instituted instead of restructuring. On the other hand, Estonian courts' restructuring practice shows that less than half of the restructuring applications have been granted and proceedings opened.

This indicates that courts are not too eager to institute restructuring proceedings, but certainly the practice to evaluate the financial situation and sustainability of corporations is still insufficient. Thus, for example, the restructuring procedure has been initiated with respect to several corporations who engage only in real estate development and lack a proper business plan.

If the value of a creditor's security declines abruptly, the creditor does not have the right under the Restructuring Act to demand termination of the restructuring procedure or give the creditor any preferential status in the restructuring procedure. This may entail a significant risk for a secured creditor considering that the market may still be in decline, meaning that the value of property may erode quickly in a short time. To mitigate the risk, it may be helpful if the corporation's liquidation value is considered in preparing the restructuring plan.

The restructuring plan focuses only or mainly on the restructuring of claims and capital, disregarding operational restructuring measures and opportunities for continuing business. Failure to implement operational organisational measures is often the main reason for the potential insolvency of a corporation going through restructuring. Restructuring can hardly be successful if the real causes of insolvency are not cured. Such causes may include wrong strategy or communication (both internal and external), marketing and sales plans, nature of assets, and the number or profile of employees. Likewise it is difficult to reorganise a corporation that currently has no business activity and plans to overcome difficulties only by expecting the market situation to improve.

In Estonia certain essential restructuring principles to protect creditors, which have been in place in US court practice, for example, for decades already, have not been rooted in court practice. These principles include the Best Interests Test, where claims of all creditors who disagree with the restructuring plan must be satisfied in the course of the restructuring procedure at least at the liquidation value of the claim. Another important principle is the Feasibility Test, which means that a restructuring procedure must be realistic (not relying on wishful thinking) and there must be a reasonable opportunity to fulfil the plan. Feasibility of the debtor is evaluated mainly by considering its prior rate of return.

The value of business of a debtor going through restructuring does not increase in the course of restructuring procedure, but declines. This in its turn may reduce the extent to which creditors' claims are satisfied. Restructuring advisers, who have the obligation arising from law to verify expediency of transactions and solvency of the debtor throughout the restructuring procedure and to prepare reports for each half year, can help mitigate this risk.

Unjustified unequal treatment of creditors and impairment

of their interests. The Restructuring Act gives a corporation being reorganised freedom to choose which debts and to what extent to satisfy them in the course of restructuring. This poses a risk of damaging creditors' interests. The factors that mitigate the risk are supervision exercised by the court and restructuring advisers, and the creditors' right to file a motivated petition with the court for non-approval of the restructuring plan and termination of the procedure. Further, it is very likely that damage caused to creditors by unjustified preferential treatment or impairment of interest can be recovered in the course of potential subsequent bankruptcy proceedings. On the other hand it may be difficult for a creditor to decide whether he has been treated unfairly compared to other creditors as the law does not require disclosure of claims that are not restructured in the course of the restructuring proceedings. Supplementation of the Restructuring Act with principles of creditor treatment would certainly enhance transparency of the restructuring procedure.

Many restructuring advisers are not covered by liability insurance. If restructuring advisers wrongfully violate their obligations, causing damage to creditors, it may be difficult for the creditor to enforce its claim with respect to an uninsured restructuring adviser because the current Restructuring Act does not require liability insurance from restructuring advisers, whereas liability insurance taken by trustees in bankruptcy and lawyers may not necessarily cover the practice of restructuring advisers.

Initiation of restructuring procedure does not suspend expiry of the period of limitation of transactions. In certain cases the Bankruptcy Act includes provisions to revoke transactions that were made before bankruptcy proceedings were declared and which impair creditors' interests. The time between making the transaction (e.g., six months, one year, etc.) and initiation of the bankruptcy proceeding is important here. Initiation of a restructuring procedure does not suspend the limitation periods for recovery and therefore certain transactions that impair the creditors' interest may remain unrecovered.

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CHAPTER FIVE:

Legal Developments -Americas

Section 503(b)(9) of the Bankruptcy Code as an impediment to reorganisation

BY PATRICK DARBY

The United States Bankruptcy Code once drew a bright line between claims that arose before the debtor filed its bankruptcy petition and claims that arose after the petition. Congress recently enacted a new law that breaks down the wall distinguishing post-petition and pre-petition claims. Congress' ostensible purpose was to give relief to suppliers who deliver goods to a debtor on credit on the eve of bankruptcy. However, the blurring of the conceptual line between pre- and post-petition claims is a radical departure from one of the basic tenets of bankruptcy and has unintended consequences for the process of corporate reorganisation under Chapter 11.

Section 503(b) of the Bankruptcy Code generally grants 'administrative priority' to claims that arise after the bankruptcy petition. Vendors who provide trade credit to debtors in Chapter 11 debtor are entitled to payment of their claims in full before any payment to holders of unsecured pre-petition claims. In addition to priority of payment, the Bankruptcy Code requires payment of post-petition administrative claims in full in cash as a condition to confirmation of a Chapter 11 plan (unless the holder of an administrative priority claim agrees to a different treatment). The policy reason for granting priority to post-petition claims is to support the administration of the bankruptcy estate by encouraging vendors to provide goods and services on credit.

In 2005 Congress added section 503(b)(9) to the Bankruptcy Code. This section grants administrative priority to the claims of vendors who deliver goods on credit in the 20 days before the debtor files bankruptcy. Congress intended to prevent a debtor from acquiring goods on credit when the debtor knows it is about to file bankruptcy. However, Congress unintentionally rendered reorganisation very difficult for many firms. Expanding administrative priority to a class of pre-petition claims upsets the delicate balance of negotiating a Chapter 11 plan by placing outsized power in the hands of one constituency to the disadvantage of the debtor and other creditors.

The theoretical basis for Congress' decision lies with the State law concept of reclamation. The Uniform Commercial Code (UCC), which is in effect in various forms in each State except Louisiana, allows the seller to 'reclaim' goods delivered on credit if the buyer is insolvent and unable to pay. A seller may not reclaim goods that the buyer has sold to a good faith purchaser for value. Most courts treat a lender holding a lien on inventory as a good faith purchaser for value.

Congress did not create a federal right of reclamation in the Bankruptcy Code, but allowed a seller of goods to assert a right of reclamation in bankruptcy, on certain conditions. Section 546(c) of the Bankruptcy Code, as it existed before 2005, provided that if the seller had a right of reclamation under State law, it could enforce the right in bankruptcy by written demand on the trustee; provided, however, the buyer could not reclaim goods that had been delivered to the debtor more than 10 days before the bankruptcy petition. If a bankruptcy court denied a valid right to reclaim goods, section 546(c) required the court to secure the seller's claim with a lien, or to grant administrative priority to the seller's claim. If the bankruptcy court denied a valid right to reclaim goods, granting administrative priority to the seller's claim made sense, because the bankruptcy court effectively required the seller to supply the debtor with goods it otherwise could have taken back under State law.

Despite section 546(c), sellers of goods on credit commonly found their reclamation efforts frustrated in bankruptcy. First, sellers could only reclaim goods that were delivered within 10 days of the bankruptcy petition and still remained in the debtor's possession. Sellers could not reclaim goods the debtor had sold in the ordinary course of business. Second, sellers were required to litigate their reclamation claims in bankruptcy court, which could be prohibitively expensive. Sellers faced an uphill battle on evidentiary issues, such as identifying goods that had been delivered within the 10 day limitation period. Third, debtors in Chapter 11 often have pledged inventory to a lender. The lien of the debtor's secured lender almost always defeats a reclamation claim.

To address these concerns, Congress amended section 546(c) in 2005 to expand the reach-back period to goods delivered up to 45 days before the petition. The new language also does not expressly refer to State law reclamation rights, leading some to argue that sellers now enjoy a federal right of reclamation without regard to State law (most courts have rejected this argument). On the other hand, revised section 546(c) specifies that reclamation rights are subject to prior security interests in inventory. Reclamation remains a remedy of dubious value. Although defences to reclamation largely arise under State law, Congress upped the ante by providing in revised section 546(c) that a seller of goods without a valid right of reclamation still may assert rights under section 503(b)(9).

Any seller of goods on credit, therefore, regardless of whether it has State law rights of reclamation, now may assert administrative priority status for the value of goods delivered to the debtor within 20 days of the bankruptcy petition. As a practical matter, 'value' means purchase price. The scope of 503(b)(9) is limited to 'goods' and does not include services. 'Goods' is not defined in the Bankruptcy Code. The UCC definition usually applies (basically, tangible things that can be moved, including manufactured items, raw materials and commodities).

The conversion of pre-petition trade claims to administrative priority claims has wrought havoc in Chapter 11 reorganisations. Administrative priority for pre-petition claims renders most debtors administratively insolvent the day they file Chapter 11. Although the debtor is not required to pay 503(b)(9) claims immediately, the debtor will face difficulty raising enough cash through operations or financing to pay allowed administrative claims in full as a condition to reorganisation. Standard credit terms in some industries are so tight that essentially all trade creditors will be entitled to administrative priority.

Even where a minority of pre-petition trade creditors assert administrative priority, section 503(b)(9) fundamentally skews the reorganisation process. The Bankruptcy Code gives Chapter 11 debtors tools to level the playing field in negotiations with secured lenders, but the absolute statutory requirement to pay 503(b)(9) claims in full, cash on the barrelhead at confirmation, leaves debtors with little leverage and may give 503(b)(9) claimants effective veto power over confirmation of a plan.

In addition to having little incentive to negotiate with the debtors, creditors protected by 503(b)(9) have an unfair advantage over other creditor groups, including trade creditors whose goods happened to be delivered to the debtor 21 days before bankruptcy. The new law creates an arbitrary distinction between one group of trade vendors and the balance of the creditor pool whose rights and interests are substantially similar. It advances the rights of 503(b)(9) claimants ahead of the rights of employees with claims for unpaid wages and benefits, who traditionally enjoyed priority over trade vendors. Section 503(b)(9) throws a monkey wrench into the careful balance of interests that Chapter 11 is intended to effect. Victims include not only the debtor but other creditors who might support and benefit from the debtor's efforts to reorganise.

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Bankruptcy remote is not bankruptcy proof – new concerns that SPEs will seek bankruptcy relief alongside their corporate parents

BY KAREN OSTAD

In a closely watched decision rendered on 11 August 2009, in the bankruptcy cases of General Growth Properties, Inc. (GGP) and certain of its subsidiaries, the Bankruptcy Court declined to dismiss as 'bad faith' filings the Chapter 11 petitions of several special purpose subsidiaries of GGP that were intended to be bankruptcy remote. The court held that while the special purpose entities (SPEs) were undoubtedly intended to have a limited purpose and be bankruptcy remote, this did not immunise the lenders to such SPEs from a bankruptcy filing by the SPEs or render the bankruptcy filings 'bad faith' acts. The court further found that although a chief goal of the SPE structure is to guard against a substantive consolidation of multiple entities, the SPE structure does not preclude an SPE debtor that is part of a larger corporate group from considering the interests of the group when making its decision on whether to file a bankruptcy petition.

This decision impacts CMBS and other securitised asset-backed lenders, as well as traditional mortgage lenders, who have structured their loans to an SPE so as to minimise the likelihood of an SPE's need for bankruptcy relief and reduce the impact of an insolvency of the SPE's parent on the SPE and its creditors.

In the past two decades, it has been increasingly common in large real estate financings and other transactions for sophisticated lenders, in structuring transactions, to require that their borrowers be bankruptcy remote SPEs. These structures, whose features are more fully described below, are intended to make a bankruptcy filing of the SPE less likely and to avoid substantive consolidation of the SPE with its parent if a filing does occur. Moreover, lending to bankruptcy remote SPEs has enhanced the lender's ability to package and securitise a pool of loans and to obtain a favourable rating from a credit rating agency with respect to such securitisation.

Traditional SPE features

The following are the main criteria that have been used by the rating agencies to assess whether an entity has the characteristics of bankruptcy remoteness (see Standard & Poor's Legal Criteria for Structured Finance Transactions, April 2002). Regardless of the organisational structure of the SPE, these elements are generally required to be included in the SPE's organisational documents and/or in the transaction documents. Moreover, it is considered good practice to provide in the SPE's organisational documents that these elements cannot be changed until the lender's financing has been fully paid.

Restrictions on the purpose and powers of the SPE. Normally, the SPE's purpose is limited to owning a particular asset (e.g., real property) being pledged to the lender. This limits the potential for the SPE to have creditors other than the lender.

Limitations on the SPE's ability to incur debt. Like the factor above, this factor is intended to limit debt, other than to the

lender, which could trigger a bankruptcy. The theory is that even in a bankruptcy of the SPE, the lender will be the only material creditor entitled to vote on a plan of reorganisation, etc., and will have control of the process.

The existence of an independent director or independent manager. The existence of an independent director, or in the case of an LLC an independent manager, whose vote is necessary for certain major decisions, including the decision to file for bankruptcy, is intended to make sure that interested parties (for example, those affiliated with the SPE's parent or subsidiaries) do not control decisions that may affect creditors. The required vote of the independent manager is intended to limit the circumstances under which an SPE will voluntarily file for bankruptcy.

Limitations on the SPE's ability to merge or reorganise. This provision is intended to prevent the bankruptcy remote status of the SPE from being undermined by a merger or consolidation with a non-SPE.

Separateness covenants. Separateness covenants, such as to keep the business, records and affairs of the SPE separate from those of other entities, are designed to provide comfort that the SPE will hold itself out to third parties as an independent entity and will not subject itself to arguments that it is the alter-ego of one or more affiliated entities or that its assets and liabilities should be substantively consolidated with those of another affiliated entity.

Security interest in assets. Requiring that the lender be given a first priority security interest on all of the SPE's assets is intended, among other things, to reduce the incentive of creditors of the SPE or its parent to file an involuntary bankruptcy with respect to the SPE.

One factor considered to weaken the SPE structure, both in terms of a potential need for bankruptcy relief and in evaluating issues of substantive consolidation with a non-SPE entity, is the existence of full-recourse affiliate guarantees of the SPE's debt. Many real estate loans to SPE structures in the recent past have contained limited recourse or 'bad boy' guarantys that trigger liability only if certain actions occur, such as a voluntary bankruptcy filing by the SPE.

Discussion of the GGP decision and its ramifications

In April 2009, GGP and hundreds of its subsidiaries (collectively, the 'Debtors'), including a number of SPE subsidiaries (the 'SPE Debtors'), filed voluntary Chapter 11 reorganisation proceedings in the US Bankruptcy Court for the Southern District of New York (Case. No. 09-11977(ALG)). GGP is a publicly traded real estate investment trust and the ultimate owner of entities whose collective primary business is the ownership and management of over 200 shopping centres in 44 states in the US.

The lenders and special servicers to about one dozen SPE Debtors (the 'Movants') filed motions to dismiss such debtors' cases as having been filed in bad faith, on the basis, among other things, that the entities were financially viable and were not in need of financial reorganisation as of the time of the filing of their petitions. On 11 August 2009, Bankruptcy Judge Allan L. Gropper issued a memorandum of opinion (the 'Opinion') denying the motions to dismiss, ruling, in part, that the independent managers of the SPE Debtors had a prima facie duty to act in the interests of the entity and its shareholders (in addition to the SPEs' lenders), and that a decision to file for Chapter 11 relief may in good faith be based on 'consideration of the interests of the group as well as the interests of the individual debtor.' Opinion at 30.

Responding to the Movants' claims that the filings were premature and that "the [SPE] Debtors had a good faith obligation to delay a Chapter 11 filing until they were temporally closer to an actual default," Judge Gropper noted that the Bankruptcy Code does not require debtors to be insolvent in order to file for bankruptcy protection and, in fact, is intended to "incentivize a debtor to file earlier rather than later, so as to preserve the value of the estate." Opinion at 26.

In the context of CMBS loans to certain SPE Debtors, the Court also noted that without the bankruptcy filings, the SPE Debtors could not get the CMBS lenders to talk to them about a restructuring. Opinion at 36. The Court cited evidence that the master servicer of certain loans refused to negotiate and the special servicers who would have the right to negotiate an extension or refinancing of a loan were not to be appointed until the loan was in or nearing a default. Id.

Rejecting the Movants' argument that the Court should consider "only the financial circumstances of the individual [SPE] Debtors" and that "consideration of the financial problems of the Group in judging the good faith of an individual filing would violate the purpose of the SPE structure", Judge Gropper found that the Movants were aware "that they were extending credit to a company that was part of a much larger group, and that there were benefits as well as possible detriments from this structure. If the ability of the Group to obtain refinancing became impaired, the financial situation of the [SPEs] would inevitably be impaired." Opinion at 28. Practice tip: It is unclear whether express disclaimers in loan documents that the lender is not relying on the existence of the SPE's group structure will be enough to negate a similar finding in future cases, especially if the lender is obtaining a related-party guaranty.

In finding that the SPE Debtors' independent managers acted consistently with their duties in voting to file the SPE Debtors into bankruptcy, the court noted that although the operating agreements of certain of the SPE Debtors required the independent managers to "consider only the interests of the Company, including its respective creditors, in acting or otherwise voting" on certain matters, including the filing of any bankruptcy petition, the operating agreements also provided that "in exercising their rights and performing their duties…any Independent Manager shall have a fiduciary duty of loyalty and care similar to that of a director of a business corporation organized under the General Corporation Law of the State of Delaware," which requires directors to consider the interests of shareholders in exercising their fiduciary duties. Opinion at 31. Judge Gropper further rejected the notion that the independent managers were to primarily consider the interests of the SPE Debtors' lenders, noting that Delaware

law provides that "the directors of a solvent corporation are authorized – indeed, required – to consider the interests of the shareholders in exercising their fiduciary duties." Opinion at 32. Practice tip: Even if the operating agreements had only required the independent managers to consider the interests of the lenders and not the interests of shareholders, a court is unlikely to uphold a waiver of fiduciary duties which exist under state law.

Judge Gropper similarly rejected the Movants' argument that the replacement of the SPE Debtors' independent managers shortly before the commencement of the bankruptcy cases constituted bad faith and grounds for dismissal. GGP's President had testified that the decision to replace the independent mangers on the boards of some of the SPE Debtors was made following discussions with financial and legal advisers with the goal of appointing independent managers with real estate restructuring experience. Moreover, the relevant corporate documents of the SPE Debtors did not prohibit termination and replacement of the independent managers, and Judge Gropper found that the Debtors had complied with the requirements of such documents in terminating and replacing the independent managers. Practice tip: It is unclear whether this outcome would have been different if the relevant organizational or loan documents of the SPE Debtors had required lender consent to replace the independent managers, or whether such a 'fix' would create lender liability issues.

Conclusion

Given the novelty of many of the issues raised in Judge Gropper's decision, it remains to be seen how other courts will treat the ability of SPEs to file for bankruptcy under various facts and circumstances. The Opinion recognises the protections of the SPE structure, and states that "the fundamental protections that the Movants negotiated and that the SPE structure represents are still in place and will remain in place during the Chapter 11 cases", including the goal of guarding against substantive consolidation. Opinion at 42. But, the Opinion should sound a warning bell to lenders that the bankruptcy remote features in their loan agreements may not prevent a solvent SPE borrower from filing for bankruptcy protection if the filing serves the greater good of the SPE's affiliates. Also, the Opinion serves as a caution that independent managers may legitimately be able to consider interests of shareholders in addition to those of creditors in appropriate circumstances.

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Otero Mills: is the protection of a non-debtor's interests for the benefit of the estate still relevant after the 2007 real estate crash?

BY ISAAC M. MARCUSHAMER

The real estate driven economic turmoil that enveloped the United States in the second half of 2007 caused a surge in the number of bankruptcy filings in the country. Many of these filings were driven by real estate investments. In the typical 'real estate' case the entity that files bankruptcy (the debtor) is the corporate entity that owns the real estate. Moreover, the debtor is generally the borrower on a loan that is secured by at least its real estate assets. Often, the principal of the debtor will personally guarantee the debt. This situation creates a potential conflict for the principal. On one hand, as the guarantor, the principal may be personally liable for the debtor's obligations and may seek to assuage the creditor by sacrificing the debtor's assets in return for personal freedom. On the other hand, the principal has a responsibility to the creditors of the estate as the debtor's representative to preserve value for all creditors. This conflict can be especially pronounced once the debtor files for bankruptcy and the secured creditor sues the principal on his guarantee.

One solution to this problem is to have the principal file bankruptcy as well, however, this is not always advisable as the principal's personal financial situation is generally markedly different from the debtor's. The other alternative, which will be explored by this article in more detail, is to seek an injunction from the bankruptcy court enjoining the creditor from pursuing the principal on his guarantee. This type of relief is often called an 'Otero Mills' injunction, named after one of the early cases granting this form of relief.

The analysis that follows will examine the original Otero Mills cases, followed by an examination of the differing standards that have developed since Otero Mills was decided. Finally, the analysis will conclude with an examination of a recent bankruptcy court decision from the District of Oregon that attempted to use an Otero Mills injunction in reverse.

Otero Mills – the original case

In March of 1982 Otero Mills, Inc. filed for bankruptcy (Otero Mills, Inc. v. Security Bank & Trust (In re Otero Mills, Inc.), 25 B.R. 1018 (D. N.M. 1982)). In April and September of 1979 Otero Mills executed two promissory notes in the combined amount of $650,000. Both notes were guaranteed by Charles J. Dugan, the president and sole shareholder of Otero Mills. On 23 April 1982, Security Bank & Trust (SB&T), filed suit in state court against

Dugan seeking to collect on the guarantees. Dugan's response to the SB&T suit was to have Otero Mills seek an injunction on his behalf from the bankruptcy court.

Otero Mills' theory was that the continued litigation against Dugan was causing an adverse effect on the bankruptcy estate by pressuring the debtor (Otero Mills) through Dugan. The bankruptcy court's first step was to analyse whether it had the jurisdiction to even consider enjoining SB&T from pursuing Dugan.

The bankruptcy court noted that 11 U.S.C. § 105(a) permits it to issue injunctions "under appropriate circumstances". The bankruptcy court then elaborated that the "power to enjoin extends to some cases of a creditor's action against a co-debtor or guarantor, but only in limited circumstances. To so enjoin a creditor's action against a third party, the court must find that failure to enjoin would affect the bankruptcy estate and would adversely or detrimentally influence and pressure the debtor through that third party". Based on this reasoning, the bankruptcy court determined that it had jurisdiction to issue the injunction.

The second step in the bankruptcy court's analysis was to determine whether issuance of the injunction was appropriate. The bankruptcy court set forth a three part test: (i) irreparable harm to the bankruptcy estate if the injunction does not issue; (ii) strong likelihood of success on the merits; and (iii) no harm or minimal harm to other party.

With respect to the first prong, the bankruptcy court heard evidence that Dugan had pledged to sell assets and contribute the sale proceeds to pay Otero Mills' creditors. It was Otero Mills' position that this funding would provide more to its creditors if it was sold orderly rather than through the judicial process. The bankruptcy court also noted that SBT offered no evidence to refute that introduced by Otero Mills. Therefore, the bankruptcy court ruled that this prong was satisfied, and irreparable harm would come to the debtor if the injunction was not issued.

The bankruptcy court defined the 'success on the merits' prong as "the probability of a successful plan of reorganization in cases such as the one under consideration". The bankruptcy court further reasoned that because Otero Mills' Chapter 11 plan was not yet due at the time that the injunction was sought "any attempt at determining probability of success would be mere speculation". However, instead of being a death knell in the debtor's case, the bankruptcy court found that the debtor was entitled to present a Chapter 11 plan and that an "injunction is proper unless or until [the debtor] fails to file its plan within the required time or the plan is not approved". In essence, under Otero Mills the second prong of the test is automatically met, provided that the debtor still has the ability to present a plan or the plan has not yet been voted upon. Therefore, at least with respect to the second prong, an Otero Mills injunction has a stronger likelihood of success in the early stages of a case than it does as the case nears confirmation.

The final prong considered by the bankruptcy court was the harm to the enjoined party. SB&T admitted that its collateral was adequately protected, at least through a date certain, because of equity in the property. The bankruptcy court determined, albeit without any contrary evidence from SB&T, based on the existence of equity in the property SB&T would not suffer any harm from issuance of the injunction.

In essence, the bankruptcy court granted the injunction on three basic findings: (i) that the principal of the debtor would contribute money or assets to the estate; (ii) that no plan had yet been proposed; and (iii) that the secured creditor was adequately protected. As discussed below, these are significantly different from the traditional or non-bankruptcy injunction requirements.

Preliminary injunction standard vs. modified standard

In *In re Excel Innovations, Inc.,* the Ninth Circuit held that when a debtor seeks an injunction pursuant to section 105(a) of the bankruptcy code to "stay a proceeding in which the debtor is not a party, the bankruptcy court must balance the debtor's likelihood of success in reorganization against the relative hardship of the parties, as well as consider the public interest if warranted" *(Solidus Networks, Inc., v. Excel Innovations, Inc., (In re Excel Innovations, Inc.),* 502 F.3d 1086 (9th Cir. 2007)). The reason the debtor sought the injunction was because a shareholder and former CEO of the debtor was subject to an arbitration proceeding. The debtor made three arguments as to why an injunction should be granted: (i) the former CEO planned to seek indemnification from the debtor on the grounds that any liability he may have stemmed from his actions relating to his tenure as an officer and director of the debtor; (ii) any defence he would have in the arbitration proceeding would be focused on him and not the debtor; and (iii) he would be compelled to reveal the substance of critical privileged communications between himself and the debtor's attorneys. The bankruptcy court granted the stay, however, the Ninth Circuit reversed.

The Ninth Circuit determined that the "usual preliminary injunction standard applies to stays of proceedings against non-debtors under § 105(a)". This standard, according to the court, has the following four prongs: (i) a strong likelihood of success on the merits; (ii) the possibility of irreparable harm to the plaintiff; (iii) a balance of hardships in favour of the plaintiff; and (iv) advancement of the public interest, in certain cases. The court also noted that the majority of circuits have applied this standard to 105(a) injunctions. The Ninth Circuit reversed the lower courts on the basis that the bankruptcy court had failed to find that there was a reasonable likelihood of a successful reorganisation. Furthermore, the bankruptcy court failed to analyse the harm that would be suffered by the enjoined party. Finally, there was no showing of irreparable harm to the moving party. For these reasons, the Ninth Circuit reversed. It appears likely that if the debtor had been able to make the same evidentiary showings that were made in Otero Mills, that the Ninth Circuit would have upheld the injunction.

The Seventh Circuit uses a modified standard for injunctions issued by a bankruptcy court. In *In re L&S Industries, Inc.*, the Seventh Circuit noted the basic general requirements for an injunction are: (i) no adequate remedy at law; (ii) irreparable harm to the moving party; and (iii) a likelihood of success on the merits *(In re L&S Indus. Inc.*, 989 F.2d 929, 932 (7th Cir.

1993)). However, the court then held that a bankruptcy court does not need to address all of these standards. Instead, a bankruptcy court "can enjoin proceedings in other courts when it is satisfied that such proceedings would defeat or impair its jurisdiction over the case before it. In other words, the court does not need to demonstrate an inadequate remedy at law or irreparable harm". Therefore, the only requirements that need to me in the Seventh Circuit are: (i) a satisfaction that bankruptcy court jurisdiction would be impaired by the proceeding; and (ii) a likelihood of success on the merits.

Under this two-part standard, all that a moving party would need to establish would be that there is an effect on the bankruptcy estate by the continuation of the suit against a guarantor and that the debtor has not yet filed a plan of reorganisation. This is a substantially reduced burden from the traditional four-part test for the issuance of an injunction.

What *Otero Mills* and *Excel Innovations* demonstrate that is that the rote application of non-bankruptcy legal principles in a bankruptcy context, while conceptually simple, is practically difficult. The clear source of agreement between the differing positions is that there must be some appreciable effect on the bankruptcy proceedings and that the proceedings must be heading towards a possible restructuring.

Latest developments

This last section examines a case where an individual owned interests in hundreds of single asset real estate entities and attempted to his own personal bankruptcy to stay the foreclosure proceedings against his entities *(Harder v. Premierwest Bank (In re Harder),* 2009 Bankr. LEXIS 854 (Bankr. D. Or. Feb 13, 2009)). This is, in essence, a reverse of the Otero *Mills* fact pattern.

The court applied the *Excel* standard for injunctions. With respect to the first prong of the test, the likelihood of success of a successful reorganisation, the court noted that it was the debtor's ability to reorganise that is the relevant inquiry. The court further opined that the debtor only had $54,000 a month to contribute to the plan, compared to $48m in claims against him. The court noted that there was little prospect of him reorganising, and it refused to consider the reorganisation prospects of the corporations that he owned. The court found that there was no harm to his estate, as all actions against the debtor were already stayed and that there would not be any money due to him from operation of the real estate entities. Furthermore, it appears as though the court was unsympathetic to a debtor having to litigate issues relating to his own bankruptcy.

The most important takeaway from *Harder* is that the corporate relationships between the debtor and the non-debtor that is seeking the protection of the bankruptcy court are incredibly important. If the debtor is the party that is managing the assets, then that entity or person already has protection under the bankruptcy code and extending protection to the assets is not likely under an *Otero Mills* injunction theory.

Conclusion

In sum, unlike most other courts, bankruptcy courts have demonstrated a willingness under certain circumstances to issue injunctions in favour of third party non-debtors that protect the ability of a debtor to reorganise. This can be a powerful tool, because it allows both the company and its principal to stay any litigation against them during the bankruptcy proceedings and attempt to achieve a comprehensive reorganisation.

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Director liability: risk and reward

BY KELLY BEAUDIN STAPLETON AND CHRIS KOLER

As economic conditions continue to shift, the changing landscape of board service mandates that potential directors be cognisant of the myriad issues associated with the oversight and management of an entity. As a director on the board of a company, one must give thoughtful consideration to changing fiduciary duties, particularly in light of increased litigation and growing media scrutiny. After carefully balancing the risks and rewards, directorship of a newly restructured company is not only a great opportunity to showcase one's talents, but also to participate in the process of growing the entity or literally bringing it back to life.

With crisis comes opportunity, and for those drawn to challenges, bringing one's expertise and knowledge to the boardroom is a fulfilling experience. While the current board environment brings dramatically increased risks and significantly more time spent on board work and board committee service, the opportunity to seize upon the chance to affect change within a company, while at the same time sharing one's pursuits with similarly-minded professionals, is a worthy endeavour for a director who thoughtfully discharges his fiduciary duties and takes adequate precautions to protect himself/herself.

Directors within solvent corporations owe fiduciary duties to the shareholders and to the corporation, and are generally

guided by their duties of loyalty and care. A decision of the board reached through a careful and good faith process is protected by the 'business judgment rule', and so long as the court finds that it applies to the action at hand, it will not second guess the board's thought process and insert its own opinion as to reasonableness.

These fiduciary duties can change when the corporation is entering a period of deepening financial distress. Whether a director must begin to consider the interests of the creditors when the corporation enters into the 'vicinity' or 'zone' of insolvency, continues to puzzle courts and boards alike. In the seminal 1991 Delaware case of *Credit Lyonnais Bank Nederland N.V. v. Pathé Communications Corp.*, Chancellor Allen expanded the fiduciary duties of the board in this situation, saying it is "…not merely the agent of the residue risk-bearers, but owes its duty to the corporate enterprise." In his now infamous 'Footnote 55', the judge added colour to this expanded duty by highlighting the conflicts inherent with the possible insolvency of a corporation, potentially altering incentives and affecting the decision-making process of directors.

Although subsequent case law has retreated from the Credit Lyonnais holding, any company in the 'zone of insolvency' brings with it additional concerns which suggest a shift in directors' obligations toward what is now commonly referred to as the 'community of interests'. When, exactly, a corporation is in the 'zone' has been a topic of debate, and courts have been loath to set forth a precise definition. But it is generally agreed that when a company cannot pay its debts as they become due in the ordinary course of business (aka, insolvent) or its financial statements reflect negative shareholder equity; when the board authorises a transaction that renders the company close to insolvency; or the board has sufficient knowledge that insolvency is imminent, it is in the zone. While it is without question that bankruptcy brings new challenges, it is a necessary and useful restructuring tool for many companies in financial distress, and a director should not fear liability as long as he/she is making informed, good faith judgments in the belief he/she is acting in the best interests of the corporation.

Moreover, increased diligence in decision-making is prudent (whether or not a corporation is experiencing distress). Business decisions should be fully considered from the perspective of both the shareholders and creditors when operating close to insolvency. As a director of a financially troubled corporation, one should be especially wary of making decisions that favour one constituency over the other. It is essential to strategically consider each decision, hopefully pre-empting potential litigation, but more importantly, saving precious time better spent rebuilding the company. Specifically, a director of a distressed company should avoid the incurrence of debt that is unlikely to be repaid, consider the contractual right of priority in the repayment of debts, and avoid decisions with the potential for huge gains for shareholders. In addition, any decisions that may affect the creditors or shareholders should be accompanied with outside solvency and fairness opinions.

Insolvent corporations bring a new set of responsibilities to the director. Governed by the 'Trust Fund Doctrine', directors are considered trustees of the corporate assets, held for the benefit of the creditors when the corporation is insolvent. In this environment, there is a distinct shift of duties – from maximising profits to preserving the corporation's assets. As is the case with solvent corporations, if a director is acting with care and in good faith, there is a decreased likelihood of litigation. Directors always have risk in an insolvent situation, but the primary litigation targets centre on the same sorts of self-dealing and breach of loyalty and care issues that would render a director equally liable in a healthy situation: misappropriating assets; making preferential payments; or authorising improper dividends (especially if creditor claims go unpaid).

Being a proactive director is increasingly important. Whether the corporation is solvent, in the zone, or insolvent, there are precautions that a director needs to consider. In 2002, the world of corporate governance was rocked when the directors of WorldCom were held responsible for the misrepresentations in its financial statements. Thus, it is essential to thoroughly understand the corporation's financials, liquidity, and credit facilities, even if this means challenging management's positions and assumptions. A director in this position would be well advised to understand the corporation's bylaws (and keep up with any amendments), and make sure his/her actions are in accord with these policies and best practices.

Proactive directors will begin to manage 'enterprise risk' to a new degree and in new ways. The board members should initiate the creation of 'risk committees' made up of knowledgeable people within the company to monitor general and specific industry trends and examine the financial health of key customers and suppliers. Keeping an open channel with management and grasping these complex relationships is particularly essential if the corporation is nearing insolvency.

Facing the risk of increased liability, some directors choose to remove themselves from duty or otherwise reduce their responsibilities, but this too can lead to litigation. Lack of meaningful director engagement is problematic and also fertile ground for a law suit – there have been more than a few cases where the board of directors has been too quick to approve a transaction and paid for it later. The costs and benefits of each transaction or potential transaction must be carefully weighed before board approval. When a board rubber stamps a 'done deal' presented to it by management (often working with an outside private equity group), it is the board that is left holding the bag. Even the act of resigning from a board can be difficult, and a director must remain if the resignation might cause or permit harm to the organisation.

Given the rise in litigation, new rules and regulations, and increased cries for public transparency, directors increasingly face the risk of personal liability for actions performed on behalf of the corporation. As such, it is a director's obligation to insist he/she is adequately protected, starting off with a thorough D&O insurance policy. D&O claims are at their highest point in three years and are expected to keep climbing. Even though a director may take all the necessary steps to avoid litigation and personal liability, there is still a need to have insurance.

A company D&O policy includes two main types of coverage, traditionally referred to as Side-A coverage and Side-B coverage. Side-A coverage typically provides coverage to directors and officers for loss, including defence costs, resulting from claims made against them for wrongful acts. Side-B coverage typically reimburses a corporation where the corporation indemnifies its directors and officers for claims against them. Employment Practices Liability coverage or EPL is often included as a subset of D&O insurance and serves the important function of protecting directors and officers for claims brought against them by employees. With the rising complexity of this type of insurance, specific attention must be paid to run-off limits with respect to organisational changes. A director, new or current, needs to review the company's D&O policy and make sure that it fits his/her needs. Directors should also ensure that the policy coverage has sufficient limits, based on an objective analysis of the company's risk profile, benchmarked against industry peers. Whether the insurer is in a financially strong position and has a good history of paying claims is an important consideration as well.

Many board members still lose sleep over the potential of facing litigation, despite the company's D&O policy and the diligent performance of their fiduciary duties. Over the past few years, Individual Director Liability (IDL) coverage has taken shape and offers additional coverage against liabilities. There are important distinctions made in IDL policies that may make it worthwhile for a director of a corporation to pursue – the main one being that an IDL's policy limits are only available to pay the defence and liability obligations of the named insured, meaning that the coverage will not be depleted by costs of the corporation or other individuals. Additionally, IDL insurance can be structured to provide coverage to the named insured for service across multiple boards. IDL policies are typically non-rescindable, while far too many D&O policies have been rescinded due to mistakes, unintentional misrepresentations, or omissions in the original applications. Other common circumstances where an IDL policy would provide protection lacking in the underlying D&O policy include an event when the underlying insurer asserts or denies coverage based on a term or condition not met, the payments from the underlying policy have been stayed by a bankruptcy court, or the insurer has become insolvent.

A final way to protect oneself as a director is to draft a personal indemnification agreement with the company, which ensures the director is covered in a case of insolvency or when the D&O policy is otherwise inapplicable, and provides detail and process when the need for legal representation arises.

Despite the risks and time commitment associated with board service and the current state of flux within the economy affecting businesses, the advantages and challenges of serving as a director provide the backdrop for an incredibly rewarding experience for new and experienced directors alike. The ability to freely communicate with management, steer clear of common traps, and represent all constituents in good faith will be the hallmark of a successful director. The opportunity to leave a lasting impression on the future of a company or guide it through a successful restructuring is well worth the considerable time and effort spent, especially if one takes a proactive role in providing advice and ensuring the corporation a better and clearer future.

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Cross-border broker-dealer insolvencies in the age of Lehman

BY JAMES W. GIDDENS AND RAMSEY CHAMIE

The historic collapse of Lehman Brothers in September 2008 has had far-reaching economic consequences that will continue to shape the financial and regulatory landscapes for years to come. As a result, we can expect new regulations and an overhaul of current practices in risk assessment, valuation, and liquidity and capital management. We can also expect a reassessment of the laws and procedures governing the liquidation of insolvent broker-dealers. The global reach of Lehman and many of its customers and counterparties, in particular its prime brokerage customers, enabled business practices that have tested the limits of current broker-dealer insolvency laws. This article examines the impact of cross-border business arrangements in the Securities Investor Protection Act of 1970 (SIPA) liquidation of Lehman Brothers Inc. (LBI), Lehman's US broker-dealer entity.

Parts I and II briefly review broker-dealer liquidations under SIPA and the various Lehman insolvency proceedings, respectively. Part III and IV discuss interrelations among Lehman affiliates, focusing on LBI's role as sub-custodian for Lehman Brothers International Europe (LBIE) and claims to property arising from that relationship. Part V examines prime brokerage arrangements at LBI and the establishment of a unique post-insolvency protocol to effect the transfer of assets held on behalf of LBI prime brokerage customers, and part VI addresses transactions between LBI and counterparties that fall outside the traditional scope of customer activity.

Broker-dealer liquidations under SIPA

In response to a wave of broker-dealer failures in the late 1960s, Congress enacted SIPA, which created special rules for the liquidation of an insolvent broker-dealer intended to protect customers and minimise disruptions to the financial markets. SIPA is an alternative to a broker-dealer liquidation under Chapter 7 of the United States Bankruptcy Code, with special provisions relating to customers. In a SIPA liquidation, claimants who qualify as customers share rateably in the fund of customer property on a net-equity basis and to the exclusion of general creditors. In a Chapter 7 broker-dealer liquidation, the trustee must reduce to money all non-customer name securities held as property of the estate; however, in a SIPA proceeding a trustee generally delivers securities to customers "to the maximum extent practicable" in satisfaction of claims against the insolvent broker-dealer.

SIPA also established the Securities Investor Protection Corporation (SIPC), a private non-profit membership corporation that administers a reserve fund (the SIPC Fund) for the benefit of customers of a failed broker-dealer. When SIPC determines that a broker-dealer faces insolvency, SIPC can file a petition in federal district court to commence a SIPA proceeding for the protection of the broker-dealer's customers.

The trustee under SIPA, appointed by the court, has special powers including the right to transfer immediately accounts to other SIPC member firms. The principal duties of a SIPA trustee – which include the powers of a Chapter 7 trustee under the US Bankruptcy Code – include marshalling of assets for the benefit of customers and general creditors, distributing customer property as promptly as possible and otherwise satisfying customer net equity claims. To the extent there are shortfalls in the fund of customer property, SIPC advances the SIPA trustee funds to cover the shortfall in an amount up to $500,000 per customer (including up to $100,000 with respect to cash held in the customer account).

Lehman Brothers bankruptcy proceedings

On Monday 15 September 2008, following a well-documented weekend of meetings among federal officials and top bankers, Lehman Brothers Holdings Inc. (LBHI) petitioned the United States Bankruptcy Court for the Southern District of New York seeking relief under Chapter 11 of the Bankruptcy Code. That same day, administrative proceedings commenced for LBIE, the principal European broker-dealer within the Lehman group, and four partners at PricewaterhouseCoopers LLP (PwC) were appointed as joint administrators for LBIE.

On September 19 2008 (the filing date), the Honourable Gerard E. Lynch of the United States District Court for the Southern District of New York, upon the application of SIPC, ordered that customers were in need of SIPA protections and appointed as SIPA trustee James W. Giddens. In total, the collapse of Lehman has led to over 75 insolvency proceedings in at least 16 countries.

Interrelations among Lehman Brothers affiliates

Prior to bankruptcy, Lehman operated as a global investment bank in over 40 countries through over 600 affiliated companies. Lehman affiliates had assets held by, and had obligations to, other affiliates. To facilitate an efficient and coordinated administration of the Lehman insolvency proceedings, administrators of the Lehman entities have entered into various bilateral and multilateral agreements.

LBIE omnibus accounts at LBI

The treatment of LBIE's omnibus accounts at LBI in the SIPA proceeding has required an innovative approach and cooperation between the trustee and joint administrators. In January 2009, PwC and the trustee negotiated an agreement to facilitate the timely filing of omnibus claims in LBI's proceeding on behalf of LBIE and its customers, which include prime brokerage customers that had relationships with both LBI and LBIE. Determining LBIE's omnibus claims requires a full reconciliation of LBIE's omnibus accounts, including the resolution of several hundred thousand fails, stock-record breaks, and other discrepancies. This ongoing reconciliation is further complicated by LBI's continued operations through 19 September, one week after LBIE's last day of business, 12 September 2008.

The trustee has also proposed a scheme to distribute assets to LBIE customers, with LBIE acting as agent. This proposal requires bankruptcy court approval prior to implementation. The trustee is pursuing claims in LBIE's proceeding as well. In aid of this effort, the trustee filed an application in the High Court of Justice in England and Wales for recognition of the SIPA liquidation of LBI as a foreign main proceeding, which the High Court granted in March 2009.

Prime brokerage arrangements and trustee's prime brokerage protocol

Within weeks of the commencement of the SIPA liquidation of LBI, the trustee, acting under the customer account transfer provision of SIPA and the Court's Order of Appointment, promulgated a consensual, voluntary protocol for the transfer of prime brokerage accounts to operating SIPC-member broker-dealers. These transfers were in advance of and separate from the SIPC claim process. With SIPC's active participation, the trustee successfully transferred to new broker-dealers over $3.4bn in prime brokerage customer assets on behalf of over 300 prime brokerage accounts. This represented over 75 percent of LBI prime brokerage account holder assets.

The protocol required an assessment of liens and potential claims of other Lehman entities (i.e., cross entity exposure), a complex and uncertain task. Lehman's prime brokerage model was in part dependent on the ability to share information among the various Lehman entities, but this information was now subject to separate insolvency proceedings in different jurisdictions. Account debits – typically created by margin lending and short positions – were no longer subject to margin calls and were often supported by securities that had dropped precipitously in value, potentially leaving LBI's affiliates exposed. Due to this uncertainty, prime brokerage assets at LBI that were not transferred under the trustee's protocol are

being administered through the SIPA claim process. Resolving affiliate exposure remains a central component to the trustee's proposed agreements with PwC and other Lehman administrators.

Repurchase agreements, TBA trades, and other financial products

In many instances prime brokerage account holders engaged in transactions with LBI that do not qualify for customer treatment under SIPA. These include, for example, foreign exchange derivatives, repurchase agreements, securities lending agreements, and TBAs ('to be announced' forward contracts for the purchase/sale of mortgage-related securities).

The trustee continues to work with counterparties and their counsel to settle the closeout value of transactions on a consensual basis. This process includes a review of the relevant termination provisions of the agreement governing the transaction, a review of any applicable notice of termination sent by the counterparty pursuant to the trustee's protocol regarding outstanding securities and commodities transactions, an evaluation of the statement regarding the selection of valuation date, the pricing and valuation submitted by the counterparty, the negotiation and implementation of a release agreement with the counterparty, and a review of any other claims or transactions between the parties.

Conclusion

The advent of the prime brokerage model offered broker-dealer customers the unprecedented opportunity to conduct business on a global scale with access to diversified markets, enhanced leveraging, and, in many cases, amplified returns. Yet, as the extraordinary events of the past year have shown, the laws protecting customers of insolvent broker-dealers fail to address many of the current practices carried out in the global financial playing field. In the SIPA liquidation of LBI, the trustee has attempted to create innovative, flexible solutions for resolving the transfer of complex prime brokerage accounts and the filing, reconciliation, and distribution of LBIE claims and customer assets. While these measures and others have proven themselves useful, the resolution of the Lehman bankruptcy and related proceedings will take years to resolve and will likely involve extensive litigation. Future regulatory reforms will likely need to address, among other things, the treatment and return of property under different regulatory regimes, the reconciling accounts and trade activity among insolvent broker-dealers with different filing dates, and coordination of proceedings among affiliates in different jurisdictions.

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Canada's insolvency laws undergo significant overhaul

BY KENNETH DAVID KRAFT

2009 marks a significant overhaul to Canada's insolvency laws. At the beginning of the year, the wage earner protection program, which granted a priority claim to certain employee claims for wages in bankruptcy and receiverships, was extended to cover termination and severance claims. In September, multiple changes that had been promulgated between two and four years ago were proclaimed in force.

As an overview one should keep in mind that in Canada there are two possible statutes under which an insolvent company may try and restructure its affairs: (i) the Bankruptcy and Insolvency Act (BIA); and (ii) the Companies' Creditors Arrangement Act (CCAA). With respect to reorganisations, the primary difference between the BIA and the CCAA is that the CCAA is only available where a debtor company has at least CAD$5m in outstanding debts. Additionally, the CCAA is considered a far more flexible statute than the BIA, which is what makes that statute more preferable for larger companies. The maximum proposal period under the BIA is only six months. There is no maximum period under the CCAA before a proposal must be put forward. Many of the amendments that have come into force align the substantive provisions between the statutes in terms of what must be contained in a proposal and how a debtor company operates while under court protection.

Employee issues

Proposals under both the BIA and the CCAA must now provide for payment of employee pre-filing wage claims immediately after court approval of the proposal. In addition, there must be a provision that provides that unpaid pension contributions be paid unless the relevant pension regulator and the other parties to the pension plan have agreed to a different arrangement. Also, if the debtor is subject to a collective agreement, the legislation now provides that the collective agreement cannot be amended without the consent of the union. However, the employer can apply to the court for an order seeking authority to reopen the collective agreement and, if there are any concessions made, the union will be entitled to claim for the value of such concessions, on behalf of its members.

Contract disclaimers

Previously, the ability of a debtor to terminate contracts or to assign contracts was purely a matter of common law. Court orders allowed termination but there were no provisions that dealt with how a court should measure whether the

termination is justified. The revisions now expressly provide for authority to disclaim a contract. However, if the trustee or monitor (discussed below) do not approve then the debtor must apply for court approval. In reality it is difficult to envision many scenarios where a trustee or monitor would disagree with management. Certain contracts, namely, eligible financial contracts, collective agreements (as noted above), financing agreements (if the debtor is the borrower) and real property leases (where the debtor is the landlord), cannot be disclaimed.

In addition, the counterparty to the contract is now granted a 15 day right to challenge any proposed disclaimer and the disclaimer itself cannot take effect until at least 30 days from service of the notice has elapsed. The debtor must provide written reasons for the disclaimer within 5 days of a request from the counter-party. Where the disclaimer involves a license to use intellectual property then the disclaimer cannot affect the licensee's ability to continue to use the intellectual property, including an exclusive right to use provision, provided that the licensee continues to perform its obligations. Previously, there was no minimum notice period for a disclaimer to take effect, or a right to challenge, nor was there any protection for intellectual property licences.

In addition to clarifying the rules around disclaimers, the amendments now set out an express mechanism for contractual assignments. The debtor now can apply for an order authorising the assignment of a contract to a third party. There are specific tests that a court must apply in deciding whether to authorise the assignment and the assignee must be able to perform the debtor's obligations under the contract and it would otherwise be appropriate to assign the rights to that person. Any financial defaults must be cured as part of the assignment.

Where such conditions are satisfied, the court may order the assignment notwithstanding any terms of the contract that restrict the assignment right. Certain agreements are not assignable: collective agreements, and eligible financial contracts. Presumably as well, contracts which by their nature are not assignable (e.g., personal service contracts, employment agreements), could not be assigned on the basis that it is inappropriate to assign same.

Asset sales

The amendments also provide a statutory basis for a debtor to sell assets outside of the ordinary course of business. Previously, this had occurred in CCAA proceedings but almost never in the context of a BIA proceeding. Secured creditors whom the proposed sale impacts must receive notice of the proposed sale.

Critical supplier designation and unpaid suppliers

In a CCAA proceeding the court can, on the application of the debtor, declare a person a critical vendor. The court can order a continued supply of product on terms of the existing supply relationship or on any other basis the court considers appropriate in the circumstances. Critical suppliers may be granted a charge over the debtor's assets and that charge can be given priority over existing secured creditors, provided that those secured creditors received notice of the proposed order.

This allows a debtor to continue to receive credit. Previously, under both the CCAA and the BIA there was no obligation to extend credit to the debtor, which meant that a filing could create an immense, immediate cash need. This will help alleviate that concern in the CCAA context. There is no such provision in the BIA so there parties will continue to be able to insist on cash on delivery.

The BIA also now provides added protection for unpaid suppliers. An unpaid supplier will now have 15 days after the date of bankruptcy or appointment of a receiver to demand back goods that were delivered within the 30 day period preceding the bankruptcy or receivership. Previously, this right simply expired 30 days after delivery, regardless of the date of bankruptcy or receivership.

Court officers

Under the BIA, a trustee must be appointed to oversee the debtor's affairs. In the CCAA a monitor is appointed. Whether as trustee or monitor the person appointed must be licensed to act as a trustee in bankruptcy and be subject to the regulations of the Superintendent of Bankruptcy (the government official responsible for administering Canada's insolvency regime). The amendments clarify that a person appointed as trustee or monitor (or as a receiver) cannot be liable for claims arising from matters arising before their appointment. Also, the person cannot be found to be a successor employer if they carry on the debtor's business. This reverses a court decision that had caused tremendous concern in the insolvency community as no one wanted to take on and run a business where there was a collective agreement in place.

The BIA has also been amended to reduce the scope of the powers previously granted to interim receivers. In one case, the 'interim' receiver was in place for over 10 years. The amendments reduce the time period in which an interim receiver can be appointed back to a much more interim basis pending determination of the rights of the creditor and the debtor. Usually, the interim receiver will not be in place for more than 30 days under the amendments.

The BIA also now contemplates the appointment of a 'national receiver'. A national receiver can be appointed on the application of a secured creditor where such appointment would be 'just and convenient'. Previously, receivers were appointed pursuant to court orders under provincial legislation and could not be obtained at all in Quebec (as a civil law jurisdiction). A recognition order was necessary in each province the receiver was needed (which was one of the reasons the interim receiver mechanism had become increasingly popular). The national receiver concept is intended to offset the narrowing in scope of the interim receivership.

Interim financing

Where a debtor files for protection, no clear statutory basis for providing financing existed. In the CCAA context, courts had utilised their inherent jurisdiction to create a super priority charge for post-filing financing. This financing usually received

priority over pre-filing secured creditors. More recently, if the party providing post-filing financing had advanced unsecured funds pre-filing, a condition of the financing was the court authorising security over both the post and pre-filing advances.

The legislative changes now provide expressly the court's authority in terms of granting security for post-filing financing. However, the court is prohibited from granting security over amounts advanced pre-filing. In addition, the provision of interim financing will now be available under both the CCAA and the BIA. Previously, the ability to obtain such financing under the BIA was the subject of much debate and was rarely granted.

An application for such financing requires notice to all existing secured creditors. In determining whether to authorise the financing the court will consider the following enumerated factors: (i) the anticipated length of the restructuring; (ii) how the business will be managed; (iii) the views of the major creditors; (iv) whether the finance will improve the debtor's ability to come up with a viable proposal; (v) the nature and value of the debtor's assets; (vi) whether the proposed charge will materially prejudice any creditor; and (vii) the monitor/trustee's report on the cash-flow statement.

Miscellaneous changes

Some other changes include a provision subordinating claims arising from the purchase or sale of equity of the debtor to all other claims. This brings the legislation in line with the US in this area. There are also provisions to enhance international cooperation and largely adopts the UNCITRAL Model Law on Cross-Border Insolvency. Finally, the court under both statutes is now expressly authorised to approve, as part of a proposal, amendments to the debtor's constating documents that would otherwise require shareholder approval.

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Recent developments in the Brazilian Reorganisation Law – successor liability and fiduciary transfer

BY RONALD HERSCOVICI AND MARCOS CANECCHIO RIBEIRO

In February 2005, a statute providing for new reorganisation rules was enacted in Brazil (the 'Reorganisation Law'). For quite sometime the Brazilian reorganisation laws had been subject to a lot of discussions among the members of our legal and business communities. The prevailing opinion was that the Brazilian reorganisation laws were not achieving their main goals since they had not been effective in preserving the going-concern value of businesses undergoing financial problems, neither were they an adequate tool to provide for an actual equitable appropriation of that value by the different stakeholders involved in reorganisation proceedings.

The new Reorganisation Law encompassed several rules which are similar to those of the US reorganisation laws, such as the legal provisions setting forth limitation on successor liability in the acquisition of assets from troubled companies and more flexibility for the administration of the troubled business provided that a certain level of agreement is reached with the different classes of creditors. Some of those concepts were foreign to the Brazilian legal system and, according to some commentators, were not in complete agreement with some Brazilian landmark laws and statutes (e.g., labour and tax laws). Accordingly, both legal and business communities were eager to see how the new Reorganisations Laws would be actually construed and applied by Brazilian courts vis-à-vis other longstanding statutes. As more than four years have elapsed since the enactment of the new Reorganisation Law in Brazil, it is now possible to find some precedents on the issues which had been discussed by the legal and business communities in Brazil.

Our main focus in this article will be on: (i) the limitation on successor liability in the acquisition of assets from a company undergoing judicial reorganisation; and (ii) the ability of creditors to foreclose certain guarantees during the reorganisation and bankruptcy proceedings.

Limitation on successor liability related to labour and tax obligations

One of the main goals of the Reorganisation Law was to provide the company undergoing financial problems with the necessary tools for its recovery. In several cases, the recovery plan involves the sale of certain assets of the troubled company. However, it would be unlikely to find interested buyers for such assets if no legal assurances were granted to potential buyers that no successor liability applies to those sales. Accordingly, Brazilian legislators included clear language in Section 60 of the Reorganisation Law providing that, if a judicial reorganisation plan approved under the rules of the Reorganisation Law encompasses the sale of assets of the troubled company, such assets shall be sold free and clear from any potential claims, meaning that no successor liability shall apply to their relevant buyers, including tax liabilities (Section 60 does not specifically mention labour liabilities although such liabilities would be expected to be captured by the broad language chosen by the legislators).

Despite the clear language of Section 60 providing that no successor liabilities shall apply, there have been frequent fillings of claims by employees of the company undergoing judicial

reorganisation against the companies which acquired its assets. Such claims were generally filed with the Brazilian labour courts (as the Brazilian procedural system has special federal courts with exclusive jurisdiction over labour issues) as opposed to the civil courts in charge of the judicial reorganisation proceedings. The claimants argued that Section 60 of the reorganisation law does not expressly mention labour liabilities and that the limitation on successor liability in connection with labour matters is not in agreement with some constitutional principles which granted certain preferences to labour rights. The decisions with respect to the issue varied depending on the relevant labour courts and, as result, caused uncertainties in the legal regime the Reorganisation Law purported to create within judicial reorganisation proceedings.

The issue was, however, resolved in a landmark decision delivered by the Brazilian Supreme Court on 27 May 2009 (ADI 3934), within a lawsuit brought by a political party challenging the constitutionality of certain provisions of the Reorganisation Law based on certain constitutional principles. The Supreme Court ruled that the challenged provisions were not contrary to the Brazilian Constitution. As explained in Justice Lewandowski's vote, the proceeds obtained with the sale of assets within a judicial reorganisation or bankruptcy proceeding will be used by the company to keep its activities or to pay its creditors (including employees of the company, who are actually the highest priority creditors up to certain limits). The decision also recognises that the price paid for the assets by potential buyers will increase to the extent that such buyers are given assurances that the relevant assets will not carry successor liabilities. Therefore, the court concluded, it is in the best interests of the company subject to judicial reorganisation and to all its stakeholders' (including employees') to obtain the highest possible price with any sale of assets within a judicial reorganisation. The Supreme Court also ruled that the civil court in charge of the relevant judicial reorganisation proceeding shall have jurisdiction over labour collection claims against the company undergoing judicial reorganisation.

The decision has been generally well received by the legal and business communities, despite some criticisms from certain labour associations and political parties. As the exclusion of successor liability is an important feature of the Reorganisation Law to enable the recovery of troubled companies, the decision represents an important step for the creation of a more stable and reliable legal environment for companies seeking recovery by means of judicial reorganisations. It also fosters third parties' interest in acquiring assets from troubled companies, maximising the value obtained with such assets to the troubled company's stakeholders.

As for successor liability in connection with tax obligations, Brazilian higher courts have not yet expressly recognised that the acquirer of assets from a company subject to judicial reorganisation shall not be liable for the troubled company's tax obligations, as set forth in Section 60 of the Reorganisation Law. On the other hand, we have not learned about any claims from fiscal authorities challenging the rule set forth by Section 60. In this respect, it is important to note that, concurrently with the enactment of the Reorganisation Law, Section 133 of the Brazilian Tax Code (which sets forth the rules for tax successor liabilities) was amended. The amendment included the sale of assets within judicial reorganisation or bankruptcy proceedings among the carve-outs for the general rule providing for successor liability. Therefore, it was clear the legislators' intent to free assets sold in judicial reorganisation and bankruptcy proceedings from any potential fiscal claims related to the activities of the selling company.

Although the matter has not yet been tested in Brazil's higher courts, we understand any attempts to establish tax successor liabilities in judicial sale of assets by companies undergoing judicial reorganisation or bankruptcy proceedings would be dismissed on the same grounds that labour successor liability was dismissed by the Supreme Court. Actually, it seems to us that the joint interpretation of Section 60 of the Reorganisation Law together with Section 133 of the Brazilian Tax Code, as emended, leaves no solid legal grounds to pursue tax successor liability in case of sales of assets within a judicial reorganisation proceeding.

Foreclosing of guarantees in judicial reorganisation and bankruptcy proceedings

Brazilian law provides for different kinds of security interests to be created over a variety of assets and rights. As a general rule, creditors of debts guaranteed by security interest over assets are senior to the other creditors of a certain debtor (such priority limited to the value of the asset subject to the security interest). However certain types of security interests offer additional protection to creditors in case of judicial reorganisation or bankruptcy of the debtor. As provided by Brazilian law, real estate property and other assets of the debtor may be subject to a fiduciary transfer (alienacao or cessao fiduciaria) in favour of a creditor, in which case such creditor shall be considered the legal owner of the relevant asset until the debtor fulfils its payment obligations. From a practical standpoint, the difference between a fiduciary transfer and a regular pledge is that, in case of bankruptcy or judicial reorganisation of the debtor, the assets subject to the regular pledge shall be subject to the judicial reorganisation or bankruptcy proceedings, as opposed to the assets subject to fiduciary transfer, which may be subject to restitution claims by the relevant creditors. Accordingly, in case of judicial reorganisation or bankruptcy, the recovery of debt guaranteed by the fiduciary assignment of assets is usually faster and more effective when compared with the recovery of debt guaranteed by regular pledges.

In this respect, section 49, third paragraph, of the Reorganisation Law sets forth that fiduciary transferees of real estate or other assets of the debtor shall not be subject to the judicial reorganisation rules preventing creditors from foreclosing their guarantees during the reorganisation period. However, section 49 also creates an exception to this rule providing that the transfer or sale of any assets of the debtor

which are essential for its activities shall not be allowed. Accordingly, if a certain creditor is the fiduciary transferee of assets which are "essential to the debtor's activities", such creditor may not be successful in its efforts to gain possession over the relevant assets.

There are several state courts decisions both recognising and denying the right of the fiduciary transferee to foreclose the guarantee. Based on such decisions we noted that Brazilian courts in general tend to recognise the right to foreclose the guarantee by allocating to the debtor the burden to prove that the asset is "essential to its activities". However, it is still difficult to identify a clear pattern on the circumstances under which the courts tend to consider (or not) certain assets as essential to the troubled company's activities.

As for the treatment of fiduciary transfers in the case of bankruptcy, article 86 of the Reorganisation Law grants the legal owners of assets in possession of the bankrupted company a procedural remedy to claim the restitution of such assets. As the fiduciary transfer operates a temporary assignment of the title over the asset to the relevant creditor, the assets subject to fiduciary transfer shall be considered assets of the creditor as a matter of law. As a result, upon the bankruptcy of the debtor, the fiduciary transferees are entitled to claim restitution of the assets under article 86 of the Reorganisation Law. In addition, some special statutes regulating the fiduciary transfers themselves (Law 9.514 and Decree 911) expressly set forth that the fiduciary transferees are entitled to claim restitution of the assets subject to fiduciary transfer if the debtor becomes insolvent. There are precedents recognising the right of fiduciary transferees to have the assets subject to fiduciary transfer restituted to them in case of bankruptcy of the debtor. As a result, the fiduciary transfer has been widely used in financial transactions in Brazil.

Final remarks

As of its enactment, the Reorganisation Law has been expected to provide an adequate legal environment which can actually enable the recovery of a troubled business. In addition, the Reorganisation Law is expected to grant the different stakeholders of a troubled company an equitable treatment, subject to the preferences and priority status afforded by law to each kind of stakeholder. The achievement of such goals, however, depends a great deal on how Brazilian courts will construe and apply the new ideas and concepts embedded in the Reorganisation Law. Although there are still some important issues which remain to be tested in court, the recent developments discussed above indicate positive prospects for the Reorganisation Law in Brazil.

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Recognition and enforcement of trust rights in a bankruptcy proceeding

BY NÉSTOR J. BELGRANO AND TOMÁS M. ARAYA

Under Argentine law, trusts are regulated through Law Nº 24,441 (the 'Trust Law') passed in 1995. Regardless of its nature and classification, all trust are subject to one principle considered to be its most outstanding feature: the principle of separate ownership of the assets held in trust (this principle is set forth in section 15 of the Trust Law which provides that "property held in trust constitutes a separate estate different from that of the trustor and that of the trustee.").

The diversity in the kinds of trusts, its adaptability to different transactions and the principle of separate ownership of estates have, undoubtedly, been key factors in the wide development and increased use of trusts in Argentina.

The Argentine Bankruptcy Law Nº 24,522 does not have any specific provision addressing the situation of trusts in the event of insolvency. Thus, principles and solutions on the matter are to be derived from the provisions set forth in the Trust Law which, unfortunately, contains only a limited number of rules regarding insolvency. In this paper, we will mainly focus on the insolvency of the trustor and some of the possible situations that may affect the beneficiaries' right to collection.

Insolvency of the trustor

The situation that has caused most conflicts lately has been the one caused by the insolvency of the trustor and, particular, the effects of the bankruptcy proceeding on the assets held in trust by the trustee.

As mentioned, section 15 of the Trust Law asserts that assets held in trust cannot be reached by any individual or collective remedy of the trustee's creditors. Likewise, and except for the fraud actions, trustor's creditors are not entitled to claim any right on the assets held in trust.

Scholars, almost unanimously, have sustained that an adequate interpretation of the Argentine laws would lead to the exclusion of the assets held in trust from the estate of the debtor in any bankruptcy proceedings. Correctly, it has been sustained that when a trust is executed the property is no longer owned by the trustor but instead the legal title is transferred to the trustee; and that there exists no reason to sustain that this basic principle of trusts may not operate in the event of default or even insolvency of the debtor-trustor. However, this issue has not been so uncontested in Argentine

case law.

In the early times, Argentine courts have been rather ambiguous on recognising that assets transferred by the debtor in trusts should be regarded as a separate estate in the context of insolvency.

The preliminary injunction rendered on 9 August 2002 in 'Dinar Líneas Aéreas S.A. s/ concurso preventivo' ('Dinar Líneas Aéreas S.A. s/ concurso preventivo'; Bankruptcy Trial Court of the Province of Salta, 08/09/2002.) is a clear exponent of the initial case law trend. Briefly, Dinar Líneas Aéreas S.A. had settled a guarantee trust in favour of Banco de la Nación Argentina as security of repayment of a loan that said bank had granted to the company. Among other assets, Dinar had transferred in trust all credit card payments which were to be applied to the repayment of the debt in case of default in payment of the loan. A few years later, Dinar filed for a reorganisation proceeding (concurso preventivo) under the Argentine Bankruptcy Law and, simultaneously, requested the bankruptcy court to order the bank to refrain from retaining those credit card payments as payment.

The Court granted Dinar's request on the grounds that, in an insolvency scenario, creditors are precluded from collecting pre petition claims, therefore, payment of all credits – including that of the bank – should be sought within the collective proceeding, regardless of the existence of a guarantee trust.

While one cannot assert that the Dinar case was a decision setting a precedent on the enforceability of trusts in the event of insolvency, it clearly shows that in a bankruptcy proceeding, certain courts would be tempted to admit this kind of defence of the debtor aimed at recovering the assets transfer in trust, notwithstanding the terms of the law. Hopefully, this trend has been gradually left aside by many courts and, nowadays, Argentine case law is leaning towards the full recognition of trust in the case of insolvency of the debtor-trustor.

One recent ruling that evidences the new trend is the preliminary injunction issued on 14 May 2009 by the National Commercial Court Nº 16 in the ongoing reorganisation proceeding of Bonesi S.A. ('Bonesi S.A. s/ concurso preventivo'; National Commercial Court Nº 16, 05/14/2009.)

Bonesi, a retail chain of home appliances, was heavily financed through financial trusts. Basically, the system worked as follows: customers bought home appliances in instalments generating in favour of Bonesi a credit that was later assigned, for a consideration, to a trustee who afterwards and with the assets held in trust as guarantee for repayment, issued debt and equity securities in the open market. Problems began when Bonesi filed for reorganisation. Although the instalments credits were already transferred to the trustee, Bonesi – acting as a collector agent– had been receiving the payments from third parties, and failed – during the months prior to the insolvency filing – to deposit such funds in the trustee banking account. After the filing, the trustee requested an order mandating Bonesi to transfer back to the trust any sum received in payment of the assigned instalment credits, based on the principle of separate ownership of the estates.

The court ruled in favour of the trustee, accepting that whenever a trust is created all the property – in this case credits – is transferred as a matter of law to the trustee who becomes the legal holder of the title to that property and, therefore, all payments received by virtue of the entrusted credits were to be considered part of the fiduciary property. The court asserted that the sums collected by Bonesi S.A. were no longer part of its estate since the ownership of these sums had been transferred to the trustee in the trust agreement, which was not to be affected by Bonesi's filing for reorganisation.

However, the implementation of the decision shows some practical problems, as Bonesi alleged that it was no longer in possession of the funds, which were applied to cover the company's costs. The Bonesi case shows that, notwithstanding its wide use and the legal separation of ownership offered by the trust, if the credits assigned to the trust involve an excessive amount of funds that leaves the company without the required funds to cover its current costs, then even the trust structure may be inadequate in the event of insolvency. Further, the case shows the problems that may arise to collect the instalment payments in the event of bankruptcy of domestic retail chains in such cases when the collection agent is the same trustor. It goes without saying that both issues prejudice the trust's ability to comply with its obligations and therefore harm the beneficiaries' rights.

As a consequence of the Bonesi case, on 28 May 2009 the Comisión Nacional de Valores (CNV) passed Resolution No. 555/09 aimed at preventing similar situations from happening in the future. In this resolution, the CNV clearly states that even when the trustee delegates its collection and administrative functions to a third person, the trustee shall continue to be liable on such regards. In line with this core principle, the resolution sets forth a number of provisions in connection to the trustee's supervising powers and some duties of the collector and administrative agents.

Another issue that has called the attention of the scholars is whether the beneficiary of a trust organised as a guarantee to assure repayment of certain obligation of the debtor (and trustor) to a third party (normally, a trust beneficiary) is under the obligation to file a proof of claim within the reorganisation proceeding of the debtor (and trustor). The lack of provisions on this matter on the Bankruptcy Law has resulted in a diversity of doctrines and trends among legal scholars and case law.

Some scholars and courts have sustained that the beneficiary is not required to submit a proof of claim so as to obtain payment from the proceeds of a trust, based on the principle of separate ownership of the assets held in trust and in the fact that trusts are totally independent from the insolvency proceeding. Therefore, on the event of default, the creditor (trust beneficiary) will be entitled to collect directly from the trust proceeds, or from the liquidation of the trust (if so provided in the trust agreement).

Contrarily, some other authors and courts have sustained that, although the beneficiary can, and normally will, seek payment from the proceeds of the trust, this claim needs to be first legally recognised by the court. Their main argument is that the principle of separate ownership of the estates does not

relegate the creditor from complying with the duty of filing a proof of claim which is levied on all creditors with no exception whatsoever.

In a recent case, in re 'TBA s/concurso preventivo' ('Trenes de Buenos Aires S.A. s/conc. prev.'; National Commercial Court of Appeals, Pannel D, 09/09/2008.), the Commercial Court sustained that, although the creditor-beneficiary is not required to submit a proof of claim with the bankruptcy court, the trustee must inform the existence of the trust guarantee to the court, on the basis that – after foreclosure of the collateral and distribution of the proceeds to the beneficiaries – the balance, if any, of the assets must be part of the debtor's estate. By recognising the beneficiaries' right to collect directly from the trustee, without need of first filing a proof of claim, the TBA decision moves in the right direction.

One last issue that may arise in these insolvency situations is whether the bankruptcy judge has the authority to suspend the liquidation of the trust. In a recent ruling in re 'Kayders S.A. s/conc. preventivo' ('Kayders S.A. s/conc. Preventive'; National Commercial Court of Appeals, Pannel E, 05/08/2006.), the National Commercial Court of Appeals ruled in favour of investing the bankruptcy judge with such authority.

In said case, the Court sustained that the bankruptcy judge may, though restrictively, order the suspension of the liquidation of the assets held in trust since, according to the Court, such decision would conciliate the rights and interests related to the trust as well as those related to the reorganisation proceedings. In this particular case, the Court decided to suspend the liquidation of the assets for 90 days.

It shall be noted that this is an isolated ruling within Argentine case law and no similar decisions have been handed since by other courts. However, it reflects the tendency of the courts to protect the debtor in an insolvency situation, notwithstanding the separate ownership of a trust property. We hope that this will not become a leading case on the matter and that courts will continue to ensure the safeguards granted by trusts as they have been inclined to in recent years.

Conclusion

Although the Argentine Trust Law has been well received since its passing in 1995, its provisions dealing with the effects of a trust in an insolvency scenario are limited and vague.

This lack of specific regulations, especially in connection to the insolvency of the trustor, has in fact resulted in different interpretations of the applicable legal framework, notwithstanding the legal recognition of the trust separate ownership. It has also given the debtor the ability to challenge and discuss the scope and enforceability of trusts in a bankruptcy scenario, which was neither the purpose nor the original intention of the law.

Problems may arise when the assets assigned in trust comprise an excessive level of funds, leaving the company without means to cover its current costs. Further, as the Bonesi case shows, there may be problems with the collection of the instalment payments – especially upon the bankruptcy of domestic retail chains – which may prejudice the trust ability to comply with its obligations.

Fortunately, the recent decision in TBA sets the correct doctrine in one of the most conflictive issues, stating that the insolvency of the trustor cannot preclude the trust beneficiaries' rights to collect their claims directly from the trust, without the need to file a proof of claim on the bankruptcy proceeding.

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CHAPTER SIX:

Legal Developments -Europe

The new German debenture act – a tool for tailor-made bond restructurings

BY ANDREAS SPAHLINGER AND CHRISTIAN BRÜNKMANS

Germany, alongside the US, the UK and Japan, is one of the most important bond markets. In addition to German companies, Central and Eastern European financial institutions have also frequently issued bonds under German law.

If a company which issued a bond becomes financially stressed or distressed, any required restructuring will usually need to include the bondholders as one of the important groups of creditors. In many cases a bond restructuring would not work if the consent of all bondholders were needed. In general, the company does not know the names of all bondholders and even if all were known, one can expect that some of them will always refuse consent because they do not agree with the restructuring measures suggested. Or they speculate that the majority of creditors will make sufficient concessions to restructure the company and that they can benefit from such restructuring without having made any concession, i.e., realise some 'windfall profit'. If the number of dissenting creditors is too high and if dissenting creditors cannot be bound by a majority vote of the other creditors, the restructuring will fail. The unsuccessful restructuring of ESCADA, the international group for women's apparel and accessories, is a recent example of such a failure.

Until recently, German law did not provide for an effective restructuring of bonds under German law by way of a majority vote of the bondholders with sufficient legal certainty. For that reason, some bond issuers, including German companies, decided that German law should not govern their bonds and turned to more restructuring friendly laws, such as English or New York law. Other German companies which issued bonds under German law have thought about following the example of Schefenacker by migrating to another member state of the European Union in order to restructure their bonds under a foreign insolvency regime.

On 5 August 2009 the new German Debenture Act *(Schuldverschreibungsgesetz)* came into force, which has corrected the shortcomings of German law and which provides a new legal framework for the successful restructuring of bonds.

The old law – continuing field of application and major insufficiencies

The new Debenture Act will be applicable for all bonds issued on or after 5 August 2009. With respect to bonds issued before this date, it does not automatically replace the old German law. The old law remains applicable for bonds issued prior to 5 August 2009 unless the bondholders amended the terms of the debenture under the rules of the new Debenture Act with a super majority of 75 percent of the votes cast and the consent of the debtor.

Until the coming into force of the new Debenture Act, Germany had a Debenture Act from 1899. The applicability of the Debenture Act 1899 was limited to bonds issued in Germany by a company having its registered office/seat in Germany. However, even groups of companies controlled by German companies have – mostly for tax reasons – issued bonds by foreign subsidiaries. Therefore the Debenture Act 1899 has been applicable in a limited number of cases only.

Generally it has been unclear under the old law whether the terms of the debenture need to comply with the German law on general terms and conditions. As a consequence it has been legally uncertain whether a provision in the terms of a debenture which allows the restructuring of the bond and amendments to the terms of the debenture by majority vote of the bondholders ('collective action clause') is valid and enforceable. Furthermore, for bonds falling under the Debenture Act 1899, this act does not provide the tools which are usually required to successfully restructure the debtor. Under the Debenture Act 1899 the creditors can resolve with majority vote only a standstill (granting a respite regarding the principal amount of the loan and/or any interests and waiving termination rights) and a waiver of interest claims. The Debenture Act 1899 does not allow any waiver of claims other than interest claims, any subordination of claims or any debt to equity swap. Moreover, the limited measures under the Debenture Act 1899 are subject to preconditions and restrictions: The measures must be required to avoid or cure an insolvency of the debtor and can be taken for a period of up to three years only.

Major changes: what can be done under the new Debenture Act?

Other than the Debenture Act 1899, the new Debenture Act applies to all bonds governed by German law notwithstanding where the debtor's registered office/seat is located and whether the bonds have been issued in Germany. It remains to be seen whether non-German bond issuing groups of companies will make use of German law because of the new possibilities provided under the new Debenture Act, however one can at least expect that those (German) companies which did not use German law for their bonds only because of the shortcomings of the old German law, will in the future use German law for their new bonds.

As a major new principle, the new Debenture Act allows that the terms of the debenture provide for amendments with a majority vote of the creditors under the amendment procedure set forth in the new Debenture Act (opt-in clause) and gives flexibility to regulate in the terms of the debenture certain

conditions and the possible scope of future amendments. The new Debenture Act provides that the creditors can adopt resolutions to amend the terms of the debenture either in a creditors' meeting or outside of such a meeting (e.g., in writing, by fax or email). The terms of the debenture itself can however provide that resolutions must be taken in a creditors' meeting or outside of such a meeting. Unless the terms of the debenture require larger majorities, any material amendment of the terms of the debenture requires a super majority of at least 75 percent of the votes cast and any other amendment requires the majority of more than 50 percent of the votes cast. The new Debenture Act contains a list of measures which are deemed to be material amendments. This list includes the change of payment dates (maturity) of interest claims and the claims for repayment of the principal amount, the reduction of interest claims and claims for repayment of the principal amount, the subordination of claims, debt equity swaps, the release or conversion of security rights, a waiver or restriction of the creditors' termination rights and the replacement of the debtor.

A creditors meeting can be called by either the debtor or the bondholders' joint representative. It shall be called upon the request of bondholders which hold together not less than 5 percent of the outstanding bonds. A creditors meeting constitutes a quorum if bondholders are present or represented which hold at least 50 percent of the outstanding bonds. If this is not the case, the debtor or the bondholders' joint representative can call a second creditors' meeting. In general, this second creditors' meeting constitutes a quorum in any case, however resolutions requiring a super majority can be taken only if bondholders are present or represented which hold at least 25 percent of the outstanding bonds.

Resolutions of the creditors which have been taken in violation of the statutory law (in particular in violation of the new Debenture Act) or the terms of the debenture can be challenged by individual bondholders by taking legal action before the Regional Court *(Landgericht)* at the place of the registered office of the debtor. Such lawsuit needs to be filed within one month after the publication of the resolution which shall be challenged. Generally, a resolution challenged in such a way shall not be consummated pending a final and binding court decision. However, upon request of the debtor, the court may allow the consummation of the resolution before the courts have come to a final and binding decision about the challenge *(Freigabeverfahren)*. The court will allow such consummation if the legal action is apparently without merits or if the court, having balanced the interests of the parties, came to the conclusion that such consummation is in the best interests of the other bondholders and the debtor and that such interests override the interests of the bondholder who challenged the resolution.

Conclusion and first steps to be taken to enable successful bond restructurings

With the new Debenture Act, German law now provides the legal framework for the tailor-made restructuring of bonds governed by German law and allows that the creditors amend the terms of the debenture by majority vote of more than 50 percent of the votes cast or, regarding material amendments with 75 percent of the votes cast. However the tools offered by the new Debenture Act do not apply automatically, neither with respect to bonds issued after the coming into force of the new Debenture Act on 5 August 2009, nor with respect to bonds issued before such date. For new bonds the amendment procedure offered by the new Debenture Act needs to be implemented in the terms of the debenture and for old bonds such implementation can be achieved by amendment of the terms of the debenture under the rules of the new Debenture Act with a super majority of 75 percent of the creditors votes cast and the consent of the debtor. Securing the applicability of the amendment procedure under the new Debenture Act will be the first step for future restructurings of bonds governed by German law.

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Germany's new Bond Restructuring Act

BY ANDREAS FUECHSEL

In answer to the need for a modern bond restructuring law permitting extensive financial restructurings outside formal insolvency proceedings, on 5 August 2009 the long awaited bill reforming the legal relationships of bondholders became effective in the German Bond Restructuring Act. The Act addresses several shortfalls of the old German Bond Restructuring Act of 1899 (the '1899-Act'), and now especially allows for restructuring measures beyond term-out, interest waiver and covenant strip. This article briefly summarises the key features of the Act.

Scope of the Act

The scope of the new Act extends to all bonds governed by German law including convertibles, commercial papers, certificates, structured products and options issued as bonds. As it is neither required that the issuer has its corporate seat in Germany nor that the bond was 'created' in Germany, the new law will also apply to German law governed bonds issued

by foreign special financing vehicles. However, excluded from the scope of the new law are covered bonds *(Pfandbriefe)* and public-sector bonds, as well as bonds governed by foreign law such as the typical New York law governed high yield bond. Bonds issued prior to 5 August 2009 will still be governed by the 1899-Act. Bondholders and the issuer may, however, agree on amending the indenture or exchanging the old bonds for new bonds so as to benefit from the new law. The restructuring means under the Act could also be applied to persons other than the issuer that have granted security for the bonds (e.g., a parent entity of a special finance vehicle that has issued the bond) as long as this has been expressly provided for under the terms and conditions of the bond.

Collective action clauses and de-acceleration

The Act provides much greater flexibility in reaching agreements on the terms of the restructuring of a bond than the 1899-Act. The new law now expressly allows the bond indenture to include collective action clauses permitting far reaching amendments of the terms. Unless stipulated otherwise in the indenture, a financial crisis or pending insolvency of the issuer is no longer a prerequisite for any such amendments; thus, a restructuring of a bond may even be agreed upon in situations outside financial distress (e.g., in the course of M&A transactions or normal restructurings). Resolutions duly passed by the bondholders will have a binding effect on all bondholders of the same bond. However, an aggregation across a range of different types of bonds of the same issuer is not possible – each class of bondholders must pass its own resolution.

While it is for the terms of the bond to decide whether and for which kind of decisions majority actions will be possible (e.g., short term bonds could be issued without the opportunity to change the indenture at all), the Act lists a number of sample actions that may, with the consent of the issuer, be crammed-down upon all bondholders such as: (i) the rescheduling, reduction and waiver of interest; (ii) the rescheduling of the maturity date of the principal amount; (iii) the reduction of the principal amount; and (iv) a subordination of claims. In line with international best practice, the Act expressly introduces a de-acceleration right, which may be of tactical importance for an issuer in a restructuring scenario. The de-acceleration right, however, only applies to cases where the indenture makes the acceleration of a bond upon default subject to a collective decision of several creditors. In those instances, the new law requires that the relevant number of votes necessary to accelerate a bond must not exceed 25 percent of the outstanding principal. In the case of a collective acceleration, the remaining bondholders may – regardless of whether the event of default is remedied or waived – rescind the acceleration within three months with a simple majority of the votes cast, provided that more creditors vote for the de-acceleration than have voted for the acceleration.

Bondholder representative

In order to promote communication between the issuer and its creditors and to jumpstart the restructuring process when an issuer faces acute financial difficulties, the new law facilitates the appointment of a bondholder representative to act as interlocutor with the issuer. The appointment could either be embedded in the original terms and conditions for the lifetime of a bond or, if allowed under the indenture, resolved upon at a later point in time. Apart from limited statutory rights, the bondholder representative is, in the first instance, vested with the powers resolved upon by, and subject to, the instructions of the bondholders. To ensure a centralised and orderly handling of the restructuring process, rights transferred to the representative must not be exercised individually by the bondholders unless expressly permitted in the resolution. The majority requirements for the appointment of the bondholder representative depend on the rights granted to the representative and the terms and conditions of the underlying bond. While a simple majority will generally be sufficient, the appointment is subject to a corresponding supermajority vote (at least 75 percent) if the representative is authorised to vote on material amendments to the indenture. The issuer must bear the costs and expenses (including a reasonable remuneration) of the bondholder representative and provide him with all information necessary for the fulfilment of his tasks.

Bondholder meetings, quorum, resolutions

Resolutions of the bondholders will generally be passed in bondholder meetings. The meeting may be called by the issuer or the bondholder representative. It is to be convened if creditors representing 5 percent of the aggregate outstanding principal amount request the meeting for the purposes of appointing (or removing) a bondholder representative, rescinding an acceleration of the bond, or for other legitimate reasons. The 14-days minimum notice period for the convening of a bondholder meeting (to be extended by three days if required for the registration of the bonds) is deliberately short so as to enable a workout within the three-week-period during which a German issuer must decide whether or not to file for insolvency. As regards the further formalities, the Act follows to a great extent the procedures for the convening and holding of a shareholder meeting as set forth in the German Stock Corporation Act (in particular in relation to the registration of the bonds, proxy voting, vote count, the publication of the resolutions, etc.). However, different to shareholder meetings, the Act also allows for voting in written form without the holding of a physical meeting (virtual meeting). This proceeding is designed to save unnecessary costs for both, the issuer and the creditors, and could be suitable for less controversial meetings.

In a first meeting/voting, the bondholders will only have a quorum if creditors representing 50 percent of the outstanding principal amount of the bond are present. If the quorum is not met, a reconvened second meeting is generally not subject to any quorum requirements; with the exception, however, that for resolutions requiring a supermajority the bondholders present in the meeting must account for at least 25 percent of the outstanding principal. While the lesser requirements

for a second meeting could enable a minority of bondholders to agree upon a restructuring in the event that only a small percentage chose to attend the meeting, it could avoid a situation where a restructuring agreement is frustrated solely because a critical mass of bondholders failed to cast a vote, which may be particularly problematic in circumstances where the bonds are largely held by retail investors.

Provided the bondholders have a quorum, resolutions of the bondholders may generally be passed with a simple majority, calculated on the basis of the outstanding principal amount. Resolutions affecting material rights under the indenture, however, require a supermajority of at least 75 percent of the votes cast. The indenture may increase the majority requirements only. Bonds held by the issuer or persons/entities affiliated with the issuer, carry no voting rights. In addition, similar to the voting procedures in shareholder meetings, it is prohibited to buy votes or to accept bribes for the exercise of voting rights.

Legal protection

For the first time, the new Act provides each individual bondholder with the opportunity to object to, and file avoidance claims against, bondholder resolutions. Similar to the proceedings for challenging shareholder resolutions established under the German Stock Corporation Act, the avoidance claims generally have a suspensive effect until a court decision becomes final and binding. While the issuer may demand the cancellation of the suspensive effect in a fast track proceeding, experience under corporate law teaches that such clearing proceedings may still require several months. As those minority protection rights offer significant potential to impede the bond restructuring, the restructuring process and, notably, the bondholder meeting should be carefully prepared by legal advisers experienced with critical shareholder meetings; in particular, in cases where a restructuring must be implemented quickly.

Insolvency of the issuer

In case the issuer is subject to insolvency proceedings in Germany (i.e., if the COMI is in Germany), bondholder resolutions will not be governed by the Act but rather by the German Insolvency Act. However, the bondholders are entitled to appoint a representative for the insolvency proceedings who is entitled and committed to exercise the rights of the bondholders alone. If not already appointed, the insolvency administrator must, for that purpose, convene a bondholder meeting in accordance with the provisions of the Act.

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Insolvency law reform in Austria

BY ALEXANDER ISOLA

In times of economic crisis, media attention increasingly focuses on companies' insolvencies. Austrian legal practice also shows that attorneys are frequently called upon to act as advisers in financial restructurings. Only by an objective, non-euphemistic, and timely look at the relevant figures and developments, in cooperation with specialised tax advisers and auditors, can companies have a realistic opportunity of sustainable financial restructuring. Supervisory board members and managing directors, in particular, realise that timely advice may prevent collateral damage in the form of personal liability.

The government is addressing the increased requirements for Austrian insolvency law by carrying out a profound legal reform. The ministerial draft of the Austrian Insolvency Law Amendment Act 2009 is now on the table. Its top-priority objective is the timely initiation of insolvency proceedings, thus improving the chances of successful financial restructuring.

Financial restructuring proceedings

For many entrepreneurs, one stigma attached to bankruptcy proceedings is the accompanying disempowerment due to the appointment of a receiver. Previously, they were able to continue their business only in the context of composition proceedings. Since, due to the minimum quota of 40 percent, which is twice that of forced composition, composition proceedings were rarely chosen, these will be abolished. The ministerial draft now provides for new financial restructuring proceedings with the debtor's (limited) self-administration. Rather than having to pay the minimum of 40 percent previously required in composition proceedings, the debtor is now required to pay only 30 percent of outstanding debts. That is 10 percent more than in the former forced composition proceedings. Those 10 percent would enable debtors to, as it were, buy their freedom from the heteronomy of a receiver, thus providing an incentive for entrepreneurs to timely file for insolvency. The receiver (financial restructuring administrator) is appointed – at least initially – to merely supervise the debtor. However, there is no light without darkness: in order to enjoy self-administration, the entrepreneur must prepare the financial restructuring proceedings in a structured manner. In addition to presenting a financial restructuring plan, the application must include information on the company and how the funds required for fulfilling the composition claims can be provided. Moreover, the financing of continued business operations must be ensured. Another parallel to the (previous) composition

proceedings is self-administration being limited to a period of 90 days; if the financial restructuring plan is not accepted within that time limit, self-administration is revoked. However, financial restructuring by virtue of a financial restructuring plan should remain an option.

Moreover, the most significant special provisions of the Austrian Composition Code, which ensure the continuation of business operations, are incorporated into the Austrian Bankruptcy Code (which, henceforth, will be called Insolvency Code). In this context, a controversially discussed cut applies to the debtor's contractual partners' rights to structure legal relationships, as these are – more or less – forced to participate in the company's financial restructuring in order to avoid putting at risk the company's continued business operations and, thus, financial restructuring. As long as the company's business operations are continued (however, no longer than for a period of six months as of the initiation of insolvency proceedings) the debtor's contractual partners may terminate agreements for good cause only. A deterioration of the debtor's commercial condition or the debtor's default in payment of claims that were due prior to insolvency proceedings being initiated (insolvency claims *(Insolvenzforderungen)*) are not deemed good cause. Thus, the legislator pursues the overall economic interest in preserving companies or jobs, generally subordinating the contractual partners' individual interests. Exemptions generally apply only in cases where the contractual partners would suffer severe losses if they were abiding by the agreements.

Financial restructuring plan

Since the term 'forced composition' does not exhaustively express the financial-restructuring character, forced composition should henceforth be called 'financial restructuring plan'. Likewise, for the sake of consistency, bankruptcy proceedings should henceforth be called 'financial restructuring proceedings', provided that the financial restructuring plan is timely presented. The form of forced composition – where fulfilment of the composition claims is monitored, with assets even being handed over to an escrow agent, should be retained. Since the equity quota will be reduced from presently three quarters to a simple majority, it will henceforth suffice for a financial restructuring plan to be accepted if a simple majority of persons and a simple capital majority agree. The result is a considerable 'disempowerment' of major creditors who, due to their strong position (blocking minority), were previously able to dictate the conditions of forced composition according to their own ideas.

In contrast, neither a reduction or elimination of the minimum quota in forced composition, which has often been requested in practice, nor a ban on obstruction (the creditors approval being replaced by court order) have been included in the ministerial draft. Hence, a 20 percent minimum quota, payable within 24 months from acceptance of the financial restructuring plan, remains applicable outside of financial restructuring proceedings.

Bankruptcy proceedings to be initiated, rather than 'rejected for lack of assets'

The presently large number of applications to initiate bankruptcy proceedings that are rejected 'for lack of assets' should be reduced in the context of this reform. After all, the rejection 'for lack of assets' is dissatisfactory, in particular, to those creditors who cannot rely on any individuals to be personally held accountable. Hence, the amendment is welcome. It is remarkable that, in future, besides the officers (managing directors), the shareholders of legal entities (e.g., limited liability companies) controlling the corporation, holding a minimum of 25 percent of the shares, or otherwise exercising a controlling influence on the corporation, should also be obligated to pay a cost advance. Creditors having paid a cost advance for bankruptcy proceedings to be initiated should be granted rights of recourse against the shareholders or managing directors who are obligated to pay a cost advance.

Carrot instead of stick

It appears questionable whether the intended reform is really extensive enough. The standards in terms of insolvency law are intended to force the generally desired earliest possible initiation of proceedings primarily by way of fines/liabilities at the officers' expense or (via the right to challenge) at the (bank) creditors' expense. It would be better to lure with 'carrots', rather than threaten with the 'stick', as is the case in the United States, for example: A decisive criterion for financial restructuring in the context of insolvency proceedings is the financing of continued business operations during those proceedings. The amendment – which boasts that it is based on the US Chapter 11 proceedings – should thus also govern the options for procuring the necessary funds. For example, loans raised in order to finance continued business operations could be classified as 'super-privileged' preferential debts; or the raising of loans could be facilitated by granting senior collateral in previously encumbered assets (so-called priming). This would be quite reasonable for the banks: Priming decisions have always been taken by the bankruptcy court and supported by experts' recommendations. Experience has shown that only in exceptional cases do companies 'crash' during the phase of continued business operations.

During the preparatory phase of insolvency proceedings, companies undergoing financial restructuring often face the problem of no longer being able to order goods or services without subjecting the companies' officers to a liability risk. As in the US system, that problem should be addressed by treating thus generated liabilities (e.g., those generated up to 14 days prior to the initiation of bankruptcy proceedings) as preferential debts. Moreover, special privileges for 'indispensable creditors' should be taken into consideration. Causing immediate relief, all those measures would render the initiation of bankruptcy proceedings much more attractive to companies capable of financial restructuring.

Debt rescheduling

Particularly in times of crisis, prominent government bailouts, or a liability of public officials and authorities, the issue of abolishing credit fees (Kreditvertragsgebühr) and registration fees for liens should be discussed outside the reform of insolvency law. Those fees often prevent debts from being rescheduled to banks offering more favourable conditions, since companies approaching a crisis usually cannot manage the related costs in the amount of 2 percent.

All things considered, the insolvency law reform is welcome – if only because its primary objective is to enable companies to continue business operations.

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Trends to resolve a debtors' insolvency in the Czech Republic

BY RADKA NEKOLOVA

On 1 January 2008, Act No.182/2006 Coll., on Insolvency and its Resolution (the 'Insolvency Act'), took effect in the Czech Republic. It replaced the previous Act on Bankruptcy and Composition from 1991, under which proceedings mostly resulted in the sale of a debtor's assets and liquidation. Moreover, bankruptcy proceedings usually exceeded five years and creditors' proceeds were very low.

The new insolvency legislation has been drafted mainly based on American, German and Austrian insolvency law, and has introduced new institutes with the aim of favouring non-liquidation methods of solving a debtor's insolvency, bringing in transparency, and accelerating insolvency proceedings. The non-liquidation insolvency resolution method used for a debtor-entrepreneur is reorganisation. The non-liquidation method applicable to a debtor non-entrepreneur is discharge from debts. Accelerating insolvency proceedings is ensured by the defined statutory deadlines for court decisions and the newly established insolvency register, which also contributes to the transparency of proceedings. To illustrate, in 2008, more than 5300 insolvency petitions were filed, which corresponds to the number of petitions filed in previous years. Until the end of August 2009 more than 5700 insolvency petitions had already been filed and hundreds of others can be expected by the end of 2009.

Based on the urgent need for an amendment to insolvency legislation arising from the economic crisis, Parliament adopted Act No. 217/2009 Coll., amending the Insolvency Act and other related legislation, which took effect upon publication in the Collection of Laws on 20 July 2009. This amendment strengthens the aim of the new insolvency legislation to enable an enterprise dealing with economic problems to survive.

Reorganisation

Reorganisation as an essential institute of the new insolvency legislation means the gradual satisfaction of creditors' claims during the operation of a debtor's enterprise, based on a court approved plan of reorganisation. Reorganisation is a resolution method mainly for larger companies which in the last accounting period recorded turnover of a minimum of CZK 100m or which employ a minimum of 100 employees. Nevertheless, these criteria do not always have to be observed and smaller enterprises may be reorganised if debtors succeed in agreeing on this method with their creditors and submitting a reorganisation plan to the court by the set deadline.

Reorganisation has two main stages (in most cases). First, an application for reorganisation is filed by a debtor. After the debtor's creditors (or the court) approve it, the debtor may submit a reorganisation plan. The statutory deadline for submitting the reorganisation plan is 120 days after the decision approving reorganisation. The court may extend this deadline at the debtor's request, but in any case by no more than 120 days. If the reorganisation plan is approved by creditors and subsequently by the court, creditors' claims are satisfied on its basis. The minimum proceeds of a debtor's creditors must at least correspond to their proceeds in potential bankruptcy proceedings.

Insolvency register

The Insolvency Register is another essential provision of the new legislation. It is a public information system administered by the Ministry of Justice and available on its official website. All filings by debtors, creditors and trustees, and all resolutions and steps taken by the court are published in the register. Consequently, the register ensures the transparency of insolvency proceedings and contributes to their acceleration, as all court resolutions are published in it. Most court decisions do not have to be delivered to addressees in any other manner.

Where the insolvency legislation stipulates a special manner of delivery, documents are delivered to the contact address as stated in the last filing. If a document is undeliverable, the court delivers it by publishing it in the insolvency register.

Without doubt the insolvency register brings positive aspects to the insolvency regime. Simultaneously, it charges individual entities with responsibility for regularly checking the insolvency register. If they miss deadlines for submitting claims, they may not be satisfied in insolvency proceedings. Consequently, all entrepreneurs are advised to consult the insolvency register on a regular basis to get up-to-date information on insolvency petitions filed against them or their debtors, and on the time-limits for submitting claims.

Amendment to the Insolvency Act

The amendment to the Insolvency Act has introduced substantial but partly temporary changes in insolvency law, mainly in response to the current economic situation and the negative impact of the economic crisis. The effect of the temporary amendments will expire in 2011 when the worst impacts of the economic crisis are expected to pass. Other long-term measures based on the one year of experience with the Insolvency Act are introduced to continue and refine new ways of solving a debtor's insolvency.

The main changes are as follows. First, in a debtor's protection period and in the period after the application for reorganising a debtor's enterprise is published, but before the reorganisation plan is approved or the debtor is declared bankrupt by the court, a unilateral set-off of claims by the debtor's creditors against the debtor's claims is prohibited, unless the relevant consent is given by the insolvency court in a preliminary ruling.

Second, a debtor is not obliged to file an insolvency petition due to over-indebtedness. This is to save entities whose proprietary situation corresponds to the legal definition of over-indebtedness under the Insolvency Act but whose cash flow is sufficient and allows the entities to get over the crisis in a different manner from filing insolvency petitions.

Third, insolvency proceedings in companies of the same concern will be handled by the same insolvency trustee. The purpose of this amendment is to accelerate proceedings and better coordinate the information exchange.

Fourth, regarding discharge from debts (as an institute which may be used by individuals who are not entrepreneurs), the manner in which a debtor who asks for discharge from debts in the form of payment under a payment schedule is entitled to ask the court to determine installments lower than installments assessed under the Act. This amendment is expected to mitigate the social impact of insolvency on socially vulnerable groups.

Finally, secured creditors can affect the decision on the liquidation of a debtor's estate property used as security. To date, a debtor's estate property used as security was liquidated by an insolvency trustee after a discharge from debts in the form of payment under a payment schedule was approved. Now, it is liquidated only at a secured creditor's request. The basis for this change is the fact that the immediate liquidation of the secured estate property is not always for the benefit of secured creditors.

Furthermore, based on the latest insolvency law amendments, changes were also introduced to the Act on the Protection of Employees in an Employer's Insolvency. Currently the state pays an allowance to the employees of an insolvent employer (debtor) for the calendar month in which the protective period was declared before insolvency proceedings are commenced or in which an insolvency petition is filed and for the three preceding and three subsequent calendar months. This rule does not apply to an employee of an insolvent employer who simultaneously (in the relevant period) was a statutory body or a member of a statutory body and had a minimum 50 percent ownership interest in the employer.

Conclusion

The Insolvency Act effective since January 2008 has brought substantial changes to Czech insolvency law. Before 2008 debtors' insolvency was followed by their liquidation and the termination of their business. The new Czech insolvency legislation has introduced completely new institutes which by reorganisation and discharge from debts enable a debtor to continue operating and discharge honest debtor non-entrepreneurs from debts. Simultaneously, the insolvency register was established which contributes to transparency and accelerating insolvency proceedings. Publishing insolvency petitions and court decisions in the register has consequences for both debtors and creditors (for example, limits on a debtor disposing of assets, the day when the time limit to submit creditors' claims starts to run, potential set-offs between mutual debtors, and creditors' claims).

Experience gained in the first year of the Insolvency Act's effectiveness indicates that the commenced process is correct, but some provisions need clarifying and interpretation problems need eliminating. In addition, the economic crisis emphasises the role of new non-liquidation institutes of insolvency legislation so that these forms of resolving insolvency become more attractive and accessible for more entities. The increased protection of the employees of an employer-insolvent debtor was another significant goal of the amendment.

Let us hope that the adopted amendment will contribute in mitigating the impact of the economic crisis and enable many economically viable entities to survive and preserve the maximum number of jobs possible.

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Two years after the bankruptcy law reform: the Italian experience

BY GIORGIO CHERUBINI

In the last few years, Italian law has been significantly amended in order to provide a more efficient and effective insolvency regime, following several criticisms due to lengthy and inefficient procedures, as well as low recovery ratios for creditors. This area of the law area has been governed for more than 60 years by the Royal Decree 16 March 1942 No. 267,

which was enforced when insolvency was considered to be an offence to the economy. Also, at the time, the entrepreneur was considered to be the sole responsible for the insolvency – *decoctus ergo fraudator* (a bankrupt entrepreneur, therefore a swindler).

In this context, bankruptcy proceedings and liquidation of assets were the only remedy to satisfy creditors and punish bankrupt entrepreneurs. But such a draconian system has become increasingly inconsistent with the continuous development of the economy. A company is deemed insolvent when it is unable to pay its debts on a permanent basis; bankruptcy proceedings are unavoidably collective because they concern all the debtor's assets and the interests of all creditors.

The financial crisis has accelerated the need for regulatory changes with the aim of harmonising Italian legislation with EU guidelines, particularly on state aid for rescuing and restructuring large troubled companies. In order to deal with the Parmalat crisis, at the end of December 2003, the government issued Decree Law 347/2003 amending Decree Law 270/1999, which previously regulated the extraordinary administration of large companies in financial difficulties.

The new procedure applies to large insolvent companies in order to support businesses through a program, which includes the transfer of strategic assets or, alternatively, the economic and financial restructuring of the company.

The above mentioned law provisions regulating the restructuring of large companies in financial crisis have recently been modified due to Alitalia's collapse, introducing, with the law 166/2008, the concept of rescue for collapsed businesses operating in the public services sector.

In a different legal framework, the application of EU Regulation 1346/2000 regarding transnational insolvency has had relevant applications in Italy, mainly in the automotive sector.

With the Law n. 80 of 14 May 2005, relevant changes concerning the introduction of new practices for debt restructuring agreements, the extension of the applicability of the composition with creditors, and a redefinition of the clawback action were, for the first time, introduced. Furthermore, with the Legislative Decree n. 5 of 9 January 2006, the bankruptcy law reform was finally approved, and additional changes were brought with the Legislative Decree n 169. The reform came into force on 1 January 2008.

The reform updates domestic legislation to the standard of other countries and aims to preserve both insolvent businesses, as a going concern, and jobs.

The entrepreneurs are subject to the new law if the three following requirements are present: (i) the overall value of the business assets and investments, determined on the average of the last three years, is more than €300,000; (ii) the average gross annual turnover during the previous three years has been greater than €200,000; (iii) and total debts amount to more than €500,000.

The government intends to limit the huge costs involved in bankruptcy procedures whenever low value claims are raised against small assets.

It is also important to note that the burden of proof is reversed, since the debtor has to prove that none of the thresholds above has been reached in order to avoid the bankruptcy.

No bankruptcy order can be issued ex officio, as it was possible in the past, but only upon a petition filed by the debtor himself, by one or more creditors, or by the Public Prosecutor. Also, the competent Court has to be chosen according to the company's registered location.

Upon the declaration of bankruptcy, subject to certain exceptions, creditors must file claims and the management of the company passes from the debtor to the trustee in bankruptcy. The reform aims to protect both the debtors' and creditors' rights to defend and prove their claims and to grant quick proceedings for the issue of a bankruptcy order. Also, in response to the creditors' requests for a US-style creditors' committee to be included in the bankruptcy proceedings, the provision for such committees and their participation in the management of the bankruptcy proceedings has been introduced.

The new regulation has a strong impact on the main players involved in the management of the insolvent debtor, i.e.b the bankruptcy court, the bankruptcy judge *(giudice delegato)*, the trustee in bankruptcy *(curatore fallimentare)*, and the members of the creditors' committee *(comitato dei creditori)*. In fact, the new rules encourage an increase in the privatisation of financial crisis management. In this respect, the role of the trustee in bankruptcy and the creditors' committee has substantially grown, while the bankruptcy judge merely controls the procedure and the compliance of the resolutions taken by other players.

Specific provisions entitle the trustee in bankruptcy to choose between continuation or termination of a company's contract, upon prior approval from the creditors' committee. New rules have been introduced with regard to the sale of buildings under construction, shareholders' loans directed to a specific matter, leasing agreements and business leases.

The new bankruptcy law intends to increase the flexibility of insolvency procedures and make the liquidation procedure of the debtor's assets more simple and efficient; the trustee in bankruptcy must sell the company's assets in a manner he/she determines as appropriate, according to a liquidation program to be formed by the trustee, while its execution is to be approved by the bankruptcy judge, subject to prior consent of the creditors' committee.

Prior to the reform, no discharge regulations applied to individual debtors subject to bankruptcy. Those individuals may now apply for discharge *(esdebitazione)* if, among others things, they have cooperated with all the players in bankruptcy after the bankruptcy order, did not delay the course of the proceedings, and did not file for discharge in the previous 10 years. The US concept of 'discharge' has long been the focus of the Italian doctrine and jurisprudence, in an effort to 'Italianise' it. The new rules now give the insolvent debtor the possibility to restart as a consumer and as an entrepreneur. The complex

and previous rigid rules have now been replaced by the need for the debtor to cooperate with the trustee in bankruptcy and maintain a correct behaviour during the procedure, in order to obtain the discharge.

The new system provides that cooperation by the debtor will be enhanced and rewarded. Also, entrepreneurs who have become insolvent without fraud will be allowed to discharge their obligations for all the debts that arose before the adjudication of bankruptcy, following the conclusion of the insolvency proceeding, with the goal to give them the opportunity for a fresh start.

Also, the clawback actions (azioni revocatorie) practice has changed, since they have traditionally been considered as favourable to the bankruptcy trustees which could apply to the Court in order to obtain the revocation of payments and transactions, or set aside a wide range of transactions if entered during a specific timeframe prior to the beginning of bankruptcy proceedings, also known as the suspect or look-back period. Following the reform, the clawback actions discipline stipulates that the suspect period has been significantly reduced; additional criteria have also been introduced to establish when transactions may be voided as transactions outside the ordinary course of business.

There are certain exemptions from bankruptcy clawbacks such as, for instance, transactions, payments, guarantees/securities in the context of certified restructuring plans, a court-supervised pre-insolvency composition with creditors, or ratified restructuring agreements. This change has been motivated by the need to give stability and protection to transactions which have taken place in a specific period, in case of subsequent failure.

It is important, at this point, to also mention the law 2364, approved on 1 April 2009 by the Senate, which was created to support families and companies facing difficulties due to the current crisis, the growing level of indebtedness, and the indequate regulation of financial markets.

The international financial and economic crisis has had in Italy a substantial impact on production and on the job levels. As a result, in the last few years, the phenomenon of excessive indebtedness has reached high levels. A specific section of the legislation is aimed at providing support for highly-indebted individuals that are excluded from the Italian bankruptcy law. The particularity of the procedure lies in the fact that it is directly activated by the debtor in 'over-indebtedness' – a term indicating a situation of permanent economic imbalance between obligations undertaken and available funds.

The debtor drafts a restructuring agreement of its debts, containing a reimbursement plan that must be submitted to the creditors. The agreement is then filed in Court with the list of all the creditors and the amount of money due to them; it is stipulated that the debtor must have the agreement validated by the majority of his/her creditors and granting the regular payment of the creditors non signatory of the agreement.

The agreement proposal also provides for the debt restructuring and the credit satisfaction through any form, including transfer of future incomes. If the goods or incomes of the debtor are not sufficient to guarantee the feasibility of the plan, the proposal must be signed by one or more third parties securing the repayment through assets or incomes.

The proposal is filed before the Court of the debtor's place of residence and the Judge immediately fixes a hearing, informing the creditors as well as parties related to the company's activity, and proceeds to the publication of the same in the Companies Register.

At the hearing, the Judge orders that individual executive actions cannot be initiated or carried forward for 120 days. In the meantime, the debtor must file the list of all the creditors, indicating also the amounts due and an attestation regarding the feasibility of the plan. The agreement must be approved by all the creditors participating in the procedure, and its non-respect towards one or more creditors terminates it. Conversely, the fulfilment of the assumed obligations leads to the conclusion of the procedure.

Concluding this brief introduction on the Italian system and its recent and substantial changes, it must be said that the reform offers new flexibility in insolvency proceedings amid the crisis, and allows companies to restructure their debt before the situation becomes irreversible.

Distressed debt investors may benefit from attractive opportunities coming from this crisis through the acquisition of business assets or of business equity. In this last period this market has grown significantly; thus, professionals operating in this field will benefit from this situation and new opportunities for the implementation of the new provisions will arise.

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Spain adjusts its insolvency regime to international trends

BY ANTONIO FERNÁNDEZ AND JUAN VERDUGO

Although the Spanish *Concurso* Law *(Ley Concursal)* (2004) is a recent and certainly sophisticated instrument, it has not yet fully taken hold as a successful tool for rescuing distressed companies. In fact, although the *Concurso* Law promotes the saving and preservation of companies as going concerns (the best known tool for doing this is reorganisation through

an arrangement with creditors, which can include debt rescheduling and composition, debt-for-equity conversion and even a third-party takeover of the business), statistics show that 95 percent of the Spanish companies deciding to use formal court proceedings in an attempt to overcome their difficulties irremediably end in liquidation after a tortuous and slow process which inexorably undermines the value of their assets.

There are many reasons for this, although the most widespread view is that it is due to the excessive involvement of the courts in the process, to the lack of post-petition financing, and to the failure of legal instruments that permit early approval of an arrangement with creditors (a paltry 2 percent of court proceedings culminate in an advance proposal for an arrangement, or 'PAC' in Spanish).

We agree that these are the main reasons why companies are averse to court proceedings and instead choose out-of-court restructuring, as this enables them to continue trading. In fact, 2008 and the first quarter of 2009 saw numerous informal restructuring processes begin outside the heavily swamped commercial courts. Most involved real estate companies suffering from severe liquidity problems but which had not yet defaulted on payments to financial institutions. Some cases, however, involved one-off defaults where the financial institutions, aware of the company's delicate situation, agreed to delay enforcing their claims for a specific period of time. Many of these out-of-court restructuring processes were successful. In fact, though these processes were complex, their brevity (between two and six months), relative confidentiality, and total absence of restrictions on what could be agreed on, made it possible to overcome temporary liquidity problems or even completely restructure the debt (fundamentally the financial debt) through various arrangements. Overcoming insolvency without going to court also enabled these companies to implement asset divestment programs, eliminate loss-making lines of business, cut labour costs and replace the management team, without having to secure a court's approval before doing any of these things. Such a 'privatisation' of insolvency solutions at the earliest (or even advanced) stages of insolvency yields unquestionable advantages that significantly help to optimise the value of business assets.

Given the success of these out-of-court restructuring deals and the fact that they were not regulated in Spain, economic and legal operators began to ask the government to make provision for out-of-court, preventative solutions in Spanish insolvency legislation, thereby endorsing such solutions and regulating some of their most problematic aspects in order to encourage economic operators to use them. The measures most urgently requested from the government were to replace unanimity (as required by common law) with majority voting; to regulate the length of the standstill period and its effects; to grant immunity for acts performed by the parties in implementing refinancing arrangements from any subsequent backdating or clawback actions; and, lastly, to grant the directors of distressed companies a moratorium on their stringent statutory duty to petition for the company's insolvency when they are in negotiating an out-of-court restructuring deal.

In response to some of these demands, in March 2009 the Spanish Government decided to partially reform the *Concurso* Law through Royal Decree-Law 3/2009. Such a reform definitely implied a change in the mindset of lawmakers, which appears to facilitate 'private insolvency solutions' from a twofold perspective. The first is by facilitating and protecting 'refinancing agreements' for viable companies, since March 2009, viable companies have been able to reach agreements which at least significantly increase the availability of credit or modify a company's obligations, either by extending their maturity date or by establishing other obligations to replace them. If such agreements result from a 'viability plan' that allows the debtor's business to continue in the short and medium term, any transactions, acts, payments or guarantees entered into pursuant to the refinancing agreements cannot be challenged in the event of a formal insolvency proceeding taking place subsequently. Nonetheless, the 'viability plan' must previously be assessed by an independent expert appointed by the Mercantile Registry, and creditors accounting for at least 60 percent of the debtor's liabilities must support the agreements, which have to be notarised. The second perspective is by extending the deadline for petitioning for formal insolvency.

The reform has also extended the time limit for petitioning for formal insolvency if the insolvent debtor has commenced negotiations with creditors. Accordingly, as soon as the debtor communicates this fact to the commercial court, the directors will be granted an additional four-month moratorium in which to petition for insolvency. During the moratorium the debtor will be protected against potential petitions for insolvency by creditors, as such petitions will be barred.

In any case, the legal reform has not only facilitated (and allayed fears over) out-of-court restructuring processes. Probably in response to statistics showing that the immense majority of insolvency proceedings end in liquidation, the government wished to also make important changes to the formal court-supervised restructuring process, mainly with a view to speeding up the company liquidation phase. The aim was therefore to maximise the value of the company's assets and to prevent whatever little (or considerable) value the assets had had at the beginning of the proceeding from being depleted by the excessive length of the proceeding or by the stigma still attached to insolvency. The aim was also to ensure that potentially more attractive business units would suffer a different fate to that of being used to bear the costs of loss-making or non-core units. In essence, this is nothing more than the route taken by General Motors or Chrysler in their respective Chapter 11 proceedings using 'fire sales' under Section 363 of the US Bankruptcy Code, in relation to which commentators have even gone as far as saying that they spell the end of bankruptcy itself, in the sense that creditors no longer control the process. We also foresee huge outlier cases in Spain in which traditional legal principles may crumble.

In this connection, the Spanish legal reform appears to have followed the widespread trend towards seeking to preserve the maximum value of the debtor's assets and, in order to do so,

has introduced a new concept known as 'early liquidation'. With this new instrument, since March 2009 any company opting for formal court proceedings to deal with its insolvency can submit a proposal for early liquidation of its assets. The proposal can be submitted by the debtor itself from the very outset of the proceeding (i.e., when a petition for insolvency is filed) and up to 15 days after the date on which the final report of the *concurso* managers is submitted.

However, the main differences between 'early liquidation' and Sec. 363 'fire sales' are the following: (i) in Spain, 'early liquidation' means the company's 'disappearance'; (ii) the proposal for liquidation can be made as soon as a petition for insolvency is filed, although liquidation operations will not be carried out immediately, since the *concurso* managers must first complete their report on the company's assets and liabilities (which usually takes as long as two or, exceptionally, three months); (ii) the concurso managers and other parties can make submissions in a much more 'serious' way, although – as happened with GM and Chrysler – it is the Judge who will approve, reject – and even amend – the proposal for early liquidation, discarding or including such submissions.

The new 'early liquidation' alternative is aimed at saving the precious time previously lost while the quantum and classification of claims were being disputed (before the reform, liquidation could not begin until a judgment resolving all these disputes was given, which sometimes did not occur until two years later). Although an attempt was made by insolvency practitioners to get round this obstacle by requesting ad hoc permission for the early sale of assets, the permission of the court, if granted, either referred to very specific assets or included very onerous terms (payment in cash, subrogation of the purchaser to all tax and salary obligations, etc.) In contrast, 'early liquidation' would make it possible, at a relatively early stage, to obtain permission to liquidate/sell assets *en bloc* using any method of payment, while the purchaser would also benefit from various incentives (such as a partial exemption from salary obligations or the possibility of modifying the terms of employment contracts associated with the assets).

Despite the above, the March 2009 reform was not, as the government itself admits, a far-reaching reform. Instead, it introduced, on an urgent fast-track basis, certain tools which not only provided comfort to financial creditors but also assuaged the concerns of the directors of distressed businesses as regards their statutory duties. Additionally, the reform attempts to expedite the 'exit' from formal court insolvency proceedings, even if it is through the early liquidation of assets, as a way to preserve the value of the company's assets if the company itself cannot be preserved as a whole.

A necessary reform, as said, but partial. In fact, the government has officially announced that a bill making major amendments to the current *Concurso* Law will be laid before Parliament in 2010. According to official sources at the Ministry of Justice, instead of amending the general structure of the *Concurso* Law, the bill will address various contentious issues, such as the recognition and re-ranking of certain claims (contingent claims, public claims, secured claims, etc.) and insolvency proceedings against groups of companies (which are not expressly provided for in the current law). Other changes have not been disclosed.

Although the initial conclusions of the Committee which is to prepare the reform will not be ready until May 2010, the government has already let it be known that the future insolvency legislation will be drafted with a view to "eliminating the stigma of insolvency", by making domestic and foreign investments more secure through "sound, speedy and flexible" legislation. A torrid autumn nonetheless beckons, with the unemployment rate having risen to 16.7 percent by the end of the first quarter of this year, and a negative outlook for consumption. With NPLs totalling an estimated €78bn and several covenant breaches on the horizon, the March 2009 reform will be tested to its very limits while we await the reform announced by the government.

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Reforms to Spanish insolvency law spark surprise and unease

BY TERESA RAMOS

Before analysing the proposals for the reforms to Spanish insolvency legislation which should now be advocated, this article will briefly comment on the insolvency legislation currently in force in Spain to provide a clear picture of the reforms which have been made over the past five years and the exponential leap which has occurred as a result to how insolvencies are treated in Spain.

Before the Insolvency Law 22/2003 (9 July 2003) came into force in Spain on 1 September 2004, it could be said that Spanish insolvency legislation was antiquated and extremely dispersed.

As the preliminary recitals of the insolvency law currently in force in Spain state, the existence of various insolvency proceedings contributes to the confusion and dispersion of Spanish insolvency legislation. In fact, in addition to the traditional bankruptcy institutions and insolvency proceedings, other preventive or preliminary proceedings have been introduced over the years such as the 'suspension of payments'

and the remission and deferral of debt proceedings. The Suspension of Payments Law of 1922, enacted provisionally as it was passed to resolve a specific case, finally became a key element of our legislation, making Spanish legislation not only confusing and dispersed, but based on initially only provisional laws.

This situation was not remedied until 2003 when the Insolvency Law 22/2003 (9 July 2003) was passed, which came into force on 1 September 2004. However, although the 'new insolvency law', as it is still called five years after it came into force, has meant a big step forward, it has clearly not been able to deal with the current economic situation.

It goes without saying that since the Insolvency Law 22/2003 came into force, insolvency proceedings have grown significantly in absolute number in all business sectors. The construction and real estate sectors represent 32 percent of the total published insolvency proceedings and they are the sectors with more growth in absolute terms, as the number of proceedings have not ceased in their constant growth since 2007.

The Royal Decree Law 3/2009

As a result of this situation, a great outcry was raised among the public, including the judges themselves, demanding a reform of the law to deal with the chaotic situation of the judicial institutions caused by the economic recession.

The complaints about the Insolvency Law 22/2003 were mainly regarding: (i) the lack of pre-proceedings guarantees covering out-of-court negotiations; (ii) the need to create a simple administrative liquidation procedure with the Companies Registry for companies where there is little likelihood of being able to collect on a debt, which would mean that a large amount of liquidations would not have had to resort to the courts and would give a large saving of the courts' human and material resources; (iii) no regulations on insolvency procedures for individuals who are required to initiate legal proceedings which do not help consumers; (iv) ineffective procedures for advance agreements with creditors, which seriously compromises the viability of the company; (v) excessively long procedures to challenge receivers' reports, which prolongs the proceedings and results in a loss of value of assets.

Finally, the Spanish government has passed some new urgent tax, financial and insolvency measures in the anxiously-awaited reform of the Insolvency Law 22/2003 and the Royal Decree Law 3/2009.

The Royal Decree Law 3/2009 has established some provisions to try to ensure the refinancing of viable companies, streamlining of the procedures for the liquidation of non-viable companies, shortening of time limits and speeding-up of proceedings with a reduction of costs, review of the situation of some credits and improvements to the situation of employees of companies in insolvency proceedings.

The reform, whose main characteristics are its urgency and temporariness, has failed to include some of the demands made previously, such as the establishing of a preventive composition and privileges for 'new money' as an incentive to motivate debtors to collaborate in the refinancing of debts. The law has also failed to seize what was an obvious opportunity to make a thorough reform of the legal statute of receivers.

The reform has contributed little. The changes made to streamline procedures have not shortened the proceedings. The three-month deferral period introduced to help debtors file an advance agreement with creditors is used more often to carry out refinancing operations or renegotiate the debt than to make an agreement. The refinancing or restructuring procedure is not regulated in an orderly way as a pre-proceedings stage. Companies with no assets are still liquidated through court proceedings and there are no provisions on insolvency proceedings for individuals.

To sum up, rather than making a reform, the Royal Decree Law 3/2009 only patches up bad patches. This fact has been obvious from the start. The Royal Decree Law 3/2009 itself comments in its preliminary recitals that an in-depth reform of the Insolvency Law 22/2003 is required. And we must refrain from going into the details of the controversy caused by the introduction of the concept of an independent expert as rivers of ink have already been expended over the vagueness of the regulations of its legal statute. As a result of this new legislation, a few days before the Royal Decree Law 3/2009 entered into force, the Spanish government announced that an Experts Commission would be set up to fully reform the Insolvency Law 22/2003.

Current legislative trends in insolvency: the Spanish system

The current situation needs some reflection and this calls for a cool head. We should go back to the beginning without the pressure of recent events and analyse what type of legislation is required and only then propose solutions.

By doing so, we will build a harmonic legislative construction with useful and reasonable architectural solutions. By not doing so, we will only be papering over the cracks and the building will finally end up collapsing. This may sound ominous or doomed to failure but we must agree that, in practice, commencing a legislative process in these times of recession only results in a 'pendulum law', swinging legislation from one extreme to another.

The result of what can only be termed as a dabbling in legislation is a law which lacks a clear purpose or direction, which has not proved positive in any way but has instead created a situation of uncertainty, which has clearly only been established as a quick fix to a difficult position and to silence the voices of those demanding an urgent reform of the law, but which has ended up being a fiasco and has only prompted a request after its publication for a full reform of the Insolvency Law 22/2003.

It is important to look at how to approach this legislation in the future as taking various approaches, as previously mentioned, could have a chaotic effect and cause the system to teeter. Traditionally, when dealing with recession situations, comparative law clearly has two tendencies: (i) the

predominantly judicial and (ii) the predominantly contractual or deregulated.

In the first case, the instrument used to deal with recessions is the legal process and, predominantly in the role of management, the trial judge, whose sole purpose it is to reach the objectives laid down by law. By no means does this mean that the creditors' interests are sacrificed. Rather, it ensures the protection of a level of equality between the parties. It is also based on the premise that the election or availability of a type of proceeding to be used cannot be left to the discretion of the debtor who does not have the required distance to do so.

The second tendency, based on the concept that recessions should be dealt with by the affected parties only, i.e., the debtor with the creditors, the instrument used is an agreement or contract without the intervention of the courts. In this case, the approach is transactional which pursues the maximum economy of costs and which is regulated by the market. The law does not intervene except to eliminate any obstacles which impede the correct functioning of the market.

No further comments are required to be able to reach the conclusion that the insolvency system in Spain, as in most of our neighbouring countries, is a system of the courts. Following these comments, some proposals on the reforms which should be made to insolvency legislation in Spain can now be raised.

Proposals for reforms

The proposals commented on in this section are made from the point of view of our judicial system. We cannot overlook that there is little tradition in our country of resorting to insolvency proceedings to solve a crisis situation. This is mainly because companies are inevitably stigmatised as bad managers. In addition, the fact that more than 90 percent of insolvency proceedings terminate in liquidation and that, in some cases, the excessive length of the procedures causes companies' assets to depreciate is not exactly an incentive for companies to file a petition for insolvency.

Establish a deferral period to restructure and renegotiate the debt. The deferral period established by the Royal Decree Law 3/2009 for the filing of an advance agreement should also be extended to cases where there is a restructuring or refinancing of the debt. The following point will discuss the requirements which should be established to apply for the time period.

Determine the situation of the company. The provisions of Spanish insolvency law on this matter should be reformed. It currently establishes two scenarios. The first is to apply to the judge for a three-month deferral period to reach an agreement with the creditors and, if no agreement is reached after such time, to file an insolvency petition.

The second is to affirm that an insolvency is 'current' or 'imminent' and to file an insolvency petition voluntarily (at the request of the debtor) or necessarily (at the request of a creditor). Spanish law currently establishes no provisions regarding a prior analysis of the debtor company. The Royal Decree Law 3/2009 only established a mechanism to shield refinancing operations which meet certain requisites. However, other countries in Europe have established a mechanism prior to the commencement of the insolvency proceedings whereby companies can be diagnosed to decide which procedures should be followed.

The proposal made in this article, taking into account that there is little tradition among companies in this country of carrying out insolvency proceedings, is for the law to establish a longer term for the filing of an insolvency petition for the debtor to either reach an agreement with the creditors and draw up an advance agreement or commence negotiations for an out-of-court settlement of the debt or business restructuring to overcome the insolvency situation. The term for filing the petition could be four months after the grounds for insolvency have occurred.

Obviously an independent expert designated by the Companies Registry should intervene in the procedures from the very start not just to validate a viability plan drawn up by a third party but to carry out a preliminary study of the company's situation to be able to decide which procedures should be followed. This would avoid the circumstances which may occur under the current legislation that, after a plan supported by 60 percent of the company's liabilities has been drawn up and executed before a notary public, it is not approved by the independent expert wasting months of work.

If the independent expert's preliminary report considers that the company is viable, the company and its creditors should draw up a viability plan to reach an out-of-court agreement with the creditors. The viability plan should be accepted by the creditors representing 60 percent of the company's liabilities and the out-of-court agreement should be officially approved by the courts, which avoids notary costs.

If the independent expert considers that the company is not viable, before an agreement is made with the creditors, the company will have to file a petition for insolvency proceedings. All these procedures should be completed within the four-month period mentioned.

In-depth regulation of independent experts. This proposal is for an in-depth regulation of the independent expert legal statute to determine how the experts should be designated, the requirements which they should comply with to act as independent expert, any incompatibilities and prohibitions, their functions, the documents which should be drawn up and their contents and, evidently, their responsibilities, all of which should be carried out after the relevant consultations have been made to the respective professional associations.

In-depth regulation of the receivers legal statute. In addition, the regulations of the receivers legal statute should take a U-turn. They should create court-appointed receivers shifts and establish that a minimum amount should be charged for companies with few assets. A creditors' committee should be set up which shall designate a third receiver (currently, creditors' interests are only represented by the receiver designated by the judge). This will undoubtedly lessen the cases of companies resorting to insolvency proceedings and thus shorten the length of the proceedings substantially.

Strict changes to how insolvencies should initially be dealt with. This is the main problem of insolvency proceedings

and, basically, it is caused by the disputes over recognition and classification of credits. A more active intervention of creditors at the stage before the lists are drawn up would help avoid a lot of disputes and allow the courts to deal only with the more serious cases. Strictly speaking, only those cases which are absolutely necessary should go through insolvency proceedings and when the judge considers that they are necessary.

Give privileges to new money. A mechanism should be established during insolvency proceedings to help contributions of new money to be made. The current lack of guarantees means that many debtors cannot gain access to the financing which they require to overcome temporary crisis situations and, as a result, such temporary situations often become permanent.

Special privileges should be given to new money contributed to companies with the possibility that, together with the debtor, creditors agree to set up guarantees, which have preference over other existing guarantees, in such a way that it is the creditors who grant this privilege to the new money. This mechanism is established in British legislation.

This article clearly illustrates that legislators in Spain should not waste the opportunity of future amendments of the Spanish Insolvency Law 22/2003 to reform these important points and any other matters which will certainly be raised along the way.

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Russia's rapidly evolving commercial bankruptcy law

BY SERGEY A. TRESHCHEV AND PATRICK J. BROOKS

Russia's Federal Law No. 127-F3, 'On Insolvency (Bankruptcy)', dated 26 October 2002 (the 'Bankruptcy Law') was amended substantially over the last nine months by three separate bills and several clarifying orders of the Supreme Arbitration Court of the Russian Federation, the highest bankruptcy court in Russia, that are effectively binding upon inferior arbitration courts, or bankruptcy courts. Moreover, starting from December 2008 the laws governing the enforcement of security interests in real and personal property in Russia were amended and various bills are circulating that would provide distressed businesses and their creditors with additional restructuring tools, such as debt-equity swaps that are currently prohibited under the law. At the time of the drafting of this article, the Ministry of Economic Development of the Russian Federation is working on a draft Bill of further amendments to the Bankruptcy Law that would, if adopted, fundamentally alter Russia's bankruptcy system and debtor-creditor relations.

Since 1992, Russia has experienced three fundamental reforms of its commercial bankruptcy laws in 1992, 1998 and 2002. If the principal concepts of the Bill are adopted, this will represent a fourth fundamental reshaping of the country's commercial bankruptcy laws in less than 20 years. These reforms are occurring in parallel with the development of all legal and commercial institutions and structures to support a dynamic market economy. The establishment of an efficient, predictable and transparent bankruptcy system is a fundamental element of achieving this goal and particularly critical at this moment given the challenges facing the world economy and Russia today.

Initiating the process

A Russia-based company or sole proprietor cannot become the subject of a bankruptcy proceeding unless it can demonstrate that it meets the following bankruptcy indicators. Either, it has failed to satisfy a monetary payment judgment (i.e., court ordered judgment for failure to pay a cash claim) within three months of the date such payment was ordered to be performed, or it has failed to satisfy an obligatory payment judgment (i.e., a court or agency, such as tax inspectorate or customs office, ordered judgment or directive for failure to pay an obligation to the state body, including, but not limited to, tax obligations) within three months of the date such payment was ordered to be performed, and the amount of such court ordered judgment(s) is more than 100,000 rubles.

The mere existence of a debt that the debtor is unable to pay is insufficient; there must be a court judgment confirming, or validating the debt, to initiate both voluntary and involuntary proceedings.

A debtor's management is required to file a bankruptcy petition as soon as possible if: (i) the satisfaction of one or more creditors' claims will result in the debtor's inability to satisfy all of its other creditors' claims in full; (ii) the authorised body of the debtor has taken a decision to file a bankruptcy petition; (iii) enforcement actions against the debtor's property will complicate or preclude the debtor's continued operation; or (iv) the debtor is insolvent on either a cash flow or a balance sheet basis.

In practice, the obligation to file typically has been interpreted to be triggered only after the manifestation of the bankruptcy indicators. Nonetheless, general managers are well advised to keep their board of directors (if any) or shareholders timely informed of collection proceedings, and board members and shareholders should heed those warnings, to minimise risk of personal liability. Most creditors can initiate involuntary proceedings provided they can prove the bankruptcy indicators.

Notice of filing of bankruptcy petition. One of the fundamental shortcomings of the system and the source of great mischief is that notice of the proceeding is only required to be published in one designated paper of national circulation. As a consequence, many creditors are unaware of the initiation of bankruptcy cases and the starting of the clock for filing claims for inclusion in the debtor's claims register.

Venue. Russia's bankruptcy courts have exclusive jurisdiction over bankruptcy proceedings. A significant limitation of the current bankruptcy system is that it does not provide for the administrative consolidation of bankruptcy proceedings of related legal persons. Each debtor is the subject of a discrete bankruptcy proceeding, which can be brought before only a bankruptcy court located where the debtor is registered.

Bankruptcy proceedings. The Bankruptcy Law provides for the following types of insolvency proceedings: supervision, financial rehabilitation, external administration, composition arrangement and liquidation. If the bankruptcy court accepts a bankruptcy petition, the debtor enters a temporary period of supervision. If during the supervision proceedings the case is not dismissed or terminated, the creditors vote on initiation of financial rehabilitation, external administration or liquidation proceedings depending on the financial condition of the debtor and the goals of the debtor and its creditor body. The debtor also always has the ability to reach a composition arrangement with its creditors and exit its bankruptcy proceedings.

Supervision. The purpose of supervision is to identify the debtor's creditors, determine the amounts of their claims and prepare a register of creditor's claims; suspend enforcement under writs of execution; analyse the debtor's financial state; and hold the first creditors' meeting at which registered creditors vote to decide whether the debtor should proceed with financial rehabilitation, external administration or liquidation, or approve a composition arrangement. Notice of the creditors' meeting is made by publication if the number of registered creditors is greater than 500, otherwise personal notice by direct mail is required but only to "persons entitled to participate in the creditors meeting". Consequently, in most cases a small fraction of creditors holding legitimate unsecured claims receive any notice of creditors' meetings –- meetings at which the fate of the debtor and the likely recovery of creditors are determined.

Financial rehabilitation. The financial rehabilitation procedure was introduced in 2002 with the current Bankruptcy Law and was intended to encourage restructuring, but this has not occurred. The problem is that a condition for concluding financial rehabilitation is the provision of security by a third party to secure the satisfaction of creditors' claims in full according to the agreed plan of financial rehabilitation and debt repayment schedule.

External administration. The goal of external administration is to restore the debtor to solvency pursuant to a plan developed by the court appointed external trustee and approved by a creditors' meeting. External administration must be concluded within 18 months, although this period can be extended for an additional six months. The external trustee is responsible for gathering and managing the debtor's property, assessing the debtor's finances, developing a plan of external administration for presentation to the registered creditors for approval and implementing any plan approved by the debtor's registered creditors. Unlike in financial rehabilitation, the external trustee is primarily responsible for the operation of the debtor's business as most of management's powers are terminated.

Liquidation. The purpose of liquidation procedures is to marshal the debtor's assets and delineate and pay all registered claims in accordance with the Bankruptcy Law's priority scheme, with claims of the same priority being paid on a pro rata basis if the debtor's assets are insufficient to pay the entire class of registered claim in full. Upon initiation of the liquidation process, all of the debtor's property forms the debtor's estate and the liquidator is appointed. The liquidator has primary responsibility for managing the liquidation of the debtor's assets and the determination and payment of claims. The liquidation process must be concluded in six months from the date of its initiation.

The debtor's claims register and the priority ranking of creditor claims

For a creditor's claim to be counted it must be registered in the debtor's register of claims. The duly serving trustee is responsible for vetting all claims, which can be registered only with the bankruptcy court's approval.

Registered claims are paid in the following order of priority. First priority is for claims for damages for personal injury and moral harm. Second priority is for claims for wages, salary, other employee benefits and royalties payable to authors of copywritten materials. Third priority is for all other creditor claims with principal amounts being settled prior to claims for lost profits, interest and penalties on unsecured claims. Secured claims are accorded third priority ranking along with unsecured claims, but the proceeds generated from the sale of a secured creditor's collateral is distributed as follows: (i) 70 percent (80 percent if obligation arises under a bank loan) is applied to satisfaction of the secured creditor's claim (principal and interest) and the balance is placed in a segregated bank account as a reserve to pay higher priority claims (if needed); (ii) 20 percent (15 percent if obligation arises under a bank loan) is applied to pay first and second priority claims, if unencumbered assets are insufficient to satisfy those claims; and (iii) the balance is applied toward current payments, if unencumbered assets are insufficient to satisfy those claims.

The early bird gets the worm: the race to the court house

A couple of key issues warrant highlighting at this point. First, among the elements of a debtor's bankruptcy petition is the identification of a candidate to serve as interim trustee, who in practice is regularly appointed by the bankruptcy court and re-appointed for other stages of the proceedings (e.g., external trustee). Second, the interim trustee is the gatekeeper

Substantial steps have been taken in the last year to better balance the interests of debtors and creditors and to provide tools to combat abuse of the insolvency system.

of the debtor's claims register. Third, only creditor claims that are evidenced by a court judgment (recognised as binding in the Russian Federation), or that have been approved by the bankruptcy court, can be registered in the debtor's claims register. Fourth, the supervision stage of the case cannot under law exceed a period of six months. Fifth, only creditors whose claims are registered in the debtor's claims register or are secured have a right to notice of, and to vote at, creditors' meetings. Lastly, the perception, right or wrong, is that the party who appoints the interim trustee exercises de facto control over a debtor's bankruptcy proceedings, at least over the supervision stage, because of his or her influence upon which claims are timely registered in the debtor's claims register entitling the creditor to vote.

As a result of these and other facts, creditors currently have a strong incentive to aggressively pursue legal action against distressed businesses and even initiate involuntary bankruptcy proceedings, to secure their vote at creditors' meetings, if not the right to propose their own candidate to serve as interim trustee.

Key proposed amendments in the bill

Name change. The title of the current Bankruptcy Law would be changed to the 'Federal Law on Financial Rehabilitation and Insolvency (Bankruptcy)' to underscore the shift in policy to support financial rehabilitation of distressed businesses.

Consolidation of bankruptcy proceedings. The Bankruptcy Law does not provide for consolidation of cases of related entities for administrative purposes. As a consequence, it is nearly impossible to restructure groups of entities because each entity is the subject of standalone proceedings, each of which may be pending before a different court in a different geographic location. The Bill provides for the consolidation of cases of a 'group of entities' – two or more entities that are under the control of one 'controlling member of the group'.

Out-of-court arrangements. The Bill expressly acknowledges and approves out-of-court arrangements and the enforceability of forbearance arrangements. The Bill further provides that debtors and creditors may agree to an out-of-court arrangement that includes a preliminary agreement on a plan of financial rehabilitation and obliges the debtor to initiate rehabilitation proceedings to seek approval of such plan on a streamlined basis opening the way for prepackaged bankruptcies.

Financial rehabilitation. The Bill would amend and restate the entire chapter governing financial rehabilitation to minimise obstacles to initiating the process and provide mechanisms to more efficiently maintain ongoing business operations. A debtor would be able to voluntarily file a petition proposing financial rehabilitation at the outset of the proceedings and would not need to produce a third party guarantee of satisfaction of claims under its plan of financial rehabilitation. The debtor would only need to demonstrate feasibility of its proposed plan. The Bill also includes a cramdown provision, but the threshold appears exceedingly low, particularly given the weak notice provisions and difficulty of creditors getting claims registered in the first instance to secure their right to vote.

Cross-border insolvency procedures. The Bill includes the addition of an entirely new chapter that would regulate cross-border insolvencies. The cross-border procedures are modelled after the European Union Regulation on Insolvency. Accordingly, the situs of the primary case should be determined by determination of the debtor's centre of main interests.

The introduction of the recognition of cross-border proceedings could further assist Russian businesses in distress to reorganise their affairs because most all Russia's private companies of any scale, particularly those with foreign investors, have offshore holding structures. However, while Russian courts are required to recognise foreign arbitral awards under the UN Convention on the Recognition and Enforcement of Foreign Arbitral Awards, recognition and enforcement of foreign judicial decisions is rare, mostly because of a lack of bilateral and/or multilateral treaties on mutual recognition and enforcement of court judgments to which Russia is a party.

Conclusion

Substantial steps have been taken in the last year to better balance the interests of debtors and creditors and to provide tools to combat abuse of the insolvency system. There is a marked tendency to make the process more transparent, increase disclosure and introduce concepts to improve the process. Because of the volume and number of recent amendments in such a short space of time, it remains unclear how the amendments will be implemented in practice. Nonetheless, the trajectory of amendments appears very positive. However, careful study of the Bankruptcy Law and Bill is warranted and efforts should be taken to better balance the interests of parties-in-interest by broadening notice requirements and further improving timely and meaningful disclosure, among other things. The adoption of the Bill (with some modifications) could revolutionise Russia's bankruptcy process by providing a workable mechanism to preserve the operation of viable businesses experiencing financial distress while more equitably addressing creditor claims. This in turn should assist the banking sector in dealing with the glut of bad debts on their books in a more efficient manner while improving recovery rates.

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Recent amendments to the insolvency and restructuring regulation in Latvia

BY GIRTS RUDA

The main sources of insolvency and restructuring regulation in Latvia are the Insolvency Law *(Maksātnespējas likums)* and the Civil Procedure Law *(Civilprocesa likums)*. Latvian law does not provide for any specific regulation applicable to privately agreed reorganisation (work out), thus general regulation applies when parties opt for renewal of the company's solvency without involvement of any public institutions.

The Insolvency Law provides for various restructuring procedures dependent on whether this procedure takes place prior or after a company being declared insolvent.

At any time before initiation of official insolvency proceedings a company can initiate its own legal protection proceedings *(tiesiskās aizsardzības process)*, i.e., formal reorganisation prior to declaration of the company insolvent. During these pre-insolvency proceedings, a company's obligations are performed within the limits set by a special plan approved by non-secured creditors and court. Recent amendments to the Insolvency Law introduced another mechanism – the out-of-court legal protection proceedings *(ārpustiesas tiesiskās aizsardzības process)*, i.e., formal reorganisation prior to declaration of a company insolvent. This is less complex and more flexible procedure that inter alia significantly increases the role of secured creditors. In practice this means that those creditors who are able to provide funding for renewal of a company's solvency will also have a say at the initiation of this restructuring process, as well as throughout the process.

Until 2008, a company could undergo a formal reorganisation only after it had been declared insolvent by the court. This approach is also followed in the new Insolvency Law, which replaced the previous regulation. Accordingly, a company can also undergo formal reorganisation *(sanācija)* after it has been declared insolvent. The same applies to settlement *(izlīgums)* between a company and its creditors. If the meeting of creditors rejects both settlement and reorganisation, then the company will be subject to bankruptcy, where the administrator sells the company's assets to settle as much of the creditor's claims as possible.

Recent legislative changes

On 1 July 2009, amendments to the Insolvency Law came into effect and changed the legal regime applicable to insolvency and restructuring. This part of the article highlights the most significant changes.

Elements of insolvency – legal entities

Total principal debt obligations of a debtor qualifying as one of the elements of insolvency proceedings of a legal entity have been increased to principal amount of LVL 1500 or approximately €2100 (previously LVL 1000 or approximately €1420).

A company's failure to implement legal protection proceedings has been introduced as a new element of insolvency proceedings. An administrator in legal protection proceedings may now also submit an application for insolvency proceedings in a court and thus initiate insolvency proceedings of a company.

Crucial time periods

Creditors' claims against a debtor must now be submitted to an administrator within one month of a relevant entry in the insolvency register. However, the court can establish a longer time period (not exceeding three months) for submitting claims against a debtor in Latvia if the proceedings have been initiated according to Section 3, Paragraphs 1 or 2 of Council Regulation No 1346/2000.

If a creditor's claim does not comply with the requirements of laws, the administrator will immediately send a request to the creditor to eliminate the established defects within a time period of five days but not later than within five days of the final date for submitting applications for creditor's claims. If the relevant time period is not observed the administrator must decide either to reject the creditor's claim altogether or to approve such claim in part. An administrator's decision regarding rejection or partial approval of a creditor's claim must be sent to the concerned creditor within three days of making such decision.

Creditors' approval

The administrator is entitled to refuse a claim or to enter into a settlement agreement on behalf of the insolvent company in respect of the insolvent company's claims against third parties if three quarters of creditors with voting rights present in a creditor's meeting vote in favour of such action. Previously consent of three quarters of all creditors was sufficient.

A recovery plan is approved if more than a half of present creditors with voting rights have voted in favour. Previously a vote of least two thirds of creditors was required for approval of a recovery plan.

A decision on closing bankruptcy proceedings is taken if more than half of present creditors with voting rights have voted in favour. Previously the law required the administrator to submit the decision on closing bankruptcy proceedings for the approval of the court and the court was required to evaluate whether there were grounds for rejecting of the decision on closing of the bankruptcy proceedings.

A new order has been introduced for establishing the number of votes of a creditor. A creditor is granted votes based on the amount of the principal debt while previously the votes were granted based on all debt (principal plus interest, default interest, and other ancillary claims).

Legal protection proceedings

The time period for implementing the legal protection proceedings is extended to two years (previously one year) as of the date the court decision regarding the implementation of the legal protection proceedings enters into effect.

In the legal protection proceedings, a secured creditor may claim the sale of pledged property of the company undergoing legal protection if the prohibition to sell the pledged property affects the secured creditor's interests and if selling the pledged property does not substantially affect the implementation of the legal protection plan; the decision to sell the pledged property is taken by the court that has initiated the relevant legal protection proceedings

In order to implement the legal protection plan, the consent of more than half of the unsecured creditors is required. Decrease or cancellation of a principal debt or interest of a secured creditor is possible in the legal protection proceedings only if the relevant secured creditor consents to such action. In the out-of-court legal protection proceedings this regulation is not applicable in respect of a decrease of interest of a secured creditor, meaning that consent of the relevant creditor is not required; however, it is applicable in respect of a decrease of the principal debt of a secured creditor if the decrease exceeds 10 percent.

According to the amendments the action plan of the legal protection proceedings may now specify advantages for persons who have granted funds for the implementation of the plan corresponding to the amount of granted funds. If the legal protection proceedings are terminated and, simultaneously, the insolvency proceedings of the legal person are declared, the acquired advantages remain effective and the claims against the debtor resulting from the funds granted for implementation of the plan are deemed to be expenses of the insolvency proceedings hence payable before settling the claims of the creditors. However, the advantages granted must not violate the interests of the secured creditors. A prohibition has been introduced to indicate the extension of the time periods for running tax payments in the action plan of the legal protection proceedings, unless the consent from the relevant tax administration has been received.

Out-of-court legal protection proceedings

The new regulation allows preparing the legal protection plan before the legal protection proceedings are initiated and declared by the court. All creditors (including secured creditors) participate in the process of agreeing on the legal protection plan.

A company has the right to submit an application for initiating legal protection proceedings and to request a court to declare implementation of legal protection proceedings when certain qualifying preconditions have been fulfilled, including: (i) development of an action plan for out-of-court legal protection proceedings in conformity with specified requirements; (ii) coordination of the action plan with creditors whose total principal claims constitute more than a half of the total amount of the principal claims; (iii) an agreement on the administrator in out-of-court legal protection proceedings between the company, creditors whose principal claims in total constitute more than a half of the principal claims and the administrator; and (iv) receipt of the opinion from the administrator regarding the possibility to implement the action plan of the out-of-court legal protection proceedings.

The action plan of the out-of-court legal protection proceedings must ensure that the benefit for the creditors who have not agreed to the action plan is at least equal to the benefit such creditors would receive if, at the moment of the approval of the action plan of the out-of-court legal protection proceedings, the insolvency proceedings against the company were declared and bankruptcy proceedings were initiated (meaning a sale of all property of the company and using the proceeds for paying insolvency costs and settling claims of creditors). In this regard, substantiation must be included in the action plan of the out-of-court legal protection proceedings. The action plan of the out-of-court legal protection proceedings must specify information required by the law for an action plan of legal protection proceedings and, additionally: (i) the administrator in the out-of-court legal protection proceedings; (ii) the above mentioned substantiation regarding the benefit for creditors that have not agreed to the action plan.

The administrator in the out-of-court legal protection proceedings is appointed by the court based on a recommendation from the company.

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CHAPTER SEVEN:

Legal Developments - Offshore

Has the shareholders' oppression remedy arrived in Cayman?

BY FRASER HUGHES

In response to a Petition to wind up a Cayman Islands' company on the just and equitable ground, recent amendments to the Companies Law permit the Court to make orders in the alternative to winding up. Those alternative powers are set out in subsection 95(3) of The Companies Law (2009) Revision. They include powers in the nature of injunctive relief and a general power to regulate the conduct of the company's affairs in the future.

While this is a recent development in Cayman Islands' law, it is an established remedy in many commonwealth jurisdictions, typically referred to as the oppression remedy.

While the specific statutory language differs between commonwealth jurisdictions, courts have applied similar principles in implementing the oppression remedy and have found the decisions of other commonwealth jurisdictions to be persuasive. There are some peculiar features of the language in subsection 95(3) that leave its application rather ambiguous. Much could turn on how that language is interpreted by the Grand Court.

Legislative history – majority rule and tyranny of the majority

A common thread that runs through the oppression remedy caselaw is the tension between protecting minority shareholder rights and holding parties to their agreements. While courts are loathe to countenance the use of a corporate vehicle as a tool of minority oppression, they are equally loathe to turn the oppression remedy into an alternative to prudently drafted company articles or to encourage its use as a means to challenge business decisions. Similarly, there is a tension between achieving a just result in the individual case and opening the floodgates to turning the courts into the arbiter of shareholder disputes that ought to be settled commercially.

Many of the rules applied in implementing the oppression remedy are attempts to navigate between these competing concerns.

The rule in Foss v. Harbottle (1843) 2 Hare 461 held that the proper plaintiff for harms inflicted against a company is the company itself and not its shareholders. The limited exceptions to this principle included violations of the personal rights of shareholders (as opposed to the shareholders as a whole), actions that required special majorities, ultra vires acts, and fraud.

Where the matter fell within the Foss v. Harbottle rule, the only remedy available to minority shareholders was to seek to wind up the company on the grounds that it was just and equitable to do so. The lacunae of that remedy are apparent. Where minority shareholders seek relief to maximise or realise upon their share value, the winding up remedy risks destroying the very going-concern share value that the minority seeks to realise.

Since it was not the ideal outcome for either party, there was fertile ground for settlement between reasonable commercial parties. It was not unusual for judges to adjourn relief on terms to attempt to encourage settlement on this basis. The difficulty remained that the only course open in the event that such matters were not settled, was to wind up the company.

In addition, there are clear policy grounds against winding up as a means of resolving shareholder disputes, including potential unemployment and other economic upheaval associated with ending a business of a going concern.

The move towards a flexible remedy

The English legislative reaction was amendments that became section 210 (1) and (2) of the 1948 English Companies Act, stating as follows: "(1) Any member of a company who complains that the affairs of the company are being conducted in a manner oppressive to some part of the members…may make an application to the court by petition for an order under this section. (2) If on any such petition the court is of opinion – (a) that the company's affairs are being conducted as aforesaid; and (b) that to wind up the company would unfairly prejudice that part of the members, but otherwise the facts would justify the making of a winding-up order on the ground that it was just and equitable that the company should be wound up; the court may, with a view to bringing to an end the matters complained of, make such order as it thinks fit…"

Two aspects of the above section limited its effectiveness as an alternate and stand-alone remedy to a just and equitable winding up. First, the oppressive conduct needed to be a course of conduct – isolated acts would be insufficient. Second, the wording is clear that the remedy was only available if the facts otherwise justified winding up the company.

The statutory wording and the caselaw interpreting it led to an anomalous result: a higher threshold was set for an oppression remedy than was required for winding up a company completely.

The move to standalone discretionary relief

The lacunae of section 210 eventually led to changes in the English Companies Act in 1980, the language of which was consolidated (with minor amendments) into s. 459(1) of the English Companies Act, 1985, which states as follows: "Any member of a company may apply to the court by petition for an order under this Part on the ground that the company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally or of some part of its members (including at least himself) or that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial."

This effectively divorced the oppression remedy from winding up. An oppression remedy under the new act simply required conduct that was 'unfairly prejudicial' to give the court wide discretionary relief.

Competing tensions

The decisions interpreting section 459 are clear that the oppression remedy ought not to be used as a tool to relieve parties of their bargains. At the same time, the exercise of legal rights will not escape equitable scrutiny.

Similarly, courts have drawn a line between conduct that justifies judicial scrutiny and 'business judgment' on the basis that courts are not in a position to review business decisions – even though they may appear unwise, inefficient or careless. However, it need not be shown that conduct was designed to cause harm to a shareholder. Even if the majority's motive was merely to enrich itself, the conduct is still capable of constituting oppression.

Cayman Islands' oppression remedy

The 'Memorandum of Objects and Reasons' preamble to The Companies (Amendment) Bill, 2007 described the new Cayman Islands provision as follows: "Subsections (3) to (6) are equivalent to section 459 to 461 of the English Companies Act 1985." (page 5).

The wording of subsection 95(3) does not appear entirely consistent with that statement. Subsection 95(3) provides: "If the petition is presented by members of the company as contributories on the ground that it is just and equitable that the company should be wound up, the Court shall have jurisdiction to make the following orders, as an alternative to a winding-up order, namely – (a) an order regulating the conduct of the company's affairs in the future; (b) an order requiring the company to refrain from doing or continuing an act complained of by the petitioner or to do an act which the petitioner has complained it has omitted to do; (c) an order authorizing civil proceedings to be brought in the name and on behalf of the company by the petitioner on such terms as the Court may direct; or (d) an order providing for the purchase of the shares of any members of the company by other members or by the company itself and, in the case of a purchase by the company itself, a reduction of the company's capital accordingly."

Certain characteristics of the above wording are striking in the context of the English statutory history. First, it does not refer to 'oppressive' conduct as was set out in the 1948 English Companies Act; nor does it refer to conduct that is 'unfairly prejudicial' as was done in the post-1980 English Companies Act and is mirrored in many other commonwealth jurisdictions. It makes no reference to the type of conduct that merits relief as an 'alternative to winding up'. Quaere the applicability of cases interpreting those English statutory provisions in the Cayman Islands.

It is unclear whether the alternative relief in subsection 95(3) of the Companies Law is only available to a petitioner who has otherwise met the criteria to justify a just and equitable winding up. This was a prerequisite of the 1948 English Companies Act that was removed in the post-1980 English Companies Act.

In addition, there does not appear to be a specific mechanism by which the alternative relief can be sought by a petitioner, as there is in most other commonwealth statutes. The only path appears to be via a petition to wind up the company likely seeking a 95(3) remedy as alternative relief.

The failure of subsection 95(3) to address these two points might suggest that a petitioner must indeed first demonstrate that a just and equitable winding up would otherwise be justified. However, its silence is equally capable of an interpretation that leaves the conduct that justifies the alternative remedies in the court's absolute discretion. The preamble's reference to the 1985 English Companies Act suggests that the latter might be the intent of subsection 95(3). The post-1980 English cases and those of other commonwealth jurisdictions might be of assistance in determining the judicial exercise of that discretion, notwithstanding the absence of express guiding language. Ultimately, it will be up to the courts to determine the extent to which the oppression remedy has arrived in the Cayman Islands.

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International insolvency cooperation in Bermuda

BY ROBIN MAYOR AND PAUL SMITH

Bermuda has no legislation providing for the recognition of foreign insolvencies or for cooperation with foreign liquidators or administrators in insolvencies with an international element, equivalent to section 426 of the UK Insolvency Act 1986 or Chapter 15 of the US Bankruptcy Code. It has therefore been necessary for the courts to look to the common law in order to determine what assistance the Bermuda courts will provide in foreign insolvencies.

Bermuda is a dependent territory of the United Kingdom and its corporate legislation is based largely on the old UK Companies Act 1948. The common law of Bermuda is based upon English common law and decisions of the English Court

of Appeal and House of Lords are regularly cited and applied in Bermuda. The Privy Council, sitting in London with the same judicial membership as the House of Lords, is the highest court of appeal for Bermuda. English common law, therefore, has provided the background for the development of Bermuda common law as to the recognition of foreign insolvencies and the provision of assistance to foreign liquidators.

Over the years, despite the absence of legislative or treaty provisions providing for international cooperation in international insolvency, the common law of Bermuda, following that of England, has achieved a degree of judicial cooperation by judicial practice. This was based upon the principle of private international law (which has been described as "modified universalism" by Professor Fletcher, Insolvency in Private International Law, 2nd ed. 2005 at pages 15-17) that there should be a unitary bankruptcy/insolvency proceeding in the court of the bankrupt's domicile which receives worldwide recognition applying to all the assets of the bankrupt. The result is that Bermuda courts will: (i) recognise a foreign liquidator and thus allow him to bring proceedings in Bermuda ancillary to the foreign proceedings; (ii) afford the foreign liquidator sufficient standing to bring proceedings in Bermuda seeking assistance ancillary to the foreign proceedings; and (iii) recognise the foreign liquidation as regards the vesting of movable property owned by the debtor which is situated in Bermuda. No such recognition would be afforded as regards the purported vesting of immovable property situated in Bermuda.

It used to be thought in Bermuda that it was necessary for a liquidator in a foreign liquidation to bring parallel proceedings in Bermuda in order to obtain assistance from the Bermuda court when dealing with assets and creditors situated in Bermuda. Thus, for example, a stay of proceedings imposed in a foreign bankruptcy would not automatically apply in Bermuda (see e.g. ACE v Pedersen [2005] Bda LR 44. The traditional view was that foreign bankruptcy law would not displace Bermuda law or rights under Bermuda law and that accordingly parallel proceedings were required in Bermuda in order to obtain the benefits of insolvency protection against creditors in Bermuda.

However, in Cambridge Gas Transportation Corp. v Navigator Holdings plc [2007] 1 AC 508, the Privy Council sitting on appeal from the decision from the Isle of Man, established clearly that the common law permitted recognition in the Isle of Man of a plan of arrangement imposed by the US Federal Bankruptcy Court without the necessity for the commencement of any parallel insolvency proceedings, or an application for a scheme of arrangement mirroring the plan of arrangement, in the Isle of Man. The Privy Council upheld an order of the Isle of Man Bankruptcy Court vesting shares owned by the appellant in the insolvent company into the names of the creditors' representatives. It should be noted that the respondent had neither appeared in or submitted to the jurisdiction of the US bankruptcy proceedings (although subsidiaries of the appellant had done so). On traditional grounds, therefore, it might be thought somewhat surprising that effect was given to the US court order. Lord Hoffmann, giving the judgment of the Privy Council held that: "At common law, their Lordships think it is doubtful whether assistance could take the form of applying provisions of the foreign insolvency law which form no part of the domestic system. But the domestic court must at least be able to provide assistance by doing whatever it could have done in the case of a domestic insolvency. The purpose of recognition is to enable the foreign office holder or the creditors to avoid having to start parallel insolvency proceedings and to give them the remedies to which they would have been entitled if the equivalent proceedings had taken place in the domestic forum".

In McGrath v Riddell [2008] UKHL 21, the House of Lords held that section 426 of the UK Insolvency Act 1986 permits the English courts to remit assets situated in England to a foreign jurisdiction to be distributed in accordance with the foreign insolvency regime despite the fact that the foreign insolvency regime contained provisions as to priority of payments to creditors different to those that would be applied under English law.

The Bermuda courts have followed the example of the Privy Council with alacrity. In Re Dickson Group Holdings Ltd [2008] SC (Bda) Com 37, Kawaley J. applied the decisions in Cambridge Gas and McGrath, but confirmed that the common law discretionary power of the Bermuda Court to recognise a foreign insolvency proceeding is not automatic and may be withheld in order to avoid prejudice to local creditors or an infringement of local law. Kawaley J. adopted the following judicial principles for application when considering whether or not to recognise a foreign insolvency proceeding. First, the fact that the Bermuda court would in similar circumstances entertain primary winding-up proceedings in respect of a foreign company is an important factor in deciding whether or not to recognise a foreign primary winding-up proceeding in relation to a Bermuda registered company in a case where there is no liquidation proceeding underway in Bermuda. Second, the main practical consideration is whether or not the foreign primary proceeding is the most convenient way of winding-up the company's affairs, having regard to all relevant commercial and/or public policy concerns. Third, the above principles have to be applied having regard to the two fundamental principles of insolvency law, namely (i) the universalist principle under which all reasonable efforts ought normally to be made to subject to a company's liquidation to a single coherent regime so that all creditors share rateably, irrespective of their location; and (ii) the presumption that most creditors dealing with the company before it became insolvent would reasonably have considered that their rights upon insolvency would be dealt with in accordance with the law of the company's place of incorporation.

Applying these principles in the Dickson case, and despite the fact that no parallel winding-up proceedings had been commenced in Bermuda, Kawaley J. recognised a Hong Kong winding-up order over the company, recognised the appointment of Hong Kong liquidators, and granted an order authorising the Hong Kong liquidators to promote a parallel scheme of arrangement in Bermuda, ancillary to a scheme of

arrangement being promoted in Hong Kong.

In Re Founding Partners Global Fund Ltd [2009] SC (Bda) 36 Com, Kawaley J went even further in following the decision in Cambridge Gas and granted an order, pursuant to a letter of request from the Cayman court, granting recognition to a Cayman winding-up proceeding over a Caymanian company and the appointment of provisional liquidators by the Cayman court. In addition, an order was granted authorising the Cayman provisional liquidators to exercise such powers as a Bermuda liquidator would be able to exercise under the Bermuda legislation to get in the assets of the company, including staying all proceedings against the company without the leave of the Bermuda court. This imposition of a stay on proceedings in Bermuda is the most novel feature of the judgment in Founding Partners. Until fairly recently it would have been necessary in Bermuda to launch parallel insolvency proceedings in Bermuda in order to obtain a stay of proceedings in Bermuda by creditors against a foreign company and the decision in Founding Partners goes beyond what would have been possible in Bermuda a few years ago.

It should be noted that neither of these applications were contested. In our view, there is a danger that the Bermuda courts may be taking the principles of universalism too far and providing recognition orders for which there is no legislative basis and without sufficient consideration being given to the protection of Bermuda creditors of a Bermuda parallel ancillary liquidation, to the detriment of Bermuda creditors of an insolvent company. Until such time as the Court of Appeal for Bermuda can consider whether this is the case, it appears that the status of Bermuda law at present time on this issue is very broad indeed.

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CHAPTER EIGHT:

Turnaround & Corporate Renewal

What were they thinking?

BY DEBORAH HICKS MIDANEK

During this period of tight credit and worldwide economic dislocation, a number of companies have faced very difficult circumstances. Some have done very well; many have not. Some have been restructured; many have disappeared into a forced sale or liquidation. Some have been 'saved' by unprecedented government intervention, some 'allowed' to fail, and the great majority have been ignored by all but those most intimately involved in them. What allows some to succeed where many flounder?

First, why do companies in a free market economy exist? In the clamour of concern about excess executive compensation, insufficient credit, frightening layoffs, confusing regulations, lack of liquidity, and arguments about whether directors are responsible to shareholders or stakeholders, to communities or creditors, accountants or taxing authorities, it is easy to forget that fundamentally companies exist to earn a profit by serving the needs of customers. Too often, companies that fail have allowed themselves to be distracted from this core organising principle. If companies are not earning a return through serving customers, they certainly cannot meet the needs of any other constituency, and will not last.

If this is true, how then can companies organise themselves to be sure they are meeting customer needs in such a way as to allow them to earn a profit and build a sustainable future? Many of our organisational models are based on old hierarchical paradigms in which various departments perform various functions and report upwards, to varying degrees invisible to each other except at the top. In such models, seeing and interpreting the meaning of what is happening to the customer, outside the company, is not only difficult but in many cases not even perceived as important.

For companies in difficulty, the first place in which this inability to 'see' the customer is often experienced in the management information available. Such systems are typically designed to answer questions that have nothing to do with customers, and were often structured to respond to a wholly different market environment. Frequently, there is a great deal of valuable data, but the way it's been aggregated disguises its value. To managers accustomed to seeing data presented in the same way for a long time, realising that it is incomplete in just about impossible.

In a recent situation, in which a company in default was close to a forced liquidation, the company maintained information by product line. By reorienting the same data to provide information by market segment, management got clarity about how it was serving its customers, and could see what was core to their operation, and what they needed to divest. Once that was clear, they could rapidly move to delever their balance sheet and then effect a turnaround at the operational level that led to substantial earnings improvement and the ability not only to avoid forced liquidation but refinance at attractive rates. Raw data needs to be transformed into cogent information about how the customer is served, and presented in a logical manner to improve the clarity of decision making.

Next, once the right information is available, the company needs to understand how its business model actually works. In the turnaround world, this is called indentifying the key drivers of success. Often there are five or six key variables that drive company success or failure, and these can be recognised by building a model that integrates the balance sheet, the profit and loss statement, and the cash flow statement into a whole that allows the user to play various what if scenarios to see what will happen in a range of circumstances. In the normal routine of creating monthly financial and operating reports, the value of these models can be overlooked, and their value as diagnostic tools not understood. Companies that keep to the discipline, however, gain an enormous advantage over their competitors in their ability to see emerging trends early, and to respond.

One of the few large Wall Street firms to survive the recent subprime mortgage crisis, for example, seems to have realised that in a world of hyper leverage on Wall Street balance sheets, liquidity was a key driver. If that was the case, the logical way to run their business was to mark their balance sheet to market rigorously and routinely so they would always know where they could find liquidity; where and at what price they believed they could sell the instruments they owned. This discipline gave them the ability to 'see' what was happening in their trading markets as mortgage spreads started to widen, to interpret the meaning of that change, and to move rapidly to reduce their exposure to the sector.

There are many ways to build these models, but a simple way is to start with building a model of cash flowing in and out of the company at the general ledger level, including receivables, payables, debt service, working capital, and capital expenditures. Compare that to budgeted flows for a period of time and see where the variances are and which side needs to be adjusted. As confidence grows in the cash flow model, model the balance sheet and income statement so that changes in one flow into all. Often a two year forward forecast on a quarterly basis will provide very useful information as to when cash may be tight, sales off more than expected, and the model's sensitivity to changes in certain variables will become very clear. These key variables need to be watched constantly, and their significance understood throughout the company.

These financial processes are the easy part of building an organisation that can 'see' what is happening in the world around it. Many companies, as they strive constantly to

improve, focus on what they can see and touch, which is often their product. Can they build it faster, better, cheaper, and can they beat the competition? Looking backwards, history is littered with companies that produced very well and are no more, having in many cases focused their sights on producing at all costs, without asking what business they were in; what needs of their customers they were trying to serve.

In one situation, a company emerged from bankruptcy with a new CEO who had attracted the financing to revitalise the company, a paint manufacturer and home improvement retailer with 300 stores in the southwestern United States. Not long after the company emerged, the CEO died and a board member with great depth of experience in industry stepped in to the breach. He focused on trying to build the paint manufacturer, a business he understood, by trying to bring in major wholesale contracts, a business the company had never been in before. He kept hoping that the retail stores, in a business he did not understand, would turn around, and did everything he could to support them long enough for that to occur, including leveraging the real estate on which those stores sat to provide them with working capital. The company ran out of cash. When the strategy of the former CEO, who had seen the opportunity to bring the company out of Chapter 11, was explored, it turned out he had been willing to give the retail system a limited effort, but had been making plans to use the unencumbered real estate in prime spots in southern California and Arizona for very different purposes, as he knew that customers no longer needed those stores.

In another situation, a well known private equity firm did a leveraged buyout of a subprime mortgage originator, a company that purchased subprime and other high risk mortgages from a network of small brokers in major states around the country, using credit lines supplied by Wall Street firms who would create securitised instruments from the loans. The private equity firm, seeing the growth and apparently believing the cash flow to be strong, brought in some junior and senior lenders to help them improve their return. The company did not originate the loans themselves, did not service the loans (collect the payments due from borrowers), and did not securitise them.

In this case, who was the customer? The company and its private equity investors and lenders likely thought that the borrowers, or possibly the brokers who originated the product, were the customers, and behaved accordingly, believing perhaps they were building a major origination platform through which multiple products could be created and sold. The true customer was instead the Street firms wanting the raw materials the loans provided so they could create new issues of securitised product to satisfy their customers. The company's new owners had paid a premium price for a company that had no customer franchise value whatsoever. Not realising this, they continued to pour new equity into the company when Street demand for its products disappeared, believing that they could perhaps find a bridge lender or even a buyer that could use this extensive 'origination platform'. The company disappeared into a Chapter 7, the bonds lost all their value, and the private equity firm was not far behind.

These stories are hard to believe in retrospect, but very difficult to influence while the process is going on, as beliefs about reality become fixed, and habits of seeing and thinking are hard to break. Simple rules for those brave enough to try: lead with your eyes and ears open to a constant review of the value the company in question is providing to its customer. Be sure that the key drivers that move the company forward in serving those customers are carefully identified and clearly understood by all. Organise the financial and operating data of the company into information that is presented in a way that is meaningful in supporting the decisions that must be made to respond effectively to the customer. Focus attention on interpreting the forces that drive customer demand for the products the company offers. Foster an environment that can see and hear how the company needs to adapt its behaviour to serve that demand.

Deborah Hicks Midanek is president of Solon Group, Inc.

Viability of restructuring plans: the influence of vested interests

BY TONY GROOM

Are restructuring professionals failing to point out when it is obvious that a restructuring plan is not viable? This paper looks at business failure post-restructuring and the role of professionals pursuing different objectives. It argues that a focus on financial restructuring is planting the seeds of failure by approving unrealistic plans. It also argues that the professionals involved should take responsibility for ensuring a restructuring plan is commercially viable, and has a management team with the ability to drive through the necessary changes.

Vested interests

Restructuring a business involves dealing with complexity where stakeholders are pursuing different interests, with

the ultimate goal of aligning the vested interests. Generally, the process is driven by financial professionals employed to represent the different stakeholders (e.g., a secured creditor, asset based lender, insurer or landlord) or a group of stakeholders (e.g., bond holders, mezzanine note holders or shareholders). Each professional is looking to get the 'best deal' for his client with representatives generally being bankers, lawyers, lenders, credit managers, accountants and insolvency practitioners.

Negotiations tend to concentrate on financial aspects, with each party looking after its own interests rather than developing a viable business.

Dealing with the causal issues that are likely to have precipitated the need for restructuring involves identifying changes that need to be implemented to achieve a new business model. Such negotiations involve strategy, organisation, sales and marketing, products, production/services, cost cutting, systems, management and a great many other key ingredients that need to be considered. But the focus on 'who gets what' often ignores the obvious: can the business deliver? Is the restructuring plan viable?

Business interests

It is often not clear who is looking after the business' own interests. Directors rarely have much experience of restructuring, and are easily bullied by professionals. Shareholders rarely get involved, leaving directors to sort out any problems, at least until their support is sought for a members' resolution. Most professionals at the restructuring table are working for single interest sponsors who expect them to look after the interests of their company/clients, as opposed to the company's interests. Influence may be why vested interest professionals do not want companies to appoint restructuring professionals, as the lack of advisers makes it easier to bully inexperienced management.

Without experienced professionals acting for the company, its interests and purpose are often not clarified. While it might be argued that a business should pursue success, defining success is difficult, let alone agreeing the definition. Furthermore, many stakeholders resent the idea of a failing business being allowed to become successful. They often expect a suitable period of atonement with appropriate reparations, especially when redundancies are made or debt is compromised.

Consequently, resolving different stakeholder interests requires complex-coercive problem solving skills. The key is to agree principles before agreeing objectives, and then to agree on a process before developing a restructuring plan. The simple approach is for all parties to agree the business purpose and develop clear objectives that can then be used to align stakeholder interests. Essentially, this involves an approach to restructuring that starts with the reasons for saving a business. Once these are agreed, balancing the seemingly conflicting objectives of individual parties is tested against the agreed business objectives. Such a rigorous approach to dealing with complex-coercive situations needs the experience of restructuring professionals who understand the process, constraints and stakeholders' vested interests.

Viable restructuring plans

Restructuring a failing business involves both financial restructuring and business restructuring. Financial restructuring involves restructuring the balance sheet to one that can be supported by the restructured business. Specifically, it relies on the business' ability to service and repay historical debt. Business viability is based on its ability to service and meet ongoing obligations both in terms of cashflow and profitability. The surplus cash defines how much historical debt can be supported.

Any plan to deliver financial targets is based on markets and availability of resources. Investment plans involve identifying the market and resources needed including funds to pay for them to deliver financial objectives. Restructuring plans assume limited resources and funds such that these define the financial outputs, specifically projecting surplus cash. This shows the distinction between normal business plans and restructuring plans, the former defining the funds needed, the latter defining how much is available to meet historical obligations.

Restructuring a business is aimed at optimising its resources to deliver non-financial objectives including, but not exclusively: sales volumes, production targets, cost reduction, reorganisation, systems efficiency, people or a whole host of other non-financial activities. But changing the non-financial ingredients of a business mix is inherently risky, as will be confirmed by distressed asset and turnaround investors. Many reasons for the old business model not working might be claimed, but identifying a new one that will succeed is not easy, not least because any new model is based on hypothesis and not yet proven. In spite of the risk, financial failure normally indicates that the old business model didn't work and it follows that it should be changed. To what? How far should the change go? Experienced restructuring professionals generally argue for more dramatic change than incumbent management – the vested interests are brought to bear.

Rover: an example of vested interest

Initial plans to rescue motor manufacturer Rover Group were led by Jon Moulton and Eric Walters of Alchemy Partners following their speculative approach to BMW in September 1999 to take Rover, 'the English Patient', off their hands. By the time a deal was struck in mid March 2000, Alchemy had developed a restructuring plan that involved redundancies at Longbridge. They planned to drop the Rover brand altogether and, as quickly as prudent, trim production volumes, while new sports cars could be developed. Alchemy proposed to rename the Rover Group as the MG Car Company and focus on manufacturing 50,000 specialist sports cars per annum including the MGF, sporting saloons, and possibly an MG-badged Rover 75. Although it involved serious cutbacks at Longbridge, the restructuring plan was intended to achieve a viable standalone British car manufacturer. The plan involved spending much of the £427m dowry from BMW on paying

generous redundancy terms to the staff.

But in March 2000 when their plans were revealed to the press, the vested interests came to the table with Alchemy being branded an asset-stripper by the unions. The proposed redundancies were not politically acceptable to the government such that the then-Trade Secretary, Stephen Byers, promoted an alternative plan hastily developed by the so-called Phoenix Four, led by John Towers. The alternative plan got the support of the vested interests without rigorous scrutiny. It subsequently failed. The tragedy is that when MG Rover failed five years later in 2007 the redundancy dowry was spent. Any argument that failure could not have been predicted doesn't hold water. This is a clear example of inappropriate influence by a party with vested interests that resulted in a flawed rescue plan.

Developing a viable plan

Developing a restructuring plan, like all business planning, relies on honing all aspects of a plan to achieve its stated objectives. The origins of business planning were adapted from the military approach to planning, where army officers used to develop plans by following four steps: (i) the aim – agree restructuring objectives with creditors; (ii) factors – resources, market information and market opportunities, analytical tools; (iii) options – alternative ways of achieving the aim; and (iv) the plan – or, the optimal/viable solution. But recently the army changed its approach to planning, recognising that resources are not infinite and, therefore, that the aim should be realistic, given the available resources. Rescue plans also need to be realistic as they also depend on the available resources. The new planning process followed by the army allows for a feedback loop, whereby the aim can be revised. The revision is based on a risk assessment of the ability to achieve an ideal aim by reviewing the factors and viability of the options. Business restructuring professionals can benefit from benchmarking their approach to planning.

So, as part of the overall restructuring plan, a new business model is developed, and its success almost certainly depends on how the management team change the old model to the new one. The migration process is key as the new structure is likely to need some changes, hence a need for flexibility. Flaws in the plan should be acknowledged and rectified, which involves measuring and monitoring the impact of new initiatives as they are implemented. Driving such changes through an organisation and dealing with the people issues can prove more of an impediment to success than the proposed new business model.

Leadership and realism

Most financial stakeholders involved in restructuring are only interested in their specific financial objectives – they prefer simplicity, and are not really interested in the complexity of developing and delivering a viable business. In general, they want to see numbers and are less interested in how they are derived.

The market is littered with failed rescues. The failures follow sponsorship by experienced restructuring representatives who supported a plan while ignoring the obvious: that the business model was not viable, and/or its implementation could not be achieved by the management team.

Management must own and take responsibility for delivering a restructuring plan. They also need stakeholder support for it to succeed so stakeholders need a degree of ownership and responsibility. This is difficult, and the need for strong leadership is key. It is not necessary that the same leader both develops and delivers the plan, but management must be happy they can deliver it, and if they are to own it, they ought to be involved in its development.

Historically, the corralling of vested interests in listed UK companies was led by the Bank of England (BoE), which adopted the 'London Approach', a co-ordinated method of whipping in bank creditors. But over the past 20 years, non-banking creditors have moved into the driving seat and the BoE has lost its ability to discipline recalcitrant creditors. In the absence of a leader like the BoE, leadership by someone with sufficient authority among creditors is needed to take responsibility for ensuring the plan is viable. The managers are also important as they must agree with the plan, and should ideally be involved with its development. They must not allow themselves to be bullied into accepting a plan that they don't believe in, and this requires strength of character. However, management should not be left with sole responsibility as it is incumbent on everyone involved, including single interest parties, to ensure that managers can deliver the plan.

Conclusion

The complex-coercive nature of aligning vested interests and a focus on financial planning has tended to ignore the commercial factors of business rescue. This has led to many unviable rescue plans such as that of Rover. Restructuring professionals should look beyond the financial objectives and take responsibility for ensuring business rescue plans are commercially viable. Furthermore, restructuring professionals with a vested interest should ensure an independent restructuring professional acts for the business to both help ensure the plan is viable and to help drive through the necessary changes.

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Do Australian laws inhibit informal restructuring?

BY NIGEL WATSON

In many jurisdictions a formal insolvency process for a large enterprise is seen as a last resort which may trigger defaults and risk forcing the effective closure of the business. The preferred course is to initiate a private 'workout' or 'turn around'.

Prior to the GFC, the Voluntary Administration procedures in Australia have been widely praised as offering an opportunity for companies facing financial difficulties to restructure under the supervision of an independent insolvency professional.

There is now a developing view in Australia, encouraged by people with experience with overseas workouts, that any formal appointment erodes value and that the Australian laws are too harsh to enable a private workout or restructuring to take place.

This article outlines the context in which these concerns have arisen and why the suggested reform may not provide the answer.

The trigger for the formal appointment of an insolvency professional as a voluntary administrator is the directors forming the view that the company is insolvent or is likely to become insolvent at some future time. The stated object of the Voluntary Administration process is to maximise the chances of the company or as much as possible of its business continuing in existence or if this is not possible, to maximise the return to the company's creditors. The insolvency professional must report to creditors and obtain their majority support both by number and value to any restructuring proposal (Deed of Company Arrangement). The Courts have a limited supervisory role but can be requested to assist with rulings or directions on difficult issues which may arise.

The concept of insolvency is linked to an ability to pay all of the company's debts as and when they become due and payable. This is basically a cashflow test but in practice it is the subject of detailed evidentiary and legal disputes.

The concept of insolvency is also linked to a statutory duty imposed on directors to prevent a company incurring a debt at a time when it is insolvent or there are reasonable grounds for suspecting that, if the debt is incurred, the company would become insolvent. The only defences available to the director are that he had reasonable grounds to expect the company was solvent, had reasonable grounds based on the advice of a competent and reliable person to believe the company was solvent or, that the director did not take part in the decision to incur the debt because of illness.

In the case of directors of large companies, the complex affairs may make it difficult for the directors to satisfy themselves that the company and its related entities are in fact solvent. There is a real temptation to resign or immediately place the company into Voluntary Administration.

In other words, the only safe and prudent course for directors is to assume that the corporation is insolvent and to make a formal appointment unless the informed consent of the creditors whose funds are at risk can be obtained through the restructuring proposal.

In the case of a large corporate, this would mean that each member of the banking syndicate must agree to a standstill and restructuring on the basis that all creditors outside that syndicate are paid in the usual course. If, as often appears to be the case, the syndicate cannot agree, the directors have little choice but to implement the Voluntary Administration process or invite a creditor holding security over the company to appoint a receiver to take control of the company and its business.

Therefore, once creditors or potential creditors' funds are at risk, the law effectively directs the appointment of an independent insolvency professional to take over control of the company.

There is a developing perception that once a company makes a formal appointment, it is an admission that the corporation is insolvent and beyond restructuring. This therefore is likely to bring about a result which is directly opposite to the objective of the Voluntary Administration process and may in fact maximise the chances of the company ceasing to continue in existence.

This situation contrasts with many overseas jurisdictions where corporations can be restructured outside a formal insolvency process and remain under the control of the directors.

The starting point for any informal workout is to obtain the support of the financiers. A recent decision highlights further obstacles for both the directors and the bankers.

The restructuring of Bell Group Limited and its subsidiaries with its bankers in 1989 was the subject of a lengthy judgment delivered in the Supreme Court of Western Australia in October 2008 [2008] WASC 239. The Court found that the directors had a duty to ensure that the restructuring results in a corporate benefit for each of the companies in the Group. The duties to act in good faith and for proper purposes involved more than looking at whether the Group could be kept alive, possibly only for a limited period, while assets are potentially diverted for the benefit of secured creditors. The directors in shoring up the position of secured creditors to keep the Group afloat were found to have breached their duties to various of the companies in the Group. The banks were found to have been aware of the breach of duties and to have recklessly refrained from considering the effect of the refinancing transactions on other creditors. In all the circumstances, the banks were found to have knowingly participated in a breach by the directors of their various duties and liable in respect of the assets received

pursuant to the refinancing on the basis they held those assets as constructive trustees.

The Bell Group decision highlights that the risks for directors on an informal restructuring are wider than just the risk of personal liability for insolvent trading. They cannot create security in favour of one creditor or give a guarantee to one creditor unless the other creditors of that company are and will continue to be paid in the normal course of business. Equally, the bankers need to examine the position of each company offering a guarantee or security to determine whether or not there is in fact some corporate benefit for that separate legal entity.

A further complication for directors of listed entities is the obligation to make continual disclosure to the market of any information which "a reasonable person would expect to have a material effect on the price or value of the entities" securities pursuant to the Stock Exchange Listing Requirements and the Corporations Law.

It is of course very difficult to carry on sensitive commercial restructuring discussions and to keep the market fully informed. The only solution may be to seek a suspension of trading while the workout is negotiated and put in place.

Directors, irrespective of whether or not they breach their duties, may well be the target of litigation brought in the name of shareholders or creditors. The High Court has accepted, subject only to limited conditions, the ability of third parties to fund and take an active interest in litigation. The litigation funders and the plaintiff law firms are pro-actively looking for breaches of the continuous disclosure obligations and directors duties and then relentlessly pursuing claims on behalf of the affected shareholders or creditors. The High Court has also accepted that shareholders who claim to have been misled are entitled to claim to be creditors of the company along with all other unsecured creditors.

The informal restructuring is therefore made even more complex through the difficulties in defending these claims and in identifying and quantifying all creditors.

A number of commentators are now urging the Government to review the law imposing personal liability on directors for insolvent trading so as to provide an additional defence to a director who can demonstrate that he is acting honestly and on the basis of appropriate sound restructuring advice in determining that the interests of the company and its creditors are best served by pursuing restructuring options without undertaking a formal appointment.

The Government has not to date given a favourable response to these suggestions and is suggesting that those requesting reforms should produce empirical evidence to support the concerns raised.

Even if the Government were to respond favourably to these suggestions, it is apparent that there are a number of other issues which are working to make informal workouts unnecessarily complex and difficult.

The underlying themes in the Australian context are the obligations for listed entities to make continuous disclosure and the importance of not undertaking any transaction or restructure which may place creditors at risk without first obtaining the informed consent of those creditors. These factors when combined, highlight the need for directors to undertake any restructuring on an informal basis at an early stage or any conservative adviser will recommend the directors look only at a formal appointment and restructuring through that formal process.

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Who's left to clean out the business world's Augean stables?

BY NICK HOOD

Whatever shape this fragile recovery may be and wherever we are on the climb out of this worst of modern recessions, the only reality is that insolvency and restructuring are lagging indicators. Statistically, the insolvency statistics peak the best part of two years after the mid point of a recession.

This time the damage is deeper and the sectors affected are more widespread than the last three downturns, so that the call for turnaround and restructuring professionals is on a scale never seen before. Worse still, this is the first time since the Great Depression that the entire global economy has gone into recession simultaneously.

Sadly, this situation has caught the bankruptcy profession with its human resources trousers round its ankles. Ten years or more of headlong growth and the most benign of economic conditions thinned out the veterans of the 1980s and 1990s, culling vital experience, which rode off into the retirement sunset or redeployed itself into M&A and other boom-time skill sets.

Not only did numbers dwindle, but the chance was missed to transfer knowledge to emerging markets, where much of the growth was taking place. We are now reaping the whirlwind we have sown, as we all struggle to find people to assist in the far flung places where key parts of globalised businesses are in trouble.

Take a look at the situation for US-based multinationals now scrabbling to sort out their worldwide messes. An analysis of America's top 15 trading partners is instructive. Take out the professionally developed jurisdictions (Canada, the UK and the Netherlands) and the remaining 12 countries boast precisely 398 members of INSOL International, the only worldwide association of workout professionals. Three countries have no INSOL members and South Korea has just one. Nine of the jurisdictions lack a chapter of the Turnaround Managers Association. To put this in context, the total US trade with the under-resourced 12 countries is just over $1.5 trillion.

The one supposed bright spot in this vicious recession has been the BRIC block of emerging nations, apparently suffering only a temporary slowing of their hectic growth. But there is another constituency within the developing world economic community where the situation is infinitely worse than anything the cosy developed world is experiencing.

A report last April by the Overseas Development Institute covered 10 lower league emerging nations with a combined population of half a billion souls. The ODI predicts that countries like these will suffer a fall in their income of up to $140bn in 2009. Many of them depend for a significant part of their GDP on remittances from their diaspora communities and on foreign aid, both of which sources are shrinking fast. This will leave not just industrial sectors in disarray, but whole economies needing complete restructuring. Here the professional resource profile is not just worrying, it is tragic. The 10 ODI countries boast just 107 INSOL members and 98 of these are in Nigeria. The TMA has only two chapters, in Nigeria and Ghana.

Another feature of the calm economic waters of recent times was a tendency to solve business problems through financial engineering, rather than deal with underlying operational faults. Balance sheet engineers were plentiful, injecting seemingly unlimited liquidity into underperforming enterprises. Hands-on turnaround managers were and still are rather thinner on the ground. Growth back in the good times was everything, a far cry from the cynical headline of a recent news item, which trumpeted: "Flat is the new Up". Hard bitten business rescuers will tell you that executives who can grow businesses are almost never any good at shrinking them.

Suddenly, genuine turnaround professionals are in huge demand. Executive placement agencies are overwhelmed, desperately trying to find, say, Danish speaking telecoms experts or, scarcer still, auto industry experts who can spread their expertise across collapsing empires such as in the Visteon Chapter 11, where suitably savvy "boots on the ground" were needed in 23 countries at once. The major shake out coming in the aviation sector, surely the most globalised of them all, is going to be yet another professional resource challenge.

In another unforgivable oversight, the restructuring community has failed to engage with governments and lawmakers worldwide to create business rescue regimes, through which underperforming assets can be recycled efficiently into more productive hands. Despite some progress, there is still an alarming number of significant economic jurisdictions where there is no effective mechanism for ring-fencing troubled businesses while they are reorganised and revitalised – India, China & Russia among them.

It was instructive to see a comment recently in the professional media that Hong Kong was at last contemplating the enactment of a modern restructuring law. If one of the most sophisticated financial and commercial locations on earth is still inventing solutions on the hoof, what chance has a struggling but potentially viable business in Nairobi, Saigon or Budapest?

One bright spot was the failure of an attempt by organised labour to overturn Brazil's new business rescue law, where a wise and pragmatic decision in the Supreme Court rescued the legislation from oblivion. Quite whether the law will work in practice is another matter, but at least it survived to be moulded into a workable regime through its application to real life restructurings.

Judicial capacity and cross-border cooperation is another worrying issue. Institutions like INSOL International have been working for many years to bring together judges to encourage a more practical application of laws, which were not designed for complex multi-jurisdictional cases and which have inevitably failed to keep pace with change in the business world. UNCITRAL, the United Nations body charged with creating world wide protocols for effective international interaction on business rescue has at last got round to the issue of international groups, but rather too late for this recession. But protectionism is never far away, especially in hard times, and even the best intentioned legislation can deliver something rather different to expectations, as Chapter 15 in the US has proved.

So how depressing it was to sit through a panel session at a major insolvency conference in Vancouver this summer and hear a panel of experienced bankruptcy judges wrestling with questions about a hypothetical global restructuring. The desire to work together was clear, but at the end, the platform was littered with enough caveats to bury any effective solution.

Who knows what is going to happen as litigation on the Lehman bankruptcy starts to engulf inter-jurisdictional cooperation and attempts to fast track the asset distribution process are vetoed by courts. Surely we should have moved on and learnt from cases like BCCI, still running after the best part of 20 years despite the creative solutions worked out by the professionals working on the case.

As we struggle upwards towards the light of recovery, there is a real risk that a return to normal business conditions and stable growth will be delayed unnecessarily by the lack of professional resource and workable legal regimes. It need not have been like this, but let us at least hope that this lesson is heeded, so that we are ready for the next recession.

Nick Hood, executive chairman of Begbies Global Network.

CHAPTER NINE:

Economic & Market Trends

What to expect in the coming year

BY JOHN D. PENN

The next 12 months will be quite interesting in the US. A rollercoaster of activity is on the horizon in the insolvency world. The confluence of economic and political trends can create some interesting developments. The economic impact of political developments (and possible changes) is undeniable.

Sectors with their futures directly linked to political developments include healthcare, energy and defence. Decisions made in Washington can dramatically affect the future of each either positively or negatively. For example, if substantial changes are made to the US healthcare (or just health insurance) system, the financial performance of companies in that sector will become less certain.

If there is a major overhaul of the system, healthcare providers and suppliers (including hospitals, medical equipment manufacturers, drug companies and doctors) will face tremendous uncertainties about their future operations and cash flows. It will be difficult to predict or forecast future revenues and profitability. That type of uncertainty can become a death knell – particularly if the current liquidity drought does not relent.

On the energy side, the outcome of the 'cap and trade' legislation could affect that sector in many different ways. Very few expect that implementing a 'cap and trade' regime will not affect energy prices and companies. The assumption is that both the cost of the program as well as the cost of complying with the program will make energy more expensive without increasing the profitability of any company. The energy cost spike in 2008 did not provide the US economy with any good news as companies responded by reducing travel and other expenditures.

The price spike in 2008 did create other issues for energy companies. Many entered into transactions (acquisitions, LBOs, borrowings and the like) based on the assumption that oil and gas prices would remain high. The drop that followed cut exploration and production companies' revenues by 50 percent or more. If energy prices remain low and the companies cannot reduce their debt loads, many of these companies will need to restructure their balance sheets.

The budget proposals currently being discussed seem to indicate that significant decreases are in store for companies that manufacture weapons systems. A contraction in that sector will affect the suppliers by reducing their revenues, and likely increasing losses for those companies and their suppliers.

Outside of the political world, commercial real estate, retail and transportation appear to be heading toward troubled times. Commercial real estate is likely to continue experiencing the troubles initially visited on the housing sector. Declining values and reduced revenues present significant challenges.

Adding to the concerns is the realisation that the securitised financing that was prevalent in this sector will mature in the next two to three years. The dearth of financing, coupled with the limited authority loan servicing companies have to restructure the obligations indicate that troubles will mount as they grow ever closer to loan maturity dates. Bankruptcy can provide an effective, yet cumbersome, way to try to restructure the obligation or sell the property for less than the balance owed.

Office occupancy rates in most major downtown areas are declining as companies continue downsizing their operations. This downsizing causes rental rate declines that can put some properties at risk of defaulting on their mortgages. The securitised mortgages on these properties will make restructuring them outside of bankruptcy difficult, if not impossible. Borrowers with securitised loans quickly learn that many loan servicers lack the authority to take certain restructuring actions without a requisite percentage of the loan's owners consenting. The more widely held any securitisation might be, the more difficult it would be to muster the consents to implement a consensual restructuring outside of bankruptcy.

If US consumers continue spending as they had in the past, retailers might not face the number of problems they have experienced during the past year. If consumers turn away from their spendthrift ways, curtail their purchases and get closer to living within their means, the Christmas season of 2009 could bring sack loads of troubles instead of joy and happiness to retailers.

The 2005 amendments to the US Bankruptcy Code have made it almost impossible for any large retailer to reorganise and the vast majority of the retail cases filed since its enactment resulted in the company being liquidated. Shuttered stores would further compound the troubles of the retail side of commercial real estate since lower retail sales means lower rent payments to shopping centres that became accustomed to larger rent checks based on retailers' sales figures.

The transportation sector could face challenges from all sides. Cargo carriers are adversely affected by reduced retail sales. Demand has been slipping since the recession has taken hold. Increases in energy prices are initially felt by transportation companies that generally absorb the higher prices for some period of time before requesting the fuel surcharges and other methods to share those higher costs. Reduced demand for business travel could result in another set of troubles for airlines as many of them are updating their fleets with newer and more efficient aircraft. Improved videoconference capabilities also make the airlines' task of returning to profitability more challenging.

The service sector has not been immune to the economic downturn. Reports abound about law firms (and other professional service firms) reducing staff, deferring the start date for new hires and reducing the salaries of current members. Some large firms have even closed their doors entirely. While most hope that the difficult times have passed, it is too early to know if the changes are temporary 'belt-tightening' or are permanent.

Lenders to companies in the sectors facing these challenges should evaluate their current lien and loan positions, including evaluating any current collateral to assure that liens are both perfected and adequate. Those providing unsecured trade credit can evaluate their exposure, then develop plans to reduce it. Whether these reductions are prudent credit practices or will compound a liquidity shortage remains to be seen.

Overall, the US is undergoing a substantial 'de-leveraging' where unsustainable debt loads are being reduced. Individuals and companies found that they were overextended and were becoming unable to service their existing debt loads. Many companies and individuals have found bankruptcy as the way to restructure their obligations and balance sheets. It is likely that this will continue well into the foreseeable future.

One interesting, and so far uncharted, development is the problems facing state and local governments. California began issuing 'IOUs' instead of paying its bills with cash. One county in Alabama curtailed its service dramatically as it teeters on the bring of a bond default. With tax revenues declining, it is likely that more of these governmental troubles will come to the forefront.

Each of these assumes that the US dollar's value remains relatively stable. If it repeats its decline from 2008, international trade will suffer. This will make the economic downturn both longer and deeper. Since the US government is issuing so much debt this year and next, the possibility of the dollar dropping in value is very real.

The ancient Chinese curse, 'May you live in interesting times' is becoming much more real. Times are very interesting, indeed.

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Liquidity challenges for manufacturing and distribution businesses

BY PATRICK DARBY

The global economic crisis has stabilised in recent months. Banks in the United States are repaying TARP funds. The stock markets have recovered some ground. New investment ideas are percolating on Wall Street.

Outside the financial industry, however, government and media attention has focused on market players deemed too big to fail, such as GM and Chrysler. Smaller firms have not received similar attention. Manufacturing and distribution businesses in the middle market are struggling with low consumer demand and a dwindling number of sources for working capital. While the US government contemplates tax, healthcare and other mandates that will hit middle market firms especially hard, the government recently declined to shore up CIT, one of the primary providers of working capital to this sector of the market. Middle market manufacturing and distribution businesses face a long, hard road before consumer confidence and spending rebound. In the meantime, the liquidity crunch is placing enormous strain on their ability to refinance loans and to maintain inventories and workforce levels.

The manufacturing and distribution industries traditionally have relied heavily on asset-based financing. Term loans might be secured by equipment and real estate, but working capital lines of credit often are based on advance rates for inventory and accounts receivable. Revenues can be seasonal for these firms. During low-sales months firms have to ramp up inventory to prepare for high volume months that might represent a large percentage of annual revenues. Asset-based lending requires close, often daily contact between borrower and lender and a significant level of expertise and industry knowledge from the lender to understand the value of liquid collateral such as inventory and receivables – and how the borrower may add value to the assets through customer relationships and the ability to build out work in progress.

Tremendous amounts of capital moved to private equity funds in the early years of this decade. The federal government estimated as many as 9000 private equity funds were operating in 2007, with as much as $1.9 trillion under management. Among other things, private equity fuelled a resurgence in leveraged buyouts. In 2006, LBOs represented 18 percent of all mergers and acquisitions in terms of dollar value. At the height of the 1990s stock market boom the figure was roughly 2 percent. The trend was part of an almost complete reversal of the entities providing capital to American business. By one measure, in 1985 commercial banks accounted for 71 percent of lending activity in the United States, private equity funds 16 percent and other institution lenders – primarily insurance companies – 16

Even as the federal government tries to stimulate lending through TARP and direct investment, the FDIC is making it harder for banks to lend, with stricter regulation on non-accruing loans and capital reserves.

percent; while in 2005, private equity funds and similar investing vehicles provided 66 percent of lending activity, banks 23 percent, and other institutions 11 percent.

As large numbers of unregulated lenders with enormous capital chased a finite number of deals, competition drove down underwriting standards and loosened practices for lender oversight. Normal pricing for a business might be at 6-8 times cash flow. Funds invested at much higher multiples, resulting in premiums based less on actual values than the imperative to put overabundant capital to work. The rush to do deals so resulted in higher leverage, less due diligence, more informal documentation, less attention to financial covenants, reporting and oversight, and fewer creditor remedies.

These developments have added to the challenges of middle market firms seeking enough working capital to survive the recession. One phenomenon is that traditional lenders often were priced out of market by private equity funds with lower capital requirements and a higher appetite for risk. Ready access to easy credit allowed many firms to ignore or delay dealing with business and operational flaws that traditional lenders may not have loaned around.

Now many financings are maturing or falling into default in an atmosphere of extreme risk aversion. Even as the federal government tries to stimulate lending through TARP and direct investment, the FDIC is making it harder for banks to lend, with stricter regulation on non-accruing loans and capital reserves. Private equity is in the market but still relies on cheap credit from traditional lending sources. At the same time as they allow lenders to delay creditor action on distressed loans, covenant-lite deals also increase the difficulty of securing refinancing in the short term. Now that the pendulum has swung back on underwriting standards, many companies find their options extremely limited.

With decreased activity by national and regional lenders, some suggest community banks can take up the slack for local businesses. This hope seems unfounded, as smaller community banks are subject to the same regulatory pressures as bigger banks. Moreover, small community banks may not be able to handle a large volume of asset-based loans. They often lack the personnel and the expertise to administer a portfolio across different lines of business. For these reasons, the sweet spot for small community banks traditionally has been localised real estate lending. Of course, banks with large real estate portfolios face their own problems due to declining real estate values and lingering softness in commercial development that is not expected to reverse itself for a period of years. These institutions seem an unlikely resource to rush to the aid of distressed manufacturers and distributors.

The relevant question may be whether existing asset-based lenders and factoring companies pick up the void left by the retreat of CIT and commercial banks. Many smaller asset-based lenders themselves obtain capital from large commercial banks, re-lending the proceeds of their own loans to their borrowers at higher rates. Even when they can find functioning, solvent financing sources with money to lend, manufacturing and distribution companies may find the cost of borrowing prohibitive from asset-based lenders that are not an arm of a large commercial bank, or that do not have the volume, capacity and reserves of a national player like CIT.

Moreover, lenders in this sector must struggle with the lack of a ready market for the resale or liquidation of collateral. Potential buyers of assets face the same lack of credit that troubles businesses trying to refinance existing loans. When the lack of market activity makes the valuation of assets difficult, asset-based lenders must choose between conservatism and aggressive pricing. Moreover, slow payment of receivables is a real phenomenon nationwide. Customers are stretching their payables and suppliers can do little about it. This trend amplifies the negative effect on the cash flow of smaller businesses, as asset-based lenders generally do not advance against aged receivables, even if collectible.

Clearly the capital markets have rebounded from late 2008, when lending activity seemed to cease altogether. For healthy firms, financing is available. Firms struggling with low demand and breached financial covenants, however, enjoy few alternatives. Commercial lenders are retrenching. Private equity is looking for bargains and their business models and investment horizons often are not conducive to permanent solutions to a company's working capital needs. As middle market manufacturing and distribution companies face these challenges, the broader economy may yet suffer from a spiralling effect from business failures in this sector. Few areas of the country can afford the resulting loss of relatively high-wage jobs and the ripple effect on the local economies.

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Trends from the frontline

BY ANDREW PEARSON

The number of companies undergoing a period of restructuring is rising at an ever faster pace. In fact, the Insolvency Service has found that there were nearly 5000 compulsory/creditor's voluntary liquidations in England and Wales in the first quarter of 2009. This was an increase of 7.1 percent on the previous quarter, and an increase of 56 percent on the same period a year ago.

From our own experience, we have seen similar trends emerging. There has been a 329 percent increase in our bankruptcy and restructuring engagements year-on-year in the first half of 2009, compared to the previous year. In light of recent headlines speculating on the demise of many well-known financial institutions, it is unsurprising that the financial services sector has been most badly hit. Indeed, a recent study of corporate M&A professionals, commissioned by IntraLinks and entitled 'Maximising M&A', 65 percent of respondents believed that the European financial services sector will witness the bulk of regional corporate restructurings, followed by manufacturing (45 percent), real estate (29 percent) and retail (29 percent).

In addition, although some financial services companies have been able to draw upon government capital injections, many firms across the globe have had to consider alternative financing options. So for many, declining revenues and market uncertainty, combined with liquidity constraints and the lack of accommodating lenders, is of concern. And in today's market, companies can run into these problems rapidly. Further, the time available to stabilise the business, bring in advisers and pull information together to develop a plan of action, can be short. Nonetheless, it is vital for companies to do this quickly and comprehensively so that creditors and debtors can correctly assess the company's position and decide on the best course of action.

As a result, the role of Chief Restructuring Officer (CRO) is becoming more prevalent in both the US and Europe. The CRO role involves making an independent and neutral assessment of the company's situation, and then relaying this information to the various stakeholder groups. Additionally, the CRO brings in skills and experience to deal with the restructuring process that may be absent in the existing management team. To add to this, by separating the day-to-day management of the business from the management of the restructuring, there are additional efficiency benefits and minimal disruption.

In fact, in 'Restructuring Today', another study of restructuring professionals commissioned by IntraLinks, over one-third of respondents believe the CRO role is a necessity in the current business environment. Efficiency is essential and time is of the essence in today's restructuring market. The process can be complicated and time intensive due to the vast amount of sensitive information that needs to be managed and communicated to various parties throughout the process. Indeed, the study reveals that 84 percent of respondents believe that the current economic environment has significantly reduced the timeframe for planning restructuring, compared to one year ago. They added that the compression of time means that mistakes can be made, to the detriment of the process – 48 percent of those surveyed believed that it will impact chances for its long term success. Additionally, 62 percent of respondents say the quickly changing environment is impacting the accuracy of information and the timeliness of its presentation, factors essential to a successful restructuring.

Furthermore, the need for a secure and structured communication platform during the workout process is particularly acute, with a significant 98 percent of survey respondents indicating that organised and secure communication can help when restructuring a business, as it creates less misunderstanding and fewer problems. This need is driving an increased adoption of technology in restructurings, as the parties involved aim to effectively manage and streamline the process. Indeed, older methods such as paper-based solutions can be both resource intensive and less secure.

As a result, technology is playing an increasingly key role in making the restructuring process quicker and less costly. This trend is reflected in the research, with 86 percent of respondents having used an online tool to manage the process and 20 percent stating they have used an online tool post-restructuring, with the majority citing ease of access, and time and cost savings as the most important benefits. More generally, respondents noted that greater efficiency offered by technology results in shorter restructuring processes and consequently reduced costs – of those surveyed, many stated time savings of over 25 percent.

In conclusion, Keith H. Mullen, a shareholder and co-chair of the Financial Services Industry Group observed on 'Tough Times for Lenders' that over the next 10 years there will be a dramatic change in distressed investments and this will be owed to technology. He comments "[o]ver the next few years, all the talk of 'how technology will change our business' will be transformed into 'technology has improved the process and the results of how we manage risk'". So against the backdrop of economic uncertainty it is reassuring to find that individuals have a positive outlook on the future of restructuring, and that they realise the value that technology can bring to manage the workout process in the most time and cost-efficient way.

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Recent developments in the German restructuring and insolvency market

BY DR CHRISTIAN BÄRENZ AND JAN HENDRIK GROSS

Until mid-2008, the subprime crisis in the US and the rise of oil prices did not appear to have a direct effect on the economy in Germany. In May 2008, the German Federal Bank confirmed its economic prognosis for 2008, projecting forecasted growth of 1.9 percent. This climate changed quickly in the early summer of 2008. The financial risks of under-secured US mortgages and loans had found their way into the books of German lenders. Due to massive write-offs, banks found it difficult to maintain required statutory capital levels. Combined with a deep uncertainty in future credit rating this caused an almost disruption of the interbank market and a significant increase of refinancing costs. As a result, the granting of loans by commercial banks became more restrictive. Banks are only willing to grant loans (if at all) where valuable collateral is provided, in particular, critical/core assets. This makes it more and more difficult for businesses and investors to obtain funds required.

In September 2008, the Ifo-Index, a monthly index that analyses the business climate, reported a decline in business conditions. The government reduced its growth forecast for 2009 to 0.5 percent, down from 1.2 percent. The figures for 2009 were further reduced after the turn of the year. Instead of a little plus, the first indication was a reduction of the GDP by 2.5 percent. At the end of April this was further adjusted to minus 6 percent.

From July 2008 onwards, the number of insolvency petitions started to rise. Compared to July 2007, July 2008 showed an 8.5 percent increase of insolvencies. In December 2008, 2237 companies became insolvent, representing an increase of 13.1 percent compared with December 2007. In May 2009 the numbers of insolvencies escalated to 2663 representing an increase of 14.9 percent compared with May 2008. In this economic framework the development of the restructuring and insolvency market in Germany has accelerated within recent years.

Market trends in the German restructuring and insolvency market

Out-of-court restructuring

Under German bankruptcy law, the main objective of insolvency proceedings is the satisfaction of the creditors. Therefore, if the liquidation of a business is more beneficial for the creditors than its continuation, the insolvency administrator is obliged to opt for liquidation. Although German bankruptcy law provides for measures to rescue and restructure a distressed company, most insolvency administrators have prematurely closed businesses in the past, even when their continuation would have resulted in a higher return for creditors. As creditors have (almost) no power regarding the decision on who becomes (preliminary) insolvency administrator, they as well as debtors are interested in out-of-court restructurings.

Until the global financial crisis, the restructuring market saw a significant increase in such out-of-court restructurings. Due to the liquidity formerly available in the financial market, investors were willing to take over weak companies. In a number of cases, private equity houses bought the loans of distressed companies and subsequently negotiated a purchase of the shares from the shareholders. This trend was interrupted by the global financial crisis. Although businesses are valued relatively cheaply at the moment, private equity funds currently cannot obtain the necessary outside financing for this kind of acquisitions.

However, the engagement of a trustee in out-of-court restructurings has got more and more common (Sanierungs – und Verwertungstreuhand). Creditors have shown their willingness to continue the support of a distressed company (e.g., by agreeing to a standstill or even by granting bridging loans) if the shares in that company are transferred from the current shareholder(s) to a trustee. Subsequently the trustee sets up a selling process and realises the business as a whole or in parts (most often by selling shares in operational businesses) in order to repay the bank debt.

Trusteeship aiming at an out of court restructuring can be an effective tool to dispose of the business or parts of it and repay with the proceeds the liabilities (or parts of it) of the debtor. The main advantage for the lenders is to avoid a blockade of the equity which often is out of the money and have more control over the disposal process. Distressed companies as well as creditors may prefer out-of-court restructuring for the further reason that, unlike insolvency procedures, out-of-court restructurings are not (necessarily) published. In particular companies fearing negative effects of their financial difficulties becoming generally known may seek the avoidance of regular insolvency proceedings. Furthermore, out-of-court restructurings allow a more flexible handling combining M&A-workflows as well as financial mechanisms (e.g., syndicated loans). Last but not least – creditors can decide who becomes trustee. They don't have such a power at the beginning of the (preliminary) insolvency proceedings.

Nevertheless, the director's duty to file an insolvency petition with the court without undue delay (three weeks at the latest) after the company has become insolvent, i.e., the company

is either illiquid or over indebted, persists. Out-of-court restructurings are, thus, no guarantee of avoiding insolvency procedures. Furthermore, the lack of a moratorium is the major problem arising in informal restructuring practices. It is therefore absolutely crucial that all or at least the main creditors agree on a stay of enforcement. Further, the various parties must actually have an incentive to participate in an out-of-court restructuring. If creditors refuse to take part for whatever reason, the informal approach runs a high risk of failure.

Among the more prominent cases in recent years are the efforts to restructure the Merckle-group. Over the last years the group had accrued several billion euros of debt. Three trustees were appointed to sell the three core divisions of the group, production of generics, pharmaceutical wholesale and cement and building materials to pay back the bank loans.

Self-administration

Another procedure is 'self-administration', consisting of a (kind of) debtor-in-possession procedure. Self-administration allows the management of the debtor to continue carrying on business under the supervision of a custodian. Self-administration can be used provided it does not delay the proceedings and where it does not disadvantage the creditors. During self-administration, the debtor retains the power to dispose over its assets. The custodian must continually monitor the economic situation of the debtor and supervises the management. The Insolvency Code allocates responsibilities and authority among the debtor, the custodian and the creditors. The most important are: (i) transactions that are of particular significance for the insolvency proceedings require the consent of the creditors' committee or the creditors' meeting; (ii) in ordinary insolvency proceedings, the insolvency administrator would be entitled to decide whether or not to fulfil contractual obligations; in self-administration scenarios, the debtor is vested with the same right; and (iii) the custodian has the power to challenge transactions occurring prior to insolvency. Further, creditors are obliged to file their claims against the debtor with the custodian. The debtor pays the proceeds to the creditors based on the claims registered. Self-administration is often combined with an insolvency plan.

In practice, self-administration was ordered by the insolvency court almost only if an insolvency expert was appointed as a director. The petition for self-administration needs to be carefully communicated both to the insolvency court and to the main creditors.

Insolvency of corporate groups

Currently the Insolvency Code does not provide special rules regulating the insolvency of corporate groups. Each subsidiary is regarded individually. Often different companies must file their applications with different courts and different administrators are appointed. This can significantly impede a restructuring of the group. Parliament is therefore considering amendments which would allow for the selection of one competent court, preventing a fragmentation of the insolvency proceedings of corporate groups. Further, greater influence over the appointment of the administrator is sought so that the appropriate administrator for the proceedings may be selected. Self-administration is especially suited for corporate group proceedings.

Outlook

It is expected that the number of insolvencies will continue to rise significantly for the of 2009 and into 2010. However, up to now the economic downturn has not had a significant impact on the job market. The unemployment rate in January 2009 was 8.3 percent, in July it was 8.2 percent. Many businesses introduced reduced working hours (Kurzarbeit) – a scheme under which the employees work reduced hours, the employer pays reduced wages and the government compensates the employees' loss to a certain extent. This scheme was generally limited to six months. In May 2009 the German government extended this scheme up to a maximum of 24 months. However, it is expected that the number of redundancies will rise in autumn/winter 2009, after the election of the parliament.

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Recent trends in the Norwegian bankruptcy and restructuring market

BY JACOB SVERDRUP BJØNNESS-JACOBSEN, LINDA HAUGEN HJELDE AND WERNER FRIMANSLUND

In Norway the economic peak was reached at the turn of 2007/2008 and the economic activity is now experiencing a downturn intensified by the international financial crisis. In spite of the negative impact of the global economic downturn Norway has not been as severely influenced as most other countries. The bankruptcy rate has nevertheless climbed by 58 percent from June 2008 to June 2009. During the first eight months of 2009 there was an increase of bankruptcies exceeding 81 percent compared to the same period in 2008. A further increase is expected, and 2009 might become the year with most bankruptcies so far, exceeding the 1992 record of 5749 bankruptcies.

The Terra Securities scandal

The Norwegian brokerage firm Terra Securities ASA arranged for eight small towns and villages in Norway to buy high risk US bonds from American Citigroup, depositing future water power income as security. Based on an accusation of numerous and serious breaches of requirements for good and correct information to the municipalities as to the risk of their investments, the Financial Supervisory Authority of Norway warned it would withdraw Terra Securities' brokerage licence. Terra Securities ASA thus filed for bankruptcy in November 2007. The eight municipalities in Norway and their destiny were held up as an example of how the financial crisis can hit innocent victims hard, thousands of miles from Wall Street. The mayors and city administrators in the municipalities pictured themselves as innocent victims of the financial crisis. Terra Securities ASA, which was forced into bankruptcy, was held up as the villain.

In August 2009, the Bankruptcy Estate of Terra Securities ASA and seven of the municipalities joined in a surprising alliance against Citigroup. The Bankruptcy Estate of Terra Securities ASA and the municipalities are now claiming over $200m from Citigroup in a joint action in New York. The claim is based on allegations of fraud and misrepresentation, and thus violations of the US securities laws by Citigroup, in the sale of risky derivative securities to Terra Securities ASA in Norway. The lawsuit contends that Citigroup misled Terra and the municipalities, and thereby induced the municipalities into purchasing notes linked to a 'tender option bond' (TOB) fund. Citigroup found the claim groundless. It is also a fact that the biggest challenge for the Norwegians and their lawyer Marc E. Kasowitz – with a success fee of over $ 60m - is to convince the court that the case can be tried in the US. This is because Citigroup are likely to argue that the case is between The Bankruptcy Estate of Terra Securities ASA and the municipalities, with jurisdiction in Norway.

The joint claim of the Bankruptcy Estate of Terra Securities ASA and the municipalities also transforms Terra Securities ASA's status as a villain into yet another innocent victim of the financial crisis, together with the small towns and villages in Norway. The joint claim can thus raise the question of how well based the decision of the Financial Supervisory Authority of Norway actually was when it warned it would withdraw Terra Securities' brokerage licence in 2007, as the warning was based on Terra's misinformation to the eight municipalities regarding the risk of their investments. Hence the question of who fooled who now touches the explanation of how the financial crisis came to Norway.

Cooperative housing estate bankruptcies

A new trend in Norway this year is the bankruptcy of several cooperative housing estates. The cooperative housing estate is a legal entity – usually a corporation – that owns real estate, typically flats in a city. Each resident in the legal entity is granted exclusive right to use one flat. In the building boom of the later years, developers have sold new flats that are apparently quite cheap, but with a hidden large shared debt. A lot of first time buyers and students have bought flats in new housing cooperatives. In time the interest and repayments increased, and the hidden large shared debt bomb became visible and unmanageable, forcing some of the new housing cooperatives to file for bankruptcy. The Norwegian government is now considering a change of law to prevent these situations from recurring.

Restructuring market

In the restructuring market the Norwegian Bård Eker – the second largest owner of the high performance sports car manufacturer Koenigsegg – is working hard to raise funding for its takeover of Saab from General Motors (GM). Koenigsegg recently found a Chinese investor as the Beijing Automotive Industry Holding Co (BAIC) has signed a memorandum of understanding with Koenigsegg of around €275m. BAIC hopes to explore Saab's growth opportunities in China. Koenigsegg's takeover of Saab is still dependent on loans from the Swedish government and the European Investment Bank. Despite acceptance from the European Investment Bank of a loan of €400m to €500m, the Swedish government has as so far resisted giving the final cut. Even if the deal is closed, Saab only sold around 98,000 cars last year, and since this trend is likely to be hard for Koenigsegg to turn around, the risk of bankruptcy must still be considered high.

Together with the bankruptcy of US investment bank Lehman Brothers, the collapse of the banks in Iceland has been the most spectacular event of the financial crisis. The internationally acclaimed Norwegian legal professional and judge Eva Joly has been appointed special adviser by the Icelandic government, and the rotten nature of these financial corpses is slowly beginning to emerge. Eva Joly believes it is the "largest investigation in history of a bank collapse", and she has compared the conditions in Iceland to those of Angola. The three banks – Landsbanki, Kaupthing and Glitnir – had undertaken loans 10 times larger than Iceland's annual income to finance a financial conquest worthy of the most aggressive Viking. The banks were very successful before it became the Bankruptcy Estate of all times. The battle is now about who is paying for the deposits lost by bank customers in Northern Europe and the UK. Eva Joly recently criticised the UK and the Netherlands for forcing Iceland to pay enormous compensation, reducing Iceland's chances of avoiding poverty. The question is why the Icelandic people should pay to clean up the mess after the ravaging party of private capitalists.

Government's Gold Card

The Norwegian Government made amendments to the Financial Services Act in effect by 1 June 2007, permitting specialised mortgage credit institutions to raise loans by issuing 'covered bonds', or literally 'bonds with preferential claim'. Bond holders are given a preferential claim over a cover pool in case of bankruptcy. The credit institutions were offered to swap the bonds into secure government bonds, providing ample security for further loans in the money market. The swap process was described by the Minister of Finance as "using

the Government's Gold Card". By August 2009, NOK 184bn has been swapped already, and figures from Statistics Norway show that credit institutions have issued a further NOK 132bn to be swapped. The initial offer (maximum) was NOK 350bn (€41bn), and 90 percent of this was utilised by the banks by August 2009.

Current market dynamics

While most governments and central banks are trying to bring economies back on track by imposing unconventional policies, the Norwegian central bank, Norges Bank, is discussing when to raise the interest rate. In its latest report, from 23 September 2009, the bank decided to keep the rate at 1.25 percent but warned that increasing demand could force the bank to raise the interest rate at a faster pace than previously communicated. Rate cuts lowered the rate from 5.75 percent in October 2008 to 1.25 percent by June 2009 and were supposed not only to stimulate demand but also to give confidence and keep markets from dropping. The downturn in production is not as severe as initially feared, and even though the unemployment rate has risen it is still Europe's lowest at 3.1 percent. The Norwegian central bank notices 'renewed growth', and is criticised by market economists who claim the rates have been cut too much. The 4.5 percent net cut has increased the spending power of people, as floating-rate mortgages are more common in Norway than in the Euro area and the UK and US, giving households more disposable income when interest rates fall. Inflation forecasts are, however, around the target of 2.5 percent, so the households refrain from spending too much.

While several market economists demand an interest rate raise, industrial leaders and the Confederation of Norwegian Enterprise (NHO) demand that the central bank keeps the rate at its current level. The production in Norwegian industry is estimated to decrease by 7 percent in 2009 and possibly fall by 5 percent in 2010. NHO claims that the Norwegian economy is running in two diverging tracks – one which is protected and one which is exposed to competition. Norwegian industry is very sensitive to the interest rates and currency exchange rates, and an increase in the interest rate will make the Norwegian Krone even stronger. This may very well drive some of the most vulnerable industry-related companies into bankruptcy.

Future prospects

The future outlook of Norway is expected to be quite rosy. The government's strong demand impetus from both fiscal and monetary policy measures is expected to limit the downturn. Lately, private consumption has increased and the low interest rates and general optimism have lead to more sales of houses and growth in house prices. On the other hand there are voices who believe the government will have to focus even harder on industry and the unemployment level in order to keep the impact of the financial crisis at a low level and avoid a downfall. Hence, it's likely to be much too early to say that the positive signs in other parts of the Norwegian economy could be the beginning of a new cyclical upturn in Norway.

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Has Asia missed the party?

BY NICK GRONOW

From 1997 to 1999, Asia was the belle of the ball. She was the radiant star, the triumphant beauty, the glamorous idol. The financial crisis that scoured Asia in the late 1990s, that rocked governments, that brought people to the streets and families to their knees placed the restructuring and insolvency spotlight fairly and squarely on Asia. Currencies collapsed, stock markets slumped and unemployment skyrocketed as the financial contagion spread across Asia. Restructuring professionals were frantically busy and indeed many would be relocated to the region to service an industry that previously barely existed. Asia was the Queen of distress. She certainly was at her glamorous best.

But just over a decade on, with what has been argued to be the biggest recession since the Great Depression, a financial crisis that has broken records for stock market declines and unprecedented bailouts of banking systems, Asia is missing out on the greatest restructuring and insolvency party in global history. And it's not as though she didn't receive an invitation to the ball. With Western economies crashing, Asia's dependence on the West buying the goods it churns out on a massive scale seemed to ensure it would have a front row seat in a global spectacular. However, after some early signs that Asia could have a starring role, she seems to have shunned the party.

When Lehman Brothers crashed in the United States and with the doom and gloom of forecasts that reduced spending in Western economies would wreak havoc among Asia's export dependent economies, combined with overpriced property markets in various parts of the region, it certainly looked like Asia would also suffer a dramatic financial collapse. Stock markets promptly retreated as Hong Kong's Hang Seng Index declined by 67 percent, Japan's Nikkei slumped by over 50 percent and the Shanghai Composite Index was pummelled down by 70 percent.

A string of layoffs followed throughout the region. Hong

Kong and Singapore, both so dependent on financial services, saw large numbers of redundancies across law firms, investment banks and other advisory firms. The Big 4 in Asia implemented a range of measures to lower costs, including forced or voluntary leave without pay schemes. M&A activity was nearly non-existent, IPOs were put on the back burner and anyone left with money stopped spending it. Growth forecasts were slashed, interest rates were cut to ease pressure and governments started to implement a range of measures to stimulate their economies.

In China, which was closing in on overtaking Japan to become the world's second largest economy behind the US, pundits forecast economic disaster. They considered that with dramatically reduced household spending in Western economies that China, now the world's workshop, would face a dramatic slump in exports, leading to mass factory closures and layoffs. And the early figures were cause for concern. China's growth was forecast to decline from around 12 percent per annum to 8 percent per annum in 2009. Sure, still good by any other standard but not in China where strong growth was needed to fuel the rising demands and expectations of the increasingly wealthy masses. Reports of mass factory closures, especially in Southern China flooded in. Exports were declining at around 25 percent year on year all of a sudden. A string of corporate failures followed.

Asia looked set to follow the rest of the World into financial oblivion. But it didn't. And hasn't. Although Asia has certainly been impacted by the global financial crisis, it is hardly belle of the (financial crisis) ball. Not even an honourable mention; more of a token appearance so as to be seen. So what are the reasons for this apparent financial distress party apathy?

The first and most significant factor is China, for a number of reasons. The Chinese Government, rightly concerned by the impact of reduced household spending in the West, introduced a substantial stimulus package. The package totalling just under US$600bn dwarfs Japan's response at US$100bn and is not that far behind the United States at US$825bn, US$275bn of which is in tax cuts rather than pure spending. With the introduction of the stimulus package, China has been able to stabilise its own economy and more importantly, help stabilise the regional and global economy. With industrial production soaring again (up 11 percent for the 12 months to July 2009), China's demand is boosting other economies which in turn further supports the Chinese economy with exports growing again.

A further factor is that Asian governments are far better placed to deal with the economic crisis. Their reserves are substantially higher than in the 1997 Asian crisis and their currencies have not come under severe attack given pressures against the US currency which has generally continued to weaken after an initial boost when the current crisis first commenced. Asian governments also have far less debt than their western counterparts, which allows flexibility in terms of monetary and fiscal policies. Indeed their stimulus packages have generally been more successful than in the West due to the lower levels of government and public debt in Asia, which has seen greater confidence in spending again. Sceptics argue that Asian countries are more likely to fiddle the figures, especially in China, to show far better figures than are actually the case. However, region-wide Q2 GDP growth results are too compelling to ignore.

A further important factor is the generally good health of Asian financial institutions. Asian banks have not had the exposures to riskier investments that their US and European counterparts had. Spurred on by pure greed and with a lack of financial regulation, financial institutions in the West took greater and greater risks to achieve returns and earn absurdly high bonuses on paper profits. Asian financial institutions, however, have acted more conservatively and as a result, have not had the exposures to subprime and collateralised debt obligations (CDOs), which brought many western financial institutions to the brink of disaster, and pushed a few notable others over the brink.

Notwithstanding the less severe economic pressures in Asia compared to the West, there is no doubt that the financial crisis has affected the region. The reduction in exports, decline in capital flows and reduction in asset prices highlights the impact. But this has not transferred into a flood of insolvencies and restructuring work, at least compared to the West. And many of the insolvencies that have occurred can be attributed to financial irregularities and fraud rather than reduced business activity. Again, there are several reasons for the absence of Asian insolvencies.

Firstly, in the early period of the financial crisis, financial institutions in Asia didn't panic. They have shown a greater propensity to manage problem loans by resetting covenants, allowing payment waivers or deferrals and supporting businesses. In turn, lending restrictions have been removed in Asia more quickly than in the West, given that problems have not been as bad. This has supported companies, allowed refinancings and promoted growth as asset prices quickly recover.

In addition, directors of companies do not face the same statutory pressures as in the West to need to file for bankruptcy. Although this may not address an underlying business viability problem, it does at least allow survival and optionality that often does not occur in a formal insolvency situation. What's more, of the tens of thousands of factory closures that have reportedly occurred in China, the vast majority of these were mopped up internally in China i.e., they have not affected lenders and investors outside the country. There are exceptions to this, but on the whole China has been able to contain its internal problems and use its stimulus package to effectively pump prime its economy, with flow on effects for the rest of the region.

Notwithstanding how well Asia has fared amid a global financial catastrophe, it is by no means out of the woods yet. Given that Asian economic policies are largely directed at managing exchange rates to avoid large appreciations against the US dollar, monetary policies are linked to the Federal Reserve in the US. With low interest rates in place following the Fed's lead, Asia risks an asset price bubble if inflation is

unchecked that could be calamitous if it pops, as it has in the past. Asian governments may be hesitant to raise interest rates to contain inflation and growth in order to continue to protect their currencies. Furthermore, while stimulus packages, especially in China, have been effective to date, domestic spending in the West will take a long time to recover and Asia still remains dependent on exports that it cannot replace with its own domestic spending. As such, the stimulus effect will eventually run out of steam and governments could face tough decisions on whether to double up or call it a day and face the consequences. Asia's restructuring and insolvency professionals hold out hope. Their dinner suits wait pressed in the wardrobe. They don't want to miss the party and just hope they will be fashionably late rather than left out in the cold.

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Impact of the global financial crisis on the Hong Kong economy and recommendations for companies on how to cope with the threat

BY DEREK LAI

The bursting of the housing and credit bubbles in the United States in late 2007 has evolved into one of the most severe global financial crises in the last decade. The global financial crises have led to the collapse of numerous financial institutions and other corporations worldwide. Hong Kong, as an open economy, is not immune to the financial crisis.

The Hong Kong economy became gloomy in the fourth quarter of 2008 and first quarter of 2009. This is evidenced by economic indicators such as the unemployment rate and Hang Seng Index (HSI). The unemployment rate increased from 3.4 percent in the third quarter of 2008 to 5.2 percent in the first quarter of 2009. The HSI fell sharply from a peak level of 32,000 points in October 2007 to around 11,000 points in October 2008. However, there are signs of recovery in the second quarter of 2009. The HSI rebounded from its low level to over 20,000 points in early of August 2009 while the property market has become active again with the number of transactions increasing. The rise in the unemployment rate has also slowed down.

However, the global outbreak of the influenza A virus subtype H1N1 (Swine Flu) has added further uncertainty to the timing of a turnaround of the Hong Kong economy. The SARS outbreak after the Asian Financial Crisis in 2003 illustrated how an epidemic could affect an economy. Since the outbreak of swine flu in Mexico and North America, there have been concerns over whether consumer spending and international travel will decrease and cause contractions in industries like air transportation, tourism, etc. With swine flu becoming widespread and more cases confirmed in Hong Kong, the timing of the recovery of the Hong Kong economy remains uncertain

So wht is the impact of the global financial crisis on the Hong Kong economy?

Background of survey and summary of key findings

Deloitte China and CPA Australia Hong Kong China Division jointly conducted a market survey between May and June 2009 to assess the impact of the global financial crisis on the Hong Kong economy and on Hong Kong-based businesses, and also on companies' outlook on a recovery. The survey also explored companies' approaches to weathering the financial storm as well as their perspectives on the restructuring and insolvency regimes in Hong Kong.

The survey was conducted by means of an online questionnaire and a total of 164 completed questionnaires were received, most of them submitted by senior executives and management based in China (including Hong Kong) and other Asian regions.

The survey reflects the collective views of the 164 respondents engaged in various industries including accounting and auditing, banking and finance, manufacturing and consumer business. Over 66 percent of the respondents came from companies with more than 100 employees, including around 40 percent who came from companies with over 500 employees.

The findings revealed by the survey can be summarised as follows. First, around 55 percent of the respondents expect the Hong Kong economy to turn around from the global financial crisis in 2010. Second, almost 48 percent of the respondents anticipate the economy will fully recover to pre-financial crisis levels in one to two years. Third, the respondents generally considered that banking and finance, air and transportation services, and manufacturing are the three most affected industries in Hong Kong. Fourth, the respondents generally considered that declining market demand/sales orders, tightening of credit terms from lenders and insufficient cash flow are identified as the most likely pressures exerted on the businesses by the crisis. Fifth, the respondents' preferred approaches to tackle the pressures brought about by the crisis are to identify the non-core or underperforming businesses and/or assets for disposal

or cessation, financial restructuring and exploring new markets/business opportunities. Sixth, only 11 percent of the respondents who favour financial restructuring would engage a third-party professional for assistance when their debtors are in financial difficulties. Seventh, 50 percent of the respondents who favour restructuring would seek assistance from a third-party professional when it comes to their own financial distress. Eighth, 64 percent of the respondents considered that the restructuring and insolvency regimes in Hong Kong are effective. Finally, around 51 percent of those who regarded the restructuring and insolvency regimes in Hong Kong as ineffective attributed the root of the perceived ineffectiveness to the absence of appropriate insolvency laws governing restructuring.

Recommendations for management on how to cope with threats arising from the financial crisis

Companies often show symptoms of distress well before a crisis occurs. Early detection and quick decisions are the keys to restoring performance and value, and more importantly ensure the company has the ability to ride through the current economic storm.

Assess the business. It is essential for the management of a company to assess regularly how the current economic climate is affecting its business. Declining sales orders, contracting profit margins, rising levels of receivables and payables and a deteriorating liquidity ratio are all symptoms of distress for a company and should be carefully monitored.

Monitoring cash position and maintaining good relationship with banks. As cash shortage is a common reason for business failure, forecasting and monitoring the cash position can reveal in advance a possible cash shortfall and alert management to the need to seek cash or credit from lenders to fill in the gap. If the lenders or bankers tighten the credit, it can further upset the operation of the businesses that are running out of cash. Therefore, maintaining a solid relationship with banks and communicating the business situation proactively can prevent a credit squeeze.

Disposal of non-core or underperforming assets or business. Companies can consider disposing non-core or underperforming assets or businesses which may not only call a halt to the outflow of cash but could also result in management's time and attention being freed from the day-to-day maintenance of those assets or businesses, as well as injecting new cash into the company.

Restructuring. Restructuring becomes crucial for distressed companies. A company in distress can be revitalised through reviewing its financial position and assessing its business viability, forecasting its profits and cash flow, formulating cost savings and non-core assets disposal plans, developing a debt settlement plan, liaising with creditors and lenders about the plans, and seeking new sources of funds.

Nevertheless, restructuring is not only for companies in distress. Healthy companies can improve the bottom-line performance and keep their businesses flourishing by introducing leaner corporate structures and more cost-effective business models as well as healthy financial leveraging through restructuring.

Corporate rescue. When businesses are on the verge of collapse, corporate rescue becomes critical. A company experiencing financial difficulties is likely to be under pressure from lenders and creditors demanding repayment of loans. A demoralised workforce in a state of chaos may make day-to day operations of deeply troubled businesses impossible. However, if the company has a viable underlying business with an ability to generate sufficient cash flows to service debt, continuance of the operations can enhance the possibility of reviving the business as a whole and yield a higher value to the stakeholders than the break-up sale of the assets.

However, the management of the company should conduct negotiations with the lenders, creditors, employees, shareholders, etc., to seek their support for a mutually acceptable stabilisation plan for the company.

In order to undergo a successful corporate rescue, it is important for the company to forecast and monitor short term cash flow necessary to maintain operations. Failure to settle demands from lenders may risk putting the company into liquidation.

Engaging third party professionals. Restructuring can be a weary task for companies in distress due to complex financial analysis and formulation of cost saving plans and non-core asset disposal plans that require various fields of knowledge such as legal, taxation, accounting and finance.

Negotiations between a company in distress and its lenders or potential investors can be lengthy and draining due to conflicting interests. As a result of the asymmetry of the information, creditors and shareholders may be at a disadvantage in identifying and safeguarding the assets of seriously distressed companies.

Without well-defined legislation governing restructuring in Hong Kong, businesses undertaking a restructuring can be perplexed by the statutory procedures and easily fall into legal pitfalls.

A singe mistake can ruin the restructuring or corporate rescue, especially for companies in distress which have limited time to turn around. To ensure restructurings are appropriately planned and smoothly executed, and that a corporate rescue can be implemented without unnecessary delay, it is advisable to consider engaging third-party professionals to assist with the process.

Other commercial considerations in an economic downturn. The management of the company should also consider other commercial issues in the timing of an economic downturn, which may include but are not limited to the following: (i) whether your terms of trade are still suitable and what rights you, as a supplier have in the event that a customer fails to pay; and (ii) what your gearing ratio and other debt covenants are, stress testing your forecasts to see under what circumstances your covenants may be breached and reconsider the value of any security and personal guarantees provided to secure finance.

Conclusion

Although there are indicators suggesting that the Hong Kong economy show signs of recovery, there is still a lot of uncertainty which may hinder the timing of full recovery, including factors affecting the economic situation of United States and mainland China.

However, in order to survive in the global financial turmoil, a company should recognise its problems in time and take appropriate action promptly (such as seeking the assistance of experienced third-party professionals, regularly monitoring its cash position, disposing of non-core business/assets, etc.). Of course, the determination of the company's management and employees' cooperation during hard times is another important factor.

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