NEWSLETTER

CMS RESTRUCTURING AND INSOLVENCY IN EUROPE

WINTER 2010

INTRODUCTION

We are pleased to present this winter edition of the CMS Restructuring and Insolvency in Europe Newsletter. We aim to give information on topical issues in insolvency and restructuring law in countries in which CMS offices are located.

This edition looks at:

- the Belgian judicial reorganisation procedure and ongoing contracts;
- the potential liabilities of management boards in Croatia for failing to initiate insolvency proceedings;
- Insolvency Plan Proceedings and proposals for their reform in Germany;
- issues on Italian restructuring and insolvency;
- personal liability of managing directors in the Netherlands;
- the Polish Supreme Court's decision on the preclusion of evidence under the Polish Bankruptcy and Recovery Law and on parallel debts;
- Romanian insolvency reform;
- debt to equity law reform in Russia;
- tips for understanding potential risks of bankruptcy and insolvency in the Ukraine;
- developments in the application of the fund ascertainment principle in English case law; and
- the landlord's right of hypothec in Scotland.

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- high quality advice
- industry specialisation

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CMS operates in 27 jurisdictions, with 53 offices in Western and Central Europe and beyond. CMS was established in 1999 and today comprises nine CMS firms, employing over 2,400 lawyers. CMS is headquartered in Frankfurt, Germany.

The CMS Practice Group for Restructuring and Insolvency represents all the restructuring and insolvency departments of the various CMS member firms. The restructuring and insolvency departments of each CMS firm have a long history of association and command strong positions, both in our respective homes and on the international market. Individually we bring a strong track record and extensive experience. Together we have created a formidable force within the world's market for professional services. The member firms operate under a common identity, CMS, and offer clients consistent and high-quality services.

Members of the Practice Group advise on restructuring and insolvency issues affecting business across Europe. The group was created in order to meet the growing demand for integrated, multi-jurisdictional legal services. Restructuring and insolvency issues can be particularly complex and there is such a wide range of different laws and regulations affecting them. The integration of our firms across Europe can simplify these complexities, leaving us to concentrate on the legal issues without being hampered by additional barriers. In consequence we offer coordinated European advice through a single point of contact.

EDITORIAL

With pleasure I herewith present the winter 2010 edition of the CMS Restructuring and Insolvency in Europe Newsletter. I hope this edition will once more increase and broaden your understanding of the insolvency regimes across Europe.

Eighteen months have now passed since the bankruptcy of Lehman Brothers marked a worldwide recession. The American economy is gradually showing signs of recovery. In Europe there is speculation as to whether a similar economic recovery will set in any time soon. For the time being, there is still great uncertainty.

In the Netherlands the level of bankruptcies during the past year has increased by 50%. The volume of sizeable bankruptcies has however been limited. Unemployment, which was expected to increase considerably due to the recession, has actually been relatively limited. A reason for this seems to be that the large amount of the currently unemployed and self-employed persons, who are not eligible to claim unemployment benefits. In addition, the Deeltijd WW (the Part-time Unemployment Insurance Act) introduced by the Dutch government in March 2009 seems to have influenced the picture. This regulation allows employers to have some or all of their employees work up to a minimum of 50% of the contractually agreed hours for a maximum period of 15 months, while the employees may appeal, using the WW (Unemployment Insurance Act), for the remainder.

Moreover, considerable investment made by the government seems to have had a positive impact on the Dutch economy. As a result, the economy has only contracted to a limited extent. The Dutch government, however, does have the intention to carry out substantial cuts in 2010. This policy is increasingly met with criticism by economists who believe that these cuts will be very damaging to the gradual recovery of the economy which is setting in.

Dominique Strauss-Kahn, Managing Director of The International Monetary Fund, seems to share the economists' opinion. Strauss-Kahn has concluded that the world economy has made a considerably faster recovery than originally expected, but also points out that growth in major economies depends on stimulus measures put in place by governments and that any current recovery remains vulnerable. He urged governments not to relax stimulus measures too early in the mistaken belief that a strong recovery has taken hold, and suggested that they could shift stimulus measures towards projects that would create additional jobs.

Several months ago, a smaller Dutch Bank, DSB Bank N.V., went bankrupt. My Dutch colleague, Marcel Groenewegen, is one of the trustees in this bankruptcy. The Ice Save (Landsbanki) Bank and DSB bank bankruptcies have resulted in the appointment of a parliamentary commission which has the task of investigating the role of both the AFM (Authority Financial Markets) as well as DNB (The Dutch Central Bank). At this stage it is unclear whether measures will be taken and whether this investigation will have consequences for senior executives in both organisations.

On 22 December 2009, the Dutch Supreme Court has pronounced an important Decree for the restructuring practice. In this Decree the Dutch Supreme Court has determined that a bank, in a refinancing deal, is not permitted additional securities if the bankruptcy (and the deficit therein) could have been anticipated by the debtor as well as the bank at the moment of issuing the credit.

It is expected that this Decree will inhibit the willingness of banks to refinance. This will possibly result in a higher volume of bankruptcies than would have been the case prior to this pronouncement of the Dutch Supreme Court. It will remain to be seen if this impacts on the current economic recovery if the lifeline of restructuring becomes less available to companies in distress.

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THE BELGIAN JUDICIAL REORGANISATION PROCEDURE AND ONGOING CONTRACTS: A THREAT TO THE RESCUE OF COMPANIES IN DISTRESS?

The Belgian Act on the Continuity of Enterprises (the "Act") passed on 31 January 2009 containing new restructuring legislation was designed to provide Belgian companies with a greater number of options and measures in order to return companies to profitability. It aims to break with the negative image of the previous judicial procedure which was often considered to be a "waiting room for bankruptcy".

As indicated by its title, the new Act focuses on encouraging business rescue and fills in some gaps in the existing legislation by providing several instruments with which to tackle a potential insolvency which are better adapted to various potential economic and financial situations. Previously, a company had to choose between a judicial composition and a bankruptcy, whereas companies can now call upon a large number of measures, with or without court supervision, in order to preserve their business as a going concern.

One of these measures is a judicial reorganisation which aims to maintain, under the court's supervision, the continuity of all or part of a distressed enterprise and its activities. The judicial reorganisation involves a moratorium granted to the debtor for a period of up to six months. During this moratorium, the debtor has three options:

(i) enter into an amicable settlement with some of the creditors;

(ii) obtain approval of a reorganisation plan involving all creditors; or

(iii) transfer all or part of the business under the court's supervision.

As a starting point, this looks promising. However, some opportunities which could protect companies' survival as a going concern may, however, be conspicuous by their absence, particularly in relation to ongoing contracts.

In principle, a company's business is preserved by the new legislation on judicial reorganisation. The Act provides that, notwithstanding any conflicting provisions in the contract, a claim or the opening of the court-ordered reorganisation procedure does not terminate ongoing agreements/contracts or how they are to be interpreted (Article 35 Paragraph 1). In order to safeguard contractual relations, grounds for rescinding contracts, foreseen in Article 1183 of the Belgian Civil Code, are even suspended if the "future event" constituting the grounds to enforce the contract is the initiation of a judicial reorganisation.

Belgian legislation, however, only partially limits the right to dissolve ongoing contracts. Article 35, Paragraph 1, part 2 of the Act stipulates that a contractual default of the debtor preceding the suspension, does not constitute a ground for termination of the contract if the debtor reverses this default within a period of 15 days after a formal notice – sent following the opening of the procedure – from the creditor. This means that a creditor may elect to rescind the contract if the company in distress fails to reverse its contractual default within this 15 day period, even if this company complies fully with its obligations during the judicial reorganisation procedure.

Some commentators consider this provision as a "second chance" for the debtor as the creditor may only rely on a (new) formal notice sent after the opening of the judicial reorganisation.

Conversely, in reality this provision impairs the prospect of continuity of ongoing contracts as the obligation is placed on the company in distress to reverse the contractual default (preceding the suspension) within a period of 15 days.

It is clear that a company in financial difficulties may not be able to reverse such contractual default within such short space of time.

Apart from Article 35 Paragraph 2 of the Act, common civil law is still applicable meaning that creditors may still rely on the *exceptio non adimpleti* contractus and suspend their contractual obligations or invoke retention rights. In other words, such creditors/co-contractors can still refuse to perform their obligations under an ongoing contract, until their debtor, the company applying for judicial reorganisation, does the same (and in particular pays all amounts outstanding to such creditor/co-contractor).

This, of course, creates an obstacle to the objective of preserving contractual relations as much as possible: the company in distress does not benefit from the principle of continuity of *ongoing* contracts if the creditor can refuse to further honour the contract because of a default in the past.

It is clear that if major suppliers opt to take advantage of the above rescission and suspension rights, it can be extremely damaging for the continuity and survival of a company in distress.

Many jurisdictions view an obligation to continue to supply companies in distress as preventing a creditor from invoking rescission or suspension rights for defaults preceding the judicial reorganisation in case the debtor complies with its obligations during the procedure.

Belgian legislation therefore falls short of protecting and preserving the continuity of companies in distress in the phase of judicial reorganisation, and it is possible that those companies will be unable to break the vicious circle of bankruptcy.

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POTENTIAL LIABILITIES OF THE MANAGEMENT BOARD FOR FAILING TO INITIATE INSOLVENCY PROCEEDINGS IN CROATIA

Introduction

In times of financial crisis, it is particularly important for the members of the management board of a company to meet all legally prescribed obligations in initiating insolvency proceedings in order to avoid any potential personal liability for damages as well as criminal liability.

The Insolvency Act

The reasons for initiating insolvency proceedings against a company, according to the Insolvency Act (N.n. 44/96, 29/99, 129/00, 123/03, 197/03, 187/04, 82/06) (IA 1996), are: a) its inability to settle debts and b) its over-indebtedness. A company is deemed to be unable to settle its debts if payments due have not been made within 60 days. Over-indebtedness is assumed when the debtor's assets do not cover existing obligations.

According to the IA 1996, the members of the management board of a company are obliged to initiate insolvency proceedings with the competent court immediately, but by no means later than 21 days, after the beginning of insolvency.

The Companies Act

Article 252 of the Croatian Companies Act (N.n. 11/93, 34/99, 118/03, 107/07, 146/08) (CA 1993) provides that members of the management board are obliged to exercise the diligence of a prudent businessman in fulfilling their duties.

In addition, Article 251 of the CA 1993 provides that the management board must initiate insolvency proceedings in a timely manner when the company becomes insolvent. Once the triggers to insolvency have arisen, the management board is not allowed to make any payments except for payments which would have been made by a prudent businessman exercising due diligence.

Members of the management board who fail to observe such duty (i.e. acting in contravention of Article 252 of the CA 1993) may be held personally liable by the company and the creditors of a company for any damage caused by such failure. It is important to note that all members of the management board are jointly liable. The personal liability of the members of the management board towards the creditors of the company becomes even more important during times of financial crisis (such as is being experienced at the moment) as there will undoubtedly be fewer assets to distribute to a company's creditors.

Furthermore, according to Article 626 of the CA 1993, if the members of the management board do not initiate insolvency proceedings when insolvency arises, they can be fined or even be sentenced to imprisonment for up to one year.

While Article 626 of the CA 1993 provides for the possibility of criminal liability of the members of the management board for not initiating insolvency proceedings, a generally accepted code of practice has not yet been established by the Croatian courts. Generally, however, Croatian courts would rarely resort to imprisonment. Despite the time limits imposed by the IA 1996 on members of the management board to initiate insolvency proceedings, so far, the courts in Croatia have not taken any measures against those who have failed to do so within the prescribed time limit. This trend in the Croatian courts may change as Croatia joins the EU.

Summary

According to Croatian law, the members of a management board may be held personally liable by the company and the company's creditors for any damage caused by their failure to act with the diligence of a prudent businessman (which includes a failure to initiate insolvency proceedings). Moreover, members of a management board who fail to initiate insolvency proceedings when an insolvency event occurs can be fined or can be imprisoned for up to one year. It is not, however, customary for the Croatian courts to enforce these penalties.

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INSOLVENCY PLAN PROCEEDINGS AND PROPOSALS FOR THEIR REFORM

The German Insolvency Act has been in force now for 11 years, which has allowed plenty of time to get used to the concepts introduced by the Act and in particular has allowed time for the insolvency plan to be put into practice and tested. In the current financial and commercial circumstances, public awareness and criticism of insolvency legislation is heightened, promoting discussions about necessary changes to the law in order to strengthen the success rate for corporate restructurings, modernise the system overall and compete in a global business environment.

The German government elected in September 2009 has specifically addressed substantial amendments to the insolvency law. The government has stated that "insolvency law must adapt to the new challenges". The proposals include special regulations to reorganise financial institutions, which until now have been subject to two competing draft laws presented by the Ministry of Justice and the Ministry of Economics respectively, neither of which, however, was passed before the new government came to power. Furthermore, the new government's aim is "to make restructurings and the continuation of the business of insolvent companies easier and thus allow the preservation of jobs. Especially, the insolvency plan proceedings will be made easier and, in terms of company rescue, even more focussed on addressing the restructuring of companies during the early stages".

In light of the above, the German Chamber of Industry and Commerce *(Deutsche Industrie- und Handelskammer – DIHK)* has recently put forward ten proposals to improve the insolvency law. These are based on the impression that the current procedures are not attractive for creditors or for the debtor companies. The aim is that a reform might lead to more successful restructurings and might increase the dividend paid to unsecured creditors. The main demands are:

— Creditors should be able to influence who is appointed as the insolvency administrator. Currently, the decision is at the sole discretion of the competent judge. While some judges have already been following the suggestions made by the debtor's management or by creditors in connection with the application for insolvency, there are also judges who would never appoint an administrator named by the applicant. The DIHK demands that judges give reasons supporting their choice of administrator.

— Self-administration should become more frequent. Although the existing law only precludes self-administration should it delay proceedings or disadvantage creditors in other ways, in practice the impression is that self-administration is generally only accepted if a known restructuring expert is named as a member of the management team in advance. The combination of self-administration and insolvency plan proceedings is seen as a way of communicating to the public that the company will be continued and restructured.

— Concerning the process of deciding on an insolvency plan, individual creditors will no longer be able to delay the process by arguing that they suffer a disadvantage compared to normal proceedings. They will only be entitled to damages if at court proceedings at a later date such disadvantage is found.

— Shareholders should also be included in the vote on the insolvency plan. Thus, there will be an incentive for them to take an active part in putting the plan together. Under current insolvency law, the creditors are divided up into different groups corresponding to their differing legal positions in and interests connected with the proceedings for the purpose of voting on the plan. For the plan to be accepted generally the majority of sums of claims in each group of creditors has to vote in favour of the plan. However, groups of creditors who try to defeat the plan may be ruled against if the majority of the groups vote in favour of the plan and those in disagreement suffer no disadvantage from the plan compared to normal insolvency proceedings. The DIHK proposes to include the shareholders in voting on the plan as a new and separate group.

— Currently, the plan's consequences and limitations are generally binding on all creditors, whether they have taken part in the proceedings or not. However, creditors may join the proceedings at a later stage which may result in greater payment obligations than were calculated when the plan was created. DIHK is seeking clear regulations regarding the position of creditors who have not participated in the insolvency plan proceedings and proposes to introduce a deadline for the participation of creditors who have received notice from the administrator.

— The existing minimum tax on recapitalisation gains should be abolished. Under the existing regulations the waiver of claims by creditors leads to a tax of at least 40% of the amount waived insofar as it exceeds EUR 1 million. As the waiver only leads to book profits and provides no further liquidity the tax regulation is a further burden and obstacle to restructurings. In future, all profits resulting from waivers included in an insolvency plan should be subject to set-off against losses brought forward from preceding years.

— The DIHK advocates creditor protection prior to insolvency proceedings for companies in financial distress in order to prepare for the insolvency proceedings and/or negotiate an out-of-court restructuring. The creditor protection will need consent of the majority of creditors and a council of creditors will have rights of supervision and intervention of the proceedings. This proposal is less precise and would probably lead to a more fundamental change than the others. In the position paper many questions remain open, like the preconditions for entering into the creditor protection, the content of this measure and especially how it relates to and engages with (preliminary) insolvency proceedings.

While of course some of the proposals have already been discussed by experts and practitioners, the DHIK-position paper offers a comprehensive assessment of possible measures. It also shows that the number of supporters of change to the law is growing and that how the law should be changed is becoming more and more concrete. It is therefore not unlikely that the framework for restructuring companies in Germany via insolvency plan proceedings will change within this framework in the foreseeable future.

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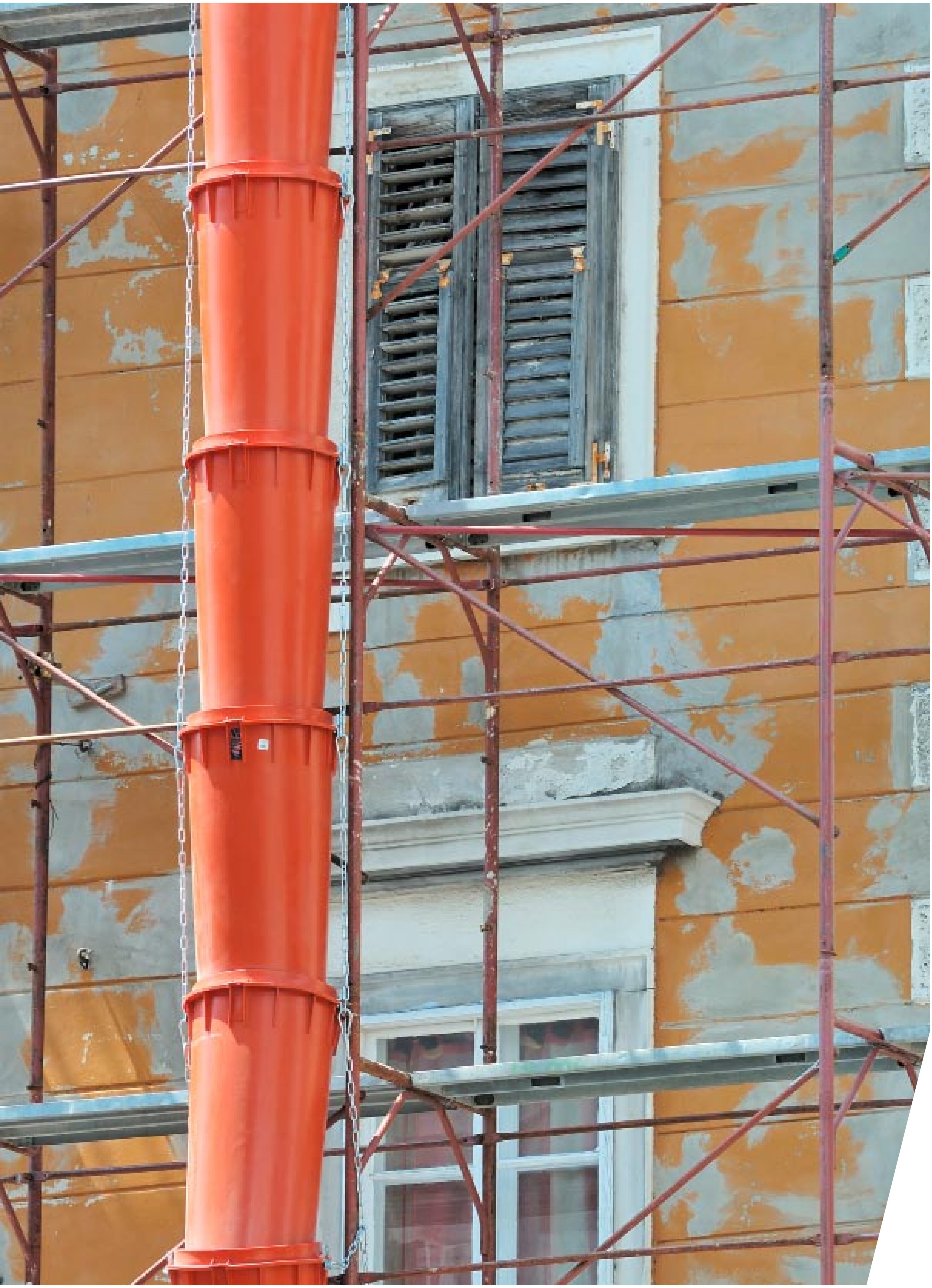

ISSUES ON RESTRUCTURING AND INSOLVENCY IN ITALY

Fiscal Settlement

Within the restructuring procedures which aim to avoid the insolvency of Italian companies facing financial distress, the Italian Bankruptcy Law (Royal Decree No. 267 of 1942, as from time to time amended) (IBL) provides for (i) the composition with creditors *(concordato preventivo)*, which needs to be approved by the majority of the creditors, and (ii) the restructuring plans *(accordi di ristrutturazione)*, which needs to be approved by at least 60% of the creditors (the creditors not approving the plans have to be satisfied in full).

In the course of either a composition with creditors or a restructuring plan procedure, a company facing financial distress can resort to the "fiscal settlement" provided for by the new Article 182-ter of the IBL, which was introduced by Legislative Decree No. 5 of 2006.

The fiscal settlement allows an insolvent company to propose a partial repayment of social security debts and taxes – even if not immediately enforceable – and/or a moratorium of due payments. Taxes which are considered to be owing to the European Union cannot be reduced by operation of the fiscal settlement. If the tax credit is a privileged credit, the percentage, timing of payment and the possible securities shall not be worse than those offered to creditors with lower priority. If the tax credit is unsecured, it must be treated in the same way as the debts owed to other unsecured creditors.

The fiscal settlement was initially intended solely for tax debts, and was subsequently applied to social security debts by Law Decree No. 185 of 2008, which also clarified that VAT debts can only benefit from a payment moratorium and cannot be entirely or partially reduced.

However, the recent Decree issued by the Ministry of Labour on 4 August 2009, has substantially limited the scope of the fiscal settlement in relation to social security debts, stating that a fiscal settlement can only be proposed by a debtor if it is being used in order to safeguard the company as a going concern and to protect the company's employment standards. Moreover, a fiscal settlement must ensure a 100% repayment of secured social credits within 60 months. Should the company fail to effect payments on the due dates, the fiscal settlement will be automatically terminated. The exclusion of VAT from those taxes which can be reduced by using the fiscal settlement will further frustrate the use of the fiscal settlement given that the principal exposure of Italian companies in financial distress is to VAT or social security debts, rather than income tax.

In light of the above it is a common view that, unless the regime of the fiscal settlement is further amended, its actual benefits to Italian companies in distress will be very limited.

The effects of insolvency on current contracts

According to the IBL, a declaration of insolvency does not automatically trigger the termination of all contracts entered into by an insolvent company.

It is worth noting that pursuant to Article 72 Paragraph 6, of the IBL, contractual clauses providing for the automatic termination of a contract on a declaration of insolvency of a party are not valid.

As a general rule, if a contract has not yet been entirely or partially performed, performance is suspended until the receiver in bankruptcy – having obtained the creditors' committee's authorisation – decides whether to continue the contract or terminate it.

The counterparty of the insolvent company may request the judge to set a period for a maximum of 60 days, during which time the receiver can decide whether to continue or terminate the contract. If the receiver does not decide within such period, the contract is deemed to be terminated.

The potential issues and consequences for certain contracts when one of the parties becomes insolvent are as follows:

— *Financial lease contracts:* upon the insolvency of the lessee, if the receiver terminates the contract, the lessor will be entitled to recover the relevant asset, subject to paying the receiver the difference (if any) between (i) the sum realised by the lessor through the sale (or any other kind of disposal or utilisation) of the asset, and (ii) the outstanding debt of the insolvent lessee. The lessor may request proof of the insolvent company's liabilities in the event that sum (i) is lower than sum (ii).

  In the case of a lessor's insolvency, the contract would continue and the lessee would be entitled to purchase the relevant asset on the date and at the price agreed in the contract.

- *Lease of a business concern:* upon the insolvency of either the lessor or the lessee, the non-insolvent party will be entitled to terminate the contract within 60 days, provided that due compensation is paid to the insolvent party.

- *Subcontracts:* as an exception to the general rule, in the event that a subcontractor is declared insolvent, the contract will *automatically* be terminated on the 60th day after the day the company enters insolvency, unless the receiver decides to continue with the contract, and on the condition that proper security is offered.

- *Insurance contracts:* if an insurance contract covers risks for damages, the insolvency of the insured party does not trigger the termination of the contract, unless termination was agreed separately by the parties or if the insured party's insolvency exacerbates the insured risk.

- *Rental agreements:* in the event that the landlord is declared insolvent, the receiver would step into the landlord's shoes and be able to collect rent monies which are due. The receiver will also be entitled to terminate the contract within one year of insolvency if the life of the contract exceeds four years, provided that due compensation is paid to the tenant. Should the tenant be declared insolvent, the receiver shall be entitled to elect to terminate the contract by paying due compensation to the landlord.

If a contract has already been completely performed by one of the parties before the insolvency of the other party, termination will not be an available recourse. Should the insolvent party be the non-performing party, the performing party would only be entitled to prove for debts owing to it.

Claw back of third-party guarantor's payment

Pursuant to Article 67 of the IBL, all debt payments made within the six months preceding insolvency can be clawed back by the bankruptcy receiver, provided that the receiver can prove that the other party was aware of the debtor's insolvency.

The principles relating to the claw back of payments made by a third party guarantor during the "twilight period" in favour of the insolvent company's creditor have largely been established by judgments handed down by the Joint Divisions of the Italian Supreme Court.

In a particular case, the receiver of an insolvent company clawed back a payment made by the guarantor of a bank's debtor. In order to decide on the case, the Court had to examine previous judgments handed down on similar issues.

On the one hand, one Division of the Supreme Court held that if the guarantor makes a payment *with its own money,* without exercising any recourse against the debtor prior to the debtor's insolvency, the payment would be considered a "neutral" act, which would be considered as separate from transactions which are detrimental to the *par condicio creditorum* (equal treatment of creditors), because it would not constitute a reduction of the debtor's assets.

On the other hand, another Division of the Supreme Court held that if the guarantor's payment was initially deposited into the debtor's account, it would represent an increase in the debtor's assets which would be available for distribution. This essentially meant that any payment made to a creditor by a guarantor, which is initially deposited into the debtor's account would be deemed to have been made directly by the debtor.

The first decision had long prevailed, on the basis that no claw back action can be brought against a payment in favour of the creditor made by the third party guarantor using its own money, provided that the guarantor does not claim against the debtor before insolvency. The same view was confirmed by the Supreme Court's decision No. 1574 of 2009, according to which the payment by a third-party guarantor of an insolvent company's debt is subject to claw back only if the guarantor paid the debt with the insolvent company's money.

Hence, the Joint Divisions of the Supreme Court have held that the payments made (during the "twilight period") by a guarantor in favour of the creditor of a company which has subsequently been declared insolvent are not subject to claw back provided that the guarantor made the payment using its own money and did not make a claim against the insolvent debtor.

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PERSONAL LIABILITY OF MANAGING DIRECTORS

Managing directors of a company cannot be held personally liable for debts of the company, unless specific circumstances occur which may lead to such liability.

In general (and under the assumption that management has fulfilled its management duties properly) a liability risk exists when management allows the company to incur further debts, but is – or should have been – aware that the company would not be able to pay these debts nor otherwise provide adequate recourse for its creditors. For a managing director to be held personally liable, such liability will usually be based on an unlawful act or act of tort *(onrechtmatige daad)* towards a third party (e.g. a creditor of the company).

When a company envisages that it will no longer be in a position to pay its debts, the continuation of trading and the incurring of further debts may lead to its managing directors bearing the liability. However, this does not mean that a director also becomes personally liable for claims that already exist (there is therefore no retrospective effect).

In addition, the mere fact that the debt of a company exceeds the value of its assets does not automatically oblige the managing directors to file for bankruptcy. The concept of “over indebtedness”, similar to the German concept of *Überschuldung*, does not exist under Dutch law.

Second Directors’ Liability Act (Tweede Anti-Misbruikwet)

The provisions of the Second Directors’ Liability Act (the “Act”) are contained in a number of acts regarding the payment of social security contributions and taxes, rather than one single act or code.

The members of the management board of a company may be held personally and severally liable under the Act for certain unpaid social security contributions and taxes (primarily wage taxes *(loonbelasting)* and VAT *(omzetbelasting)* owed by the company. However, it is only the relevant social security and tax authorities that may file a claim against the managing directors and such claims are limited to the amounts of social security premiums and taxes which remain unpaid by the company.

Nonetheless, in practice, such liability will only arise in the event that social security contributions and taxes are not being paid by the company on time and the relevant authorities are not notified within a reasonable period of the fact that the company is unable to pay the relevant debts *(melding betalingsonmacht)*.

Liability of managing directors in an insolvency (faillissement)

Improper management

Section 2:9 of the Dutch Civil Code ("DCC") states that board members are responsible for the proper performance of duties assigned to them. They have a so-called "obligation to perform to the best of their ability" *(inspanningsverplichting)*, but they are not obliged to achieve a certain result. Furthermore, board members are expected to have adequate knowledge to carry out their assigned responsibilities and act with the due care expected from someone with such experience. A board member may be held liable for damages that the company suffers, if he is "at fault" (*ernstig verwijt*).

According to the Dutch Supreme Court, whether a board member is "at fault" will be determined by the particular facts of the case, having regard to:

— the nature of the activities of the company;

— the risk arising from the activities;

— the assignment of responsibilities within the board; and

— guidelines for board members.

The Dutch Supreme Court also states that breaching a statutory provision which aims to protect the interests of the company is a significant factor to consider in determining whether a director is liable.

It is worth noting that board members can be granted reprieve by a resolution of the company's members. The reprieve, however, will only relate to information that was provided to the members in the general meeting. A resolution to discharge the board from liability does not apply to matters that were not disclosed in the general meeting before the resolution was passed. In addition, such members' resolution may be challenged by a directly interested person because the resolution is based on incomplete information.

Pursuant to Section 2:248 DCC, in a company's insolvency, individual board members may also be held personally liable for any shortfall in payments to creditors if:

(i) the managing board was negligent in performing its duties *(kennelijk onbehoorlijk bestuur)* in a period of three years prior to the date of the insolvency; and

(ii) the managing board's negligence was a major contributing factor which led to the company's insolvency.

In the event the board fails to meet its obligations under Section 2:10 DCC (i.e. conducting a proper administration) or Section 2:394 DCC (publication of the annual accounts), there is a presumption, by operation of law, that the board as a whole has failed to adequately fulfil its duties generally. Non-compliance with these statutory obligations also automatically provides probable cause that such negligence was a major cause of the ensuing insolvency. In any event, a board member may disclaim responsibility by proving that he has not acted negligently at all times. Furthermore, the court has the authority to determine the amount for which a board member is held liable.

Finally, pursuant to Section 6:162 DCC, the trustee may hold individual board members liable for committing an unlawful act *(persoonlijk voldoende ernstig verwijt)*. Under certain circumstances this unlawful act can qualify as a criminal offence. It must be noted that Section 6:162 DCC is a personal liability ground where the trustee needs to prove that an individual board member committed a specific unlawful act (as opposed to mere unintentional management, for example).

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THE SUPREME COURT'S DECISION ON THE PRECLUSION OF EVIDENCE UNDER THE POLISH BANKRUPTCY AND RECOVERY LAW AND ON PARALLEL DEBTS

In October 2009, the Supreme Court handed down a judgment concerning a petition of a bank for the exclusion of assets covered by *agreements on the transfer of ownership as security for a debt* from the insolvent estate of two Polish companies (the "Companies") (case file number: IV CSK 145/09).

There are two things that make this decision significant: first, the Supreme Court analysed the regulations on the preclusion of evidence contained in the Bankruptcy and Recovery Law (BRL) (and in the regulations governing civil procedures in commercial cases). Second, the Supreme Court specifically analysed the issue of the so-called 'parallel debt' in the light of the admissibility of security created over assets located in Poland securing this type of debt.

Undoubtedly, the decision will affect the practice in respect of both issues mentioned above and the following is a summary of the key issues that follow on from the decision.

Preclusion of evidence

The regulations of the BRL, as well as those governing civil procedures in commercial cases, provide for analogous regulations concerning the principles on evidence preclusion. According to this principle, all evidence in a case must be presented in the initial phase (i.e. it must be presented in the petition or with the statement of claim), and the penalty for failing to do so would be the possibility of losing the right to present such evidence later on in the proceedings.

It must be noted that even though the regulations are very similar, they are not identical. Those contained in the BRL are more rigorous in that the claimant must present all statements and charges (proving the legitimacy of the petition for assets to be excluded from the insolvent estate) alongside the petition. On the other hand, whilst the civil procedure regulations in commercial cases also permit statements and charges with evidence in support, in some circumstances, evidence can be introduced later in the proceedings.

It was held by the Supreme Court that, due to the BRL regulations being stricter, the petitioner was deprived of its right to present evidence at later stages of the proceedings. The Court held that such a strict interpretation might be justified because establishing the insolvent estate is of utmost importance when dealing with ongoing insolvency proceedings. In particular, both the receiver and the judge commissioner should be informed of all circumstances that would prove that the petition is justified as this helps in making the correct decision when assessing which assets should be excluded from the insolvent estate.

This decision will undoubtedly be influential in drafting petitions for asset exclusion from the insolvent estate.

Parallel Debt

The other issue addressed by the decision is the analysis of the circumstances surrounding the creation of a parallel debt. Generally speaking, a parallel debt is an abstract, independent pecuniary claim by one party (usually a party which is appointed to act as security agent in a syndicated lending) against a debtor, for an amount corresponding to the claims of all the finance parties in a syndicated lending (i.e. under a credit facility agreement) against such debtor. However, such parallel debt arises not from the credit facility agreement itself, but rather, from a separate document called a deed of trust (or an intercreditor agreement) which "parallel" the debts under the credit facility agreement.

Parallel debts facilitate the creation and enforcement of security. Instead of creating separate security in favour of each finance party in a syndicated lending, a debtor will only create security in favour of one party (i.e. the security agent); and in enforcement, the proceeds received will be divided between the finance parties in accordance with the terms of the deed of trust or intercreditor agreement.

Polish law does not recognise the concept of parallel debts. Moreover, under Polish law, "abstract" liabilities (such as parallel debts) may only exist if it is expressly recognised under legal regulation (i.e. the principle of causation). Therefore, the agreement under which a parallel debt is created would need to be governed by law which allows for the creation of such legal instrument, such as English law. A Polish court would then need to apply the relevant foreign law (such as English law), rather than Polish law, to establish whether the parallel debt has been validly created.

In this case, the Supreme Court appears to have fully accepted that if a deed of trust governed by English law is capable of creating a single abstract obligation referred to as a parallel debt (reflecting the liabilities under the credit facility agreement, but separate from those liabilities), then such parallel debt is in turn capable of being secured with Polish law security instruments. The Court found that such a parallel debt was created through the execution of a deed of trust and it is that debt (and not liabilities under the credit facility agreement) that was secured. This therefore meant that the security in respect of liabilities under the deed of trust was validly created.

This is one of the few decisions in which the Supreme Court expressly held in favour of security created over assets situated in Poland to secure an abstract liability. This decision signifies the Supreme Court's progressive attitude towards the possibility of recognising parallel debts under Polish law.

In practice, the concept of parallel debts is frequently used to facilitate the creation and enforcement of security when such security includes real property. This is because Polish law contains severe mortgage restrictions and according to the relevant regulations, it is impossible to create a mortgage for the benefit of a trustee (i.e. a party which, by virtue of law, can act on behalf of other parties in administering security), such as a security agent. As a result, there are two practical solutions that may be employed to get around this predicament.

The first option is to create a separate mortgage for each of the finance parties, (i.e. it is impossible to establish one mortgage to secure the repayment of more than one facility; and secondary syndication, that is, selling parts of the loan to other banks is impossible without registering the respective new secured creditors in the land and mortgage register, which can be a time consuming process).

The other much more flexible and appealing solution is to create an abstract parallel debt and then secure its repayment with a mortgage held by a security agent. This option can be used when the credit facility documentation is governed by the laws of England or Germany, especially when the agreement creating the parallel debt is governed by laws which recognise the creation of such abstract liability. Due to the principle of causation mentioned above, such abstract liability would not be recognised if Polish law governed such documentation.

Therefore, the discussed decision of the Supreme Court had been very helpful in practice because it has confirmed that it is admissible to establish security over assets located in Poland in order to secure the repayment of an abstract parallel debt created by the parties. It means that this instrument, which is used very often in practice, raises no objections on the side of the Supreme Court.

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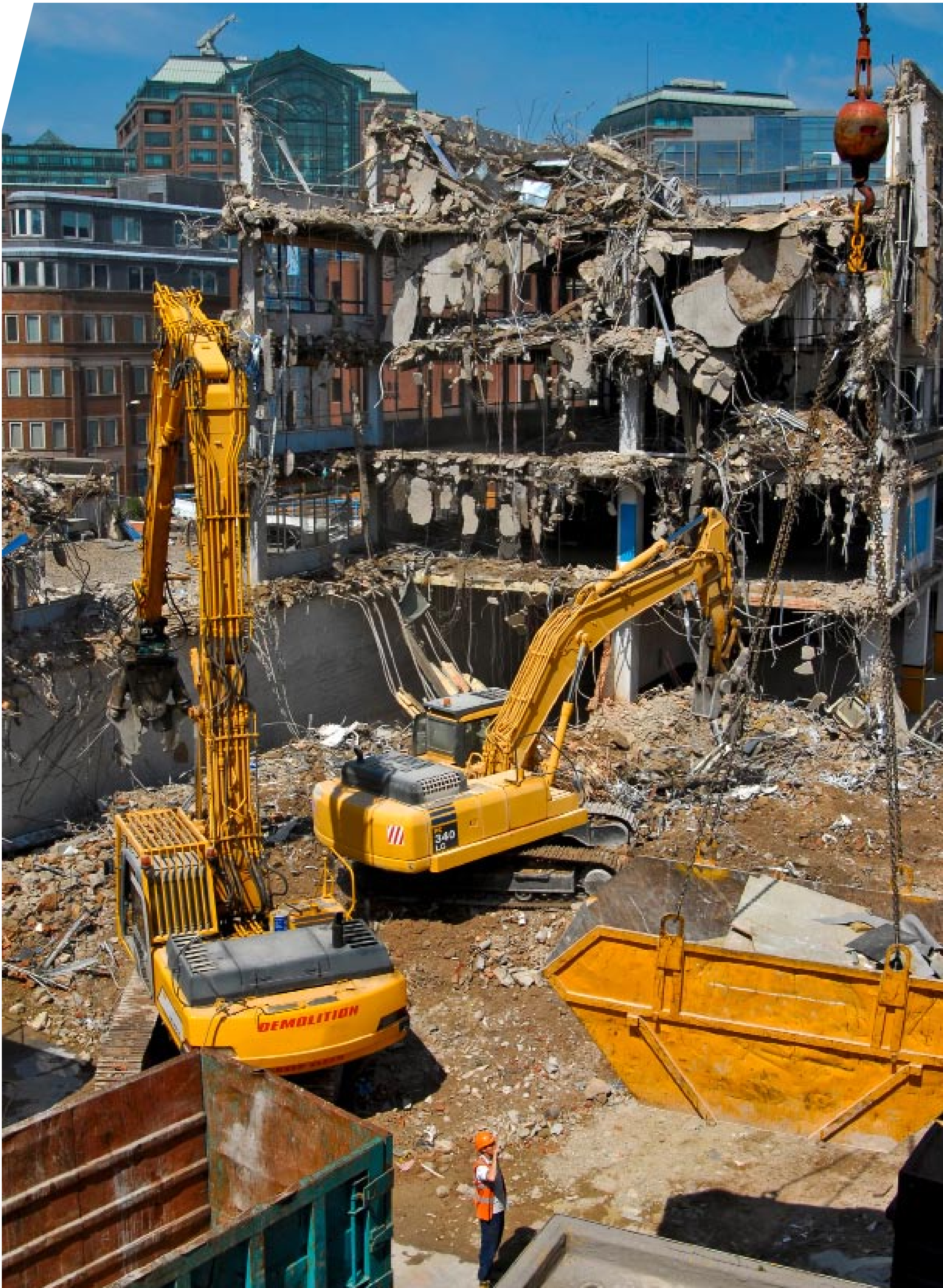
DEMOLITION

ROMANIAN INSOLVENCY REFORM

Introduction

While the Law No. 85/2006 regarding insolvency proceedings (the "Insolvency Law") has sought to promote a "rescue culture" in Romania, concerning bankruptcy and liquidation, there has been very little evidence that a "rescue culture" has in fact been established. Very few restructurings have been tested in the Romanian Courts and, of the cases which have, very few have reached a full judgment and conclusion.

The Romanian Parliament has recently passed Law No. 381/2009 (the "Concordat Law") which will have an impact on the insolvency system in Romania. The Concordat Law introduces two new formal procedures to work alongside those set out in the Insolvency Law, both of which aim to help distressed companies avoid insolvency.

Under the Concordat Law it is now possible for a company which is still capable of repaying its outstanding debts but that is, however, facing financial distress, to apply to court for either an *ad hoc* mandate procedure or a concordat procedure. Both procedures aim to organise the continuation of the company's business and trading, so that the company can repay its creditors and avoid insolvency.

The ad-hoc mandate

The *ad hoc* mandate is a procedure whereby, upon the application of a distressed company to court, the court appoints an insolvency practitioner to act as the agent of such company, provided the company can supply reasons in support of its application.

The agent's duty, vested with important negotiation powers, is to help the debtor reach an agreement with its creditors through negotiation in respect of key matters, such as the writing-off or rescheduling of debts, the maintenance or termination of on-going contracts, the restructuring of personnel and other similar measures. The agent's mandate is terminated if no agreement is reached within 90 days of his or her appointment by the court.

The overall aim of the procedure is to find a way to protect the company's business and repay its creditors. The procedure does not allow the court to vary the rights of either the distressed company or its creditors. An attractive feature of this procedure is that it is confidential (confidentiality is mandatory for all parties and institutions involved) as opposed to standard judicial restructurings that involve a much higher level of public disclosure.

The preventative concordat procedure

Under this procedure, upon the application of a distressed company[1], the court appoints an insolvency practitioner to act as a temporary conciliator. This conciliator will prepare and submit to the company's creditors a "concordat proposal" (a settlement plan).

This settlement plan sets forth proposed measures to be taken by such company in order to avoid insolvency (e.g. change of management, reorganisation of personnel, etc.), the means for its reorganisation (share capital increase, bank loan, assets sale, setting up or closing branches or other units), the projected percentage in terms of the realisation of debts (i.e. at least 50%) and the rescheduling of the creditors' claims (i.e. over a period no longer than 18 months from the conclusion of the settlement).

Consequently, the creditors will have to vote on this proposal to approve or reject it. The voting rules are set out in detail in the Concordat Law but in principle, for the proposal to be accepted, the approval of creditors holding at least two thirds of the claims (accepted or not challenged) is required.

Importantly, while the approval of the creditors is pending, the company may apply to court for a temporary stay of any on-going individual enforcement proceedings. If approved by the court, the stay continues either until the approved plan is published or until the plan is dismissed by the majority of creditors.

If the plan is accepted by the creditors with the required majority, the court can submit it to all the creditors and have it registered with the Trade Registry. Conversely, if the creditors vote against the plan, the debtor is entitled to prepare and submit a new plan to the court.

In the event of approval, all creditors who voted for the plan are bound by its terms and the enforcement proceedings they may have initiated are stayed (if this has not already been done). As of the date of approval, all interest and penalties due by that company to the creditors having approved the plan are suspended.

It is worth mentioning that the conciliator may request the syndic judge to authorise this plan. Authorisation by the syndic judge is subject to the following conditions being met:

(i) the distressed company is in financial difficulty;

(ii) the value of the challenged claims does not exceed 20% of the total claims; and

(iii) the plan has been approved by the creditors holding at least 80% of all claims against this company.

Authorisation of the plan has the following important legal implications:

(i) the provisions of the plan will be binding upon all creditors (including those having voted against the plan and any unknown creditors);

(ii) all enforcement proceedings against the company are stayed;

(iii) no insolvency proceedings may be initiated against the company; and

(iv) the syndic judge may, following the conciliator's proposal and on condition that further guarantees are given, impose on the other creditors a moratorium of no more than 18 months (i.e. repayment of principal and payment of due interest, penalties and other related costs are postponed).

Essentially, any measures within the approved plan also benefit the sureties, the guarantors and the entities that are joint debtors with that company.

Benefits of the new system

Although the Concordat Law does not make it explicit, failure by a distressed company to reach an agreement with its creditors at the end of either the ad hoc mandate or the concordat procedure does not automatically trigger insolvency proceedings. This should relieve the distressed company of the stress of impending bankruptcy if the measures do fail, as would be the case in a standard judicial restructuring. As a result, a distressed company is able to focus on the commercial and financial aspects of its restructuring and agree directly with its creditors on the measures required in order to avoid insolvency without the need for a court-led restructuring.

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1) Certain companies are not eligible for this procedure (e.g. companies that have been the subject of insolvency proceedings less than five years before the concordat offer or have used the preventative concordat procedure less than three years before such offer are not eligible to initiate this procedure again).

DEBT TO EQUITY LAW INSOLVENCY PROTECTION REFORM – ANOTHER CHANCE FOR DISTRESSED DEBTORS? PROPOSED LIQUIDATION NETTING LAWS FOR DERIVATIVES

Introduction

Insolvency related legal reform continues at a healthy pace in the Russian Federation with the enactment of "debt to equity" law and the introduction of extensive draft corporate insolvency protection and derivatives liquidation netting laws for consideration by the Government. A legislative timetable for the enactment of the draft laws is not specified, but our expectation is that the laws may be passed in the first half of 2010. One word of caution: any enacted laws may vary significantly from the proposed draft legislation.

Debt to equity law

On 31 December 2009 a highly anticipated federal law (the "D2E Law") permitting "debt to equity" conversion for Russian companies came into effect. The D2E Law is part of the Russian legislative reform that has resulted during the current financial downturn, and which may assist borrowers looking to avoid insolvency.

Under the D2E Law the Russian Civil Code is amended to allow the set-off of payment obligations between the company and its shareholder (or participant, as the case may be) and the provisions of the JSC Law and the LLC Law are redrafted to support this. Relevant corporate laws are also correspondingly amended to allow the application of the "right of claim" from the shareholder against the obligation of the shareholder/participant to pay its stake of the charter capital in a company. Also, companies are now entitled to increase the charter capital in order to cover incurred losses.

It should be noted that the decision of payment of the increased charter capital in the limited liability company by set-off must be adopted by the unanimous decision of the participants of the company. In the case of joint stock companies, the set-off is possible in the case of a private offering of the additional share issue.

One point worth noting is that, during a legal reform discussion early in 2009, there was a drive to limit the availability of "debt to equity" for use only by "sophisticated investors", but such limits do not feature in the enacted law.

Initial overview

The D2E Law introduces for the first time the potential for a straightforward debt to equity rearrangement. Previously, due to prohibitions in Russian law against debt to equity swaps companies and their creditors sometimes looked to structure relatively complicated (usually offshore) schemes to effect a debt to equity conversion. These approaches would appear now less relevant, and further onshore restructuring is likely to result.

Insolvency proceedings and protections

A major set of structural reforms to Russian insolvency law has been proposed under the draft Federal Law "On amending the Federal law", "On insolvency (bankruptcy)" and the Federal law "On Judicial Enforcement Procedures in terms of improvement of rehabilitation measures" (the "Draft Insolvency Law"). The Draft Insolvency Law (which is voluminous) is considered to be a product of industrial lobbying and appears to enhance debtor protection, with some reserved protections for creditors. Key features of the Draft Insolvency Law are:

(i) the promotion of financial rehabilitation;

(ii) the consolidation of proceedings; and

(iii) the regulation of trans-border insolvency.

Financial rehabilitation

Procedures for debtor financial rehabilitation exist under current law, however in substantial variance to these, the Draft Insolvency Law:

— introduces a recognition of (pre-judicial) amicable settlement or standstill agreements, and preliminary agreements with respect to financial rehabilitation planning;

— contemplates debtor-initiated financial rehabilitation planning (and moratorium) that may last up to five years and include modifications to key contracts, set-off, debt to equity conversion, an introduction of creditor classes and modification of the order of debtor's mandatory payments (including reductions);

— provides for cancellation of injunctive relief and enforcement against debtor assets, relief against default interest or contingent costs/penalties, for the imposition of uniform interest at Russian Central Bank refinancing rates;

— introduces creditors' consent requirements for dividends, entering into significant contracts (and asset disposals) and incurring indebtedness, with thresholds all at around 5% of balance sheet value; and

— provides for an obligation on each of

  (i) the executive officer of a debtor;

  (ii) the management of a debtor;

  (iii) an insolvency administrator; and

  (iv) the members of a creditors' committee, to act reasonably and in the best interests of all creditors.

Consolidation of proceedings

Key procedural changes are contemplated in connection with consolidation of insolvency proceedings. Currently, the insolvency process is generally on an entity-by-entity basis. The Draft Insolvency Law contemplates the initiation of proceedings by a debtor (which is entitled to file an application for insolvency of its "controlled entities", "controlling entities" and "affiliates"), or that proceedings may mandatorily apply (which relates to the bankruptcy of debtors that comprise a group of companies). In the latter case, bankruptcy has to be handled under unified proceedings which would mean (among other things) that bankruptcy cases are to be reviewed by the same judge(s). Consolidation would apply to all stages of bankruptcy.

Trans-border bankruptcies

The Draft Insolvency Law introduces the notion into Russian law that insolvency proceedings may differentiate between "main" and "auxiliary" bankruptcy actions and the well-known offshore concept of a "centre of main interests". In addition there appears to be some recognition that Russian insolvency proceedings may be subjugated by a dominant offshore proceeding and court resolution.

Initial view

Our initial view of the Draft Insolvency Law is positive, but cautioned with our experience that Russian legislative drafting is seldom clear and can introduce additional issues and *ad hoc* court practice. However, at a conceptual level, positive attributes in the draft include:

(i) acknowledgement and regulation of widely used (offshore and at holding company level) standstill and restructuring arrangements;

(ii) consolidation of bankruptcy proceedings which may facilitate a quicker and more efficient handling of bankruptcy cases by Russian courts; and

(iii) regulation of trans-border bankruptcies.

Liquidation netting for derivatives

With the enactment in November 2009 of significant legislative reform (the "New Derivatives Laws") regarding the recognition and taxation of derivatives in Russia, additional key draft laws supporting (amongst other things) liquidation netting are continuing to make their way through the *State Duma.* Draft Federal Law No. 186832-5 "On amending certain legislative acts of the Russian Federation (regarding the introduction of a mechanism for liquidation netting)" (the "Draft Netting Law") has passed a first reading (9 June 2009) before the Russian Parliament. The Draft Netting Law proposes changes to the insolvency laws generally (and to other laws) which apply to banks and credit organisations.

Proposed changes

The proposed changes are intended to allow liquidation netting in the context of insolvency, with the following pre-requisites (amongst others):

— at least one of the parties to the agreement must be a Russian bank or a qualified securities market participant; and

— the relevant agreement must meet certain prescribed criteria for derivatives contracts recognised under the New Derivatives Laws.

Initial view

The amendments generally aim to create favourable conditions for further development of the Russian domestic exchange market and over-the-counter derivatives market. Russian companies and banks will therefore have better opportunities to hedge their risks. It would appear that legislators are still aiming to reduce credit and insolvency process risk and further improve the financial markets in the Russian Federation.

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NEW REFORM OF THE INSOLVENCY ACT: STUDY AND DRAFTING STAGE

The Spanish Ministry of Justice is currently implementing new amendments to the Insolvency Act (the "Act"). The Act has generally functioned in a positive manner, however certain deficiencies in its application have arisen over the last three years.

Insolvency proceedings are rarely used (although in the past two years they have risen from an average of 1,000 cases per year to 6,000 at the end of 2009), cases of unworkable companies have not been settled quickly and effectively, and the recovery of viable companies recovered have been significantly hindered by delays.

Among the basic ideas to take into account for improved reform of the Insolvency Act, and in order to improve insolvency proceedings in Spain, the main objective of the amendments is to reduce the deadlines for delivery of the Insolvency Trust Panel's report on the assets of the debtor and list of creditors as well as the creditors' discussion of that report, collectively known as "the common stage" *(fase común)* of the insolvency proceedings, to a year, or in more than a few cases, to six months. For this purpose, it is proposed that credit notifications are received from insolvency administrators without having to have them formalised by the Commercial Court. There is also a proposal to give the insolvency administration an initial right to contest debts: a very short period of 15 days to contest and a further period of 15 days for resolution by the insolvency administration.

The reduction in deadlines can also be achieved through an automatic and provisional approval of the insolvency – upon request with the appointment of the insolvency administration – and granting the debtor applicant a period of 15 days to remedy any formal defects. If such defects are not resolved following this period, the insolvency would be rejected and would not be declared.

The reform of the law should provide the commercial courts with more technical resources, but some of these will be useless if the procedure is not simplified by reducing the deadlines.

In addition, one of the major differences regarding insolvency in neighbouring countries such as Italy, Germany or the United Kingdom, is that Spain does not have a culture of insolvency. In Spain, the employer will attempt to stave off insolvency until the last day. For this reason, another pillar of the reform will adapt the legislation to make insolvency more attractive, and prevent the debtor from acting too late to salvage their insolvency situation.

In 2010, it is expected that the number of insolvency proceedings will be at the same level as last year. As we have pointed out, in 2009 there were 6,000 insolvency proceedings – a figure which is almost double the number in 2008 when there were only 3,105 insolvencies. The number of insolvencies in 2010 is expected to be in line with the levels in 2009.

It is hoped that in the long term, with the new reform of the Act, Spain will have an insolvency regime which is more in line with those of the European powers.

On the other hand, the refinancing paragraph of the Royal Decree 3/2009 is also being considered for reform. Ordinarily an agreement *(convenio)* is made to finalise the insolvency proceedings. This agreement can alternatively be made at the beginning of the proceedings when it is known as a propuesta anticipada de convenio. This option has been used in very few cases since last April (only nine). Although it is a good solution, the negotiations are complicated especially with financial institutions and therefore change in this area cannot be ruled out.

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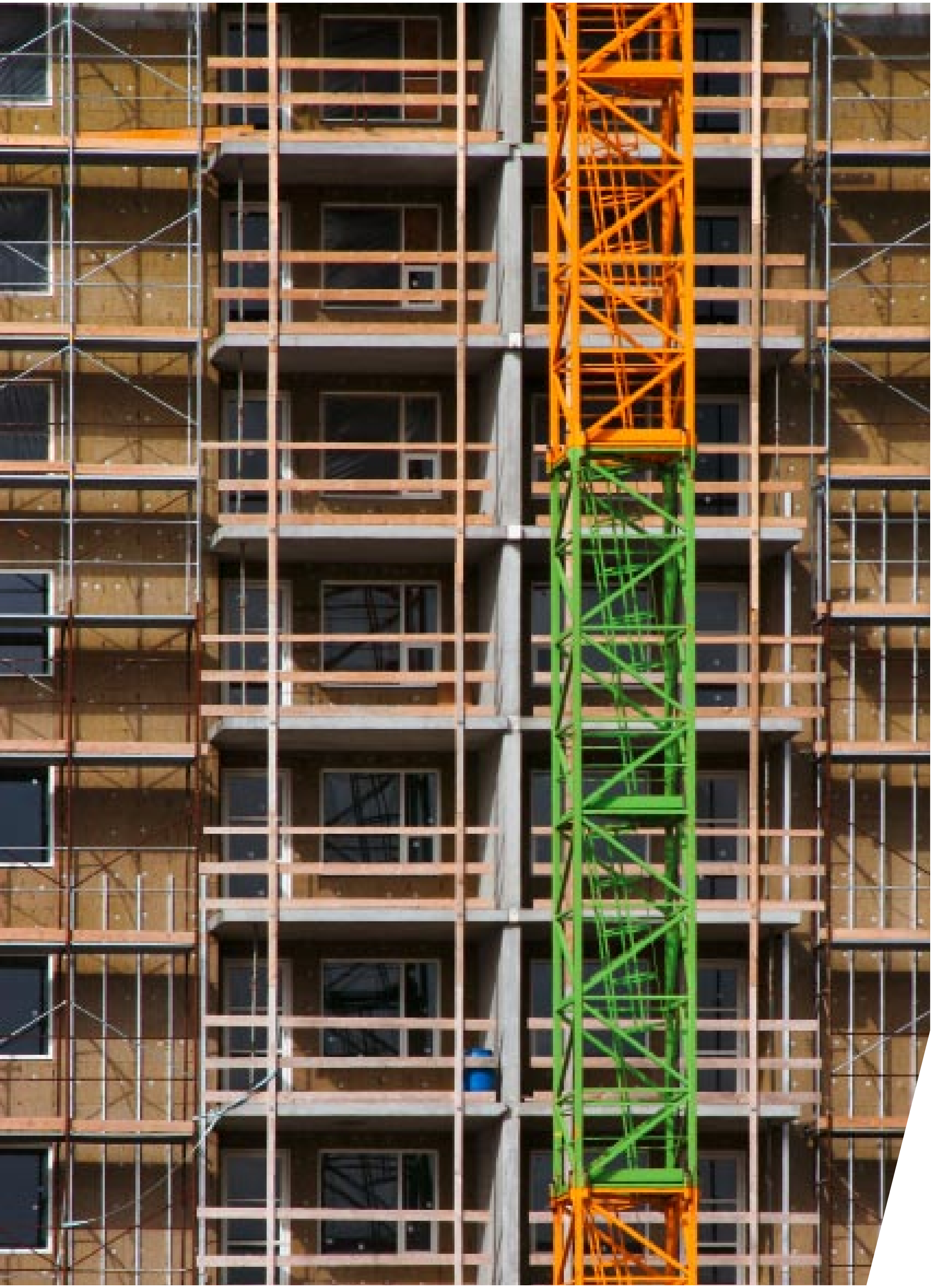

TIPS FOR UNDERSTANDING POTENTIAL RISKS OF BANKRUPTCY AND INSOLVENCY

As a result of the current economic downturn, the effective assessment of potential risks of insolvency and revealing the grounds for declaring bankruptcy become more important. This article aims to assist understanding as to what insolvency and bankruptcy are and whether there is a risk of them occurring, as well as reviewing particular measures that could be taken in order to overcome them. For this purpose we provide a general summary of what, how and when insolvency and bankruptcy may threaten the debtor under Ukrainian bankruptcy laws, in particular, the Law of Ukraine "On Restoring Debtor's Solvency or Declaring a Debtor Bankrupt" No. 2343-XII, dated 14 May 1992, and significantly revised in 1999 (the "Bankruptcy Law").

Difference between insolvency and bankruptcy

Insolvency is defined under Ukrainian law as a debtor's inability to meet its pecuniary obligations to its creditors (including salaries) as they fall due, and/or a failure to pay any compulsory contributions towards all types of obligatory State social insurance, taxes and dues (the "Compulsory Payments"), other than through the restoration of its solvency (i.e. at this stage it is possible to restore the debtor's solvency by applying special procedures provided for by the Bankruptcy Law).

On the other hand, bankruptcy is the inability to recover a debtor into a state of solvency and to satisfy creditors' claims other than through liquidation.

Who can initiate bankruptcy proceedings and when

The threshold for commencing bankruptcy proceedings under Ukrainian law is relatively low. The commercial court can commence bankruptcy proceedings if there is proof of material signs of insolvency, in particular: (i) the aggregate amount of undisputed creditors' claims is equal to or exceeds the level of the Ukrainian minimum wage multiplied by 300 (currently approx. EUR 22,500); and (ii) the debtor has failed to settle such creditors' claims within three months of the date that they become due.

An application to the commercial court to declare a debtor bankrupt may be filed by the debtor itself or by its creditor(s). The debtor has the right to apply to the commercial court to be declared bankrupt, provided that: (i) the bankruptcy is anticipated by the debtor; and (ii) the debtor has sufficient assets to cover the court expenses.

The creditor is entitled to initiate bankruptcy proceedings against the debtor if:

(i) its demands relate only to the payment of cash;

(ii) its demands are not disputed;

(iii) its claim has not been settled within three months of the date on which the debt became due; and

(iv) the aggregate amount of the demands is equal to or exceeds the level of the Ukrainian minimum wage multiplied by 300.

Who must initiate bankruptcy proceedings and when

The debtor must apply to the commercial court to initiate bankruptcy proceedings, if:

(i) satisfaction of the debts owed to one or more creditors would result in the debtor being unable to meet its obligations to other creditors in full;

(ii) an authorised governing body of the debtor decides to initiate bankruptcy proceedings; and/or

(iii) the debtor is unable to satisfy the demands of its creditors in the course of the liquidation procedure initiated separately from the bankruptcy proceedings.

Who can be declared bankrupt

Any business entity or natural person-entrepreneur that is unable to meet its pecuniary obligations to its creditors, including any Compulsory Payments, within three months of the date on which such obligations arose may be declared bankrupt and liquidated.

Who can declare bankruptcy

The courts in Ukraine have jurisdiction over bankruptcy proceedings for debtors that carry out their core business in Ukraine. A petition for a declaration of bankruptcy must be submitted to the commercial court at the debtor's place of registration/ residence as indicated in its certificate of state registration as a legal entity or a natural person-entrepreneur.

When can liquidation be initiated in bankruptcy

Liquidation follows the declaration of the debtor's bankruptcy by the commercial court if:

— no debtor's sanation (rehabilitation) plan has been submitted to the commercial court within six months of the sanation judgement being issued;

— no settlements have been agreed with creditors within the timeframe envisaged by the sanation plan;

— the funds derived from the sale of the debtor's property during the sanation do not satisfy the debts owed to all of the creditors, and no amicable settlement agreement has been concluded; or

— the committee of creditors does not approve the report of the sanation manager.

Special treatment of certain debtors

It should be noted that certain categories of debtors have absolute or limited immunity from bankruptcy. Moreover, bankruptcy proceedings for certain categories of debtors (including banks, insurance companies, securities traders, etc.) have important specific features (such as different priorities of creditors' claims, the extension of the term of bankruptcy court hearings, special sale procedures and restrictions on the attachment of the debtor's assets, etc.), in comparison to the standard bankruptcy regime.

From insolvency to bankruptcy

Ukrainian Bankruptcy Law provides for the following four bankruptcy procedures:

(i) asset management (receivership);

(ii) sanation (rehabilitation);

(iii) liquidation; and

(iv) amicable settlement.

The decision as to which procedure will be followed will depend upon the debtor's circumstances.

Asset management is a system of supervision and control over the management and disposal of the debtor's property, with the aim of ensuring the maintenance and efficient use of its property assets. Additionally, an analysis of the debtor's financial standing will be carried out. Asset management is similar to receivership in other jurisdictions.

Sanation is a series of actions that might include (amongst other things) borrowing, rescheduling debt repayments, or the restructuring the debtor or its business, etc. This is aimed at restoring the debtor's solvency and discharging its outstanding debts in order to prevent the bankruptcy and liquidation of the debtor. Sanation is almost equivalent to a rehabilitation procedure in other jurisdictions.

Liquidation is the termination of the activities of a debtor that has been declared bankrupt by the commercial court. The aim of liquidation is to implement an arrangement that will allow creditors' debts to be repaid through the disposal of the debtor's property.

Amicable settlement involves the debtor and a creditor (or a group of creditors) reaching an agreement that would allow respite for the debtor. This may be an agreement to defer the repayment by the debtor of its debts or even the cancellation of the debtor's liabilities.

What can be done to restore solvency

The Bankruptcy Law provides the debtor with an alternative to liquidation, creating conditions by which the bankruptcy procedure can be carried out, that would lead to the restoration of the company's solvency. This may be fulfilled through operational restructuring and legal techniques in respect of both the debtors and creditors. Together with various operational restructuring measures, the following provisions of the Bankruptcy Law may, to a certain extent, allow companies to move out of bankruptcy.

Moratorium

The respective commercial court must introduce a moratorium on the satisfaction of the creditor's demands simultaneously with the initiation of bankruptcy proceedings. The moratorium will cover the debtor's performance of its pecuniary obligations and Compulsory Payments that had become due before the moratorium declaration date. It will also provide for the termination of actions taken to secure the payment of such obligations and statutory fees that became due prior to the moratorium being declared.

Elimination of Claims Filed after the Deadline

After acceptance of the petition, notice of bankruptcy proceedings must be published. Creditors must then file claims within 30 days period after publication of the notice. Claims that are not filed within this period, or that are successfully contested by the debtor in court, will be struck off.

Automatic Tax Relief

Under the amicable settlement provisions of the Bankruptcy Law, in the event that the debtor concludes such a settlement, it can receive, by majority vote of the committee of creditors, automatic relief for tax debts (except for due pension and social insurance payments) that occurred at least three calendar years before initiation of the bankruptcy proceedings.

Debt Relief by Commercial Creditors

Commercial creditors may provide debt relief or agree to a deferred repayment schedule. Under Ukrainian tax law, the creditor can deduct the amount of debt relief it provides. This sum then becomes taxable against the debtor.

Debt to Equity Swaps

Under an amicable settlement agreement, debt owed to creditors may be exchanged for corporate rights (i.e. shares) in the debtor.

Rejection of Contracts

In the event that a sanation is initiated, the sanation manager may reject (within three months of the commencement of the sanation) any economically burdensome contracts that have not been fully performed.

Preferences and Fraudulent Transfers

The sanation manager may attempt to recover monies paid out by the debtor that constitute voidable preferences or fraudulent transfers. Specifically, the sanation manager may pursue payments which have been made to unsecured creditors at the expense of the remaining pool of creditors within six months of the beginning of the sanation period, as well as transactions at an undervalue to "insiders". These provisions attempt to ensure equality of distribution to creditors, as well as providing additional sources of funding for the debtor.

Challenging Transactions

Transactions entered into and implemented by the debtor prior to the onset of bankruptcy proceedings can be challenged under the Bankruptcy Law and the Civil Code of Ukraine, via separate methods, at any stage of the bankruptcy proceedings. In particular, the court may invalidate transactions which involve preferences and transactions with interested parties, if:

— the performance of the agreement will result in losses to the debtor; and/or

— it is a long-term agreement (concluded for more than one year) or is structured in a way which will provide the debtor with benefits in the long-term; and/or

— the performance of the agreement may prevent the restoration of the debtor's solvency.

A successfully challenged transaction is deemed invalid. Furthermore, all parties to the invalid transaction are required to reciprocally compensate each another with any gains made from the transaction. As a consequence, the receiver may demand that the assets excluded from a bankruptcy estate as a result of such transactions be returned and included in the bankruptcy estate. If it is impossible to transfer such assets in kind, a sum equivalent to the assets in question should be contributed to the bankruptcy estate.

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TWO BITES AT THE CHERRY

The rule in *Cherry v Boultbee* (the "Rule") had all but disappeared from reported cases in this jurisdiction for more than half a century until 2006 when it was revived in the Court of Appeal, with potentially dramatic consequences for those within the sphere of influence of insolvent companies. Recently, two more cases bolstered the rather obscure Rule's new lease of life. The parties in both *Cattles Plc v Welcome Financial Services Ltd & Ors [2009] EWHC 3027 (Ch)* and *Mills, Bloom & Ors (as joint administrators of Kapthing Singer and Friedlander Ltd) v HSBC Trustee (C.I.) Ltd & Ors [2009] EWHC 3377 (Ch)* accepted (for the purposes of their respective High Court hearings) the Court of Appeal's 2006 interpretation of the Rule in *Re SSSL Realisations (2002) Ltd [2006] Ch. 610*, but sought a ruling on whether the non-compete clauses in their respective finance documents evidenced a sufficiently clear intention to oust the Rule's effect in the calculation of dividends payable to creditors who are also debtors of the insolvent company.

The rule in Cherry v Boultbee

The Rule is sometimes referred to as a "right of quasi-retainer", or alternatively the "fund ascertainment principle". It can be briefly summarised as the principle that no one should be admitted to share in the distribution of a fund until he has discharged his obligation to contribute to the fund.

At first sight, the principle looks similar to a right of set-off, but it is not. The Rule can only apply where there is no set-off, because where set-off (such as insolvency set-off) applies, the Rule is displaced.

The Rule can also be displaced by clear contractual intention, but it has often been problematic deciding whether such a clear intention has been demonstrated, especially since the Rule's legal characteristics are hard to describe and do not fit easily within common definitions such as "asserting" or "enforcing" "rights", "security" and/or "claims".

Chadwick LJ in *SSSL* described the Rule as follows:

"(i) The general rule applicable in the distribution of a fund is that a person cannot take an aliquot (i.e a defined) share out of the fund unless he first brings into the fund what he owes. Effect is given to the general rule, as a matter of accounting, by treating the fund as notionally increased by the amount of the contribution; determining the amount of the share by applying the appropriate proportion to the notionally increased fund and distributing to the claimant the amount of the share (so determined) less the amount of the contribution…

(ii) That general rule is applicable not only where the claimant (X) is indebted to the fund but also where the fund has a right to be indemnified by X against a liability which the fund may be required to meet in the future, as surety for a debt owed by X to a creditor (Y). It is not necessary that the liability to Y has been satisfied out of the fund: it is enough that it may have to be satisfied in the future…

(iii) The general rule – as applicable to a case where the fund has a right to be indemnified by X is not displaced in a case where the claimant (X) is in bankruptcy…"

Mills & Ors v HSBC Trustee (C.I.) Ltd & Ors

KSF went into administration owing its subsidiary, Funding, GBP 242,568,988. Funding also went into administration owing HSBC Trustee (the "Trustee") GBP 240,330,000, which had been guaranteed by KSF.

The Trustee proved for the full amount in both KSF's and Funding's respective administrations. Funding submitted a proof for its debt in KSF's administration. The rule against double proof prevented KSF from setting off its indemnity claim against Funding (which arose from its guarantee of Funding's liability to the Trustee) in accordance with the usual insolvency set-off rules.

KSF's Administrators gave notice under r.2.68 of the Insolvency Rules 1986 that they intended to make a distribution in the administration. KSF's Administrators sought to apply the Rule to Funding's claim against KSF. In that event, KSF's fund of assets available for distribution to creditors would be notionally increased by the amount of the debt contingently due by Funding to KSF, but the dividend (calculated on the notionally increased fund) due from KSF to Funding would be reduced by the same amount (see the method described in (1) above).

Funding had no significant creditors other than the Trustee, who stood to lose the ability to recoup a significant part of its debt if Funding's dividend was reduced by the Rule. It was in the Trustee's interests to establish that the Rule had been excluded or should be applied differently. Bound by the method of application settled by the Court of Appeal in *SSSL* (for the purposes of the High Court hearing), the Trustee therefore sought to argue that the non-compete clause contained in the finance documents excluded the application of the Rule.

The Chancellor held that while an express reference to the Rule was not required to exclude it, a clear intention had to be demonstrated in the wording of the contract. He then went through the non-compete clause, bit by bit, taking a literal interpretative approach to the meaning of the words and the legal characteristics of the Rule, and concluded that the relevant non-compete clause did not evidence a clear intention by the parties to exclude the operation of the Rule.

Cattles Plc v Welcome Financial Services Ltd & Ors [2009] EWHC 3027 (Ch)

The *Cattles* case involved a group of companies that was seeking to restructure its finances. In order to do so, it became necessary to establish certain creditors' entitlements if the group companies were to go into insolvent liquidation. As with *Mills*, the case involved a parent and its subsidiary, various banking facilities, and some notes and bonds, some of which had been guaranteed by various group members. Also as in *Mills*, the parties considered themselves bound by the *SSSL* interpretation of the Rule, at least in the hearing before the High Court, and so they, too, sought to establish whether the various non-compete clauses contained in the several finance documents excluded the operation of the Rule. The Judge's finding on this point was obiter but he thought it appropriate to give reasons for the purposes of a subsequent appeal.

HHJ David Cooke referred to the modern approach of the courts to construction of documents contained in the principles of construction set out by Lord Hoffmann in *Investors Compensation Scheme v West Bromwich Building Society [1997] UKHL 28*. Cooke HHJ, differing from the Chancellor's approach in *Mills* (whose judgment was published after *Cattles*), took a more commercial view of the parties' intention as evidenced by the non-compete clauses and decided that the parties had effectively ousted the application of the Rule.

Comment

The approaches taken to contractual interpretation by the two judges in *Cattles* and *Mills* are completely different: the literal approach of the Chancellor in *Mills* contrasts with HHJ Cooke's commercial approach in *Cattles*. Obviously arguments relating to contractual interpretation depend upon the drafting of a particular clause, and so neither case can provide an exact answer to other cases unless an identical clause is being considered. However, an appeal to settle the correct approach to contractual interpretation in these circumstances is highly desirable in the interests of establishing some certainty, especially as the current economic climate is likely to produce more corporate insolvencies where the argument of whether the Rule has been excluded or not will be repeated. As in these two cases, and in *SSSL* before them, the effect of applying the Rule often produces big winners and losers. The issue is not likely to go away.

The other interesting aspect of any appeal will be the opportunity to review the Court of Appeal's finding in *SSSL* on how the Rule should be applied, particularly with respect to the amount of an indemnity liability contribution that is required to be brought into account where the guarantor is insolvent. As *SSSL* was a Court of Appeal decision, a "leapfrog" appeal to the Supreme Court will be necessary, and we understand that leave to apply for such an appeal has been given. We further understand that permission to appeal was also given in *Cattles*.

It seems that there's life left in the old Rule yet.

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HYPOTHEC - ICAL PROBLEMS FOR IPS

Recently it has become increasingly common that solicitors acting for Landlords in Scotland on insolvency of a tenant are using the Landlord's right of hypothec as an argument to obtain a higher ranking in the insolvency proceedings (winding up, receivership, administration and CVAs) in relation to any arrears of rent, using it as leverage to negotiate a better settlement for their client.

What is the landlord's right of hypothec?

The hypothec provides the landlord with security over the moveable effects of a tenant owned by the tenant and brought onto the leased premises (subject to limited exceptions). This is a similar right to distress in England and Wales.

Historically, the manner of enforcing hypothec was by court action for sequestration of rent. This enforcement method was abolished by the Bankruptcy and Diligence (Scotland) Act 2007 (BAD), and, instead, hypothec has become a right in security arising by operation of law. The effect in Scotland is that the Landlord's hypothec claim ranks ahead of floating charge holders.

What sum is secured by the hypothec?

The legislation says that it is security for "rent due and unpaid only" for so long as it remains unpaid. Accordingly, the general consensus appears to be (although BAD is unclear):

- all rent due at the commencement of insolvency proceedings would be secured by the hypothec (including any advance payment):

- there is divided opinion on whether rent falling due after such commencement is secured or whether it, for example, should be treated as an administration expense.

Until there is a ruling on this by the courts we can only guess what the legislators had in mind when BAD was drafted.

What is subject to the hypothec?

The hypothec attaches to the moveable effects (goods) of the tenant on the leased premises. BAD is unclear on whether this is the goods on the leased premises on the date of the insolvency procedure or whether it covers goods subsequently brought on to the leased premises.
An administrator (for example) who wishes to continue to stock and trade from leased premises in Scotland needs to consider strategies for mitigating this potential liability and think about the terms on which they do so.

Selling goods subject to the hypothec?

Goods on Scottish leased premises should not be sold without either the consent of the Landlord or the court (Paragraph 71 of Schedule B1 of the Insolvency Act 1986). If goods are sold inadvertently without such consent then it would be sensible for any IP to take legal advice on a mitigation strategy but also to do, amongst other things, the following:

- record what moveables have been sold;

- record the sale price (and any evidence indicating the sale to be at open market value); and

- keep the sale proceeds separate from the floating charge fund "pot" and earmark those proceeds as subject to the hypothec.

Conclusion

Until the law is tested in this area any IP would be well advised to:

- treat any Scottish leasehold property differently from property in England and Wales; and

- take advice on mitigation measures e.g. negotiations with Landlords and strategic lease renunciations.

If the amounts are substantial consider seeking directions from court (made under Paragraph 63 of Schedule B1 of the Insolvency Act) to clarify the position as to what sums are actually secured by the hypothec.

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