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NEWSLETTER
CMS RESTRUCTURING AND INSOLVENCY IN EUROPE
SPRING 2010

INTRODUCTION

We are pleased to present this spring 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 ECJ's ruling on MG Probud and the interpretation of cross-border insolvency rules;

— the Austrian insolvency law reform;

— Bulgarian insolvency proceedings;

— insolvency and enforcement proceedings in Croatia;

— the French Court of Appeal's ruling regarding the use of the sauvegarde procedure;

— recent court decisions in Hungary with respect to the liquidation process;

— the fund established in Italy to rescue and restructure firms in financial difficulty;

— issues to consider when granting secured loans to companies in financial difficulty in the Netherlands;

— the review of the proposed amendments to Polish regulations regarding "consumer bankruptcy";

— threats to lenders restructuring loans in Romania when the borrower faces imminent insolvency;

— the early agreement proposal in Spain as a speedy way to complete the insolvency process;

— directors' liability in relation to social security contributions in Switzerland;

— key issues in debt restructuring in Ukraine; and

— the dangers of failing to keep insolvency event clauses up to date in the United Kingdom.

CMS aims to be recognised as the best European provider of legal and tax services. Clients say that what makes CMS special is a combination of three things: strong, trusted client relationships, high quality advice and industry specialisation. We combine deep local expertise and the most extensive presence in Europe with cross-border consistency and coordination. 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

The last 18 months have seen intense debate not only on if and when the economy would pick up for good, but also on *policy*, i.e. if and how governments should intervene both financially and through adapting the legal restructuring framework. In the heat of the recession, there was rarely time to debate whether a State should actually buy a major bank, inject capital into an aerospace company or provide considerable loans to an automobile manufacturer. Today we witness (mainly retrospectively, unfortunately) debate on the policies driving this, throughout Europe.

"Should aid be granted to firms in difficulty?" was the provocative title of a report made by Oxera Consulting Ltd. upon the request of the European Commission (the "Commission") and made public in December 2009. Perhaps unsurprisingly, the report suggests that there is little correlation between the granting of State aid and the preservation of jobs or continued macro-economic activity. Furthermore, the report indicates that if such a relationship exists at all, it hinges more on the specific merits of each case.

The Commission carefully specifies on its website that the Oxera report does not represent the opinion of the Commission, but *"will be taken into consideration in the Commission's assessment of individual cases and its future review of its general guidelines"*. These guidelines were adopted in 2004 and were due to be reviewed in 2009. During the crisis, the Commission decided to keep the guidelines in force and extended their validity until 2012.

Obviously, in preparation for its new guidelines, the Commission is lending an ear to the opinion that State aid, in a large number of cases, delays unprofitable firms from exiting the market (such a view rejects the argument that a restructuring plan can actually restore a company's long-term viability). This shifts the burden of structural adjustment onto more efficient firms who are managing without it.

The European Commission has always taken a tough line on State interference in restructurings as it goes against the principle of 'competition on merits', reinforces the market power of the aid recipient, reduces dynamic incentives of competitors, encourages moral hazard and excessive risk-taking and undermines the single market. According to the Commission, all these effects still exist in times of crisis, but that (certainly in relation to the financial crisis) economic stability and consumer confidence must also be considered. Moreover, there are further reasons why competition rules are especially important during a systemic crisis; one of them, according to the Commission, is the need to ensure that states do not resort to protectionism. In any event, restructuring aid must encourage the "restoration of long-term viability, adequate burden-sharing and measures to limit distortions of competition".

But that's the theory. The reality is that, according to the European Commission's December 2009 "scoreboard on State aid", State aid has quadrupled amongst EU countries (from 0.5% of GDP to 2.2%)

since the beginning of the financial crisis. 80% of that aid went towards State-financed bail-outs or other restructuring interventions.

And in a situation of financial, economic and budgetary crisis, the differences between Member States in terms of resources available for State intervention become more pronounced, and obvious differences in policy appear. Ireland's State aid rose from 1% to over 20% of GDP in 2008, Luxembourg's from 0.2% to 8%, whereas Italy's (and, interestingly, Greece's) State aid remained unchanged at 0.4%. In absolute terms, the United Kingdom and Germany offered the most in aid (EUR 72.5 billion and EUR 66.8 billion respectively), more than three times the amount spent by France, an economy comparable in size.

So what is the policy at national level? Many countries (including Italy, see page 18) are creating or reinforcing specific government-financed funds for restructuring aid. The figures tend to show that State aid will not drop to pre-2008 levels for a considerable time. The use of public monies to assist in restructuring private companies is certainly not driven by macro-economic, long-term or pan-European reasoning. By their nature, national interventions have the potential to focus on national markets and retrench behind national boundaries. Furthermore, such measures are driven by political reality, which is both a short-term and a local concern. The Commission is right in stating that, overall, this hinders the functioning of the single market, creates entry barriers and reduces incentives for cross-border activities to the detriment of European businesses and consumers. The Commission could have followed the Oxera report and added that the macro-economic effectiveness of State aid must be judged on a case-by-case basis, if it can be measured at all. But then again, the effectiveness of state aid, in itself, does not rank highly amongst important national policies – other than generally preferring national interests.

However, the Oxera report suggests that an efficient insolvency process would help ensure more positive outcomes from distressed situations.

Indeed, a number of countries (notably France, Italy and Belgium) have implemented new laws on bankruptcy protection and restructuring. In the Belgian example (as in many others) the legislator intended to provide alternatives in a formal bankruptcy procedure. Interestingly, these alternatives are all based on the 'debtor-in-possession model' (although court supervision has been tightened) and are so flexible that in many scenarios the end result for most creditors will be identical to that of a bankruptcy. The law also allows the courts to give preference to a restructuring scheme which is not *fully* in the creditors' interests, but also takes into account macro-economic and social factors – and companies and courts alike have made very creative use of this flexibility. In other words, this time it is not the State, but the creditors who are paying, in part, for the survival of the business and related employment. Whether this is a good policy is open to debate.

Nonetheless, one year after it came into force, the options offered by the new law have been both acclaimed and widely used. However, one type of creditor has made it a policy to systematically oppose any restructuring plan, and to appeal any judgment instigating one, that adversely affects its right – the State. The same government that passed the law now claims that the principle of "tax equality" means there can be no reduction in the amount of tax due from the restructured company.

Did anyone say there was a policy?

On 11 March 2010, the Brussels Court of Appeal (with a little help from the CMS restructuring team) reminded the Belgian State it did have a policy in this matter – allowing restructured companies to only partially repay creditors, outside of a formal bankruptcy procedure – and that the law treats the State as it treats any other creditor.

So at least that part of the policy is now clear. And luckily, it's the one part that works.

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INTERPRETATION OF CROSS-BORDER INSOLVENCY RULES THE ECJ'S RULING ON MG PROBUD

The European Court of Justice (ECJ), in its verdict passed on 21 January 2010 (C-444/07), specified the scope of rules regulating the recognition and enforcement by Member States of judgments relating to insolvency proceedings.

After the opening of main insolvency proceedings in one Member State, competent authorities of another Member State are required, in principle, to recognise and enforce all judgments concerning the main proceedings.

Facts of the case

In 2005, MG Probud – a Polish-based construction company, engaged in construction work in Germany via its branch – was declared insolvent by a Polish court.

As a result of procedures initiated by the *Hauptzollamt Saarbrücken* (Principal Customs Office in Saarbrücken, Germany), the *Amtsgericht Saarbrücken* (Local Court in Saarbrücken) issued a decision in respect of an attachment of the company's funds in a German bank account, as well as various claims in Germany.

Following the decision, the *Sąd Rejonowy Gdańsk-Północ w Gdańsku* (North Gdansk District Court in Gdansk, Poland) sought a preliminary ruling from the ECJ on whether the German authorities' conduct could be considered lawful under the European regulations.

Statements of the ECJ's ruling

The ECJ presented in its judgment a detailed interpretation of the EU Insolvency Regulation (No. 1346/2000 of 29 May 2000; "Regulation"), highlighting the following:

1. Universal scope of main insolvency proceedings

The Court emphasised the universal scope of main insolvency proceedings, opened by a competent court of a Member State, on which territory the debtor's centre of main interest (COMI) is located. The reach of main proceedings extends over a debtor's assets situated in each Member State. The ECJ held that only the opening of secondary proceedings in another Member State, on which territory the debtor is active through its branch, can diminish the universal scope of main proceedings. However, secondary proceedings have effect only in respect of the debtor's assets located in the State of their opening.

2. Universal powers of an insolvency liquidator

The ECJ also stressed that the universal scope of main insolvency proceedings regularly relates to the authority of an appointed liquidator. All powers, vested in a liquidator by the law of a competent Member State, can be exercised in every other Member State, including the power to possess the debtor's assets. Likewise, such authority can also only be limited by the opening of secondary proceedings and appointing a separate administrator in another Member State.

3. Automatic recognition of judgments

The Court highlighted that the judgment opening main insolvency proceedings in one Member State is to be recognised in all the other Member States from the moment of becoming effective in the State of the opening; and without any formalities it has the exact effect in all the other Member States, as it has under the law of the State of the opening. The rule also applies to any other judgment relating to the main proceedings issued by a competent court.

4. Applicable law

The ECJ indicated that authorities of other Member States should not only recognise the judgment opening insolvency proceedings but also ought to follow all the other related rulings originating from the law of the State of the opening. The Court held that main insolvency proceedings opened in one Member State, as well as any other action taken

in another Member State, are governed by the law of the State of the opening. Only actions undertaken within secondary proceedings are regulated by the law of the State of their opening.

Moreover, the ECJ indicated that the Regulation only provides two possible causes for refusing the enforcement of judgments on insolvency proceedings – a threat of limiting personal freedom or postal secrecy, or if such judgement is manifestly contrary to the State's public policy, its fundamental principles or the constitutional rights and liberties of the individual in particular.
As highlighted by the Court, all these stem from the basic principle of European cooperation – the rule of mutual trust.

The decision

In interpreting the Regulation, the ECJ found the conduct of the German authorities to be unlawful. The Court held that the universal scope of main insolvency proceedings, initiated by the Polish court, extends over all of MG Probud's assets, including those located in Germany. As secondary proceedings were not initiated, the Polish law regulates not only the opening of the insolvency proceedings, but also their course and closure in each Member State.

The ECJ concluded that **"after the main insolvency proceedings have been opened in a Member State the competent authorities of another Member State,** in which no secondary insolvency proceedings have been opened, **are required,** subject to the grounds for refusal (…) **to recognise and enforce all judgments relating to the main insolvency proceedings and, therefore, are not entitled to order, pursuant to the legislation of that other Member State, enforcement measures relating to the assets of the debtor declared insolvent that are situated in its territory when the legislation of the State of the opening of proceedings does not so permit** (…)."

Consequences

The ECJ's interpretation of the Regulation has far reaching consequences. From a creditors' point of view, it is important to ascertain whether a debtor has already been declared insolvent in a different Member State, because such a creditor may face a number of problems in respect of main insolvency proceedings opened in another Member State, such as the necessity to understand the powers of a foreign administrator and the insolvency law regime of the State of the opening, among other things. In addition, the auditor will inevitably encounter problems with the usage of common language. It may also turn out to be very costly to start legal action or judicial executions against a debtor or its branch, if the insolvency administrator already appointed in another Member State is legally allowed to contest any legal act that satisfies creditors' debts. For instance, in Germany the insolvency administrator has a wide range of legal powers to contest legal acts, including payments to creditors, carried out by the debtor during a ten-year period prior to the petition for the institution of insolvency proceedings or subsequent to the filing of such a petition provided that specific criteria are fulfilled, e.g. the other party was aware of the debtor's illiquidity and/or the payment disadvantaged other creditors.

Therefore, the most convenient solution is to request the opening of secondary insolvency proceedings. The problem with this however is that not every legal system provides a creditor with such power. However, at present, this is the only option available to creditors to be able to subject insolvency proceedings to their respective national law.

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AUSTRIAN INSOLVENCY LAW REFORM 2010

A comprehensive reform of insolvency law is about to be achieved in Austria: on 2 March 2010 the government bill for the amendment of the Insolvency Law Act was issued (the "Insolvency Law Reform Act" (ILRA)) which shall come into force on 1 July 2010. The reform was made against the backdrop of the financial crisis during which the current insolvency law regime proved to be inadequate to meet the challenges of the changed economic environment. The philosophy behind the ILRA can be summed up by the slogan "Restructuring instead of Liquidation". In the following we will briefly outline the main aspects of the reform.

General

The current structure of insolvency proceedings

If a debtor becomes insolvent either bankruptcy proceedings *(Konkursverfahren)* or settlement proceedings *(Ausgleichsverfahren)* are opened. Settlement proceedings primarily aim to discharge the debtor's debts whilst still carrying on its business, whereas bankruptcy proceedings generally lead to the winding-up of the business of the debtor. Under the current regime when undergoing settlement proceedings the debtor must settle at least 40% of the creditors' claims within two years.

Once insolvency proceedings have been initiated against the assets of the debtor, the debtor may also file for a "forced settlement" *(Zwangsausgleich),* in which case the debtor must settle at least 20% of its obligations within a period of two years.

The benefit for the debtor is that in the event that the settlement offer is approved, the debtor will be discharged of its remaining debts upon fulfilment of the settlement ratio, whereas in ordinary bankruptcy proceedings the debtor will not be discharged unless all of its debts are entirely satisfied.

According to a study by the Institute of Economics of the University of Salzburg, in Austria nearly 75% of insolvencies are filed too late. Further, a large number of insolvencies are not filed by the company itself but by creditors. This is due to the fact that insolvency creates a negative image and entrepreneurs are afraid of being stigmatised by admitting failure.

Furthermore, settlement proceedings *(Ausgleichsverfahren)* are rarely undertaken in practice whereas forced settlements are commonplace since the ratio of obligations to be fulfilled is more favourable to the debtor than in settlement proceedings. In 2008, 34% of insolvency proceedings were settled by "forced settlement" *(Zwangsausgleich)* whereas only 1.3% of insolvency proceedings were settled by court settlement proceedings *(Ausgleichsverfahren).* The main reason for the disparity is that the statutory requirement to settle no less than 40% of the debtor's obligations in the case of court settlement proceedings was often not achievable.

The new structure of insolvency proceedings

"Insolvency proceedings" *(Insolvenzverfahren)* is the new umbrella term encompassing bankruptcy proceedings *(Konkursverfahren)* on the one hand and the so-called restructuring plan *(Sanierungsplan)* and restructuring proceedings *(Sanierungsverfahren)* on the other. The procedural provisions are broadly the same.

Restructuring proceedings *(Sanierungsverfahren)* correspond to the former settlement proceedings *(Ausgleichsverfahren).* As with the former settlement proceedings, restructuring proceedings may, at the latest, be applied for at the commencement of insolvency proceedings. They may also be applied for when there is merely a threat of becoming insolvent.

The main goals of the reform and their implementation under the ILRA

Early commencement of insolvency proceedings

One of the objectives of the reform is to prevent companies from delaying filing insolvency proceedings.

The intention is that this will be accomplished by (i) a restructuring proceeding, which will permit the debtor company (under supervision of the restructuring receiver) to undertake its own administration *(Sanierungsverfahren mit Eigenverwaltung);* and (ii) reducing the mandatory ratio of obligations to be fulfilled to at least 30% of the creditors' claims within two years instead of 40%, as required under the current regime.

A prerequisite for a restructuring proceeding is that the debtor presents a restructuring plan, either concurrently with the application for insolvency proceedings or, at the latest, with the opening of insolvency proceedings. Furthermore, the debtor has to specify in the application that it has or will obtain the means to fulfil the quota and has to present a finance

plan as evidence that (initial) funding of the company is secured. A restructuring proceeding may also be initiated if insolvency is merely threatened.

To encourage the use of "forced settlement" (now the restructuring plan)

Under the ILRA, the restructuring plan must be accepted by and the settlement offer must be approved by (i) a simple majority of all creditors present at a creditors' meeting; and (ii) creditors representing at least 50% (instead of the present 75%) of the total amount of all outstanding claims represented in the meeting.

When undergoing a restructuring plan the debtor must settle at least 20% of its obligations within a period of two years (i.e. the same quota which applied for the "forced settlement").

After completing the restructuring plan, the debtor may apply to be removed from the insolvency register and commercial register.

Restricting the ability to contest restructuring loans

The amendment to s.31 of the Insolvency Act concerning the ability to contest unfavorable transactions is important for banks that are granting loans for the purpose of restructuring companies in crisis. Currently, any of the debtor's transactions that are directly or indirectly adverse to creditors may be challenged if: (i) the transaction has been entered into following the debtor becoming insolvent or after an application to commence insolvency proceedings has been issued; and (ii) the other party to the agreement was aware or should have been aware of the insolvency or the application for insolvency proceedings.

Under the ILRA, agreements which are concluded after the company has become insolvent (but before the commencement of insolvency proceedings) that are indirectly adverse to creditors can only be challenged if the other party to the agreement was aware or should have been aware of the insolvency or the application for insolvency proceedings, and that objectively such party should have foreseen that the company had no suitable restructuring plans. In particular, banks providing credit for restructuring purposes and maintaining an open credit account are considered as potentially "indirectly adverse to the creditors": banks and debtors will benefit from the increased restrictions on the ability to contest transactions. As restructuring (in court as well as out-of-court) is dependent on the provision of credit in order to continue the running of the business, this restriction will also facilitate the restructuring efforts of the debtor.

Facilitations to keep the company operating

In order to facilitate the operation of the insolvent company's business the IRLA has proposed restrictions on the ability to terminate most kinds of contract during insolvency proceedings. Therefore, during the first six months after the commencement of insolvency proceedings the contracting party may not terminate the contract except for good cause, if termination of the agreement could threaten the continuance of the operation of the business. Thus, ordinary termination rights are postponed. Deterioration of the debtor's financial situation and delay in receiving payment from the debtor for receivables that have been due before the commencement of insolvency proceedings do not constitute good causes for termination. This amendment is of course advantageous for a business in trouble; at the same time, however, it presents a danger for creditors that cannot easily end their contractual relationship with an insolvent debtor.

Conclusion

With the reform, the legislator has attempted to improve the chances of successfully restructuring a company. Only time will show the actual impact of the reforms in practice. It is hoped that the reform will ensure more companies are successfully restructured. However, some of the new provisions present the danger that in the future creditors will have to bear more of the risk when a business fails, merely for the sake of restructuring a troubled business.

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INSOLVENCY PROCEEDINGS WHEN DEBTOR COMPANIES CANNOT AFFORD TO PAY

During the economic downturn, it has been difficult for many companies to pay their debts and to perform their obligations. An increasing number of such companies, or their creditors, have filed for insolvency.

In many cases, the company is already in a very poor financial condition by the time a petition to initiate insolvency proceedings is filed. The situation may be so serious that the company does not have sufficient funds or assets to cover the expenses of the insolvency proceedings. In such circumstances, there are a number of scenarios where the court may decide to deviate from usual insolvency proceedings. These are outlined below.

Prepayment of the initial insolvency proceedings costs by the creditors

There are normally three main parties to an insolvency proceeding: (i) the debtor company; (ii) its creditors; and (iii) the State (if the proceedings involve a competent body such as National Revenue Authorities). If the company itself does not have sufficient funds or assets to cover the initial costs of the insolvency proceeding then the court, in its first decision, determines the initial costs and gives one of the other parties (i.e. the creditors) time to prepay them. Insolvency proceedings may only then be opened once the initial costs have been paid. One of the main features of this court decision is that it cannot be appealed against and is not enforceable against either the company or its creditors.

There is no requirement that money to pay the initial insolvency costs be available in cash. These expenses can be covered by realising the company's assets into cash. Standard court practice requires that a company's assets must be sufficient to cover the initial expenses.

Suspension of the insolvency proceedings

In the event that the company or its creditors are unable to pay the initial costs of the insolvency proceedings, the court may suspend the insolvency proceedings under Art. 632, para.1 of the Commerce Act[1]. By making such a decision the court declares the state of insolvency/ over-indebtedness, sets the insolvency

trigger date (usually backdated), opens the insolvency proceedings and declares the company insolvent or over-indebted. The debtor may not dispose of its assets and the court may also allow a distraint over the company's property and the termination of its activity. However, the company remains registered in the Commercial Registry.

It should be noted that it is the company's lack of funds that differentiates normal insolvency proceedings from those under Art. 632, para.1. In the course of standard insolvency proceedings, when deciding to open insolvency proceedings, the court would normally declare the state of insolvency/over-indebtedness, set the insolvency trigger date and open the insolvency proceedings and as well as make other orders. The court can only declare the company insolvent/ over-indebted and terminate its activity after a number of things have happened. These include the insolvency administrator taking control of the insolvent estate, the creditors' claims being approved and no recovery plan being proposed or accepted.

The court's decision under Art. 632, para.1 may be appealed against by interested third parties (such as other creditors that have claims against the company arising from other court decisions or from a liability towards the public).

If the insolvency petition was filed by a creditor, the decision to suspend proceedings becomes effective the moment the creditor's right to withdraw the petition ceases.

Reopening insolvency proceedings

Insolvency proceedings that are suspended may be reopened within one year from the date the court's decision to suspend proceedings is registered at the Commercial Registry. Proceedings will only be reopened if the petitioner can prove that the company holds sufficient assets to cover the initial costs of insolvency proceedings or a creditor can provide the required amount.

All timelines governing claims against the company start to run from the moment the decision to reopen proceedings is registered at the Commercial Registry.

Termination of the insolvency proceedings

However, if no party makes a request for the reopening of the insolvency proceedings within the one-year period, then the court may terminate the proceedings and order the company's deregistration from the Commercial Registry. And once insolvency proceedings have been terminated, a new prescription period regulating the creditors' receivables from the company starts to run.

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1) State Gazette Issue No. 48 dated 18 June 1991, as amended.

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INSOLVENCY AND THE ENFORCEMENT PROCEEDING

Introduction

Croatia, together with the rest of the world, is currently facing the ongoing financial crisis. Many entrepreneurs and companies are now only just struggling to survive in this new 'hostile' environment. The biggest problem for a 'healthy' company is the increase in the number of consumers that are rejecting or failing to pay for products or services rendered.

Before the financial crisis, many companies became reckless in extending credit to customers, blinded by the desire to boost profitability. These companies either took less effective security or none at all. As an example, bank guarantees, being the more expensive security, were frequently replaced with promissory notes. Consequently, these companies had been left with very limited recourse once a customer defaulted on payments. As a result, companies can either initiate legal proceedings against such customers followed by enforcement or insolvency proceedings (if the required terms are fulfilled). However, enforcement proceedings can no longer be initiated once insolvency proceedings have been initiated.

Enforcement

Generally, when a debtor ceases paying its debts, the creditor may be left with no other option but to enforce any security it may have. If the company has used effective security, enforcement can be initiated immediately. If not, companies first have to drag their debtor through lengthy legal proceedings followed by enforcement. Therefore, there is a substantial time lag between initiating actions against the debtor and receiving payment on the outstanding claim.

During this time lag, it is however common for insolvency proceedings to be brought against a debtor once a creditor has initiated enforcement. Although these two will overlap, the insolvency proceedings will generally prevail. Given that insolvency proceedings protect all the debtor's creditors (including employees of the debtor and the State) and not only the creditor that initiated enforcement, insolvency proceedings are considered by the legal system to be of a greater importance than enforcement.

What now?

The Croatian Insolvency Act stipulates that creditors are not entitled to initiate enforcement (including a request for interim measures) on the debtor's assets once insolvency proceedings against the debtor have been initiated. The creditor is only allowed to submit its claim as part of the insolvency proceedings.

The creditors are given an opportunity to submit their outstanding claims against the debtor on the terms set by the Court. The time period for submitting claims will be no shorter than 15 days and no longer than 30 days from the day when the insolvency proceedings were initiated.

Furthermore, any enforcement that is pending (which means that the proceedings are ongoing and no legally binding ruling has yet been adopted) at the time the insolvency proceeding is initiated, will be suspended (and ultimately ceased).

This inevitably means that insolvency proceedings block any future or ongoing enforcement against a debtor. It is worth noting that any creditor (or indeed the debtor itself) may make a request to the Commercial Court to initiate the insolvency proceedings against the debtor.

Is it all lost?

An issue that a creditor may have in respect of the insolvency proceedings against its debtor is that in insolvency proceedings, all of the debtor's unsecured creditors shall have equal rights to be compensated (i.e. all claims that are undue shall become due at the moment the insolvency proceeding is initiated). Furthermore, insolvency proceedings are expensive and the expenses involved are the first to be deducted from the debtor's

assets. This means that a creditor is unlikely to receive the full amount owed to him.

As mentioned above, an enforcement that is pending will be suspended if insolvency proceedings against the debtor are commenced. However, such enforcement may continue if the creditor has taken a pledge over the debtor's assets – and the creditor may even initiate enforcement against the debtor's assets once the insolvency proceedings have commenced as long as it has the benefit of such pledge.

A creditor, for example, shall receive a pledge over the debtor's property during enforcement once a notice of the enforcement has been registered at the Land Registry. The same applies to chattels owned by the debtor once these are registered on the "dispossession list" *(pljenidbeni popis)*. Note that the dispossession list, drafted by the court administrator, is the list of the debtor's goods seized in each enforcement proceeding.

It should however be noted that the Croatian Insolvency Act includes a provision which states that any creditor will lose the benefit of a pledge or a similar right if it was taken 60 days prior to the commencement of the insolvency proceedings. It is also important to note that interim measures (e.g. measures stating that the debtor is not entitled to dispose of its property), even if issued during the enforcement, do not create a pledge in favour of the creditor.

Options

If, as stated above, the creditor has taken a pledge over certain assets belonging to the debtor, it may choose to:

— submit its claim in the insolvency and participate in the insolvency as a regular creditor; or

— continue with enforcement without submitting a claim in the insolvency proceedings; or

— submit its claim in the insolvency proceedings whilst reserving the right to separate compensation.

From a creditor's point of view the first option would be the least favourable because this means that the creditor will rank equally with all other creditors. The second option will be preferred by a creditor whose pledge has been duly registered and where the value of the pledged assets is sufficient to cover all amounts owing. Under the third option, the creditor will first be compensated from the value of the asset that is subject to the pledge and thereafter, such creditor may pursue the debtor for the remainder of its claim through the insolvency proceeding.

Conclusion

Insolvency proceedings generally prevent a creditor from initiating enforcement against an insolvent debtor. However, this is not always necessarily the case and a creditor may establish a preferred status in the insolvency proceedings if such creditor acts promptly.

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A CONCLUSION TO THE HEART OF LA DÉFENSE'S CASE: THE PARIS COURT OF APPEAL OVERTURNS A DEBTOR'S IMPROPER USE OF THE *SAUVEGARDE* PROCEDURE

The *sauvegarde* procedure is a formal insolvency procedure which can be used by a debtor to restructure its debts pre-emptively even though it is still solvent. It is seen as a powerful way for distressed debtors to help come to an arrangement with their main creditors.

Under the provisions of the initial *Loi de Sauvegarde* of 26 July 2005 (which applied to the present case), the *sauvegarde* proceedings could be initiated to assist a business entity in any kind of difficulty. However, these difficulties had to be of such a nature that could ultimately lead to a state of *cessation des paiements* (i.e. the debtor's inability to pay its outstanding due debts with its current available assets), and the debtor must be unable to overcome them by its own means.[1]

Under the *sauvegarde* procedure, the debtor benefits from stays of (i) demands for payments of debts that arose prior to the judgment initiating the proceedings and (ii) of any legal actions or enforcement measures relating to those debts. This puts the debtor under court-protection and allows it to reschedule its debts through renegotiations with its creditors or, if necessary, by means of a coercive court order.

Given the protection it offers, the *sauvegarde* procedure is liable to being improperly applied by unscrupulous debtors in order to impose rescheduling of their debts to their creditors even if they are not facing significant difficulties. Consequently, French courts must carefully consider whether the *sauvegarde* procedure is appropriate from the outset.

In this respect, the judgment from the *Cour d'appel de Paris* (a French appellate court), delivered on 25 February 2010, is a commendable example of how the French courts could control debtors' use of the *sauvegarde* procedure.

In this recent and long-awaited judgment, the Court had to decide whether it was appropriate to initiate the *sauvegarde* procedure for the SPV company Heart of La Défense (HOLD) and its parent company Dame Luxembourg (part of the Lehman Brothers group).

The facts of the case can be summarised as follows: French company HOLD acquired

and owns a real estate complex located in *Paris La Défense* (the western business district adjacent to Paris). This complex included a business premises, the Towers "Coeur Défense". HOLD is a wholly-owned subsidiary of Dame Luxembourg, which is incorporated under Luxembourg law, which is itself controlled by companies in the Lehman Brothers group. In order to finance the acquisition of the building, which amounted to roughly EUR 2.11 billion, HOLD obtained two loans for a total amount of EUR 1,638,950,000. HOLD had granted a mortgage over its assets as security and had also assigned the rental claims arising from the leases of the premises. At the same time, Dame Luxembourg had granted the lenders a pledge over its shares in HOLD.

Under a clause in the loan agreement, creditors were entitled to demand early repayment for non compliance relating to the LTV ratio and if no new solvent bank could be substituted as counterpart for Lehman Brothers. Following the collapse of Lehman Brothers and its financial rating, the creditors warned the debtor that they would require early repayment of the entire debt.

Given the cost of replacing Lehman Brothers and their inability to enter into a new hedging agreement, HOLD and Dame Luxembourg applied to court to initiate *sauvegarde* proceedings. Their request was accepted and two separate *sauvegarde* proceedings were opened by the *Tribunal de commerce* of Paris on 3 November 2008.

Eurotitrisation, a creditor, applied to court as a third party (under the *tierce-opposition procedure*) to challenge the opening of the *sauvegarde* proceedings. It claimed that the conditions necessary to commence *sauvegarde* proceedings had not been met. When the first instance court rejected its application, Eurotitrisation appealed to the *Cour d'appel de Paris*.

In its judgment delivered on 25 February, the *Cour d'appel* allowed the appeal and overruled the *Tribunal de commerce's* decision. In doing so, the appellate court reassured creditors by ensuring that lax applications of the *sauvegarde* procedure would not be entertained.

The *Cour d'appel* consequently granted the creditor's request to revoke the decision initiating the *sauvegarde* proceedings in relation to HOLD and Dame Luxembourg. This decision automatically revoked the rescheduling plan that had been adopted by the *Tribunal de commerce on* 9 September 2009.

The *Cour d'appel* based its decision on the fact that the debtor companies did not establish that they faced real difficulties, which adversely affected their core business. For HOLD, this was renting business premises; and for Dame Luxembourg, this was holding shares.

In particular, the Court found that HOLD had not shown that it was facing difficulties in continuing to let properties and had only used arguments relating to how unforeseen circumstances rendered its contractual obligations under the loan agreement more onerous.

As the loan agreement was a binding contract, HOLD could not unilaterally amend it. In the absence of real difficulties impacting its business, HOLD's request to initiate *sauvegarde* proceedings was simply

aimed at getting around the legal barriers preventing it from unilaterally modifying the contract.

The protection offered by the *sauvegarde* proceedings must not be inappropriately used and be seen by debtors as an easy way to amend unilaterally the terms of their contract, just because they were unable to successfully renegotiate them.

Indeed, it might be advisable for a debtor to try and come to a voluntary arrangement with its main creditors under the amicable procedures of *mandat ad hoc* or *conciliation* before trying to benefit from the *sauvegarde* proceedings.

The *Cour d'appel's* decision offers some protection to creditors that have granted loans or offered funding within the framework of structured finance schemes, against abusive practices which some debtors may have been tempted to employ.

The judgment tackles the concerns that were identified in the Autumn 2009 edition of this newsletter and delivers a warning to debtors intending to exploit the *sauvegarde* procedure for reasons that the legislator had not intended to address.

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1) *Under new provisions introduced by the Ordonnance n° 2008-1345 of 18 December 2008, the debtor requesting the opening of sauvegarde proceedings no longer has to establish that the difficulties it faces would lead to a situation of cessation des paiements.*

// Hungary

RECENT COURT DECISIONS REGARDING LIQUIDATION PROCEEDINGS UNDER HUNGARIAN LAW

A couple of important court decisions have dealt with some issues that may arise during liquidation proceedings in Hungary. In this article, we analyse two recent decisions dealing with the right of set-off and prepayment in the context of an insolvency process.

The Act XLIX of 1991 on Bankruptcy Proceedings and Liquidation Proceedings (hereinafter the "Liquidation Act") provides that a right of set-off may be exercised during liquidation proceedings, provided that the claim:

— has been registered by the liquidator as acknowledged; and

— has not been assigned after the liquidation proceedings commenced.

The first court decision stated that even if the right of set-off is permitted after the commencement of liquidation proceedings, the court may declare the contract invalid on the basis that the contract had been concluded with the intention of giving preference to a creditor (Court decision of the Tribunal of Debrecen No.GF. III. 30.694/2006/7.).

The above is relevant for banks because the right to exercise a (purchase) option combined with a set-off against the outstanding debt is often used in Hungary as security in liquidation proceedings. The fact that the Liquidation Act treats the right to an option as security (which more or less reflects the current practice of banks) raises the problem as to when it would be best to exercise an option for banks (i.e. before or after the commencement of liquidation proceedings). If, for example in an asset finance, a bank exercises its option by setting off the purchase price of an asset (e.g. real estate; quota) against monies held by the debtor with the bank, and the court subsequently decides that the contract is invalid on the basis that preference had been given to a creditor, the bank will then be unable to set-off. Instead, it has to seek repayment along with other (unsecured) creditors in the liquidation proceedings.

The second court decision states that a commercial arrangement may be deemed invalid on the basis that a preference was given to a creditor, if such commercial agreement was concluded before the liquidation proceedings commenced and includes prepayment by the debtor (Court decision of the Tribunal of Budapest No. 11. Gf. 40.344./2008.3.)

The facts of the case are as follows: a debtor entered into a finance agreement with a bank in order to purchase a vehicle. Before the liquidation proceedings commenced, the debtor sold the vehicle to a third party. In accordance with the provisions of the sale contract, the buyer paid the purchase price to the bank. At the same time, the debtor requested the bank to treat the amounts outstanding under credit agreement due because the debtor wanted to prepay all its debt. The credit agreement would have run for three more years if not for the prepayment.

The court deemed the whole commercial agreement invalid, on the basis that the bank received payment earlier than the due date stated in the credit agreement. The court ordered the entire transaction to be unwound (including repayment by the bank of the monies to the debtor), leaving the bank to claim alongside other unsecured creditors in the liquidation proceedings.

We are of the view that the above court decision is detrimental and contrary to commercial practice.

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RESCUE AND RESTRUCTURING FUND FOR FIRMS IN FINANCIAL DIFFICULTY

On 25 February 2010 the Ministry of Economic Development created a rescue and restructuring fund for firms in financial difficulty (the "Fund"). This was established by a Ministerial Decree, which will be published shortly in the Official Journal.

The Fund has a budget of EUR 70 million for 2010, which can only be used to help medium or large companies that are not already involved in insolvency proceedings.

EU legislation defines medium-sized companies as those with an annual turnover between EUR 10 and EUR 50 million or those with a balance sheet value between EUR 10 and EUR 43 million. Furthermore, these companies must employ between 50 and 250 people. Large companies are those which exceed these thresholds.

In accordance with the EU Commission's 2004 Communication ("Community guidelines on State aid for rescuing and restructuring firms in difficulty"), companies that meet these criteria are eligible to receive support from the Fund to assist their rescue or restructuring.

The Fund's resources are made available in the form of a Governmental Guarantee to secure bank loans aimed at ensuring the companies' rescue or restructuring.

In order to be considered for a guarantee the applicant must provide the Fund with:

— a copy of its balance sheet or last quarterly/semester report, if available;

— a declaration confirming that the balance-sheets from the last two financial years were registered correctly and on time;

— a declaration, attested by the company, that it is in financial difficulty; and

— if the share capital has decreased by over 33%, the company must provide a copy of the notice calling for a shareholders' meeting, the minutes of that meeting and a copy of the resolution to increase the company's share capital.

The applicant must also provide a long-term business and financial plan to restore the company's long-term profitability.

Such a plan may provide for:

— the reorganisation and the rationalisation of the company's business;

— the restructuring of activities which will allow the company to compete effectively on the market;

— a diversification strategy which identifies new profitable activities.

The Ministerial Decree states that when deciding which companies will benefit from the Fund's intervention, the Fund must prioritise companies:

— that employ more than 250 persons;

— that at the date that the request for assistance is made, benefit from the extraordinary earning supplement fund *(Cassa integrazione guadagni straordinaria),* or those that have made the same request during the previous year;

— whose financial difficulties are not structural (for example a company with a positive EBITDA on at least one of the balance sheets for the last two financial years);

— whose financial difficulties have social and economic repercussions in the area. The Fund would consider whether that company employs a significant proportion of employees in a particular industry in that region; and

— that are sub-suppliers which have contributed to at least half of a large company's turnover that has benefitted from an Extraordinary Administrative Procedure *(Amministrazione straordinaria delle grandi imprese in crisi)* since 1 July 2008.

In order to ensure a prompt response, the Fund must reach a decision within 30 days from the date the application was filed (in the case of a rescue) or within 60 days (in the case of restructuring).

A Lender may enforce the Governmental Guarantee, on demand, if the beneficiary company defaults. If this occurs, the Fund must pay the lender within 30 days and the

Fund is subrogated to the lender's position in relation to the borrowing company.

According to most recent press releases from the Italian Ministry of Economic Development, the creation of the Fund, which will operate on a rotating basis, will enable many Italian medium and large companies to receive financial aid totalling several hundred million Euros over the next few years and help the economy to recover.

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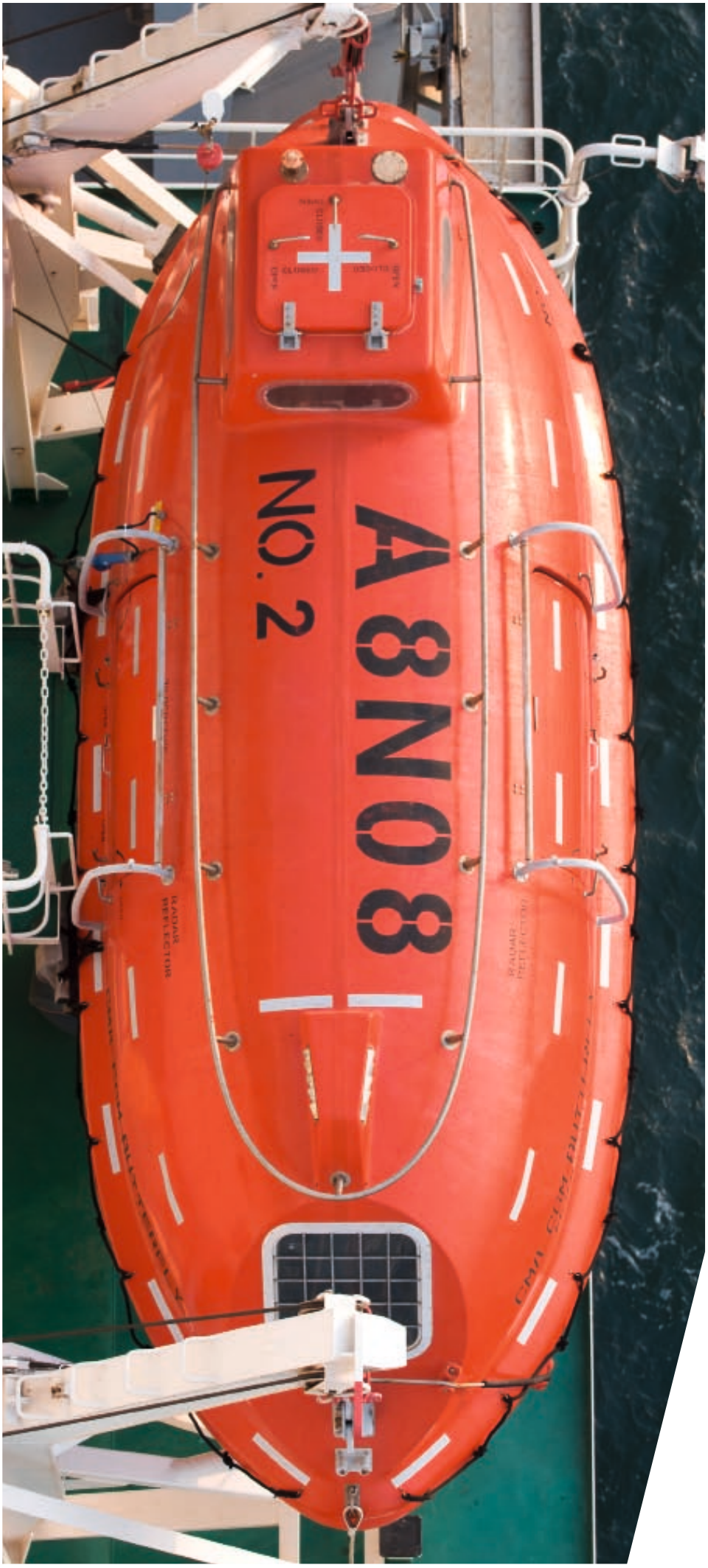

INCREASED DUTY TO INVESTIGATE WHEN GRANTING SECURED LOANS TO COMPANIES IN FINANCIAL DIFFICULTY: A WARNING FOR LENDERS

Lenders should be aware of a recent decision by the Dutch Supreme Court when granting secured loans to companies in financial difficulty.

A liquidator can invoke the legal remedy of *actio pauliana* to nullify legal actions undertaken before an insolvency, which have prejudiced other creditors. Where the legal act was undertaken without a corresponding legal obligation, the liquidator will have to prove that both the debtor and the other party knew or should have known that the legal act would prejudice the other creditors.

Such knowledge is presumed when the act relates to security for a debt that is not yet due and payable. In this event it is the lender's responsibility to furnish evidence to the contrary.

In the past it has been argued that prejudice is not an issue if new credit is employed to settle debts with creditors since this does not affect the debtor's financial position. However, in 2005 the Supreme Court ruled (in an earlier hearing of the same case, ABN AMRO/Van Dooren II) that a debtor which pays one of its creditors by using credit granted to it, effects an increase by the same amount of its debt to the bank. This means that, while there may be no change to the debtor's total debt burden, the remaining creditors are now prejudiced by the bank's preferred status, instead of ranking *pari passu* with other creditors. In an insolvency this of course means that the transaction results in less money for the remaining creditors.

On 22 December 2009 the Supreme Court passed judgment for the third time in the ongoing legal proceedings between ABN AMRO and Mr. Van Dooren. On the issue of knowledge of prejudice, the Supreme Court ruled that such knowledge is present "if, at the time of the legal act, the insolvency and a negative balance could have been anticipated with a reasonable degree of probability [by the debtor and the party with whom, or with respect to whom, the legal act was undertaken]". The Supreme Court further held that creditors are prejudiced if the debtor incurred the additional debt for the sole purpose of paying preferential creditors. As settling those debts does not alter the fact that other unpaid preferential creditors of higher or equal rank are prejudiced by the fact that fewer assets will be available for distribution.

In the same judgment the Supreme Council ruled that lenders have to conduct a thorough investigation of the financial data when negotiating a secured loan with a company in financial difficulty. If a liquidator proves that the bank knew or should have known that an insolvency could have been anticipated with a reasonable degree of probability, the liquidator can nullify the legal act that created the security.

Consequences for restructuring

By virtue of the Supreme Court's ruling, a bank that wishes to grant additional loans to and take security from a company in financial difficulty has a duty to investigate comprehensively (or more comprehensively than before) the borrower's financial position. A credit provider may not demand additional collateral for additional credit if it is evident from the borrower's financial data that insolvency can be reasonably expected. If the bank nonetheless accepts additional collateral there remains a risk that such security may be nullified by the liquidator by successfully invoking the *actio pauliana*.

As expected, the consequences of this judgment are far-reaching when it comes to restructuring. For one, it is expected that banks will be more hesitant to cooperate in the restructuring of a company in financial difficulty. The banks will wish to avoid a situation where a liquidator can invoke *actio pauliana* in respect of the credit provided and the collateral obtained. As a consequence of the court's judgement, banks will be more restrictive when it comes to granting loans and fewer companies in financial difficulty will be able to avoid insolvency through restructuring. This will inevitably lead to an increase in the number of insolvencies.

Conclusion

The central question is how will banks deal with the more detailed interpretation of the requirement of "knowledge of prejudice". Banks may interpret or amend their general credit terms to state that granting additional credit against additional collateral will be deemed to be a legal act the debtor was obliged to undertake (a major bank already amended its general terms and conditions pursuant to the earlier rulings by the Supreme Court in the matter of ABN AMRO/Van Dooren). On this regard it is worth noting that when it comes to obligatory legal acts, another standard applies in respect of the *actio pauliana*. The liquidator may only nullify the legal act if he proves that the bank knew that a petition for insolvency had been filed at the time of the legal act, or if he proves that there was "fraudulent consent" between the bank and the debtor. This will be much less of an issue in practice.

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REVIEW OF THE PROPOSED AMENDMENTS TO REGULATIONS REGARDING "CONSUMER BANKRUPTCY"

The Polish Parliament is working on an amendment to the Act of 28 February 2003 – Bankruptcy and Rehabilitation Law (the "Act") in the area of bankruptcy proceedings involving natural persons who do not operate a business, popularly called "consumer bankruptcy"(the "Bill").

The legal instrument of consumer bankruptcy was introduced into the Polish legal system only a year ago, as a result of several years' work and discussion. Until then, Polish law had not provided for the possibility of declaring consumers bankrupt and both the subject matter and proposed solutions, including basic issues, raised discussions and a storm of controversy.

The Bill provides for fundamental changes to the existing model of consumer bankruptcy. The key assumption that consumer bankruptcy is a privilege, and that only a debtor may benefit from it if his financial distress arises out of extraordinary circumstances, would be removed. According to the authors of the Bill the need to introduce such extensive changes to the existing regulations derives from the fact that debtors, afraid to lose their home are reluctant to initiate bankruptcy proceedings. Press reports claim that the courts received a total of 985 applications for consumer bankruptcy in 2009, however only ten applications were granted. The court generally granted bankruptcy if the bankrupt owned no property.

This article will present the fundamental changes proposed in the Bill and compare them to the current regulations.

I. Fundamental changes envisaged by the Bill

Grounds for declaring consumer bankruptcy

The existing law provides that consumer bankruptcy may be declared only in exceptional circumstances. The current system is based on the principle of extraordinarity and the concept of consumer bankruptcy is regarded as a kind of privilege for the debtor who became insolvent through no fault of his own.

The Bill removes the above principle and, as a consequence thereof, under the Bill any consumer could be declared bankrupt, even one who may be held liable for becoming insolvent, including in particular through his own recklessness. It seems that as a result of the lack of any limitations included in the Bill, a consumer could also be declared bankrupt if he became insolvent solely through his own actions or even as a result of deliberately acting to the detriment of creditors.

Two types of proceedings

The Bill introduces two different types of proceedings, depending on whether insolvency is the result of extraordinary circumstances beyond the debtor's control or not. This is an essential structural difference compared to the law currently in force.

Under the current regulations consumer bankruptcy proceedings may be conducted exclusively by way of liquidation of the bankrupt's assets. The aim is to realise his estate to satisfy his obligations.

Additionally, the Act provides that if any obligations remain outstanding after the liquidation of the bankruptcy estate, the court, upon the application of the debtor, will decide on a schedule for the repayment of such outstanding obligations over a period of no longer than five years (in principle). In addition, if the bankruptcy estate comprises residential property, the court may decide on a schedule for the repayment of the debtor's obligations only after the debtor leaves the property.

The Bill would regulate the same issue in a different way. In the event that a debtor becomes insolvent as a result of extraordinary circumstances beyond his control the court would issue a decision declaring the debtor bankrupt and establishing a 14-day period in which the debtor must submit a draft schedule of his repayment obligations. After the submission of the draft the court issues a decision regarding the schedule of repayments, specifying to what extent and over what period of time (however no longer than five years) the debtor is obliged to repay his obligations and what part of the obligations will be remitted once the repayment schedule is satisfied. The major change in comparison to the existing regulations is that if the repayment schedule is duly observed, no liquidation of the debtor's assets is performed. Additionally, in this situation the debtor will not undergo any inspections of a receiver. Under the Bill the receiver would be appointed only after other circumstances have arisen, for example if the bankrupt does not observe the schedule of repayment or it becomes evident that he concealed his revenues or assets or acted to the detriment of creditors.

It should be emphasised that if a person is bankrupted as a result of extraordinary circumstances (as mentioned above) his estate does not have to be used to satisfy the claims of creditors, as the Bill does not provide for the liquidation of a bankrupt's estate in this situation. In such circumstances creditors' claims must be satisfied only within the scope of the repayment schedule. This means that the risk associated with insolvency arising as a result of extraordinary circumstances beyond the debtor's control lies exclusively upon the creditors, irrespective of the value of the debtor's estate.

However, if the court finds that such extraordinary circumstances do not exist (i.e. in particular when insolvency arose as a result of reasons other than extraordinary circumstances beyond the debtor's control), bankruptcy proceedings will take the form of a liquidation procedure. Additionally, the Bill envisages that if the debtor fails to meet the schedule of repayments, the schedule would be annulled and the proceedings changed to the liquidation of the bankrupt's assets. Such a change would consist of appointing a receiver whose task would be to commence the liquidation process immediately.

Compulsory liquidation of a bankruptcy estate by a receiver

Under the current law, a bankrupt acting under the supervision of a receiver, on condition of obtaining the relevant consent from the judge-commissioner, has the ability to liquidate the bankruptcy estate by himself.

The proposers of the Bill regard this as both risky and inadvisable as it creates a major risk for creditors. Therefore, they propose either to delete the provision specifying such possibility or to make it possible for a creditor to challenge the decision of the judge-commissioner because the creditor may have further information on the circumstances of the debt.

Repeating the procedure

Currently the same person may undergo bankruptcy proceedings and be cleared of debt on numerous occasions, provided ten years has passed from the completion of the previous proceedings. The Bill proposes that a consumer should have the right to benefit from consumer bankruptcy proceedings only once in a lifetime, regardless of the reasons for which he became insolvent.

Obligation to leave residential property once sold

The Bill does not envisage any specific sanction that would force the bankrupt to leave his place of residence (a flat or a house) after it is sold. The current regulations provide for such a sanction in the form of preventing a schedule for the repayment of the debtor's obligations from being prepared, which means that the bankrupt cannot enjoy any positive aspect of bankruptcy (i.e. partial remittance of the debt) unless he moves out of his property.

II. Conclusions

Given that it has been a year since the concept of consumer bankruptcy was introduced into Polish law there has not been sufficient time to adequately assess the need for such extensive and fundamental changes as proposed in the Bill.

From the perspective of properly securing creditors' interests the major disadvantage of the proposed amendment is the removal of the existing principle of extraordinarity when conducting bankruptcy proceedings against a natural person who does not operate a business. Such liberalisation is likely to trigger an avalanche of applications and, as a consequence thereof, absolve those who became insolvent as a result of their own doings. From the creditors' point of view the limitations that the Bill proposes to place on the rights of creditors against the estate of a debtor who have become insolvent as a result of extraordinary circumstances beyond his control is also highly unfavourable.

The existing regulations are far from perfect. However, it seems that in principle the solutions that have been put forward in the Bill to rectify the flaws will prove to be ineffective.

It is also unquestionable that introducing such extensive and fundamental amendments to regulations in force for merely a year will have a negative impact on the stability and reliability of the Polish legal system.

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THREATS TO A LENDER RESTRUCTURING LOANS WHEN THE BORROWER FACES IMMINENT INSOLVENCY

When a company faces impending insolvency, its creditors will often attempt to restructure the loans granted to that company with a view to ensuring that they will be able to realise any claim they may have to the fullest extent and within the shortest time possible.

This article highlights certain risks that lenders should carefully consider when attempting a loan restructuring in the context of a borrower's potential imminent insolvency in Romania.

Background

Law 85/2006 on insolvency proceedings ("Insolvency Law") vests broad powers in both the judicial receiver and the liquidator to manage and enhance the worth of assets owned by a company that is subject to insolvency proceedings.

In exercising such powers, the judicial receiver and the liquidator have to assess whether certain contracts entered into by a company shortly before becoming insolvent were, in fact, entered into with a view to defraud creditors. If this is found to be the case, they may, before the syndic judge, request the annulment of these contracts and demand that the property transferred or the money paid by such a company be returned to the 'pool' of remaining assets.

Examples of contracts presumed fraudulent under the Insolvency Law

The Insolvency Law indicates by way of example several types of contracts that are presumed to have been made for the purpose of defrauding the interests of an insolvent company's creditors. The following types of contracts are worth noting from a lender's perspective:

— the creation or perfection of security to secure a previously unsecured claim within 120 days before the initiation of the insolvency proceedings;

— property transfers to a creditor in settlement of an earlier debt effected within 120 days before the initiation of the insolvency procedure, provided that the value of the property so transferred exceeds the amount that such a creditor would be able to realise upon the conclusion of the insolvency procedure; or

— anticipated debt payments made at least 120 days before the initiation of the insolvency proceedings, provided that their original repayment date was to occur after the time the insolvency proceedings were initiated.

Procedure for annulment

Where a contract is deemed to fall within any category of contracts presumed fraudulent under the Insolvency Law, the judicial receiver or the liquidator may file an application to the syndic judge requesting the annulment of such contract.

A claim for annulment must be filed within one year from the time when the judicial receiver presents the syndic judge with his report on the causes that led

to the insolvency of a company (which must be completed within 60 days of its appointment) but no later than 18 months after the initiation of insolvency proceedings.

However, where the judicial receiver or liquidator declines or fails to bring such a claim before the syndic judge, the creditors' committee can do so at any time within the 18 months referred to above.

Effects of annulment

The syndic judge will examine the existence of fraud in the contracts that are challenged by the judicial receiver or liquidator. Where the presumption of fraud is rebutted, the syndic judge will dismiss the claim and the challenged contracts will be reinstated.

If the syndic judge upholds the presumption of fraud and approves the claim, the assets transferred from, or monies paid by, the insolvent company under such a contract must be returned to form part of the company's assets.

The effects of annulment on the contracting party depend on whether such a party acted in good or bad faith when entering into the annulled contract, namely:

— if the contracting party can show that it acted in good faith and without any intention to delay, hinder or defraud creditors in realising their claims when the transfer or grant was effected, such a party will be granted a claim against the insolvent company proportional to the value of the returned assets; or

— if, however, it is proved that such a party entered into the agreement in bad faith, it will not be entitled to receive any compensation for the returned asset. A finding of bad faith means that the contracting party has been proven to have had knowledge that insolvency was imminent when the contract was entered into.

Exception

Importantly, it should be noted that the contracts a company enters into as part of its normal day-to-day activities (e.g. contracts made in the course of performing its business objectives, payments and cash collections, working capital financings) escape the presumption of fraud.

As a consequence, contacts entered into by the insolvent company as part of its day-to-day running cannot be annulled, unless the judicial receiver or liquidator is successful in proving that they have been entered into for fraudulent purposes, despite their ordinary nature.

Conclusion

Lenders should be careful when accepting anticipated payments, property transfers in settlement of their claims or perfection of security for unsecured claims from a borrower that could be facing imminent insolvency.

Even though such acts may appear to place a lender in a safer position in respect of their exposure to a borrower, there is a good chance that these will be set aside in the event that the borrower subsequently becomes insolvent.

Therefore, restructuring the debts owed by a company struggling on the brink of insolvency should be planned in a way that does not significantly affect the claims of other creditors. If this is not done, there is the potential risk that such a restructuring would be viewed as a means of fraudulently avoiding the risk of non-payment of claims in the event of the borrower's insolvency and thereby defrauding other creditors. These contracts may then be reversed and if the lender is proven to have acted in bad faith it will lose any claim it may have had on the value of the returned asset.

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THE EARLY AGREEMENT PROPOSAL: A SPEEDY WAY TO COMPLETE THE INSOLVENCY PROCESS

In normal circumstances, an agreement *(convenio)* is made to finalise insolvency proceedings. However, this agreement can also be made at the beginning of the proceedings and is referred to under Spanish Insolvency Law as an Early Agreement Proposal *(propuesta anticipada de convenio)*.

1. Formation of the agreement: the proposal system

The early agreement proposal must be in writing and signed by the debtors or their representatives. If third parties are also to provide guarantees, financing, make payments or assume any other obligations (such as assuming the debtor's liabilities), they too must be made in writing.

The proposal must be accompanied by a payment plan detailing the resources necessary for its implementation. When any of these resources arise from the continued activity of the insolvent company, a feasibility plan must also be submitted which must specify the necessary resources, how they will be employed and, if relevant, commitments by others to provide such resources.

The proposal must be straightforward and not subject to any conditions. It must also be complete and irrevocable, and no alterations or amendments can be made once it is admitted to the insolvency proceedings.

2. Deadline for presentation

The debtor may submit the early agreement proposal to the court following a request for voluntary insolvency. When insolvency is declared, the proposal may be submitted up until the end of the reporting period for debts (one month from the final publication of the declaration of insolvency).

3. Admission to proceedings

If the proposal is filed along with the application for insolvency or at any time prior to the declaration of insolvency, a judge shall decide on its admissibility in proceedings for the declaration of insolvency.

If the proposal is filed following the declaration of insolvency, a court order will be issued within three days of the proposal being submitted. In these circumstances the insolvent company will be notified of the existence of any defects in the proposal, which will need to be remedied within three days.

4. Inadmissibility

The early agreement proposal will only be rejected if it does not cover the necessary proportion of liabilities, if the proposals are illegal or if the debtor is subject to a prohibition. Spanish Insolvency Law states that in some cases the debtor cannot make a *propuesta anticipada de convenio.* This includes if the debtor has been declared guilty of committing a criminal act against the Tax Authority or if the debtor has not fulfilled its obligation to submit its annual accounts to the Commercial Register during any of the last three years. There is absolutely no opportunity to appeal against these orders.

5. Content of the agreement

Regarding the content of the proposal, it is possible to include alternatives and particular solutions for one or more class of creditors. The proposal may include both traditional agreements such as debt-relief, which are organisational agreements, and transfer agreements where another party assumes the debtor's liability.

6. Adhesions to the proposal

Adhesions are votes by the creditors in favour of approving the proposal.

Other than the matters that must be processed before the proposal is admitted, the remaining adhesions can be provided at any time between the proposal's admission and the deadline in which to appeal against the inventory (the list of debtor's assets compiled by the Trustee Panel) or list of creditors.

The adhesions must be made in writing and, in principle, are definitive and irrevocable. However, where the class or amount of a consigned debt in an adhesion modifies the definitive list of creditors, a creditor may withdraw its consent within five days of being notified of this change.

7. Majority required for an adhesion to the proposals of the agreement

For an adhesion to the proposal to be accepted, it is necessary to gain the approval of creditors representing at least half of the ordinary liabilities of the insolvent company. For the purposes of calculating the majority, privileged creditors will be treated in the same manner as unsecured creditors that vote in favour of the proposal, and will be considered as part of the ordinary liability of the insolvent company.

8. Judicial approval

The proposal will be admitted once the requisite number of creditors has voted to support the proposal. When the proposal is admitted, it is then transferred to the insolvency administrators, who will have ten days to evaluate it. If the administrators approve the outcome it will be added to the insolvency administration report.

If during the administrators' evaluation the administrators do not approve the proposal or have reservations, a judge may render it inadmissible.

Within the five days following the end of the deadline in which to appeal the inventory and the list of creditors, or at the end of the deadline for withdrawing consent for the proposals, the judge will verify if there has been sufficient votes in support of the proposal and, if so, will legally approve the agreement.

If a majority has been obtained, the opposition phase will be opened. If there is no opposition or if such opposition is rejected, the common phase of insolvency will end and the judge will declare the agreement approved.

In the event that there were insufficient adhesions or there was any opposition to the proposal, the judge will require the debtor to state within three days whether it wants the proposal to be submitted before a meeting of creditors or whether it requests liquidation.

9. Challenging the agreement

An application to challenge the agreement must be based on the fact that rules have been infringed on any of the following subjects:

(i) the terms of the agreement;

(ii) the form and content of the adhesions;

(iii) the formation or conclusion of the meeting; and

(iv) that the vote or decisive adhesions to accept the agreement proposal had been issued by someone who was not an actual creditor or had been obtained through ways that undermine the equal treatment of ordinary creditors.

Any opposition will be processed through the insolvency channels and will be resolved by a decision that will approve or reject the accepted agreement.

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// **Switzerland**

THE LIABILITY OF BOARDS OF DIRECTORS RELATING TO SOCIAL SECURITY CONTRIBUTIONS IN SWITZERLAND

In Switzerland, an employer has to pay social security insurance contributions to compensation funds, including old age insurance (AHV), disability insurance (IV), income compensation insurance (EO), family compensation insurance (FAK), and unemployment insurance (ALV).

The employer has to reimburse the compensation fund for any damage caused by non-fulfilment of its obligations. It is estimated that several thousand written orders for payment are executed by the compensation funds each year, and that an average of 1,000 court cases are heard on this matter.

Even though the applicable law provides for "employer's liability", the courts have developed a practice by which not only the company but also the members of the board of directors are held liable in the event that the employer does not fulfil its payment obligations.

Consequently, the issue of personal liability for directors arises when companies face financial difficulties and insolvency. During this time all board members need to be aware of their potential liability and how they can avoid being held personally liable for a company's failure to make the required social security insurance contributions.

For a board member to be held personally liable, the compensation fund must show (i) damage, (ii) breach of law, (iii) causation between the breach and the damage suffered, and (iv) fault.

(i) Damage - Damage means any social security contribution that is due and has not been paid. This includes administrative costs, reminder charges and default interests. A member of the board of directors is also liable for contributions that were already due at the time he was elected to the board.

(ii) Breach of law – This requirement is satisfied when the employer does not fulfil its duty to provide contributions and information to the compensation fund.

(iii) Causation – Adequate causality between the damage and the breach of law is usually deemed.

(iv) Fault – The law stipulates that liability arises if a member of the board of directors has acted intentionally or with gross negligence in not making social security contributions. However, deviating from both the legal definition and common practice in private law, Swiss courts have established a very strict practice for social security contributions. Under case law, the mere fact that contributions have not been paid is deemed to amount to gross negligence by each member of the board unless the individual member is able to prove the contrary (exculpation).

In this respect, the Swiss Federal Supreme Court distinguishes between the members' duties in small companies and in large enterprises:

— Where there is only one board member, such member is deemed to be aware of all important matters – whether or not the company also has management who do not sit on the board. The board member is obliged to ensure that the contributions are paid regularly. Where there are

several board members, the Swiss Federal Supreme Court recognises that each member will have different responsibilities. Consequently, every member need not have knowledge of all details concerning the contributions for social security. However, as soon as the company suffers financial difficulties, each board member is required to make sure that the contributions are made. The topic has to be on the agenda of every board meeting, such meetings have to take place regularly and non-executive members must insist upon seeing evidence that the payments were executed. In addition, for evidentiary purposes it is important that these activities are detailed in the minutes of the board meeting. Following case law, salaries must not be (fully) paid without first ensuring the payment of all social security contributions. If necessary, salaries have to be reduced proportionally. In the case of outstanding payments, the board of directors must contact the relevant contribution fund in order to arrange a payment plan.

To summarise, in respect of the payment of social security contributions, case law has turned a liability for tort and gross negligence into virtually a strict liability – with the wrongdoers being jointly and severally liable for the whole amount. Therefore, every board member should adhere to the following principles:

— Before joining a board, future members should seek confirmation that there are no social security payments outstanding.

— When sitting on the board, each member should periodically request evidence showing that payments to the compensation funds are being made.

— In the case of the company suffering financial problems, the board member should ask for such evidence at every board meeting and insist that these safeguards are duly mentioned in the minutes.

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DEBT RESTRUCTURING IN UKRAINE: KEY ISSUES

The specific features of a debt restructuring depend on the particular circumstances and initial terms of the transaction. The parties to a restructuring should, however, always start by considering and agreeing the following key points:

— registration requirements;

— a grace period/payment holiday;

— interest capitalisation;

— interest payments;

— change of the parties to the transaction;

— surety/guarantee issues;

— amendments to the security package; and

— a standstill agreement.

Each of these is discussed in turn in more detail below.

Registration requirements

Any changes to information contained in the registration certificate that is issued by the National Bank of Ukraine (the "NBU") when a loan agreement is first registered must be properly registered by the NBU. Such changes may include the amount of the principal, interest and other payments under the loan, and the final repayment date.

It must be noted that in October 2009 the NBU reintroduced caps on the interest rates foreign lenders are able to charge on loans made in a foreign currency. As a result, the interest rate payable under these loans (amendments to which will need to be registered) must not exceed the maximum interest rate cap set by the NBU at the date the amendment is registered.

Grace period or payment holiday

A grace period or payment holiday will commonly include an extension to the general term of the loan whereby the loan's final maturity date is postponed. However, this alone will not prevent a borrower from defaulting and, as such, the whole schedule of payments will also need to be revised. By increasing the term of the loan the amount regularly paid out under the loan is decreased, thus reducing the financial burden on the borrower.

Furthermore, a party may suggest capitalising the interest due under the loan. With respect to cross-border loans however, every time interest is capitalised it only takes effect once it is registered with the NBU.

Issues related to interest payments

During a debt restructuring the parties to a loan will normally first agree the amount and type of interest to be paid.

One option (which a borrower would usually prefer) is for the interest rate to be reduced, either for the entire term of the loan or at least for a certain period.

The other option is to change the interest rate type. For example it may be appropriate to replace a floating interest rate with a fixed one, or vice versa. Although a fixed interest rate guarantees more certainty for the borrower in terms of its financial management, implementing a fixed interest rate usually leads to a hedging arrangement being put in place. Apart from additional costs, certain restrictions within Ukrainian legislation may well prevent a Ukrainian borrower from signing a hedging agreement.

In practice, a Ukrainian borrower is prohibited from directly making hedging payments abroad. As a result, hedging structures in cross-border loan transactions tend to be rather complicated.

Possible change to the parties to the transaction

A restructuring can also be based on parties assigning their rights and obligations. Ukrainian legislation provides the parties with the following options:

— assignment or sale of a loan;

— repayment of a loan by a surety or guarantor; and/or

— assignment of a debt (debt transfer).

As soon as the parties have agreed on one of the options above, the following steps need to take place:

(i) the relevant assignment agreement (or any other agreement of the same

nature) between the parties needs to be executed;

(ii) the relevant payments provided for in the agreement from step (i) need to be made;

(iii) for cross-border loans, if the new lender, surety or guarantor is a non-resident or if the new borrower is a Ukrainian entity but the previous one was a non-Ukrainian entity, the lender or borrower's replacement will need to be registered with the NBU; and

(iv) the security documents and records at the State Register of Encumbrances over Movable Property and/or the State Mortgage Register and/or the Unified Register of Bans of Alienation of Immovable Property will need to be amended accordingly.

Each option will also have its own peculiarities and specific consequences. For example, although a lender is able to assign its claims under the Civil Code of Ukraine, it may not do so if prohibited under the loan agreement. The same is true of the borrower's consent to the assignment: it is not required unless directly provided for within the terms of the loan agreement.

Surety and guarantee issues

When restructuring a debt with the assistance of a guarantor or surety provider it should be remembered that there is a difference between the concept of a surety and a guarantee under Ukrainian legislation. The discharge of the borrower's debt by a surety leads to the lender being replaced by the surety in the loan agreement and security documents. This takes place by operation of law. Conversely, where a guarantor repays the loan, the guarantor only receives a right of regress against the borrower with respect to the amount paid to the lender under a guarantee agreement. The guarantor does not replace the creditor as party to the loan and security agreements.

Amendments to security package

It may also be necessary to amend the security documents in addition to the loan agreement. It is worth mentioning the following key issues relating to security documents:

— the possible need to register amendments on the respective registers both in Ukraine and (if applicable) abroad, depending on the nature of the amendments and the identity of the parties;

— a Ukrainian company (non-financial institution) cannot act as a guarantor; and

— the effect which increasing the amount secured will have on the priority ranking of the charge.

Standstill agreement

A standstill agreement is effectively a "contractual moratorium" whereby creditors agree to postpone their rights against a borrower. A standstill agreement will also likely include provisions designed to stave off insolvency in respect of the borrower.

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KEEP YOUR INSOLVENCY EVENT CLAUSES UP TO DATE

The decision of the Technology and Construction Court in June 2009 regarding the use of up to date insolvency event clauses has recently been confirmed by the Court of Appeal in William Hare Limited v Shepherd Construction Limited and CR Reynolds (Construction) Limited v Shepherd Construction Limited [2010] EWCA Civ 283.

When an employer went into administration, a contractor wanted to rely on a standard definition of insolvency contained in one of its sub-contracts to avoid paying a sub-contractor nearly GBP 1m. The contractor must have been surprised to discover that the clause did not work.

This article will discuss the facts and implications of the case.

Facts

A contractor included in a sub-contract the definition of insolvency that was originally drafted in 1998 for use with a "pay when paid" clause. A "pay when paid" clause does what it says: the contractor with the benefit of the clause need only make payment when he has himself been paid by the employer. However, s.113(1) of the Housing Grants, Construction and Regeneration Act 1996 (the "1996 Act") outlawed "pay when paid" clauses in the construction industry, unless it could be shown that the third-party employer was insolvent. The 1996 Act included a definition of insolvency that referred, among other things, to an administration order.

Before the Enterprise Act 2002 introduced changes to the administration regime, companies wishing to go into administration could only do so by court order. Following the Enterprise Act, two out-of-court filing routes (or "self-certifying routes" as the judge referred to them) became available. The definition of insolvency in s.113 of the 1996 Act was amended accordingly to include administration accessed by an out-of-court filing.

However, the contractor in this case failed to update its definition of insolvency in the contract and used the pre-Enterprise Act definition of insolvency in a sub-contract in 2008. The part of the clause dealing with administration referred only to "the making of an administration order…" and not to the out-of-court filing routes into administration.

The employer in the case went into administration but did so via an out-of-court filing route. The contractor tried to rely on the "pay when paid" clause to refuse to pay the subcontractors substantial sums that were otherwise clearly due.

There was no dispute that the ordinary meaning of the definition of insolvency in the contract did not include a reference to an out-of-court filing for administration. However, the contractor argued that it was "absurd" for the sub-contract to be construed without taking into account the subsequent amendments to the insolvency regime and that given that this was one of those cases where it was so clear something had gone wrong with the drafting, the court should construe the clause as covering all routes to administration. In other words, the contractor argued that the clause should be construed as if it had been amended with an updated reference to administration.

Seeking to rely on the well-known authority on contractual interpretation, ICS v West Bromwich Building Society [1998] 1 WLR 896, the contractor argued that this was one of those cases where the parties must, for whatever reason, have used the wrong words, but that the parties' intention was clear. The test established in ICA V West Bromwich is that "in construing contractual documents the aim was to find the meaning which the document would convey to a reasonable person having all the background knowledge reasonably available to the parties, including anything which would have affected the way a reasonable man would have understood it, but excluding previous negotiations and declarations of subjective intent".

At first instance, Coulson J sitting in the Technology and Construction Court in June 2009 was not persuaded and held in favour of the sub-contractor. The contractor appealed.

Court of Appeal decision

On appeal, the Court agreed with Coulson J. The Court cited Chartbrook Limited and Another v Persimmon Homes Limited and Another [2009] 1 AC 1101, which stresses the need for there to be a "strong case" if the court is to be persuaded that something must have gone wrong with the language.

The Court of Appeal was doubtful whether the principles in ICS v West Bromwich would apply to a case such as this. Giving the judgment, Waller LJ said that: "Pay when paid clauses were made ineffective unless the third party was insolvent and insolvency was defined by reference to the ways in which a company could become insolvent. If a main contractor wishes to have a pay when paid provision in a subcontract he would be bound, if it was to be effective, to identify a way in which the third party employer became insolvent as defined in the legislation. If he chose a way which was not in accordance with the legislation because he misdrafted the provision, I can see no reason why, however obvious it was that he had misdrafted the provision, the principles identified by Lord Hoffman [in ICS v West Bromwich] would come to his rescue."

The appeal was dismissed.

Comment

Where a party wishes to include in a contract a clause that is intended to relieve him of a liability to pay what he otherwise would have to pay, it is for him to get the clause right. Only clear words will do. Any ambiguity or lack of clarity will, as in this case, be resolved against the party seeking to rely on it.

Despite coming to a result that is, perhaps, counter-intuitive to insolvency professionals, we respectfully agree with the Court of Appeal on contractual interpretation principles. Let it be a salutary lesson to all parties entering into contracts to ensure that insolvency event clauses have been updated to reflect the 2002 changes.

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