Corporate Bankruptcy & Restructuring

2010 | DIGITAL GUIDE

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Edited by Oliver Hargreaves

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AMERICAS

UNITED STATES

Restructuring for Strategic Viability

BY DARON GIFFORD, DAN CHENG, DOUG HARVEY AND JACK KOBUS | A.T. KEARNEY

As the global economic recession of 2008-09 begins to recede, the US industrial markets (especially automotive) remain in turmoil. Manufacturing growth is slowly coming back, capital markets continue to be constricted, and commercial credit is still difficult to access. Bankruptcy has been used extensively, with the assistance of the US Treasury in the automotive industry, to restructure the bloated debt on the balance sheets of corporate America. However, without sufficient attention to restructuring the rest of the company, strategically and operationally, the current wave of bankruptcies may well occur again. This is a time where bold action is required for long term survival and positioning for growth when the market rebounds.

Restructuring is a Requirement

Regardless of the strength of the balance sheet, all companies have been called upon to implement some level of restructuring. The most aggressive have begun to launch an accelerated restructuring plan with a strong focus on improving cash flow from operations. The limited availability of traditional financing in the capital markets has enforced this need. A comprehensive approach should entail a full assessment of market position – analysing the product portfolio, regional markets, market segments and customer base. This review of the revenue drivers will help define the next steps in designing the restructuring. For example, should the focus of the business shift to acquisitions? After all, the market value of many businesses (especially in manufacturing) is at historical lows, and these assets could be used to strategically position companies for future growth. Should divestitures and new market positions be considered? What about a new capital funding plan? Manufacturers that take significant action, and have a credible plan in place, will attract the most new capital for restructuring.

Cost-cutting must also be on the table. The restructuring plan will encompass generating short-term cash flow and identifying long-term business remedies. This will include revamping product strategy by eliminating non-performing products and improving pricing, and reducing SG&A costs, potentially through off-shoring and extracting the full value from internal shared services. Savings can also be found through improved management of working capital processes, such as inventory management, and applying operating asset effectiveness techniques to production.

Capacity needs to be right-sized immediately so that target product lines and market segments are ready to grow again, once the market recovers. Other potential actions are to reduce raw material costs through improved productions planning, cut transportation and distribution costs, and reduce quality control costs detecting, preventing and eliminating potential earlier in the production process.

Avoid Bankruptcy or Use It as a Tool?

For many industrial companies in the US, Chapter 11 bankruptcy has been the only way to survive, albeit in a different form upon emergence from bankruptcy for many organisations. Determining if bankruptcy is necessary begins with gauging how much cash can be generated quickly (short term cash generating potential) and how much time is left before the business runs out of liquidity (operating cash). Engaging external bankruptcy advisors is essential to efficiently move through this decision making effectively and efficiently.

The tools available to be used in restructuring depend upon whether or not the company enters into the legal process of bankruptcy. Let us look at the relevant tools for those who do not enter the bankruptcy process, and those who do *(see Figure 1)*.

Figure 1: Accelerated Restructuring Tools

	Levers Outside of Chapter 11	Additional Levers Under Chapter 11
Financial Restructuring	- Renegotiate/refinance credit - Accelerate ARs, Stretch APs - Debt for equity swaps (structured) - Collateralise assets	- Resolve pre-petition debt at deep discount - Debt for equity swap (imposed) - Secure exit financing
Short Term Cash Improvement	- Rationalise headcount - Adjust wages, benefits, overhead - Reduce external spend - Reduce inventory - Liquidate/decouple assets - Reevaluate capital plan - Manage risk with troubled suppliers	- DIP Financing - Freeze AP - Disposition of executory contracts
Operational Restructuring	- Refocus product portfolio - Accelerate SG&A restructuring - Focus capital expenditures - Assess manufacturing footprint; asset utilisation - Re-Source materials - Streamline distribution	- Restructure long term contracts (labour, JVs, facilities, long term leases, etc.)

Chapter 11 avoided. If the company can be restructured for long term business viability outside of a bankruptcy filing, financial restructuring options will include many traditional actions such as renegotiating or refinancing credit terms, accelerating accounts receivable collection, stretching accounts payable, structuring "debt for equity" agreements, and collateralising assets. Keep in mind, however, that these financial changes may be difficult given the continued restriction of credit markets. Thus, increasing short-term cash flow must also consider aggressive operational actions such as trimming headcount, lowering wages, benefits and overhead, drawing down inventory, liquidating or decoupling assets, reevaluating capital commitments, and actively managing supply chain risk associated with troubled suppliers.

Chapter 11 filed. If filing for bankruptcy is deemed the right option, an additional set of restructuring tools … financial and operational … will become available and come in handy. Financially, these tools will include resolving pre-petition petition debt at a deep discount, executing debt for equity agreements imposed by the court, and securing exit financing. From a cash flow perspective, "debtor in possession financing" (DIP) may be available from the existing creditors or outside entities, although the primary focus may be on preparation for selling the company and its assets. It may be necessary to freeze accounts payable, and renegotiate or break executor contracts with providers. Operationally, reworking long term contracts, such as labour agreements, joint ventures, facility leases and other long term leases, can be a significant tool in the operational restructuring plan.

Companies that emerge successfully from Chapter 11 bankruptcy protection need to have a clear vision for their future business in terms of products, markets, customers, and cost structure.

Restructuring for Long Term Change

In order to secure a solid foundation for the restructured company, a focus on restructuring the key operations is needed, with the overall objectives to cut costs, grow revenues, and improve productivity. Every area is inextricably tied together for business success, so a comprehensive "top to bottom" restructuring plan is required. Figure 2 illustrates the key focus areas to be addressed to execute long term operational change. Product strategy will drive revenue improvement and growth through new markets and higher value pricing to the customer. Cost structure improvements across the company will allow for operational methods in developing, producing and delivering products on an efficient manner. For example, rightsizing the manufacturing footprint using a disciplined operating asset effectiveness program will prioritise the potential financial impact with organisational risks in service level and quality. The scope of effort would encompass a measured effort based on man-hours, cultural change, capital investment required, and contractual constraints, among other factors. The entire product supply chain needs to be considered along with the manufacturing footprint, in order to evaluate the overall cost to the organisation (and ultimately contribution margin) for delivering products to the customer. When evaluating SG&A, the utilisation of zero-based cost and budget analysis to examine the value to the organisation will drive decisions to outsource or insource many business processes. Working capital and long term capital decisions will have the benefit of a comprehensive view of the organisation to determine benefits that will have true accountability both financially and strategically to the company. Without a restructuring plan for the long term operations of the company, the financial restructuring focused on debt reduction will merely postpone an inevitable next crisis.

Figure 2: Operational Restructuring Focus

Savings Levers	Key Activities
1. Product Strategy	Exit Non-performing Products, improve value/tiered pricing
2. SG&A Costs	Offshoring & Outsourcing Opportunities, Extract Full Value of Shared Services
3. Working Capital Management	Tooling Cost Reduction, Inventory/WIP improvement
4. Manufactoring	Operating Asset Effectiveness Improvement
5. Material Cost Management	Direct / Indirect Material Cost Reduction, Production Planning
6. Distribution / Outbound Logistics	Transportation Cost Improvement, Network Optimisation
7. Quality	Problem Prevention, Detection, Elimination, Improvement and Recovery

Opportunity to be Bold

The current crisis can be an opportunity to take bold action by bringing all stakeholders together to aggressively address the situation. Due to the severity of the financial and operational crisis, major changes should be expected.

These changes can turn out to be good or bad depending upon how the business adapts to the structural changes and new market realities. Opportunities like the current ones are rare, and those that take advantage of all the tools available to them can emerge as financially viable and strategically strong competitors.

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Exchange Offers, Pre-Packaged Plans and the CDS Hurdle

BY RENÉE DAILEY, EVAN FLASCHEN AND KATHERINE LINDSAY | BRACEWELL & GIULIANI LLP

Financial derivatives have been immensely important to the financial landscape over the past 10 years. They have enabled substantial increases in capital, hedging against currency and interest rate fluctuations, and insurance against potential risks. We are all painfully aware, however, of some of the unintended consequences of the worldwide derivatives market, including its leading role in the recent economic collapse.

Over the past 18 months, financial derivatives have had unintended consequences in the world of financially-distressed companies, in particular credit default swaps (CDS) have adversely affected public bond exchange offers and pre-packaged Chapter 11 plans of reorganisation. In many cases, the existence of CDS has disincentivised active participation in restructuring discussions, having the potential to complicate and impede restructuring efforts of a company in financial distress.

Exchange Offers and Consensual Plans

The magic ingredients for a successful exchange offer, pre-packaged plan or pre-negotiated plan are: (i) consensual discussions with an organised group of the affected creditors; and (ii) the ability for those discussions to lead to overall acceptance of the offer or plan by the requisite percentage of all affected creditors. Without an organised group, there is no one to provide feedback on proposed exchange offer terms and no one in the affected class of creditors to consent to a pre-packaged plan. And without the ability to obtain the requisite percentage of acceptances, the company is unable to achieve its economic objectives in pursuing the offer or the plan in the first place.

An exchange offer is a mechanism by which a company with publicly traded debt securities can seek to restructure its debt obligations outside of formal court proceedings. Essentially, the company will offer to exchange or trade the current debt securities for new securities, which could be debt or equity securities (or a combination of both), typically with the objective of reducing interest expense and postponing maturities. In order to ensure that the exchange offer is accepted by the target threshold of debtholders, companies frequently engage in negotiations with a group of the debtholders prior to the commencement of the exchange offer. Alternatively, companies will launch an exchange offer but then, if a group forms, negotiate with the group as to appropriate modifications to the offer.

Similarly, a pre-packaged plan is a pre-bankruptcy negotiation and solicitation of a class (or classes) of creditors where such creditors vote for or against a proposed plan of reorganisation that seeks to restructure the debt obligations of the company upon emergence from bankruptcy. As in an exchange offer, in a "pre-pack" a company generally seeks to trade current debt instruments for new and different debt or equity instruments. The goal of a pre-pack is to avoid an uncontrollable bankruptcy case often called a "free fall", and to minimise any adverse affects of a bankruptcy filing on the debtor's business. Generally, pre-packs are best suited for companies with a clear capital structure, and for companies without significant contingent liabilities or in need of an operational restructuring. Pre-packaged plans are challenging to organise because of the need to solicit all creditors in an impaired class of creditors prior to the bankruptcy filing to vote on the plan of reorganisation. Because of that, many prepetition reorganisation negotiations result in an agreed upon term sheet between the company and a particular class of creditors, rather than the solicitation of votes for a plan of reorganisation. This is often referred to as a "pre-negotiated" bankruptcy because the terms have been negotiated prior to the filing but, unlike with a pre-pack, actual voting does not occur until after the filing.

The CDS Market

In simple terms, a CDS is insurance on the performance of an underlying debt obligation (note, however, that CDS are not treated as "insurance" for regulatory purposes, a loophole that substantially contributed to the excessive risk-taking in the CDS market over the past several years). Historically, holders of a certain debt instrument would purchase CDS as insurance against the risks associated with holding such debt. For example, a bondholder purchases bonds issued by a company. In order to insure against default by the company on the bonds, the bondholder will purchase a swap contract from a third-party. The bondholder will make scheduled payments under the swap contract to the third-party. If the CDS is triggered, the third-party will make a payment (typically par or face value) to the holder in exchange for the underlying instrument. Payments by the third-party-seller of the CDS to the bondholder-purchaser of the CDS will cancel, or at least mitigate, any losses realised by the bondholder. Typical CDS trigger events include default under the bonds, restructuring by the company, or a bankruptcy filing.

More recently, however, CDS have become increasingly divorced from the underlying debt instrument. That is, while historically CDS have only been issued to existing debt holders, more recently CDS have traded as an independent financial instrument among market participants who do not hold (or who have not shorted) the underlying bond instrument. As a result, it has become possible for a $500 million debt issuance to be the subject of billions of dollars of CDS. CDS traders are betting on whether the underlying debt will or won't default, just as a bettor will wager on the results of a horse race without having any ownership interest in the horse s/he is betting on. Due to this decoupling of CDS from actual bond ownership, estimates on the size of the CDS market ranged as high as $44 trillion (*See DTCC Addresses Misconceptions About the Credit Default Swap Market*, October 11, 2008 Press Release).

In an exchange offer, since the goal is generally to amend key payment terms and/or the maturity date of the underlying bonds, each affected holder needs to agree to accept the new securities with the revised terms. Accordingly, while it would be ideal for 100% of the holders to agree, a target threshold of 90-95% is usually set in order to recognise that not all holders will respond to or be in favour of the exchange offer request.

In contrast to an out-of-court exchange offer, the US Bankruptcy Code provides that creditors comprising a majority in number and two-thirds in amount can bind the entire class of creditors. For example, for a $100 million issuance of notes held by 50 investors, if 26 holders who have $67 million in value of the notes vote to accept a plan, all holders of the issuance are considered to have accepted the plan and be bound by its terms (note that the requisite majorities are actually based only on the creditors who actually vote, so in the given example, if only 30 investors holding $60 million actually vote, it would require 16 holders with $40 million of exposure to bind the class as a whole). Accordingly, while the greater the consensus, the greater the success of a reorganisation, the target minimum threshold for a pre-packaged plan of reorganisation is 66 2/3%.

And here is the rub. Traditional analysis assumes that all voting investors are seeking to maximise the recovery on their bonds and, therefore, will have similar economic incentives, including, if possible, the avoidance of a default. Given the CDS market, however, there will be some holders who would actually prefer a default to occur, because the default will trigger the obligation of the seller to pay the holder in full – certainly a far better result for that holder than accepting the terms of an exchange offer that provides lower value. At the same time, the existence of CDS means that fewer holders are willing to participate in the creditor groups that are needed for negotiations with the borrower.

First, CDS contracts may contain provisions restricting creditors' ability to consent to a restructuring, and may be written so as to void coverage in the event that creditors do so. Accordingly, creditors view engaging in discussions as risky, and as potentially jeopardising their CDS coverage. In addition, as noted above, the buyer of CDS protection is assured par payment if there is a default, and this disincentivises creditors from becoming active participants in a restructuring, whether in the context of an exchange offer or a pre-packaged plan. If a significant enough percentage of the bonds have CDS, and the holders do not join in restructuring discussions for any of the reasons above, the requisite thresholds are impossible to meet and this makes consummation of exchange offers and pre-packaged plans very difficult and sometimes impossible.

A recent example graphically illustrated this dilemma. YRC Worldwide had three issuances of public debt – two series of contingent convertible securities ("CoCos") and a series of 8.5% notes ("8.5s"). When YRC proposed an exchange offer that contemplated the conversion of the CoCos and the 8.5s into 95% of YRC's equity, the CoCos overwhelmingly accepted the offer. The 8.5s, however, were the subject of heavy CDS coverage, resulting in a low acceptance rate that threatened to force YRC into a free-fall bankruptcy. It was only due to the effective, albeit heavy-handed, intervention of the Teamsters' Union that YRC finally squeaked by with a 70% acceptance rate. (*See Teamsters Call on YRC Bond Exchange Holdouts to Convert,* December 29, 2009 Press Release, and Pierre Paulden & John Detrixhe, YRC Gets Bondholder Support for Swap, Averts Failure (Update 2), December 31, 2009, Bloomberg.com.)

Conclusion

Any possible solution to the group formation issue and requisite consent issue where there is substantial CDS coverage is not without drawbacks and difficulties. For example, one way for the company to draw the CDS affected bonds into restructuring discussions is to trigger an early default (i.e., by intentionally failing to make a scheduled interest payment even though there is sufficient cash on hand) on the underlying bonds. This would trigger the CDS insurance, liquidate all CDS positions, and leave in place only holders that shared an interest in maximising bond recoveries via a consensual exchange offer. Of course triggering a default is not an action without its own potentially unintended consequences. With YRC, for example, there was substantial concern that the cross-defaults and tightened trade terms that would be triggered as a result of an interest payment default would be insurmountable hurdles to an out-of-court solution.

Another partial solution would be acknowledging that CDS are, in fact, insurance products, and therefore they should be tightly regulated the same as any other insurance market. This would substantially reduce the risk of systemic shock because the aggregate notional exposure of all CDS would be reduced to a fraction of the current amount. However, unintended consequences would be at play here, as well, because the loss of much of the CDS market would have substantial market implications that, in themselves, could risk other systemic shocks.

In sum, we live in a financial world where CDS provide great value to the market but also threaten great risk, not only to individual borrowers seeking to effectuate distressed exchange offers and plans, but also to a market that has become reliant on a successful CDS trading strategy as a major contributor to the bottom line. This is an area that cries out for greater regulation but that also requires the avoidance of overregulation such that the good is thrown out with the bad.

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US Bankruptcy Exit Funding – A Changing Market

BY NICK HOOD | BTG MESIROW FINANCIAL CONSULTING

Come financial sun or rain, boom or bust, there is one fundamental reality. Successful business rescue and restructuring outcomes in the US depend above all else on one essential ingredient: a major cash injection. Almost without exception, no new money equals no rescue.

The past year has seen some remarkable changes in the way that this life-giving medicine is provided. In happier days before subprime and excess leverage threatened the survival of the financial system, most rescue funding came from traditional financial institutions, with an element of activity from vulture funds anxious to profit from the misfortunes of others.

As the seriousness of the recession had become obvious during 2008, debtor-in-possession (DIP) funding from the banks had dried up and the statistics for Chapter 11 reorganisation filings fell sharply in favour of straight liquidations. Commentators called the ending of business rescue in the US, at least as we had all come to know it.

But as we moved through 2009, signs emerged that the levers of this vital commercial mechanism had passed into the hands of new players. Suddenly, the DIP finance for a whole series of major restructurings was coming from private equity, instead of the banks. Few had predicted this development.

The first clear indication came in the Lyondell Chemical Chapter 11 early in the year, in which the $6bn DIP funding package featured a number of major private equity players, including KKR, Apollo and Ares Management. As spring gave way to summer, the auto industry restructurings of the car seat manufacturers Lear Corp and the wheel makers Hayes Lemmerz confirmed this trend with strong private equity involvement in the lender group. Across in the media sector, Readers Digest provided another example.

The factors which were driving this shift in funding practice had themselves grown out of the recession. The lack of liquidity in the banking system and the severe risk aversion of traditional lenders were its root cause. Not only were the banks unwilling, or in some cases unable to lend to distressed businesses, but they had also stopped funding the leveraged deals for healthier corporations, which were the lifeblood of strong private equity returns. Lending for LBOs had dropped by 91% from 2007 levels.

Faced with the conundrum of what to do with the $600bn of capital it raised before the credit markets seized up, private equity concluded that the answer was to adapt the traditional "loan to own" strategy to modern times. Whilst there were decent returns to be made from providing DIP funding, they were not at the levels required to keep their investors satisfied. But factoring in the ability to convert into substantial equity positions suddenly made the sums add up.

Typically, investors in these new loan-to-own deals could earn an annual rate of return of 18 percent and convert their positions into a substantial equity piece, far better than the typical returns of around 12% on straight DIP finance transactions.

The scope for these types of transactions was obvious. In the first eight months of 2009, over 150 US companies were bought out of bankruptcy, a rise of 60% on the equivalent period in 2008 and three times the number in 2007. US corporate defaults were continuing to rise, despite signs of recovery.

Worldwide, companies missing interest payments on bonds and loans were up by over 50% on 2008. Standard & Poor's predictions suggested that US speculative grade defaults would surge to 13.9% in July 2010, an increase from 10.2% in August 2009. By October, this prediction was being confirmed, as the default rate had already soared to 12.4%. The last loan-to-own peak had been back in 2003, when the value of debt for equity conversions was $52bn. This record may well have been broken in 2009.

With the banks thought unlikely to be active in this market any time soon, the private equity dominance seemed likely to continue. And it might even address another feature of this deepest of modern recessions. Restructuring professionals worldwide, whether they operate in the US, the UK, Hong Kong or any other developed economy, are still commenting about a lack of activity at a time when the correction has wreaked commercial havoc across whole economies. They believe that whole swathes of enterprises are in urgent need of professional turnaround attention, so they are understandably perplexed about why their workload is 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. This is despite the opportunity in this bad news environment to drag all of the financial skeletons from the cupboard to see what scope there might be a miracle restructuring resurrection. In the UK, the forthcoming election may be the cause, in the US perhaps a desire to avoid derailing a fragile recovery. Many experts share a real concern that by the time the mood changes and reality reasserts 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 reflects the thought that if cash calls can be avoided, then perhaps value impairments might not have to be recognised, avoiding damage to capital adequacy ratios at banks or returns for private equity investors.

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

Another problem is the lack of turnaround talent available to do the hands-on work in restructurings, especially operational workout specialists, as opposed to the financial engineers so predominant before the recession. 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.

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 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?

But as 2009 ended, another shift in market behaviours prompted a re-think about prospects for rescue funding in 2010 and beyond. Suddenly lenders began to emerge blinking into the dim sunlight of the US recovery and commit to rescues. The exit of elevator music provider Muzak Holdings from Chapter 11 came with the support of $108.75m of loans from a consortium including GE Capital's restructuring finance unit, previously largely out of the market.

In as further sign of encouragement to a thawing of the traditional bank-driven sector of the rescue funding market, Standard & Poor's/LSTA US Leverage Loan 100 Index soared a record 46% up to December 2009, compared with a loss of 28% in 2008. This trend was confirmed by Merrill Lynch's US Master II Index, which showed that high yield bonds were likely to make a return of over 50% in 2009.

So it may be that 2009 will turn out to have been an aberration, a brief period when funding conditions forced a temporary change and 2010 will see a return to old sources and old methods will reassert themselves. But if the many forecasts from world authorities that banks have so far only recognised 50% of their real losses turn out to be true, the next 12 months could be another challenging period for those trying to rescue damaged businesses in the US.

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Cross Border Restructuring – the Final Frontier for the US

BY NIGEL ATKINSON | BTG RESTRUCTURING

Modern stereotyping has cast Americans as isolationist non-travellers, with estimates that only some 20% actually hold passports. True or not, this cliché certainly cannot be applied to US industrialists, investors and bankers. Taking just its top 15 trading partners, the US conducts some $1.5 trillion of international trade each year.

So how are US professionals dealing with the impact of the current recession on overseas commercial involvements? Much praise has been heaped on the efficiency and effectiveness of the Chapter 11 business rescue process, despite its eye-watering cost implications and the underlying principle of leaving management in charge of putting things right. Sly comparisons to leaving the lunatics in charge of the asylum are rightly countered by the generally accepted opinion that if General Motors had been anything other than a US corporation, it would not have survived its recent crisis.

Despite its success with the GM and Chrysler insolvencies, Chapter 11 is heavily debated in the US. It has been tinkered with in recent years to make it less debtor-friendly and will no doubt be further amended once the present financial firestorm has finally burnt itself out. But worldwide, it is a much admired process and has been used as the model for restructuring laws enacted in the past few years in a number of jurisdictions. More generally, however, the restructuring community has failed to engage with governments and lawmakers worldwide to create workable business rescue regimes, which can be used to address issues in the foreign operations of troubled US corporates.

There are still many significant jurisdictions where there is no effective mechanism for ring-fencing troubled businesses while they are reorganised and revitalised. India, China and Russia are amongst them. Earlier this year, Hong Kong was reported in the professional media to be considering passing a modern restructuring law at last. If one of the world's most highly developed financial centres needs to reinvent the restructuring wheel, what chance of rescue has a struggling but potentially viable outpost of a US corporation in South Korea or Italy?

One happier outcome was the rejection recently of an attempt by organised labour to overturn Brazil's new business rescue law, where an unexpectedly pragmatic decision in the Supreme Court rescued the legislation from being strangled at birth. It remains to be seen if the law will work in practice, but at least it has survived to be turned into a workable regime through its application to real life restructurings.

Another worry for US professionals working with overseas issues is judicial capacity and cross-border cooperation. Institutions like INSOL International have long been working to bring together judges from around the world to encourage a more practical application of laws, which were not designed for complex multi-jurisdictional cases and which have lagged behind rampant change in the commercial 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 sadly far too late for this recession.

Taking these factors into consideration, it is worth considering the narrow escape US professionals have had following the decision of General Motors to keep its European operations, rather than sell them. What might have happened if General Motors itself or if GM had walked away from Opel after the proposed Magna rescue collapsed? The US components of the sprawling empire were successfully rescued in record time under Chapter 11. But there is nothing remotely comparable with that process anywhere in Europe, with its unworkable patchwork quilt of competing debtor-friendly, creditor-friendly, employee-biased and grossly inefficient court-driven systems.

GM's European division has operations in 34 European countries, only 24 of which come within the framework of the European Union and therefore the EU Insolvency Regulations. It employs around 60,000 people across 29 nations, with more than a thousand in ten different countries. There are over 3,000 GM-owned car dealerships in eight countries and manufacturing plants in seven jurisdictions. Dealing with just the intra-Europe insolvency issues alone would have been severely testing, even without the multi-dimensional problems which would be created by the inter-connection on contractual, funding, intellectual property and regulatory aspects to the other worldwide GM entities, especially the US mother ship.

How would the European insolvency regime have coped with this if GM worldwide had gone the same way as Lehman Brothers? Major manufacturing centres and the greatest concentration of assets and employees are located in Germany, the UK, Poland and Russia. There are large chains of dealerships in France, Spain, Greece, Portugal and Austria. Deciding the location of GM Europe's Centre of Main Interest, the most vital element in any insolvency proceedings, would have exercised the finest legal minds. The result might have been the ultimate European restructuring nightmare, with over-arching and potential oppressive control vested under Chapter 11, a US trustee answerable to a bankruptcy court in Manhattan and an unsecured creditors committee with no knowledge of the commercial world outside America's borders and precious little interest in learning about it.

This highlights another issue for US professionals dealing with overseas operations. Not only are there complex legal issues and severe resource restrictions, but the effectiveness of local professionals is frequently hampered by their lack of understanding of the Chapter 11 process. This was well illustrated by a recent case when a substantial Korean manufacturing corporation proposed to rescue itself through a sale to a Korean investment fund, but chose to file for bankruptcy protection in Delaware.

Fortunately, the mandate to represent the unsecured creditors committee was awarded to a US firm with genuine international capability. Even so, the first obstacle was explaining to its Korean associates that a success fee basis was inappropriate because the role was purely to review, inform and monitor – not actually to realise assets or undertake the sale, as most insolvency professionals around the world would have expected their task was. A further challenge was managing their expectations on the payment of fees in the face of the seemingly endless delays in getting approval from the US bankruptcy court, concerned to protect the interests of the insolvent corporation which was footing the bill.

US restructuring firms have a massive job ahead of them to educate the world about the American rescue regime, whilst themselves being on a steep learning curve about foreign bankruptcy regimes. Ultimately, the degree to which they will succeed is likely to be dictated by the quality of the overseas professionals with whom they engage. This is no time to be instructing auditors or generalist corporate lawyers; local help must be sought from commercially aware, problem solvers who make their living from insolvency and restructuring and who understand the need for pragmatic, value adding solutions.

This introduces the final and most challenging problem facing US restructuring professionals as they find that they need to mobilise workout resources in many unfamiliar overseas jurisdictions and on a scale never previously experienced. Not only this, but their search for foreign support is taking them to places where the local professional talent will be scarcer than they can ever have imagined, at least as regards those with any meaningful cross-border experience or awareness.

Just consider the position in America's leading trading partners around the world. Discounting the professionally developed jurisdictions such as Canada, the UK and the Netherlands, the other 12 countries in the top 15 have only 928 members of INSOL International, the only global association of workout professionals. Three countries have no INSOL members and South Korea has just one.

If finding insolvency and restructuring experts outside the US is problematical, hiring operational turnaround professionals is something else altogether. Only seven of the US's top trading partners have a chapter of the Turnaround Managers Association. Given the continuing squeeze on liquidity in the financial system around the world, the days are long gone when financial engineering and repeated cash injections could be deployed as the sole strategy for solving business problems. Successful outcomes now demand that underlying operational faults are fixed. Suddenly, turnaround skills are in huge demand and short supply.

How, for example, can you find at short notice enough auto industry experts to deal with cases like the Visteon Chapter 11 filing, where suitably savvy "boots on the ground" were needed in 23 countries at once, especially when the entire sector is undergoing a complete make over? The good ones are already over-committed, although there is no shortage of retrenched former executives willing to try their hand. Sadly, experienced business rescuers know from bitter past experience that few executives who developed their skills in the headlong growth of the past two decades are any good at downsizing businesses.

No wonder that a successful pitch document from a respectable US restructuring firm, appointed earlier this year to represent the unsecured creditors committee in a major US Chapter 11 filing contained an organisation chart for the corporation which contained massive detail of its US businesses, but just a dotted line to a dotted outline box containing the remarkable description "Sundry Non-US Operations & Assets". These just happened to be 43% of the insolvent group's total assets and activities. "Out of sight" was clearly "out of mind", a problem parked.

In future, there will have to be far more focus in the US on issues and challenges in implementing "Plan B" for overseas subsidiaries and investments, together with far more recognition that only a truly global solution using experienced local professionals will produce acceptable results. Otherwise, troubled US parents and their US advisors will continue to have rings run round them overseas by local management, local creditors and local lawyers.

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A Brief Primer on Current Issues in Oil and Gas Restructuring Cases

BY DEBORAH D. WILLIAMSON AND MEGHAN E. BISHOP | COX SMITH MATTHEWS INCORPORATED

In the last half of 2008, a rapid decrease in oil and natural gas prices, and the price depression of natural gas has contributed to the dramatic increase in restructuring engagements with some analysts predicting that more are on the horizon through 2012. It has been almost two decades since the last cycle of Exploration & Production ("E&P") bankruptcies and although many of the issues are familiar, the players have changed significantly. In addition, the people filling the roles of lenders, management, vendors and unsecured creditors may lack experience with an E&P workout or restructuring.

Oil and gas leases are the bricks from which an E&P company's house is built. Depending on the oil and gas producing state, this right could take the form of a defeasible fee interest in real property (such as in Texas, Oklahoma, Mississippi, North Dakota and South Dakota, to name a few), or an interest more akin to a profit- à-prendre (as in Louisiana and California). In general, and as with a traditional interest in real estate, a security interest in an oil and gas leasehold must be perfected by filing in the real property records of the county where the property is located. However, unlike traditional real property security interests, such as a commercial building, an E&P company's portfolio of leases changes over time, thereby altering the nature, and possibly the extent of the secured party's security interest.

There is both a risk of loss of collateral and a risk that creditors could fail to obtain a security interest in newly acquired property.

An E&P company may have an interest in a lease as to certain depths and, subsequent to the loan, acquire interests in other depths; a borrower may enter into a "farmout" agreement either before or after the loan and "earn" acreage from the primary working interest owner by drilling; a lease may expire as to certain acreage not held by production ("HBP"); a lease may be unitised or pooled only as to certain depths; or the mortgage itself may be limited only as to certain depths in a given lease. It is therefore crucial for secured lenders to systematically review the borrower's interests in real property and keep current their perfection with new filings, particularly if the collateral description is arguably limited to a particular lease or if the borrower has acquired acreage or even the right to acquire acreage in another county.

Farmout arrangements present a few issues that must specifically be dealt with in a bankruptcy case. The Bankruptcy Code in section 541(b)(4) deals with farmout arrangements and provides that mineral leases covered by certain types of farmouts are not property of the debtor's estate. Where the debtor is the farmor, the debtor cannot reject the farmout agreement to prevent the farmee from otherwise receiving title to the interest earned. Where the debtor is the farmee, and has earned an assignment of an interest in a lease, but such assignment has yet to be executed at the time of the filing, the bankruptcy estate includes the equitable interest, pursuant to section 541(a)(1). Where the "earning event" has yet to take place at the time of the filing, and the interest is earned subsequent to bankruptcy, the extent of a secured party's right to after acquired property must be carefully analysed.

Other issues which may arise include the potential for competing liens among oil and gas service providers and other statutory lien creditors. Recent decisions in Delaware emphasise the importance of reviewing all statutory lien interests in mineral properties as liens of secured party lenders may defeat statutory liens. Most oil and gas producing states have a form of lien statute that gives oil and gas service providers a lien on the oil and gas lease on which the work was performed, to secure payment for their services. This lien, generally speaking, attaches to the entirety of the lease and not just the particular well or wells on which the work was performed. The nature of the industry is such that E&P companies often request services on a well basis, and accounting is almost always set up on a well basis, with the well being the fundamental cost and revenue centre. Likewise, reserve report valuation is undertaken on a well basis, with relatively less value typically being attributed to undeveloped acreage.

Because of the general rule that the vendor has the right to assert a lien against the entire lease, a thorough mapping of wells to leases must be undertaken to properly "tie" cost centres and reserve report values to individual leases. The very nature of oil and gas exploration and production complicates this mapping due to the layering of and carving out of various interests. For example, liens filed on properties on which horizontal drilling techniques were used requires not only an awareness of the surface location, but the bottomhole location and every lease that the horizontal lateral crosses; the sidetracking of a vertical wellbore into more than one formation results in the assignment of multiple reserve values and potentially multiple leases covering one vertical wellbore; where multiple leases cover the same lands due to the mineral interest owners holding undivided mineral interests, this situation must analytically be distinguished from leases covering distinct tracts of land by a review of the leases' legal descriptions; and depth-severed leases may mean that the debtor has a different percentage interest as to different depths, or that the mineral lien attaches only to certain depths.

When a mineral lien incepts is also a topic of frequent controversy. Under the Texas mineral lien statute, for example, courts have interpreted the lien's inception to relate back to the date of first work. An issue is being raised in some cases as to whether such liens can "relate back" even if the invoices related to such work were timely paid. In other words, is there a lien right from the date any service is provided, even if there is no unpaid claim arising from those services? If the theory ultimately prevails, it will be extremely difficult for lenders to have a valid and perfected first lien on any oil or gas lease unless the security interest attached before the initiation of any drilling or other work on a lease. Other evolving issues include whether such vendors have a security interest in the proceeds from production (the oil and/or gas as produced and/or the receipts attributable to such production) or the joint interest billings (which are amounts owing to an operator by other non-operator participants in a well or lease).

In Texas and other states, the vendor issue is even more complicated due to the requirement that once a valid vendor lien is established, all vendors holding valid liens on a particular lease share pro rata in any recovery, regardless of the date of perfection. And, of course, vendors have issues and concerns with the requirements of perfecting their liens. Several recent cases, many of which have come down from bankruptcy courts, hold these mineral lien claimants to (arguably) a higher standard than the "substantial compliance" standard of Texas law. As a result, the oil and gas service industry is taking an active role in E&P bankruptcies. Moreover, courts continue to struggle with how to address the variety of setoff, recoupment and related issues which are rife in oil and gas cases. How these concepts interact with a secured claim under the mineral lien statute poses its own set of unique problems.

Like other restructurings, a sale of assets is the most common method of paying creditors. The determination of a debtor's interest in the assets and a determination of value are two of the key issues to be resolved. An interest in oil and gas is severable from the interest in the surface estate. Thus, a seller of real property may retain some or all of the interests in the underlying mineral estate. A debtor's interest in a lease is usually computed based on working interest (the percentage of cost-bearing interest) and net revenue interest (the percentage of revenue earned) which result from a number of factors, including the percentage interest held by the mineral interest owner(s), the royalty interest retained by the lessor or other non-participating or overriding royalty interest owners, and the interest of other working interest owners. Unlike other situations, 11 U.S.C. §363(h)(4) prohibits the sale of the interest of a co-owner if the property is "used in the production, transmission, or distribution, for sale, of electric energy or of natural or synthetic gas for heat, light or power." Title issues are often very complicated as interests are gained, lost or traded, and the typical Purchase and Sale Agreement will specify the percentage interest in each lease being transferred, providing for adjustments if less (or more) is determined to be owned or otherwise capable of being sold by the debtor. Furthermore, once the interest is determined, the allocation of value must be determined for each property. Valuation of oil and gas properties is particularly difficult due to constantly changing pricing, the relatively high risk associated with the E&P business, much of which comes from external factors and the high front-end capital expenditures required. Thus, resolution of title and valuation of a debtor's interest in what may be hundreds of leases is often a time-consuming process which may be accomplished before consummation of a sale.

These, and myriad other issues, are the current points of discussion in oil and gas restructuring cases. These cases require an understanding of the unique nature of oil and gas properties and the state law in which such properties are located.

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To Trade, or Not to Trade: That is the Question

BY JOHN W. AMES AND IVANA B. SHALLCROSS | GREENEBAUM DOLL & MCDONALD

In recent years, the United States has seen a rise in bankruptcy filings, especially in the class of large scale commercial bankruptcies. These large scale bankruptcies, such as those of Enron, Lehman Brothers, Chrysler, or General Motors, often leave their creditors holding sizeable claims with no certainty of recovery since emerging from bankruptcy takes years in most, if not all, of these cases. In order to avoid the delay and uncertainty of recovery in these bankruptcies, or because they are on the verge of bankruptcy themselves and need an infusion of cash-flow, the creditors often resort to claims trading; finding a purchaser in the rising bankruptcy claims trading market and selling their claims for less than their face value. The purchasers of the bankruptcy claims, on the other hand, are motivated by their desire to gain control in the bankruptcy proceedings, since creditors often have voting powers and are even sometimes able to convert their claims to an equity stake in the debtor so that they could exert corporate control after the debtor emerges from bankruptcy, or by the desire to ultimately profit from claims that were bought inexpensively. Both sellers and purchasers in this unique bankruptcy claims trading market, however, need to be cautious when trading claims because, in certain instances, their risk-taking can prove to be detrimental.

"Claims trading has evolved into a multi-billion dollar industry" and "is viable because the purchaser of the claims assumes all of the rights and disabilities of the claim from the seller" (*Claims Trading: The Need For Further Amending Federal Rule of Bankruptcy Procedure 3001(e)(2)*, 2 Am.Bankr.Inst.L.Rev.495, 495-496 (1994) (citations omitted)). The expectation is that the seller of a particular claim will "get rid" of the claim and cease his/her participation in the bankruptcy proceeding while the purchaser will buy the claim at a discount and inherit all of the rights (and disabilities) of the seller, including the right to recover the full face value of the claim. Yet, these expectations are not always met. As written by Erik Krusch in his recent Westlaw Business article, "Unwitting creditors can end up signing away value or agreement that leave them on the hook for years after the assignment" (Erik Krusch, *Creditors Bearing Gifts: Bankruptcy Trade Claims Cash Out*, October 15, 2009). Likewise, purchasers of claims can lose money in the transaction if they misjudge the viability of a particular claim or if they miscalculate the cost of the recovery of that claim, forgetting to account for associated administrative and/or litigations costs. Furthermore, purchasers sometimes overlook that, in addition to inheriting all of the seller's rights connected to the claim, they are also inheriting all of the disabilities relating to that claim, including being subject to various avoidance mechanisms, equitable subordination claims and set off rights.

Nevertheless, there is some hope for purchasers with respect to "stepping into the shoes of the seller" when purchasing bankruptcy claims. In its *In re Enron Corp.*, 379 B.R. 425 (S.D.N.Y. 2007) decision, the District Court for the Southern District of New York distinguished between a pure assignment and a sale of a bankruptcy claim, holding that in the purchase context, a purchaser of a particular claim could acquire more rights than the seller had in a purchased claim. Based on the foregoing distinction, the District Court ruled that a purchaser of the claims could take free and clear of all defenses to these claims under 11 U.S.C. §§ 510(c) (which addresses equitable subordination) and 502(d) (which addresses disallowance of claims), as those defenses were personal defenses which did not attach to the claims. The District Court did note, however, that an assignee (as opposed to a purchaser) of a particular bankruptcy claim remains subject to all of the defenses available against the transferor. The lesson to learn here is that in order to have an opportunity to claim the protections discussed above, a transferee of a bankruptcy claim needs to make sure that the transfer is a sale rather than a pure assignment. This may prove to be a difficult task since the District Court failed to define the term "pure assignment." For this, and other, important reasons, assistance provided by competent bankruptcy counsel becomes crucial and invaluable.

Besides the issues discussed above, both sellers and purchasers of bankruptcy claims need to keep in mind additional considerations that have an impact on bankruptcy claims trading in the United States. For instance, Federal Rule of Bankruptcy Procedure 3001(e), which regulates claims trading. Rule 3001(e)(1) governs the assignment of claims which are transferred, other than for security, before the proof of claim is filed while Rule 3001(e)(2) governs the assignment of claims after the proof of claim has been filed with the court. If the claim is purchased prior to the filing of the proof of claim, Rule 3001(e)(1) requires that the purchaser file the proof of claim in the bankruptcy case. If, however, the claim is purchased after the proof of claim has already been filed, under Rule 3001(e)(2), the purchaser is automatically substituted as the claim holder if no objections to the purchase are filed within 21 days of the notice to object to the purchase is mailed by the clerk of court. Purchase of claims that are "based on a publicly traded note, bond, or debenture" is not covered by Rule 3001(e), although Rule 3001(e)(4) –(5) addresses claims (other than ones mentioned above) that are transferred for security either before of after the proof of claim has been filed in the bankruptcy case (*See* Federal Rules of Bankruptcy Procedure, Rule 3001(e)(4) and Rule 3001(e)(5)). Interestingly, Rule 3001(e) does not require notice to debtor of the purchase of the claim and there is no requirement to disclose the claim purchase price.

Purchasers of claims should also keep in mind that the bankruptcy court has the power to prevent their participation in the bankruptcy proceedings if there is evidence that they purchased the claim in "bad faith". While it is true that purchasing claims for the purposes of obtaining voting power or gaining the ability to block a debtor's plan of reorganisation does not constitute bad faith, the bankruptcy court will prohibit the purchaser from participating in the bankruptcy case if the court finds that the purchaser bought a particular claim with the intent to destroy the debtor, gain a competitive advantage or by using blackmail or coercion (*See In re Adelphia Communications Corp.*, 359 B.R. 54, 61 (Bankr. S.D.N.Y 2006) (citations omitted)).

Another important factor to take into account when engaging in claims trading comes into play when the purchaser or the seller is a member of the Creditors' Committee in the bankruptcy case. Since Committee Members owe fiduciary duties to all of the creditors and interest holders in the bankruptcy case, they have certain obligations if they choose to participate in claims trading. Under Rule 2019 of the Federal Rule of Bankruptcy Procedure, each Committee Member must file a verified statement, disclosing the nature and amount of his/her claim at the time of the acquisition (unless acquired more than a year prior to the filing of the bankruptcy petition) as well as filing a supplemental statement should there be any changes in the nature and amount of said claim. Given these obligations, a Committee Member may engage in claims trading only if the bankruptcy court is satisfied that the claims trading will not be conducted based on confidential and/or inside information.

In view of the recent trends in bankruptcy filings and the rapid growth of the bankruptcy claims trading market, it is safe to say that the issues associated with bankruptcy claims trading will only get more complex and intricate with time. The claims trading market participants should avail themselves of the many resources that are available to them before taking part in claims trading (for example, the Loan Syndications and Trading Association, in existence since 1995, "promotes a fair, orderly and efficient corporate loan market and provides leadership in advancing the interests of all market participants," and has established a Code of Conduct and many standardized forms for use by purchasers and sellers of claims), including hiring competent bankruptcy counsel who can help with the multitude of these issues.

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The Prepack is Back

BY JOHN W. AMES AND MILES S. APPLE | GREENEBAUM DOLL & MCDONALD

The prepackaged bankruptcy, or "prepack", is back in vogue. The dramatic increase in American corporate bankruptcy filings over the past year has resulted in the need for accelerated bankruptcy proceedings and simplified reorganisations. This, in turn, renewed interest in the prepackaged bankruptcy plan. There are three reasons for this: time, cost and control. A prepack is generally shorter, cuts down on fees and limits the ability of others to wrestle the ultimate outcome from the debtor. Prepackaged bankruptcies are now the new reality in the American bankruptcy world.

The pre-pack is a hybrid of two methods of reorganising a troubled firm: a workout and bankruptcy. The idea behind a prepackaged bankruptcy plan is to negotiate with creditors and stockholders before a company actually files for bankruptcy. This shortens and simplifies the process, ultimately saving the company money. It also reduces the amount of time spent under bankruptcy protection which implies less damage to a company's enterprise value. The sooner a company can emerges from bankruptcy, the sooner it can implement its restructuring and return to generating revenues from its core operations.

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Prepackaged bankruptcies first came into being about 20 years ago. In 1989, the hospital operating company Republic Health Corp. became one of the first successful prepacks. A victim of a botch leveraged buyout three years earlier, it had its plan confirmed less than five months. Prepacks became increasingly popular during the 1990s. Many were used, like Republic's, in the context of failed leveraged buyouts but were also seen in mass-tort settlements or in sales or mergers of companies. Notable prepackaged bankruptcies include General Motors, CIT, Donald Trump's Taj Mahal Casino in Atlantic City, TWA and Zenith Electronics.

The principal advantage of a successful prepack is a substantial savings in time and disruption as compared with the ordinary Chapter 11 bankruptcy case. The average Chapter 11 case, even a relatively small one, is rarely likely to be completed in less than a year. However, many can often take two or three years, or even longer. A lengthy proceeding can waste the enterprise value of a company and can take away the ability of the debtor to control the restructuring. In the typical large bankruptcy, committees made up of creditors, bondholders and employees all vie for a say in the restructuring which can lead to a result not in the long term survival of the company. By contrast, prepackaged cases typically take less than six months, thus saving both time and money. For example, Davis Petroleum filed bankruptcy on March 7, 2006. Its plan of reorganisation was confirmed on March 10. While an unusual exception, it illustrates the rapid rate at which prepacks can be approved.

However, the speed of the process also raises suspicions among those most impacted by the bankruptcy. In the Davis Petroleum case, for example, creditors and shareholders were given 48 hours to consider the prepackaged plan. While the essential majorities approved the plan, the allegations of fraud by disgruntled minorities and the resulting litigation still lingers. Many shareholders claimed that insiders misrepresented the true value of the company in order to force a "low-ball" bid for the company.

This concern played out again in the Chrysler bankruptcy in 2009, much to the dismay of bankruptcy practitioners and scholars, when the forced sale seemingly ignored the Bankruptcy Code to the detriment of the automakers bondholders. While not technically a prepackaged plan, the proposed 30 days from the bankruptcy filing to the sale of the company was extraordinary for an incredibly complex, large case. When the 30 day period was first proposed, the lawyer for Chrysler even remarked that such an accelerated proceeding made it appear that the parties were "stuffing the judge". While the US government certainly exerted its influence in that bankruptcy proceeding both pre and post filing, it was an incredibly short period.

However, as was argued in the Chrysler and General Motors case, time was of the essence. Conventional wisdom holds that a lengthy Chapter 11 proceeding hastens the deterioration of the intrinsic value of a business. The argument made by many practitioners is that a prepackaged plan blunts the attendant uncertainty that accompanies a bankruptcy filing and thus saves that intrinsic value.

The most important characteristic is that the major players in the bankruptcy have come to an agreement among themselves about the most important issues of financing, lien priority, and whether debt will be discounted or terms of repayment extended. In a time when financing is scarce, this is incredibly important. Traditional forms of bankruptcy financing, called debtor-in-possession financing, which make lengthy bankruptcies possible, are not available. Thus, discounting or extending existing debt may be the only available solution to a troubled firm.

The agreement also reduces the potential of the debtor to lose control of the proceeding and allows it to proceed directly to its contemplated reorganised operations. By minimising the time spent subject to the restrictions and various oversight provisions embodied in the Bankruptcy Code and reaching agreements before filing, the likelihood of full blown creditor second-guessing and need to balance the influence of various interests is thought to be significantly and productively decreased.

Section 1126(b) of the Bankruptcy Code and Bankruptcy Rule 3018(b) allow prepetition solicitation of votes for approval of a plan of reorganisation. The key elements to a successful prepetition solicitation are:

- The proposed plan must have been transmitted to substantially all creditors or equity security holders entitled to vote in a class;
- Sufficient time which is not "unreasonably short" must have been allowed for voting (which is made on a case by case judgment)
- Those class members solicited must have been provided with "adequate information" in connection with the solicitation of their vote.
- The provisions of any applicable nonbankruptcy law, such as federal securities law governing communication with shareholders of public companies must be complied with.

A prepackaged bankruptcy allows the debtor to bypass lengthy time periods involved in the bankruptcy procedure. Debtors can avoid the notice and hearing periods of getting a disclosure statement approved by the Bankruptcy Court, as well as the administrative costs of getting a plan distributed to creditors, gathering and tabulating ballots approving or rejecting a proposed plan.

However, there is the risk that the Court will determine after the filing that the prepetition solicitation process did not meet the requirements of either the Bankruptcy Code or Bankruptcy Rules. Usually, this can happen either as a result of a motion by a party in interest or the Court can make such a finding on its own initiative.

However, a debtor still must pass the requirement of creditor approval of a plan of reorganisation. Pursuant to section 1126(c) of the Bankruptcy Code, a class of "impaired" creditors will be deemed to have accepted the plan if and only if the creditors in that class voting hold two-thirds in amount and at least a majority in number of claims voted do in fact vote to accept the plan. In addition, pursuant to section 1129(a)(10), the plan cannot be confirmed unless at least one class of impaired creditors vote to accept the plan.

Prepackaged bankruptcies tend to work best where there are a sophisticated creditors involved in the process. Those more creditor who are more knowledgeable tend to now the realities facing a business , which leads to more productive negotiations.

Prepackaged bankruptcies tend to work less well when a debtor has a large number of creditors of different types. For example, trade creditors, employees, landlords, equipment lessors are have different interests and are entitled to varying treatment under the Bankruptcy Code. Also, these interests can intensify and lessen as the proceeding progresses. Large numbers of contingent claims can also be an obstacle for the obvious reason that time must be spent determining the amount of such claims.

In addition, by immediately proceeding to the plan confirmation phase, a debtor does lose the benefit of the "breathing spell" provided by the automatic stay which arises immediately upon the filing of the petition. And, of course, it does tip the debtor's hand as to its financial distress.

While there are certainly some useful rights and remedies available to companies seeking to file a prepackaged bankruptcy, there are also substantial risks. Prepackaged bankruptcy is advanced by many as a way to maximise the advantages of being a Chapter 11 debtor while eliminating the "down side" of a bankruptcy filing. It's not that simple. But, it seems to be the new reality.

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Top 10 Issues Facing the Restructuring Industry

BY JAMES S. STILL | MAINSTREAM MANAGEMENT

As the United States economy approaches 2010 with a combination of optimism over an improving market and concern over a possible jobless recovery, the restructuring industry faces equally challenging issues. In this article, we identify 10 of the key issues facing the industry during these difficult economic times.

Over-leverage of Existing Companies

A reflection of the challenges facing corporate America is the fact that US companies carry $1.4 trillion in high-yield bonds and loans on their books as of June 30, 2009. This level is triple the level held by US industry in 2001, the product of eight years of low interest rates and increased availability of debt capital from both domestic and international lending sources. As a result of the increased debt burden on the balance sheet, the pressure on achieving stable and strong operating performance is significantly greater than at any point in recent corporate history. Looking ahead, more than half of the debt comes due over the next five years, a period during which economic recovery is likely – but not certain – to occur.

The increased debt load combined with worldwide recessionary economic conditions has caused default rates to skyrocket to 11% in fiscal year 2009, up from 2.4%, according to Moody's. Of even more concern is that Moody's forecasts a default level of 12.8% by year-end 2009. "Be prepared for multi-year period of high defaults," says Louise Purtle of CreditSights. Only two industries – telecommunications and utilities – have default rates below their historical averages. In addition, many companies are taking advantage of "band aid" approaches to handling their debt load, including stretching out the length of loan amortisation and not paying interest through the life of the loan.

The increased pressure on operating performance will place a premium on restructuring teams with the history and experience of working in similar environments. The existing conditions will also place a premium on not simply operating performance but addressing critical capital needs in an environment of limited capital resources, especially on the debt side.

Financial Institutions Valuation Challenges

One of the major challenges facing the financial services industry – and indirectly the financial restructuring sector – is that the fair value of loans by the nation's largest banks continue to decline. Among the banks that were stress-tested in May 2009, the difference between carrying values and fair values grew 14.4% from December 31, 2008 to June 30, 2009. The gap of $164.4 billion as of June 30, 2009, represents the largest gap in US financial institutions history. With over 70% of this gap coming from three of the largest financial institutions in the country – Bank of America, Wells Fargo, and Regions Bank – the implications for middle market lending in the near-term are significant.

The principle reason for the increased gap is the lower cash flows generated by corporations, both private and public, as a result of the recessionary economic conditions. A secondary factor is that discount rates, a critical component of any valuation, are significantly higher due to higher perceived riskiness in loan portfolios. The combination of these factors and the dormant M&A marketplace has been the primary reasons for the relatively illiquid climate to exist for middle market lending. Looking forward, the proposed changes by FASB to the new mark-to-market valuation practices would increase the challenges facing lenders.

Lack of Debt Capacity for Lending

According to the Federal Reserve Loan Officer Opinion Survey in July 2009, domestic banks indicated that they tightened standards and terms on corporate lending over the past three months. During that same period, demand for loans continued to weaken across all major sectors of the economy. According to lenders contributing to the Federal Reserve national survey, decreased loan demand and deteriorating credit quality were the most important reasons for the decline in C&I lending over the three-month period. On the international front, foreign lenders cited a less favourable economic climate and a more uncertain economic outlook as the principle reasons for decreased lending throughout 2009.

The implication for private equity firms has been nothing short of dramatic. Buyout firms, which represented over 22% of all M&A activity over the past five years, have shifted strategies to include all-equity deals, reduced ownership stakes, and seller financing. Each is a variation on the need to raise unconventional capital, according to Dow Jones Review. Moving from a period where the average equity contribution was approximately 33% of total capitalisation, the average equity contribution for LBO transactions in 2008 was over 45%. During that same period, LBO loan issuance decreased by 80% for 2008 as compared to 2007 levels. For the first quarter of 2009, LBO loan issuance occurred at a measly 2% of the first quarter 2008 levels, according to Thomson Reuters.

Limited M&A Activity, Especially by Financial Buyers

Over the first five months of fiscal year 2009, approximately 2,500 deals worth $248.7 billion were closed in the United States. This represents a reduction in number of deals closed of almost 30% as compared to the 3,750 transactions closed over the same time frame in fiscal year 2008, according to data supplied by Thomson Reuters. Even with a slight uptick in M&A interest in Q4, the level of activity in 2009 is lower than M&A activity in any period over the past five years, according to industry experts.

The largest decline has occurred in the private equity community. In fiscal year 2008, the private equity community generated 26% of all deal activity in the United States. That same figure for 2009 on a year-to-date basis was less than 5%, a dramatic decline in activity for a community that represented such a significant source of capital over the past 10 years. While the private equity community continues to have close to $1 trillion of capital to invest, it is clear that concerns over portfolio company operating performance and unclear market valuations will keep the private equity community largely on the sideline for the foreseeable future. The exception to this will be traditional "bottom fishers" who accumulate capital to invest in the types of market conditions that exist today. Not surprisingly, there was an increase in distressed purchasing during the first half of 2009.

For restructuring organisations, the challenge that is posed by the dramatic reduction in M&A activity is that lenders will need to hold onto portfolio companies for a longer period of time in order to realise legitimate long-term market value. Operational turnarounds that may have transitioned more rapidly into capital events will face a longer time horizon before a liquidation or recapitalisation event can occur.

Increase in Corporate Bankruptcies

The dramatic downturn in the United States and international economies has, not surprisingly, resulted in significant increases in the number of bankruptcies filed in the country. What is surprising to many is the magnitude of the increase. According to the American Bankruptcy Institute, the number of US businesses filing for bankruptcy totalled 45,510 for the first three quarters of 2009. This compares to 29,960 fillings for the same period in 2008, an increase of over 34% on a year-to-year basis.

These statistics are revealed on the heels of total filings for 2008 totalling 43,546, the highest level since 1997 and over 50% greater than in 2007. Many forecasts call for 2009 bankruptcies to reach levels never seen in the United States and around the globe as well. A successful emergence from a Chapter 11 typically requires the debtor to have three specific economic components:

- a stockpile of cash;
- positive EBITDA; and
- a debtor-in-possession loan facility to finance the bankruptcy.

As the recent economic downturn and associated credit crunch has had a negative impact on each of these the implications for restructuring firms are a strong likelihood that there will be fewer companies successfully emerging from Chapter 11.

Impact of Limited Availability of DIP Financing

Debtor-in-possession financing has been characterised as "the credit equivalent of a life raft during difficult times". Companies typically use this form of financing to fund operating expenses and pay external advisers during a period of bankruptcy. Because DIP facilities are considered a "super priority" claim, lenders have traditionally found this form of financing to be attractive from a return standpoint. However, the downturn in the economy and the pressures facing financial institutions has limited the availability of debtor-in-possession financings for companies in Chapter 11 while also reducing the number of firms willing to provide lifelines to companies undergoing restructuring. While these conditions have improved slightly throughout 2009, availability to DIP financing remains an uncertainty.

According to bank industry experts, the rates charged on loans has also increased significantly over the past 18 months. Prior to the credit crunch, a bankruptcy loan could be issued at a rate of Libor plus 250 basis points, whereas these same loans are now priced at Libor plus 600 basis points. The covenants of DIP loans are also getting tighter while the length of loans has dropped from 12-18 months to a range of 2-6 months.

The implications to restructuring experts of the last change in terms will be to shorten the time for a stand-alone reorganisation. In addition, companies that are considering a bankruptcy filing may need to figure out how to raise capital to carry them through a reorganisation given the declining number of DIP lenders.

Government Role in Bailout and Impact on Private Sector

The recent bailouts provided to automakers, financial institutions, and to some degree homeowners by the United States government has been the source of considerable debate by economists throughout the country. An argument can be made that bailing out industries in this fashion "interrupts" the normal cycle of businesses, which allows the best to flourish while other less successful firms fail. The counter to this argument, of course, is that the dire straits that the United States economy faced in 2008 required dramatic, overwhelming reaction on the part of the federal government to avoid an economic catastrophe of even greater proportion.

According to Dr. Michael Cosgrove, economics professor at the University of Dallas, the economy may actually become so stifled by government intervention that it could stop growing at a rate of 4% per year and instead grow at 2%. This would occur because the bailouts would unfairly affect companies that did not need capital to survive, putting them on the same level playing field of firms that did receive government capital. Put differently, the "delicate balance of the free market" was interrupted.

For firms undergoing restructuring, the notion of additional capital being made available for bailouts impacts the evaluation of different alternative options. For instance, a situation that heretofore would have been considered a likely liquidation candidate might now respond differently if the possibility of capital being made available occurred. A bailout in any form by the federal government is now best characterised as an additional lifeline or strategic alternative, something that changes the landscape of alternatives available to ailing companies.

Increased Complexity of Capital Structures and Competing Interests

In today's restructuring market, the diversity of stakeholders and agendas in restructuring negotiations are greater than ever, particularly for large corporations. Debt and equity structures are larger and more complex than at any time in corporate history and financial stakeholders may very often have competing agendas within the same organisation. One financial institution, for instance, might own an equity interest in a company facing bankruptcy while also holding a senior or junior debt position. In that case, the interests of the limited partners in the equity ownership position, including the financial institution itself on a minority basis, may be in direct conflict with the debt holder solely representing the shareholders of the financial institution.

This conundrum renders the work of restructuring experts more complex and complicated than in most restructuring initiatives they have worked on. When the competing interests of management, organised labour, state government, suppliers, and other parties are taken into account, the number of moving parts with disparate interests is very high and difficult to manage. Only seasoned restructuring teams with a keen understanding of the multi-faceted interests of various constituents can thrive in this day and age of increased capital structure complexity.

Private Equity Portfolio Operating Performance

Many experts believe that the foremost challenge facing the private equity community is portfolio company operating performance. Servicing an overloaded debt service is secondary to ensuring stable, growing EBITDA or, in today's economic climate, mitigating the reduction in EBITDA. Firms with ample stores of capital will have more options for continuing to support portfolio companies that require capital infusion to survive, either to cover operating losses or to continue making debt service payments. However, under any circumstances, it is clear that private equity firms will face longer holding periods and higher equity requirements, either up-front or in supporting portfolio company cash requirements.

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For restructuring firms, the opportunity is to work with private equity firms not on workouts and turnarounds but on operational improvement. Private equity firm portfolio companies that are suffering from mismanagement or from the general economic downturn will require intensive, out of the box management to survive and thrive in this recessionary climate. With the principle focus of private equity firms over the past five years being portfolio company acquisitions or platform acquisitions, a revised focus on improved operating performance will need to occur for the foreseeable future.

Recessionary Climate

Advisers to then presidential candidate Bill Clinton were quoted in 1992 as advising the young governor from Arkansas that "it's the economy, stupid." Sound advice then, sound advice now.

The plethora of factors impacting the restructuring community in 2009 and into 2010 all revolved around the continued questions regarding the economy in the United States and globally. The golfing equivalent of hitting a weak shot into a 40-miles per hour wind – one never knows whether the problem was the swing or the blustery winds – the existing economic conditions are the most challenging this country has seen since the Great Depression. Addressing over-leveraged companies; trying to raise capital to allow business enterprises to survive; or working with private equity portfolio companies to improve operating performance, all will either succeed or not based largely on the economic conditions in the United States stabilising and improving over the next 12-18 months.

There are a multitude of macro and micro level issues facing struggling companies and lenders to those companies. The breadth and depth of the economic recession caught most experts by surprise, with the woes facing the financial services industry exacerbating the problems due to the lack of available debt capital. Restructuring firms will need to bring the full range of management services and techniques to the table in assisting owners and lenders to stabilise and improve operations in order to create value during these extraordinarily difficult economic times.

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Recent Cases Reveal Trend Towards Limiting Secured Creditors' Right to Credit Bid in Connection with Sales Under a Debtor's Plan of Reorganisation

BY FREDRIC SOSNICK AND CRAIG CULBERT | SHEARMAN & STERLING LLP

The ability of secured creditors to credit bid in the event that the collateral securing their debt were sold in a bankruptcy proceeding often is viewed as a fundamental creditor protection. Two recent decisions – from the Court of Appeals for the Fifth Circuit and one from a district court within the Third Circuit – have found that a secured creditor may not have such right in the context of a plan of reorganisation that involves a sale of collateral.

In both the Fifth Circuit's decision in *In re Pacific Lumber Co*, 584 F.3d 229 (5th Cir. 2009) and the District Court for the Eastern District of Pennsylvania's decision in In re Philadelphia Newspapers, LLC, Bankr. No. 09-11204, 2009 WL 3756362 (E.D. Pa. Nov. 10, 2009) the courts held that a plan of reorganisation involving the sale of the collateral securing the secured creditor's loan could be crammed down on the secured creditor as long as the plan provided the secured creditor with the "indubitable equivalent" of the value of its collateral from the sales proceeds.

At the centre of these decisions is section 1129(b)(2)(A) of the Bankruptcy Code, which contains the test for determining whether a plan of reorganisation is "fair and equitable" to a secured creditor in the context of a "cram down", i.e. if the plan proponents sought to confirm a plan that had been rejected by the class of secured creditors. Section 1129(b)(2)(A) provides that a plan would be "fair and equitable" to a secured creditor if it provides for: (i) the secured creditor to retain its liens and receive cash payments equal to the allowed amount of the claim; (ii) "the sale, subject to section 363(k)" of the collateral, with the liens of the secured creditor attaching to the proceeds (the "Sale Prong") or (iii) the secured creditors to receive the "indubitable equivalent" of its claim (the "Indubitable Equivalent Prong"). Section 363(k) of the Bankruptcy Code, on which the Sale Prong is predicated, contains the right to credit bid, stating that "unless the court for cause orders otherwise the holder of [a secured] claim may bid at such sale, and, if the holder of such claim purchases the property, [it] may offset such claim against the purchase price of such property." (As the language in 363(k) makes clear, the right to credit bid is not absolute, and can be denied for cause shown. Although rarely utilised, courts have denied credit bidding in a 363 sale context when the claim or lien was subject to a bona fide dispute and there was a need for a prompt sale of the assets. *See In re Akard St. Funds*, No. Civ. A. 3:10-CV-1927-D, 2001 WL 1568332 (N.D. Tex. Dec. 4, 2001); *See also In re McMullan*, 196 B.R. 818 (Bankr. W.D. Ark. 1996) (holding that a creditor would not be entitled to credit bid any of its alleged liens or security interests because the validity of its liens and security interests were unresolved).)

In the Matter of Pacific Lumber Co.

Pacific Lumber Company and five of its affiliates, each of which was involved in the growing and the processing of redwood timber in California, filed separate Chapter 11 bankruptcy petitions in the Southern District of Texas. Within a year of the bankruptcy filing, a plan of reorganisation (the "MRC Plan") was proposed jointly by a creditor, Marathon Structured Finance ("MSF"), and a competitor, Mendocino Redwood Company ("MRC"). The MRC Plan provided for MSF and MRC to convert debt into equity and inject cash to fund payments under the plan, including a cash payment of approximately $513.6 million to certain secured noteholders (the "Noteholders"). After an extensive valuation hearing, the bankruptcy court found that, based upon the value of the Noteholders' collateral, a cash payment of $513.6 million was the "indubitable equivalent" of the Noteholders' secured claim, and, as a result, the MRC Plan complied with the Indubitable Equivalent Prong in section 1129(b)(2)(A)(iii) of the Bankruptcy Code. (*In re Pacific Lumber Co,* 584 F.3d 229, 238 (5th Cir. 2009))

In reaching its decision, the bankruptcy court overruled the Noteholders objection that in the context of a sale, confirmation of a plan would not be fair and equitable unless it complied with the Sale Prong, and afforded the secured creditor the right to credit bid its debt. On appeal, the Fifth Circuit affirmed the bankruptcy court's decision.

In addressing this issue, the Fifth Circuit held that the subsections of section 1129 are disjunctive and should be treated as alternatives, based upon the separation of the subsections with the word "or", and the fact that the lead in to the section provides that it "includes" the Sale Prong and the Indubitable Equivalent Prong. (Id. at 246) Accordingly, the Fifth Circuit determined that even in the context of a sale of assets under a plan, the Indubitable Equivalent Prong can afford a distinct basis for confirming a plan so long as the plan in fact offers the realisation of the indubitable equivalent of such claims.

Although the term "indubitable equivalent" is not defined in the Bankruptcy Code, the Fifth Circuit reasoned that for purposes of satisfying the Indubitable Equivalent Prong, "paying off secured creditors in cash can hardly be improper if the plan accurately reflected the value of the Noteholders' collateral." (Id. at 247) The Fifth Circuit made clear that, based upon the procedural history of the case, the Noteholders had no basis to object to the bankruptcy court's determination that the $513.6 million being paid under the plan was the market value of the collateral. *(Id.)*

In Re Philadelphia Newspapers

Following the reasoning of the Fifth Circuit in *Pacific Lumber,* the United States District Court for the Eastern District of Pennsylvania in *In Re Philadelphia Newspapers, LLC*, Bankr. No. 09-11204, 2009 WL 3756362 (E.D. Pa. Nov. 10, 2009) held that the bankruptcy court erred in rejecting the proposed bid procedures that precluded the secured creditor (the "Senior Lenders") from credit bidding because the Senior Lenders did not have a right to credit bid at an auction being held in connection with a plan of reorganisation that was being confirmed under the Indubitable Equivalent Prong. The bankruptcy court had rejected the procedures based upon its conclusion that, although section 1129 was not entirely free from ambiguity, it would be "illogical" and at odds with the canon of statutory construction that prevents the use of a general provision to achieve a result contemplated by a more specific provision, to permit a debtor to cash out a secured creditor through a sale under the general Indubitable Equivalent Prong when the specific means to do so is provided for in the Sale Prong. (*In re Philadelphia Newspapers, LLC*, No. 09-11204, 2009 WL 3242292 (Bankr. E.D. Pa. Oct. 8, 2009))

The District Court held that the bankruptcy court incorrectly determined the language of section 1129(b)(2)(A) to be ambiguous, and instead found the language to be clear in providing three distinct alternative arrangements for plan confirmation and that a debtor is free to select any of the three to proceed to confirmation. (*In re Philadelphia Newspapers, LLC*, 2009 WL 3756362 at *36) The District Court held that the language was clear that Congress intended three separate paths to confirmation. (*Id.* at *37) In reaching its decision, the District Court observed that the very "vagueness of the term 'indubitable equivalent' is an invitation to craft an appropriate treatment of a secured creditor's claim, separate and apart from subsection (ii)." (*Id.* at *39) Relying on *Pacific Lumber*, the District Court found that a plan sale is potentially another means to satisfy the indubitable equivalent standard and that it is entirely plausible that Congress envisioned a situation where a debtor could assure a secured creditor the benefit of its bargain in an asset sale even without permitting a credit bid.

The District Court was clear, however, that its decision was narrow in scope, and applied only to the pre-confirmation bid procedures being considered by the court. (*Id.* at *55) As a result, the Senior Lenders retained the right to argue at confirmation that the prohibition on credit bidding failed to generate fair market value at the auction, thereby preventing the Senior Lenders from receiving the indubitable equivalent of their claim. (*Id.*) The Senior Lenders have appealed the District Court's ruling to the Court of Appeals for the Third Circuit.

Impact of Recent Decisions

As noted in *Pacific Lumber*, most contested reorganisation plans that are crammed down on secured creditors are done either by having secured lenders retain their liens and receive deferred payments or through the Sale Prong. As such, there is relatively little case law available to guide secured creditors in determining what measures constitute the indubitable equivalent for the value of their allowed claim to satisfy the Indubitable Equivalent Prong. After the ruling in *Pacific Lumber* and *Philadelphia Newspapers*, parties have some guidance that paying cash to a secured creditor – assuming the cash amount accurately reflects the value of the collateral – could be considered indubitable equivalent treatment. Even if the Third Circuit in *Philadelphia Newspapers,* or courts in other jurisdictions were willing to adopt the statutory construction utilised in both cases, it is possible that the lack of an ability to credit bid could provide a justification for the court to hold that a proper price was not obtained for the assets, and, therefore, did not provide the indubitable equivalent.

In addition, one potential context in which a secured creditor could seek to limit the debtor's ability to invoke the Indubitable Equivalent Prong in the context of a sale would be in a situation where it is consensually agreeing to the use of cash collateral under section 363 of the bankruptcy code. In such a situation, the secured creditor could seek, as part of its adequate protection package, to condition the use of its cash collateral on the debtor's agreement that if it were to pursue a sale of collateral under a plan, it would only seek to cram down the secured creditor under the Sale Prong.

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Management and Key Employee Severance in Chapter 11 Restructurings

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We are certainly living in "interesting" times – economically and otherwise. The collapse of the financial and capital markets in 2008 will have lingering effects for the next two to four years at least. For good or bad, corporate bankruptcies are an established part of the economic landscape. This article will explore the area of key employee retention programs (or "KERPS') and other management incentive devices and their use (and limitations) in Chapter 11 restructurings.

Pre-confirmation Severance and Indemnity Arrangements for Senior Level Executives – Pre-BAPCPA

Generally the more sensitive issue in Chapter 11 cases is what types of severance and indemnity arrangements are available to senior level management during the Chapter 11 reorganisation, but prior to plan confirmation. Senior management will generally want full indemnification for prebankruptcy acts (and lawsuits), as well as severance arrangements for changes of control or terminations without cause. The rationale for this is straightforward. If a plan of reorganisation is confirmed which liquidates the assets of the company, sells the company to a third party, or converts debt to equity such that there are new stockholders with a new board, frequently the new owners of the company will want new management. This happens in non-bankruptcy situations as well. Existing management, being savvy, understands that remaining with the company through a Chapter 11 without some degree of protection is a no win proposition for them. In effect, they are working for a paycheck with no upside, and only a downside in that their actions will be second- and third-guessed and criticised. It is a reality in a bankruptcy that usually no one is completely happy at the end of the day. As such, in order to keep management incentivised to see the process through to completion, some degree of severance arrangements are generally agreed to and approved by the Bankruptcy Court. Preconfirmation packages for senior management prior to BAPCPA generally consisted of some or all of the following types of protections.

Indemnification. Senior management will want (and should get) indemnification for any actions from the date of the bankruptcy forward. Compare this with the indemnification that existed under either the company's bylaws or applicable corporate law. With respect to indemnification for prebankruptcy actions by a board and officers (which are generally covered by a D&O policy), most Bankruptcy Courts will not approve those types of agreements because once they are approved, any indemnification damages would be subject to being paid in full as an administrative expense of the company. That can have a devastating effect on the chances of success for the enterprise in the Chapter 11 plan process. As a practical matter, giving broad indemnification rights to senior management for post-bankruptcy activities is not very expensive in any terms for creditors to give. The reason for this is simple. Any action of any degree of materiality that is done once a bankruptcy is filed is going to be subject to Bankruptcy Court approval. This will happen after creditors are given some amount of notice and the Court will authorise and direct the DIP to do the actions that are being considered. Once a Bankruptcy Court approves an action, it would be difficult to imagine some party being able to sue the directors and officers for negligence because the Bankruptcy Court has approved it (and generally on the basis that the action being considered represents a reasonable exercise of the debtor's business judgement). With respect to fraudulent acts, the indemnifications will not cover those actions under any circumstance, so it really is not very difficult for creditors to give broad indemnifications (certainly for negligence) to officers and directors with respect to post-bankruptcy activities, but pre-plan confirmation. In addition, most plans contain a release of claims against officers and directors for any actions taken in the bankruptcy and plan confirmation process. BAPCPA has not really altered post-bankruptcy indemnifications.

Severance Arrangements. Management will generally also want some sort of severance arrangement to protect them from terminations without cause or change of control circumstances. Again, to the extent that a plan of reorganisation that is negotiated results in debt being converted to equity, and the new stockholders want new management simply to "start fresh", senior management will want some sort of protection and compensation for having stuck around through the rather difficult process to get the company to the confirmation stage. So what types of arrangements are "reasonable"? Two months' salary and bonus? Five years?

In reality, the packages that have been negotiated between management and creditors and ultimately approved by the Bankruptcy Court vary according to a number of factors. These are general and common-sense type factors, such as creditors' satisfaction with management, how easily senior management can be replaced, how loyal non-senior management is to senior management (such that if senior management were to go, junior level but important people would go as well), and other factors. Some are also industry specific. For example, in certain high tech industries, senior management may also be the holder of patents or licences, or have a specialised knowledge such that they are truly essential to the operation of the company. Those senior level people will obviously have more leverage in this process. Generally speaking, deference was given to the debtor's business judgment in this area.

This will be, and should be, an area of serious and deliberate negotiations with the creditor constituencies. This is an area that was materially changed by BAPCPA.

BAPCPA Changes to Post-Bankruptcy Severance/Retention Arrangements

Bankruptcy Code §503(c) is the result of a last minute amendment that was added to the bankruptcy bill by Senator Kennedy during the Judiciary Committee mark-up. Its purpose was "to prevent unfair and unnecessary retention bonuses to insiders in [C]hapter 11 companies." (See 151 Cong Rec S 2306, 2340 (March 9, 2005).) There is little to no legislative history with regard to Kennedy's amendment, although from the limited history, it appears to have been adopted in response to the anti-corporate abuse sentiment that was voiced to and by Congress during the period before the Judiciary Committee mark-up. More specifically, the Kennedy amendment seems to be motivated by "a desire to combat KERPS in Chapter 11 cases where employee-related fraud substantially contributed to the bankruptcy of the company." (See AIRA Letter to Senator Arlen Specter (March 1, 2005).) It also appears to be aimed at preventing abuses of the system, where creditors', employees' and retirees' monies are unnecessarily expended for the enrichment of management. (Id.) Although the amendment's detractors were concerned that it would prevent responsible companies from successfully reorganising, and advanced that §503(c) should only prevent payments to insiders in the event of fraud, mismanagement or conduct contributing to insolvency, the amendment was adopted in its original, broad-brush form.

What BAPCPA Did. In the end, Congress adopted Senator Kennedy's amendment in its original, broad-brush form, despite the concerns of some of its prominent detractors such as Senator Hatch, Representative Cannon, and the AIRA. Kennedy's amendment was codified as §503(c) of the Bankruptcy Code and is effective in cases that were filed on or after October 17, 2005. BAPCPA severely limited the scope and flexibility of KERPs by: (i) prohibiting retention payments to insiders except under certain conditions; (ii) prohibiting severance payments to insiders (generally, officers, directors, partners, control people, etc.) except under certain conditions; and (iii) prohibiting payments outside the ordinary course of business except under certain conditions.

Restrictions on Retention Payments to Insiders. Under BAPCPA, §503(c)(1), transfers to an insider that are made "for the purpose of inducing [the insider] to remain with the debtor's business" are prohibited unless the court finds that three conditions are satisfied:

- The insider has a bona fide job offer from another business at the same or greater rate of compensation (since the reference is to "compensation", rather than "salary", all components of compensation should be taken into account, including benefits and the potential for incentive compensation);
- The insider's services are essential to the survival of the business; and,
- The amount of the transfer is capped at: (i) 10 times the average (i.e., mean value) of similar transfers made to nonmanagement employees for any purpose during the calendar year of the proposed transfer; or (ii) if no such transfers were made to nonmanagement employees, 25% of any similar transfer made to the insider for any purpose in the year preceding the proposed transfer.

Restrictions on Severance Payments to Insiders. Under BAPCPA §503(c)(2), severance payments to insiders are prohibited unless two conditions are satisfied:

- The payment is part of a severance program that is "generally applicable" to all full-time employees; and,
- The payment is capped at 10 times the average severance payment made to nonmanagement employees during the calendar year of the proposed payment.

Restrictions on Payments Outside the Ordinary Course of Business. BAPCPA §503(c)(3), which is a catch-all provision, prohibits all transfers and obligations "that are outside the ordinary course of business and not justified by the facts and circumstances of the case, including transfers made to, or obligations incurred for the benefit of officers, managers, or consultants hired after the date of the filing of the petition."

Are there "Loopholes?" There are a number of loopholes that potentially may assist a debtor in implementing a compensation program outside of BAPCPA §503(c)(1). Some of these loopholes have already been advanced by the Debtors in such large cases Refco, Musicland, FLYi, and Nobex, while other loopholes have yet to be tested.

Incentive Bonus Plans Based on Clear Performance Targets. One popular option is to steer clear of traditional KERPs and instead offer bonuses for achieving certain goals to key employees. In Nobex, the court approved an incentive plan for insiders in which the insiders' bonuses were tied to the amount of the sale price over the stalking horse bid pursuant to §503(c)(3). Likewise, in Musicland, the court approved the modified Corporate Management Incentive Plan in which the corporate executives' bonuses were based on: (i) the employee's contribution to the Debtor's operating and financial results; (ii) the extent of the employee's increased responsibility due to the Debtor's financial situation; and (iii) the employee's value to the business on a forward-looking basis.

Demote Insiders to Non-Insider Status. Another option is to demote key employees to a non-insider status pre-petition. According to the court in Refco, only current insiders under a post-petition KERP would be subject to the limitations imposed by BAPCPA §503(c).

Insiders Resign Pre-Petition and Rehired as Consultants or Advisors. This option is a way for a Debtor to avoid having a key employee fit within the definition of "insider" under either BAPCPA §§ 503(c)(1) or 503(c)(2). However, if a consultant is hired post-petition, any transfer made to them will most likely be subject to approval under BAPCPA §503(c)(3).

Insiders Resign Pre-Petition and Rehired Under Richer Employment Contract. Under this option, a debtor could essentially retain an insider by terminating them pre-petition and then rehiring them post-petition under a new employment contract at an increased salary point. However, it is possible that a party may object to this "new" obligation being incurred as a KERP in disguise under BAPCPA §503(c)(1). One possible way to get around this objection may be to reinstate the executive's pre-petition salary, but offer them extra compensation for meeting particular performance targets under the new employment contract. It is also foreseeable that the new employment contract would be subject to approval under BAPCPA §503(c)(3) since it is an "obligation incurred for the benefit of" an "officer…hired after the date of the filing of the petition."

Implement KERPs Pre-Petition. Another option is to implement a KERP pre-petition in order to avoid having to seek bankruptcy court approval. However, this option may be futile in that creditors may be able to later object to the pre-petition KERP on fraudulent transfer grounds under §548(a)(1)(B)(ii)(IV). (This provision was added to the Bankruptcy Code under the BAPCPA.) Under this provision, "the trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor…if the debtor…[1] received less than a reasonably equivalent value in exchange for such transfer or obligation; and [2] made such transfer to or for the benefit of an insider, under an employment contract and not in the ordinary course of business." The likely resulting debate will be over: (i) the value the Debtor received in exchange for the KERP payment; and (ii) if the KERP payment was in the ordinary course of business.

Business Liquidation Exception to § 503(c)(1). This option is only available to liquidating debtors. Under this option, the liquidating debtor would claim that §503(c)(1) is inapplicable to its proposed KERP because the term "business" in that subsection must be construed to refer only to a viable commercial business, and that a liquidation by definition is not a "business". This argument was raised by the Debtor in FLYi. FLYi also argued that even if a "business" existed after cessation of operations, the KERP was not designed to induce the insiders to remain with the Debtor's nearly non-existent business.

Reconfiguring a Retention Bonus into a Severance Bonus. In certain situations, debtors may be able to reconfigure a retention bonus into a severance payment in order to avoid the onerous §503(c)(1). For instance, where the debtor needs to incentivise insiders to consummate a going-concern sale of the debtor's business, the debtor can propose a severance (rather than retention) plan that contemplates the payment of bonuses to such insiders upon termination, which shall necessarily occur within a specified period of time after or upon the closing of the sale.

Post-confirmation Agreements and Court Approval

There will be a substantial amount of negotiation as part of the plan negotiation process as to what type of protection senior management would get on a post-confirmation basis. In these cases, senior management may be able to negotiate and consensually reach a deal with major creditor constituencies that they will receive a certain percentage of stock options or in-the-money warrants, as well as appropriate severance arrangements. Conversely, where the creditor constituency feels that the "jury is still out" on whether or not this management team would necessarily continue post-confirmation, a plan of reorganisation may provide that there will be a time period after the plan is confirmed when the new board of directors will evaluate senior management and determine at that point what type of employment contracts (with appropriate severance arrangements, stock options and warrants, etc.) will be offered to senior management.

Finally, it is essential that the Bankruptcy Court approve any preconfirmation severance arrangements with any employee (and certainly any senior level executive). Not surprisingly, Bankruptcy Courts will want to know the impact of these packages coming due because, once approved by the Bankruptcy Court, they will be administrative claims against the estate.

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Do the Recent Rulings in the General Growth Properties Bankruptcy Spell Doom for Equipment Debt Securitisations?

BY JAMES R. CAIRNS | WHITE & CASE LLP

Not necessarily so, according to the recent rulings of Southern District of New York Bankruptcy Judge Allan Gropper in the $27 billion General Growth Properties Chapter 11 bankruptcy – at least with respect to the issue of substantive consolidation. Judge Gropper's denial of motions to dismiss certain solvent special purpose entity (SPE) subsidiaries from the General Growth Properties bankruptcy confirms, however, that creditors of a solvent "bankruptcy remote" SPE should not assume that the SPE's "independent" director or manager will refrain from putting the SPE into bankruptcy when its parent also files. In denying the motions to dismiss, Judge Gropper ruled that the managers of the SPEs, including the independent managers, were within their rights and breached no law or duty when they decided to cause the SPEs to file for bankruptcy along with their parents, General Growth Properties, Inc. and General Growth Properties LP (General Growth), and nearly 400 of their affiliated companies. He made it clear in his published opinion, however, that permitting the solvent SPEs to remain in bankruptcy does not mean that they will be substantively consolidated with their affiliates.

Judge Gropper's ruling on the motions to dismiss and his prior approval of debtor-in-possession (DIP) financing allowing General Growth access to cash collateral generated by subsidiary SPE assets and pledged to the SPEs' lenders has sent shock waves through the debt securitisation and structured finance markets. While not necessarily killing off those markets, the General Growth Properties rulings will have a direct effect on the way rating agencies, lenders, underwriters and other creditors view traditional bankruptcy remote structures in equipment, as well as real property financings, particularly with respect to two of the basic tenets of securitisations and structured debt: (i) the owner of the securitized assets or collateral will remain out of reach of the equitable powers of a bankruptcy court; and (ii) such assets will not be used to support the bankruptcy estate of such owner's parent.

General Growth Properties, Inc. is a publicly traded real estate investment trust and general partner (with a 96% equity stake) of General Growth, a limited partnership that manages more than 200 shopping centers, many of which are owned by separate General Growth SPE subsidiaries and separately financed. Such management was done on a nationwide, integrated basis with General Growth providing centralised leasing, marketing, management, cash management, property maintenance and construction management services as well as the arranging of financing.

As in the case of other structured financings and debt securitisations, many of the General Growth SPEs were structured and capitalised in a manner to protect the interests of their secured lenders by ensuring that the assets and liabilities of each SPE were isolated from the affairs of the SPE's owner and affiliates. Separateness was sought so that each financing (generally, conventional mortgages and mortgages securitised through commercial mortgage backed securities) stood on its own merits, creditworthiness and value without reference to the financial stability of the SPE's owner.

In response to the recent collapse of capital markets, certain recent debt defaults and cross-defaults and looming maturities or "hyper" amortisations of secured and unsecured debt, General Growth, General Growth Properties, Inc. and 359 of their approximately 700 wholly-owned subsidiaries filed for bankruptcy protection under Chapter 11 in the Southern District of New York on April 16, 2009. Another 28 subsidiaries filed on April 22nd. At the time of filing, General Growth's shopping centre business had a stable and, generally, positive cash flow and was performing well, in spite of the current financial crisis.

The first big news to come out of this case (other than the bankruptcy filings themselves) was Judge Gropper's approval of General Growth's first day motion for the use of cash collateral belonging to certain of the General Growth SPE subsidiaries and pledged to their respective lenders. Notwithstanding the lenders' interest in the pledged cash, Judge Gropper, exercising his equitable powers, permitted the pledged cash to be upstreamed to General Growth in the form of DIP loans to finance General Growth's post-petition operations. Judge Gropper later affirmed this DIP financing over the objections of the SPE lenders, ruling that the separateness of the SPEs in bankruptcy did not preclude the court from exercising its equitable powers to permit the upstreaming of pledged cash to General Growth so that it may continue to manage the business and financing of its various SPE subsidiaries. Judge Gropper justified his ruling by granting the SPE lenders what he deemed to be "adequate protection" for the use of their collateral, including the payment of post-petition interest on the SPE debt at the non-default rate (the amortisation of principal, however, was suspended), the continued maintenance of the shopping centre properties by General Growth, a lien on the cash upstreamed and a second priority lien on other assets. Furthermore, the upstreamed cash would be treated as DIP loans, the repayment of which would be a superpriority administrative claim over which the SPEs' lenders would have a first priority lien. The DIP financing also included a $400 million loan by a consortium of lenders led by Farallon Capital Management secured by, among other assets, second priority liens on SPE assets pledged to the SPEs' lenders and first priority liens on unencumbered SPE assets.

Certain of the SPE lenders later filed motions to dismiss the bankruptcy proceedings of their respective SPE debtors on the grounds that their bankruptcies were initiated in bad faith. One SPE lender also asserted that there was no reasonable likelihood the SPE debtor would emerge from bankruptcy because the lender, which would control approval of any plan of reorganisation, would not approve a plan that would modify the terms of its financings. Each of the moving lenders asserted, without any substantial contradiction, that their respective SPE debtors had sufficient cash flow to cover their current debt obligations. In other words, the SPE debtors were not insolvent at the time of filing for bankruptcy.

Most, but not all, of the SPE debtors covered by the motions to dismiss were limited liability companies. Other than one SPE that was a trust, Judge Gropper did not distinguish in his published opinion between the SPEs that were limited liability companies and those that were not.

In a well-reasoned, detailed opinion, Judge Gropper denied all of the motions to dismiss. Under Second Circuit bankruptcy law, a Chapter 11 reorganisation case shall be dismissed upon a finding of both objective futility of the reorganisation process *and* subjective bad faith in filing for bankruptcy. A debtor does not have to be insolvent at the time of filing. Financial distress, alone, may be sufficient to overcome a claim that a bankruptcy was initiated in bad faith.

After considering the analyses, deliberations and actions of the SPEs' management boards, the SPEs' debt maturing or hyper-amortising within the next couple of years, the lack of refinancing available in today's capital markets, as well as the financial problems of the General Growth Properties group as a whole, Judge Gropper found neither of the two requirements necessary for dismissal. In justifying his consideration of the financial problems of the General Growth Properties group as a whole, Judge Gropper acknowledged the separateness of each of the SPE debtors and the intention of the SPEs and their lenders to make each SPE "bankruptcy remote".

On the other hand, he also noted the following: "Nevertheless, the record also establishes that the Movants each extended a loan to the respective Subject Debtor with a balloon payment that would require refinancing in a period of years and that would default if financing could not be obtained by the SPE or by the SPE's parent coming to its rescue. Movants do not contend that they were unaware 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 subsidiary would inevitably be impaired."

The organisational documents of some of the SPE debtors that the lenders sought to have dismissed from the bankruptcy required the appointment of one or more "independent" managers (i.e., individuals not affiliated with General Growth) whose votes would be necessary to put the SPE into a voluntary bankruptcy. Judge Gropper held that prior to insolvency, all of the managers, including the independent managers, owed duties to their respective SPE debtors and their members, notwithstanding statements in the SPE organisational documents to the effect that the independent managers were to consider only the interest of the SPE "including its creditors". This holding was based on the fact that the SPE organisational documents also provided that the independent managers would be subject to the same duties and loyalties required of a director of a Delaware corporation, which duties and loyalties require that the directors of a solvent corporation consider the interests of both the corporation and its shareholders in exercising their fiduciary duties (noting that under Delaware law the directors of an insolvent corporation may also owe duties to the corporation's creditors.)

According to Judge Gropper, if the SPE lenders believed that the independent managers served on the boards solely for the purpose of voting "no" to a bankruptcy filing for the benefit of the lenders "they were mistaken". The independent managers, burdened with the obligations and loyalties of a Delaware corporate director, owed their duties to the SPEs and, absent insolvency, the SPEs members, i.e., the General Growth group of companies. Accordingly, the independent managers acted within their rights and authority when they elected to put their solvent SPEs into bankruptcy in order to benefit the General Growth Properties group as a whole.

Much was made of the fact that independent directors of many of the SPE debtors were replaced just prior to the bankruptcy filings, with the replacement mangers providing the necessary votes. This was done on a confidential basis without informing the individuals (provided by Corporation Service Company (CSC)) being replaced. Judge Gropper found that replacing the CSC independent managers, none of whom had any particular real estate experience, with two "seasoned individuals" did not constitute bad faith sufficient to dismiss the bankruptcies.

Upon denying the motions to dismiss, Judge Gropper concluded: "The salient point for purposes of these Motions is 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. This includes protection against the substantive consolidation of the project-level Debtors with any other entities. There is no question that a principal goal of the SPE structure is to guard against substantive consolidation, but the question of substantive consolidation is entirely different from the issue whether the Board of a debtor that is part of a corporate group can consider the interests of the group along with the interests of the individual debtor when making a decision to file a bankruptcy case. Nothing in this Opinion implies that the assets and liabilities of any of the Subject Debtors could properly be substantively consolidated with those of any other entity."

Do the above rulings on the DIP financing and motions to dismiss mean the death of bankruptcy remote SPE securitisations? Probably not. The bankruptcy court's use of its equitable powers to permit SPE cash collateral to be used to finance the operations of the SPE's parent may have a chilling effect on future SPE debt securitisations and structured financings and will certainly increase the level of uncertainty in structured transactions. On the other hand, the denials of the motions to dismiss were based on established principles and should not change the perceptions or expectations of the rating agencies and capital markets with respect to the role of independent directors or managers (although Judge Gropper's opinion may be an uncomfortable reminder of those principles). In any event, the opinion preserves, for the time being, the primary goal of separateness in debt securitisations and structured financings, the avoidance of substantive consolidation.

With regard to the equitable powers issue, the best way to avoid being subject to such would be to keep an SPE debtor out of bankruptcy. Relying solely on an independent director or manager to vote "no" to bankruptcy is not going to work. Instead, rating agencies, arrangers, underwriters and other creditors should consider structures where the power and authority of a limited liability company SPE to file for a voluntary bankruptcy is limited to the SPE being insolvent or obtaining the consent of 100% of its members, with a nominal membership interest held by a representative of the SPE's lenders. Unlike the director of a corporation or the managers of the General Growth SPEs and subject to properly drafted organisational documents, a limited liability company minority member controlled by the SPE's lenders would owe no fiduciary or other duty to the SPE or the majority member. But even this would not be a fail-safe fix. The Bankruptcy Court should dismiss any Chapter 11 voluntary proceeding if the debtor had not, under the laws of the debtor's jurisdiction of formation, duly authorised the bankruptcy filing (for example, if the manager of a limited liability causes the company to file for bankruptcy without first obtaining the requisite member consent). Under Section 349 of Chapter 11 of the Bankruptcy Code, any such dismissal would generally unwind any prior Bankruptcy Court orders relating to the company's assets, but herein lies the rub, "[u]nless the court, for cause, orders otherwise."

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EUROPE

E U R O P E

European Cross-border Insolvency Wakes Up

BY TOMÁŠ BABÁCEK | AMBRUZ & DARK

Since the beginning of the global economic downturn, not only the Czech Republic, but practically all EU Member States report a steady increase of corporate downfalls. It is in this context that the Union coordination mechanism for cross-border insolvencies seems to be waking up, and the legislative investment made 10 years ago seems to have started paying off.

When One Goes European – and then Bankrupt

In recent decades, thousands of European entrepreneurs have become active in different Member States' markets. More and more creditors of one Member State therefore have had to enforce their claims against their insolvent business partners in proceedings held in a different Member State. That is why, in 2000, the European Community adopted Regulation 1346/200 on Insolvency Proceedings, aiming to relieve the European internal market from disputes over jurisdiction in cross-border insolvency cases.

One Union, One Insolvency

Instead of creating a single EU Insolvency Law, the Insolvency Regulation created a system of coordinating the application of the different national insolvency laws. Since 2002, as a principle, there is only one insolvency proceedings to be opened in the Union against a debtor, and this in the Member State and in accordance with the law of the Member State where the debtor's centre of main interests is placed. A judgment opening the respective proceedings shall automatically produce the same outcome in the rest of the Union (except for Denmark) that is prescribed by the law of the State in which the proceedings take place.

The centre of main interests is usually placed in the State in which the debtor is incorporated. However, based on factual circumstances, the respective court can come to a conclusion that, e.g., a Dutch letterbox company carrying out business almost exclusively in France will have a centre of main interest in France. The only fact that, e.g., a debtor is to a certain extent controlled by a parent company should not be a circumstance per se rebutting the presumption of the centre of main interests being placed in the State of incorporation.

One Exception

As an exception to the above rule, along the above main insolvency proceedings, other so-called secondary insolvency proceedings can be opened in the other Member States if a debtor's establishment is located there. The main effect of opening secondary insolvency proceedings is that the debtor's assets situated in the State of the secondary proceedings are singled out from the main insolvency proceedings and it is the liquidator for the secondary proceedings who becomes eligible to realise the debtor's assets. Secondary insolvency proceedings will be governed by the law of the State opening the proceedings. As opposed to the main insolvency proceedings which can also lead to reorganisation of the debtor's assets, secondary insolvency proceedings may be only winding up proceedings leading to realisation of the debtor's assets.

… and More Exceptions

The Insolvency Regulation is far from giving clear guidance on many aspects relevant to EU cross-border insolvencies. Many of the shortcomings can, however, be overcome through cooperation between the (potentially numerous) liquidators, and through the creditors' efficient involvement in the proceedings. Moreover, the aforementioned increase in insolvencies across the Union will inevitably lead to gradual clarification of the Regulation before the courts.

What to Do and Look For

Irrespective of the possible future clarifications or modifications of the EU Insolvency Law, creditors across the Union may consider following some generally applicable advice, including the following:

- When a company attempts to ascertain whether its contractual partner is subject to insolvency proceedings, they should not only look for information on local national insolvencies, but also on possible insolvencies taking place elsewhere in the Union (as the main insolvency proceedings opened in a different State will have a direct effect on the debtor's assets and creditors' rights in the Union). In some States, such information can be found more or less operatively through the respective public registers and databases (e.g., in Belgium, the Czech Republic, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands and Portugal). In the States where there is no such public register at hand, one should seek ascertainment from the counterparty.
- Where a creditor finds out that the main insolvency proceedings had been opened elsewhere in the Union and disagrees with the conclusion of a court in the Member State in that the debtor's centre of main interest is located there, they should appeal against the decision in the Member State where the main insolvency proceedings were opened. Except for some exceptional cases, courts of the other Member States will be bound by the conclusion of the first State's court as to the existence of bankruptcy and the location of the debtor's centre of main interests.
- Where one considers purchasing a debtor's assets from the liquidator in the main insolvency proceedings, they should make sure that, at the time of the acquisition, the respective assets had not become subject to secondary insolvency proceedings and powers of a secondary liquidator, and that the main liquidator thus remains eligible to the realisation of the assets.

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UNITED KINGDOM

The English Courts' Approach to Cross Border Insolvency Co-Operation

BY DEVI SHAH AND CATHERINE PEDLER | MAYER BROWN

Not surprisingly, the English courts have recently seen an increasing number of applications pursuant to the Cross Border Insolvency Regulations 2006 (the "CBIR"), which implement the UNCITRAL Model Law on Cross Border Insolvency (the "Model Law") in Great Britain. On the whole, the English courts have demonstrated an approach to these applications which is consistent with the principles of international cooperation embodied in the Model Law, an encouraging development for insolvency practitioners seeking recognition in Great Britain. The case of *Rubin & Anor v Eurofinance & Ors* [2009] EWHC 2129 (Ch) illustrates this approach.

Background

In this case, the Court considered an application under the CBIR by the joint receivers and managers of The Consumers Trust ("TCT") for recognition of the TCT bankruptcy proceedings in the US as foreign main proceedings and an order enforcing a default judgment of the US bankruptcy court, holding the respondents liable for the debts of TCT, as a judgment of the English courts. The US bankruptcy proceedings could apply to TCT as if it were a separate legal entity pursuant to the "Business Trust" classification under US law.

The TCT Entity

TCT was a business trust under US law, the beneficiaries of which were consumers who had claims in promotions owned or operated by the settlor of the trust. The promotions took place in the US and Canada but the administration of the promotions was carried out by the trustees in England. TCT was subject to litigation brought by the State of Missouri pursuant to consumer protection legislation which TCT settled by agreeing to pay out US$1.65 million plus costs.

The settlor formed the view that similar litigation was likely to be taken in other States and, accordingly, decided to institute bankruptcy proceedings with respect to TCT. The bankruptcy proceedings were instituted in the US because nearly all of the creditors of TCT were located in the US or Canada, all of the assets were in the United States and the bankruptcy procedure was available to TCT under the "Business Trust" classification under US law.

In appointing the joint receivers, the US bankruptcy court made an order authorising the receivers to make an application for recognition under the CBIR and to seek assistance from the High Court in relation to, among other things, enforcement of the default judgment of the US bankruptcy court in England.

The Application for Recognition

Insolvency proceedings will be afforded recognition as foreign main proceedings under the CBIR where those proceedings are a "foreign proceeding taking place in the State where the debtor has the centre of its main interests". It was common ground in this case that TCT's centre of main interests was in the US. Accordingly, if recognition were to be granted to TCT's bankruptcy, it would be recognition as a foreign main proceeding.

The only question for the court to decide, therefore, in relation to the recognition application was whether TCT was a "debtor" within the meaning of the CBIR.

The respondents argued that, although the term "debtor" is not defined in the CBIR, it must be given its ordinary meaning under English law. In other words, a debtor would have to be a legal entity recognised by English law, which a business trust was not.

The Court was not persuaded by this argument for three reasons.

- The drafting origins of the relevant terms are international, not domestic (as they are contained in the Model Law). Therefore, the terms should be interpreted having regard to those origins.
- The definition which is principally relevant to a recognition application is the definition of "foreign proceeding". In that definition, the key phrase is "in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court". In light of this definition, the Court was of the view that the word "debtor" ought to be given the meaning given to it by the foreign court in the foreign proceeding.
- Finally, article 8 of the Model Law provides that in interpreting the Model Law, regard must be had to its international origin and to the need to promote uniformity in its application. The Court found that these objectives would not be achieved were the courts of each country to adopt what was described as a parochial approach to interpreting the meaning of "debtor" and, as such, refuse to provide assistance in relation to a bona fide insolvency proceeding taking place in a foreign jurisdiction.

The Court briefly considered whether there would be any practical difficulty in making an order for recognition and in implementing the automatic stay on the commencement or continuation of proceedings that would arise as a result. The Court held that the stay would apply to both proceedings involving, or assets held by, the trustees such that it could be applied in practice.

The Court therefore held that TCT was a "debtor" for the purposes of the CBIR and that recognition ought to be granted to the insolvency proceedings as foreign main proceedings.

In attempting to defeat the recognition application, the respondents also argued that the receivers were seeking recognition pursuant to separate proceedings, described as the "adversary proceedings" which could not be considered to be foreign proceedings within the meaning of the CBIR. The Court was not persuaded by this argument as the adversary proceedings were an integral part of the TCT bankruptcy proceedings and were a court sanctioned mechanism for getting in the assets of TCT. The Court noted that a purposive approach should be given to the provisions of the CBIR, the purpose of which is to facilitate cooperation between different jurisdictions in relation to bankruptcy proceedings. The fact that the adversary proceedings were additional proceedings to the primary bankruptcy proceedings ought not to be used to prevent recognition of those proceedings.

The Application for Assistance in Relation to the Default Judgment

In considering the receivers' application for assistance with respect to enforcing the default judgment in England, the Court demonstrated that there are limits to the assistance it will provide to foreign insolvency practitioners where that assistance is contrary to principles of English private international law.

The Court was not prepared to make an order enforcing the judgment against the respondents pursuant to the CBIR because, absent the insolvency of TCT, that judgment could only have been enforced by TCT at common law. A precondition to such enforcement is that the defendants have in some way submitted to the jurisdiction of the foreign court, which they had not done in this case as the judgment was obtained in default of appearance. The Court held that its discretion to cooperate with foreign courts or foreign representatives should not be exercised in a manner that is inconsistent with the principles of its own legal system and rules of private international law. Accordingly, given that the judgment was unenforceable at common law, the court declined to make an order for enforcement under the CBIR.

Comment

This case sets a helpful precedent for insolvency officeholders seeking recognition of their appointment over entities which may not be recognised under English law and demonstrates the willingness of English courts to provide assistance to foreign officeholders consistent with the spirit of the Model Law as implemented by the CBIR. However, the Court in this case would not go as far as exercising its discretion to provide assistance if that would, as it saw it, elevate the status of the default judgment beyond what it would have enjoyed had TCT not been in insolvency proceedings. Therefore, although the recognition application was successful, the decision effectively leaves the creditors of TCT without remedy unless TCT's receivers can find jurisdiction to bring the claim against the respondents again in England. The case is subject to an appeal, due to be heard in late January 2010.

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Charterparties, Conscionability and Comity: the English Courts can Protect the Assets of a Company in Administration from Foreign Attachments and Executions

BY DEVI SHAH AND CATHERINE PEDLER | MAYER BROWN

The Court of Appeal in Harms Offshore AHT "Taurus" GmbH & Co KG & another v Bloom, Dempster, Burton and Bailey as Joint Administrators of Oilexco North Sea Limited & another has confirmed that the English courts have jurisdiction to protect the assets of a company in administration where those assets are outside the UK from foreign process, but that the court will only make orders protecting those assets in exceptional circumstances. Creditors that seek to attach assets outside the UK may therefore face injunctions effectively requiring them to give up claims advanced in any foreign process.

The case also serves as a reminder to administrators that they should consider making applications for recognition of an administration order in foreign jurisdictions in which the company has assets or may be transferring assets during the course of the administration, where that process is available to them.

The Facts

On 7 January 2009, the Companies Court made an administration order in respect of Oilexco North Sea Limited ("Oilexco") and appointed the first four Respondents as administrators (the "Administrators"). On the application of the Administrators, the Companies Court also made an order authorising them to enter into a loan agreement with specified lenders and to draw down funds under that loan agreement to enable them to pay post-administration expenses such that they could achieve the purpose of the administration.

The Appellants were pre-administration creditors of Oilexco pursuant to time charterparties of two vessels. The charterparties were governed by English law and included an arbitration agreement requiring any dispute arising under them to be referred to arbitration in London.

On the date of their appointment, the Administrators wrote to the creditors of Oilexco, including the Appellants, informing them that it had entered administration and that the Administrators were carrying on Oilexco's business with a view to realising a sale of Oilexco, its business or its assets.

On 9 January 2009, without notice to the Administrators, the Appellants commenced proceedings in the United States District Court for the Southern District of New York (the "District Court") under its admiralty and maritime jurisdiction seeking judgment for the sums due from Oilexco under the charterparties and attachment and garnishment of Oilexco's property in New York sufficient to satisfy that judgment. The Appellants' complaint before the District Court made no mention of Oilexco's administration or of the London arbitration agreements in the charterparties. On 21 and 26 January 2009, the District Court made ex parte orders attaching the property of Oilexco within New York, which extended to property held for its benefit or moving through or within the possession of 19 named banks. The Appellants did not notify the Administrators of the US proceedings or the orders they had obtained for some two months after the orders were made.

In ignorance of the orders, the Administrators made a significant payment to a post-administration supplier's account that was held with one of the banks that had been served with the attachment orders. That payment was consequently attached.

The Administrators sought a mandatory injunction from the Companies Court requiring the Appellants to use their best endeavours to procure the release of the attachment orders made by the District Court. The Administrators contended that the release of the attachment orders was necessary for them to be in a position to vacate office and complete the sale of the shares of Oilexco that was to be effected as part of a company voluntary arrangement. The Administrators also separately sought an order from the US Bankruptcy Court that the attachment orders be vacated on the basis that the Bankruptcy Court in New York should recognise the administration order under the principles of comity embodied in Chapter 15 of the US Bankruptcy Code (by which the US has adopted the Model Law on Cross-Border Insolvency promulgated by the United Nations Commission on International Trade Law in 1997).

At first instance, the Companies Court granted the mandatory injunction sought by the Administrators and also made an order restraining the Appellants from taking any steps in the substantive proceedings they had commenced in the District Court for judgment of the sums due from Oilexco. The appeal was heard urgently on 20

May 2009, the same day that the US Bankruptcy Court was due to hear the Administrators' separate application. The Administrators' application before the US Bankruptcy Court was successful and the Court made an order granting recognition of Oilexco's administration as a foreign main proceeding under Chapter 15.

The Issues on Appeal

The Appellants contended that the stay of legal process against a company in administration pursuant to the Insolvency Act does not have extra-territorial effect and that the assets of a company in administration (unlike those of a company in liquidation) are not subject to a trust that would justify anti-suit injunctions against creditors of that company. Further, the Appellants argued that the principles of comity (or reciprocity between the English courts and the US courts) require the English courts to refrain from interfering with proceedings before the US courts.

Counsel for the Administrators submitted that the actions of the Appellants interfered with the Administrators' exercise of their functions and that the subject matter of the US proceedings had no connection with that jurisdiction. Accordingly, it was appropriate for the Companies Court to grant the mandatory injunction in these circumstances.

The Decision

The Court of Appeal referred to the long established principle that the statutory prohibition against creditors bringing proceedings against a company being wound up by the court does not have extra-territorial effect. However, where a company is in liquidation, it is accepted that the property of that company is subject to a trust such that the property may be protected from legal process in any jurisdiction. The Court of Appeal did not see any reason why that protection should not be afforded to the assets of a company in administration and, therefore, concluded that it had jurisdiction to protect the assets of a company in administration even where those assets are outside the UK.

The Court of Appeal went on to say that whether that jurisdiction will be exercised in any particular case will depend on the facts of the case and "must be tempered by considerations of comity". While the Court of Appeal accepted that there is a strong presumption that the English courts will not interfere with the proceedings of a foreign court, the conduct of the Appellants before the District Court and subsequently justified the English courts acting in this case. In particular, the Court of Appeal relied on, among other things, the fact that the District Court made the attachment orders in ignorance of the administration of the Company and the arbitration agreements and that, by failing to promptly inform the Administrators of the orders of the District Court, the Appellants effectively set a "trap" for the Administrators who allowed funds to be transferred into the US which were then attached by the orders. In this regard, the Court of Appeal found the conduct of the Appellants to be unconscionable. Further, the Court of Appeal noted that the funds transferred by the Administrators were the proceeds of a loan entered into pursuant to an order of the Companies Court that was made to allow the Administrators to continue to trade the company and pursue the purposes of the administration. Accordingly, the attachment orders interfered with the performance by the Administrators of their functions and duties.

For these reasons, the Court of Appeal was prepared to uphold the injunction granted against the Appellants.

Comment

It is clear that the Court of Appeal was persuaded to exercise its jurisdiction to protect Oilexco's assets in this case by the conduct of the Appellants before the District Court and subsequently. However, it seems that the

District Court may have approached the Appellants' application differently had they been made aware of all the relevant facts relating to Oilexco's administration. In any event, the Court of Appeal has demonstrated that it will be prepared to exercise its jurisdiction to protect the assets of a company in administration where those assets are outside the UK and where the court is persuaded that a creditor has acted in a manner that interferes with the orderly administration of that company's assets.

The Court of Appeal also commented that administrators generally should be aware of the jurisdiction of the District Court to make orders attaching payments passing through New York and that, as such, it may well be unsafe for administrators to make payments through New York bank accounts without first having obtained recognition of the administration as a foreign proceeding under Chapter 15 of the Bankruptcy Code.

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Court of Appeal Guidance on the "Anti-Deprivation" Rule

BY DEVI SHAH AND ALEXANDRA WOOD | MAYER BROWN

In a recent decision in two combined appeals the Court of Appeal considered the scope of the "anti-deprivation" principle. The decision involved the appeals of *(1) Perpetual Trustee Co Ltd (2) Belmont Park Investments Pty Ltd v (1) BNY Corporate Trustee Services Ltd (2) Lehman Brothers Special Financing Inc; and (1) Butters (2) Kahn (3) Dargan (joint administrators of WW Realisation 8 Ltd & Woolworths Group Plc) v (1) BBC Worldwide Ltd (2) 2 Entertain Ltd (3) BBC Video Ltd* [2009] EWCA Civ 1160.

The "anti-deprivation" principle is the rule that "there cannot be a valid contract that a man's property shall remain his until bankruptcy, and on the happening of an event shall go over to someone else, and be taken away from his creditors". In effect, contracting out of the pari passu rule of distribution is contrary to public policy.

In its decision the Court of Appeal afforded the anti-deprivation rule a very narrow interpretation, being little more than a direct application of the *pari passu* principle of distribution enshrined in the insolvency legislation. Compliance with the statute in this regard is both the foundation of the rule and its only rationale. A wider rule of public policy which invalidates contractual provisions merely because they reduce the value of the insolvent estate was rejected.

Background to the Perpetual Appeal

The Court of Appeal gave its ruling in two combined appeals.

Perpetual was concerned with a synthetic CDO. An SPV formed by a Lehman entity (the "Issuer") issued credit-linked notes to investors ("Noteholders") as part of the "Dante" note programme. With the subscription monies paid for the notes certain collateral was purchased. The Issuer entered into a swap agreement with a Lehman company (Lehman Brothers Special Financing Inc, which filed for protection under Chapter 11 of the US Bankruptcy Code on 3 October 2008) under which LBSF paid to the Issuer the amounts due by the Issuer to the Noteholders in exchange for sums equal to the yield on the collateral. The Issuer charged the collateral in favour of a trust corporation to secure its (the Issuer's) obligations to the Noteholders and to LBSF on terms which changed their respective priorities (the "flip") on the occurrence of certain specified events, including the insolvency of LBSF.

The "flip" was worded in the Supplemental Trust Deed and Drawdown Agreement as follows: "The Trustee shall apply all moneys received by it under this Deed in connection with the realisation or enforcement of the Mortgaged Property as follows: Swap Counterparty Priority unless … an Event of Default … occurs under the Swap Agreement and the Swap Counterparty is the Defaulting Party…in which case Noteholder Priority shall apply."

"Swap Counterparty Priority" meant that the claims of LBSF were payable in priority to the claims of the Noteholders, whereas "Noteholder Priority" meant the converse, in each case after providing for payment of certain specified costs and charges.

Those administering the estate of LBSF contended that the anti-deprivation rule applied so as to vitiate the "flip". The Court at first instance did not agree and found in favour of the Noteholders, upholding the contractual structure put in place by the parties. The Court of Appeal upheld the first instance decision, with the Master of the Rolls and Patten LJ giving the substantive judgments.

Background to the Woolworths appeal

The appeal in *Woolworths* arose from the administration of Woolworths Group Plc ("Group") and Woolworths Media Plc (now WW Realisation 8 Ltd) ("Media").

An entity (2e) was owned by BBC Worldwide ("BBCW") and Media pursuant to a joint venture agreement (JVA). Further, Video (a subsidiary owned by 2e), was granted an exclusive but non-assignable licence to exploit BBCW's video and DVD catalogue.

The licence ("MLA") was terminable on the insolvency of Group (the "termination provision"). However, such termination was dependent upon the service of a notice under the JVA pursuant to which BBCW would become unconditionally bound to buy Media's shares in 2e (the "option"). BBCW had to pay fair value for the shares, however, the valuation exercise had to take into account the status of the licence.

The administrators of Group and Media argued that the combined operation of these provisions infringed the anti-deprivation rule. Peter Smith J at first instance agreed and imposed various amendments to the contractual provisions to rectify this. On appeal the Court of Appeal concluded that the provisions did not infringe the anti-deprivation rule and therefore Peter Smith J's "blue-pencilling" exercise was unnecessary.

The Master of the Rolls and Patten LJ gave the substantive judgments.

The Court of Appeal's Decision

Woolworths

There was nothing in the termination provision or the option, whether taken together or separately, which could engage the anti-deprivation rule.

The invocation of the termination provision did not involve what was the property of the insolvent party becoming vested in a third party, it merely involved a limited interest being brought to an end, in accordance with its terms, by a third party grantor. The option plainly did involve property which had been owned by a party who is now insolvent becoming vested in a third party. However, it did not fall foul of the anti-deprivation rule as the disposal was for market value.

Perpetual

The only interest/property which LBSF had in the collateral was the charge granted by the Issuer. That security interest remained part of the property unchanged by the bankruptcy of LBSF. The reversal of the order of priority was always a facet of the security designed to regulate the competing interests of the collateral between LBSF and the Noteholders. To say that its operation in the event of LBSF's bankruptcy constituted a removal of the asset from the liquidation was to confuse the security itself with the operation of its terms in the events prescribed by the charge. Patten LJ reached his conclusion that the anti-deprivation rule did not apply on the basis that the flip could not be caught by the rule (even if it operated after the liquidation of the company – see below in relation to timing) at least in so far as the reversal was an original feature of the charge. The Master of the Rolls had considerable sympathy with that view but ultimately he reached his conclusion on more limited grounds. He was persuaded by the fact that the assets over which the charge existed were acquired with money provided by the chargee in whose favour the flip operated and that the flip was included merely to ensure, so far as possible, that the chargee was repaid out of those assets before LBSF received any money from those assets pursuant to its charge.

Application of the Rule

The Court of Appeal concluded that the anti-deprivation rule had no application where the deprivation had been effected by the time the winding up order (or equivalent bankruptcy or administration order or Chapter 11 filing) had been made against the company which was deprived.

The argument that the rule could be triggered if a company was merely insolvent (and no winding up order, or its equivalent, had been made) was rejected as it would lead to uncertainty (therefore the suggestion in *Fraser v Oystertec PLC* [2004] BPIR 486 that the anti-deprivation rule can apply to invalidate contracts even when no bankruptcy or winding-up order is ever made should not be followed).

Further, the winding up (or equivalent) of another entity (such as a parent company), even if closely connected to the company which is deprived, was not sufficient.

Determination of a Limited Interest

The Court of Appeal confirmed that the ability of a company to determine a limited interest (such as a lease or licence) which it has granted over its own property does not infringe on the anti-deprivation rule because it does not remove from the insolvent estate property in which, prior to the insolvency, the company ever had an unfettered interest. The liquidator is bound to take the lease/licence on the terms on which it was granted.

Conclusion

The Court of Appeal's decision clarifies certain aspects of the scope and application of the rule. However, as the Master of the Rolls said in his judgment ".... because of the multifarious, sophisticated and increasingly complex arrangements contained in modern financial instruments, such as the synthetic collateralised debt obligations in these proceedings, it is probably inevitable that the courts must develop the law in this area, at least for the moment, on a relatively cautious, case-by-case basis".

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No Jurisdiction for Lehman Scheme Dealing with Client Assets

BY IAN MCDONALD AND KRISTY ZANDER | MAYER BROWN

On 6 November 2009, the English Court of Appeal unanimously held that the Court did not have jurisdiction to sanction a scheme of arrangement proposed by the administrators of Lehman Brothers International (Europe) (LBIE) with respect to trust assets held by LBIE as trustee. This decision was of critical importance, not only to those whose assets are tied up in the LBIE estate, but also to depositors and others who rely on the sanctity of the English trust as a pillar of the English banking and financial system.

The Facts

The essential element of an English trust, which is a legal concept dating back to the Crusades, is that whilst the trustee may be the holder of bare legal title to the assets, it is the beneficiary who is the beneficial owner of the assets. As such, assets held on trust do not form part of the trustee's estate available for distribution to ordinary unsecured creditors and must instead be returned to their rightful owner on demand.

At the time it went into administration on 15 September 2008, LBIE held assets on trust for clients, particularly for hedge fund clients through its prime brokerage business. As a part of that business, LBIE came to hold securities on trust for its clients, either as custodian or by holding positions on a charge basis as collateral. LBIE also held various property on trust for its affiliates across the world, as custodian or sub-custodian. In turn, those affiliates (which are in insolvency proceedings in their respective jurisdictions) may have held the assets on trust for their own clients.

Since the early days of the administration, the administrators of LBIE have encountered a number of challenges in identifying and returning trust property to its clients and affiliates. The administrators have recently estimated that LBIE is currently holding (directly or indirectly) up to approximately US$18.9 billion worth of trust assets, of which approximately US$11.4 billion is within the administrators' direct control. However, due in large part to the dismal state of the records kept by the Lehman Brothers companies, the administrators still do not have a clear picture of precisely what assets are held on trust, on what terms and for which client or clients. LBIE did not always hold the assets itself, but rather held them through third party and affiliated banks, custodians, agents, counterparties, exchanges and clearing houses and LBIE still does not have control of all of those assets. Some holdings of trust property were held subject to contractual security or set-off rights. In addition, it seems likely that there will be shortfalls in relation to some or all classes of assets on trust and the administrators face the daunting task of determining a method of distributing trust assets to their owners without exposing themselves to the risk of claims for breach of trust in the event of the subsequent emergence of competing claims to the assets.

To move matters forward, the administrators of LBIE proposed that a scheme of arrangement be implemented to effect a process for the distribution of the trust assets to their beneficial owners. A scheme of arrangement is an arrangement between a company and its creditors (or members) pursuant to the Companies Act 2006. It must be sanctioned by a 75 percent majority of various classes of creditors, and by the Court. When effective, it binds all creditors (including those who did not vote in favour of the scheme).

The administrators originally sought leave from the Court to propose the scheme of arrangement to trust claimants. Counsel for the London Investment Banking Association appeared at the hearing to question whether the Court had jurisdiction to sanction such a scheme and the administrators subsequently sought directions from the Court in relation to the issue of jurisdiction. Mr Justice Blackburne decided, on 21 August 2009, that the Court did not have jurisdiction to sanction such a scheme. The administrators then appealed to the Court of Appeal.

The issue on appeal (as in the judgment at first instance) centred on whether a person for whom LBIE held assets on trust could be regarded as a "creditor" and thus whether the proposed scheme of arrangement could apply to compromise proprietary claims against LBIE for the return of trust property held by LBIE as trustee.

The Decision

The Court held that a person with a purely proprietary claim against a company is not its "creditor". Since "creditor" is not defined in the Companies Act 2006, the Court gave effect to the ordinary conventional sense of the word "creditor" as someone with a pecuniary claim against the company.

The administrators submitted, as they had done in the Court below, that trust claimants were "creditors" insofar as they had a pecuniary claim against LBIE (for example, for damages for breach of trust). The administrators argued that once a person is a creditor, they can be caught by the scheme even in relation to non-pecuniary claims. The Court rejected that argument as being inconsistent with the intention of Parliament. The Court found that such a pecuniary claim is merely incidental to the trust claim and, in any event, the fact that someone is a creditor in connection with a different claim does not justify him being treated as a creditor for the purpose of the proprietary claim.

The administrators also sought to rely on authority to the effect that the Court has jurisdiction to sanction a scheme of arrangement affecting proprietary rights held by secured creditors. However, the Court distinguished the position of secured creditors (who, despite having security over property, hold that security only in their capacity as creditors of the company, only for so long as the underlying indebtedness continues and subject to the company's equity of redemption) from that of beneficiaries under a trust.

In addition, the administrators sought to rely on the decisions in *Re T&N Limited (No. 3)* [2006] EWHC 1447 and the Australian case of *Re Opes Prime Stockbroking Limited* [2009] FCAFC 125, in which it was held that schemes of arrangement can extend to release rights against third parties related to, and essential for the operation of, the scheme. Those decisions are not without controversy and, interestingly, both Lord Neuberger MR and Patten LJ indicated, obiter dicta, that they considered them to be correct. However, those decisions did not assist the administrators in this case.

Implications

For those parties whose assets are tied up in the LBIE administration, the decision may result in the passing of further time (and the expenditure of additional costs) before the return of the assets. The administrators have indicated that they are considering alternative options for facilitating the return of trust assets.

The Court has recently made an order that a bar date of 19 March 2010 be set for trust claimants to lodge claims in relation to trust assets held by LBIE. This means that the administrators will be protected from breach of trust claims if, after that date, they distribute trust assets on the basis of information then available to them. In addition, the administrators have made a proposal to trust claimants inviting them to bind themselves voluntarily to a proposed contractual settlement. The settlement is in similar terms to the proposed scheme of arrangement, except that those who do not agree to the settlement will not be bound by its terms. The administrators have reported that a high threshold (by value) of trust claimants signed up to the settlement and it became operational on 29 December 2009. The practical effect of the settlement on those remaining trust claimants who did not sign up to it, remains to be seen.

In addition to the impact of the Court of Appeal's decision on those directly affected by the LBIE administration, the decision has important implications for the world of English trust law. The concept of an English trust, and the sanctity of assets held on trust, permeates England's legal and financial systems. The Court has shown its inclination to protect the trust concept and not to allow the interests of trust beneficiaries to be "crammed down" by use of a scheme of arrangement. The comments made by certain of the Appeal judges supporting the concept that companies proposing schemes of arrangement can extend such schemes to release claims against third parties will also be of general interest to the restructuring community.

While the decision of the Court of Appeal will not have surprised many, it will be interesting to see, given the very significant complexities that the LBIE administrators face, whether their alternative proposals for dealing with trust assets meet with any success.

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Reaction to the Statement of Insolvency Practice 16

BY MORGAN BOWEN | MOON BEEVER

Statement of Insolvency Practice 16 became effective from 1 January 2009. It sets out guidance notes to insolvency practitioners on the proper conduct of so-called "pre-packs". A pre-pack is defined therein as "an arrangement under which the sale of all or part of a company's business or assets is negotiated with a purchaser prior to the appointment of an administrator and the administrator effects the sale immediately on or shortly after his appointment". As a consequence, administrators now have to make extensive written disclosure to creditors in all cases where there is a "pre-pack".

History

The prevailing view under the old authorities was that permission of the court was needed where an administrator wished to sell prior to the section 24, Insolvency Act 1986 creditors' meeting. At such an application, the company would need to provide independent valuation evidence and evidence that any delay in the sale process would lower the going concern value of the assets being sold.

However, in In *re T & D Industries Plc* [2000] 1 WLR 646, Neuberger J held that permission of the court was not needed for such pre-pack sales. In fact, Neuberger J held that the decision on whether or not a pre-pack sale should occur was a decision best taken by the administrator himself, not the court and that it was inappropriate for the court to be used as "a sort of bomb shelter" for the administrator.

The power of the administrator to sell on a pre-pack basis without the approval of the court survived the introduction by the Enterprise Act 2002 of Schedule B1 to the Insolvency Act 1986.

The Problems Presented by Pre-Packs

Notwithstanding the fact that the administrator has the power in law to engage in pre-pack sales without court approval, the creditors of course retain the full panoply of powers laid out in the Insolvency Act post-sale, including the power to apply for an order by the court removing the administrator – this power is contained in para 88 of Schedule B1. Just such a removal was ordered by the court in the recent case of *Clydesdale Financial Services v Smailes* [2009] BCC 810 where David Richards J held that, in the specific circumstances of that case, the terms of the contract for the pre-pack sale and the circumstances that led to its promulgation did give rise to a legitimate concern that warranted an investigation by an appropriate office holder and that, as the administrator, Smailes, had been so closely involved with the negotiations that gave rise to the eventual contract, it would be difficult for him to conduct such an independent review, thus necessitating his removal pursuant to para 88 of Schedule B1. Pre-packs thus represent a veritable minefield for practitioners as they cannot hide behind the approval of the court and yet may find themselves open to attack by creditors. Nevertheless, there are many occasions where pre-packs are the best way of preserving going concern value and the only way of preserving jobs and, in appropriate circumstances, must continue to be used by administrators.

As the recession has bitten and as the number of administrations in general has risen, increasing concerns have been expressed by creditors as to the general practice of pre-packs, particularly where there is a pre-pack sale back to existing management. SIP 16 has been issued in this context with the intention of improving in each administration the creditors' understanding of the underlying rationale for the pre-pack. Close compliance with it should definitely assist an administrator in preventing subsequent successful attacks by creditors seeking her removal.

What Does SIP 16 Say?

The key substantive provisions of the statement relate to disclosure by the administrator to the creditors and are contained in para 9 of the statement. The following information is to be provided by the administrator to all creditors on all pre-packs unless there are exceptional circumstances and, if there are such exceptional circumstances, the reason why the information is not provided should be stated:

- the source of the administrator's initial introduction;
- the extent of his involvement prior to the appointment;
- any marketing activities;
- any valuations;
- any alternative courses of action considered;
- why it was not possible to market the business as a going concern and sell it in the administration;
- what efforts were made to consult with major creditors;
- the identity of the purchaser;
- any connection between the purchaser and the directors or shareholders;
- the names of any directors or former directors who are involved in the management or ownership of the purchaser;
- details of the assets involved and the nature of the transaction;
- the date of the transaction;

- if the sale is part of a wider transaction, a description of other aspects of the transaction;
- the consideration for the transaction and payment terms (including any conditions that could materially affect the consideration;
- any options, buy-back arrangements or similar conditions in the contract of sale;
- details of requests made to potential funders for working capital; and
- details of any guarantees given by any of the directors to any prior financier and whether that financier is financing the new business.

By para 11, unless it is impracticable to do so, the disclosure should be provided with the first notification to creditors and, in any case where there has been a pre-pack, the administrator should hold his initial creditors' meeting as soon as possible after his appointment.

The Insolvency Service's Report on the First Six Months' Operation of SIP 16

The Insolvency Service has subsequently issued its Report on the first six months' operation of SIP 16. In its executive summary, the Service stated that information relating to 370 out of a total of 572 companies in administration was compliant with the disclosure requirements of SIP 16, representing 65% of the total. The Service stated however that failure to comply with SIP 16 did not imply misconduct in the pre-pack itself. In many cases, apparent non-compliance could be attributed to early differences in interpreting the requirements of the guidance. However, in 17 of the cases reviewed the insolvency practitioners' conduct was such as to warrant its being referred to their authorising bodies.

The report went on to state that there did remain significant room for improvement in the information provided in a good proportion of cases. In particular there were three areas where improvements in the compliance with SIP 16 was expected going forward.

Firstly, the timing of the statements: given that all the relevant details would usually be known to the insolvency practitioner at the time of appointment, it could ordinarily be expected that the information could be sent to creditors upon completion of the sale. Secondly, failure to provide full details of a valuation or marketing exercise was a common weakness in the SIP 16 information, and of particular concern. Without details of the value placed on assets, it would usually be very difficult for creditors to determine whether the pre-pack sale was in their interests. Thirdly, it was highly important that any connection between the insolvent company and the purchaser of its business be fully disclosed. Failure to do so could give rise to the perception that the directors and insolvency practitioner had colluded to withhold this information from creditors, with a consequent loss of confidence in the integrity of the sale and the insolvency regime as a whole. A further report is expected early in 2010.

The Insolvency Service has since issued further guidance which is at para 14, Chapter 1, Dear IP on the Insolvency Service's website.

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Insolvency – What Does it Mean for Scottish Companies?

BY ALISTAIR DRUMMOND AND STEVEN JANSCH | BIGGART BAILLIE LLP

With many high profile names recently hitting the headlines for all the wrong reasons this article looks at the main types of insolvency in Scotland, how they differ, and what this means to you if you are a creditor.

CVA

A CVA is a flexible tool that should not be overlooked by companies in financial difficulty as a means of securing the future survival of the company. It is a proposal made by a company to its creditors to compromise or settle its debts in some way. If approved by 75% by value of the company's creditors it is binding on all the creditors for so long as the company complies with its terms. This is a flexible procedure as there are no restrictions on what the proposals must be in relation to settling liabilities but the creditors must agree to it before a CVA will be approved and become binding.

There is no moratorium (other than in the case of some small company CVAs) against actions by creditors, as would be the case in administration, so a company considering a CVA has to consider this factor against the flexibility of the proposals that are possible. In a CVA the existing management are also able to carry on managing the business in accordance with the terms of the CVA (directors can no longer act when an administrator is appointed and control of the business is lost to the insolvency practitioner as outlined below).

The majority of major creditors should be contacted in advance of a CVA proposal being finalised for approval if the now publicly analysed experiences from the recent unsuccessful Powerhouse CVA as against the successful JJB Sports CVA are to be learned. If you are a creditor of a company that is considering a CVA you will therefore likely be contacted before a CVA proposal is made public for your consent in principle. Your decision at that point is likely to be sought on the basis that receiving some money through a CVA will be better than receiving less through some other form of insolvency. Each CVA is necessarily bespoke so each decision will need to be taken based on its particular proposals.

Administration

Administration is a procedure available under the Insolvency Act 1986 which allows a company's affairs to be reorganised or its assets realised under the protection of a moratorium preventing its creditors pursuing their debts.

The Insolvency Act sets out the purpose of administration as being:

- rescuing the company as a going concern (the primary objective);
- achieving a better result for the company's creditors as whole than would be likely if the company were wound up (the second objective); or
- realising property in order to make a distribution to one or more secured or preferential creditors (the third objective).

A practice has developed in some cases of selling the business immediately following the appointment of the administrator to a purchaser who has agreed the terms of purchase with the proposed administration prior to his appointment. This has become known as a "pre-pack". With the sale proceeding before the administrator has put his proposals to creditors. A quick sale may be best for all creditors as it can maximise sale value before there is a loss of confidence in the business. The Insolvency Service has now issued guidelines requiring more transparency in the process.

From the creditor's perspective, one of the most significant aspects of administration is that from the time at which the notice of intention to appoint an administrator is filed at court or an application is made for a court appointed administrator, a moratorium takes effect for the period of the administration, initially 12 months. That prevents any action being taken against the company without the administrators (whomfailing the Court's) consent so as to allow the administrator a period within which to try and achieve the purpose of the administration.

Liquidation

Liquidation is the winding-up of a company, the realisation of its assets to pay its creditors after which the company ceases to exist. Liquidation is a last choice for companies facing financial difficulties and is often referred to as the ultimate debt recovery method because of its finality.

As with Administration, a moratorium arises so that the insolvency practitioner who takes over from the existing management can deal with the liquidation process without becoming embroiled in any one particular dispute with a creditor. Unlike administrations the moratorium arises automatically but again pre-pack sales are not uncommon.

If you are a creditor of a company that has gone into liquidation you will be asked to file a claim and supporting evidence with the liquidator but will not receive any payment until after completion of all the statutory procedures that the liquidator has to undertake. That procedure involves the gathering in all of the assets of the company and realising those assets (often including the sale of the business as a going concern). Creditors are then paid out in order of the priorities laid down by statute. If the debt is an unsecured one, the best advice for creditors is normally to write off the debt as a bad debt (claiming back bad debt tax relief if appropriate) with any sums eventually received in satisfaction of their claim (usually a pence in the pound dividend) being treated as a windfall. The payment of any dividend will not be made for a significant period of time, generally at least 12 months after the start of the liquidation process, but often a good deal later than this.

So What Does it all Mean?

Of the three main types of insolvency outlined above, it is only liquidation that results in the company ceasing to exist. Even then there may be a sale of the business as a going concern. Keeping open lines of communication with the company (whether that be with the existing management or the insolvency practitioner who has been appointed) will always help you to manage the insolvency process. As a creditor of a company that says or goes into any form of insolvency it is crucial that you take proper advice on what that entails and where it leaves you as a creditor as soon as possible, particularly as there can be an ability to challenge the company or it's directors' actings through the insolvency or a parallel procedure.

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GERMANY

Trust Agreements (Treuhandverträge) as Restructuring Tools

BY PETER H. HOEGEN AND KARSTEN RAUPACH | ALLEN & OVERY

German law governed trust structures, which clearly differ from the concept of English trusts, have proved to be a viable means to achieve successful out-of-court restructurings of distressed companies in Germany. Such German trust structures regularly base on the idea that the distressed borrower or its shareholder, as the case may be, as trustor (the "Trustor") transfer part of their assets (e.g., the shares in the holding company as key assets of the group) (the "Trust Assets") (Treugut) to a trustee (the "Trustee") which will acquire legal ownership of the Trust Assets but will hold them on trust for the Trustor and, as the case may be, for the lenders as beneficiaries. Such transfer of key assets from the distressed borrower or its shareholder to the Trustee, which will be vested with a certain mandate taking into account the interest of the lenders, can stabilise the distressed group and provide for a viable structure fitting with the individual restructuring concept and even serve as security for the lenders. The lenders may be incentivised to support the restructuring of the distressed company, e.g., by entering into standstill agreements and/or making available further facilities (i.e., bridge facilities or restructuring facilities).

Generally, there are different kinds of trust structures according to their respective purposes. If the purpose of the trust is that the Trustee merely holds and administers the Trust Assets for the Trustor, which is "disempowered" in this respect, the trust is understood to be an "administration trust" (*Verwaltungstreuhand*). If the Trustee shall be entitled to ultimately acquire the Trust Assets or to dispose of the Trust Assets if certain events of default on the part of the Trustor occur (*Sicherungsfall*), the trust is understood as a "security trust" (*Sicherungstreuhand*), and if the trust is used as an exit scenario to dispose of and to realise the Trust Assets, the trust structure can be regarded as a "realisation trust" (Verwertungstreuhand). If third parties benefit from the disposal of the Trust Assets as beneficiaries, e.g., in a restructuring scenario the lenders involved, the trust qualifies as a "bilateral trust" (*Doppeltreuhand*).

The Trust Agreement

The actual structure of the trust is set out in a Trust Agreement which will be entered into between the Trustor and the Trustee; the lenders will not necessarily become party to the Trust Agreement but can benefit as beneficiaries of the trust by way of a provisions in their favour (*Vertrag zu Gunsten Dritter*). The Trustee can be a natural person but for liability reasons also a company with limited liability (e.g., *GmbH*), which may be held and managed by the person who is to be appointed as "true" Trustee. The Trust Agreement typically includes two key elements, one dealing with the mandate of the Trustee (*Auftrag/Geschäftsbesorgungsvertrag*) and the other with the legal transfer of the Trust Assets to the Trustee.

The mandate of the Trustee will be established according to the purpose of the trust. It may contain provisions regarding the definition of the Trust Assets and their transfer to the Trustee, the rights, obligations and authorisations of the Trustee and indemnities, and the rights of the Trustor and/or the beneficiaries to receive information from and/or give instructions to the Trustee. Furthermore, it may contain provisions regarding the security purpose of the trust (in case of a security trust) and, in particular in the case of a bilateral trust in favour of the lenders as beneficiaries, provisions regarding the asset disposal process and provisions which will otherwise typically be found in intercreditor agreements or security pooling agreements, such as clauses with respect to the ranking of claims and the application of proceeds, the so-called "waterfall". As such waterfall must reconcile the various and different interests from an economic perspective, the negotiation of the waterfall amongst the parties involved may be one of the most complicated issues in the procedure of setting up the trust structure, in particular if lenders do participate which have lent their moneys to related group-companies of the Trustor (cross-collateral).

The transfer of the Trust Assets to the Trustee, which will be the fulfilment of the Trustor's respective obligation under the mandate, will result in the Trustee acquiring the legal ownership of the Trust Assets. However, as the Trustee will typically still be bound by the instructions of the Trustor to a certain (limited) extent, as set out in the Trust Agreement, he will not acquire the economic ownership of the Trust Assets. This may in particular be important for tax reasons. As far as the Trustee is not bound by instructions, he acts in his sole discretion with regard to his mandate.

The transfer of the Trust Assets to the Trustee may trigger taxes, for example real estate transfer tax, if the Trust Assets consist of shares in a company which holds real estate, so that a close cooperation with accountants and tax advisers is advisable when setting up the trust structure. In such a situation the triggering of real estate transfer tax can be avoided if the Trust Assets are transferred not to just one Trustee, but to two unrelated Trustees, each of which will hold a part of the Trust Assets (for example 90% and 10%). The additional risk of triggering income tax, however, can be avoided by leaving the economic ownership of the Trust Assets with the Trustor (see above). In complex structures it may be advisable to obtain a binding ruling of the competent tax authorities (verbindliche Auskunft) in advance.

The Implementation of the Trust Structure

The implementation of trust structures depends on the purpose of the trust and on the actual situation and circumstances of the restructuring. In case of a security trust or a realisation trust it may be prepared and accompanied by a standstill agreement between the respective lenders, obligors and other stakeholders, as the case may be, covering the period until the trust structure has been implemented, the distressed company has been restructured and the M&A process has been completed. In such a situation the standstill agreement will typically include, amongst others, provisions regarding the appointment of the Trustee and, as the case may be, an investment adviser to support the Trustee in the M&A process, and may already define the assets which shall function as Trust Assets. Furthermore the use of the trust structure in a restructuring scenario should be acknowledged by a restructuring opinion (Sanierungsgutachten) of an experienced accounting firm, if applicable. With respect to the process for the selection and the appointment of the Trustee, it is important from the lenders' perspective to make sure that they do not run the risk of exposing themselves to the risk of equitable subordination in the event of an insolvency of the distressed company (their borrower).

The process of asset disposal will be implemented by the Trustee on the basis of the Trust Agreement, once the relevant trigger events have occurred. If the Trust Assets consist of the shares in a company, the Trustee, with the support of an investment adviser, as the case may be, may then identify and address possible investors and start an M&A process. Finally, the Trustee will enter into a share purchase and transfer agreement with the investor which has presented the most attractive offer; the purchase price paid may be deposited in a trust account and finally applied against the waterfall as set out in the Trust Agreement.

Even if the transferred Trust Assets are already subject to pledges in favour of the lenders, a disposal of the Trust Assets by way of a trust structure can still be reasonable from the lenders' perspective. An advantage may be that the trigger event for an asset disposal as well as the procedure for realisation of the assets can be defined more flexibly than enforcement events and enforcement proceedings under customary pledge agreements and the German Civil Code (*Bürgerliches Gesetzbuch*). In such a situation the lenders will have to release their pledge in the course of the disposal process.

Trust Structures in Insolvency Scenarios

To serve as a valid security for the lenders in restructurings, it is important that the trust structure can be regarded as insolvency-proof in particular in an insolvency of the Trustor. If the trust structure has been set up for the benefit of the lenders (security trust), it will in an insolvency of the Trustor provide a right to separate satisfaction (*Absonderungsrecht*) for the Trustee in favour of the beneficiaries, meaning that the Trustor will still be entitled to the value of the trust assets. In case of an administration trust, there will be no such right of the Trustee. However, it has to be noted that in an insolvency of the Trustor each trust structure and the transfer of the trust assets to the Trustee may be subject to challenge by the insolvency administrator, depending on the time and circumstances in which it was set up.

Conclusion

A trust under German law has been successfully used quite recently in mid size and big restructurings. Its added value is that it may serve as additional security and provides certainty in the transaction (*Transaktionssicherheit*) for the lenders (in particular if a waterfall has been agreed), being prepared to support the distressed (group) companies on the basis of a positive restructuring opinion. For the shareholder the handover of its assets to the Trustee might be acceptable due to the impartial nature of the Trustee, to maximise value in a pre-agreed procedure with the most important stakeholders.

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Creditors' Claims and Recovery under German Insolvency Law

BY CHRISTOPHER J. WRIGHT | GÖRG PARTNERSCHAFT VON RECHTSANWÄLTEN

In the wake of numerous large corporate insolvencies in 2009, German law firms have increasingly been tasked with representing creditors of insolvent businesses. Given the multi-jurisdictional scale of many of these insolvencies, creditors (e.g., suppliers, lenders, shareholders or affiliated entities) are often located outside of Germany.

The following note provides a brief overview of the position of creditors in the context of a German insolvency. It is intended to primarily assist foreign businesses and their counsel to understand the filing of a creditor claim in a German corporate insolvency scenario.

Application for the Commencement of Insolvency Proceedings

In Germany, insolvency proceedings are commenced by way of an application to the district court (*Amtsgericht*) in which the affected company has its registered office. Most commonly, the application will be filed by the company's management, which is under a statutory duty to do so where the company is either over-indebted or illiquid (or illiquidity is threatened). However, creditors may also apply to commence insolvency proceedings.

In order to make such an application, a creditor must demonstrate that it has a legitimate interest in having such proceedings commenced (e.g., the protection of the creditor's claims against the company). It must primarily demonstrate that it has a valid and enforceable claim against the business, and must also credibly demonstrate that the company is either illiquid (unable to pay its debts as these become due) or that the company is over-indebted. Unless the creditor has access to up-to-date information concerning the company's financial position, the latter will be very difficult to prove and this rarely occurs in practice.

Depending on the facts contained in the application, the court will either commence preliminary insolvency proceedings and will appoint a preliminary insolvency administrator tasked with securing and preserving the insolvent company's assets for the benefit of creditors, or will proceed directly to commencing main insolvency proceedings (conclusive insolvency proceedings). A preliminary administrator may be empowered to continue the insolvent company's business where such continuation would assist the immediate preservation of the company's assets. The administrator ultimately appointed for main insolvency proceedings is additionally tasked with realising upon the assets of the company and distributing these to creditors.

In contrast to some jurisdictions, the court will appoint an individual as administrator (preliminary or conclusive). This individual is almost always a specialised local lawyer with his or her practice in the court's jurisdiction. Firms, such as law firms or accountancy practices, are not appointed in their own right, although it is common that the administrator will work in close partnership with his own firm, appointing practitioners to advise and assist him. In rural areas or where the administrator is part of a smaller local firm, the administrator's experience with foreign documents and languages may be limited and communications restricted to German. For larger insolvencies and in urban regions, it is more likely that the administrator will be willing to communicate with creditors in English.

Notice to Creditors

In the event that a German company files for insolvency, key suppliers and lenders will likely find out about the insolvency immediately, either through the media or a notice issued by an administrator. Upon the appointment of a preliminary administrator, the court will notify parties who are determined to have liabilities vis-à-vis the insolvent company. The court will publish the order commencing preliminary proceedings in the court's register in any event; creditors often monitor these court registers where a company is known to be encountering financial difficulty.

The court order commencing main insolvency proceedings will be published by the court register and served on the (known) creditors of the company. This order notifies all creditors that these are required to submit creditor claims to the administrator within a specific filing period. The filing period may be anywhere from two weeks to three months (more common in large corporate insolvencies). Creditors are also obliged to immediately inform the administrator of the nature of any security interests held in property owned or possessed by the insolvent company.

Filing of a Creditor Claim

Creditors who are aware of an insolvency but who have not yet been served with the court order are well-advised to obtain a copy of the order independently (by contacting the respective court), since this order contains the time period in which to file creditor claims and will name the administrator with whom such claims must be filed. The court order will only be issued in German; for large-scale insolvencies with clearly international dimensions, the administrator may provide creditor-related information in English on the homepage of the insolvent company or his own homepage.

Pursuant to section 174 of the German Insolvency Act, creditor claims must be filed in writing and should contain copies of the documents on which the claim is based. The claim filing must provide details on the amount of the claim and the legal substantiation for the claim. Subordinated creditors need not file creditor claims unless explicitly instructed by the court (such an instruction may be contained in the court order commencing proceedings). The filing of creditor claims may take place electronically if the administrator has expressly consented to such filing. In all cases, copies of the relevant documentation substantiating the claim must be provided in hard copy.

These statutory requirements are deceptively simple. In practice, the filing of a creditor claim can be considerably more onerous. First, the insolvency administrator is within his or her rights to request certified translations of documents submitted in other languages. The costs and time involved in preparing such translations can be significant. The administrator may also respond to correspondence in German, although in practice, many administrators and their firms will discuss issues relating to the creditor's claim in English.

Most administrators make use of a standardised electronic form for filing the specific information required for submitting a creditor claim. It is important to fill out this form completely and correctly. In particular, this form requests information as to the "legal substantiation of the claim". It is not sufficient to simply refer to a loan agreement or other contract. Instead, the creditor must set out the actual legal basis for the creditor's claim. This will generally involve pointing the administrator to the specific terms of the agreement or arrangement which entitle the creditor to demand payment and establishing any facts which give rise to such entitlement (such as default). In general, the creditor must paint a comprehensive and detailed picture for the administrator of the creditor's right to demand payment from the insolvent entity. This right must have existed as of the date of the commencement of proceedings, and primary creditor claims will be limited to the amount payable to that creditor as of that date.

Administrators do not actively seek to reject creditor claims on the basis that they do not satisfy one or more of the requirements discussed above. However, administrators will likely reject any claims which are improperly documented or filed in a manner inconsistent with the administrator's form, or which fail to clearly establish the legal basis for the claim. It is recommended that the creditor liaise informally with the administrator and his staff to ensure a claim filing is properly and fully prepared prior to submission.

A claim may (and should) be filed on a precautionary basis, e.g., where a creditor has already sought to set-off its claim against amounts owing to the insolvent company, and such set-off has not yet been rendered effective as against the administrator. In the event that a claim amount is unable to be determined precisely, a claim should still be filed with an estimated amount and comprehensive details explaining the basis for the estimate.

Once a creditor claim is validly filed, the administrator will register this claim in a chart. Only those claims which have been registered will be reviewed by the court in a hearing to confirm these. Creditor claims documents and the chart are made available to the parties to the insolvency proceeding (e.g., other creditors) by the court.

Claims which are filed after the expiry of the creditor claims notice period may still be admitted. However, the creditor may bear the costs associated with a special review of these claims by the court.

Review Hearings

The court will call and hold two special review hearings in the course of the insolvency proceedings. Creditors may attend these hearings and are commonly represented at these by counsel. The first hearing permits the administrator to report on the status of the insolvent company and the proceedings to date. In the second hearing, the creditor claims filed to date are reviewed and confirmed by the court. If doubt exists as to the validity or nature of a claim, this second hearing provides the creditor with an opportunity to make submissions to the court. Creditor claims which are confirmed on the basis of the chart by the court will give rise to a legal entitlement to pro-rata proceeds from the disposal of the insolvent company's assets.

Meetings of creditors and creditors committees may be convened or appointed by the court. The members of these committees should represent secured, unsecured and small creditors. The committee is afforded special rights to monitor and obtain information from the administrator.

Secured Creditors and Distribution of Assets

Secured creditors are not treated as creditors in insolvency per se. Instead, their rights vis-à-vis the assets in which a security interest is held may be asserted independently of the insolvency proceedings. The assets are segregated from the remaining assets of the insolvent entity. However, the administrator may – under certain circumstances – be entitled to realise upon these assets himself. The creditor will be entitled to the proceeds of such an auction, but not to the assets themselves. This is the case in respect of claims which have been assigned as security. Other typical forms of security (pledges of claims, pledges of shares) may be realised upon by the creditor independently. Land charges may be realised upon by applying for a public court auction of the charged property. In particular, German law does not expressly provide for a foreclosure sale in insolvency as is available in some other jurisdictions.

Proceeds from the realisation of the insolvent company's assets will be distributed generally in accordance with the following priority:

- secured creditors, to the extent that proceeds result from the realisation of the secured property

With respect to the remaining assets:

- payment of administrators' costs and court fees
- pro-rata among unsecured creditors (typically, unsecured creditors in a German insolvency can expect to receive between 3% and 7 % of their original claims)
- interest and other costs claims of creditors which have arisen since the commencement of insolvency proceedings
- public law penalties or criminal fines
- claims against the insolvent company which are based on no consideration (promises)
- repayment of shareholder loans
- distribution of residual proceeds among shareholders

Note that in contrast to many other jurisdictions, German law does not provide for a range of statutory liens in respect of the claims of tax authorities, lawyers, etc.

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Contestable Transactions and Creditor Preferences under German Insolvency Law

BY CHRISTOPHER J. WRIGHT | GÖRG PARTNERSCHAFT VON RECHTSANWÄLTEN

Once appointed by a court, a German insolvency administrator is subject to several fundamental obligations. These include securing the assets of the insolvent business, establishing the scope of and foundation for creditor claims and realising on the insolvent business' assets for the benefit of the creditors. In addition, the administrator must also ascertain whether transactions entered into prior to insolvency may be challenged as creditor preference transactions.

The German Insolvency Act (*Insolvenzordnung*) grants an administrator considerable power to set aside transactions which served to prejudice creditors generally or to afford certain creditors an advantage over the relative position held by unsecured creditors post-insolvency (creditor preference transactions). Similar to the approaches adopted by other jurisdictions, the Insolvency Act sets out specific periods of pre-insolvency time. Transactions occurring within these periods may be challenged (Anfechtung) by the administrator.

If the administrator's challenge is successful, the transaction will be set aside by law, i.e., deemed to have been ineffective. The administrator will have a claim against a creditor which has benefited from such a transaction and may reclaim payments made by the insolvent business. The affected creditor may have a claim against the insolvent business in respect of goods or services provided to date; these are likely to be valued at objective market rates. However, the creditor's claim will constitute an unsecured claim against the insolvent business and is therefore unlikely to be satisfied in full.

Three parties therefore have compelling interests in respect of the administrator's ability to set aside preferential transactions: (i) the party to the transaction; (ii) the administrator, who is obliged to assess whether transactions exist which may be set aside; and (iii) unsecured creditors, since the setting aside of a preferential transaction may result in additional assets available for distribution.

The following brief overview sets out the administrator's rights to challenge certain transactions based on the Insolvency Act.

Transactions which may be Challenged under the Insolvency Act

The Insolvency Act contains 17 separate provisions which regulate the ability of an administrator to set aside transactions undertaken by the insolvent business. In addition, upon his or her appointment, the administrator "steps into the shoes" of the business itself and is able to pursue any actions which the business would have been able to assert under corporate, civil or criminal law against related parties, such as directors or shareholders.

Transactions with Creditors

Transactions with creditors immediately prior to insolvency are subject to special attention in the Insolvency Act, which uses terminology unfamiliar to common law practitioners to characterise these. In particular, the Insolvency Act allows the administrator to challenge so-called "congruent" transactions which take place three months prior to the commencement of insolvency proceedings where these transactions satisfy or secure the claim of an insolvency creditor (or make this possible) and the insolvent business was, at the time of the transaction, illiquid, and the creditor was aware of this circumstance. Note that a "transaction" is defined broadly and includes any legal act (such as payment).

The same applies in respect of transactions undertaken after the filing of an application for insolvency where the creditor was aware of either the illiquidity of the insolvent business or the fact that an application had been filed.

This challenge right is excluded where the transaction is based on a security interest which has been granted in order to ensure that the security interest shores up outstanding obligations already granted subject to security (i.e., additional security taken in a crisis situation).

The creditor's knowledge of the insolvent business' illiquidity or its application for insolvency proceedings is implied where the creditor has knowledge of facts which would suggest that such circumstances exist. Positive knowledge of such circumstances is assumed in respect of parties affiliated with the insolvent business.

The same three-month period applies to transactions occurring prior to insolvency where the transaction directly prejudices the business' creditors, the business was illiquid at the time of the transaction and the other party was aware of this fact.

The administrator is also empowered to challenge transactions taking place one month prior to the commencement of insolvency proceedings or after such commencement where such transactions are "incongruent", i.e., where insufficient consideration is exchanged between the parties. This is the case where a transaction benefits a creditor (e.g., by way of payment or the provision of security) and the creditor was not entitled to such benefit at the time such benefit was received. This would include prepayments on liabilities not yet owing (e.g., payments of future rent to a landlord).

This provision seeks to target those transactions which were performed where the insolvent business was aware of impending insolvency and deliberately sought to privilege a creditor at the expense of others. This period is extended to three months where the insolvent business was already aware of its own illiquidity or where the creditor was aware of the relative disadvantage this would pose to other creditors (classic creditor preference).

In practice, these rights are powerful tools available to an administrator to challenge creditor preference transactions immediately preceding insolvency. The transactions occurring in the three-month period preceding insolvency are therefore subject to special review; creditors doing business with a company in crisis should be aware that extreme care is warranted.

Transactions with Intent to Prejudice Creditors

Section 133 of the Insolvency Act sets out an additional *10-year* "look back" period in which transactions prior to insolvency may be challenged. In order to be caught under this section, however, the insolvent business must have entered into the transaction with the intent to prejudice its creditors and the other party to the transaction must have been aware of such intent. Such awareness is presumed where the party knew that the business was threatened by illiquidity and that the transaction was likely to prejudice creditors. In order to challenge a transaction under this Act section, an extremely high burden of proof will have to be satisfied; where the transaction party can demonstrate having held doubt with respect to the intent of the insolvent business to prejudice its creditors, a challenge is likely to fail.

In addition, an administrator can set aside agreements entered into between the insolvent business and affiliated entities for consideration where these agreements prejudice creditors. The "look back" period here is two years. Transactions may not be contested where it cannot be proven that the affiliated entity was aware of the business' intent to prejudice creditors.

Finally, "gifts" or other grants of assets or services for no consideration which take place in the four-year period prior to insolvency may also be challenged. An exemption exists for gifts of negligible value.

Transactions with Related Parties

Upon assuming his appointment, the administrator will be empowered to exercise any rights available to the business to claim against its own shareholders, management or affiliated parties. These rights may include claims against management in respect of payments made to shareholders from the business' basic stated capital (in violation of §§ 30, 31 of the German Limited Liability Companies Act), claims against board members for certain payments made to these in violation of the German Stock Corporations Act, and any claims in tort which may be available to the business (e.g., under the intentional tort provision contained in § 826 of the German Civil Code).

In addition, claims may be asserted against the company's management for payments made by the company which were made when the company was illiquid or insolvent and where no due care was exercised in making such payments. Finally, payments made on shareholder loans and the granting of security to shareholders in respect of such loans may be set aside where these take place within, respectively, one-year and 10-year periods prior to insolvency.

Typically, an administrator will be obliged to review whether grounds for such claims exist. In performing such a review, he or she is bound by the statutory limitations for such claims (typically three years), but will be obliged to use reasonable means at his disposal to investigate grounds for and pursue such claims. In practice, German administrators commonly aggressively make use of the rights available to them to secure creditor assets.

Avoidance Measures

As mentioned above, special care must be undertaken when entering into transactions with companies in crisis. For major transactions, common commercial due diligence may include obtaining audited accounts of the counterparty and requesting cash flow projections. In addition, in the event a transaction is later subject to a challenge, it can be beneficial to have established a paper trail of documents detailing the deliberation and investigations made on the counterparty's financial status prior to entering into the transaction.

When structuring such transactions, it can also be helpful to ensure that the transaction is fair and reasonable in light of market rates and standards. Fees and bonus payments should generally be designed to take place only after a project has been completed in full, and should not be structured as advance payments; interim financing provided to a company in crisis to enable it to perform the project should be characterised as such, and appropriate security taken.

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Germany's Maritime Industry is Under Threat from the Economic and Financial Crisis – Analysis and Proposed Solutions

BY NILS R. KUHLWEIN VON RATHENOW AND JENS-CHRISTOPH UHR | ROLAND BERGER STRATEGY CONSULTANTS GMBH

Germany has become a strong maritime business location over the past decades. Much of the global shipping industry is controlled from Germany. Around 35% of the world's container ships belong to German ship owners, who built up Germany's current position in the maritime industry together with shipyards of global reach. The maritime cluster consists not only of ship owners and shipyards but also ports, specialised financing institutions, issuing houses and many suppliers and service providers, also global leaders in their fields.

A German top 10 global liner shipping company has 7,100 employees and plays a key role in 130 countries. Next come many other large, midsized and small charter shipping companies. The German shipbuilding industry, with 37 shipyards, some of which are global market leaders in their segment or niche, covers various needs: Meyer Werft (cruise ships), Lürssen (luxury yachts) and HDW (fuel-cell submarines) are known around the world. The Port of Hamburg dispatches some 10 million standard containers to major ports around the world. The Jade-Weser-Port is another planned German deepwater port, which highlights the importance of the shipping industry for the economy. The business location benefits from good infrastructure and hinterland connections, and from a strong, multi-faceted supplier industry. Large German companies such as Siemens, MTU (Tognum) and MAN Roland help shipyards build modern ships by supplying refined technologies. Tax incentives led to the establishment of a highly sophisticated ship financing industry. Alongside bank financing by leading international banks in the ship financing sector such as HSH Nordbank, Deutsche Bank (Shipping), Commerzbank and HVB/Unicredit, over the last two decades issuing houses also sprang up to co-finance the shipping industry via closed-end ship funds. As a result, German banks are now global leaders in the financing of ship commitments with financing volumes of around €200 billion.

Precursors to the Crisis

The current shipping crisis did not happen overnight. Even before the start of the crisis in 2008, overheating could be seen as a precursor to the crisis: charter rates had skyrocketed in recent years. Relevant freight indices such as the Baltic Dry Index and Hamburg Index for Container Time Charter Rates had risen constantly since 2003. Between August 2008 and July 2009, the Hamburg Index fell by 76%, from US$11.30 to US$2.73 per 14t in the category of ships up to 2000 TEU. On the brink of the crisis, used ships became more expensive than new ones not yet built due to their rapid availability for limited tonnage. The resale value of Panamax bulk carriers (75,000 tdW) fell by 58% between 2008 and 2009. Lead times at shipyards for docks to build new ships increased to three or four years pre crisis, while currently shipyards desperately seek order placements.

Global Economic Crisis Led to Massive Industry Slump

When global trade fell by around 12% in 2009, the whole maritime industry suffered. Declining goods traffic led to a massive fall in charter rates for ships. Due to poor capacity utilisation, ship owners decommissioned ships and cancelled or postponed orders for new ships. Experts estimate that around 30% of global order books are currently affected by cancellations and postponements. The cancellations and declining order intake have already led or will lead sooner or later to major difficulties at German shipyards. Although current order books will be enough for the next few months, soon many shipyards will be struggling to fill capacity.

The Worst is Yet to Come

In the near future, too, the situation will remain tight in the German shipping industry. The current overcapacity has to be reduced over the next few years. Despite the expected recovery in worldwide trade and increased container shipping, the current overcapacity, which depends on market trends, will get worse. Even with market growth of 3% p.a. from now until 2013, estimates still show considerable overcapacity in the market. In addition, the intake of orders (47% of the current fleet) at shipyards placed well back in 2008 or before, has still to be at least partly financed and the delivery of the additional capacity has to be absorbed on the market. Many experts thus believe that the container ship market will not balance before 2014, putting high pressure on the carriers.

Financing Banks are also Hard Hit

The largest German ship financiers are themselves hard hit by the recession and are struggling with huge falls in the value of their ship mortgages. Government support and EU constraints are now forcing those banks to consolidate. They therefore have limited scope to continue to perform their financing function in the shipping industry in full.

The situation in the equity market is also tight. As of June 2009, issuing houses' equity placing volume was 90% down year on year and currently it is pretty unclear how long it will take until equity financing is up on used levels again.

Crisis has now Arrived at the Shipyards and will have a Knock-On Effect Throughout the Maritime Value Chain

The financing crisis has hit the shipbuilding industry in the meanwhile and already led to four insolvencies at midsized German shipyards. With the current market and financing situation, other shipyards may also go bust. Suppliers and service providers will therefore face further major falls in sales.

Maritime Industry about to Collapse?

Those recent developments are heavily challenging the total maritime industry. The loss of charter rate revenues because of overcapacity may put some ship owners out of business. In addition, the high intake of ships from current order books and the development of charter rates affect those ship owners with too little equity and who have grown enormously in the last few years. They may not finance the high intake of ships and are sliding into a precarious cash situation due to charter rates that do not cover costs.

A downward spiral looms: banks will probably not be able to cover the whole financing gap themselves and will be forced to streamline their own portfolios. Writedowns of nonperforming loans will lead to further hits to banks' balance sheets. This in turn will increase pressure on shipyards, suppliers and service providers.

Also, private investors are potentially facing severe setbacks, too: equity shares in shipping companies (limited liability companies) that are financed by private investors are being placed in the capital market via closed-end funds. The loss of charter rate revenues will lead to the loss of returns at the limited liability companies and, in the worst case scenario, additional funding obligations or the total loss of investors' capital.

Could Current Solutions be a Model for Success?

There are many solutions currently being used. On the operational side, ship owners are trying to reduce overcapacity through slow steaming and delaying delivery or renegotiating with shipyards.

On the financing side, the banks usually negotiate solutions on a case-by-case basis with their clients from the maritime industry, for example pay-as-you-earn clauses for one-ship companies. Shipyards are trying to force their customers to pay the internationally standard downpayments according to construction progress. Opportunity funds are acquiring assets or financing the ships' shortage of cover.

The maritime industry is also being supported by the government. The federal and regional governments have already taken action via stimulus packages and regional state guarantee schemes to secure the availability of loans.

Long-Term Solutions are Required

To stabilise the maritime industry in the long term requires structural changes involving all interest groups and avoiding further hits to bank balance sheets. The fragmented industry needs a clear consolidation to create world scale players among ship owners. Weak competitors will most likely be forced out of the market and their assets acquired by larger players to achieve synergies in servicing. In addition, cost structures must be adapted to internationally competitive dimensions. With this in mind, the current crisis has a huge chance of sustainably restructuring the industry.

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NETHERLANDS

Using Foreign Insolvency Laws to Implement Financial Restructurings: International Developments from a Dutch Perspective

BY JAKO VAN HEES, NICOLAES W.A. TOLLENAAR AND LUCAS P. KORTMANN | RESOR NV

In recent years the number of options and legal instruments available for carrying out financial restructurings has vastly increased due to the possibility of making use of the insolvency regimes of foreign jurisdictions. Companies are moving across borders in order to implement restructurings under insolvency laws more suitable to their needs. In Europe, one of the main jurisdictions of departure is Germany, but companies are also leaving other jurisdictions for restructuring purposes. For a while, the main destination has been the UK. Due to recent case law in the UK and in the US, European companies are now increasingly looking towards the US to benefit from the US Chapter 11 proceedings.

Which Jurisdiction?

Which jurisdiction is the most suitable, and whether or not it is possible and useful to shop abroad, depends on the specific circumstances of the case, such as the financial position and capital structure of the company and the size and nature of its business. For instance, for financial vehicles with a large amount of unsecured debt that needs to be restructured, Dutch proceedings can be very attractive. This is due to the relatively low majority of 50% +1 in number and amount that is required to cram down dissenting creditors. The required majorities in other jurisdictions are often much higher. The Netherlands can also be a favourable jurisdiction for secured lenders. In the Netherlands, holders of security rights have a strong position. Secured lenders are not or hardly affected by a moratorium. They can enforce their rights notwithstanding the opening of insolvency proceedings. To enforce their security rights lenders may, but do not have to, obtain prior court consent. According to an international study on debt enforcement conducted by the World Bank and Harvard in 2006 the Dutch insolvency system gives secured creditors the highest recovery rates in the world, preceded only by Japan and Singapore.

Nevertheless, the Dutch system also has a number of flaws which, in specific circumstances, can act as drivers for companies and banks to look abroad for more suitable legal tools. Under Dutch law a court does not have the power to order the sale of encumbered assets to a specified buyer without the consent of the holder of the relevant security right, regardless whether the creditor is offered fair value or is "out of the money". As mentioned above, a moratorium in the Netherlands has no or limited effect against secured creditors. Secured creditors cannot be "crammed down" by means of a court approved plan. Whilst this gives individual secured lenders a strong position which can be an advantage, it also gives secured creditors with debt below the level where the value breaks substantial hold-up value, which can be a disadvantage. In the UK an office holder can be retained before the formal insolvency commences. This enables him or her to arrange a controlled auction of the business, assess the value of the company and prepare a transaction before formal insolvency proceedings are opened. The office holder can then sign-off on the pre-packaged deal immediately after formal insolvency commences. In the Netherlands, however, there is no way of involving the future office holder in the process before the formal insolvency proceedings are opened. This inevitably leads to fire sales and destruction of value if formal insolvency proceedings cannot be prevented.

Shopping within the EU

Depending on the specific circumstances, companies and interested stakeholders can have good reason to explore the possibility of migrating to other jurisdictions in order to benefit from the more effective restructuring provisions those other jurisdictions may have to offer.

European legislation provides that a company in distress has access to the insolvency laws of the jurisdiction in which its so-called "centre of main interests" (COMI) is located. For the purpose of this article COMI can be summarised as the "head office" of the company. Migrations within the EU can take place by shifting the COMI of the company, while the main assets and operational activities can mostly be kept in place. However, such a migration does not always enable the company to benefit from the new insolvency regime to the full extent. European legislation limits the cross-border effects of insolvency proceedings to a certain degree. The operational activities left behind in the "old" jurisdiction, likely constitute a so-called establishment allowing secondary insolvency proceedings to be opened under the laws of the "old" jurisdiction. These secondary proceedings apply in the jurisdiction in which the establishment is located and carve out the geographic reach of the insolvency proceedings opened in the jurisdiction of the new "head office". In the event of secondary proceedings the "old" insolvency regime therefore still applies to the assets and activities that have remained behind. Various techniques have been developed to prevent the opening of secondary proceedings, but none are completely "fool proof". Another significant limitation of the cross-border effects of the main proceedings, i.e., the proceedings opened in the jurisdiction of the new "head office", is that insolvency proceedings, including a moratorium, do not affect creditors with security rights on assets in other jurisdictions. In other words, the insolvency proceedings opened in the jurisdiction of destination, do not prevent secured creditors from enforcing their rights against assets left behind in the jurisdiction of departure. Similarly, it is assumed that creditors cannot be prevented from enforcing security rights on assets in other Member States by means of a plan or composition. Finally, recent case law in the UK has confirmed that it is more difficult to migrate the COMI of a company than many have thought in the past and that an effective migration not only requires the place of the corporate decision making to be moved, but also relevant activities visible to third parties and preferably also the registered seat of the company. This means that an effective migration will often be too time consuming or costly to offer a practicable solution.

Shopping from the US Seemingly Easier

As a result of the practical and legal hurdles in gaining access to the insolvency laws of other European jurisdictions and the limitations of the cross-border effects of European insolvency proceedings, companies and their stakeholders are increasingly turning towards the US. In order to gain access to the provisions under the US Bankruptcy Code it is not necessary to move the head office or registered seat of the company. Having assets in the United States is generally sufficient, which can relatively easily be achieved, in theory, for instance, by opening a bank account. Insolvency proceedings in the United States formally have no effect whatsoever on assets of the company situated in the Netherlands. However, in a relatively recent judgment a US court ordered that any action outside the US in contravention of its orders would be deemed to constitute contempt of court and the resulting penalties would be enforced on assets of the infringing creditors in the US. The practical result of this order was that the judgment had universal effect. This development in the case law has boosted the interest in US Chapter 11 proceedings as a tool for restructuring European companies. In recent restructurings Dutch companies and their lenders have preferred the US to possible European jurisdictions.

Whether or not it is useful and possible to make use of foreign insolvency laws depends on a case by case analysis. It is, however, important to realise that the restructuring toolbox can include instruments available in other jurisdictions. What might not possible in one jurisdiction may be possible in another.

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SWITZERLAND

Substitute Equity Loans in Switzerland

BY DR. LUKAS BOPP | KELLERHALS

Intercompany claims running from a parent to its subsidiary or running from one affiliate to another and claims of others with a close relationship to an insolvent debtor often require special attention in insolvency proceedings, as such claims may – from a economical point of view and under certain circumstances – qualify as equity rather than debt. Consequently, such claims will be treated differently from the claims of other creditors. In some jurisdictions such claims are recharacterised as equity, in others they are subordinated towards the claims of other creditors. In Switzerland such concepts are discussed under the German phrase *"Eigenkapitalersetzendes Darlehen"*, which can be translated as "substitute equity loans". The following article will give a short outline on the present status of substitute equity loans in Switzerland.

Currently, there are no statutory rules or regulations on substitute equity loans. The concept of substitute equity has rather been – or more precisely still is – developed primarily by jurisprudence and doctrine, based on the principle of abuse of right. In Swiss doctrine, two positions on substitute equity loans can be identified. These position primarily differ with respect to the consequences the qualification of a certain claim as substitute equity entails. According to one position, such a claim must be recharacterised as equity and therefore does not accrue interest and cannot be claimed back, be it before or after bankruptcy, it cannot be accepted into the schedule of claims and all collateral is void. According to the other view, the qualification of a claim as substitute equity leads to an implied subordination of such a claim towards all other claims in the schedule of claims and will accordingly only being paid back once all other claims have been fully satisfied. Collateral cannot be realised and interest paid can be claimed back. Recent court decisions and also an *obiter dictum* in a decision of the Swiss Federal Court seem to favour the concept of subordination over that of recharacterisation. In practice, the two different positions are of limited relevance since in both cases, such claims are likely not to be paid back in case of an insolvency.

Of more practical relevance are therefore the premises for a recharacterisation or subordination. There is unanimous consent that as a first requirement only loans can be subject to recharacterisation or subordination. Yet it seems to be clear that not only loans in a strict legal sense but also claims deriving from other types of contracts such as rent, leasing, licensing etc., may qualify as substitute equity loans provided credit is granted with these contracts to the insolvent debtor.

Such unanimous consent cannot be identified as to the second requirement: some advocate that amount, conditions (including collaterals), or point of time of when the loan was established, must imply that such a loan would not have been granted by an independent third party under such conditions and circumstances (so-called "Third Man's Test"), or alternatively, if at a point of time in which the loan was granted only a new contribution of equity would have rescued the company from being or becoming over-indebted (so-called "Reorganisation Test"). The simple economical principle underlying the Third Man's Test is, that no reasonable party would grant a loan to a company that is over-indebted, and every party would hesitate to provide funds to a company whose shared capital is only covered by 50% (underfunding). The same is true, once the "going concern proposition" of a company ceased to exist, because the continuation of the business is endangered or no longer possible. According to some views the concept of the Third Man's Test can be extended to loans granted to a company before it entered such financially critical points of time, provided that the loan granted earlier is not claimed back in a financially difficult time although legally possible, and provided that the decision not to claim the loan back can be regarded as a new investment decision.

According to the critics the Third Man's Test as well as the Reorganisation Test are improper instruments, as they provide only a vague determination of the point of time at which the loan must be granted in order to be qualified as substitute equity. The critics advocate that only loans granted at a point of time in which the company is over-indebted can be qualified as substitute equity and thus be subordinated, because only in this financial situation Swiss law imposes certain duties on the bodies of the company which all relate to protection of the company creditors from further losses. They argue that specific lenders with a close relationship to the debtor, such as directors, managers, main shareholders, auditors, affiliates, related parties, or other insiders who grant a loan to a company in a critical financial situation influence in undue manner the risk allocation between shareholders and outside creditors to the detriment of the latter. Such lenders would therefore violate the duties imposed on them in the situation of over-indebtedness (always provided they knew about it). With directors, such knowledge is irrefutably presumed, with all others this presumption can be rebutted. In return, a connection between the granting of the loan, the continuation of the business of the company, and the loss of the creditors is required. In essence, a subordination is deemed, if at the point of the granting of the loan the company was over-indebted, if the party granting the loan was or should have been aware of that fact, and if there is a connection between granting of the loan, continuation of the business, and loss of creditors.

Swiss Courts seem to favour a combination of the concepts developed in doctrine under the parenthesis of the abuse of law. This allows the Courts to also consider other aspects, such as whether there is a close relationship between debtor and creditor, whether the equity ratio is adequate, whether interest is accrued on the loan, whether more than one shareholder has given loans in proportion to the shareholding, whether the loan can be terminated by notice of the creditor, or whether unreasonably long notice periods apply, whether it is a secured or unsecured loan, whether there is a sufficient documentation for the loan, or whether a loan has regularly been subject to redemptions.

In 1993, the High Court of Zurich (Court of 2nd instance) explicitly applied the Third Man's Test and dismissed a claim from admittance to the schedule of claims deriving from an intercompany loan granted by one sister company to another. The Court held that it would be considered an abuse of law, if a shareholder that has provided further capital to his over-indebted and economically unviable company and so has prolonged the existence of his company to the detriment of old and new creditors, only after the bankruptcy proceedings have started were to claim back his loan. The Court explicitly argued that these principles developed by doctrine for the relation between shareholder and company can equally be applied to all intercompany loans in a group of companies. The Court accordingly concluded that since the debtor company was obviously indebted at the time the loan was granted to it by its sister company, the claim from the loan had rightfully not been fully admitted into the schedule of claims.

In a more recent decision of September 14, 2004, the District Court of Zurich had to decide whether a loan granted by a grandmother company was correctly subordinated in the schedule of claims in the insolvency of the granddaughter company. In view of the proportion of the share capital of the insolvent company of CHF 20'000 and the intercompany loan granted of CHF 37.5 Mio. the District Court assumed a massive undercapitalisation of the insolvent company. The District Court held that because the loan was not properly documented, not secured, and no interest or redemption was due or paid on it, the loan would clearly fail the Third Man's Test. The Court argued that a creditor should be allowed to trust that the assets of a company are supported by sufficient equity. By granting a loan to the over-indebted granddaughter company, the grandmother company prevented the over-indebted company from insolvency proceedings and enabled continuation of the business to the detriment of all other creditors. The other creditors may rely on their presumption that the loan granted to the company would eventually serve as equity and would therefore not compete with all other claims in the insolvency. The Court concluded that the creditors relying on the supposed creditworthiness must be protected by subordination of such intercompany loan. The District Court thereby aligned its reasoning with the principle of abuse of rights and declared the doctrine on substitute equity as a usecase of abuse of rights.

In summary, following currently prevailing doctrine and jurisdiction in Switzerland, there is a certain risk that a claim might be subordinated towards the claims of other creditors in the insolvency of a debtor company provided that:

- the creditor has a close relationship to the debtor company (i.e., director, major shareholder, affiliate), and
- the claim of the creditor qualifies as a loan, and
- the loan was given or not called back at a point of time, in which the debtor company was over-indebted or was otherwise in such a distressed financial situation, that either the loan per se would not have been granted by an outstanding third party, or not at such terms and conditions.

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Enforcing Foreign Insolvency Decisions in Switzerland

BY VINCENT JEANNERET AND OLIVIER HARI | SCHELLENBERG WITTMER

Enforcement of foreign insolvency proceedings is governed within the European Union by the Regulation 1346/2000 on Insolvency proceedings, adopted by the EC Council on 29 May 2000, which came into force on 31 May 2002 (the "EC Regulation 1346/2000"). The EC Regulation 1346/2000 applies to all EU member states (except Denmark) and automatically overrides where necessary any conflicting provisions in national members laws. The Regulation applies to insolvency proceedings, whether the debtor is a natural person or a legal person, a trader or an individual. The insolvency proceedings to which this Regulation applies are listed in its Annexes. Insolvency proceedings concerning insurance undertakings, credit institutions, investment undertakings holding funds or securities for third parties and collective investment undertakings are excluded from the scope of the Regulation. Moreover, the Regulation only applies to proceedings where the centre of the debtor's main interests ("COMI") is located in the European Union.

The above-mentioned Regulation provides for rules of jurisdiction and of conflict of laws. The rules of jurisdiction set out in the Regulation establish only international jurisdiction, i.e., they designate the Member State courts which may open insolvency proceedings (main proceedings and secondary proceedings). Territorial jurisdiction within the Member States must be established by the national law of the Member State concerned. The Regulation does not provide for uniform substantive law provisions for members of the European Union. Unless otherwise stated, the law of the Member State of the opening of the proceedings is applicable.

Basically, the *lex concursus* determines all the effects of the insolvency proceedings, both procedural and substantive, on the persons and legal relations concerned. It governs all the conditions for the opening, conduct and closure of the insolvency proceedings. Under Article 16 § 1 EC Regulation 1346/2000 any judgment opening insolvency proceedings handed down by a court of a Member State which has jurisdiction shall be automatically recognised in all the other Member States from the time that it becomes effective in the State of the opening of proceedings. According to Art. 18 EC Regulation 1346/2000, the liquidator appointed by a court which has jurisdiction may exercise all the powers conferred on him by the law of the State of the opening of proceedings in another Member State, as long as no other insolvency proceedings have been opened there, nor any preservation measure to the contrary has been taken there, further to a request for the opening of insolvency proceedings in that State. He may in particular remove the debtor's assets from the territory of the Member State in which they are situated. The liquidator appointed by a court which has jurisdiction may in any other Member State claim through the courts or out of court that moveable property was removed from the territory of the State of the opening of proceedings to the territory of that other Member State after the opening of the insolvency proceedings. He may also bring any action to set aside which is in the interests of the creditors.

Switzerland is not a member of the European Community. The relevant EC Regulation 1346/2000 on Insolvency Proceedings is therefore not applicable in Switzerland. Furthermore, despite the Bilateral Agreements I and II ratified by Switzerland with the EC, this Regulation has not been implemented in Switzerland. Neither has Switzerland adopted the uncitral model law on insolvency. A foreign insolvency decision will thus only be recognised in Switzerland in accordance with the Swiss Private International Law Act ("PILA"), in particular provision 166 et seq. Said provisions provide that foreign decisions may be recognised in Switzerland should certain conditions be met, namely such decision leads to liquidation proceedings or reorganisation measures in Switzerland. Recognition ("exequatur"), however, is limited to assets held by the debtor in Switzerland. The territoriality principle in Switzerland – as opposed to the bankruptcy unity – is therefore limited. It must be noted that only foreign formal decisions may be recognised, not foreign proceedings.

The trustee of a foreign bankruptcy estate or a creditor may apply to a Swiss Court to obtain the recognition in Switzerland of a foreign bankruptcy decision. The bankruptcy Court having jurisdiction in the country in which the assets are located, or the first Court seized when assets are located in various States, will have jurisdiction for the *exequatur* of the said bankruptcy decision. The trustee of a foreign composition agreement or the debtor, but not a creditor, may also apply to a Swiss Court to obtain the recognition of the said composition agreement. Since 1997, a foreign decision with similar effects as the Swiss composition moratorium is also likely to be recognised in Switzerland.

The conditions for recognition of a foreign bankruptcy or a decision related to a composition agreement or to any other similar proceedings are identical, according to article 175 PILA. In practical terms, a foreign decision will be recognised if the following four conditions are cumulatively met:

- The decision must have been rendered at the debtor's domicile;
- The decision must be enforceable in the State in which it was rendered;
- There is no ground to deny recognition under article 27 PILA; and
- Reciprocity must be granted to Switzerland by the State in which the decision was rendered.

In addition, the decision must have comparable effects as bankruptcy or composition proceedings in Switzerland in order to be recognised.

Whereas the second and third conditions are easy to understand and ensure due respect for public policy and the principle of legal certainty, the first condition as to domicile is problematic insofar as EU regulation considers the COMI, i.e., the effective location from which the company organises its activities and not the registered office or debtor's domicile, in determining location. Consequently, Switzerland and an EU State could simultaneously start insolvency proceedings in two different locations.

The exequatur of a foreign bankruptcy judgment in Switzerland will result in local bankruptcy proceedings in Switzerland, in which case "summary" procedure will apply. First, the assets located in Switzerland will be liquidated and privileged creditors and secured creditors domiciled in Switzerland will be refunded. Any positive balance will then be allocated to the foreign creditors (i.e., the foreign bankruptcy estate) only if the foreign schedule of claims is recognised in Switzerland. In other words, the unsecured creditors domiciled in Switzerland should not be discriminated vis-à-vis any other foreign creditors. Should it be the case, the positive balance will only be split among the Swiss ordinary creditors (art. 174 PILA).

In connection with a decision related to judicial composition proceedings, the effects of said decision might be different; the Swiss judge may grant a stay or ratify a composition agreement in which the contractual terms of the credits are modified or in which the debtor obtains a partial release from his debts. In any case, the recognition of similar decisions will result in local composition proceedings and any debt enforcement proceedings will be stayed. This, in turn, will prevent any creditors from commencing special debt enforcement proceedings against the debtor.

The Swiss Court in charge of the *exequatur* of the foreign decision may assist with the implementation of the composition agreement in Switzerland, appointing a commissioner or a co-trustee in Switzerland if necessary.

The recognition of a foreign insolvency decision is also deemed necessary to allow the trustee, the liquidator and/or the commissioner to act in Switzerland. However, this is a disputed issue, since article 29 §3 PILA provides that a foreign decision might be preliminarily recognised. Furthermore, special conservatory measures may have been granted pursuant to article 168 PILA.

Finally, it is worth mentioning that the Swiss Federal Law on Banks and Savings Banks ("LB"), contains two relatively new provisions applicable to foreign decisions and measures regarding banks, savings banks and securities dealers. These provisions were adopted during the revision of the LB on October 3, 2003 in order to ensure first the realisation of the assets and second equal treatment for foreign and Swiss creditors. These provisions are important since the notion of domicile or registered office pursuant to article 166 PILA does not correspond to existing requirements in practice, as the foreign Authorities and the Swiss Financial Market Supervisory

Authority ("FINMA") often initiate bankruptcy proceedings at the effective location at which the bank or the savings bank organises its activities (COMI). Therefore, when a bank,a savings bank or a securities dealer has its registered office in Switzerland and a foreign branch office, the Swiss liquidator will have to coordinate the Swiss proceedings with one or more foreign proceedings pursuant to article 37f LB. Said provision also provides equal treatment for creditors that were partially refunded abroad and creditors participating in the Swiss proceedings, thus the amount allocated to a creditor within the foreign proceedings will be deducted from the dividend to be distributed in the Swiss proceedings. Furthermore, pursuant to article 37g LB, the decision rendered in the State of the effective location from which the bank organises its activities is also recognised in Switzerland and the privileged creditors domiciled abroad are also allowed to participate in the Swiss proceedings.

In conclusion, cross-border liquidations or reorganisation have not yet been simplified in Switzerland, since this country does not apply the uncitral model law on insolvency and since, not being an EC member State, it does not apply EC Regulation 1346/2000.

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SPAIN

Preference Granted to Petitioner-Creditors in Insolvency Proceedings

BY ANTONIO FERNÁNDEZ AND JUAN VERDUGO | GARRIGUES

A creditor who petitions for insolvency against a debtor acquires, where such the insolvency order is made, preference in the order of priority of payment of claims for up to 25% of his claim. The preference is granted to the petitioner-creditor in return for his beneficial contribution to the other creditors by bringing a court proceeding.

In this respect, a claim can become "generally preferred" (ranking second in the order of payment of insolvency claims) in up to one quarter of its amount provided that the creditor holding the claim petitions for an insolvency order, the Judge handling the petition formally orders an insolvency proceeding and the insolvency managers (charged with examining the validity and nature of the claim) grants this preference to the petitioner-creditor.

Legal Basis

The preference granted to petitioner-creditors is based on Title IV, Chapter III, Section 3, Article 91 part 6, of Insolvency Law 22/2003, of July 9, 2003, on "Generally preferred claims", which provides: "The following are classed as generally preferred claims: (...) 6. Up to one quarter of the amount of any unsubordinated claims held by the creditor which petitioned for the insolvency order."

Conditions Giving Rise to the Petitioner-Creditor's General Preference

The mandatory conditions that must be met in order for a petitioner-creditor's claim to be considered "generally preferred" are as follows:

- The existence of a claim against the debtor/insolvent party (the claim need not be due, liquid and/or payable; all that is required is for the debtor to have a relationship with the petitioner-creditor that is lawful, valid and mandatory, giving rise to the obligation to pay a specific sum of money, in legal tender).
- The creditor's claim must not be a subordinated claim, a specially preferred claim, or a generally preferred claim, as defined in the Spanish Insolvency Law. Should the creditor hold a specially or generally preferred claim, the Insolvency Law respects the priority ranking of the claim in question, although this priority cannot be increased, quantitatively or qualitatively, as a result of the new preference acquired.
- The creditor must petition for an insolvency order against the debtor.
- As a result of that petition, the debtor must be the subject of an insolvency order according to the

Spanish Insolvency Law, and the insolvency managers, who are responsible for drawing up the list of the debtor's creditors, must grant the above-described preference in the list of creditors (the decision of the insolvency managers, if negative, may be revoked by the insolvency Judge).

- The preference must cover up to one quarter (25%) of the amount of any claims that are neither subordinated nor specially or generally preferred.

Special Situations

It is important to know what happens in the event of multiple petitioner-creditors (two or more creditors petitioning for the insolvency of the same common debtor). In these circumstances, there are two possibilities:

- Joint petition (two or more creditors jointly sign a single petition for an insolvency order): all petitioner-creditors must benefit from the preference, although the most recent case law indicates that this preference should be divided on a pro-rata basis among the claims held by each of the petitioner-creditors (Judgments of March 29 and May 23, 2006, of Málaga Commercial Court, Mr. Enrique Sanjuan Muñoz).
- Simultaneous petitions (two or more creditors sign, separately, different petitions for declarations of insolvency): if more than one petition is filed regarding the same debtor, the only claim that will benefit from the preference will be the claim of the creditor whose petition has been admitted for consideration first, and was the reason for the insolvency order. This is so because, according to the Insolvency Law, the remaining petitions are joined to the admitted petition and for that reason it would not make sense for the preference to apply to the claims of creditors whose petitions had not resulted in the insolvency order (see condition iv, part 3, above).

Evidence of the Insolvency by the Petitioner-Creditor

Any creditor petitioning for an insolvency order is required to evidence the insolvency of its debtor by reference to the events in article 2.4 of the Insolvency Law. In this respect, the petitioner-creditor may either evidence that it has followed an enforcement process against the debtor which has not freed up enough assets for the payment, or the creditor *must prove* that *any* of the following events has occurred with respect to its debtor:

- General cessation of payment of the debtor's obligations as they fall due.
- The existence of attachments as a result of unenforced debts that have a general effect on the debtor's assets.
- Dealings in or liquidation of its assets by the debtor in a way that is either precipitated or financially damaging.
- General failure to meet obligations of any of the following types: payment of tax obligations in the three months preceding the petition for an insolvency order; social security payment obligations and other joint collection obligations in the same period; salary and severance obligations, and any other payments arising from employment relationships relating to the last three months.

In this respect, unlike an insolvency requested by the debtor itself, in an insolvency petitioned by the creditor providing evidence of the insolvency *ab initio* does not automatically lead to an insolvency order, but rather is only a necessary step for it to be admitted for consideration. Admission for consideration may even be denied by the Commercial Court if the proof provided by the creditor is not sufficient or even if the Judge finds unscrupulous conduct by the petitioner-creditor, as explained in the following section.

Some Words of Caution in Relation to the Preference of the Petitioner-Creditor

The most recent case law of the Spanish Commercial Courts refers to the existence of unscrupulous creditors (commonly known as snipers) who try to force an insolvency order, in an outright attempt to achieve either immediate collection of their claim or preference for the petitioner-creditor. The Commercial Court Judges are aware that these attempts to petition for insolvency of the debtor can destroy any debt refinancing processes in progress and cause an infinitely greater amount of damage to the debtor.

Spanish Commercial Court Judges are proving to be sensitive to this problem and have been trying to avoid greater damage by denying the insolvency order whenever possible. This happened in Madrid (Order of May 18, 2008, of Commercial Court number 2 of Madrid, Judge Mr. Antonio Martínez Romillo), with a subsidiary of real estate company Nozar, when an insolvency order petitioned on it by a creditor was ultimately denied because, according to the Court, the decision to admit the petition for insolvency for consideration can only be rendered once the petitioner has produced all of the documents necessary to make a reasonable judgment on the existence of the debtor's insolvency.

The same occurred in Barcelona, where the presiding judge at Commercial Court number 3 (Judge Mr. Jose María Fernández Seijó) went one step further and in his Order of April 15, 2008 denied admission for consideration of a claim for insolvency petitioned by a creditor against Fbex Promotora Inmobiliaria because "given the extremely serious effect that would be caused to the debtor by having its position published on the basis of a purported insolvency, it seems more than reasonable to expect the Judge to determine at least whether the petitioner has met the requirements in article 7". In this case analysed by the Court of Barcelona, it was a public and well-known fact that the developer was then negotiating a refinancing arrangement with its creditor financial institutions which would inevitably have been thwarted.

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GREECE

The Rescue Ethos of the New Greek Insolvency Code: Between the Scylla and Charybdis of Anachronism and Modern Nomothetical Principles

BY CONSTANTINOS N. KLISSOURAS AND YIANNIS G. SAKKAS | ANAGNOSTOPOULOS BAZINAS

The reform of Greek insolvency legislation could not have been better timed. A new insolvency code (Law 3588/2007 (the IC), SG A 153/10.7.2007) was introduced in 2007, two years before the current economic crisis peaked, affording just enough time to courts and to all insolvency actors to come to terms with the new law and for basic case law to develop and provide a degree of legal certainty in the face of the horde of challenges raised by the current economic environment.

Reform was, of course, not brought about by inspired foresight of the legislature, but rather by the pressing need for an efficient and effective insolvency regime identified in analyses and reform recommendations originating in the leading international fora and organisations, such as the World Bank and UNCITRAL, in lieu of the antiquated law previously in force, for the most part a remnant of the Napoleonic *Code de Commerce* of 1807.

A lot of ink has already been shed debating whether the new law meets modern tests of efficiency and effectiveness, and in significant measure the answer is affected by the overall speed, cost and efficiency of the court process in general. On balance, it is probably accurate to say that notwithstanding the extraordinary burden on court dockets occasioned by the crisis, the new law provides reasonable and efficient solutions to most of the usual issues raised by insolvencies, large and small.

In the words of the legislative committee, the spirit of the new law is one of minimum departure from established insolvency law principles, but with due regard for efficiency, salvage of going concern value, and speedy conduct of proceedings. The rescue ethos of the new law is embodied in two types of workout proceedings, provided in articles 99 ff and 107 ff respectively.

"Insolvency mediation" (articles 99 ff) is structured as a pre-opening proceeding available to debtors not technically insolvent, i.e., debtors who have not ceased payments in a general and permanent way, but with a current or projected financial distress (Article 100 (1) IC). The IC does not expressly define the threshold of such projected distress, since that would run foul of the principle of economic freedom and the business judgement rule, but case law has usefully focused on financial weakness indicators such as a negative balance sheet, excessive short term borrowing, the termination of credit lines from parent companies, the existence of fire sales or other disposals for the satisfaction of short term liabilities, contraction trends discernible from order books, and similar tests, which have tended to focus in a pragmatic manner on the particulars of each debtor, market and case.

Article 99 proceedings seek to address the debtor's financial distress through the negotiation of a voluntary workout with individual creditors. A mediator is appointed by the court with the mission of assisting in the negotiations with creditors, analysing workout options and formulating a restructuring plan, and opining to the court (together with a court appointed auditor) on the plan's viability. Subject to the approval of the debtor and a simple majority of creditors, the plan is ratified by the court and, while not affecting the quality of the claims of dissenting and non-participating creditors, it results in a stay of action against the debtor for a period of up to two years.

Although the legislature draws from the experience of other jurisdictions which have similar regimes like the company voluntary arrangement of the UK or the French *procédure de conciliation*, it unfortunately fails to fully exploit the idea of "pre-packaged" workouts. Article 99 proceedings, in line with various pieces of previous legislation, still require the appointment and substantive involvement of the mediator, which has proven to be an unnecessary and time consuming exercise in the many cases where the debtor may have already agreed with its key creditors, the consensus of which would be enough to fulfil the simple majority threshold for the approval of the workout before is entered in the court for ratification. This increases the time required from filing to ratification, in which time, the debtor may have progressed from a projected financial distress to a *de facto* inability to satisfy debts and the proposed arrangement would be rejected by the court given the prerequisite of solvency.

A "restructuring plan" (articles 107 ff) is essentially a debtor-creditor arrangement of contractual nature subject to judicial review by the insolvency court. The proposed restructuring plan may provide for any measure of a restructuring nature, financial, operational or other, including going concern sale of the debtor or the debtor's business, simple and complex refinancing, leases and concessions, piecemeal asset sales, and, in general, whatever satisfies the statutory creditor majority that sufficient value will be generated to satisfy their claims in whole or in part, i.e., as such claims are modified (in respect of their amounts, maturities or other characteristics) under the plan. Subject to the acceptance of the statutory majorities of 60% of all claims, at least 40% of which must be secured creditors, the plan is submitted to court for ratification, upon which the plan is binding *erga omnes*, including dissenters and non-participating creditors.

The rescue ethos of the IC is, importantly, marked by the recognition, for the first time in Greece, and contrary to previous law, of super-priority ranking status for claims arising under post-petition funding, as well as with the tight time limits adopted (although presently not always complied with) for all procedural acts and stages of the insolvency.

The IC also attempts to relieve court dockets from some of the ultimately inefficient burden, by rules preventing the opening of insolvency proceedings for debtors, whose assets are manifestly insufficient to fund procedural costs (Article 6 (2), IC), as well rules for "fast-tracking" small insolvencies (Article 162, IC).

Well timed and pivotal for domestic business law, the reform, and its restructuring principles and mechanisms in particular, have also started to prove instrumental to the efficient operation in Greece of European insolvency legislation. Experienced practitioners know the horrors of labouring to *export* – translate, interpret and explain – old Greek insolvency law as the *lex concursus* to be applied by foreign courts and arbitral tribunals. The IC is fast becoming a good ambassador of state for the quality of modern Greek insolvency law. This acquires particular significance in view of the relatively recent EU enlargement, which did away with a lot of borderlines in the Balkans and rendered transactions between Greece and the new EU entrants intra-community trade. It is estimated that the stock of Greek capital in the Balkans is over €7 billion, making Greece the largest investing country in the region; efficient and effective Greek restructuring laws are, therefore, fast becoming indispensable for defending its going concern value.

Greek insolvency legislation has never been more in line with current trends of international insolvency law. The introduction of insolvency mediation, the adoption of the debtor in possession principles, the regulation of first day orders and other conservatory relief, the *mot-a-mot* use of the wording of the key jurisdictional notion of the centre of main interest as used in the EIR and the UNCITRAL Model Law, are few examples of the effort made to provide a modern legislative framework to ensure the efficient and effective rescue of corporate entities in financial distress. While wishful of signs of upturn in the current cycle, the legal and business community avails today of a much more powerful arsenal to rescue value and reduce the impact of the cycle on business and society.

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RUSSIA

Acquisition of Non-Core Assets in the Reality of the Financial Crisis in Russia

BY ELENA MAKAROVA | MAGISTERS

At present, the number of defaults on contractual obligations has increased significantly. Creditors may choose different ways for protection of their interests, and in many cases they prefer to obtain some assets in lieu of waiting for execution of duties on the primary obligation. The exploration of such popularity is as follows. As practice has shown, company management does not file a petition on bankruptcy procedure at the first signs of company's bankruptcy (insolvency) as the Law on Bankruptcy (Insolvency) requires, and if a bankruptcy proceeding has been initiated it is actually impossible to restore the solvency of such a company. Thus in most cases the pending bankruptcy case means that creditors' demands will not be met. Once the first signs of bankruptcy in the debtor's activity are revealed, the most insightful participants of economic turnover try to enter into negotiations with the debtor and protect their interests in extrajudicial procedure. As a result of this, an acquisition of some assets with discount instead of demand to perform a primary obligation becomes more and more popular; and at present there are a lot of companies owning a bulk of different types of non-core assets.

It should be noted that acquisition of non-core assets was always recognised as a normal practice (to some extent it is connected with a peculiarity of the Russian economy – the widespread practice of accumulation of non-core assets within one company or a group of companies). Generally, the practicability of acquisition of non-core assets is explained by plans of further selling or renting thereof.

However, the termination of a primary obligation instead of conveyance of other debtor's assets raises some questions.

First of all, it concerns the utility of such an adjustment. In the pre-crisis period it was not difficult to get rid of that property at a time convenient for the creditor, so resolving a problem with the debtor by this means was always considered optimal. But today the situation has changed, and holding non-core assets in some cases has become an obstacle for the normal activity of many companies. One of the reasons for this is that most market participants are not geared up to invest money in new projects due to the necessity of supporting their own business. Thus creditors acquiring non-core assets are forced to incur unplanned costs on the management of such assets and on creating new ways to sell them.

But for banks, for example, this method is still in some cases "a life line". According to the requirements of banking legislation, a bank has to build up a reserve for every unsatisfied debt at an amount close to the amount of the debt. If this debt is cancelled by receiving assets rather than cash, it is fixed on a special account and not subject to being secured by the reserved funds. Consequently, this procedure makes it possible to get rid of the problem debt as well as get additional monetary funds from former reserves. But it should be noted that the Bank of Russia (Bank Rossii) is concerned by the growing number of such transactions because the absence new free monetary funds combined with the presence of non-profitable assets negatively impacts the solvency of banks. As a result, the Bank of Russia is poised to enforce the requirement of building up reserves on such assets in the near future.

When a creditor has made a decision to acquire a non-core assert instead of demanding execution of a primary obligation, it should choose the method of acquisition. The most popular ways are as follows: (i) establishing an SPV with subsequent conveyance of non-core assets for intended use thereof or for letting them on lease; (ii) acquisition of shares in a company – an owner of non-core assets; and (iii) acquisition of the assets and putting them on the balance sheet interim (with the intention to sell them off as soon as possible). Each method has both positive and negative aspects and choosing a particular way depends on the specific circumstances of the case. For instance, establishing an SPV with subsequent conveyance of non-core assets is a rather prolonged and labour intensive procedure. So it is suitable for generally highly liquid assets that cannot be put on the owner's balance sheet for legal, economic, reputational and other reasons. In addition, it entails significant costs (creation of SPV, searching for highly skilled management, paying wages to them, paying taxes, maintaining the property, etc.). Consequently, if an acquirer has not foreseen the costs that will be incurred due to the acquisition of such a property, the additional non-core business may ruin its primary business.

Second, there are some risks connected with the procedure for acquiring such assets. The procedure for settling a dispute out-of-court is exercised within a rather tight schedule that may deprive a potential acquirer from the possibility of carrying out different types of due diligence on the assets. It may cause a dispute regarding the legal title of the previous asset owner or other "latent claims". Furthermore, new "anti-crisis" regulation has added new legal risks in such transactions. The most substantial amendments regard pledge regulation and the procedure of challenging transactions in the course of bankruptcy proceedings. It would seem that pledged creditors were provided with more rights. For example, the procedure of extrajudicial foreclosure procedure provided by the Civil Code of Russian Federation and the Law on Pledge has been simplified; in bankruptcy procedures, pledged creditors have been vested with a right to receive 70 percent of the funds (or 80 percent if the creditors are a credit organisation) from the sale of the pledged property in urgent priority. However, the given legal restrictions in the amount of receiving funds in the course of a bankruptcy procedure raise a question about the legitimacy of termination of the primary obligation by producing the compensation (some assets of the debtor). It is significant that the Law on Insolvency (Bankruptcy) has essentially strengthened the provisions on challenging transactions entered on the threshold of the bankruptcy proceedings. Consequently, there is a clash between the provisions of the Civil Code of Russian Federation and the Law on Pledge, from the one side, and the Law on Insolvency (Bankruptcy), from the other side. Unfortunately, due to the fact that the amendments are rather new, there is no settled judicial practice on this issue. Consequently, when entering into such transactions the parties should take into account the risk of further challenges.

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POLAND

Bankruptcy in Polish Law – The Premises of Instigation and the Course of Proceedings

BY IWONA KARASEK | KUBAS KOS GAERTNER

Bankruptcy is declared in relation to a debtor which has become insolvent. A debtor is insolvent when it fails to perform the required pecuniary obligations. If the debtor is a legal entity or organisational unit not possessing a legal personality, but a separate act grants its legal capacity, it is also deemed as insolvent when its obligations exceed the value of its estate, even if the obligations are met on a standing basis.

The Court may dismiss a declaration of bankruptcy if the delay in meeting obligations will be less than three months, and the sum of the outstanding obligations does not exceed 10% of the balance sheet value of the of the debtor's enterprise. This exception is not applied if the debtor is permanently unable to meet its obligations or if the motion's dismissal may be detrimental to creditors.

Two Forms of Bankruptcy Proceedings

Bankruptcy proceedings may take two forms. The first is aimed at concluding the proceedings with a reorganisation agreement with creditors (a "reorganisation bankruptcy") while the second centres on the liquidation of assets and satisfying creditors with the funds obtained (a "liquidation bankruptcy").

A reorganisation bankruptcy is considered plausible if the results of a reorganisation agreement will satisfy creditors to a higher extent than they would if the debtor's assets were liquidated. Bankruptcy proceedings under a reorganisation agreement are not conducted if previous actions of the debtor mean there is no certainty that the reorganisation agreement will be carried out, unless the reorganisation agreement proposal foresees a liquidation agreement. If there is no basis on which to pursue a reorganisation bankruptcy, liquidation bankruptcy is declared.

Formal Requirements of a Motion for the Declaration of Bankruptcy

A motion declaring bankruptcy may be submitted by the debtor or any of its creditors. Motions may also be submitted in relation to a general partnership, limited liability partnership, limited partnership or private unlimited company with share capital, among others. Each of the shareholders is responsible without limitation for the company's liabilities, in relation to legal entities as well as organisational units not possessing a legal personality, where a separate act grants its legal capacity, and each person is entitled to represent it individually or jointly with other persons.

The motion on the declaration of bankruptcy should include among others:

- the name of the debtor, the company name, the place or residency or the registered seat, and if the debtor is a partnership or a legal entity, the representatives of the company or legal entity and the liquidators, if they are established, and moreover, in the case of the company, the names as well as the addresses of the shareholders responsible for the company's liabilities without limitations;

- an indication of the venue in which the enterprise or some other of the debtor's assets are located; and
- an indication of the circumstances which substantiate the motion, and their plausibility.

If the motion on the declaration of bankruptcy is submitted by the creditor, it should make its liability plausible. Moreover, if it motions for the declaration of reorganisation bankruptcy, it should include the initial reorganisation proposal.

If the motion on the declaration of bankruptcy is submitted by the debtor, it should include many additional elements.

Capacity for Proceedings on the Declaration of Bankruptcy

The entities of the bankruptcy proceedings may be entrepreneurs. An entrepreneur is a natural person, legal entity or organisational unit not possessing a legal personality, a separate act of which grants its legal capacity, conducting business or professional activities in their own name.

Apart from the entrepreneurs, bankruptcy may be declared in relation to:

- limited liability companies and joint stock companies not conducting business activities;
- the shareholders of commercial companies bearing liability for the company's liabilities without limitation with their entire assets; and
- the shareholders of a limited liability partnership;

Bankruptcy of the following may not be declared, among others:

- local government entities;
- public independent health care institutions; and
- institutions and legal entities created by means of an act as well as created in the execution of the obligations placed upon them by the act.

The Course of Bankruptcy Proceedings from Declaration to Completion

A common stage for both forms of bankruptcy proceedings is the lodgment and establishment of claims (in certain cases, some creditors may participate in proceedings actions without such a lodgment). After the claims have been lodged, they are verified and a list of claims is established. After considering the objections, including the refusal to include certain claims on the list, the court approves the list of claims.

In reorganisation bankruptcy proceedings, attempts are made to conclude a reorganisation agreement. The reorganisation agreement is, in principle, accepted when a majority of the creditors entitled to vote, possessing at least two-thirds of the total sum of the claims entitled to vote, vote in favour of the agreement. Subsequently, control of the content of the reorganisation agreement and its approval by the court is necessary.

The reorganisation agreement binds all the creditors whose claims are covered under the reorganisation agreement, even though they may not be included on the list. According to the act, the reorganisation agreement, in principle, does not violate the rights resulting from a mortgage, pledge, registered pledge and maritime mortgage.

This also regards the rights resulting from the transfer of the ownership of goods, claims, or other rights onto the creditor in order to secure the claims. The reorganisation agreement also binds any creditors which the bankrupt party intentionally failed to disclose and who did not participate in the proceedings.

If the reorganisation agreement is approved, the bankruptcy proceedings are subject to conclusion and the execution of the reorganisation agreement takes place. In the event that a reorganisation agreement is not reached, liquidation bankruptcy proceedings are declared.

In the event of a liquidation bankruptcy, the receiver makes an inventory list and prepares a liquidation plan, and then subsequently begins to liquidate the bankrupt estate. The liquidation of the bankrupt estate takes place, in principle, through: the sale of the bankrupt enterprise, in full or its organised parts; the sale of the real estate and chattels; the collection of claims from the bankrupt party's debtors; and the execution of its other estate rights, being a part of the bankrupt estate or their sale.

The next stage of the liquidation bankruptcy is the satisfaction of the creditors. Some creditors (specifically those secured by a mortgage, pledge, or registered pledge, and also a trust) are entitled to the right of separation, i.e. the right to be satisfied from the object of the pledge, apart from the division of the estate's funds. The remaining creditors are satisfied within the framework of an established plan of the division of the bankrupt estate's funds. The bankruptcy law foresees several categories of privileged creditors, satisfied in first order, before the others.

Possible Variants of Concluding Bankruptcy Proceedings

Reorganisation bankruptcy usually ends with the conclusion of a reorganisation agreement. In the event that there is a discrepancy in the execution of the reorganisation agreement, a possibility exists to open the concluded bankruptcy proceedings, this time in the of liquidation.

Liquidation bankruptcy, as a rule, is concluded with at least a partial satisfaction of the creditors though the division of the bankrupt estate's funds. The Court then issues a decision on the conclusion of the bankruptcy proceedings. In special cases, such a bankruptcy may be concluded with a reorganisation agreement or with its restructuring into liquidation bankruptcy or the discontinuation of the bankruptcy proceedings.

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ESTONIA

Adoption of Reorganisation Act – Last Piece in the Insolvency Puzzle Set?

BY HOLGER TILK | LEPIK & LUHAÄÄR LAWIN

The history of Estonian insolvency law begins on 1 September 1992 with the enforcement of the first Bankruptcy Act. It is notable that during the period of Estonian First Independence (1918-1940) the bankruptcy laws of tsarist Russia had been continuously applied. The grounding idea of the Bankruptcy Act has been the foremost protection of the creditors' interests. A creditor's main interest is to satisfy its claim to the fullest extent possible, whether from the liquidation proceeds (winding-up) or from the capital gains of the debtor (reorganisation). In other words, satisfaction of creditors' claims must not necessarily result in liquidation of the debtor; rather it should be the measure of last resort.

To be sure, the Bankruptcy Act has always included the regulation of reorganisation. However, due to some of its essential features, it has rarely been applied (four compromises in 2006 and two compromises in 2007). Reorganisation under the Bankruptcy Act is only possible after the claims of creditors have been defended. As the claims of creditors could be defended from three to six months after the bankruptcy has been declared and the bankruptcy petition is usually filed too late, in most cases reorganisation in bankruptcy proceedings would be futile. Therefore Estonian insolvency law has been strongly in need of an effective alternative approach to winding-up type of proceedings and the term "bankruptcy law" instead of "insolvency law" would be more exact to describe the period preceding the adoption of the Reorganisation Act (the "Act").

The Act entered into force on 26 December 2008 with high hopes of offering entrepreneurs a preventive proceeding that would help them to overcome their temporary insolvency or probable future economic difficulties. Pursuing this goal should also guarantee employment, increase the payables received by creditors, retain the necessary entrepreneurs, promote a more stable business environment and in the long-run should raise the states' tax returns. According to conservative estimates presented in economic analyses of the Act, approximately 10% of all the entrepreneurs subjected to bankruptcy proceedings are eligible for reorganisation. This would result in the survival of around 20 entrepreneurs with 800 jobs and at least EEK 20 million in additional tax returns per year.

The purpose of the reorganisation proceedings deviates from the so far established principle of the foremost protection of the creditors' interests. Although the Act itself stipulates that the interests of entrepreneurs, creditors and third persons must be considered and protected, it is evident that these interests are conflicting. The Supreme Court held in its recent decision 3-2-1-122-09 that in the reorganisation proceedings the interests of the entrepreneur are somewhat more important than the interests of the creditor. The decision of preference must be based on the test of "fundamental breach", meaning that the interests of the entrepreneur could be preferred to creditors' interests to the extent that the creditors' interests have not been fundamentally breached. For determining the fundamental breach of interests, it has to be clarified whether the creditor is still financially better off than in bankruptcy proceedings. However, this standpoint has to be interpreted from the perspective of a reasonable person, as in most bankruptcy cases, creditors without security rarely receive any payments from the bankruptcy estate.

The Act provides an open list of measures for improving the economic health of the entrepreneur. That complies with the recent trend of insolvency law to offer a wide range of different measures in order to guarantee the availability of suitable means for every specific situation. Lawmakers have enacted the following measures as examples: extension of the payment term, payments by instalments, reduction of the claim and substitution of the claim with the share of the legal person (i.e., transfer reorganisation). Nevertheless, not all the claims can be transformed. The Act stipulates explicitly that the claims arising from the employment agreement are excluded from being transformed. The Supreme Court confirmed in the aforementioned decision that this list is exhaustive and by taking this standpoint it denied the argument of the Tax and Customs Board (the "Tax Board") that transforming the tax claims would result in unequal treatment of taxpayers. The Supreme Court held contradictory that exclusion of tax claims would violate the principle of equal treatment of the creditors and would hinder the attainment of the goals of reorganisation. Although the Tax Board accepts the standpoint of the Supreme Court, it currently considers payments by instalments as the only possible measure for transforming the tax arrears.

The main stages of reorganisation proceedings are commencement of the proceedings, approval of the reorganisation plan and execution of the reorganisation plan. Reorganisation proceedings can only be commenced with a petition from the entrepreneur who is suffering from economic difficulties and has convinced the court that future insolvency is probable, the entrepreneur needs reorganisation and subsequent to reorganisation sustainable operation of the entrepreneur is likely. It should be noted that the object of reorganisation is entrepreneur not enterprise (except for sole proprietor) as falsely stipulated in the Act. Entrepreneur in the sense of the Act includes not only commercial undertakings but any person owning an enterprise, including non-profit associations and sole proprietors. Nevertheless, several commercial entities such as credit institutions, electronic money institutions, insurers, investment firms, management companies (trustee), investment funds established as public limited companies, operators of Estonian Central Register of Securities, operators of clearing and settlement systems and operators of payment systems, have been excluded and subjected to special regulations.

Lawmakers have not clarified the characteristics of economic difficulties which enable the commencement of reorganisation proceedings. Reasonable interpretation would allow all entrepreneurs that are not permanently insolvent to apply for reorganisation. Therefore, simply the existence of arrears as well as absence of arrears at the moment of filing of the petition should not hinder the commencement of the proceedings. However, for the entrepreneur to be eligible, it must also need reorganisation, meaning that current economic difficulties are caused by economic activity, not by malevolent behaviour or immutable global trends, reorganisation of entrepreneur is possible and its future operation without constant subsidising is probable.

Under current regulation, the court has seven days from the filing of the application to decide whether or not to commence reorganisation proceedings. Although the court is not expected to carry out any economic analysis and should base its decision solely on the probability of the successful reorganisation, it is doubtful that even assumption of probability can be made without special knowledge, especially within seven days. A working group of insolvency law established by the Ministry of Justice has taken a standpoint that all the dates enacted in the Act should be reviewed to guarantee that they are realistic for achieving the purpose and effectiveness of the proceedings. Due to lack of time and knowledge, courts have often commenced reorganisation proceedings for many entrepreneurs, who simply use protection from creditors as a possibility to postpone the commencement of bankruptcy proceedings, to transfer the property from the entrepreneur or enterprise and to abuse the fact that the limitation period for recovery of property enacted in the Bankruptcy Act is not suspended. This is shown by the statistic that less than 10% of the commenced reorganisation proceedings have resulted in the approved and confirmed reorganisation plan. Unsuccessful proceedings result in unnecessary costs, which do not comply with the pursuit of increased payables.

Commencement of reorganisation proceedings bring about several consequences which protect an entrepreneur from creditors until the reorganisation plan has been approved or reorganisation proceedings have been terminated. After reorganisation proceedings have been commenced, the court suspends all the compulsory execution proceedings carried out towards the entrepreneurs' property, suspends accounting of the late payment interest (excluding regular interests) and contractual penalty increasing in time, postpones the rendering of the decision of commencement of the bankruptcy proceedings on the creditors' bankruptcy petition and may upon the entrepreneurs' request and reorganisation advisers' approval suspend the court proceedings, which have monetary claim against the entrepreneur, as its object. Initially, lawmakers had deliberately excluded tax interests from the list of suspended calculations, however, in light of the aforementioned Supreme Courts' decision, tax interests should also be considered as suspended. This is also current practise of the Tax Board.

The key figure in the reorganisation proceedings is the reorganisation adviser, who will be appointed by the court upon commencement of the proceedings. Its main obligations are supervision of the entrepreneurs' economic activity during reorganisation, to determine the extent of creditors' claims and to assist the entrepreneur in composing and executing the reorganisation plan. Although the reorganisation adviser has supervisory authorities, the entrepreneur retains its independent right to execute transactions.

At the commencement of the reorganisation proceedings, the court establishes the term for composing, approving and confirming the reorganisation plan within a maximum of 60 days. The process of approval is two staged. Firstly, the majority of creditors whose claims form a majority of claims being transformed take a vote on the plan. Secondly, the court must confirm with the court ruling that the process of approval has been duly executed. Only subsequent to the confirmation will the reorganisation plan be entered into force. Based on the idea of preferring entrepreneurs' interests in the reorganisation proceedings, the court may under specific conditions confirm the reorganisation plan, which has not been approved by the creditors. The purpose of granting the court with the right of bypass has been to exclude the possibility that the creditors could force the probably viable entrepreneur to go into bankruptcy. After confirming the plan, all creditors whose claims were transformed are subjected to the plan even if they voted against it or refused to vote but were duly informed.

The Act does not stipulate any periods for achieving the goals provided in the reorganisation plan. However, the Supreme Court stated in a cited case that the term for execution has to be reasonable and for example, a term of 10 years is reasonable only under exceptional circumstances. Furthermore, the longer the term, the more the reorganisation plan has to concentrate on the benefits of reorganisation compared to bankruptcy. Three reorganisation plans which have been confirmed by the courts so far had terms from 10 years for a biodiesel factory to four years for a producer of construction material.

The main consequence of confirming the reorganisation plan for the creditors whose claims have been transformed is the prohibition to file an action or bankruptcy petition to the court based on the transformed claim. Nevertheless, when an entrepreneur fails materially to perform its obligations, the court will terminate the plan and the rights of creditors are restored retrospectively. The rights of creditors whose claims were not transformed are allowed to file an action to the court and to calculate late payment interest and increasing contractual penalty from the date of confirmation of the plan.

In conclusion, there is no doubt that the Act has enriched Estonian insolvency law with a preventive proceeding with emphasis on the protection of entrepreneurs' interests. However, it has failed to protect creditors' interests to the extent necessary, as too many entrepreneurs with no hope or intention for survival have been allowed into reorganisation proceedings. All these proceedings bring about additional costs and therefore decrease possible payables. Nevertheless, there is nothing essentially wrong with the regulation and with the help of court practise, improvements in the courts' competence, a few amendments to the Act, development of business culture and the recovery of economic growth, most of the problems could be healed. Therefore, the last piece of insolvency law is ready, but some delicate tailoring is needed to fit this piece properly into the puzzle of insolvency.

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ASIA PACIFIC

AUSTRALIA

Maximising the Chances of Recovery for Distressed Australian Companies: a Change in the Legal Landscape

BY JONATHAN MILNER AND LEON ZWIER | ARNOLD BLOCH LEIBLER

Part 5.3A of the *Corporations Act* 2001 (Cth) ("Act"), which was enacted in 1993, provides a statutory framework for the reconstruction of financially distressed Australian companies.

Until recently, the Part 5.3A framework was considered to provide a relatively rapid, flexible, inexpensive and straightforward way for insolvency practitioners to attempt to "save" companies that are insolvent or nearing insolvency. Indeed, the Act itself provides that the object of Part 5.3A is to provide for the business, property and affairs of an insolvent company to be administered in a way that:" (a) maximises the chances of the company, or as much as possible of its business, continuing in existence; or (b) if it is not possible for the company or its business to continue in existence — results in a better return for the company's creditors and members than would result from an immediate winding up of the company."

Until recently, accepted wisdom was that these objects were indeed most likely to be achieved using the Part 5.3A framework and, since its introduction in 1993, this framework has been the principal form of insolvency administration used in Australia.

However, a recent decision of the Australian Federal Court has called into question the scope (and therefore the efficacy) of a key aspect of that framework, particularly when it is compared with the available alternative.

Voluntary Administration and DOCAs

In very general terms, the Part 5.3A framework enables an insolvency practitioner to be appointed as an administrator of a company that is insolvent or nearing insolvency. The appointment of an administrator gives the company some "breathing space". It does so by conferring a range of external protections, including, subject to certain limited exceptions, a stay of all enforcement procedures.

Once under administration, a company has a number of options. One option is to engage in a process of reconstruction through the execution of a deed of company arrangement (DOCA). A DOCA does not need to be approved by a court and may be executed pursuant to a resolution by a simple majority (in number and value) of a company's creditors.

A DOCA is a binding agreement between an insolvent company and its creditors. It is a creature of statute and derives its force from the Act. If a bare majority of creditors (in number or value) as a whole vote in favour of the execution of the DOCA, creditors' debts may be compromised and creditors' other rights may be varied without their consent.

Once executed, a DOCA has the effect of determining the rights of creditors by reference to the terms of the deed. Commonly, the DOCA will provide that creditors' debts are to be discharged on payment of a dividend calculated in accordance with the terms of the DOCA.

As part of this process, DOCAs also typically include releases of all claims as between the creditors and the insolvent company. However, because DOCAs are intended to "draw a line" between the company's pre and post-administration affairs, they typically also include releases by the creditors of their claims against the company's directors, its auditors and other third parties in relation to the "pre-DOCA" affairs of the company.

The Contrast Between DOCAs and Schemes of Arrangement

Part 5.1 of the Act provides a process by which a company may make an agreement or arrangement with its creditors as an alternative to liquidation. These agreements are known as schemes of arrangement ("Schemes").

Schemes are binding on the creditors of a company and on the company (or its liquidators) only if: (i) a majority in number of the creditors present and voting, being a majority whose debts or claims against the company amount in the aggregate to at least 75 per cent of the total amount of the debts and claims of the creditors present and voting, or of the creditors included in that class present and voting; and (ii) the compromise or arrangement is then approved by order of the court.

A court may grant its approval to a compromise or arrangement subject to such alterations or conditions as it thinks fit.

Traditionally, Schemes have been used to give effect to solvent corporate reorganisations or to mergers or acquisitions. However, principally because the Scheme procedure is procedurally cumbersome, until recently Schemes were seldom used for the purposes of reconstructing insolvent companies or companies nearing insolvency.

Litigation Spawned by the GFC

It is axiomatic that the global financial crisis gave rise to numerous corporate collapses. In Australia, these included the collapse of Lehman Brothers' Australian corporate group and the collapse of a number of margin lenders, including the Opes Prime group of companies.

These corporate collapses in turn gave rise to spate of litigation concerning the scope and effect of both DOCAs and Schemes. Two of those decisions have had significant wider ramifications.

In *City of Swan v Lehman Bros Australia Ltd* (2009) 260 ALR 199 the Full Federal Court decided a series of questions relating to a DOCA entered into by Lehman Australia. The DOCA provided for funds made available by the Lehman group to be distributed to distinct classes of creditors who, in exchange for an entitlement to share in those funds, agreed by the terms of the DOCA to release and fully discharge Lehman Australia, all other Lehman entities and the directors, officers and employees of all Lehman companies from any suit or claim in respect of the marketing and sale of financial products to those creditors. The DOCA purported to bind all creditors, including those minority creditors who did not vote in favour of execution of the DOCA.

Certain creditors argued that because the DOCA purported to extinguish their rights to sue third parties, the DOCA was beyond the power conferred by Part 5.3A. The Court agreed with this submission. It found that the purpose of a DOCA under Part 5.3A of the Act is to regulate the rights and obligations between a company and its creditors, not between a company's creditors and any third parties associated with that company. Justice Stone stated that "the language of Pt 5.3A does not lend itself to a wholesale adjustment of the rights and obligations of a company's creditors", while Justice Rares stated that if the DOCA were to stand it would involve "the involuntary destruction of the private rights and interests of some creditors against third parties".

By coincidence, just prior to the Lehman Brothers decision, a differently constituted bench of the Full Federal Court had occasion to consider the scope of third party releases in a Scheme document. *Re Fowler v Lindholm; Opes Prime Stockbroking Ltd* (2009) 259 ALR 298 concerned the Opes Prime group which, until its collapse in March 2008, was engaged in providing stockbroking services to institutional and private clients, predominantly in the form of securities lending and equity financing. After its collapse, the creditors of the Opes Prime group commenced legal proceedings against ANZ Bank and Merrill Lynch alleging, among other things, that those third party financiers had engaged in misleading conduct in relation to a range of financial products that were marketed and sold by the Opes Prime group.

Ultimately, a Scheme was proposed as part of a settlement proposal. Under the Scheme in question, ANZ and Merrill Lynch were to contribute to a fund for distribution to creditors, in return for which unsecured creditors, the Scheme companies and the liquidators of the Opes Prime group would release all pending and future claims against the third party financiers. However, a Scheme creditor commenced proceedings challenging the Scheme's validity primarily on the basis that Part 5.1 of the Act did not permit the Court to approve an arrangement that required unsecured creditors of the Scheme companies to release their claims against third parties.

The creditor's claim failed. The court held that a Scheme can bind a creditor to provide a release of that creditor's claim against third parties provided there is an "adequate nexus between a release or indemnity, on the one hand, and the relationship between the creditor and the company, as creditor and debtor, on the other hand". It was held that the necessary nexus was present in the Opes Prime Scheme principally because of the overlapping nature of creditors' claims against the Opes Prime group and the third party financiers.

The court held that if a Scheme transaction involved some "give and take" or the provision of some "benefit" to creditors, third party releases could properly be incorporated into a Scheme document.

Changing Attitudes to the Efficacy of Schemes?

These decisions have called into question accepted wisdom as to the relative merits of Schemes and Part 5.3A in the context of an insolvent workout. Part 5.3A was introduced to simplify, expedite and enhance the prospects of such workouts. Whilst that regime remains simpler and more cost-effective than Schemes, in one important respect it has been emasculated.

The efficacy of a DOCA depends on the various stakeholders, including importantly third parties who may be considering contributing funds for the purposes of resolving creditors' claims, being satisfied that the DOCA in fact represents a "clean break". The decision in the *Lehman Brothers* case means that this outcome cannot now be achieved through a DOCA.

There are a number of possible responses to this (apparently unintended) shortcoming in the legislation. First, an appeal from the Lehman Brothers decision is to be heard by the High Court of Australia in February 2010. It is therefore at least possible that the problems identified above will be short-lived. Secondly, even if the High Court does not uphold the appeal, the Commonwealth government may consider introducing legislation designed to address the lacunae, a possibility alluded to by Justice Stone in the *Lehman Brothers* decision in the following passage: "Whether a wider scope would lead to a better commercial outcome and whether it would be appropriate to provide for that expansion of Part 5.3A is a question for the legislature and not for the court".

In the interim, or in the event the High Court dismisses the appeal and remedial legislation is not passed, insolvency practitioners may have to utilise the more cumbersome Scheme procedure to implement insolvent reorganisations. More inventive insolvency practitioners may also consider whether cross-conditional DOCAs can be used, the DOCA being conditional on the approval by the Court of a Scheme providing for wider releases than are currently possible under a DOCA.

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Phoenix Activity Targeted in Australia

BY DAVID COWLING | CLAYTON UTZ

The Assistant Treasurer of Australia recently released a discussion paper on "Action against fraudulent phoenix activity".

The Assistant Treasurer commented that: "Fraudulent phoenix activity is an abuse of the corporate form and the privilege of limited liability. At a time of greater uncertainty for workers, the avoidance of employee entitlements such as superannuation and long service leave is particularly unacceptable."

As befits its origins in Treasury, the discussion paper tends to focus mainly on the protection of the revenue. The reality, of course, is that the problem of phoenix companies extends far beyond the revenue and employees. Trade creditors such as suppliers and customers are often burnt by phoenix activities and currently enjoy considerably less protection that either the Australian Tax Office or employees (the latter group enjoy priority creditor status and, in any event, are often "taken care of" by phoenix company operators as a matter of business practicality).

One important part of the regulatory picture in regard to phoenix company activity is the structural one: to what extent does the current Corporations Act actively discourage – or even encourage – phoenix company activity? There are, for example, claims that phoenix operators have attempted to misuse the statutory voluntary administration regime, which is intended to facilitate corporate recoveries.

It is, therefore, a little disappointing that the new discussion paper is relatively narrowly focused, especially since there have been three other official reports on the subject since 1996, none of which has resulted in any significant change to the law. Indeed, whether the problem even requires legislative amendment is debatable. There is a considerable body of informed opinion that the existing substantive laws may be adequate to deal with phoenix activity: on this view, it is enforcement – and the enforcement mechanisms – which require attention.

With those caveats in mind, what does the discussion paper propose?

Protecting the Revenue

Under Australian law, directors of companies are personally liable for a small range of corporate taxes – most importantly, unremitted employee income tax deductions. Australian companies are required to deduct income tax from employees' wages and to remit the deductions to the Tax Office. If a company fails to remit the tax, the company's directors may be personally liable for that tax, if the Tax Office serves a penalty notice on them.

The discussion paper claims that only a small percentage of otherwise liable directors are ever served with a penalty notice, because of the "highly resource intensive" procedures for issuing notices. It also notes that the regime does not apply to other significant revenue-related imposts, including:

- indirect taxes such as Goods and Service Tax (Australia's value added tax);
- the company's own tax liabilities;
- employee superannuation contributions (although not strictly part of the revenue, the Australian compulsory private pension contribution system is largely enforced through the tax administration regime).

Accordingly, one major proposal is to extend directorial liability to these and other tax-related liabilities. Two related changes would:

- do away with the prerequisite of a penalty notice and simply impose liability on a director where a tax-related liability had remained unpaid for a certain period of time (such as three months); and
- expand the Tax Office's current ability to require a company to provide a bond for its income tax liabilities, to include "other liabilities that are often avoided through phoenix activity".

The paper moots a range of other technical changes to improve the efficiency of tax enforcement mechanisms that would discourage phoenix company activity.

Corporate Law Proposals

While the bulk of the paper is concerned with changes to existing tax-related legislation, it also proposes a number of anti-phoenix concepts that are new to Australian corporate law.

Two of these would already be familiar to many overseas practitioners: restrictions on successor companies' use of similar names and the adoption of the doctrine of inadequate capitalisation.

Similar names

The discussion paper notes that both the UK and New Zealand impose personal liability on directors of a failed company who subsequently become directors of a company with the same or a similar name.

The paper identifies some benefits of such a provision:

- it would hinder phoenix operators' ability to continue their business ventures by transferring their operations to a new company, in two respects: (i) the inability to use the same or a similar name would be "a significant impediment to effectively transferring the business to a new company"; and (ii) the inability to use the same or a similar name would "impose additional, often substantial costs on the new entity";
- it would make directors "personally liable for the debts of the liquidated company" (although it is not immediately clear what this means);
- it would target "one of the key indicators of fraudulent phoenix activity".

Inadequate capitalisation

Another imported idea in the proposals paper is the possible introduction of the US doctrine of inadequate capitalisation.

As the paper notes, "inadequate capitalisation" is a doctrine that has been used by US courts to lift the corporate veil where a subsidiary has been established with insufficient capital to meet its reasonably expected debts.

The paper says that the 2004 Special Commission of Inquiry into the inadequate funding of asbestos liabilities by the James Hardie group of companies "gave some support" to the adoption of the doctrine in Australia.

It is not clear which part of the Special Commission's report the paper is referring to. The main report does refer to a submission that the Corporations Act 2001 should be amended to allow the corporate veil to be pierced in cases of "under-capitalisation". However, the report itself concluded that the proposal had little relevance to the subject matter of the Inquiry: "The doctrine aims at what might be characterised as a form of deceptive conduct, misleading creditors. So characterised, it may be thought to have little relevance to the circumstances [of the companies being considered by the Inquiry], whose liabilities are mostly in tort rather than contract, arising in circumstances where reliance on capitalisation was not a relevant circumstance."

The Commission's only encouragement for the doctrine lay in its observation that the adoption of the doctrine in the US suggested that "significant inroads can be made into the corporate veil doctrine without undermining international competitiveness".

The proposals paper goes on to suggest that the adoption of the doctrine of inadequate capitalisation would allow creditors of a group company "to access the assets of related companies". Interestingly, it does not mention that the Corporations Act already contains provisions to similar effect. Sections 588V-588X make a holding company liable for debts of a subsidiary if the debts are incurred when the subsidiary cannot pay them. The only significant practical difference between these provisions and the doctrine of inadequate capitalisation is that the existing provisions impose liability upon the holding company, rather than sibling companies within the group. However, as a matter of practicality, it is unlikely that sibling companies in a group could be quarantined from liabilities imposed upon the parent company.

In addition, it is unclear what the paper means by "inadequate capitalisation". It says that inadequate capitalisation occurs "where a company sets up a subsidiary with insufficient capital to meet the debts that could have reasonably be (sic) expected to arise". Australia abandoned the doctrine of maintenance of capital a decade ago, and so it is difficult to see how it could be established that a company had been set up "with insufficient capital" to meet its debts. This confusion is evident when the paper mentions one drawback of the proposal – that it could "reduce the level of start-up businesses through increased costs caused by the need to conduct due diligence on the capitalisation of subsidiary companies". If this is intended to refer to an investigation of the availability of funding to the subsidiaries (uncalled share capital, cash at hand, book debts, WIP, loan facilities, guarantees, etc.) then it is self-evident that establishing "under-capitalisation" would be an extremely difficult exercise in any situation, let alone in the sometimes document-free zone of a corporate insolvency. If it is intended to refer simply to share capital, the due diligence exercise would be a relatively straightforward matter – but largely irrelevant to the company's ability to meet its debts.

Director Disqualification

Australia presently has a "Two Strikes" rule for directors of failed companies. If a person has been a director of two failed companies which paid their creditors less than 50 cents in the dollar, he or she may be disqualified from managing corporations by the Australian Securities and Investments Commission (ASIC). In addition, a Court may disqualify a person who was responsible for the failure of two companies.

The proposals paper proposes dropping the requirement of involvement in two failed companies: "If this was implemented, a Court, or ASIC could disqualify a person from being a director if the relevant company had been wound up and the conduct of the person, as a director of the company (either taken alone or taken together with conduct as a director of any other company) makes them unfit to be concerned in the management of a company."

Conclusion

It would be unfair to criticise this discussion paper as being too focussed on protecting the revenue. To the extent that phoenix activity is driven by tax-avoidance, a reduction in that incentive would hopefully lead to a reduction in phoenix activity overall.

Nevertheless, it is disappointing that the non-tax proposals in the paper are relatively undeveloped.

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The Insolvency of Trusts in Australia – A Legal Black Hole

BY NUNCIO D'ANGELO | MALLESONS STEPHEN JAQUES

In the last few decades the trust (included in its regulated form, the "managed investment scheme") has evolved into a widely used business entity for large-scale enterprise in Australia, but the law has not evolved with it to protect stakeholders in insolvency. Unlike the corporation, the trust was not originally intended, and even today remains poorly equipped legally, to be used as a business vehicle. The law in this area is burdened with a range of uncertainties, particularly when compared with the corresponding law relating to corporations.

As large trusts and managed investment schemes have begun defaulting on their obligations on a scale not before seen, financiers have found themselves in a double bind. On the one hand, they have been forced to confront weaknesses in their documentation and security (negotiated in a more "borrower-friendly" environment) and, on the other hand, they are faced with material uncertainties in the laws around enforcement and insolvency in relation to trusts. Directors of trustee companies have come under intense scrutiny, via various provisions of the Corporations Act 2001 (Cth) which can impose personal liability on them for trust debts and liabilities.

The problem stems from the fact that, strictly speaking, trusts and managed investment schemes, not being legal entities, cannot be insolvent as such, and cannot be placed into the insolvency administration regimes contemplated by the Corporations Act (e.g., voluntary administration, receivership and liquidation). So the matter is left to be resolved on first principles, largely by reference to the state of solvency of the trustee and the financial state of the trust fund, applying an uncomfortable amalgam of modern company insolvency law and ancient trust law.

In this article, "trust" includes managed investment scheme and "trustee" includes responsible entity.

The Key Uncertainties

When a trust comes under financial pressure, its financiers, and directors of the trustee (and their respective legal advisers), are faced with the following material uncertainties, most of which do not admit of a clear and concise answer under the current state of the law in Australia:

- The expression "insolvent trust" is a legal nonsense and yet is commonly used. What precisely is meant by that expression?
- How is the solvency or otherwise of a trustee to be analysed?
- Can a corporation be insolvent "in its capacity as trustee", even if otherwise solvent? What about a corporation that is trustee of several trusts, some of which are performing well financially and others which are not?
- What are the rights, priorities and ranking of unsecured creditors (both trust creditors and non-trust creditors) in relation to a trustee that is or may be insolvent?
- What are secured creditors' rights in relation to a trustee that is or may be insolvent?
- In what circumstances can a trustee's directors be personally liable for the trust's debts?
- Unsecured creditors of the trustee are able to access the trust assets via subrogation to the trustee's rights of indemnity. How secure is that right of subrogation? What is the position of unsecured creditors if the trustee has impaired or lost its right of indemnity?
- What part is played by "trustee limitation of liability" clauses in answering these questions?
- Which insolvency administration regimes are relevant and applicable to trustees and trusts?
- Can an administrator or a liquidator of a trustee administer trust property? What conflicts arise?
- Can and should an insolvent corporate trustee be removed as trustee?
- How is trust property to be distributed among the insolvent corporate trustee's creditors?
- What are the courts' powers in relation to insolvent trusts?

As the major trust collapses of 2008/9 and into 2010 begin to throw up these issues, we expect at least some of them to find their way to the courts where, in the absence of statutory guidance and in the face of inconsistent precedent, our judges will face an unenviable challenge. In effect, in the absence of statutory intervention, the next few years will see an acceleration in the evolution of judge-made law relating to the insolvency of trusts. We are yet to see if this will clarify the uncertainties or exacerbate them.

A Brief History – the Company vs the Trust

Like the trust, the company is, of course, also a collective investment vehicle, but unlike the trust it has, right from its inception, been essentially about facilitating risk-taking for the purposes of enterprise, and the need to allocate risks among stakeholders in an orderly fashion consistent with articulated policy objectives. Insolvency law in Australia as it relates to companies is governed by a comprehensive and fully evolved statutory framework which brings together the core rules, and imposes a relatively logical and coherent structure for dealing with the competing claims of stakeholders in insolvency. Unfortunately, this is not the case in relation to trusts. Australian law is badly lagging commerce in this regard, leaving unsecured creditors in particular in a quite disadvantaged position, and trustee directors in fear of personal liability.

Unlike the corporation, the trust was not originally intended, and is poorly equipped, to be used for entrepreneurial risk-taking activities like trading and carrying on business (or, of course, borrowing money). Indeed, use of the trust for these purposes was described long ago as a "commercial monstrosity" (Ford HAJ, "Trading Trusts and Creditors' Rights" (1981) 13 MULR 1). Right up until the middle of the 20th century, the trust was fundamentally intolerant of risk-taking. Equity regarded trust assets as being "owned" by the beneficiaries and so the primary emphasis of trust law was the protection of the beneficiaries and "their" assets. The consequences of failure were usually visited on the trustee personally (and, sometimes, on their directors) and, therefore, on anyone claiming through it (which includes unsecured creditors). This led to trustees and their directors being highly conservative in the way they managed trust assets. Under this construct, there was perceived to be little risk of insolvency. Consequently, the legislature and the courts were not pressed to develop a legal framework beyond ordinary principles of equity and trusts law.

Despite this, in the latter half of the 20th and early 21st centuries, the trust evolved to become an increasingly commercial vehicle, used in some of the largest and riskiest businesses in Australia, including as listed entities. The impetus included legal and commercial flexibility and tax advantages, but it was also encouraged by legislative change. This development brought with it a greatly elevated risk of insolvency and material loss for the principal participants, including equity investors, debt investors, trustees themselves and their directors.

The law in relation to the insolvency and insolvent administration of trusts in Australia has not kept pace with these developments. Because of the historical bias towards favouring beneficiaries, this has left financiers and other creditors of trusts in a much more vulnerable position, vis-à-vis other stakeholders (particularly the equity investors), than creditors of corporations, and exposed directors of trustees to personal liability.

Recent History: How Did it Come to This?

In 1993 significant changes were made to the Corporations Act (then, the Corporations Law) in relation to the insolvency of Australian corporations in response to the perceived excesses of corporate Australia in the late 1980s. The voluntary administration regime was introduced and the laws relating to voidable transactions and the liability of directors for a company's insolvent trading were substantially rewritten and modernised. However, the legislature did not see fit to effect corresponding changes to the laws relating to insolvent trusts. The reasons for this omission are a mystery – it is not as if trusts were not commonly used as business entities for large-scale enterprise at that time. The use of unit trusts to pool investments grew noticeably during the 1960s and 1970s, and in 1988 the Australian Law Reform Commission noted that "the trading trust has been used extensively for more than a decade" (ALRC, Report on *General Insolvency Inquiry,* Report No 45 (1988) at [240]-[241]).

In the 1990s and into the new millennium, the use of trusts as vehicles for acquiring and holding assets, and conducting businesses, of substantial value escalated dramatically. The property sector was in the vanguard of this trend, through the growth of A-REITs (Australian real estate investment trusts) and LPTs (listed property trusts). The aggregate market capitalisation of A-REITs on the ASX (Australian Securities Exchange) grew from less than $10 billion in 1993 to over $120 billion in 2007. During the same period, managed investment schemes, listed and unlisted, also began to be used widely as collective investment vehicles for holding infrastructure assets and, on a more "retail" level, for cash management trusts, equity trusts, agricultural, timeshare schemes, some mortgage schemes and other "managed funds". Thus, the 1990s saw professional trustee companies becoming involved in increasingly complex and larger scale activities, the rapid expansion of the funds management industry, and investors and other stakeholders increasingly demanding better, more effective regulation.

The Managed Investments Act 1998 (Cth) introduced a new Ch 5C into the Corporations Law for better regulating the use of trusts as collective investment vehicles. However, it did not comprehensively deal with insolvent administration. This change roughly coincided in timing with the relaxation of trustees' investment empowers in the State Trust/Trustee Acts. Trusts became increasingly structured so as to appear to investors, and to operate commercially, almost as if they were companies. For many practical purposes, people in commerce began to regard trusts and companies as being commercially identical, or at least economic equivalents, and drafters, legislators and regulators increasingly endeavoured to make trusts mimic companies as far as the law would allow.

As the scale of the business, trading and investment ventures undertaken by trusts grew, so too did the quantum of the debts they incurred. Investors were attracted to the entities' increasing asset values, which grew the equity base against which the trustee could borrow. Simultaneously, lending standards were relaxed and financiers became comfortable lending to trusts unsecured. Driven, on the one hand, by boom markets and rising asset values from the mid-1990s to 2007, and, on the other, by fear of accusations of "lazy balance sheet management" from investors and market commentators, directors of corporate trustees took full advantage of their borrowing capacity.

Conclusion

In light of the many uncertainties that surround the way Australian law deals with the insolvent administration of trusts, Ford's damning assessment in 1981 that trusts, when used in trading and business, are a "commercial monstrosity" remains generally true, even after the Managed Investments Act changes. Despite ample opportunity for the legislature to remedy these defects, the law remains inadequate, particularly when compared with the corresponding law relating to corporations.

Given the widespread use of these vehicles for risk-taking entrepreneurial activities in Australia, the scale of their borrowings and the impact of the global financial crisis, this is an unfortunate, and economically dangerous, defect in our legal system.

Until statutory reform properly remedies this situation, participants have no choice but to either be pragmatic in seeking solutions outside the courts or brave the uncertain (and expensive) waters of litigation.

This above is a summary of a lengthier legal article by the author, published in December 2009, entitled "The trust: evolution from guardian to risk-taker, and how a lagging insolvency law framework has left financiers and other stakeholders in peril" (2009) 20 JBFLP 279.

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Forensics and Insolvency – Odd Couple or New Age Symbiotic Business Relationship?

BY DAWNA WRIGHT, DEAN NEWLAN AND SHANE BELL | MCGRATHNICOL FORENSIC

It is no surprise that a growing number of insolvency practices around the globe now include, or at least make use of, specialist forensic resources. There are many common links and interdependencies between the insolvency and forensic disciplines.

In the current economic climate, significant actual or potential corporate failures are attracting intense scrutiny from an increasing number of stakeholders. In addition to creditors, regulators, shareholders and the media are increasingly interested in the reasons for the collapse and how and by whom the mess is cleaned-up. In Australia, the Australian Securities and Investments Commission, the Australia Prudential Regulation Authority and the Australian Competition and Consumer Commission – to name a few – are all intensely interested in corporate failure. The Corporations and Markets Advisory Committee ("CAMAC") of the Australian parliament, with an ongoing mandate to monitor governance in the corporate sector, has had a particular focus on the way in which insolvent corporations are administered in recent years. In addition, a Senate review was recently launched (*Inquiry into Liquidators and Administrators*) with a reporting deadline of August 2010.

In juggling the interests of these many and varied stakeholders, one of the tools that the insolvency practitioner can add to their arsenal is the "forensic specialist". Insolvency practitioners call in forensic resources to assist in a variety of ways – either in delivering the basics, following the money trail or bringing added efficiencies to work that would otherwise be delivered by the insolvency practitioner's own team.

This article is intended to provide an overview of this symbiotic relationship between the insolvency practitioner and their new business partner... the forensic specialist. Their exact mission can be many and varied but in every case a constant theme is that the forensic specialist will need to work hand-in-glove with the insolvency practitioner.

Let's Start With "The Basics"...

One of the most important first-steps in an insolvency appointment is securing electronic data on Day 1 – enter the forensic technology specialist. It has been estimated that more than 80% of business communication is now transacted electronically. The use of computer forensic techniques is the only way to ensure that records are captured and preserved to satisfy the requirements of all stakeholders.

Computer forensic techniques allow data collection across entire organisations to be achieved efficiently. Capturing forensic images, securing backup tapes, mapping IT architecture and understanding the inner workings of an organisation's IT department are key computer forensic functions. These processes are invaluable in responding to various requests and notices issued by Courts, regulators, other stakeholders and their legal advisers – sometimes arising many years after the date of the initial appointment.

Deploying a computer forensic team ensures that all relevant or potentially relevant data is correctly identified, captured, preserved, analysed and produced to the required standard. It is also a question of efficiency. Employing sound forensic techniques can mean the difference between searching through emails one employee at a time in Microsoft Outlook or having them indexed and searched en masse by one single and powerful application.

Following the Money Trail – Fraud as a Cause of Insolvency

Sometimes, corporate failure can be linked to fraud – either asset misappropriation or manipulation of financial statements. Misappropriation of company funds – or even uncommercial transactions – can be a significant contributing factor in the collapse. This is where the roles of the insolvency appointee and the forensic accountant truly overlap, and where there is a clear opportunity for the forensic accountant to assist.

While insolvency experts do have investigative skills, forensic investigators have a particular specialisation in identifying the modus operandi of criminal conduct and "tracing" the flow of funds on the basis of evidence gathered in their investigations. Having gathered the evidence, they can quantify the financial impact of the transactions in question, be they misappropriation, uncommercial payments or preference payments, in order to assist the insolvency practitioner in forming a view as to whether or not to proceed with action for recovery.

The common "red flags" pointing to where it might be advantageous to involve forensic investigators are:

- *Where profit cannot be reconciled to cash flow* – this may be an indicator of a misappropriation of cash or assets, and of a need to "ramp up" the context of the investigation.
- *Where the corporate structure and related party transactions appear unnecessarily complex* – this may be a means of concealing fraudulent or uncommercial transactions from auditors and advisers. Forensic charting tools can assist in this regard – a recent forensic specialisation involves reducing myriad financial transactions and relationships into one easy-to-follow computerised chart that lays the whole case out for all involved.
- *Where there is a lack of basic internal controls* – misappropriation of cash or other assets is often the result of a weakness in internal controls being exploited. This may be in relation to a lack of controls over journal entries or other access to the accounting system, and/or in relation to cash payments (such as electronic funds transfers). Forensic investigators are experienced in identifying instances of financial system manipulation.
- *Where there is suspicion around the validity of a debtors' ledger* – recording revenue either not yet or never to be earned is a common technique used to falsely record profits and underpin the financing of a distressed corporation. Forensic data analysis tools and techniques can be used to help identify manipulation of a corporation's business records.

In such cases, the forensic technology tools, as well as the behavioural interviewing techniques of a forensic investigator, will be invaluable in not only proving fraud or other uncommercial or questionable transactions more efficiently, but also in capturing and preserving the evidence in a manner that will be acceptable to the Courts in any subsequent proceedings.

Using Forensics to Support 'Traditional' Insolvency Procedures

Forensic analysis techniques can also increase the efficiency and effectiveness of many procedures traditionally performed by the insolvency practitioners. Here are some examples.

- *Combining financial systems and establishing a consolidated view of the financial position* – A common feature of organisations with cash flow problems is a dearth of quality financial reporting. Forensic data analysis tools can help synthesise data across multiple systems and/or multiple accounts to provide better financial data for commercial decision making.

- *Preference payments* – One of the first tasks of an insolvency practitioner in Australia is to identify preference payments (i.e., payments to one creditor or class of creditors by the corporation in preference to the body of creditors generally). Forensic data analysis tools can assist in several ways: (i) transforming accounting data collected from the corporation's financial systems into a validated, reconciled analysable data set that can create an aging profile of payments made to suppliers; (ii) looking for "non-obvious" matches between vendor/supplier data (e.g., partial names, addresses, phone numbers and bank accounts) to eliminate account splitting in examining possible preferential payment activity; and (iii) using sophisticated tools to troll through huge volumes of transactions looking for "unusual" payments (such as "round dollar" amounts or payments made on dates outside of the usual cheque runs).
- *Establishing the "point of insolvency"* – In Australia the date that a corporation becomes insolvent can be important as directors become personally liable for debt incurred by the corporation after that date. Forensic tools can assist in establishing the "mindset" of the organisation and its directors (i.e., "who knew what when") by searching emails or other correspondence between directors, financiers, investors, management, creditors and other stakeholders. Organisations can have multiple email servers with hundreds of email accounts totalling into the millions of individual email messages and attachments. Without forensic technology tools, insolvency practitioners could spend months looking for the "needle in the haystack".
- *Assisting with legal proceedings* – Many insolvency appointments involve litigation at some stage in the process, whether it be pursuing the recovery of funds or defending actions from creditors or third parties. Forensic accountants are often used to assess the quantum of claims for the insolvency practitioner, or act as independent expert witnesses in such matters.

The Cycle Continues – Insolvency as a Cause of Fraud

An increase in the risk of fraud in the future is one of the yet-to-be-quantified side effects of the Global Financial Crisis. Many organisations have been restructured and/or have engaged in severe cost cutting in the recent times, which has likely involved some level of headcount management if not outright redundancies.

The current economic climate, as well as an organisation's restructuring in response, can have a direct impact on the "Fraud Triangle" (developed by Dr. Donald Cressey in the late 1940s) – which is a widely-accepted view of how and why frauds are committed. It describes three features, being:

- Motivation – related to an individual's "need" for funds.
- Opportunity – the most directly-related element to an insolvency environment, being the increase in opportunity resulting from an organisation reducing its headcount and inadvertently eliminating key "checks and balances".
- Rationalisation – the fraudster must be able to rationalise in his or her own mind that their behaviour is in some way justified.

All three of these elements can be exacerbated in organisations undergoing a restructure and/or headcount reduction. And so an organisation's response to cash flow difficulties can, in turn, create further problems if cash or other assets are subsequently misappropriated. This after-effect of the current economic climate cannot yet be quantified as it will only manifest itself in the coming months and years as employees adapt to their new economic situation and to "leaner" business structures.

However, responsibility lies with current management and restructuring advisers to see to it that the restructuring and other measures put in place to "maintain" solvency do not inadvertently result in the continuation of the insolvency cycle.

Conclusion

One could indeed argue that the relationship between forensic and insolvency is neither "odd" nor "new age" – but one containing many historical and synergistic linkages. The recent Global Financial Crisis, as well as developments in forensic technology tools in particular, has seen this relationship take on a new found vigour. It is no surprise that both insolvency practices and forensic practices have experienced profound growth over this period.

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SINGAPORE

Ring-Fencing Assets of Foreign Companies in Liquidation to Pay Domestic Debts

BY DESMOND HO | ALLEN & GLEDHILL LLP

Throughout the greater Commonwealth and much of the developed world alike, there exists a modern orthodoxy, based upon model law and economic efficiency, in which all assets of foreign companies are to be remitted to a central source of liquidation for distribution by administrators in support of a shared benefit of all creditors worldwide. Nevertheless, within Singapore section 377(3)(c) of the Companies Act deviates from this modern philosophy. Establishing a unique point of difference from the greater developed world, the legislation effectively ring-fences the assets of insolvent registered foreign companies, so that locally based creditors may be relieved ahead of those based abroad.

Section 377(3)(c) of the Companies Act

In the event of insolvency by a Singapore registered foreign company, section 377(3)(c) of the Singapore Companies Act, as currently interpreted by the Singapore Court of Appeal in *Tohru Motobayashi v Official Receiver & Anor* [2000] 4 SLR 529, constructs a ring-fence of assets to pay domestic debts. These assets are then utilised by a Singapore liquidator to relieve creditors of outstanding debts and liabilities incurred in Singapore. Only after all local debts have been serviced will the remaining (if any) assets be remitted to the foreign liquidator for distribution.

Section 377(3)(c) may be viewed as retrogressive and off par with current internationally accepted cross-border insolvency norms, e.g., the UNCITRAL Model Law on Cross-Border Insolvency (1977), and Part III of the World Bank Consultation Draft on *Effective Insolvency Systems: Principles & Guidelines* (October 2000). Whilst it may be anticipated that ring-fencing would encourage greater investment by Singapore-based creditors due to local favouritism in the event of insolvency, by not demonstrating reciprocity vis-à-vis foreign liquidators, there is an uneasy tension created where other jurisdictions may be reluctant to assist Singapore-based insolvency proceedings, in light of Singapore's self-serving legislation.

There are few principled policy arguments to support the case that Singapore creditors of a foreign company registered in Singapore ought to obtain special preferential treatment over the creditors with debts based abroad. Those dealing with a Singapore based foreign company would not have anticipated such difference in treatment in the event of the foreign company's liquidation.

Although a Singapore liquidator of a registered foreign company is required to pay Singapore based liabilities first, in order to do so the Singapore liquidator must apply for exemption from section 337(3)(b) which espouses the general orthodoxy that no creditor should be paid to the exclusion of another. Once such an order has been successfully obtained, the locally based liquidator must sift through each proof of debt and determine if such debts or liabilities fulfil the requirement of being incurred in Singapore. This daunting task requires making determinations under applicable domestic and international laws of the origin and "nationality" of the particular debt or liability.

In addition to creating a bias towards local creditors, the provision establishes an anomaly in its non-application to foreign companies that do not register in Singapore. Such a divergence of treatment based on non-registration, as highlighted in the case of *RBG Resources plc (In Liq) v Credit Lyonnais* [2006] 1 SLR 240, demonstrates the arbitrariness of the ring-fencing principle.

RBG Resources plc (In Liq) ("RBG") v Credit Lyonnais

Prior to the *RBG Resources* case, the law was silent about whether section 377(3)(c) applied to non-registered foreign companies. Involving the liquidation of a foreign company that was not registered in Singapore, the case established that section 377(3)(c) would not apply to non-registered companies.

Involving a motion by Credit Lyonnais to have its debts paid from the Singapore liquidation estate of RBG before all realised assets were relocated to the English liquidation, Credit Lyonnais relied upon section 377(3)(c), contending that the provision applied not only to registered foreign companies, but also those foreign companies which are not registered, but satisfy the requirements of establishing a place of business in Singapore. While it was common knowledge that RBG was a non-registered foreign company, this claim by Credit Lyonnais generated several key issues, such as:

- Does section 377(3)(c) apply to RBG (and its Singapore liquidators)?
- If not, can and should the ring fencing principle nevertheless apply?

With respect to the first issue, Woo Bih Li J, interpreted the provisions of the Companies Act strictly and concluded that section 377(3)(c) did not apply to unregistered companies, and thus RBG's Singapore liquidators were not bound to ring-fence their assets. This case confirmed the existence of an anomaly whereby companies which failed to register, or did not register within the requisite period, would be able to escape the ring fencing provisions applicable to registered companies; an effect it was argued that was not intended by Parliament but, nevertheless, one that only Parliament could resolve through legislation.

Consequently, the issue at hand was Credit Lyonnais's contention that the principle in section 377(3)(c) should nevertheless apply to RBG. In submission, Credit Lyonnais contended that section 350(2) of the Companies Act applied to non-registered foreign companies empowering the Singapore liquidators to exercise powers or perform any act which might be exercised or done in winding up companies, effectively empowering the Singapore liquidators to pay out debts and liabilities incurred in Singapore in a manner similar to section 377(3)(c). In response to these submissions, Woo Bih Li J disagreed that section 350(2) imported the principle in section 377(3)(c) and noted, in particular, that section 350(2) did not fall under that part of the Companies Act that dealt generally with the winding up of companies.

Perhaps the most illuminating point in the case is that, having determined that section 377(3)(c) did not apply and that the legislation is silent, the court declined to adopt the principle of ring-fencing to non-registered foreign companies. Instead, the court accepted and applied the common law principles enunciated *In re Bank of Credit* *and commercial International SA* (No. 10) [1997] Ch 213 . These principles are:

- Where a foreign company is in liquidation in its country of incorporation, a winding up order made in Singapore will normally be regarded as giving rise to a winding up ancillary to that being conducted in the country of incorporation.
- The winding up in Singapore will be ancillary in the sense that it will not be within the power of the Singapore liquidators to get in and realise all the assets of the company worldwide. They will necessarily have to concentrate on getting in and realising the assets in Singapore.
- In order to achieve *a pari passu* distribution between all the company's creditors, it will be necessary to pool the assets of the company worldwide and declare a dividend out of the pooled assets. Hence, the winding up in Singapore is also ancillary in the sense that it will be the liquidators in the principal liquidation who will be best placed to declare the dividend and distribute the pooled assets.

The result of this decision is that where section 377(3)(c) does not apply, e.g., in the case of the Singapore liquidation of RBG, the common law principles require the Singapore liquidator to remit the realisations to the principal liquidation, and not ring-fence the realisations to pay debts and liabilities incurred in Singapore.

Conclusion

The outcome of *RBG Resources* is one which is understandably correct. While the ring-fencing principle in section 377(3)(c) remains as a specific statutory exception applicable to registered foreign companies, *RBG Resources* has clarified that outside of the narrow confines of the application of section 377(3)(c), Singapore stands together with the main common law jurisdictions in respecting the ancillary nature of a Singapore liquidation of a foreign company.

If section 377(3)(c) is repealed, there would be more consistency in the treatment of creditors of registered and non-registered foreign companies in Singapore. Ultimately, when dealing with a foreign company, one should not expect a debt incurred in Singapore to be treated differently solely on the basis of whether the foreign company is or is not registered in Singapore.

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EMERGING MARKETS

E M E R G I N G   M A R K E T S

Emerging Markets – A Crisis of Professional Resources and Legal Systems

BY NICK HOOD | BTG MESIROW FINANCIAL CONSULTING

Insolvency and restructuring have been lagging indicators in all recessions over the past 40 years. Statistically, business failures peak somewhere between 12 and 24 months after GDP starts to grow once more. This time round the damage is deeper and the sectors affected are more widespread than any of the last three downturns, creating a level of demand for turnaround and restructuring professionals on an epic 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 found the bankruptcy profession's human resources sadly wanting. A decade of headlong growth, a liquidity glut which staved off many business failures and the most benign of economic conditions thinned out the insolvency veterans, battle-hardened in the 1980s and 1990s downturns. This culled vital experience and reduced capacity as people disappeared into the sunset of retirement or were redeployed in the M&A and other boom-time professional sectors.

As resource and expertise was allowed to drain from insolvency and restructuring, a worse still sin was committed when the chance was missed to transfer knowledge to emerging markets, where much of the growth was taking place. Apart from a few committed internationalists, complacent professionals stayed in their comfort zones in their home jurisdictions. As a result, investors and lenders are now discovering problems in their portfolios and struggling to find people to assist in the far flung places where significant parts of globalised businesses are in trouble.

It seems that the premier league of the emerging world, the BRIC countries are busy congratulating themselves that they have escaped the worst of the recession, despite some well founded concerns about the banking system in Russia. After some initial concerns, it looks as though China and India really are de-coupled from the mayhem in the global economy, powering away again with significant growth rates. Brazil is doing very nicely, thank you.

But look down into the lower reaches of the economic league and a truly horrific picture appears. A 2009 report from the respected Overseas Development Institute (ODI) quoted a World Bank prediction that developing countries will have lost a staggering $750bn in income in 2009. Not much perhaps by comparison with the trillions being tossed around by the US authorities in their ill-coordinated efforts to bring stability to the world's most important financial and economic system. But in the emerging markets sector, this sum is almost unimaginable, as is the horrors it will cause. This outcome was not predicted and these economies do not have the sophistication and economic infrastructure to withstand this sort of savage and sudden correction without very considerable collateral damage.

According to the ODI report, foreign direct investment is set to have fallen by 10% in 2009, crippling vital development projects. Inward remittances by diaspora communities have reduced by 5%, laying waste to the many economies dependent on this flow of support. The IMF estimates that these and other negative factors will create a funding gap for low income countries of between $25bn at best and $140bn at worst. The World Bank surveyed a larger group of developing nations, a sample of 84 countries and found the range of their funding requirements to be between $250bn and $750bn.

In case anyone might think that these are just numbers, the consequence will be rising unemployment and hunger on a scale beyond the comprehension of the developed world: the number of people trapped in absolute poverty is expected to have surged from 40 million to 90 million in 2009. Another World Bank forecast suggests that an extra 400,000 babies will die in the developing world as a direct result of the current crisis. On this basis, the professional resource profile is not just worrying, it is tragic.

The ODI report focused on 10 particularly vulnerable nations, including Bangladesh, Cambodia, Ghana, Indonesia, Kenya, Nigeria and Zambia, with a combined population of half a billion poor souls. These countries have just 107 members of INSOL International, the only recognised worldwide organisation for insolvency and restructuring professionals, out of which 98 of these are in Nigeria. The Turnaround Managers Association, a global network of operational and financial business rescue experts has only two local chapters, in Nigeria and Ghana. There is little chance of business rescue or even preservation on any meaningful scale any time soon in these benighted places.

One characteristic of the last 10 years of calm economic waters has been a preference for solving business problems through financial engineering, rather than by dealing with underlying operational faults. Balance sheet engineers were plentiful, inundating underperforming and threatened enterprises with seemingly unlimited liquidity. Hands-on turnaround managers have been and remain 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 announced: “Flat is the new Up”. Experienced business rescuers will tell you that executives who can grow businesses are rarely any good at shrinking them.

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 are still an alarming number of significant emerging market jurisdictions in which there is no effective mechanism for ring-fencing troubled businesses while they are reorganised and revitalised – India, China and Russia amongst 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 making up solutions as it goes along, what chance has a struggling but potentially viable business in Nairobi, Phnom Penh 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. Sadly, protectionism is never far away, especially in these hard times. Even the best intentioned legislation can sometimes deliver something rather different to expectations, as the Chapter 15 cross border insolvency code in the US has proved with its imperialistic interpretation in connection with some Cayman Island hedge fund failures.

So how depressing it was to sit through a panel session at a major insolvency conference in mid-2009 and hear a panel of experienced bankruptcy judges wrestling with questions about a hypothetical global restructuring involving developing jurisdictions. 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, one of history's most monumental business failures, which was rooted in the emerging world and is still running after the best part of 20 years despite the best efforts of the professionals working on it.

As we struggle upwards towards the light of recovery, there is a real risk that emerging markets will go on suffering many years after even the UK has finally returned to something like normal business conditions, with stable growth deferred because of the lack of professional resource and workable legal regimes. It should not have been like this, but let us at least hope that this lesson is heeded, so that we are ready to help the economically needy in the developing world next time round. It would be better still if we can also help them to help themselves in the future.

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