FIXED INCOME RESEARCH

NOMURA INTERNATIONAL PLC

Global Guide to Corporate Bankruptcy

A comprehensive guide to corporate bankruptcy and a survey of global corporate bankruptcy regimes

21 July 2010

Dominic O'Kane
dominic.o'kane@nomura.com

Patrick Bawlf
+44 20 7102 2113
patrick.bawlf@nomura.com

www.nomura.com/research
Bloomberg: NRE

With the assistance of

LATHAM & WATKINS

This report and the research upon which it is based have been commissioned from Quantitative Insights Limited by Nomura International plc. Please see important disclosures starting on page 160.

Acknowledgements and Disclaimer

We would like to thank Mike Guarnieri, Sean Kelly, Fabio Vassel, Andrew Riebe, Alison Miller, Herb Lust, Arthur Roulac, Toshihiro Uomoto and Matthew French at Nomura for their comments and assistance.

We would also like to acknowledge Dominic Newcomb and James Chesterman of the law firm Latham & Watkins for reading and commenting on this report, and for providing the resources of their firm to comment on the country sections. Their details are provided below.

Dominic J. Newcomb
LATHAM & WATKINS
99 Bishopsgate
London EC2M 3XF
United Kingdom
+44.20.7710.1191
dominic.newcomb@lw.com

James Chesterman
LATHAM & WATKINS
99 Bishopsgate
London EC2M 3XF
United Kingdom
+44.20.7710.1004
james.chesterman@lw.com

We would also like to thank the law firms Mason Hayes+Curran, Koutalidis, Rajan & Tann LLP and Herbert Geer (together with Latham and Watkins, "the Contributors") for their comments on the Ireland, Greece, Singapore and Australian sections respectively. Their contact details are provided at the end of the corresponding country sections.

Highlights

- Global credit markets have changed markedly in recent years as new products, new structures, new investors, new regulations and new documentation have altered the way in which large companies finance themselves.
- As a result, the nature and complexity of corporate bankruptcy has changed, especially with respect to corporate rehabilitation, as more parties with different forms of debt and differing motivations are now at the negotiating table.
- The increased internationalisation of credit portfolios caused to a large extent by the advent of the European single currency, the disintermediation of banks, and a desire for diversification have required credit investors to better understand the treatment of bankruptcy across a broader range of jurisdictions.
- This report has therefore been written with the aim of providing credit investors with a clear explanation of how bankruptcy procedures work within many of the major jurisdictions across North America, Europe and Asia.
- This report is in two parts. Part one begins by setting out the different forms of corporate debt which exist and the factors, including security, payment and structural subordination, which determine recovery.
- Part two provides a detailed description of the insolvency regimes found in the major and some of the other frequently encountered insolvency regimes. We cover the United States, Canada, England and Wales, France, Germany, Italy, Spain, Ireland, Greece, Japan, Hong Kong, Singapore and Australia.
- We explain how debtor or creditor-friendly each regime is, how the respective rights of secured and unsecured creditors are treated, what the priority of payments is in liquidation and what formal procedures are provided to facilitate the reaching of a binding restructuring agreement.
- In each country we set out at least one case study in order to highlight specific aspects of each jurisdiction's insolvency framework and to give a sense of the time taken by the procedures.
- We note that many countries have revised their bankruptcy regimes in the past decade with the aim of encouraging company rehabilitation as an alternative to liquidation.
- We perform a country-by-country comparison of liquidation and rehabilitation procedures, highlighting the important features of each regime.

Contents

1 Introduction 6
2 The Bankruptcy Process 9
2.1 The generic insolvency procedure 11
3 A Survey of Corporate Debt 17
3.1 Bonds 19
3.2 Loans 21
4 Events of Default 27
4.1 Incurrence covenants 28
4.2 Maintenance covenants 29
4.3 The covenant breach process 30
5 Determining the Recovery Rate 33
5.1 Security 35
5.2 Subordination 36
6 Evaluating a Bankruptcy Regime 41
7 Survey of Bankruptcy Regimes 43
7.1 The legal traditions for bankruptcy law 43
7.2 UNCITRAL and cross-border insolvency 44
8 North America 45
8.1 United States 45
8.2 Canada 53
9 Europe 59
9.1 England and Wales (UK) 59
9.2 Germany 67
9.3 France 74
9.4 Italy 81
9.5 Spain 90
9.6 Greece 97
9.7 Ireland 103
9.8 EU Insolvency regulations 109
10 Asia 114
10.1 Japan 114
10.2 Hong Kong 122
10.3 Singapore 130
10.4 Australia 137
11 A Country Comparison 146
11.1 Liquidation procedures 146
11.2 Rehabilitation procedures 148
12 Conclusions 152
13 Glossary 154

1 INTRODUCTION

The considerable changes in the credit markets in recent years have transformed the nature of corporate bankruptcy

Global credit markets have changed markedly in recent years. With increased disintermediation have come new products, new structures, new investors, new documentation, and new regulations which have significantly changed the way in which large companies finance themselves. As a result, the nature of corporate bankruptcy has been transformed.

Credit investors now need an understanding of bankruptcy across a range of jurisdictions

Furthermore, the increase in internationalisation of debt has required credit investors to better understand the treatment of bankruptcy across a broader range of jurisdictions. This report has therefore been written with the aim of providing credit investors with a clear explanation of the main features of corporate bankruptcy within many of the major jurisdictions across North America, Europe and Asia.

This report aims to provide credit investors with an understanding of the factors which determine recovery

In order to explain bankruptcy, we need to set out in detail the factors that determine the recovery rate of defaulted debt. Many of these factors are set out in the contractual documents of bonds and loans. These include covenants, the creation of security, contractual subordination and structural subordination. However, much of what happens in bankruptcy also depends on the bankruptcy regimes of the countries in which the bankruptcy proceedings are conducted. Indeed, when it comes to bankruptcy it is usually the letter of the law in this jurisdiction that determines the negotiating positions of the parties and the final outcome.

The multinational nature of many large borrowers means that investors are exposed to many bankruptcy regimes

The need for a report that covers multiple jurisdictions is largely driven by two observations. First, many of the large companies that issue debt are multinationals and so their creditors have exposure to the local bankruptcy regimes of the subsidiary operating companies which may be spread across a range of jurisdictions. Second, credit funds seeking to diversify their risks now own debt from companies across a broader range of jurisdictions than previously. This fact is nowhere more important than in Europe, where the advent of the euro has made it easier for companies across the eurozone to fund themselves via both the capital markets and the loan markets. However, although the members of the eurozone share the same currency, their bankruptcy regimes can differ significantly. Investors holding this debt need to appreciate how a bankruptcy regime can have a material impact on the expected recovery rate of a bond or loan.

This report consists of an introduction to corporate default followed by a review of the main global bankruptcy regimes

This report is divided into two parts. Part one is an introduction to corporate default. This consists of a detailed description of the generic bankruptcy process, a survey of the various forms of corporate debt, a description of the mechanics of how a company ends up in a state of insolvency, a description of the various forms of subordination and a discussion of the use of security. Part two of this report is a detailed survey of the treatment of financially distressed companies, and their creditors, across several of the major and some of the minor bankruptcy jurisdictions around the world.

In section 2, we set out the key ingredients of the generic bankruptcy procedure

Part one of this report begins in section 2, where we introduce the reader to bankruptcy as a process. We do this by setting out the key stages of what we call the "generic bankruptcy procedure". We explain how companies enter such a procedure, what the main stages are, and how the procedure results in either corporate rehabilitation or liquidation. The aim of this section is to raise awareness of which features of a bankruptcy process encourage successful rehabilitation, how the legal details of the procedure can determine the balance of power between the interests of the debtor, shareholder and creditor, and how the differing rights of secured and unsecured creditors are treated. This discussion provides a useful reference point against which the many country-specific procedures described in part two of this report can be compared.

Section 3 surveys the many types of debt that may feature in an insolvency process

In section 3 we survey the many types of debt that a company may assume. We start with publicly issued bonds, both investment grade and high yield. We then survey the many forms of loan-based debt. These include syndicated investment grade loans, leveraged loans and mezzanine finance. The more recent phenomenon of covenant-lite leveraged loans are also described. It is essential to know the main characteristics of these forms of debt in order to understand how they are affected by bankruptcy.

Section 3 also surveys the many different types of creditor found in a typical restructuring

In section 3 we survey the different types of creditor. These consist not just of banks but also private equity shops, hedge funds, distressed debt funds and CLO funds. It is important to understand who these investors are, and what are their motivations and constraints, if we are to understand the many factors that drive the modern debt restructuring procedure.

Section 4 describes the various "events of default" that can lead to a company entering a state of bankruptcy

In section 4 we describe the key "event of default" that ultimately leads to the company entering into discussions and possibly formal bankruptcy proceedings if these discussions fail. We discuss the various types of events of default. These include not just a failure to make a promised payment, but also the breaching of covenants which we also explain in detail. We describe how a covenant breach may be cured, the use of standstill periods and how a failure to cure an event of default can lead to cross default or cross acceleration and a state of insolvency.

Section 5 discusses the factors that determine how much of the bankruptcy estate a creditor receives

In section 5 we discuss the factors that affect determine recovery, i.e. how much of the bankruptcy estate a creditor obtains. This is a more complex procedure than a simple application of the statutory priority of payments defined by a bankruptcy code since it must also take into account factors such as lien subordination, contractual payment subordination and structural subordination. These are all explained in detail. Section 6 ends the first part of the report with a list of questions that can be used to evaluate and compare the different features of an insolvency regime.

Part two of the report is a country-by-country review of the bankruptcy law in 12 different jurisdictions

Part two of the report, which comprises sections 7-10, is a country-by-country review of the bankruptcy law in the United States, Canada, England and Wales, France, Germany, Spain, Ireland, Greece, Japan, Hong Kong, Singapore and Australia. These specific jurisdictions have been chosen because they include the major world economies and hence the source of much of the outstanding international corporate debt. They also include some more minor jurisdictions chosen because their economies are especially exposed to the current economic environment. Each country section follows the same standard template:

1. We set out the relevant laws and courts that relate to insolvency;
2. We discuss the various forms of asset security that exist in that country and the local definition of insolvency;
3. We discuss the pre-insolvency procedures, if any, which exist to help companies resolve their financial problems before any formal state of insolvency occurs;
4. We discuss the procedures that are triggered once insolvency occurs, broken down into rehabilitation procedures and liquidation procedures;
5. We set out the order in which claims are paid in liquidation;
6. We provide one or more case studies used to highlight certain important features about the practical application of the law; and
7. We comment on the general characteristics of the framework in terms of who it favours and who it disfavours and how this impacts recovery rates.

This report also discusses the phenomenon of "forum shopping"

Part two of this report also discusses the phenomenon of "forum shopping". This is an aspect of bankruptcy law that occurs when companies move their bankruptcy from one country to another in order to benefit from some advantage of the bankruptcy regime in the destination country. Typically, it is done because the destination regime makes it easier for management to push through a binding restructuring plan against the wishes of a minority of creditors.

The report discusses in detail the process of COMI shifting within the European Union

Within the European Union this phenomenon is known as "COMI-shifting", where COMI stands for the Centre of Main Interests of the company. It is also possible for companies to commence proceedings in jurisdictions where they have some lesser connection than their COMI. This has particular significance in the context of foreign companies commencing bankruptcy proceedings in the US to take advantage of that regime's features. This report discusses when these moves are allowed, and in the European case, we present a number of examples of when this has been used in the recent past.

Section 11 of the report contains a discussion of the different insolvency regimes in terms of liquidation and rehabilitation. We attempt to identify which regimes favour the debtor and which favour the creditor. We also compare the different rehabilitation procedures with each other and especially with the US Chapter 11 procedure. Section 12 of the report sets out our general conclusions and section 13 contains a glossary of the many technical terms used in the report.

This report cannot cover all of the intricate details of each insolvency regime but does aim to capture the main features

Instead of providing a completely detailed description of each jurisdiction, the aim of this report has been to provide the reader with an introduction to bankruptcy and with a sufficient amount of information to capture the salient features of the insolvency procedures in each of the countries covered. This should provide enough understanding of the procedures to allow the reader who has interests in a particular jurisdiction to be able to identify the key issues and to ask the right questions from the outset.

Readers should always seek guidance from a practising insolvency expert

Insolvency law is complex and it is therefore impossible to summarise all of the detailed nuances and exceptions of each jurisdiction's legal code into several pages. It is also a fast-moving area of law. For these reasons, we stress that readers should not rely on this report for legal advice, but should always seek up-to-date professional guidance from a practising insolvency expert.

2 THE BANKRUPTCY PROCESS

Bankruptcy is an inevitable consequence of a free and competitive market

It is an inevitable consequence of a free and competitive market that some companies will thrive and prosper while others will falter and enter a state of bankruptcy. This may be the start of their journey into a rehabilitation process, in which case their debt is restructured, the ownership is potentially redistributed, the business is reorganised and the company emerges as a solvent going-concern. However, in the other case when rehabilitation is not possible, for example if the business model is not viable, there is then a liquidation process in which the company's assets are sold and the proceeds used to repay the creditors in a pre-determined order of priority.

Historically, most bankruptcy frameworks have focused on enabling liquidation, but this is changing

Historically, most bankruptcy frameworks, with a few notable exceptions[1], have focused on enabling an efficient and fair liquidation of the company, with a strong emphasis on the repayment of creditors and the penalisation of debtors and shareholders. However, in recent years, this emphasis has changed. Legislators in different countries have become more appreciative of the need to shift the focus of bankruptcy legislation from one of enabling liquidation towards one of encouraging rehabilitation.

Rehabilitation is being encouraged where possible to prevent the destruction of economic value associated with liquidation

This shift in focus has been based on the observation that if the business carried out by the company is viable, it is often better to keep it alive rather than permit the destruction of economic value and the consequential social fallout that would result from a liquidation. To do this the insolvency regime must provide management and creditors with a framework that makes successful rehabilitation easier. It has also been noted that a reduction in the severity of any punishment and a lowering of the stigma associated with insolvency should encourage companies to take advantage of such a rehabilitation framework earlier. The danger is that waiting until the company is insolvent increases the risk that it will then be too late to rescue it.

If rehabilitation is not possible then liquidation should be fast, orderly, predictable and cost-effective

At the same time, bankruptcy frameworks need to recognise that rehabilitation is not always the answer. If the business is not viable or if liquidation (e.g. a sale of the parts of the business) offers a higher recovery than rehabilitation then it is usually preferable to allow the company to fail so that the resources it uses can be better deployed to other more productive uses. This should be done in a way that is fast, orderly, cost-effective and predictable and it may involve a piece-by-piece sale of the company's assets or a sale of the company as a whole.

Bankruptcy and insolvency are essentially the same thing and usage differs from jurisdiction to jurisdiction

Before proceeding, we need to clarify some terminology regarding the use of the words "bankruptcy" and "insolvency". We generally think of insolvency as a state that a company is in when it fails a solvency test, i.e. when it is unable to pay its liabilities as they fall due. or when the value of its debt is greater than the value of its assets. Bankruptcy is the legal recognition of this state and the term assigned to the panoply of laws usually designed to protect the company from uncoordinated creditor actions with the objective of preserving overall recovery. However, this is not a hard rule as it varies from jurisdiction to jurisdiction. For example, some regimes choose to use the word bankruptcy in relation to individuals in a state of insolvency. These regimes usually reserve the word insolvency for companies in a state of insolvency. In what follows we will use both bankruptcy and insolvency, choosing each according to the terminology used in the jurisdiction being discussed. In general, the simplest advice we can give the reader is to treat them as though they mean the same thing.

A state of insolvency is usually the entry requirement for an insolvency regime

All of the jurisdictions discussed in this report have legal frameworks that recognise that companies do fail and have some form of test or criteria for recognising such a condition. The most commonly used criterion is based on the company's ability to pay its debts as they fall due, but in some cases the criterion can be a balance sheet test that states a firm is insolvent or bankrupt if the value of the company's debt exceeds the value of its assets. Some jurisdictions may allow an insolvency procedure to be used pre-insolvency, i.e. when the company is in financial difficulties, but not formally insolvent.

---

[1] The US Bankruptcy Code has long stood out as a bankruptcy regime that favours creditors and does not seek to punish debtors.

There is a close connection between the concept of insolvency and that of the "going concern"

One concept that is closely connected to insolvency is that of the "going concern". A going concern is simply a company that its management and auditor have judged capable of continuing to realise assets and discharge its liabilities for the foreseeable future (usually the next financial year). The concepts of insolvency and going-concern are different in the sense that going concern is an accounting concept that typically looks forward one year, while insolvency is a legal concept that usually looks at the current state of the company.

One of the main challenges of insolvency is determining whether an insolvent company should pursue rehabilitation or liquidation

Perhaps the single greatest challenge of insolvency is determining whether an insolvent company should pursue rehabilitation or liquidation. To resolve this dilemma, it becomes necessary to assess the survivability of the company. This ultimately comes down to an assessment by management, creditors, shareholders, and in most jurisdictions, the courts on whether the company's business problems are transitory or permanent. To perform this analysis, the problems of the business need to be diagnosed. Financial difficulties need to be separated into liquidity and solvency issues. It is also necessary to accurately determine the appropriate level of debt that can continue to be serviced by its cash flows. The intent of a restructuring procedure must be to leave the debtor *feasible*, meaning that the company is unlikely to have to go through a second restructuring or have to enter liquidation.

A number of countries now recognise the important role that law can play in helping companies to rehabilitate

As stated previously, more and more jurisdictions have adapted their insolvency legal frameworks to recognise the important role that law can play in helping companies to restructure and rehabilitate themselves. This does not mean to suggest that companies were unable to restructure their debt previously. Informal, private, consensual, out-of-court restructuring has always been possible. The reason why it is not recognised as being sufficient is that it presents a number of difficulties.

Informal, consensual, out-of-court restructuring has always been possible, but is not always easy

First of all, for informal restructuring to be successful, typically unanimous agreement is needed between the debtor company and all of the affected creditors. Obtaining such a level of agreement is not usually easy, especially when the number of creditors is large and when their structure is complicated by them being split into different classes of seniority. The impairment on creditors' recoveries that would occur in a formal insolvency should the restructuring negotiations fail does help to focus the minds of the participants and incentivises agreement. However, such negotiations will always be fraught. Moreover, in some cases unanimity will be impossible to achieve because of the sometimes widely differing objectives of the creditors themselves.

New insolvency regimes address these issues using court supervision, a fairness requirement, a stay on creditors and a cramdown mechanism

A number of countries have addressed these concerns by putting in place formal restructuring procedures which can include legal mechanisms that impose some form of stay on the actions of secured creditors, which enforce some degree of supervision of the restructuring process, which require fair treatment of creditors, which allow some form of priority financing and which also permit some degree of compulsion, known as a "cramdown", to make sure that a restructuring cannot be held up by blocking in-the-money minorities or out-of-the-money constituents.

Many of the new developments have been based on the US Chapter 11 procedure for company rehabilitation, which for many is the "gold standard" for corporate rehabilitation. As we will see, countries such as Canada, France, Germany, Italy and Japan have all revised their bankruptcy laws over the past decade by copying various features of the Chapter 11 procedure in order to make company restructurings more likely to succeed. However, differences in legal culture and socioeconomic policy mean that none of these countries has actually replicated Chapter 11 in full.

A key question is how a corporate insolvency regime manages the conflicting wishes of the managers, shareholders and creditors

One general characteristic of any corporate insolvency regime is how it manages the potential conflict between the wishes of the managers and shareholders of the failing company and its creditors. The aim of the managers is typically to retain control, rescue the company and restore any equity value it may possess. The aim of secured creditors is often to foreclose on the assets of the company which may be to the detriment of junior creditors. Junior creditors on the other hand need to study remedies available to them with respect to senior creditors to preserve value and prevent being "squeezed out" of the capital structure. A major aspect of a particular bankruptcy law is how different legal jurisdictions strike a balance between these conflicting goals and this is something we discuss in the country-specific chapters in part two of this report.

The APR is a US concept that is not always obeyed in other insolvency regimes

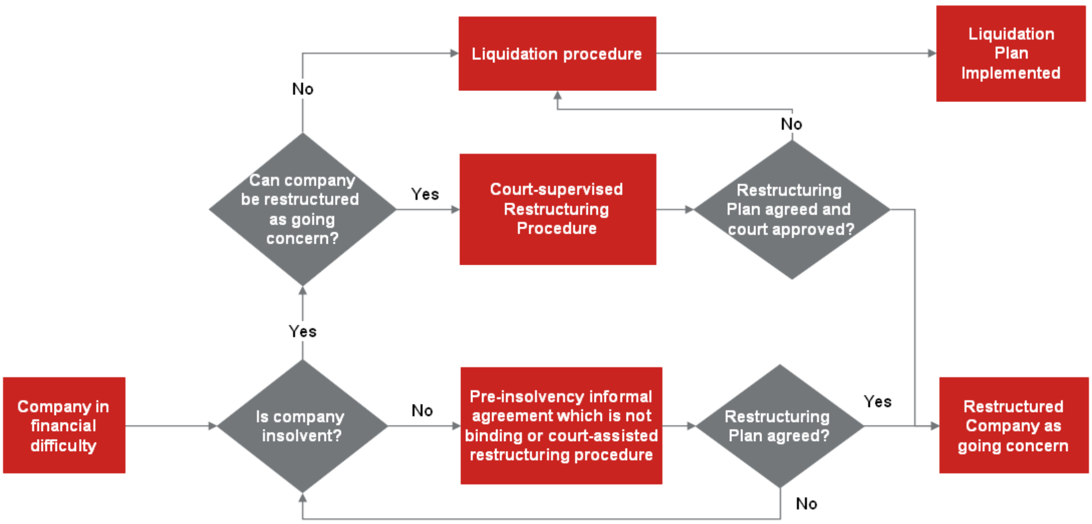
One well-known principle of liquidation is the absolute priority rule (APR). This is primarily a US concept that states that in liquidation a creditor cannot be repaid in part or in whole until a more senior creditor has been repaid in full. Although this rule only comes into effect in a liquidation scenario, it is one of the guiding principles for negotiating a debt restructuring plan in the US Bankruptcy Code since a reorganisation plan cannot be confirmed by the court if a rejecting creditor class would achieve higher recovery in liquidation. This rule is not generally found outside the US where courts may have the discretion to rule that other stakeholders, who in theory are “out-of-the-money”, should be granted a share of the bankruptcy estate.

2.1 The generic insolvency procedure

In preparation for what follows we now describe a generic insolvency process

In this section, we will set out an abstract template for the typical insolvency procedure. In particular, we will outline the many stages in the procedure and what impact these will have on the debtor company and its creditors. The purpose of this is to establish a reference for the different insolvency procedures that will be described in the review of bankruptcy regimes in part two of this report.

Figure 1. Flowchart for a generic bankruptcy procedure



Source: Nomura

The first step in the procedure is to determine whether the company is insolvent or not

Figure 1 shows a flowchart of a generic liquidation and rehabilitation procedure. It begins with a company in financial distress, which may or may not be in a state of insolvency. The first step in the procedure is to determine if the company is insolvent or not. Each jurisdiction will generally have its own definition of insolvency. In most jurisdictions it is a simple “cessation of payments” test of whether the company has failed to make a liability payment when it has fallen due. In other jurisdictions it may be a balance-sheet test that is triggered if the value of the assets of the company falls below the value of the debt. This second test is more complex to establish than a cessation of payments test. It could also be a third and more subtle test, such as whether management expects that insolvency in the future is more likely than not.

If the company is solvent, management and creditors can pursue an informal, consensual, out-of-court agreement

If the company is in financial difficulty but the test shows that the company is solvent, there is generally no requirement to enter into any formal bankruptcy procedure[2]. Management and creditors are free to conduct informal and private negotiations to restructure the debt using methods such as a standstill or forbearance agreement (described later in section 4.3). The challenge here is to find an agreement that is acceptable to all of the affected creditors, and this generally works best when they are small in number and have similar interests. As the number of creditors grows, the scale of the logistical issues involved with bringing them together for the purpose of negotiating and the risk of conflicts of interest tend to increase. These considerations only worsen

[2] Some jurisdictions do allow for a company to enter a formal procedure pre-insolvency.

when the creditors are split up into multiple classes of seniority. Moreover, engaging in restructuring negotiations with creditors can represent an event of default under certain debt contracts. There is also a timing issue since if insolvency is approaching rapidly the time needed to reach an agreement may be short.

In practice, the issues leading up to a declaration of insolvency are rarely clear cut

In practice, the issues leading up to a declaration of insolvency are rarely clear cut. Management may realise that the business is approaching insolvency and be doing its utmost to avoid default, depleting valuable cash reserves to ensure that interest payments are made and that trade creditors are satisfied. This desire to avoid default at all costs may lead management to keep its financial difficulties to itself. It may also discourage management from entering into pre-insolvency discussions with creditors.

The success of a restructuring procedure may depend on cultural issues

Cultural differences in the attitude towards corporate insolvency can have a significant effect on the way that management behaves in times of financial distress. This can clearly determine the ultimate survivability of the distressed company. For this reason, in jurisdictions where corporate default is highly stigmatised, legislators may introduce restructuring procedures that can allow restructuring agreements to be negotiated and agreed in private subject to certain strict conditions.

In some jurisdictions there is no requirement for an insolvent company to enter an insolvency procedure

If the company is found to be insolvent, considerations of public interest arise in the form of the need to protect unsuspecting creditors from extending credit to an insolvent company. As a result, some jurisdictions impose a hard requirement for a company to enter a formal insolvency procedure as soon as it becomes insolvent. Failure to do so can expose management to personal liability.

In other jurisdictions the decision to enter into insolvency proceedings is left to the directors of the company. This freedom can be used by the debtor and creditor to extend ongoing and informal negotiations. However, there is an important exception. That exception is encapsulated by the principle that once a company enters the “zone of insolvency”, the directors’ duties must be discharged in the interests of the company’s creditors rather than its shareholders. Unsurprisingly this principle finds expression in several of the jurisdictions covered in this report.

Once the insolvency process has been successfully initiated, the question is whether the company should be rehabilitated or liquidated

Assuming that the insolvency process has been successfully initiated, the next question is whether the company should attempt a rehabilitation procedure or should it simply be liquidated. This is a complex decision that in most cases has to be made by some independent adjudicator. In some jurisdictions this is a judge in a court of law and in others it may be an independent insolvency practitioner appointed as an administrator to the company. To take the decision, the adjudicator will typically confer with the company’s creditors, shareholders, management and financial advisors. A decision to restructure will only be made if there are reasonable grounds to believe that the company can emerge from a restructuring as a going concern and that such an outcome is economically superior to liquidation.

Liquidation proceedings

A company can enter liquidation proceedings if it has been determined that there is no prospect of the company emerging from insolvency in a viable form

A company will enter liquidation proceedings if there is no prospect of the company emerging from insolvency in a feasible form. In this case the liquidation procedure is intended to dispose of the assets of the company in a way which maximises the recovery of the creditors. The procedure is usually initiated voluntarily by a debtor filing a petition with the appropriate court. In some cases it can also be initiated by a creditor filing a petition together with evidence demonstrating that the debtor is insolvent. In this case the debtor can usually challenge the petition.

Once approved by the court, the liquidation procedure is typically undertaken by an insolvency practitioner that is usually an experienced member of an accounting firm. The power of the company’s management usually ceases and the liquidator sets about selling the assets of the firm. The proceeds of the sale are then distributed according to some statutory order that we call the priority of payments. It is usual for the fees of the liquidator to be the first to be paid followed by the various categories of creditors preferred by statute and then unsecured creditors. Secured creditors will usually receive the net proceeds from the disposal of any secured assets, and then rank as unsecured creditors for any claim amount not covered by these proceeds.

In some cases, a company can apply to be liquidated even if it is not insolvent

In some cases, a company can apply to be liquidated even if it is not insolvent. This is commonly referred to as a “voluntary winding-up”. It typically occurs if a company has fulfilled some purpose for which it was especially created. Management usually has to declare that the company is solvent and all of the creditors must be repaid in full. A failure to be able to do this usually converts the procedure into the more standard liquidation procedure which is controlled not by management but by the creditors.

Violation of the APR can occur in jurisdictions that view some non-creditors as stakeholders in a business

In some jurisdictions, the absolute priority rule (APR) is not strictly observed. This rule states that a creditor cannot be paid until all more senior creditors have been fully repaid. Violation of the APR can occur in jurisdictions that take the view that equity holders and employees are stakeholders in a business and retain some residual rights even if they are "out-of-the-money" in terms of their position in the capital structure.

APR deviation (or value leakage) can be due to the inefficiencies of certain bankruptcy regimes

Another practical reason for APR deviation (or value leakage) is the inefficiencies of certain bankruptcy regimes which provide out-of-the-money shareholders or creditors with an "insolvency put". This is a tactic or device which allows these parties to delay the process or force liquidation and destroy value owed to in-the-money stakeholders. In return for not exercising their insolvency put, these parties, who formally have no economic value in the company, are usually provided with some form of financial compensation, overriding the APR. The problem with overriding the APR is that unless the new framework for distributing proceeds is clearly defined, it can add uncertainty to the outcome.

Restructuring proceedings

The longer the necessary corporate restructuring is delayed the greater the risk of "value destruction"

The longer the necessary corporate restructuring is delayed, the greater the risk of "value destruction" from the company, as cash reserves fall and customers and employees leave. This detrimentally affects the likely recovery of "fulcrum" creditors, i.e. the layer of debt at the level at which the enterprise value breaks (see section 5 for an explanation). Numerous jurisdictions have therefore introduced proceedings described variously as "rescue", "rehabilitation" or as "restructuring", to allow companies breathing space in which to restructure and avert insolvent liquidation.

In some countries a company can enter formal insolvency procedures before the company is technically insolvent

Many countries permit a company in financial difficulties to enter into a formal restructuring procedure even before the company is technically insolvent. Typically, these procedures have a number of important features designed to incentivise prompt action by management, bring about stability during restructuring negotiations and to facilitate the implementation of a restructuring. These include:

1. Voluntary and involuntary restructuring.
2. A stay on actions by creditors which may be comprehensive, i.e. include both unsecured and secured creditors.
3. Management control with court or court-appointed supervision.
4. Insolvency financing with preferential status.
5. The ability of a restructuring plan to be approved by a majority subject to some standards of fairness.

We now consider each of these features in more detail.

Once insolvency has been declared, or is suspected, initiation of insolvency proceedings is usually voluntary or involuntary

The initiation of a restructuring proceeding can be voluntary or involuntary. Voluntary means that the proceedings are initiated by the company management. Involuntary means that the proceedings are initiated by one or more creditors. In the latter case, management may dispute with the creditors as to whether the company is truly insolvent and such a dispute is usually resolved by a court.

The advantage of allowing a creditor to force the company into a restructuring procedure can be viewed as a way to compel management or other creditors to begin negotiations. It may also be used by unsecured creditors wishing to benefit from any stay on secured creditors that may result. The concern for an unsecured creditor is that a rapid seizure and sale of assets by secured creditors following an event of default will only damage the recovery prospects for the unsecured creditor.

One of the most important features of a restructuring procedure is usually the stay on creditors

Indeed, one of the most important features of a restructuring procedure is usually the stay on creditors. This is particularly true in the case of action by secured creditors. When a secured creditor enforces its security, it (usually through the Security Agent) will be able to take possession of and sell assets, which may be vital to the continued existence of the company. As a result, the chances of the company being successfully rehabilitated can be greatly reduced.

A stay on actions gives the company the breathing space to negotiate a restructuring agreement

A stay on actions is therefore essential to a rehabilitation procedure since it gives the company the breathing space needed in which to negotiate a restructuring agreement with all creditors in the knowledge that secured creditors cannot suddenly veto the agreement by exercising their enforcement rights. The stay also prevents suppliers from collecting overdue payables and abandoning the company or trying to negotiate more onerous terms with the debtor, which can undermine restructuring initiatives.

Some restructuring procedures allow management to remain in control while a restructuring plan is being formulated. This makes it easier for the company to continue its operations with minimal disruption. However, it should only be possible if the creditors approve. For example, if the insolvency was caused by mismanagement then the creditors will almost surely insist on a replacement of the management. Other restructuring procedures insist on management being replaced.

The restructuring procedure usually imposes court or court-appointed supervision, which varies in scope depending on the procedure used and the jurisdiction

If management stays in control, the restructuring procedure may also impose court or court-appointed supervision. This varies in scope depending on the procedure used and the jurisdiction. Typically, a supervisor who is an insolvency practitioner – their precise title is jurisdiction specific – will be appointed. At the very least the role of the supervisor will be to assist management and the creditors to reach some agreement. In many jurisdictions, court approval is required for transactions that may be considered to be outside the scope of the normal business activities of the company.

When the management is displaced by a supervisor, a key question for creditors must be the level of competency of the supervisor who has assumed the role of manager. Given that the restructuring procedure is an attempt to preserve the economic value of the company, it is usually important for the supervisor to have the requisite skill level and experience needed to ensure that the operations of the business continue without interruption. Replacing management with a supervisor without the correct management skills can have the unintended consequence of being value-destructive rather than value-preserving for the business.

Some insolvency procedures allow the company to benefit from post-insolvency financing, which obtains preferential status

Some insolvency procedures allow the company to benefit from post-insolvency financing, which obtains preferential status in the priority of payments in any subsequent liquidation. Such financing is usually a key ingredient to a successful restructuring since additional cash is often required to maintain the activities of a business while the restructuring is being negotiated. However, obtaining such financing can be impossible or prohibitively expensive unless the lenders are provided with a level of seniority often equal to or better than that of secured creditors. While a number of jurisdictions do permit this form of preferential status financing, they do not always agree in the precise position of the financing in the priority of payments and those who provide such loans need to check the precise legal treatment. The effect of inserting these new priority creditors into the capital structure will be to “prime” existing creditors who rank below them in the priority of payments. In a minority of cases, these creditors may receive some form of compensation to “adequately protect” them from their loss of seniority.

Management, or whoever replaces management, is usually charged with producing some sort of restructuring plan within some specified time period

Management, or whoever replaces management, is usually charged with producing some sort of restructuring plan within some specified time period. This may be done by a process of negotiation with creditors via some forum in which management and creditors, or their representatives, meet. In some jurisdictions, creditors can also propose their own competing plan. The next stage is for the creditors, and in some cases the equity holders, to approve the restructuring plan before it can be implemented. To do this, the creditors usually vote in a forum known as a creditors’ meeting or in some cases a committee. Some jurisdictions will exclude secured creditors from participating in this decision to the extent that their security is “money good”.

Each class of creditors is usually allowed to vote on the plan

Precisely what majorities and what classes of creditors are needed to approve a restructuring plan is something on which insolvency regimes differ considerably. One approach is to split up the creditors’ meeting or committee into different classes. Each class will normally consist of creditors with a similar legal status and financial interest.

The division of creditors into different classes should allow the plan to address the requirements of each class of creditors

The division of creditors into different classes is intended to allow the plan to address the requirements of each class of creditors individually, subject to a requirement that it does not unfairly treat other creditors. Each class of creditors is then given an opportunity to express a view on the plan by voting. Cross-holdings where investors have positions in different debt instruments (e.g. a bond and a loan position) can complicate restructurings as conflicts can arise due to interests within a class not being aligned. Credit derivatives, which allow creditors to privately hedge their exposure, can also create unaligned interests[3].

Different jurisdictions have very different voting thresholds for the approval of a restructuring plan

Recall that in an informal restructuring, a unanimous vote in favour of a restructuring plan is required. Otherwise, any dissenting secured creditor can simply enforce their security thereby nullifying the agreement or an unsecured creditor can hold out for the preservation of the original (and advantageous) terms and conditions. In a formal insolvency procedure, the threshold for agreement is reduced below 100% and the resulting agreement is usually binding on all creditors. Some jurisdictions require a simple majority of creditors in number and value. Others impose a higher bar such as 66.6% or even 75%. A plan that is approved becomes binding on all creditors, including those creditors who voted against.

In theory, only in-the-money creditors should have any say on the restructuring plan but this does not always happen in practice

Most companies are insolvent in balance-sheet terms when they enter into a restructuring procedure meaning that the economic value of the company is less than the value of the company's debt. This means that the equity holders are out-of-the-money. As a result, the value of the company must "break" at a particular debt seniority level. Debt subordinate to this level is considered to be out-of-the-money. By this reasoning only those creditors at or senior to this level own the economic value of the company and only they should have any say on the restructuring plan. However, this is not always the case. In some jurisdictions, equity holders and employees are viewed as stakeholders in the business and granted greater influence in a restructuring plan than their economic interests would suggest.

Some jurisdictions provide for a cramdown meaning that the wishes of a class of dissenting creditors may be overridden subject to certain provisions

In order to prevent a class of dissenting creditors from jeopardising the prospects for a successful restructuring, some jurisdictions provide for a cramdown. A cramdown occurs when the wishes of an entire class of dissenting creditors are overridden subject to certain safeguards being met. For example, a class of creditors may not be allowed to veto a plan if another group of creditors with a sub par recovery vote in favour. In some cases the court will decide whether to allow the cramdown based on issues of fairness. This may involve a valuation of the company with the aim of determining the recovery prospects of the different classes of creditor.

At the end of the restructuring procedure, the company emerges as a going concern or enters liquidation

At the end of the restructuring procedure, the company either emerges as a solvent going concern with a reduced or rescheduled debt burden and a business that is perceived as viable in the long term, or the restructuring procedure fails. In the latter case, either agreement was not possible between the creditors, or the business was not determined to be feasible. In this case, the restructuring process typically converts into a liquidation process. This may actually have a beneficial effect for creditors as it can allow all or some of the company's assets to be realised in a more stable environment than liquidation, and therefore achieve a higher recovery.

When a process is viewed as being destructive, creditors may prefer to avoid it all together

While a restructuring process may appear to contain some or all of the provisions listed above, it does not automatically follow that it will be a successful procedure. A successful procedure is one that creditors and debtors find efficient, fair and reasonably predictable. Additional factors such as the level of expertise of the appropriate court, the speed of proceedings and the ability of the court to impose long-lasting moratoriums can also tip an otherwise constructive procedure into one that is perceived as being destructive. In some rare cases, it is possible for a restructuring procedure to be considered as so potentially destructive that creditors prefer to seek an informal, out-of-court agreement rather than use it. In certain limited circumstances discussed in detail in later sections, it is also possible for a company to shift its centre of main interests to another jurisdiction in order to benefit from a jurisdiction with more favourable restructuring procedures.

---

[3] It is worth noting that the true financial interest of a creditor may be different from that based solely on their debt holding, e.g. if they have used a credit default swap to hedge their exposure. It is possible for creditors with credit derivative protection to have an incentive to block a consensual restructuring in order to trigger a credit event that allows them to receive payment on their protection. For example Lyondell Chemical Company in the US Bankruptcy Court, Southern District of New York (Case No.09-10023), saw the court issue a temporary restraining order using section 105 of the US Bankruptcy Code to restrain holders of credit default swaps, who were attempting to accelerate the bonds in order to trigger a credit event. The planned acceleration would have potentially jeopardised the restructuring of the company in the court's eyes.

The costs of restructuring can be significant and depend on the duration and size of the case

One important cost of restructuring is the fees to be paid for the court, lawyers and insolvency practitioners. These typically rank first in any liquidation and need to be paid out of the cash reserves or asset disposal proceeds of the restructured company. In general, the amount of the fees will depend on the duration, size and complexity of the insolvency case and detrimentally impact creditors' recovery. They are generally larger for rehabilitation procedures which replace management with insolvency practitioners.

Fees can be reduced by a fast pre-pack restructuring plan

One way to avoid large fees is for the debtor and creditor to agree to a pre-pack restructuring in which the plan of restructuring is drawn up and agreed before the bankruptcy filing. Given a sufficient level of creditor approval, on filing, the plan can be put into more or less immediate effect and the cost of the procedure is then greatly reduced. A number of jurisdictions provide for such a procedure.

3 A SURVEY OF CORPORATE DEBT

Companies have two main sources of financing: debt and equity

Companies have two main sources of financing: debt and equity. Determination of the appropriate balance between the two requires companies and their prospective lenders to strike a balance between the cost of debt (and their ability to service it) and equity financing to arrive at the appropriate capital structure. In the case of financial institutions, managers and regulators need to create a financing structure consisting of debt and equity that matches the maturity profile of its assets and liabilities and, at the same time, ensures sufficient levels of liquidity to safeguard against short-term funding difficulties.

For investment grade companies, the financing source is driven by a need to maintain a rating while at the same time minimising equity dilution

At the risk of oversimplifying, the financing source for investment grade companies is driven by a need to balance the competing desires of maintaining the investment grade rating by limiting its financial leverage, while at the same time minimising equity dilution. This also leads management to search out cheaper and alternative sources of funding. Indeed, well-developed investment grade bond markets in North America, Europe and Asia can diversify the sources of corporate debt funding at more favourable spread levels to bank loans and enable companies to extend their debt maturity profile, thus reducing their reliance on shorter-term funding.

For sub-investment grade companies, the main sources of funding are leveraged loans and high-yield bonds

For sub-investment grade credit quality companies, one of the main sources of funding is leveraged finance, i.e. leveraged loans and high-yield bonds. These forms of financing are used by companies that have, or intend to have, debt levels above those normally found in that industry. This is usually done for specific reasons such the financing of an acquisition or buy-out. High-yield bonds are also preferred because they generally impose less restrictive covenants on the borrowing company than loans. However, the amount of leveraged finance available to a company is limited in terms of the amount of capital that bank lenders and equity investors will commit to a capital structure given the nature of the collateral and their risk limits.

Market Survey

There is a fairly even split between bonds and loans across Europe and North America

We now wish to compare the size of these different debt markets. More specifically we wish to understand how the usage of bonds and loans differs at a regional level. We also want to understand how the US, Europe and the rest of the world differ with regard to the credit quality of the company. To do this, we have gathered data on the outstanding notional of corporate debt broken down by bond and loan, by region and by investment grade versus sub-investment grade.

Figure 2. Global outstanding corporate debt broken down into bonds versus loans and by region of issuer domicile

Outstanding Notional ($bn)	Corporate Bonds (investment grade and high-yield bonds[4])	Loans (investment grade and leveraged loans)
Europe	1,989	5,419
North America	3,310	5,518
Rest of the world	1,379	2,952

Source: Dealogic April 2010

Loans are a more important source of corporate funding in Europe and the rest of the world than in the US where the bond markets play a larger role

Figure 2 shows the notional in dollars of all outstanding corporate bonds and loans by region. We see that the outstanding notional of the European loan market, at $5,419bn, is more than twice the size of the European corporate bond market at $1,989bn. At $5,518bn, the outstanding notional of the North American loan market is only about 50% larger than that of the North American corporate bond market size at $3,310bn. We can also compare the size of the corporate bond markets by region and we see that the North American corporate bond market is also more than 50% larger than its European equivalent. We conclude that loans in general are a more important source of corporate funding in Europe and the rest of the world than in the US, where the bond markets play a larger role.

[4] We have excluded financial companies from this data survey. The data includes MTN issues.

Figure 3. Breakdown of the international corporate bond markets into investment grade and sub-investment grade bonds by region of issuer domicile

Outstanding Notional ($bn)	Investment Grade Corporate Bonds	HY Corporate Bonds
Europe	1,889	99.6
North America	2,630	680
Other	1,231	26

Source: Dealogic April 2010

Lower credit quality companies in Europe are more dependent on the loan markets for funding than comparable credit quality companies in the US

Figure 3 shows a breakdown of the international corporate bond market by region, subdivided into investment grade and high-yield bonds. The main difference between the North American and European bond market is the much smaller size of the European high yield market. The North American high-yield market has a size of $680 billion which is about seven times as large as the European high-yield market size of $99.6 billion. We conclude that lower credit quality companies in Europe are more dependent on the loan markets for their funding than comparable companies in the US.

Figure 4. Breakdown of the global loan market by loan quality and region of domicile of issuer

Outstanding Notional ($bn)	Investment Grade Loans	Leveraged Loans	Highly Leveraged Loans
Europe	3,758	1,695	34
North America	3,070	3,552	1,104
Rest of the world	2,657	342	47

Source: Dealogic April 2010

The European investment grade loan market is larger than its US equivalent

Having looked across the corporate debt markets and into the bond market, we now look at the structure of the corporate loan market. Figure 4 shows a breakdown of the global loan market into investment grade, leveraged and highly leveraged loans and by region. We see that the investment grade loan market in Europe is larger than its North American equivalent. We also see that the outstanding notional of the investment grade loan market in the rest of the world is not that much smaller than that in Europe and the US. This reflects the greater importance of good quality corporate bank lending versus capital market lending outside North America.

When it comes to lower credit quality companies, the US has more developed bond and loan markets than Europe

However, this reverses for leveraged and highly leveraged loans (discussed in section 3.2) as we see that the outstanding notional for lower credit quality corporate loans is larger in the US than in Europe and the rest of the world. This shows that when it comes to lower credit quality companies, the US has both a more developed bond and loan market than Europe and the rest of the world.

Another feature which differentiates the loan markets of Europe and the US is the greater use of private loans in Europe

Another important difference between the bond and loan markets in Europe and the US appears when we consider the question of public and private debt. In the US and Europe, almost all bond issues are public. However, while most loan issues in the US are public, most loan issues in Europe are private. Investors who wish to either hold or analyse whether they are interested in buying senior bank debt are able to get access to additional information such as management forecasts, monthly financial results and additional information about the company's credit arrangements if they choose to be "taken private".

Organisations and individuals need to balance market liquidity against the informational advantages of being private

Compliance rules mean that it is not possible to trade public securities (bonds and CDS) while having access to privileged private information concerning the issuer. Organisations and individuals therefore need to balance their ability to trade these public securities against the informational advantages of being private. Ultimately, prospective buyers of European private loans must choose whether or not they wish to be taken private. In most cases, where public securities of the company trade, hedge funds and investment banks will choose to trade leveraged loans from the public side, therefore forgoing the benefits of private information.

By issuing different forms of debt the company can tap into the different risk-reward profiles of banks and institutional investors

We must not forget that the rationale behind all of the different forms of funding we will encounter in the following sections is for the company to have access to capital at a level that minimises its funding cost while at the same time balancing its maturity profile and retaining flexibility over its funding sources. By issuing different forms of debt at different levels of the capital structure, the company is able to tap into the different risk-reward profiles of banks and institutional investors. We now describe these different debt instruments in more detail.

3.1 Bonds

Large corporate entities have a choice of taking out a loan or issuing bonds. The choice is typically driven by credit profile, disclosure, speed of execution, size and pricing

When large corporate entities wish to borrow, they have a choice of taking out a loan, usually with a bank syndicate, or issuing bonds into the capital markets using one or more investment banks as bookrunner, and sometimes underwriter. The choice is typically driven by credit profile, disclosure, speed of execution, size and pricing. In the US, and increasingly in Europe and Asia, it is uncommon for a bond not to be rated by one or more of the credit rating agencies. The credit rating of an issuer dictates the universe of buyers.

Investment grade bonds

Many buyers of corporate bonds are limited to investment grade bonds

Many buyers of corporate bonds, such as pension funds, mutual funds, banks and insurance companies, have restrictive investment mandates and thus are limited to investment grade bonds. Large investment grade companies often choose to borrow in the investment grade bond market because they find that it is often a cheaper source of funding than bank loans. This is because it matches the needs of long-term institutional investors who require good quality, long duration assets with the borrowing needs of the company.

The governing rules for the bond are set out in either the bond indenture or the trust deed. The trustee is a party to that document and acts on behalf of the bondholders during the life of the bond.

Large corporate bond issues are usually underwritten by a group of lead managers

Corporate bond issues are arranged by a lead manager who works with the company to determine the structure of the bond and then builds an order book to determine the price at which the bond clears the market. For large benchmark deals, the risk of the underwriter being left with a concentration of credit risk due to unsold bonds may be reduced by having more than one lead manager.

Medium-term notes reduce the risk of the underwriter

An alternative form of issuance for an investment grade company is to set up a medium-term note (MTN) program with an investment bank acting as lead manager. The bank, on behalf of the company, can then issue bonds on a best-efforts basis, and by being part of an issuance programme, the documentation can be reused with only minor changes.

The size of the bond coupon reflects market perceived credit risk of the issuer

Most bonds pay a fixed coupon, which is set on issue at a fixed spread to the coupon of a similar maturity government bond. The spread reflects the market perceived default risk of the issuer and the expected recovery of the bond in a default, which depends on its position in the capital structure of the company. In some cases, the bonds are issued with a floating coupon equal to Libor plus a fixed spread. This spread is based on the perceived credit risk of the issuer on the issue date. The coupon is floating because the Libor rate resets before each coupon payment. This lowers the interest rate duration of the bond compared with a fixed coupon bond. However, the credit duration remains similar, making it an almost pure credit play.

As commercial paper is short-dated and only issued by high credit quality companies, it does not generally feature in the bankruptcy process

One form of financing that we shall mention only briefly is commercial paper. These are short-dated unsecured promissory notes not backed by collateral with a maximum maturity of nine months. Commercial paper is issued by highly-rated corporate and financial companies to primarily fund operating expenses and provide less expensive funding than a bank credit line. It is ranked as senior unsecured debt so in any default it is *pari passu* with other forms of unsecured, unsubordinated corporate debt. Since they are short dated and are only issued by high credit quality companies, they are not generally found in the capital structures of insolvent companies.

High-yield bonds

If an issuer's credit rating is below investment grade, the bond is called "high yield"

If an issuer's credit rating is below investment grade, (BBB- and below by S&P, and Baa3 and below by Moody's), the bonds it issues will be known as "high yield" and will be of interest primarily to specialised credit funds whose investors have allowed them to buy non-investment grade or "junk" bonds.

High-yield financing is usually used once the ability to use the senior secured loan market is exhausted.

High-yield bond financing is usually a more expensive form of financing than secured loans, which it usually supplements. At the risk of oversimplifying, banks will usually lend to a limit that depends on the industry, the size of the equity injected by shareholders and the market environment, of say 3.0x to 4.5x EBITDA on a senior secured basis. To obtain the rest of the funding requirement, which may take the business to a significantly higher leverage, the company will need to issue high-yield bonds, despite the higher cost of financing. High-yield bonds are also liked by banks as they provide an unsecured (or secured but subordinated) cushion between them and the equity in order to protect them in bankruptcy. High-yield bonds also enable the company to diversify its funding sources.

High-yield debt includes "fallen angel" bonds that were downgraded from investment grade

High-yield bonds comprise not just those bonds that were issued as high yield, but also those bonds that were issued as investment grade but saw their ratings subsequently downgraded to non-investment grade. The latter are commonly referred to as "crossover" or "fallen angels", with the most famous examples being those issued by large US auto companies, such as Ford, General Motors and Chrysler.

High-yield bonds are traditionally senior unsecured obligations

High-yield bonds are traditionally senior unsecured obligations and so rank junior to senior bank debt. However, more recently, the reduced appetite from banks and CLOs for leveraged loans has led to companies issuing secured high-yield bonds. These have replaced the leveraged loans previously used by companies.

High-yield bonds tend to be bullet bonds with maturities of seven to ten years

Like investment grade bonds, high-yield bonds tend to be bullet bonds with maturities of seven to ten years, paying a fixed coupon semi-annually until maturity when they redeem at par. In practice, most high yield bonds do not remain outstanding until maturity, but tend to either be refinanced or redeemed by the issuing company after three to five years. This enables the company to refinance at a lower cost if the credit quality of the company has improved. However, this early redemption has a negative effect for investors who lose out on an above-market coupon.

Call protection assists the investor by preventing the HY issuer from calling during the first half of the bond's term of maturity

To allay investors' concerns about early redemption, high-yield bonds usually have a call protection feature that prevents the issuer from redeeming the bond during the first half of the bond's term. Following the expiry of the non-call period, the cost of calling back the bond normally starts at par plus 50% of the coupon in the first year declining to par as the bond approaches maturity. This means that the investor obtains a small premium to offset part of the loss of the future coupons if the issuer decides to call the bond early.

Some high-yield bonds incorporate a make-whole call premium

Some high-yield bonds incorporate a make-whole call premium. In return for a premium to the market price of the bond this enables the issuer to call back the bond. The premium is calculated using a pre-specified formula which sets it equal to the present value of the future coupons that would be received if the bond were to be left outstanding discounted at a fixed spread to the same maturity Treasury bond yield.

One other common feature in high-yield bonds is the equity claw-back

One other common feature in high yield bonds is the equity claw-back. This is an option that allows an issuer to redeem up to some fraction, say 35%, of an outstanding high-yield bond during the non-call period at a price of par plus accrued interest where the purchase price is funded by an equity raise. For example the issuer could decide to do an IPO to redeem 20% of the outstanding bonds at a price of 108% of par.

High-yield bonds can be issued in PIK form

High-yield bonds can also be issued which bear interest in a non-cash PIK form. PIK stands for "payment in kind" and means that rather than pay a coupon in cash, known as cash-pay, the coupon will be paid in the form of additional bonds that roll up and are cash settled at maturity.

A more credit risky version of the PIK instrument is the PIK toggle

One variation on the PIK high-yield bond is the PIK "toggle" bond. These bonds begin by paying a cash coupon but the toggle feature permits the issuer to switch off the cash-pay element at its discretion and without the approval of bondholders. A triggering of the PIK toggle may reflect the issuer's decision to preserve cash which may be needed to service non-PIK debt. The high credit risk associated with this toggle feature means that these bonds can be viewed as a bull-market phenomenon.

An important difference between high-yield bonds and investment grade bonds is their tighter documentation

In addition to their structural differences described above and their different credit quality, an important difference between high-yield bonds and investment grade bonds is their tighter documentation. Specifically, high-yield bonds will usually have more restrictive covenants (as discussed in section 4). These aim to protect the credit quality of the bonds by limiting the actions of the company, for example by requiring that certain financial ratios are maintained. These tighter covenants are intended to offset some of the investors' concerns regarding the higher credit risk attached to high-yield bonds.

Many issuers outside the US perceive the initial transaction costs and disclosures involved in issuing high-yield debt as being prohibitive

We saw in Figure 3 that the European high-yield market is smaller than the US high-yield market. There are a number of reasons for this. For a start, many first-time issuers outside the US view the costs and disclosures involved in issuing public high-yield debt as being prohibitive when compared with the financing alternatives of senior bank loans and equity. Another reason is that the fragmented nature of local markets in Europe prior to the advent of the euro had limited investor capacity and this directed Europe-based private equity investors towards loans from banks and the mezzanine loan markets. In addition, the greater uncertainty, compared with the US, about bond recovery outcomes across the many different European and Asian insolvency regimes has also damped high-yield market expansion.

We expect the European and Asian high-yield markets to grow in size

We expect the European and Asian high-yield markets to grow in size over the next few years as banks' willingness to assume leveraged loans remains impaired or becomes permanently reduced through regulatory changes.

3.2 Loans

For many companies, loans are the only source of financing

For many companies, bank loans are the primary and often the only source of financing. These loans can be bilateral or syndicated.

Bilateral loans

Some borrowers prefer bilateral loans because they can obtain better terms and pricing

Bilateral loans are loans made between a company and a single bank for an agreed period with regular interest payments and repayment of principal at maturity. Some borrowers prefer bilateral loans because they can obtain better terms and pricing, especially if they are able to lean on relationship banks who may be interested in ancillary advisory work for the borrower, or if they are able to put different banks into competition.

Syndicated loans

As the size of loans become larger, or the credit quality weakens, banks prefer to syndicate the loan

As the size of loans increases, or the credit quality of the borrower weakens, banks prefer to syndicate the loan to share the credit risk, costs and the burden of administrating the loan. Further advantages for lenders in syndicated loans are the greater liquidity and pricing transparency that they provide compared with bilateral loans. Syndicated loans are structured and arranged by a group of banks which may be commercial or investment banks, or a combination of both.

Banks either hold the resulting credit risk, sell the loan or use credit derivatives to hedge it

A typical syndication can consist of one to several lead arrangers plus any number of banks acting as lenders. They will lend using the same documentation and fees may vary depending on the size of the commitment. Banks will either hold the resulting credit risk, sell the loan or use credit derivatives to hedge it. In fact, the growth of the credit derivative market has been a key driver in the very rapid growth of the global syndicated loan market over the past decade, and vice versa.

The growth of the syndicated loan market is partly due to the bank disintermediation trend

The growth of the syndicated loan markets has also been part of a larger industry-wide trend over the past 20 years of bank disintermediation in which banks have gradually shifted their business model from being warehouses of credit risk to arrangers. Rather than hold the credit risk, they parcel it up and sell it on the various investors, thereby removing it from their balance sheet.

The syndicated loan market can be split into an investment grade loan and a leveraged loan market

The syndicated loan market plays an important role in providing leveraged companies access to credit. In markets such as Europe and Asia, syndicated loans make up a disproportionately large part of the capital structure, especially when compared to the US where the high yield bond market is more developed and prominent. The syndicated loan market can be split into an investment grade syndicated loan market and a leveraged syndicated loan market. We will focus here on the leveraged loan market as it is more relevant to insolvency.

Leveraged loans

Leveraged loans have been an important source of corporate financing

Leveraged loans are an important source of corporate financing, which has been used to satisfy a range of needs, including providing companies with working capital and capital expenditures. Because they can normally be arranged quickly, they are used widely to bridge acquisition financings However, their most important role has been to finance leveraged buyouts, in which the buyer uses the leveraged loan market to raise the capital needed to buy out the company being acquired.

Leveraged loans are secured debt

Because of the high credit risk of such M&A activity, leveraged loans are a form of debt which often features in insolvency cases. To overcome any weaknesses in the credit quality of the company, the company tends to grant the creditors security over the operating assets, shares and other forms of collateral.

There is no standard definition for a leveraged loan

There is no universal definition for what constitutes a “leveraged” loan. Bloomberg specifies a leveraged loan as one with a Libor margin greater than 250bp. Standard and Poor’s uses a criterion of a Libor margin greater than 125bp and the Loan Pricing Corporation defines leveraged loans as those with a credit rating of BB and lower.

Our definition of a leveraged loan relies on documentation

Our definition of a leveraged loan is based neither strictly on spread nor on rating, but relies on the documentation of the loan. In today’s market, most loans with margins between 125bp and 225bp are provided either to investment grade credits that undertake large, leveraging acquisitions that lead to temporarily elevated credit ratios, or to unrated quasi-investment grade companies. The documentation of these loans is more akin to investment grade loans with only a handful of restrictive covenants and a margin grid[5], which incentivises borrowers to deleverage rapidly. It is debatable whether these are leveraged loans, but since they are less frequently found in insolvencies, they will not be our focus. True leveraged loans are typically executed under LSTA, LMA[6] or equivalent leveraged loan documentation and carry a margin (spread) of around 225bp or greater.

In Europe, only one-third of leveraged loans are publicly rated while most are in the US

In the US, the leveraged loan market is fairly balanced between corporate and financial sponsor (private equity) borrowers, whereas in Europe and parts of Asia, the market is principally dominated by private equity-backed companies. These markets are inherently private ones. In Europe, only one-third of leveraged loans are publicly rated while in the US, public credit ratings are a *de facto* requirement for leveraged loan issues.

Leveraged loans are an alternative to high-yield bonds that differ in two important ways

Leveraged loans are often seen as an alternative to high-yield bonds. However, they differ in three important respects. First, leveraged loans usually pay a floating rate coupon of Libor plus a preset spread or margin and so its price has a lower interest rate duration than the comparable fixed coupon high-yield bond. Second, leveraged loans are almost always senior, both structurally and contractually, while high-yield bonds are usually senior with respect to payment but subordinated with respect to collateral. In addition in Europe, high-yield bonds also tend to be structurally subordinated as we discuss later in section 5.2.3. Third, leveraged loans usually have more restrictive incurrence covenants than high-yield bonds which makes them more attractive to creditors.

There are three main ways of issuing syndicated loans and the choice is driven largely by the geographic region

The borrower wishing to raise leveraged loan finance via a syndicate of lenders begins by appointing a set of banks to be arrangers. One of their roles is to advise the borrower on the best form of facility for its funding requirements. One or more of these arrangers will be given the task of assembling a syndicate of banks to provide the facility. Syndicated loan deals are then issued in one of three ways:

1. **Underwritten Transactions**: This is the main type of leveraged loan syndication in Europe. The arrangers first commit to provide the full loan amount and the deal is then sold down to other banks and institutional investors. If the entire loan cannot be sold then the arrangers will end up holding some of it on their balance sheets, or they can choose to sell it. The use of “flex” language in the syndication documentation reduces the market risk of the arrangers as it allows them to amend the pricing, terms or structure of the deal during the syndication process, subject to certain constraints.

---

[5] A margin grid, also known as a pricing grid, links the spread paid on the loan to the credit rating of the company or agreed financial ratios (e.g. Net Debt/EBITDA). If the rating improves or the ratio improves from a credit perspective, the margin will also fall.
[6] The Loan Syndications and Trading Association (LSTA) and the Loan Market Association (LMA).

2. **Best Efforts Transactions**: This form of syndication is very common for leveraged loans in the US and Europe. In a best efforts deal the lead banks do not underwrite the transaction and the issuer runs the risk that the loan is not fully subscribed. However, the deal usually gives the arrangers the ability to amend the terms of the loan in consultation with the borrower if needed to get the deal fully subscribed.

3. **The Club Deal**: This form of syndication is typically small and regional in nature with a typical size of up to $200 million. These are pre-marketed to banks that have a relationship with the borrower and the fees are split equally among lenders. Club deals have become more prominent during the credit crunch because of the reduced appetite of banks to underwrite deals as a result of a lack of market liquidity.

The two main forms of bank lending facilities are the revolving credit and term loan

Most syndicated loans are structured into a number of components, or facilities, designed to satisfy both the borrowing needs of the company and to appeal to the two main types of loan buyers – banks and institutional investors. The main components are the revolving credit facility and the term loan facility. Of these, the bulk of leveraged loan capital structures are funded via term loans. Other less common forms of senior bank debt include bridge loans (principally used in acquisition financing), letters of credit and equipment financing. Here we focus just on the two forms of syndicated loan facilities which we might expect to encounter in an insolvency procedure: the revolving credit facility and the term loan.

Revolving credit

A revolver allows the borrower to draw, repay and borrow again up to a preset limit for a specified period

The revolving credit facility, or "revolver", is a loan facility that allows the borrower to draw, repay and borrow again up to a preset limit for a specified period. The facility pays a commitment fee on the unused commitment which is typically 30-40% of the margin. The revolver generally ranks *pari passu* with the term loans.

In the US revolvers commonly take the form of asset-based lending (ABL)

In the US, revolvers can take the form of asset-based lending (ABL) facilities, where the funds made available are strictly limited by the assets in the borrowing base. The pool of collateral (receivables, inventory, etc) is closely scrutinised and monitored by the collateral agent and lenders. ABL revolving credit facilities are less common in Europe due to issues related to perfecting security in different insolvency regimes and the different legal forms of security. In Europe revolvers are also more likely to be used to fund working capital and capital expenditure.

Term loans

The term loan is a corporate loan in which a fixed amount of cash is borrowed for a set term at a set spread over Libor

This is the typical form of corporate loan in which a fixed amount of cash is borrowed for a set term at a pre-agreed spread over Libor – note that some term loans are subject to a margin grid or ratchet. Repayments of the term loan amount are either "amortising", i.e. scheduled contractual principal repayments made during the life of the loan, or they can be in "bullet" form, with interest payments made during the life of the loan and principal repaid in full at maturity. Unlike a revolver, once a term loan has been repaid, it cannot be re-drawn.

Most leveraged term loans are split into an amortising term loan and two bullet term loans

Most leveraged transactions include a mix of amortising and bullet maturity term loans. These are generally split into an amortising term loan A (TLA) and, prior to the credit crunch, two bullet repayment term loans B and C (TLB and TLC). Since the credit crunch term loan C has more or less disappeared. It is important to remember all tranches are governed by the same facilities agreement and rank *pari passu*.

The different types of term loan have different risk-return profiles that can appeal to different investor types

The tenor of the term loans A, B and C[7] have traditionally been consecutive years typically set at 5, 6 and 7 years (7, 8 and 9 years in Europe) respectively. These different term loans have different risk-return profiles that appeal to different investor types. The amortising term loan A is principally bought by banks as part of a pro-rata package which also includes the revolving credit facility. Banks like the term loan A for its low duration and low risk profile. The TLBs and TLCs are bought by traditional institutional credit investors such as insurance companies, investment funds, CLOs and hedge funds which view them as an interesting investment in terms of their risk-adjusted return.

[7] Outside the US.

The interest paid to TLB and TLC buyers reflects their longer duration and higher repayment risk

The interest margin paid to term loan B and term loan C tranche lenders reflects the longer duration and lack of early principal repayments that they are exposed to. Currently, typical pricing sees TLAs at spreads over Libor of 400-450bp, TLBs 50-100bp wider at 500bp and TLCs even wider, if included.

Reasons for the growth of the leverage loan asset class include their steady returns and negative correlation with many other asset classes

One reason for the growth of the leverage loan asset class is that their fairly steady and attractive returns, which were often negatively correlated with many other asset classes. were useful for portfolio diversification. With their limited interest rate risk, full security, creditor-friendly documentation, and predictable security regimes, these loans were perceived as having relatively limited downside risk. This explains why many large institutional investors, including CLO managers, mutual funds, insurance and credit hedge funds, were increasingly drawn into the loan asset class. Syndicated loans have therefore become a major asset class for institutional investors, especially in the US and Europe.

The growth in non-bank investment in syndicated loans by standardised trading and loan documentation

The growth in non-bank investment in syndicated loans has also been helped by the loan industry trade groups, the LMA and the LSTA, which have developed standardised loan documentation. This has helped to attract new participants to the loan market and in doing so created a more liquid secondary loan market. It also means that arrangers need to consider the different investment considerations of bank and institutional investors when structuring new primary deals.

DIP lending facilities

DIP facilities are granted by US bankruptcy courts to debtors who remain in possession in Chapter 11 and need access to new financing

Another special form of loan facility is the debtor-in-possession ("DIP") lending facility. These are worth mentioning given their prevalence in the US where Chapter 11 of the Bankruptcy Code encourages priority status post-filing financing. These DIP facilities are usually made available to debtors in possession (i.e. the company in a Chapter 11 procedure) by specialised lenders as discussed in section 8.1.3.

They are intended to enable the company to access the funds needed to continue to operate while a plan of restructuring is being prepared and negotiated. Judges in certain cases allow lenders to prime (subordinate) pre-existing secured claims and charge a new fair market rate to compensate for the risk. The key feature of Chapter 11 DIP financing is that it allows DIP lenders to take first priority priming liens, for example, over all working capital thereby giving them a super priority claim should the debtor be forced into liquidation.

Second-lien loans

Second-lien loans are a more aggressive form of lending than first lien

Second-lien loans are a form of syndicated debt which have existed in the US for well over a decade, and whose popularity grew enormously during the middle of the last decade. This is also true in Europe where they arrived in 2004. However, since the credit crunch, they have all but disappeared from the market. Before then, they were instrumental in financing certain types of M&A activity including large leveraged buyouts and recapitalisations.

Borrowers viewed second-lien debt as an attractive form of financing because it enabled them to pay a lower interest rate than mezzanine and high yield. Creditors were attracted by the security interest over collateral which put them ahead of senior unsecured creditors and paid relatively attractive spreads between 100bp and 150bp over TLBs.

Second-lien loans rank second (or junior) to first-lien loans

To be precise about the exact form of protection provided to second-lien debt, we first need to state that the senior secured revolver and term loans mentioned above are usually granted first-lien status. This means that they are the first to be paid off from the proceeds of selling the underlying collateral with which they have been secured. Second-lien loans rank second to the first-lien loans with respect to collateral. This means that they can get paid from the remainder of the proceeds of selling the security but only after the first-lien creditors have been fully repaid. This is known as being lien subordinated. The second-lien debt also ranks ahead of senior unsecured bonds with respect to the value of the collateral left over once the first-lien loans have been paid.

If the loans are under-collateralised, in certain jurisdictions, they rank *pari passu* with generally unsecured debt (unsecured bonds) on the gap between the size of the claim and the value of the collateral. Second-lien loans are therefore senior to mezzanine loans (described in detail below).

The precise relationship between first- and second-lien loans is set out in the intercreditor agreement

The precise relationship between first and second-lien loans is set out in the intercreditor or creditor agreement, or if not, it is set out independently the second-lien credit documents. From the perspective of the first-lien holder, it is important for this document to establish that they are the first to be paid on any collateral and that they have control over any subsequent negotiations with the borrower. The aim in the latter case is to make the second-lien holder silent, or as silent as possible so that the first-lien holder can protect his interests. The precise details are subject to negotiation. In general, security enforcement rights are much weaker in second-lien loans with joint security trustees since this typically allows the more senior first-lien loan holder to make all of the key decisions as set out by the intercreditor agreement, e.g. deciding to pursue collateral sales.

At the peak of second-lien issuance in the mid-2000s, leveraged loan investors were willing to forgo warrants and equity kickers and accept looser maintenance covenants. These buyers of second-lien loans were also willing to forgo the more attractive margins paid to mezzanine and high-yield bondholders in return for the perceived safety of owning secured debt.

Collateralised loan obligations

Structured investment vehicles are another important buyer of syndicated loans, using them to create collateralised loan obligations (CLOs)

Structured investment vehicles, such as collateralised loan obligations (CLOs), are also important buyers of syndicated loans. CLOs use the syndicated loans as the source of the credit risk needed to create the investment. Specifically CLOs take a portfolio of syndicated loans and, using a waterfall priority of payments to create structural subordination, tranche up the credit risk into various debt securities, which are then sold to meet the particular risk-return demands of investors. The demand for leveraged loans to use in the creation of CLOs was an important factor in the rapid growth in leveraged buyouts in the second half of the last decade.

While a single loan presents the investor with an exposure to one specific issuer, an investment in a CLO exposes the investor to the credit risk of all of the companies in the loan portfolio. This reduces the idiosyncratic risk of the CLO. It also exposes the buyer to changes in the market implied level of default correlation between these companies.

CLOs are limited in the techniques they can use in order to restructure the debt of a distressed company

In times of distress, CLOs are generally not in a position to extend new money to cash-starved, credit-impaired companies since their rules preclude this. This can have a destabilising impact on companies in search of new money. CLOs also have a strong preference against haircutting principal and lack the flexibility to hold restructured equity. However, the lenders are also not keen to allow the company to enter bankruptcy since this will crystallise any losses. Instead, there is a preference for forbearance, which includes resetting covenant levels (see section 4.3 for a discussion), extending the amortisation period of the loan, and boosting interest margins on the loans in the portfolio. However, in practice these may not be sufficient to solve the problem of over-leveraged structures. These considerations go some way to explaining the prevalence of cashless restructurings, i.e. restructurings that involve neither haircuts nor material equity injections, since the start of the credit crunch.

Mezzanine loans

Mezzanine loans are subordinated to both the first- and the second-lien debt

A mezzanine loan is a secured loan, which can be syndicated, and is lien subordinate to first- and second-lien debt. Private equity funds tend to prefer mezzanine to high-yield bonds due to their private nature, limited disclosure requirements and the absence of call protection. However, mezzanine loans are seen as relatively expensive for the borrower versus senior bank debt.

PIK mezzanine is viewed as an equity-like investment with high returns in a bullish market, but a low recovery in liquidation

The interest payments on a mezzanine loan are normally a combination of cash pay and payment in kind ("PIK") margins. The PIK component of a mezzanine loan reflects the borrower's preference for cash preservation or an inability to service more cash-pay debt. For investors, PIK mezzanine can provide very high equity-like returns if things go well. For example, an investment of \$100 with an 8% PIK coupon per year for five years will roll up to pay \$140 at maturity provided there is no event of default.

The downside of mezzanine loans is that they are commonly lien and payment subordinated to other secured creditors which usually translates into a very low recovery if the company needs to restructure. Prior to 2005 mezzanine loans tended to include warrants to compensate investors for the increased downside risk. However, many of these were stripped away from investors during the boom years from 2005 to 2007.

Mezzanine ranks behind first- and second-lien loans in terms of paying claims from the secured collateral

Mezzanine can be issued with the same financial covenants as first-lien debt or with weaker covenants than senior bank loans. For example, in Europe, mezzanine debt has always had weaker financial covenants than bank debt and always has some form of credit support (same cross-guarantees and security as senior debt subject to legal limitations, but on a second ranking basis with). Senior lenders are typically comfortable granting mezzanine this degree of credit support. For example, mezzanine ranks behind first- and second-lien loans in terms of paying claims from the secured collateral and this may be deemed to be better than a senior unsecured claim if the collateral is worth more than the secured debt. This support is usually counterbalanced by contractual subordination and lengthy standstill periods of between 90 and 150 days as established in the intercreditor agreements.

As stated previously, mezzanine loans are typically used as an alternative to high-yield. However, in the very rare instances where both forms of debt co-exist in a capital structure the ranking of mezzanine relative to high-yield debt depends on contractual and structural considerations as discussed in section 5.

Figure 5. Example of a recent leveraged buyout capital structure

Debt type	Size (£)	Maturity	Interest margin (over Libor)
Revolving Credit Facility	30mn		L+450bp
Term Loan A	80mn	6	L+450bp
Term Loan B	240mn	7	L+500bp
Mezzanine	135mn	8	L+ 4% cash-pay + 7% PIK
Equity	475mn		N/A

Source: Nomura

Figure 5 summarises the capital structure for a typical leveraged buyout deal. This consists of loan-only financing with a revolving credit facility, a term loan A and a term loan B and a mezzanine loan. We also see that the mezzanine loan pays Libor plus 4% in cash plus a PIK coupon of 7%.

Covenant-lite loans

Covenant-lite loans are loans which have had their maintenance covenants stripped out

Covenant-lite loans are loans which have had their maintenance covenants (see section 4.1) stripped out. Instead they have financial incurrence covenants similar to those of bonds. Such loans clearly benefit issuers because they constrain them less in their actions than traditional loan covenants. At the same time a loan such as this poses a higher risk for the investor and thus should command a higher margin.

Since the credit crunch, the market for covenant-lite loans has effectively dried up

The market for covenant-lite loans only works if there is sufficient demand from investors that they are willing to forego the safety provided by appropriately restrictive maintenance covenants. They were effectively a “bull market” phenomenon and have disappeared since the start of the credit crunch. We mention them here because it is probable that such loans will be found in the capital structures of insolvent companies.

4 EVENTS OF DEFAULT

An event of default allows the owner of the debt to accelerate the instrument

In simple terms, an event of default (EoD) on a debt instrument is an event that allows the creditor to accelerate the instrument. If the creditor decides to accelerate (he can always decide not to), the debt becomes immediately due and payable at par plus the accrued interest. If this debt cannot be repaid then the company is in a state of default and will likely need to explore restructuring its debt or entering into insolvency.

There are many different events of default set out in the bond and loan documentation

There are various different events of default that lead to acceleration and these are detailed in the bond and loan documentation. The best known is when a company either chooses not to, or is unable to, make a principal or interest payment on a bond or loan. This is an event of default known more formally as a *failure to pay* or a *payment default*. There will usually be a short grace period of up to five days on interest payments. The purpose of the grace periods is to enable the company time in which to "cure" the event of default. Note that principal payment failures do not tend to have grace periods.

One way to reduce the perceived credit risk exposure for investors in high yield bonds and leveraged loans is to include covenants

After non-payment the most common trigger of an event of default is usually a covenant breach, also referred to as a technical default. Covenants are contractual statements included in the bond indenture or loan agreement that prevent the company's management from engaging in certain activities that may harm the credit quality of the company. For example, covenants may impose rules stating that an event of default will occur if certain financial ratios cross some pre-defined threshold. So-called "positive covenants" also exist which require the company to perform certain tasks, e.g. to maintain various forms of insurance. The aim of covenants is to require management to take remedial action before matters deteriorate to the extent that a failure to pay occurs.

Some covenants are tested periodically while others are tested on the borrower's engaging in a precluded action

Some covenants are tested periodically while others are only tested on the borrower's engaging in a precluded action, as defined by the credit documentation. The grace periods on covenant breaches are typically 30 days for loans and 14 to 28 days for bonds. Once again, the purpose of the grace period is to enable the company time to "cure" the event of default. We will describe the triggering and curing of covenant breaches in greater detail in the following sections.

There are many other events of default and these can include covenant breaches

There are other events of default that are included as standard in most debt documentation. These include any misrepresentation in the financial documentation of the debtor, the company entering insolvency proceedings, and the company ceasing its business activities. It is important for the borrower and the lender to be aware of all of them. Some events of default trigger automatically, while others require a trustee or agent to determine that the event was materially prejudicial to creditors.

To ensure all creditors are treated fairly, bond and loan agreements typically include a cross-default clause

A company that has experienced a payment default on one bond or loan will generally have other debt outstanding. Since the event of default on a single loan or bond will allow the affected creditor to initiate certain enforcement actions against the company, which in some cases include seizing and selling secured assets, such actions may disadvantage other creditors, who would see their recovery detrimentally affected. Therefore, in order to ensure that all creditors are treated fairly and in an orderly manner, bond and loan agreements include cross-payment default, cross default or cross-acceleration clauses to give all of the other creditors equal acceleration rights on their debt.

Cross default states that if any debt instrument has an event of default then all other debt instruments of that issuer will also be in a state of default

Cross default states that if any loan or bond of the company has an event of default then all of the other outstanding debt instruments with cross-default protection of that issuer will also default and can be accelerated by the creditors. Cross acceleration is a similar but alternative clause that can also be found in credit documentation. It states that it is the actual event of acceleration of the debt by the initially affected creditor that triggers the acceleration of the other debt. This requirement for the affected creditor to accelerate weakens the bargaining position of the unaffected creditors since their claim does not exist until acceleration occurs. As a consequence, cross default is a stronger form of protection for creditors since there is no requirement for the initial creditor to accelerate.

Cross default usually applies also to subsidiaries of the company

Debt documentation will generally specify that the cross default applies to subsidiaries of the company. The default of an operating company subsidiary may also cause the bonds issued by the holding company to default. This all depends on the loan and bond documentation and whether the subsidiary qualifies as a relevant (or principal) subsidiary or is a guarantor of holding company debt (see a discussion on this topic in section 5.2).

Creditors may agree to waive the event, effectively agreeing not to accelerate so that the company has a chance to rectify the problem

If there is an event of default, there is an alternative to acceleration. Creditors can waive the default at the company's request, typically in return for some form of compensation. Depending on the event of default, approval of the waiver requires a requisite majority or, in certain cases depending on the particular default and terms of the debt documentation, all of creditors to agree. In effect, the creditors agree to ignore the default and forgo their ability to accelerate, giving the company a chance to rectify the problem that caused the default. Waiving the default may also allow the company and its creditors to enter into discussions regarding a restructuring of the debt without the company having to fear that the debt will be accelerated if the discussions fail. In some cases the creditors may simply grant a temporary waiver.

In general a waiver will only be granted if the nature of the default is not considered serious

However, in general a waiver will only be granted if the nature of the default is not considered serious, for example, a breach of one of the maintenance covenants described in the next section. A failure to pay is usually considered a more serious default trigger than a covenant and is a breach that creditors would not generally waive. The important thing about a waiver is that once an event of default has been waived, it cannot then be used to trigger acceleration on a later date. Acceleration is only possible if another event of default occurs.

A standstill agreement can also be used

A standstill agreement can also be used to allow for a temporary halt on enforcement or acceleration rights, only allowing creditors to regain their rights after the standstill period elapses.

4.1 Incurrence covenants

Incurrence covenants are legal restrictions on the actions of the issuing company

Loan and bond covenants can be split into incurrence covenants and maintenance covenants. Incurrence covenants are legal restrictions on the actions of the issuing company that are written into the bond documentation or the loan credit agreement. Many of these restrictions are based on financial ratios that involve the well-used financial figure known as EBITDA[8], i.e. Earnings Before Interest, Tax, Depreciation and Amortisation.

They are only tested for compliance when the company undertakes one or more of several designated actions

The key feature of incurrence covenants that differentiates them from maintenance covenants is that they are only tested for compliance when the company undertakes one or more of several designated actions. These include taking on more debt or acquiring another business, either of which may weaken the creditors' positioning. They are found in both high yield and leveraged loan credit agreements. There may also be restrictions on certain financial ratios such as those defined in the next section on maintenance covenants.

Incurrence covenants are often called "negative covenants"

Incurrence covenants are often called "negative covenants" because they impose restrictions on the activities of the company. We list below some of the typical forms of negative covenant:

- There may be restrictions on the company's ability to incur additional debt. The restriction on preventing the company from assuming additional debt usually has exceptions (known as "carve outs"), allowing what is called "permitted debt", which can include debt that replaces maturing debt or debt that is vital to the ongoing business of the company. There may also be an exception allowed if the company's performance means that it can satisfy certain ratio tests. The financial ratios used typically include the fixed charge coverage ratio and the leverage ratio, defined in the following section.
- To protect the creditors' interests, there will be restrictions on granting security liens to other creditors. This is known as a negative pledge. Here also there are usually carve outs that may be governed by financial ratios with different ratios being used for senior secured first-lien and second-lien loans, and unsecured debt.

[8] EBITDA is a commonly used view of profitability and captures the main component of cash flow generation for a company. EBITDA is a useful quantity, especially on a comparative basis, because it does not take into account the effect of debt (it is calculated before interest payments are subtracted) or regional effects such as differing tax regimes. Even though it is not reported according to official accounting standards such as GAAP, it is easily calculated by taking the EBIT or operating profit from the income statement and subtracting away the depreciation and amortization from the cash flow statement.

- There will be limits on the company's ability to make certain capital expenditure and investments.
- There may also be restrictions on the type of business the company can undertake.
- There may be limits on certain payments with affiliates with conditions to ensure that these payments are arm's-length and have board or independent approval.
- There may be limits on selling certain assets, and engaging in mergers and acquisitions activity.
- Dividend payments may also be prohibited, especially if they can push the company into default.

Incurrence covenants may have some cure period

By definition, incurrence covenants only trigger an event of default if the issuer engages in one of the non-permitted activities. There may also be some "cure" period to allow the company to rectify the covenant breach before an event of default is triggered. If one of these covenants is broken then the bond or loan is in a state of default.

4.2 Maintenance covenants

Maintenance covenants are tested periodically

Maintenance covenants are conditions imposed that are contingent on the performance of the company. They have many similarities with incurrence covenants, but with one important difference – they are tested periodically rather than following the occurrence of a specific event. Maintenance covenants are normally found in bank loan agreements where the covenants are generally stricter than those found in bonds.

At the very least they require the company to perform certain actions on a periodic basis

Due to their periodic testing, maintenance covenants can require a company to perform certain actions on an ongoing and periodic basis. These include basic things such as keeping records, paying taxes, maintaining insurance, providing regular financial reports and maintaining assets. These are called affirmative covenants, as opposed to negative covenants which restrict the actions of the company.

These are usually tested on a quarterly basis

They may also require the periodic testing of a number of the financial ratios including those discussed in the previous section. For example, maintenance covenants can include tests of the net worth, earnings, leverage ratios and fixed-charge coverage ratios. These are usually calculated, tested and reported on a quarterly basis.

There are several important financial ratios that are widely used in covenants

Some of the most important financial ratios commonly used in maintenance (and incurrence) covenants are defined below. The first is the leverage ratio defined as the amount of debt divided by the EBITDA:

$$\text{Leverage Ratio} = \frac{\text{Debt}}{\text{EBITDA}}.$$

The leverage ratio is a simple measure of how many times bigger the debt is than the EBITDA

This is a simple measure of how many times bigger the debt is than the EBITDA. Generally speaking, the larger the number the higher the credit risk and typical values vary between 5 and 10 for leveraged credits, with investment grade levels often lower. There is then the interest coverage ratio that is defined as the EBITDA divided by the interest expense:

$$\text{Interest Coverage Ratio} = \frac{\text{EBITDA}}{\text{Interest Expense}}.$$

The interest coverage ratio tells us how many times EBITDA can cover the annual cost of servicing its debt

The interest coverage ratio tells us how many times the EBITDA can cover the annual cost of servicing its debt. In this case a higher number generally indicates a lower credit risk. Finally, we include the fixed charge coverage ratio. This is a simple extension of the interest coverage ratio where the numerator can be the EBITDA or some other measure of cash flow and the denominator includes not just the interest costs but also the cost of meeting some pre-determined dividend expense, i.e.

$$\text{Fixed Charge Coverage Ratio} = \frac{\text{Cashflow}}{\text{Interest} + \text{Dividend Expense}}.$$

The other main types of financial covenants are the current-ratio covenant which requires the borrower to maintain the ratio of assets to liabilities above some threshold, a tangible net-worth (TNW) covenant which imposes a minimum threshold on the TNW of the company, and the maximum-capital-expenditures covenant which imposes a limit on the amount of capital expenditures.

Exact definitions vary so investors are advised to check the documentation

These are the simplest definitions of these quantities. However, exact definitions can vary so investors are always advised to carefully check the legal documentation to be sure of how the covenants are defined and what powers they grant to management.

The effect of a maintenance covenant can be much stricter than an incurrence covenant

Although a maintenance covenant may look identical to an incurrence covenant, in practice it can be much stricter because it is tested periodically. Suppose, for example, that the incurrence and maintenance covenants specify a maximum leverage ratio of 5.0x. Then suppose that the EBITDA falls so that the leverage ratio rises to 6.0x. The incurrence covenant will only be tested if the company decides to assume more debt. Given that the debt to cash flow ratio is 6.0x, the company will not assume more debt because to do so would push it into default. As a result, the company can simply avoid triggering default on an incurrence covenant by not issuing new debt.

Unlike the incurrence covenant, a company may not be able to avoid triggering the maintenance covenant

However, if this ratio is also a maintenance covenant, then it is tested at the end of each quarter. Failure of the test will cause an event of default. Unlike the incurrence covenant, the company cannot avoid triggering the maintenance covenant since the reporting of the ratios is quarterly, which enables creditors to anticipate covenant breaches based on either private (management) or public (investor) forecasts.

A maintenance covenant is seen as an early warning system for default

In a sense, a maintenance covenant is an early warning system for default. If a covenant is about to be triggered, the debtor may approach the creditors to negotiate and request that the creditors waive the breach of the covenant before it occurs rather than allow it to trigger a default. In return for waiving the breach creditors may demand a higher margin or other form of compensation for the deterioration in credit quality.

Figure 6. Use of covenants for different types of debt

Debt	Incurrence Covenants	Maintenance Covenants
First-lien loans	Yes	Yes, excluding covenant-lite
Second-lien loans	Yes	Yes, excluding covenant-lite.
Mezzanine	Yes	Typically yes
High-yield bond	Yes	No

Source: Nomura

Demand for loans has meant that private equity sponsors have been able to borrow using "covenant lite" loans

Clearly, companies prefer loose covenants, while creditors like the covenants to be tightly drawn. In recent years, when investor demand for loans was very strong, there was a tendency for covenants to be weakened creating "covenant-lite" loans. These are loans that have similar covenants to high yield bonds, i.e. they have incurrence covenants but very few, if any, maintenance covenants. Figure 6 provides a summary of the different forms of debt and the type of covenants they typically have.

4.3 The covenant breach process

A covenant breach may be fixed using a "cure"

Figure 7 sets out a generic process showing how a covenant breach can end up with the company in an insolvency procedure. The first question following the breach will be whether or not the breach is curable. In this case, it may be possible to use a cure to fix it. This is a special provision that is not available in all credit agreements.

An equity cure may be used to repair a leverage ratio covenant breach

One type of cure used in the case of the breach of a financial maintenance covenant is the equity cure. This is generally used to repair a breach of a leverage covenant by injecting equity into the company. It is common to cure the deficiency by adding the new funding directly to the EBITDA. By increasing the EBITDA, the ratio of debt to EBITDA can be brought back below its covenant threshold.

There is usually a limit to the number of times a cure may be used

Since an equity cure is not generally considered to be a lasting solution to the survivability of a business, there is usually a limit on the number of times an equity cure can be used to solve a covenant breach.

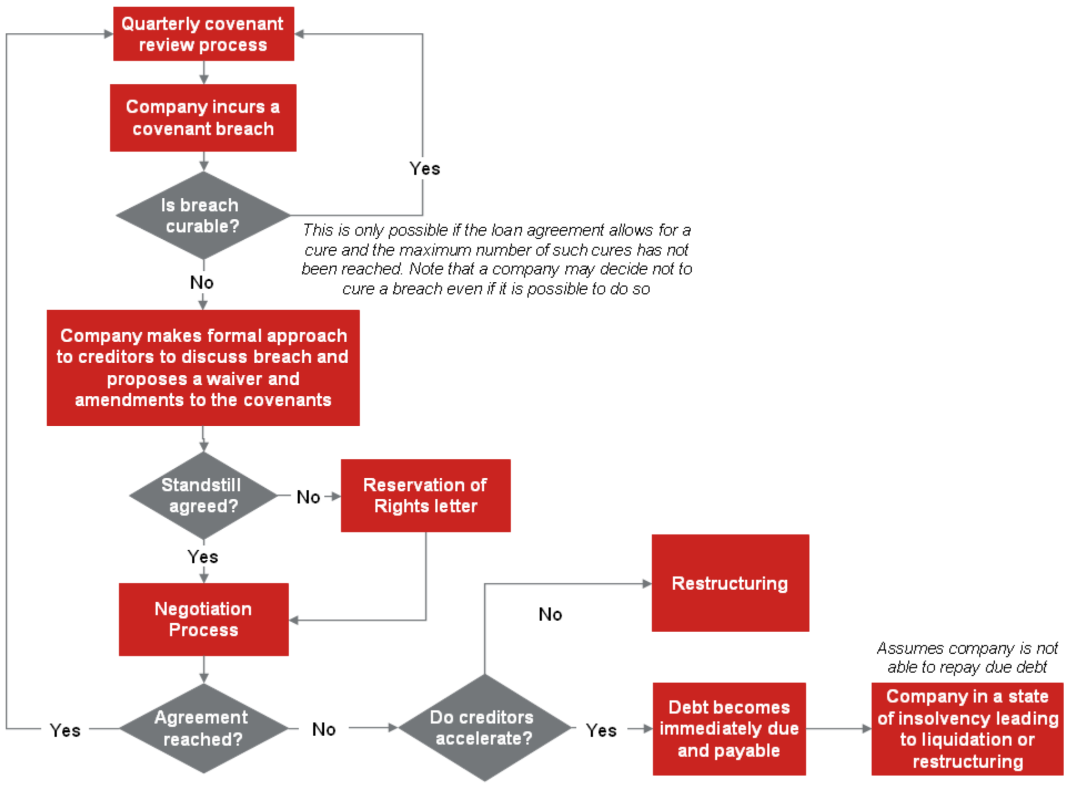
Even if a cure is possible, it may not be done if it is not a permanent solution

Historically, two or three such cures of a covenant breach are a typical limit. However more some of the more recent documentation has given some debtors unlimited cures. Even if a cure is possible, it may not always be done since the company may realise that it is not a permanent solution and may prefer to enter into restructuring negotiations.

Assuming that a covenant breach has occurred that cannot be cured, the company will usually seek to enter into formal negotiations

Assuming that a covenant breach cannot be cured, the company will usually seek to enter into formal negotiations with the creditors to first request a waiver and to then negotiate in an attempt to reset the covenant levels for a fee, or for an increase in the interest margin. If a covenant amendment or waiver cannot be agreed, the company may request a standstill while negotiations continue on the appropriate level of compensation for creditors or the company initiates debt restructuring talks with its creditors. The objective of the waiver is to get the creditor to forgo its right to accelerate so that negotiations can begin without the company having to be concerned that an acceleration of the debt is imminent. The creditor may not wish to agree to the waiver if the breach is considered serious or if creditors intend to pursue a more aggressive “loan-to-own” strategy such that they would either move to accelerate or to force negotiations into more serious restructuring scenarios.

Figure 7. From covenant breach to insolvency



Source: Nomura

At the start of negotiations, the company will usually ask creditors to sign up to a standstill agreement

In order to start the negotiations, the company will ask the creditors to sign up to a standstill agreement. This is a contract between the company and its key creditors, in which the creditors agree not to enforce their rights to accelerate the debt for some short time period while negotiations are being conducted. It is also known as a “forbearance” agreement. In some instances the creditors may not wish to sign such an agreement and will actually respond with a Reservation of Rights letter in which they retain the right to accelerate the debt during the negotiation period.

Standstills are intended to prevent subordinated creditors from enforcing their security for set periods

Senior lenders typically benefit from 120- to 180-day standstill periods which their credit agreement imposes on other creditors. During this period senior creditors are the only creditor group able to take enforcement actions. Standstills are intended to prevent subordinated creditors (second-lien, mezzanine or bondholders) from pursuing claims or enforcing their security for set periods of time depending on the type of event of default (payment, financial covenant or other). They can also be used to force junior creditors/bondholders to wait for the company to strike a deal with senior lenders before addressing the junior creditors’ breach.

If the breach is not seen as serious then it may be possible to relax the covenant thresholds to provide more "headroom"

At this point negotiations get under way. If the breach is not seen as serious then it may be possible to agree a relaxation in the covenant thresholds in order to provide more "headroom". In return for agreeing to this, the creditors will typically receive an enhanced interest margin as well as a consent fee. If agreement is reached and the debt documentation is amended accordingly, the covenant breach is cured, the company reverts back to its activities and the maintenance covenant tests resume.

If the covenant breach is seen as symptomatic of a long-term decline in credit quality then insolvency proceedings may be started

If the covenant breach is seen as something more symptomatic of a long-term decline for the company then negotiations on the covenant breach will end and the debtor and creditors will typically focus on negotiating a debt restructuring. The company will usually engage with those financial creditors who are in-the-money and also, at an appropriate time, any critical third parties whose consents may be necessary to implement the restructuring. Negotiations with creditors will focus on the options for restructuring the company by any combination of deleveraging, debt-for-equity swaps, or a pre-pack sale.

Distressed debt funds take advantage of the unwillingness of banks to take control of a business

We will now make a few final comments about factors that can affect acceleration and enforcement. First, acceleration and enforcement by secured lenders usually leads to either the sale of large parts of the business or sees them take control of the business. In many jurisdictions, secured lending banks resist taking control unless they have the necessary operational expertise. This is one of the gaps that vulture or "loan-to-own" investors attempt to exploit since they specialise in bringing in their own expert teams of management.

It is in the interest of junior creditors to ensure that payments to senior debtholders are maintained

For out-of-the-money debt holders, the preference is to see that payments to the senior debtholders are maintained since this prevents enforcement rights being used against them. In the meantime, they hope to continue to receive interest and so continue to improve their recovery to the detriment of in-the-money creditors. In this case, junior creditors need to proactively explore alternative ways to improve their recovery, e.g. by considering consensual restructuring prior to enforcement, or by injecting new capital in order to improve their leverage with senior creditors.

5 DETERMINING THE RECOVERY RATE

Recovery rates can be defined in a number of related ways

There are a number of measures of recovery used in the market that are all related but different. The rating agency Moody's defines the recovery rate as the price of defaulted debt some 30 or so days after a default event. The credit default swap market defines the recovery rate as the price obtained in an auction of the deliverable debt of a company that has experienced a credit event[9] where the auction usually occurs within 1-3 months of the credit event. For the holders of distressed debt, the recovery more generally refers to what will ultimately be obtained by creditors going through an insolvency procedure. As this procedure can result in liquidation or a restructuring of the debt with the associated haircuts, maturity extensions and other features, the final recovery can be difficult to predict.

The post-default bond price not only reflects expectations about future recovery, it is also driven by market technical factors

It is worth noting that the post-default price of bonds or loans is also not always a good predictor of the final recovery due to the significant technical effects that affect this market. This is because the funds that held the company debt before it entered insolvency are often unable or unwilling to hold the security through the insolvency procedure. Instead, they will generally sell the debt to specialist distressed debt investors. As a result, the price obtained will be driven not only by expectations of the future workout price, but also by the amount of distressed debt currently outstanding. This is believed to be one reason why average recovery rates, defined as the average price of defaulted bonds within a 30-day period after default, tend to drop as macroeconomic default rates rise. Basically, distressed debt funds do not have sufficient capacity to absorb all of the newly distressed debt and so the price drops[10].

Distressed valuation

Our focus is on the recovery defined as the final value of the debt following an insolvency procedure

In the remainder of this section, our focus will be on the recovery defined as the final value of the debt following an insolvency procedure. The starting point for any determination of the debt recovery rate is the company valuation. It is important to remember that valuation is highly subjective, especially when a company is in financial distress, i.e. it has experienced rapid erosion in its trading and financial health. The factors that determine the recovery for specific debt instruments, which differ greatly for each class of debt, are priority of debt, collateral, enforcement rights and subordination.

Recovery is also determined by whether the insolvency process can create price tension for the debtor's assets

Recovery is also influenced by the degree to which an orderly insolvency procedure can create price tension with prospective bidders for the debtor's assets. If the sale procedure is too quick and prevents buyers from performing their due diligence, and limits their access to internal information, they will be unlikely to bid. Without informed bidders seeking to pay a fair price and creditors seeking to maximise the value of the debtor's estate, we end up with "fire-sale" values being achieved, to the detriment of creditors.

We must first determine where the value "breaks" in a capital structure

The recovery of different seniorities of debt is determined by where the value "breaks" in a capital structure. This involves performing a valuation of the debtor's estate and determining which creditors, paid according to their priority of claim, end up fully repaid, partially repaid or without anything. The class of debt at which creditors receive less than their full claim is said to be the "fulcrum security". It is the security at which the value "breaks" in the structure. All holders of the fulcrum security are ranked equal (*pari passu*) and so this class of creditors will all be paid the same fraction of their face value claim.

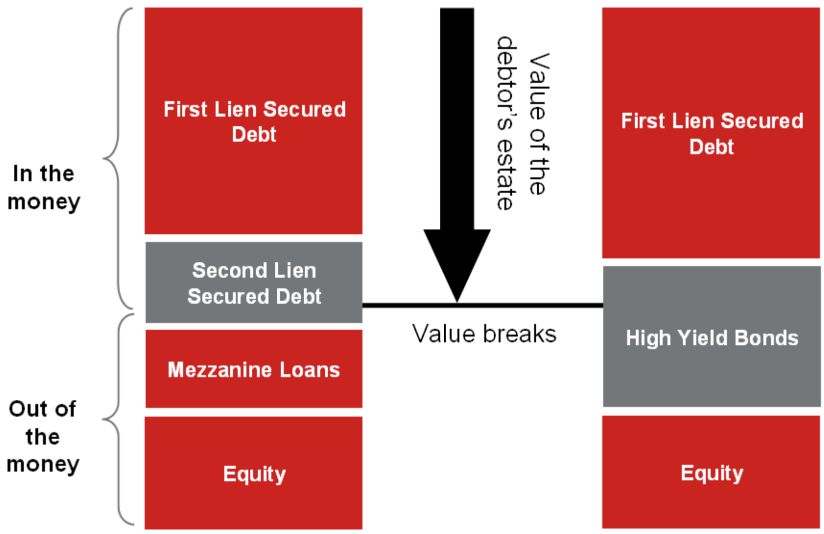
Determining where the value breaks is important in order to assess which classes of creditors are in-the-money

Figure 8 shows an example of two different capital structures and the value of the debtor's estate. For the loan-based capital structure on the left the value breaks in the second-lien loan. For the capital structure with high-yield bonds, the value breaks in the high-yield bonds. Determining the level of the capital structure at which the value breaks is important as it enables investors to assess which classes of creditors are in-the-money and so have an economic claim on assets, and whose interests should be consulted in the restructuring. This is always the starting point for any restructuring negotiation.

---

[9] In Europe and Asia the credit event is seen as a less severe event than a default since it also includes restructuring as a trigger.
[10] See *The Link between Default and Recovery Rates*: Theory, Empirical Evidence and Implications by Edward I. Altman, Brooks Brady, Andrea Resti and Andrea Sironi, November 2005.

Figure 8. Two example capital structures showing where the value breaks based on the value of the debtor's estate



Source: Nomura

Different regimes deal with out-of-the-money stakeholders in different ways

It is important for investors to review thoroughly the relevant loan and bond documentation with legal assistance to determine the strength of their position regarding security and subordination in anticipation of approaching corporate distress. This is particularly important if the insolvency process will be initiated outside the US bankruptcy regime where the range of outcomes is less certain. As we will see later in the country chapters, different jurisdictions can deal with out-of-the-money stakeholders in different ways.

In restructuring, conflicts will arise among the various levels of creditor and equity holders over how to distribute the distressed company's economic interests

An overriding principle of distressed valuation is that insolvent companies that are worth more as a 'going concern', than in a winding-up or liquidation, should be permitted to restructure in order to minimise the destruction of value. This normally requires the creditors of the company, the management team and the court or administrator to consider the economic viability of the company when determining the best course of action. Whichever restructuring route is chosen, conflicts will arise among out-of-the-money creditors, equity holders and more senior in-the-money creditors over how to distribute the distressed company's economic interests.

One of the most common approaches to determine where the value breaks is an auction of its assets as a going concern

One of the most common approaches utilised to help determine where the value breaks in an insolvent company is an auction of its assets as a going concern. The US bankruptcy code provides for bankruptcy sales, which allow the assets to be sold to a prospective purchaser free of any liens or encumbrances. In the UK, a pre-packaged administration sale serves a similar purpose of transferring and preserving the business' value. Whether asset sales are executed or merely entertained by the court, administrator or its creditors, the diligence process conducted by prospective buyers should give a clear picture of where the value breaks in the company's debt.

For secured creditors there are two commonly chosen paths that are viewed as superior to piecemeal valuation and disposal of collateral.

1. The most common is the debtor in possession route that pervades US bankruptcy. This sees management, and in some cases former shareholders, retaining control of the company and helping it to recapitalise whilst shepherding creditor reorganisation to arrive at a more sustainable debt level.

2. Debt-for-equity swaps, which typically see the partially impaired fulcrum creditors converting financial claims into new shares of the distressed debtor, are also used. These tend to be an efficient way to recapitalise and get creditors to agree to essential debt haircuts. What percentage of the new share capital the fulcrum creditors are entitled to is a function of valuation and the degree of new cash (if any) that is being infused into the restructuring.

A creditor's recovery depends on its security, payment and structural subordination

Given an enterprise valuation, creditors need to determine where they rank in terms of their security, their ranking in the priority of payments, and the position of the borrowing entity in the corporate structure. These components are paramount in allowing investors to arrive at a reasonable estimate of recovery.

5.1 Security

Security allows secured creditors to seize and sell specific collateral or a class of assets up to the claim value of the debt

In order to protect the repayment of a loan or bond, creditors usually demand some form of security. Following a default, this allows secured creditors to claim and sell specific collateral or a class of assets to cover the claim value of the debt. These assets can include property, plant, equipment, inventory, cash, receivables, intangibles and capital stock. Any residual proceeds must flow back into the bankruptcy estate.

Security assets are divided into immovables and movables

From a legal perspective, these assets can usually be divided into two broad classes. The first is known as immovables in some jurisdictions and refers to real estate. The second is known as movables and applies to almost everything else.

There are usually several legal devices that can be used to grant rights over assets to a creditor

In practice, each jurisdiction usually provides several legal devices that can be used to grant rights over assets to a creditor. The particular device used depends on the level of protection provided and the particular jurisdiction. To get a sense of the legal variation involved, we present in Figure 9 a list of the several types of security interests found in English law, along with a simplified description of how each works. Care must be taken since the same name security may differ in the rights it grants in different jurisdictions. Other legal traditions will have their own definitions of security that need to be understood to determine the precise rights of the creditor over the secured assets following a default.

Figure 9. Forms of security in English law

Name	Description
Legal mortgage	A transfer of the debtor's legal ownership of the asset to the creditor on default
Pledge	The creditor takes actual or "constructive" delivery of the debtor's assets and holds it as security until a debt is repaid.
Lien	This is the right to retain possession of another person's property until that person performs a specific obligation. It is not the same as a pledge because the assets used as security are deposited with the creditor not for the purpose of security but for some other purpose, e.g. custody
Charge	This is the appropriation of an asset or class of assets for the purpose of paying off a debt. There are two types: fixed and floating charges.
Fixed charge	This is a security provided by a specifically designated asset. The holder of the charge does not possess the asset even though he or she is owed any proceeds from its sale. The debtor can only sell the asset once the debt has been repaid at which point the charge is released
Floating charge	This is like a fixed charge except that it is not specific to designated assets but to a class of assets which can include future assets e.g. the company stock inventory. If an event occurs that triggers the floating charge, e.g. a missed interest payment, then the floating charge attaches itself to specific assets and so becomes a fixed charge.

Source: Nomura

The creditor will always require that the collateral used as security be "perfected"

One risk that secured creditors face is that a company asset that was used to secure a loan they have made can also be used to secure other debt without their knowledge. In this case, it is unclear who has priority. To prevent this, the secured creditor must require that their collateral be "perfected". This means that the borrower who has secured a loan against some security or collateral must record this fact in some centralised public register. Loan providers will often seek a legal opinion that verifies whether the collateral has been correctly registered and that the registration lasts beyond the scheduled maturity date of the loan. In other words, they verify that the collateral has been perfected.

Each jurisdiction can have its own registrar for different types of collateral

Each jurisdiction can have its own registrar for different types of collateral. For example, in the US, the securing of a loan using real estate is registered with the Registrar of Deeds. In France, real estate is registered in the Conservation des Hypothéques and in Japan the *houmu kyoku* is the place of registration for all deeds. Other forms of security such as intellectual property, shipping, aviation and other transportation equipment will generally also have their own registrars.

With perfection, it is possible for the same collateral to secure more than one loan

Once registered and so perfected, it is then possible for the same collateral to be used to secure more than one loan. However, in most cases it is the date of registration that determines the order in which the lenders are repaid. Those securities that were registered first will be repaid first.

Following a default, a court may impose a stay on creditor actions to stop the creditor from enforcing his security

Following a default, secured creditors can be prevented from enforcing their security, i.e. taking possession of the asset, selling it and using the proceeds to repay the face value of the debt. This will occur if the company files for bankruptcy protection in a jurisdiction where there is an automatic stay, or if the stay is not automatic, the court decides to impose one. The purpose of such a stay is to give the company a reasonable prospect of carrying on its business and achieving a restructuring through the proceedings. As a result, the stay can assist the company, its management and its creditors to negotiate some restructuring plan intended to allow the company to continue as a going concern. In the case that the subsequent decision is to put the company into liquidation, the stay is usually disapplied.

5.2 Subordination

Subordination is, by definition, a relative concept

Subordination is, by definition, a relative concept. A bond or loan is subordinated to another more senior bond or loan if, after a default and liquidation, it only gets paid what remains after the more senior bond or loan has been paid. We describe below the three ways in which this subordination can be created.

5.2.1 Subordination by lien

Lien subordination is all about the rules needed to enforce the priority of the first lien creditors relative to the second-lien loan creditors

If the company enters a liquidation procedure, this usually begins with a listing of all the assets of the company and an assignment of some sort of value to them. As discussed previously, some or all of these assets may have been used to secure the company's debt. First-lien secured debt holders can enjoy the proceeds from any sale of these assets up to the value of their claim. If there is a second-lien debt holder then he will be paid with any remaining proceeds. Any remaining value from the security then flows to the secured mezzanine creditor. This is the main rule governing subordination by lien.

Figure 10. Different types of credit documentation

The Credit Agreement	This is the governing document for a loan. It sets out the description of the loan, the size, the currency, the interest rate, the maturity, any amortisation schedule, guarantors, any early redemption rights and the precise name and status of the issuing entity. It also sets out the covenants that define when a loan is in a state of default and what remedies are allowed before a full default is triggered.
The Intercreditor Agreement	This document establishes the relationship between first lien creditors, second-lien and mezzanine creditors. Both bond holders and equity holders can also be party to the intercreditor agreement. The intercreditor agreement contains the security trustee provisions between (amongst others) the senior lenders, second lien lenders and mezzanine lenders.
The collateral trust agreement	When the debt is secured, there is also a collateral agreement that sets out the nature of the asset or assets being used as security. It also sets out the rights and the obligations of the different parties to the agreement.
Security documents	These are documents which create a security over all or part of the borrower's assets in respect of its debt obligations.

Source: Nomura

Lien subordination is set out in the inter-creditor agreement

A list and description of the various types of legal document used to create the loans in a capital structure is given in Figure 10. Of these documents, it is the intercreditor agreement that is important for first- and second-lien loan creditors since it establishes the rules about how they get paid and so establishes the lien subordination.

The main mechanic is that second-lien lenders cannot interfere with the enforcement of the first-lien creditors' security

The main mechanic used in most intercreditor agreements is enforce lien subordination is to state that the second-lien lenders will not interfere with the enforcement of the first-lien creditors' security. The second mechanic is an agreement by the second-lien creditors to stand still for some period of time after a default. This gives first-lien creditors the time needed to enforce their security. If assets need to be sold, this will need the approval of the second-lien lenders. To reassure the first-lien holder, the inter-creditor agreement will generally include some provision in which the second-lien lender will agree in advance to allow the asset to be sold. Another mechanic is for the first-lien debt holders to insist that their security is perfected before that of the second-lien debt holders.

There may be conditions on new priority loans

The intercreditor agreement might allow the company to take on US-style DIP loans provided it does not exceed a certain threshold. It may also be a condition that any DIP financing be *pari passu* with the first-lien debt.

Second-lien creditors usually retain a right to vote on a plan of reorganisation

In the event of a default, second-lien creditors usually retain the right to vote on any plan of reorganisation or any assumption of additional debt. They also retain the right of adequate protection in the form of additional collateral or replacement liens if the value of the collateral declines. They generally waive the right to seek relief against any automatic stay on the assets without the consent of the first lien holder.

The interests of the secured creditor may not be aligned with those of an unsecured or more subordinated creditor

It is worth noting that the interests of the secured creditor may not be aligned exactly with those of an unsecured or a more subordinated creditor. This is because a secured creditor may be happy to accept the quick sale of an asset provided the price covers the value of the loan. He may not be prepared to wait or negotiate hard for a higher price which would only benefit more subordinated creditors.

5.2.2 Payment subordination

Payment subordination determines how the proceeds of any liquidation flow to the different classes of creditor

Payment subordination determines how the proceeds of any liquidation flow to the different classes of creditor. Secured creditors have first access to those assets that secure their debt. If neither the first- nor second-lien secured creditors have been made whole by the proceeds from the sale of the secured assets, they must then join with the other senior unsecured creditors with whom they are then *pari passu* on their remaining claim amount. However, mezzanine creditors are payment subordinated to the first- and second-lien creditors and so will not be paid unless the first- and second-lien creditors are fully repaid.

In the rare case where the proceeds from the sale of the secured assets are more than sufficient to pay off both first- and second-lien creditors, and any secured mezzanine creditors, unsecured creditors will have rights over this remaining value.

The bond indenture or trust deed specifies the order in which bonds will be repaid

The bond indenture or trust deed is the agreement entered into by the issuer and the bond trustee, who acts on behalf of bondholders. It also specifies the seniority of the bond and may also specify which bonds will get repaid and in what order. Using this approach it is fairly straightforward to create senior, subordinated and junior levels of subordination. Each jurisdiction has its own rules about the priority of payments in liquidation. It is therefore important for the intercreditor agreement and the other credit documents to be drafted in a way that respects the bankruptcy code in the jurisdiction in which the company has its centre of main interests.

When we combine collateral subordination with payment subordination and the jurisdictional rules about priority, we arrive at a ranking of creditors which, starting with the most senior creditors, usually looks as follows:

1. **Secured Creditors**: These lenders have collateral as security in support of their credit to the extent of the value of the collateral. These creditors are usually financial creditors but may also include creditors with “quasi-security” such as trade creditors with retention of title claims.
2. **Privileged or Preferential Creditors**: This includes fees paid to insolvency professionals, administrators, receivers and court expenses. Depending on the jurisdiction it may also include certain wages and benefits and tax liabilities.
3. **Unsecured creditors**: This is the vast majority of creditors and may include financial creditors who are either not secured or are under-secured. It also includes suppliers and non-preferred employee claims.
4. **Subordinated creditors**: These are lenders that have agreed to be paid after unsecured creditors.

Both collateral subordination and payment subordination are forms of contractual subordination

Both collateral subordination and payment subordination are forms of contractual subordination since it is the clauses in the loan and bond documentation that establish the relative priority of these different bonds and loans. However, there is another form of subordination that can also affect the recovery of the debt and this is called structural subordination.

5.2.3 Structural subordination

Structural subordination is a form of subordination based on issuing debt from different entities of a corporation

Structural subordination is a form of subordination that arises when debt is issued from different entities of a corporation. The corporation will typically consist of a parent company with one or more subsidiary operating companies (OpCos). These operating companies are usually the holders of the main assets of the company and the providers of the cash required to service the debt issued by the holding company. As they are closer to the money and the assets, the operating companies are in a sense structurally senior to the holding companies.

Structural subordination is all about determining proximity to the assets

In the event of a winding up (liquidation) of the company, the effects of lien, contractual and structural subordination all come into play. Roughly speaking, structural subordination is all about determining proximity to the assets. To see this, consider the mechanics of a winding up. We start at the lowest operating company level in the structure, pay off the liabilities there and then work up the capital structure to the next level, carrying forward any surplus capital. This continues until all of the liquidation proceeds have been exhausted.

Guarantees can be used to eliminate the structural subordination

Guarantees can be used to overcome or eliminate the effects of structural subordination. In particular, guarantees from the operating companies are used to improve the recovery prospects and credit quality of debt issued from entities higher up the company structure.

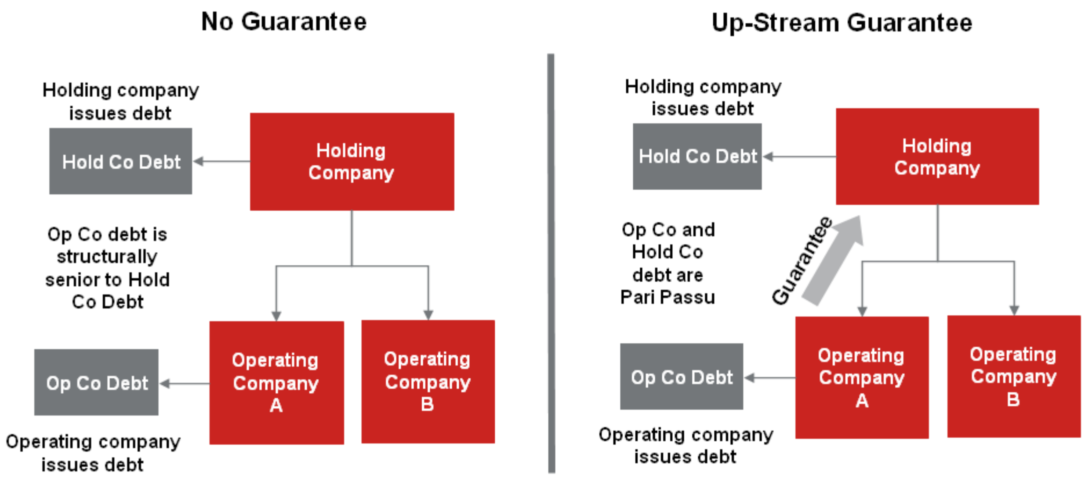
Guarantees from a subsidiary to a parent company are known as up-stream guarantees

Guarantees from the subsidiary operational companies for the benefit of the debt of other parent holding companies within the group structure are known as “upstream” guarantees and constitute a senior unsecured claim for debt issued out of the parent company. Any debt issued by a holding company or financial company with such a guarantee then ranks *pari passu* with any unsecured debt issued by the subsidiary operating company, assuming it is not subordinated.

Without a guarantee, debt issued by the operating company is structurally senior to the debt issued by the holding company

This is shown in Figure 11 where we show the case of a holding company with two operating companies A and B. If there is no guarantee, then the debt issued by operating company A is structurally senior to the debt issued by the holding company. With a guarantee in place they are *pari passu* to each other and to other senior unsecured operating company debt with respect to contractual subordination.

Figure 11. Structural subordination showing effect of an up-stream guarantee



Source: Nomura

With a guarantee they become *pari passu* with respect to contractual subordination

If the operating companies go bankrupt then the guarantee means that they must first pay off any structurally senior debt borrowed directly. They must also pay off any additional debt at the operating company level, which typically includes senior bank debt and trade creditors before any remaining cash can be passed up the organisation structure to the main holding company.

Senior bank lenders in the US are comfortable with contractual subordination for HY bonds issued out of the same entity

The importance of structural subordination depends on the region. In the US it is not uncommon for a company with senior bank loans to also issue high yield bonds out of the same entity. This is because senior bank lenders in the US are comfortable that the contractual subordination embedded in the high-yield bond documentation will protect their senior secured rights in a bankruptcy.

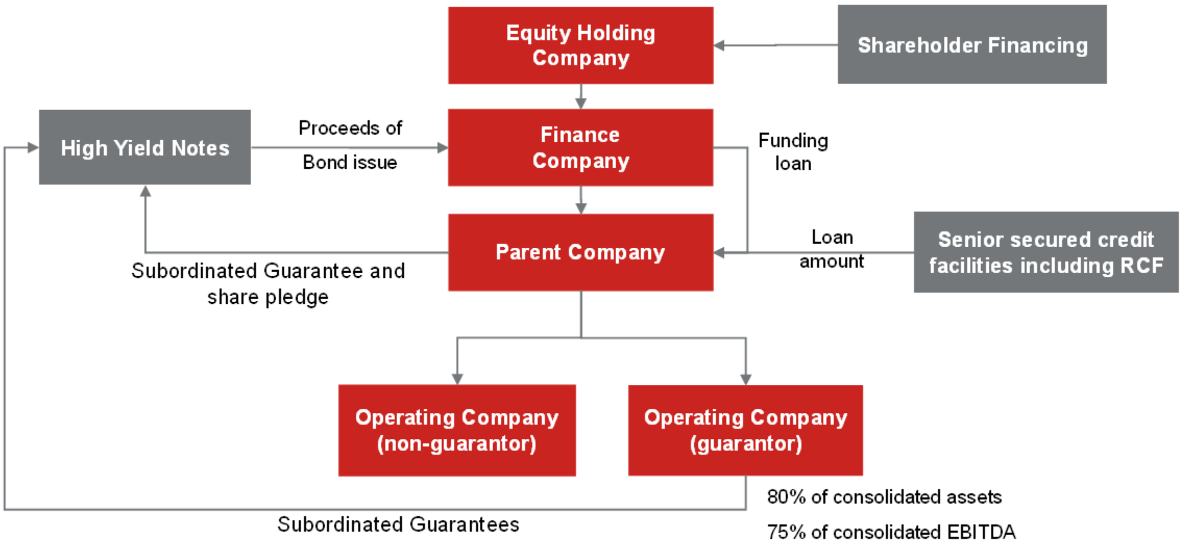
In Europe, banks tend to insist that bondholders also be structurally subordinate

In Europe, banks are concerned that European insolvency regimes will not respect their seniority rights and so tend to insist that bondholders be structurally subordinate. To achieve this, bonds are issued out of a financing holding company that is one or more levels above the operating companies in the group structure and therefore is one or more degrees more remote from the assets than the senior bank debt.

High-yield bonds will either have no guarantee from the operating companies or will at best have a subordinated guarantee

High-yield bond investors who witnessed the first generation of restructurings of European high-yield bonds, which began in 2001, recognised that they needed to improve their standing in comparison to senior bank debt and so began lobbying for structural improvements. Since the Legrand transaction in 2003, most high-yield deals in Europe have given high-yield bondholders subordinated credit support, where legally possible, from operating subsidiaries. High yield bonds therefore have either no guarantee from the operating companies, or will at best have a subordinated guarantee, whereas senior bank debt will have guarantees from all of the relevant operating subsidiaries.

Figure 12. An example corporate structure



Source: Nomura

An example of a typical European leveraged corporate structure is shown in Figure 12. This is a simplified schematic showing where structurally senior (bank debt) and junior creditors (high yield) sit within the corporate structure. The initial shareholder equity is injected at the top of this structure and then lent downwards either via intercompany loans or an equity contribution until it reaches its final destination (typically the parent company). High-yield notes are issued by the finance company with the proceeds also lent downwards to the parent company via an intercompany loan.

The parent company is where the secured credit facilities and the revolver will usually reside, provided there are no local financial assistance[11] rules preventing this. Below the parent companies are the operating companies, which can be split into two groups – those that guarantee the secured debt and provide weaker subordinated guarantees to high-yield bond investors, and those that do not. In this typical example the operating companies, that contribute the lion's share of the company assets and EBITDA, will provide those guarantees.

[11] Most European countries have rules that seek to prohibit companies from giving "financial assistance" in connection with acquisition of its own shares. These rules restrict a target company from guaranteeing a loan made to finance the purchase of its shares (as occurs in LBOs), or to otherwise provide security to a lender where money has been given for that purpose. These rules are designed to protect the share capital of the target company being diverted to leveraged shareholders and ensure that a company is not too heavily leveraged to its detriment.

The high-yield notes are structurally subordinated as they are one legal entity removed from parent company and even further removed from the operating companies

The high-yield notes are issued by the finance company, which will have virtually no assets of its own other than its funding loan to the parent company. The high-yield notes are structurally subordinated as they are one legal entity removed from parent company and even further removed from the operating companies in a wind up or liquidation. To remedy this weak position, they are granted subordinated guarantees, firstly from the operating company that owns 80% of consolidated assets and 75% of the EBITDA and also from the parent company. The secured bank debt at the parent company level is therefore in a stronger position with respect to the collateral of the operating companies given the subordinated nature of unsecured bondholders guarantee. By itself this means that these bonds are contractually subordinated in terms of payment on proceeds received by any enforcement action of secured creditors or on wind up.

5.2.4 Substantive consolidation

A court may consolidate companies if their separateness is disregarded by controlling interests

In certain circumstances and jurisdictions, a bankruptcy court may be asked to consider, and then decide whether or not all of the companies within a corporate group should be consolidated into one company for the purpose of liquidation of assets. This is known as substantive or financial consolidation and is only used when related corporate entities are so entangled that it is clear that the separateness of the legal entities is disregarded by the controlling interests.

The issue is that a consolidation may remove the effect of structural subordination and so affect recovery rates

Courts accept that this should only be used in narrowly defined instances to ensure that creditors are not materially prejudiced by such a decision. The issue is that a consolidation may remove the effect of structural subordination features and so affect recovery rates. In general, substantive consolidation issues are rare and so have little if any impact on recovery in the vast majority of cases. As a result, we do not consider it any further in this report.

6 EVALUATING A BANKRUPTCY REGIME

Before we survey the different bankruptcy regimes, we set out a list of questions whose answers will enable us to compare different treatments.

- **How is insolvency defined**? In some cases it is an inability to pay debt as it falls due, although this can be due to a lack of liquidity. Alternatively it can be when the assets of the firm have a lower value than the debt.
- **What courts are charged with insolvency cases**? Court that are specially focused on insolvency issues will be more likely to have judges with an experience of dealing with such matters.
- **What forms of security exist**? Different forms of security grant the creditors different rights. This is especially relevant in jurisdictions with a legal tradition based on English law where both fixed and floating charges exist as forms of security.
- **What are the directors' personal risks regarding insolvency status?** Very strict rules about filing for bankruptcy as soon as the company is insolvent may not allow the management the time needed to negotiate an out-of-court settlement. Very lax rules could allow the company to continue to trade when it is, to the knowledge of the directors, not a going concern.
- **Does the creditor have the right to trigger either liquidation or a restructuring?** Allowing a creditor that believes the company to be insolvent to trigger liquidation against management's wishes could increase the ultimate liquidation value of the company by preserving cash and other assets. Conversely it may allow senior and comfortably in-the-money creditors to trigger a fire sale detrimental to the recovery of subordinated creditors.
- **Is there a legally recognised restructuring procedure?** Establishing a restructuring plan outside a legally recognised formal procedure can be difficult since it requires the unanimous agreement of all the creditors. A formal legal restructuring procedure will usually facilitate the imposition of a binding restructuring plan by some form of majority.
- **Is there a stay at the start of the insolvency procedure?** The aim of a stay is to prevent the unsecured creditors from initiating or continuing legal actions against the company and to prevent secured creditors from seizing assets of the company. The stay is important as it can prevent valuable assets which are business critical from being seized. Such a stay may be automatic or may be at the discretion of a judge. There may also be a moratorium on debt servicing by the company for some period, thereby allowing it to retain its cash assets during the rehabilitation procedure.
- **Does management retain control during a liquidation or bankruptcy procedure?** If the financial difficulties of the company are viewed by creditors as a result of bad management, then creditors will have low confidence in the success of any restructuring if it is led by management. On the other hand, the costs and disruption of replacing an experienced management team with an external supervisor can sometimes be perceived as value destructive.
- **What input do creditors have in the formulation of a rescue plan?** Through negotiation, creditors would be expected to be involved in determining how the company should be restructured financially. The question is whether their degree of influence in this procedure reflects their position in the capital structure and whether debt holders who might otherwise be considered to be "out-of-the-money" get a say in the plan.
- **What power do creditors have in accepting or rejecting a rescue plan?** Here the concern is the power balance between senior secured and more junior creditors. Specifically, we want to know the voting power of creditors and whether the agreement is binding on a dissenting minority of creditors. The question is also whether the wishes of a dissenting class of out-of-the-money creditors can be overridden using a cramdown.
- **Is it possible to obtain new financing during the reorganisation process?** The introduction of additional financing can help in restructuring a company as it can provide cash flow to allow the business to continue to operate. However, the

question is the extent to which it takes priority over other claims and whether this allows existing loans to be “primed” without compensating the existing creditors.

- **Is there set-off?** If a creditor owes the company money, and can set this off against the debt owed by the company to the creditor, then this set-off effectively creates a form of security for the creditor.
- **Where do taxes, employee pay, fees and other charges rank in liquidation?** This is given by the priority of payments and the position of these claims can have an important effect on the recovery value of secured creditors and certainly unsecured creditors. It can also have a role in the formulation of a recovery plan since it may permit parties who are very junior in the capital structure to have a say.
- **How fast and proven is the process?** In either liquidation or a restructuring, the longer the process takes, the more likely it is that the economic value of the company assets will fall. A shorter process is almost always better, also because it will almost certainly result in lower fees. The length of the existence of the process, the experience of the judges and the existence of a body of past cases should make the process more predictable and assist creditors in determining how best to use the process. Also, a process which allows a restructuring plan to delay payment for several years can also be viewed as damaging to creditors.
- **Is claw-back possible and for what period** ? Claw-back occurs when transactions which occurred within some specified period before the insolvency filing are voided. It is intended to avoid granting an effective preferential treatment to certain creditors, and to stop the assets of the company from being uncommercially diminished. It applies even if no fraud was committed.
- **How large are the fees?** Both a liquidation process and especially a restructuring process reply on the time and expertise of judges, insolvency experts and lawyers. The longer the procedure takes, and the more parties involved, the greater the expense of the procedure will be and this will affect the recovery for creditors, especially those creditors who are unsecured. Since these factors vary from case to case, the only way to compare the average fees of different jurisdictions is by comparing the average time taken by a restructuring procedure in each jurisdiction.

7 SURVEY OF BANKRUPTCY REGIMES

7.1 The legal traditions for bankruptcy law

It is possible to trace the origins of almost all bankruptcy laws to the traditions of civil and common law

There is no global legal framework for bankruptcy. Instead each jurisdiction follows its local bankruptcy laws. Although there are 319 legal jurisdictions in the world, there are some basic similarities between their legal frameworks as most have their origins in one of two major traditions – civil and common law. Our aim here is to provide a quick sketch of the historical background to these two traditions and why they are found in different locations across the world. This is useful as it explains some of the differences and similarities between the bankruptcy regimes we will encounter.

Civil law

Civil law originated in Roman law which has descended to us today in a number of variations

Civil law originated in Roman law which was codified in the 6th century and has since descended to us today in a number of variations. It is based on written laws in the form of statutes and comprehensive codes which are interpreted by legal scholars in order to form its rules. The members of the civil law family can be subdivided into three distinct traditions:

- **French**: The French commercial code was written under Napoleon in 1807 and was carried to Belgium, the Netherlands, Poland, Italy and western Germany. This framework was also exported to many of the ex-colonies of these countries including North Africa and Indochina. It was also copied by the Spanish and Portuguese colonies in Latin America and South America. Overall, the French Napoleonic group of legal jurisdictions comprises about 25% of the world's jurisdictions.
- **Roman-Germanic**: This tradition comprises about 10% of legal jurisdictions. Like the Napoleonic code, the Roman-Germanic tradition originates in Roman law, but its modern form is largely based on the German Bankruptcy Act of 1879. This framework has been exported widely and has influenced legal theory and doctrine in Austria, Czechoslovakia, Greece, Hungary, Italy, Switzerland, Yugoslavia, Japan and Korea. Taiwan's bankruptcy laws come from China which borrowed heavily from the German code.
- **Scandinavian**: This is the family of law used in Denmark, Finland, Norway, Sweden and Iceland. It is probably based on Danish law. It comprises about 1.5% of all jurisdictions.

Common law

Common law originated in England and is formed by judges who have ruled on specific disputes

Common law originated in England and is formed by judges who have ruled on specific disputes. Considerable weight is assigned to previous legal decisions which are known as precedents. This legal tradition was then exported to the United States and was also carried into other countries by the expansion of the British Empire.

Common law jurisdictions currently comprise 45% of the world's jurisdictions and include economies such as the United States, the United Kingdom, Canada, Australia, India, Hong Kong, Ireland, New Zealand and Bermuda.

Other legal traditions

A number of regions sit outside these broad categories by having a mix of common law and civil law traditions

A number of regions sit outside these broad categories by having a mix of common law and civil law traditions. These include the Channel Islands, Quebec and South Africa. It is also arguable that China and Japan are mixed law since their Roman-Germanic codes also include some common law features such as the trust.

Some other jurisdictions are based on Islamic Sharia law which may in certain cases be combined with one or other of the civil or common law frameworks.

7.2 UNCITRAL and cross-border insolvency

The UNCITRAL model law is a framework designed to allow states to manage insolvency cases which cross national boundaries in an efficient, fair and cost-effective manner

Before we embark on the country-by-country survey of bankruptcy regimes, we introduce the UNCITRAL model law. In May 1997 the United Nations Commission on International Trade Law (UNCITRAL) adopted a model law on cross-border insolvency. This was developed as a framework to allow states to manage insolvency cases which cross national boundaries in an efficient, fair and cost-effective manner. One of the main aims was to enhance the ability of creditors to protect and maximise the value of debtors' assets existing in a different jurisdiction.

The model law is not intended to harmonise different insolvency regimes

The model law is not intended to harmonise different insolvency regimes. This would be almost impossible given the broad variation in legal traditions which exist and the fact that insolvency law is fundamentally entwined with the commercial law in each jurisdiction. The more achievable purpose of the model law is to create a framework for mutual recognition of insolvency proceedings, providing rights to foreign creditors and co-operation between the respective authorities of the different states. However, even a law with this narrower scope cannot easily be introduced across a large number of jurisdictions. The reason for calling it a model law is that it is a set of rules which individual states can adopt in a way which is in tune with their own legal traditions. So even if the detailed implementation of the model law may differ from one jurisdiction to another, the aim is that the spirit of the law should be similar. More specifically, the model law is designed to handle a range of situations, which include[12]:

a) Providing the person administering the foreign insolvency proceeding with access to the courts of the state enacting the model law, and so allowing the foreign representative to seek a temporary "breathing space", and allowing the courts in the enacting state to determine what coordination among the jurisdictions or other relief is needed to best expedite the insolvency;

b) Determining when a foreign insolvency proceeding should be accorded "recognition" and what the consequences of recognition may be;

c) Providing a transparent regime for the right of foreign creditors to commence, or participate in, an insolvency proceeding in the enacting state;

d) Permitting courts in the enacting state to cooperate more effectively with foreign courts and foreign representatives involved in an insolvency matter;

e) Authorising courts in the enacting state and persons administering insolvency proceedings in the enacting state to seek assistance abroad;

f) Providing for court jurisdiction and establishing rules for coordination where an insolvency proceeding in the enacting state is taking place concurrently with an insolvency proceeding in a foreign state;

g) Establishing rules for coordination of relief granted in the enacting state in favour of two or more insolvency proceedings that may take place in foreign states regarding the same debtor.

One of the most complicated situations it is intended to deal with is when there is a company with operations, assets, affiliated entities, subsidiaries and creditors in multiple jurisdictions.

To date, adoption of the UNCITRAL model law has been fairly limited

So far, there has been only limited adoption of the model law. The countries covered in this report which have adopted it are Japan (2000), the United States of America (2005), Great Britain (2006), Canada (2009), Australia (2008) and Greece (2010).

[12] These situations are taken from the *UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment* at the UNICITRAL website http://www.uncitral.org

8 NORTH AMERICA

8.1 United States

In the US, bankruptcy law is federal and so applies uniformly across all of the 50 states

The US Bankruptcy Code is perhaps the most well established and influential of all currently existing bankruptcy regimes. Its origins date back to the US constitution of 1789 which granted the US Congress the power to establish bankruptcy law. For this reason, US bankruptcy law falls under the federal law system and so applies uniformly[13] across all 50 states. The current bankruptcy framework is governed by the Bankruptcy Code which was adopted in 1978 and then amended several times, most recently in 2005.

In the US, bankruptcy proceedings are dealt with in specialised bankruptcy courts which are units of the US district courts. While bankruptcy courts only have jurisdiction over "core" matters arising under the Bankruptcy Code, they may also rule on "non-core" matters if they impact a bankruptcy case. If a party to the bankruptcy objects to "non-core" decisions being made by the bankruptcy court, then the matter may be raised to the district court for its approval, and ultimately to the US Supreme court if necessary.

There are two main bankruptcy procedures

There are two main types of bankruptcy proceeding for corporate entities in the US Bankruptcy Code. They are:

- **Chapter 7**: This is the procedure for the liquidation of the debtor under the auspices of a court-appointed trustee.
- **Chapter 11**: This is a framework for attempting to reorganise or rehabilitate a company in which management remains in control and is known as the "debtor in possession". Chapter 11 can also be used to permit an orderly liquidation of the company by management.

To be eligible for either of these bankruptcy procedures, the debtor must have a domicile, a place of business or a property in the US.

Bankruptcy procedures are not confined to insolvent companies, nor are insolvent companies required to file

Insolvency is defined by the Bankruptcy Code as a condition in which the sum of the company's debts is greater than the value of its assets. However, there is no requirement for the firm to be insolvent in order to use these procedures. Indeed, the US framework encourages giving companies an opportunity to use the special rights granted by the Bankruptcy Code to solve an approaching financial crisis sooner rather than later. There is also no requirement for an insolvent company to apply for bankruptcy protection if it can reach an agreement with its creditors.

The main form of security on property in the US is the mortgage

Although the Bankruptcy Code is federal, the granting and perfection of security is done at the level of state law using the corresponding state registry. The main form of security on property in the US is the mortgage, while security on other types of collateral is governed by the Uniform Commercial Code which applies in all but one of the 50 states. Other forms include the Deed of Trust and the Land Sale contract. With respect to secured creditors, almost any asset can be used as collateral to secure a loan. Also, there is no concept of a "floating charge" in the US. Set-off rights are also permitted by the Bankruptcy Code provided they are also permitted under state law.

8.1.1 Pre-insolvency

Companies in financial difficulty can agree a debt modification plan without going via the courts

As already noted, US companies in financial difficulty are free to reach an agreement with their creditors which may involve some modification of existing agreements and rights without entering into a formal bankruptcy procedure. However, to have any legal force, such modifications require approval from an overwhelming majority of creditors and are not binding on those creditors who do not consent. If obtaining an overwhelming majority is not possible, or if the financial status of the company is weakening and time does not permit, then bankruptcy becomes the necessary next step.

Companies can file even before the company is insolvent

A company may also decide to file for bankruptcy even if it has reached an agreement with its creditors. This can allow the company to take advantage of the special

---

[13] While the US Constitution does specify uniformity in relation to the application of the Bankruptcy Code, this uniformity does not need to be perfect. See *Bankruptcy and Debtor/Creditor* by B. Blum for a discussion.

protections provided by the Bankruptcy Code (such as a stay on all creditor enforcement actions) and benefit from the breathing space provided by the code.

The pre-insolvency period may also be used to formulate a prepackaged plan

One widely-used approach is the "pre-packaged plan" in which the debtor seeks agreement on a plan of reorganisation from its creditors in advance of any filing. Once an agreement has been reached, the company then files for Chapter 11 protection and presents its plan with the support of the various creditor groups to the bankruptcy court on the first day of the case. By doing this, the company minimises the amount of time spent in bankruptcy and consequently the negative impact that an announcement of a bankruptcy filing can have on the company.

8.1.2 Liquidation

Liquidation can be voluntary or involuntary

A company or a creditor can file a petition to start a Chapter 7 liquidation procedure. In the latter case the company can contest the filing and continue to operate the business and the onus is on the creditor to prove that the debtor is not paying its debts as they become due.

The role of the debtor in Chapter 7 is mostly passive

As soon as the petition is filed, a Chapter 7 trustee is appointed whose role is to sell the debtor's assets and distribute the proceeds to the investors. A company in Chapter 7 typically ceases ongoing operations and immediately begins winding down its business. While most of the employees will be released, a small number may remain with the company and continue to be paid in order to assist an orderly liquidation. Otherwise the debtor's role in a Chapter 7 liquidation is a relatively passive one.

There is an automatic and worldwide stay on secured and unsecured creditors

As soon as the petition is filed there is an automatic stay that stops all judgments, collection activities, foreclosures and repossessions of property that may be in progress regardless of whether they are being brought by secured or unsecured creditors. The stay also applies to set-off rights. If the company is a multinational, the reach of this stay is worldwide, affecting all the assets of the company.

The code allows assets to be sold quickly if their economic value is time sensitive and falling

The rules governing the liquidation of the assets of the company are set out in Section 363 of the Bankruptcy Code. Sales of the entire business or substantially all of its assets require court approval. An interesting and often important point of law when it comes to the liquidation of assets is the "melting ice cube" test[14]. This allows assets to be sold off quickly if their economic value is time sensitive and decaying.

In some cases a Chapter 11 liquidation may be preferable

The main difference between liquidation in Chapter 7 and liquidation in Chapter 11 is that in the latter case, it is the management which performs the liquidation of the assets and not a court-appointed trustee. Although the end result will be the same as Chapter 7, a Chapter 11 route may give the debtor more time to sell the company as a "going concern" and distribute the proceeds to creditors. As the proceeds from selling the company as a going concern are likely to be higher than those realised from a true liquidation, creditors may prefer Chapter 11 liquidation.

8.1.3 Restructuring

Reorganisation can be triggered by a voluntary or involuntary petition filing

Companies restructure under the auspices of Chapter 11 of the Bankruptcy Code. As with Chapter 7, the procedure begins with the company or a creditor filing a petition with the bankruptcy court. The automatic stay comes into effect as soon as the petition is filed and stops all creditor enforcement claims. Shortly after filing the petition, the debtor must provide the bankruptcy court with a schedule of all assets and liabilities, a schedule of current income and expenditures, a schedule of contracts and unexpired leases and a statement of financial affairs.

Management becomes the debtor in possession (DIP) and retains control of the company

A company operating under Chapter 11 protection is known as the "debtor in possession" (DIP). In a typical filing, management continues to run the business and keeps control of the company's assets, subject to the supervision of the company's secured lenders and, in most cases, a court-appointed committee of unsecured creditors. The company continues to operate, and in general the management is allowed to exercise its own judgment on most decisions occurring in the ordinary course of business. However, court

---

[14] The genesis of this test dates to a case which occurred in the period before the age of refrigeration when the sale of vegetables was permitted because they were wasting away and losing their economic value.

approval is required for transactions outside the ordinary course of business such as the sale of any significant part of the debtor's assets or the entry into a new borrowing facility.

Management can lose its DIP status if it does not perform its duties well

In cases where the management has been shown to be dishonest or guilty of mismanagement, a separate trustee is appointed by the bankruptcy court at the request of the creditors. This trustee manages the business during the restructuring procedure. Although the management tends to remain in position following a Chapter 11 filing, it does not have a free hand. Failure to manage the business well or to provide an acceptable plan of reorganisation can result in the creditors either filing their own plan, or moving to convert the Chapter 11 case into a Chapter 7 liquidation.

Supervision of the management's operation of the business is carried out by the US trustee

Management's operation of the business is overseen by the United States Trustee[15]. The US trustee is an independent public official who is not an officer of the court and whose role is purely supervisory and administrative. The US trustee periodically reviews the debtor's books and records and also conducts meetings at which the creditors may question the management under oath concerning its conduct.

The stay lasts for the duration of the case and applies to secured and unsecured creditors

The automatic stay lasts for the duration of the case, although it may be lifted "for cause" following an application to the bankruptcy court. Reasons for lifting the automatic stay over certain property or collateral can include the debtor not having any equity in the property or the property not being essential to the debtor's reorganisation. Since the stay includes secured as well as unsecured creditors, it effectively compels secured creditors to take part in the restructuring procedure in order to protect their interests.

Recent amendments to the bankruptcy code have shortened the period which management has in which to assume or reject a commercial lease

The 2005 amendments to the bankruptcy code have shortened the maximum time period which management or a trustee has in which to assume or reject a commercial[16] lease. This period is now 120 days with a single possible extension of 90 days if "cause" is established. Further extensions have to be approved by the landlord. This rule is especially important for large retail chains entering Chapter 11 with a view to undertaking large-scale store-closing programmes in order to streamline a business. It means that advance work should be done before filing in order to move quickly afterwards, especially given that the landlord has a priority ranking for post-petition claims.

The creditors' committee can play a major role in Chapter 11

The court-appointed creditors' committee, which usually consists of the seven largest unsecured creditors, can play a major role in a Chapter 11 case. It acts as a safeguard to ensure the orderly and appropriate restructuring of the company's debts and to protect the rights of unsecured creditors. The creditors' committee has the right to retain advisers, accountants and lawyers and to have their expenses paid for by the company. The committee can also interview and interact with management and obtain company records and other information.

New money can be injected into the company in the form of DIP loans which can be granted super priority status

New money can be injected into the company during this period in the form of "DIP loans". These can be granted "super priority" status so that the claim created by the DIP loan will rank above all existing liabilities (including administration fees, senior secured debts, taxes and wages) in a liquidation. With these enhanced credit rights, DIP lenders are more ready to extend financing to the company than they would otherwise have been. These DIP loans require court approval which will only be obtained if the court finds that other secured lenders have been "adequately protected", typically through the periodic payment of interest, new liens on the debtor's property (junior only to the liens ensuring the DIP loan) or the continued payment of the legal fees of the secured creditors.

Management has 120 days in which to file a plan of reorganisation

Within 120 days of the bankruptcy filing (which may be extended to a maximum of 18 months), management (or the trustee if management has been replaced and is not operating the business) must file a written disclosure and a plan of reorganisation with the court. The purpose of the disclosure document is to provide the company's creditors with enough information concerning the debtor's reorganisation and business prospects to allow them to evaluate and vote on the debtor's plan of reorganisation. Note that the debtor has the exclusive right to propose a plan during a maximum period of 18 months after the filing. If the debtor does not produce a plan within this period then a competing plan can be proposed, e.g. by one or more creditors.

---

[15] In North Carolina and Alabama the role of the US trustee is carried out by bankruptcy administrators.
[16] Or more precisely, non-residential real property.

Unimpaired creditors are deemed to accept the plan and so do not vote

The plan of reorganisation is a contract between the debtor and the various classes of creditor which must specify how each of the different classes of debt will be treated. While all of the creditors are dealt with in the plan of reorganisation, not all creditors will vote on the plan. Unimpaired creditors who are receiving full payment on their claims are deemed to accept the plan and so do not vote. Conversely, creditors who will receive nothing from the plan are deemed to reject the plan and also do not vote.

All those creditors whose claims are impaired must vote on the plan

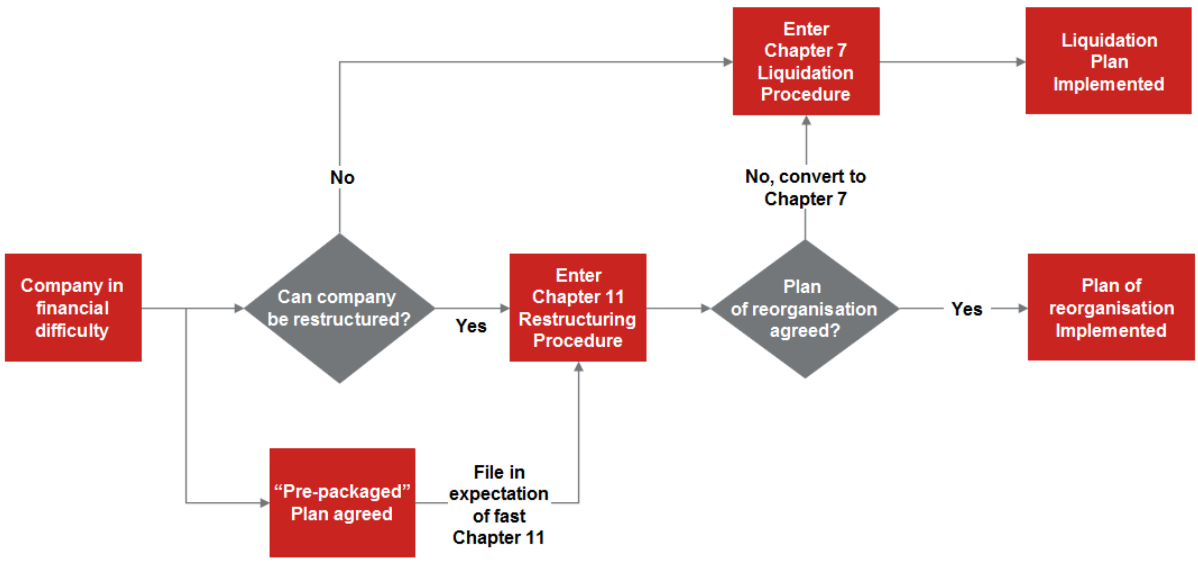
All other creditors, i.e. those whose claims are "impaired" as they will receive less than the full value of their claims, must vote on the plan. These creditors are split into "classes" of similar-situation creditors, and each creditor votes within its own class. In each class two-thirds or more of creditors by size of claim and more than 50% of creditors by number must vote for the plan for it to be approved by that class. That class is then said to have "accepted" the plan and all creditors in the class are bound by its terms even if they voted against the plan. The court cannot confirm a plan unless it has been accepted by at least one class of non-insiders[17] who hold impaired claims.

The Bankruptcy Code has a well-established cramdown mechanism

The Bankruptcy Code includes a "cramdown" mechanism in which the vote of a particular class to reject a plan of reorganisation can be overridden provided certain conditions are met. These conditions include a requirement that another class of impaired creditors must have voted in favour of the plan, that there must be no unfair discrimination, that the plan must be fair and equitable and that the plan must obey the absolute priority rule. This states that a junior creditor cannot receive any payment until all more senior creditors have been repaid in full.

Once ballots have been counted, the court conducts a confirmation hearing to decide whether the plan of reorganisation complies with the requirements of the Bankruptcy Code and can be confirmed. If the bankruptcy court decides to confirm the plan, then the debtor can put the plan into effect and emerge from Chapter 11 free of all its pre-petition debts.

Figure 13. A flow chart of the US bankruptcy process



Source: Nomura

If the plan is accepted and put into effect then the company can emerge from Chapter 11 in a state of financial good health

Assets can also be sold off during the Chapter 11 procedure provided the debtor files a motion with the bankruptcy court, gives notice to all creditors of the sale and has the sale approved by the bankruptcy court following a hearing. Section 363 of the Bankruptcy Code governs these sales and will generally allow them to take place if the debtor can show that such a transaction is in the best interests of the estate and is not being done to avoid the other more rigorous provisions of the Bankruptcy Code.

An overview of the flow chart from financial difficulty to a final state of rehabilitation or liquidation is shown in Figure 13.

[17] Insiders are relatives, general partners, and directors or officers of the debtor.

8.1.4 Priority

The Bankruptcy Code is governed by the “absolute priority rule” which states that no creditor can be paid any recovery on his claim until all creditors senior to it in order of priority have been paid in full. The relative priorities are as follows:

1. Super priority claims that result from DIP loans.
2. Administrative expenses including costs of operating the estate (including legal fees), certain taxes and any claims arising after the filing of the bankruptcy petition.
3. Limited wage claims, employee benefit plans and certain non-priority taxes.
4. Secured claims to the extent of the value of the lien securing the collateral.
5. General unsecured claims which may include any deficiency claim that results from the value of the collateral securing a secured claim being worth less than the value of the claim.

Note that since the 2005 revisions[18] to the Bankruptcy Code, a seller of goods to the debtor which occurred within the 20-day period before the bankruptcy filing has an administrative level claim to the value of the goods provided they were sold in the ordinary course of business.

8.1.5 Case studies

Chrysler

Chrysler filed for Chapter 11 bankruptcy on 30 April 2009 at the US Bankruptcy Court of the Southern District of New York because it was unable to achieve an agreement with its secured creditors over a proposed debt-restructuring plan. While a majority of the senior creditors, specifically the four major creditor banks representing 70% of the secured creditor class, had already agreed to accept $2 billion in return for their $6.9 billion of outstanding debt, equivalent to about 29 cents on the dollar, a minority of secured creditors did not accept this deal. The aim of the filing was to use Chapter 11 to impose a cramdown on this dissenting minority of secured creditors.

To provide working capital during the bankruptcy period, the US and Canadian government jointly agreed to a total of $4.5 billion of DIP financing which was priced at Libor + 300bp. The DIP financing was conditional on a timetable of milestones including a requirement that the sale of Chrysler be completed by 27 June.

Rather than develop a plan of reorganisation which would have taken many months, Chrysler proposed a sale of its assets under section 363 of the Bankruptcy Code to a new company called New Chrysler, for $2 billion. This new company would be owned by a number of entities including a subsidiary of Fiat (20%, with an option to acquire up to 35%), the United Autoworkers’ benefit plan known as VEBA (55%), the United States (8%) and an agency of the Canadian government called EDC (2%).

This proposal was contested by some of the secured lenders who argued that the absolute priority rule was being violated since the sale would result in certain unsecured creditors receiving recoveries before all secured lenders had been paid in full. The bankruptcy court judge rejected these legal challenges and approved the sale. This decision was immediately appealed to the Second Circuit Court of Appeals and eventually to the United States Supreme Court. The appeals were not successful and the sale of Chrysler occurred on 10 June 2009.

In the final ruling by the Second Court of Appeals, the decision to disallow the appeal was explained. It first stated that the use of a Section 363 sale was permitted using the “melting ice cubes test” which allows an asset to be sold if its value is deteriorating rapidly. Indeed, the court made this explicit saying “With its revenues sinking, its factories dark and its massive debts growing, Chrysler fit the paradigm of the melting ice cube”. It also noted that the equity values in the new company were entirely attributable to the government loans which were not a part of the debtor's estates.

---

[18] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

The Chrysler bankruptcy was a unique event which pushed US bankruptcy law to its limits in terms of the size of the enterprise, the need to move quickly and the complexity of Chrysler's liabilities. What it does show is that the US bankruptcy framework is flexible, allows for new financing, is judge-driven and can move very quickly when needed – the company was only in bankruptcy for 42 days.

However, it can also be argued that this case is highly atypical because of the way in which a minority of senior secured creditors were crammed down. While the 70% approval for the plan would normally be a sufficient number to enable a cramdown, what was considered by some as controversial was the existence of a potential conflict of interest since a majority of the senior creditors were, at the same time, dependent on the US government for funding via the TARP.

Charter Communications

In January 2009, Charter Communications, the fourth largest US company providing high-speed internet and cable services, had more than $21 billion of debt on its balance sheet and a market capitalisation of just $57 million. Despite having the necessary cash, it missed an interest payment of $73.7mn on 15 January 2009.

On 12 February 2009, Charter Communications announced that it planned to file for Chapter 11 bankruptcy and this finally happened on 28 March 2009. The plan was pre-packaged and had the backing of controlling shareholder Paul Allen, bond holders and other unsecured lenders.

The plan was challenged by one of the company's senior secured lenders, JP Morgan, which was not included in the pre-filing discussions. In the plan the company had proposed that it simply reinstate the $11.8bn of senior secured debt with new debt with the exact same terms as the previous debt. However, the fact that the market yield for Charter Communications was much higher than the coupon on this debt meant that the price of the senior secured debt was trading below par. Charter had chosen this course of action specifically to avoid cramming down the bond holders which could have resulted in them being given a higher interest rate.

This dispute played out in court where JP Morgan argued that its claim was impaired since the low interest rate and the high spread at which Charter Communication's debt was trading meant that it loans were trading below par. It also noted that there had been numerous "incurable" events of defaults due to the change of control at the company and breaches of representation. These could allow JP Morgan to accelerate its debt. It requested a stay to be imposed by the court.

The court rejected the stay and allowed the debt to be reinstated using the initial terms. This decision was seen by many as breaking with the past. In his ruling the judge stated that the circumstances of the bankruptcy were unique and were related to the once-in-a-lifetime market conditions and the fact that the plan was only viable if the senior debt was reinstated. The plan was approved on 30 November 2009.

This case was unique because it shows how junior creditors were able to reinstate senior bank debt even though it was trading below par and so was effectively impaired.

Lyondell Chemical

Lyondell Chemical, a world leading oil refiner and petrochemicals producer, filed for bankruptcy in January 2009. The company Lyondell Chemical was just the US operations of the multinational LyondellBasell, a holding company registered in Luxembourg with its main activities in the Netherlands. At the time Lyondell Chemical had assets worth about $27 billion and a debt burden of approximately $19.3 billion.

The company was able to use Chapter 11 to impose a 60-day stay on all creditor actions against the worldwide company. This prevented the opening of proceedings in other less favourable jurisdictions. The advantage of the US process was perceived to be the fact that, unlike in some European jurisdictions, management retains control during a reorganisation, and also the possibility of access to DIP funding.

Lyondell sought to raise about $8.25 billion in DIP financing. Fourteen lenders participated in the $8 billion of DIP financing that was finally approved on 1 March 2009. Of this $3.25 billion was new money.

Another $3.25 billion was provided by using DIP financing to increase existing senior secured credit facilities, a process know as “rolling-up”. It is not unusual for existing debt holders to provide additional funding in a DIP format in order to protect their existing claims which they would expect to be worth more after a successful restructuring than after liquidation. The final $1.54bn was provided by an asset-backed lending facility. To attract these lenders Lyondell was required to offer a high interest rate of 13% plus a commitment and exit fee of 7% to creditors.

The rolling up of their debt into new DIP financing by existing lenders meant that their pre-petition debt then became senior to the debt of other pre-petition lenders and this raised the issue of “adequate protection”. Other objections were also raised concerning the viability of the company as certain creditors argued that the plan deadlines were unrealistic and liable to push the company into default.

Despite this, the DIP financing was approved with the argument that the very difficult credit markets made the raising of DIP financing both difficult and expensive. Given these circumstances and the fact that without this plan the company would have had to enter liquidation, DIP finance was seen as the best overall course of action.

8.1.6 International

In 2005, the UNCITRAL model law was adopted, with some modifications, by the US as Chapter 15 of the US Bankruptcy Code. This allows a foreign representative of a foreign company to obtain US bankruptcy court recognition of foreign insolvency proceedings.

Companies which conduct most of their business outside the US can file under Chapter 11 provided they have a demonstrable link to the US

The US Bankruptcy Code can also be used by foreign companies. The Bankruptcy Code states that “only a person that resides or has a domicile, a place of business or property in the United States, or a municipality may be a debtor under this title”. The US bankruptcy court have used this to allow companies which conduct most of their business outside the US to file under Chapter 11 provided they have a link to the US which can be demonstrated such as bank accounts, dollar bond issuance or both. The advantage of a filing under Chapter 11 is that the company can benefit from the automatic and worldwide stay. However, it does not always follow that foreign courts will accept the US procedure.

This ability for foreign companies to file for Chapter 11 has been used on a number of occasions including by transport group Cenargo in 2003. This was challenged by one creditor in the English courts and ultimately required the respective judges to discuss and for a deal to be negotiated allowing a consensual administration procedure to be used.

8.1.7 Summary of procedures

Figure 14 summarises the main features of the US insolvency procedures.

Figure 14. A summary of the main US corporate insolvency procedures

Criterion	Chapter 7	Chapter 11
Purpose	Liquidation	Restructuring
Condition for entry	Court Approval	Court Approval
Stay on creditors	Yes, comprehensive stay on secured and unsecured creditors	Yes, comprehensive stay on secured and unsecured creditors
Control	Court-appointed trustee	Management stays. Court approval is needed for transactions outside the ordinary course of business.
Approval for plan	N/A	More than 50% by number and 66.7% by value in each class. At least one class of impaired creditors must approve the plan.
Binding	N/A	Yes
Court involvement	Approves petition and appoints trustee	Approves petition and approves transactions outside the ordinary course of business. Also approves final plan.
Enhanced priority financing	N/A	Yes
Average procedure time (estimate)	Typically 1.5 to 2.0 years	Six to nine months for a pre-pack while a full-blown court case with angry creditors could be two to three years on average
Recent uses	Linens N Things, Movie Gallery, Fleming Cos. Inc.	Chrysler, Lyondell Chemical, Charter Communications

Source: Nomura

8.1.8 Commentary

The US Bankruptcy Code was the first to recognise the importance of rehabilitation

To many observers, the genius of the US bankruptcy framework is that it recognises that it is generally better to try to preserve the value of a distressed company and facilitate its rehabilitation than to focus on assigning blame to management and possibly force an immediate liquidation to pay off creditors.

It is both creditor and debtor friendly

The US Chapter 11 restructuring process is both debtor and creditor friendly. It is debtor friendly because it allows management to remain in place to develop and implement a restructuring plan. It is creditor friendly because of the degree of oversight and control, and the participation in the process allowed to creditors, both secured and unsecured. It is also highly pragmatic as it seeks to maximise the chances of the company re-emerging as a going concern. At the same time it attempts to treat all creditors fairly and to preserve economic value.

It has been influential in the reform of other bankruptcy frameworks

In recent years, the Chapter 11 procedure has influenced a number of countries including France, Germany and Italy, in their attempt to improve the rehabilitation rate of distressed companies. However, the major advantage of Chapter 11 over these more recent rehabilitation frameworks is that it has been in operation in its current form since 1978. It is therefore a tried and tested process and its strengths and weaknesses are well known. This provides a level of comfort to lenders and may lower the overall risk premium and hence the financing costs of companies subject to the United States Bankruptcy Code.

8.1.9 Acknowledgements

We would like to thank David Heller and Keith Simon for their comments and assistance on this section. Their contact details are as follows:

David Heller / Keith Simon
LATHAM & WATKINS LLP
885 Third Avenue
New York, NY 10022-4834
david.heller@lw.com / keith.simon@lw.com
+1 212 906 1200

8.2 Canada

Canada has a number of insolvency laws with each applying to a different type of company

Canada has a number of insolvency laws which include the Bankruptcy and Insolvency Act (BIA), the Companies Creditor's Arrangement Act (CCAA), the Winding-up and Restructuring Act (WURA) and the Canadian Deposit Insurance Corporation Act (CDICA). These acts differ in the type of institutions they cover and the provisions they allow. In general, we can say that:

- The BIA applies to any corporation which has an office in or carries on a business in Canada. It can be used for company liquidation or rehabilitation. The BIA does not apply to many types of financial institutions nor to railways and a number of other company types (although the holding companies of such entities are covered under the BIA).
- The CCAA applies to corporations with total claims against them in excess of C$5 million. It is intended to be used for company reorganisation, although it has been used recently to facilitate the sale of a distressed business. The CCAA does not apply to various types of financial institution, nor does it apply to railways.
- The WURA provides a liquidation procedure for financial institutions.
- The CDICA provides a restructuring and reorganisation mechanism for deposit-taking institutions insured by the CDIC. It applies to banks[19] and other deposit-taking institutions.

Here, we focus on the BIA and the CCAA since we wish to understand the bankruptcy regimes for medium- and large-sized non-financial corporations.

Both the BIA and CCAA are federal

All of these statutes are federal law. Unlike the US, there is no specific bankruptcy court in Canada. Instead, it is the Superior Court in each of Canada's ten provinces that has jurisdiction over bankruptcy matters. The main insolvency proceedings in Canada are:

a) Liquidation under the BIA bankruptcy provisions;

b) BIA Restructuring Proposal; and the

c) CCAA Plan of Arrangement.

Canada has three conditions for insolvency

In Canadian law, a company is insolvent if one or more of the following three conditions is met:

1. The debtor is unable to meet its obligations as they fall due.
2. The debtor has ceased paying its obligations in the ordinary course of business as they become due.
3. The fair value of the assets of the company is less than the value of its liabilities.

Trading while insolvent is not in itself an offence but directors must show that they exercised due diligence

Trading while insolvent is not in itself an offence. However, directors do have liabilities for employee wages, unpaid taxes and unpaid pension contributions. They are only exempt from some or all of these if they can demonstrate that they exercised the due diligence and skill of a competent director. Once insolvent, a firm is only bankrupt once it or a creditor has filed a bankruptcy application.

There are two systems for security based on whether it is personal property or real estate

Security on immovable objects usually takes the form of a mortgage or charge which is registered in the land registry office for the province where the real estate is. Each province apart from Quebec also has the Personal Property Security Act (PPSA) which governs the creation and perfection of security over non-real-estate assets. Each province also has a Personal Property Security Register where non-real-estate debt can be perfected. In Quebec both personal and real estate property is registered as a "hypothec" at the Quebec registry for hypothecs.

Set-off is recognised

Both the BIA and the CCAA recognise claims for "set-off".

[19] Neither the BIA nor the CCAA apply to banks, insurance companies and railways and a number of other company types (although the holding companies of such entities are covered under the BIA).

8.2.1 Pre-insolvency

There are no formal pre-insolvency procedures. A firm will need to be insolvent before it can apply for bankruptcy according to one of the bankruptcy statutes.

8.2.2 Liquidation

Most liquidations take place under the BIA

Most liquidations take place under the bankruptcy provisions of the BIA. There are three ways for a company to enter into the liquidation procedure under the BIA:

1. The debtor can file voluntarily for an assignment in bankruptcy under the BIA if it is insolvent. In this case the assets of the insolvent company are assigned to the Official Receiver.
2. Involuntary liquidations can be initiated by a creditor if he can prove that he is owed at least C$1,000 and that the debtor has committed an "act of bankruptcy" within the previous six months, e.g. failing to make a due payment.
3. A company will also enter into liquidation proceedings automatically if it fails to file a restructuring proposal under the BIA before a specified deadline.

In all three cases, a trustee is appointed by the court. It is the trustee who is responsible for conducting the claims process and selling the assets. One of his tasks is to call a creditors' meeting within 21 days of the bankruptcy.

A stay is usually imposed on unsecured creditors

A stay is usually imposed on unsecured creditors. However, these liquidation procedures do not impose an automatic stay on secured creditors although the court may impose a limited stay if asked for and justified by the debtor.

8.2.3 Restructuring

We consider restructuring under the BIA and under the CCAA

There are two formal procedures for the restructuring of the liabilities of an insolvent business under court supervision, one under the BIA and one under the CCAA. We consider them both.

BIA restructuring proposal

The BIA allows the debtor to continue to run the company subject to overview by a trustee

Under the BIA, a debtor can propose a restructuring plan to the secured and unsecured creditors. The process starts with the debtor filing a Notice of Intention. Following this, the debtor has 10 days in which to file cash flow statements for the business, and 30 days in which to file a restructuring proposal. Provided the debtor is acting in good faith and is proceeding with diligence, this deadline can be extended up to six months with each extension being for an additional 45 days. During this time the debtor can carry on operating the business subject to review by a trustee and the court. It is possible but rare for restructuring proceedings to be initiated by creditors.

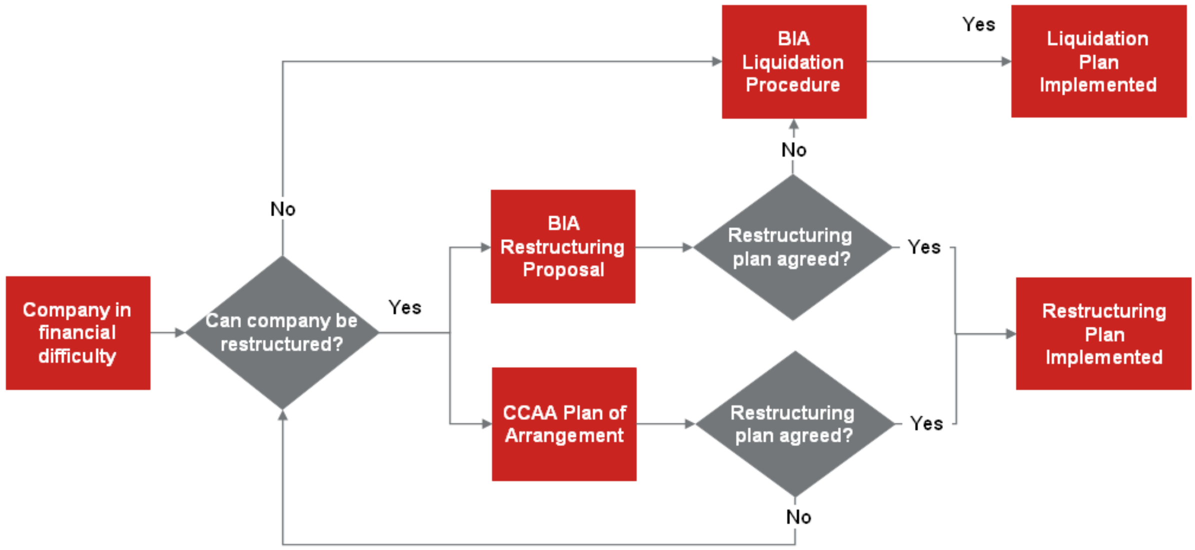
There is an automatic stay on secured and unsecured debt which can last up to six months

The debtor obtains an immediate stay of proceeding by filing this proposal or giving notice of the intention to file a proposal. This automatic stay applies to both unsecured and secured creditors and can be extended by court order to a maximum of six months. The court can choose to lift the stay for certain creditors if they are likely to be "materially prejudiced". It is also worth noting that some secured creditors may not be subject to the stay if they took possession of their collateral 10 or more days before the Notice of Intention was filed.

US-style DIP financing is now permitted in the BIA

Since September 2009, new provisions have come in which permit the use of post-insolvency financing within the BIA. Such financing can be granted priority status over existing secured debts if it is essential to the debtor.

Figure 15. A flow chart of the Canadian bankruptcy process



Source: Nomura

Failure to approve a plan results in automatic liquidation

To be accepted a restructuring proposal needs the votes of more than 50% of both secured and unsecured creditors in number, and more than two-thirds in value.

If the debtor fails to file a proposal before the deadline, the debtor is assumed to have made an assignment in bankruptcy and so automatically enters the liquidation procedure described in the previous section. If the proposal is not accepted, then the company also automatically enters into this liquidation procedure.

CCAA plan of arrangement

The CCAA is a more flexible process aimed at larger corporations

This is a restructuring procedure which falls under the CCAA. It is only available to debtors with total debts greater than C$5 million. It is closer in form and spirit to the US Chapter 11 procedure than a BIA restructuring proposal in the way that it grants both the supervising court and the debtor much greater flexibility in the restructuring proceedings.

To obtain the protections provided by the CCAA the debtor must make an application to the court

To initiate the procedure the debtor must make an application to the court to convince it of the appropriateness of being given the protections provided by the CCAA. This application must contain a projected cash flow statement as well as previous financial statements. The court then decides whether or not to grant the application. It is also possible but rare for creditors to initiate this procedure involuntarily.

The stay is not automatic but is usually granted against secured and unsecured debt

If the court grants the application, there is no automatic stay. However, the court usually grants an immediate and comprehensive stay on actions by both secured and unsecured creditors while a rescue plan is being negotiated. Although it is initially limited to 30 days, the stay can be extended indefinitely by the court to assist the formation of a plan. Compare this with the BIA route where the maximum length of the stay is six months. The stay may be lifted if it appears unlikely that an acceptable plan will be devised.

The debtor continues to run the business and a monitor is appointed to protect the interests of creditors

Following the granting of the application, the debtor has the right to continue to run the company and to sell assets as long as these are within the normal course of business. A "Monitor" is appointed to protect the interests of creditors and to report back to the court and to the creditors on the status of the plan. Any non-normal transactions will need court approval. With court approval, it is also possible to sell some or even substantially all of the assets of the company before the plan has been produced.

US-style DIP financing is now possible within the CCAA

New provisions came into effect in September 2009 which permit the use of post-insolvency financing within the CCAA and confirm the fact that it can be granted super priority over the rights of existing secured creditors.

Under the CCAA, the debtor can apply to the court for a meeting of creditors to consider a plan of arrangement. If the rights of shareholders are to be affected, the CCAA plan of arrangement can be combined with an application for an arrangement under the applicable Canadian corporation legislation. The CCAA law also allows shareholders of the company to be considered. However, shareholders should not expect to participate in the financial restructuring process if creditors' claims are not expected to be repaid in full.

Acceptance of the plan requires a vote in favour by 50% by number and more than two-thirds by value of credit of each class of creditor

Acceptance of the plan requires a vote in favour by 50% in number, and more than two-thirds by value of credit of each class of creditor. Unlike Chapter 11, all classes of creditor must vote in favour of the plan for it to be approved so it is not possible to cram down a single class of creditors. If the plan is rejected, the restructuring does not convert automatically to a liquidation procedure as in the BIA proposal procedure. Instead, the court-imposed stay is lifted and creditors are then free to pursue their own remedies.

A flow chart showing the entire Canadian insolvency process is given in Figure 15.

8.2.4 Priority

Recent changes have raised the priority of employee wage arrears

The order of claims in Canada depends on whether or not the debtor has sought protection using one of the bankruptcy laws. For a large corporation which has sought this protection, the order of claims in decreasing seniority is as follows:

1. Super priority claims[20]. These include employee wage arrears, including vacation pay, and pension contributions (but only in liquidations). They also include post-insolvency financing, trustee's fees and expenses.
2. Major priority claims. These include government taxes on wages, environmental cleanup costs and property taxes.
3. Secured claims.
4. Administration expenses, municipal taxes and rent arrears.
5. Unsecured creditors.

Set-off is recognised and allowed without a stay.

8.2.5 Case studies

Nortel Networks Corporation

In early 2009, Nortel Networks Corporation, North America's largest manufacturer of telecom equipment, was struggling due to intense competition from European and Asian rivals. This was compounded by a reduction in spending by telecom companies due in part to the recession after the 2008 financial crisis. At the start of 2009, Nortel had about $4.5bn of long-term debt. However, aiming to conserve its $2.4bn cash position, and with interest payments falling due, Nortel sought the protection of a bankruptcy regime.

Based in Toronto, Canada, Nortel decided on 14 January 2009 to seek creditor protection under the CCAA. This was just one day before it was due to make a $107mn interest payment on its debt. At the same time its US subsidiaries filed voluntary petitions in the United States under Chapter 11 while its European subsidiaries make analogous filings in Europe under their bankruptcy regimes.

The application to file under the CCAA was heard by the Ontario Super Court of Justice and the order was granted. Ernst & Young Inc. was appointed as Monitor of the process. An application was also made and granted to recognise the US Chapter 11 process and to enforce its automatic stay in Canada. This stay was for 30 days.

To allow more time for the restructuring, Nortel successfully re-applied in February to have the stay extended to 1 May 2009. The annual general meeting of shareholders was also pushed back until after the end of the stay period to allow management to focus on the restructuring. In April, the stay was once again pushed back, this time to 20 July 2009.

At the end of July 2009, Nortel obtained approval from the court to allow the sale of its CDMA business and LTE Access assets for $1.13bn. The stay period was extended again until 30 October 2009. Agreement was then obtained from the court to sell additional assets to Hitachi Ltd and to extend the stay until 18 December 2009, and subsequently to 29 January 2010.

By March 2010, Nortel had raised about $3 billion from asset sales. However, the restructuring plan was running into difficulties due to the form of plan approval required under the CCAA. This requires both a majority of creditors by number and two-thirds by

[20] These claims are ranked above secured creditors and were introduced by the 2009 Wage Earner Protection Program and amendments to the BIA which came into effect in September 2009.

value to vote in favour. Employees made up a majority of creditors while bondholders held more than two-thirds of the debt. It was not clear whether an agreement satisfactory to more than half of the creditors could be reached. The case is ongoing.

Canwest Global

Canwest Global, Canada's largest media company, filed for bankruptcy protection on 13 October 2009. With liabilities of under $6bn based on its most recent financial statements and declining revenues due to the worldwide recession, it needed time to come to an agreement with creditors. The Ontario Superior Court granted the application for protection under the CCAA and FTI was appointed as monitor. Canwest also filed in the US, but did so using Chapter 15 which is designed to handle cross-border cases.

Canwest was one of the first filings after the provisions allowing super priority US-style DIP financing came into force in September 2009. The court approved the use of $100mn of such post-insolvency financing. Unlike the Nortel case which was filed before these provisions came into force, the Canwest case also assigned a super-priority status to unpaid wages.

8.2.6 International

Since 1997, both the BIA and CCAA have encouraged cooperation between Canadian courts and the courts of other jurisdictions. Measures include the discretionary recognition of foreign insolvency proceedings and significant cooperation in cross-border insolvencies. Canada implemented the UNCITRAL model law for the recognition of foreign insolvency in 2009.

8.2.7 Summary of procedures

Figure 16 summarises the main features of the Canadian insolvency procedures.

Figure 16. Main insolvency procedures in Canada

Criterion	BIA Liquidation Procedure	BIA Restructuring Proposal	CCAA Plan of Arrangement
Purpose	Liquidation	Restructuring	Restructuring
Condition for entry	Company is insolvent	Company is insolvent	Company is insolvent with debts greater than C$5 million
Stay on creditors	Yes on unsecured creditors. The court may impose a stay on enforcement by secured creditors if justified by the debtor, trustee in bankruptcy or interested party.	Immediate stay on filing notice of intention to make a proposal or filing of a proposal. The court can lift the stay in certain circumstances.	No automatic stay but court usually grants a comprehensive stay at the outset of the proceedings while the plan of arrangement is being developed and negotiated. The court can lift the stay in certain circumstances.
Control	Trustee	Debtor subject to review by trustee and court	Debtor subject to review by monitor and court
Approval for plan	N/A	More than 50% by number of votes by unsecured creditors and more than 66.7% by value. The same voting requirement if proposal also made to secured creditor class. Proposal to unsecured class can still proceed even if rejected by secured creditor class.	More than 50% in number and 66.7% by value of creditors in each class. All classes to which the plan is directed must vote in favour.
Binding	N/A	Yes	Yes
Court involvement	General supervision but less than restructuring process	General supervision but less than CCAA process; court must sanction proposal voted on by creditors	Yes; proceeding commenced by court order; general supervision throughout; court must sanction plan voted on by creditors
Enhanced priority financing	N/A	Yes	Yes
Average procedure time (estimate)	Until trustee's discharge; time required for administration is case specific	Proposal must be filed within six months of filing of a motion of intention	Case specific; usually 12 to 18 months for large cases unless prepackaged plan before filing.
Recent uses	Outright liquidation in bankruptcy is more common for smaller companies.	Proposal more common for smaller cases given six-month limit to file proposal and risk of automatic bankruptcy.	Most of the larger sophisticated businesses file under CCAA. Canwest and Nortel are recent examples. Nortel is liquidated under CCAA as no restructuring was possible.

Source: Nomura, L&W

8.2.8 Commentary

The BIA is a comprehensive rules-based law which works best for small companies

For large corporations, the two reorganisation frameworks under the BIA and CCAA are very different. While the BIA is a more comprehensive law with over 275 separate sections, the CCAA is more skeletal as it has only 22 sections. The more detailed and rules-based BIA law with its set timelines is aimed more at smaller companies where the restructuring process is fairly simple.

CCAA reorganisation works best for large complex corporations

This lack of detail in the CCAA allows for more judicial discretion in the process. It also allows for more debtor and creditor flexibility in the formulation of a reorganisation plan. For this reason, it is generally the preferred route for large and complex corporations entering into a reorganisation and it is the path considered to be closest to Chapter 11.

There are similarities between the CCAA and the US Chapter 11 procedure

There are a number of similarities between the CCAA and the US Chapter 11 procedure. These include a stay on the actions of creditors, DIP financing, the filing of a restructuring proposal, voting on the proposal by the affected creditors and final court approval. However, there are also some important differences including the lack of a cramdown mechanism.

Under CCAA failure to agree a plan does not result in automatic liquidation

Other reasons which favour the use of the CCAA are the fact that the stay may be extended indefinitely compared with the six-month limit under the BIA. This was seen very clearly in the ongoing Nortel case study where the stay has been extended for well over a year. Also, the risk of failing to agree a plan does not automatically result in liquidation. Recent changes to both the BIA and CCAA allow specifically for granting priority to DIP lenders.

Neither CCAA nor BIA has a cramdown mechanism

Unlike Chapter 11, the CCAA has no cramdown mechanism. All classes of creditor must vote in favour in both numerical and value terms. As seen in the Nortel example, this can make it harder to reach an agreement and may cause the process to end in a stalemate.

8.2.9 Acknowledgements

We would like to thank Michael Harquail for his comments and assistance on this section. His contact details are as follows:

Michael R. Harquail
Blake, Cassels & Graydon LLP
199 Bay Street
Suite 2800, Commerce Court West
Toronto ON M5L 1A9 Canada
michael.harquail@blakes.com
+1 416-863-2400

9 EUROPE

9.1 England and Wales (UK)

Within Europe, perhaps the best known and most used bankruptcy regime is that of England and Wales

Within Europe, perhaps the best known and most used bankruptcy regime is that of England and Wales[21]. Not only is it used by registered companies which have been incorporated in England and Wales, it is also used by companies formed outside England and Wales which can establish certain types of connection to the jurisdiction. The bankruptcy regime is based primarily on a number of laws including the Insolvency Act 1986, the amendments to the Insolvency Act 2000, and the Enterprise Act 2002.

The main proceedings in England and Wales are:

a) Members' voluntary liquidation;

b) Creditors' voluntary liquidation;

c) Compulsory liquidation / Winding-up;

d) Administration;

e) Company voluntary arrangements; and

f) Schemes of arrangements.

These are all described below.

There are no dedicated bankruptcy courts but large bankruptcies are heard in the High Court

In England and Wales, there are no dedicated bankruptcy courts. Bankruptcy procedures are dealt with by the county court of the district in which the company's registered office is located. For companies with a share capital in excess of £120,000, the case will usually be heard in the High Court in London.

The test for insolvency includes a balance sheet test and a cash flow test

According to English and Welsh law, insolvency occurs when a company is "unable to pay its debts". The statutory definition of this phrase consists of a balance sheet test and a cash flow test. The first asks whether the company's assets exceed its liabilities, while the second asks whether the company can pay its debts as they fall due. If either response is negative, the company is considered to be insolvent. As we will see below, some bankruptcy procedures have an entry requirement that the company be insolvent while others have no such condition.

There is no requirement for an insolvent company to file for bankruptcy but directors can be liable for creditor losses if they do not

There is no compulsion for a company to file for insolvency even if it is technically insolvent. The 2006 Companies Act states that it is the primary duty of directors to act in a way which they consider in good faith would be most likely to promote success for the company for the benefit of its members as a whole. Failure to do this, for example by assuming new debt which management knows cannot be repaid, is an offence known as "wrongful trading". Even if directors do believe that they are acting in the interest of the creditors, the risk of being found personally liable for creditor losses can push directors to file, although there are various safe harbours that can protect directors if they are pursuing a restructuring.

The main forms of security for real estate are the mortgage and the fixed charge

Security in England and Wales can take a number of forms. Immovable property, i.e. real estate, can be secured using a mortgage or fixed charge. A mortgage transfers the debtor's legal ownership of the property to the creditor, with this ownership being returned once the debt has been repaid. A fixed charge means that the owner (the debtor) can only sell the property once the creditor has been repaid. It does not transfer ownership. To be perfected, these forms of security have to be registered with the Registrar of Companies. Real estate mortgages must be registered at the Land Registry for England and Wales.

For non-real-estate assets, the forms of security also include the floating charge

For moveable securities, the forms of security also include mortgages and fixed charges. In addition there are floating charges, pledges and liens. A floating charge applies not to a specific asset but to a class of assets. It only becomes "fixed" to a specific asset on a default and then acts just like a fixed charge. A pledge gives the creditor actual possession of some assets until the debt is repaid. A lien also gives a creditor the right to

[21] Within the UK, most bankruptcy cases use English and Welsh law since most companies are incorporated in England. The legal system of England and Wales differs in some respects from that practised in Scotland and Northern Ireland.

hold an asset until a debt has been repaid. The difference between a pledge and a lien is that in the lien, the creditor holds the asset for a reason other than securing the debt.

9.1.1 Pre-insolvency

The pre-insolvency period is often used to structure a pre-pack sale of the company

Because of the ability of a company to continue to trade while insolvent, the distinction of pre- and post-insolvency is not a clear one in England and Wales. Assuming that the company is either insolvent or close to insolvency, one of the favoured pre-insolvency routes is known as the “pre-pack”. This is an agreement to sell the company, or some of its assets, which has been reached prior to the commencement of formal insolvency and has been seen and approved by the administrator prior to his formal appointment. As soon as the company enters the administration procedure, described in detail in section 9.1.3, the administrator executes the sale agreement.

9.1.2 Liquidation

There are three ways to liquidate a company

There are three ways for a company to begin a liquidation proceeding. Which one is chosen depends on whether the company has been declared insolvent or not, and whether the liquidation is voluntary or involuntary. We now describe them.

Members’ voluntary liquidation

Members’ voluntary liquidation is used if the company is solvent and is being liquidated for some other reason

This procedure can only be used as long as the directors can declare that the company is solvent. It also requires approval by 75% of the company shareholders (members). The directors’ powers cease and a liquidator is appointed. In general, the members’ voluntary liquidation is really only used if the company is being liquidated because it has fulfilled some purpose and not because of insolvency. If the directors cannot make the declaration of solvency then the procedure switches to a creditors’ voluntary liquidation.

Creditors’ voluntary liquidation

Creditors’ voluntary liquidation requires that the company is insolvent and its members have voted to liquidate

To qualify for this form of bankruptcy procedure the company should be insolvent and at least 75% of the shareholders (members) must have voted to place the company into liquidation. The shareholders can appoint a liquidator with limited powers. The company’s directors must then hold a creditors’ meeting within 14 days. At this meeting the creditors will receive a statement of affairs describing the state of the company. A vote by a majority of creditors can be used to replace the liquidator if so desired. The liquidator can then apply to the court for a stay on proceedings.

Compulsory liquidation / Winding-up order

In a compulsory liquidation a creditor can petition the court to put an insolvent company into liquidation

A company can be put into liquidation involuntarily if a creditor petitions the court for a compulsory liquidation, also known as a winding-up order. The main ground for such an order is that the company is unable to pay its debts because it has failed the cash flow or balance sheet tests described above. If the court approves the petition and the winding-up order is made, the company directors have no further power and the company must cease trading so that it can be wound up.

In all cases, a liquidator is appointed to sell the company’s assets and distribute the proceeds

In all of these liquidation procedures it is the liquidator who has the power to sell the company’s assets. This may be done by public auction or private contract without court sanction. The proceeds are then distributed to creditors and members according to the English and Welsh law on the priority of payments.

9.1.3 Reorganisation

Current English and Welsh bankruptcy law allows for three ways to restructure a company

If there is a prospect of rehabilitating the company, which may or may not be insolvent, there are three possible reorganisation procedures. They are administration, company voluntary arrangement and scheme of arrangement. We do not include administrative receivership in our survey since this was repealed for most companies in 2003 with the aim of encouraging greater use of the administration procedure[22].

[22] However we note that companies that entered into a qualifying floating charge before 15 September 2003 can still be subject to administrative receivership.

Administration

Administration was introduced by the Insolvency Act 1986

Administration was introduced by the Insolvency Act 1986 with a primary aim of rescuing the company as a going concern. It has subsequently been revised by the Enterprise Act 2002 to make it more favourable to unsecured creditors and to encourage its use as a reorganisation procedure.

Administration can be started either out-of-court or by court order

Administration can be started either out-of-court or by court order. In the former case the holder of a security which grants a qualifying floating charge [23] can appoint an administrator. Alternatively, the directors of the company can appoint an administrator but must give notice to the holder of the qualifying floating charge. In the latter case, the company or its creditors can apply to the court for an administration order. The court has to ensure that the company is insolvent or likely to become insolvent. It also has to be satisfied that the aims of the administration procedure can be achieved.

The primary aim of the administration is to rescue the company as a going concern

The aims of administration are set out in a fixed hierarchy of statutory priorities. The first is to rescue the company as a going concern. If this is not practicable, the second statutory objective applies, which is that administration will lead to a better result for creditors than if the company were simply wound up. If this is not possible, then the aim of the administration must be to realise the company's property for the benefit of its secured and preferential creditors without harming the interests of creditors as a whole.

Once in administration, there is an immediate stay with some exceptions

Once in administration, there is an immediate stay on proceedings and creditor enforcement actions. However, there are some important exceptions as the holders of financial collateral (cash, debt securities and shares) are free to terminate contracts (if contractually allowed), enforce security, and exercise rights of set-off. It is also possible for a creditor to apply to the court for permission to lift the stay. This will be granted by the court only if the applicant can show that lifting the stay would not impede the administration procedure.

Company directors lose control when an administrator is appointed

The company directors lose their powers with respect to the company and these are assumed by an administrator who is a licensed insolvency practitioner. The administrator has a duty to act in the interests of both secured and unsecured creditors. One of the first acts of the administrator must be to notify all of the company's creditors of the appointment of an administrator and to publicise the fact in the relevant newspapers.

Within eight weeks the administrator must present a plan whose acceptance requires a simple majority by value of the unsecured creditors present and voting

The administrator has eight weeks from his appointment in which to send to creditors a proposal for the conduct of the administration. A creditors' meeting must be held within 10 weeks of the date that the company entered administration at which the administrator presents the proposal. Acceptance requires a simple majority by value of the creditors present and voting. Generally this will only include unsecured creditors. It can include secured creditors but only to the extent that their claims are not fully covered by the value of the secured assets. If the proposal is rejected then the administrator must seek guidance from the court. The administration expires after 12 months but can be extended once with the consent of the creditors by an additional six months or otherwise as the court may approve. It is possible for the company to assume new loans in administration which will be granted priority status over floating charges and unsecured assets only.

Administration is mostly used as a mechanism to enable a "pre-pack sale"

In many cases, administration is used as a mechanism to enable the sale of a company using a "pre-pack sale". In this case the administrator is contacted before being appointed by the company and provided with a plan for selling the company. This plan should typically include a valuation analysis to show that the creditors are obtaining the best possible price. A buyer is then found for the business – either an existing company or a new company set up for this purpose. In the latter case, this company may be owned by the directors of the debtor company. Approval to sell assets will typically be sought from secured creditors as a practical matter. However, the administrator does have extensive power to deal with secured assets free from the security (subject to certain protections in favour of the security holder). Once the sale has been agreed upon, the administrator is then formally appointed and the sale executed immediately or very soon afterwards. If the entire business and undertakings of the company is sold then the company does not survive as it will be wound up. The business does survive.

[23] A qualifying floating charge holder is a creditor who holds a security interest over all or substantially all of the company's assets in the form of a floating charge. It might, for example, be the company's main banker or the agent in a syndicated financing.

Company voluntary arrangements

A company voluntary arrangement (CVA) is an out-of-court procedure

The company voluntary arrangement (CVA) is a procedure introduced by the Insolvency Act 1986 and used when there is a high likelihood that the company will emerge as a going concern. The goal of a CVA is to reach an arrangement or compromise between the company, its shareholders and creditors in which the creditors typically agree to delayed or reduced debt repayments.

Unlike liquidation or administration, it does not involve an insolvency practitioner assuming powers over the company to the exclusion of management except to the extent that the CVA proposal itself provides for this. Furthermore, there is no requirement for the firm to be insolvent to enter this process, but this is almost always the case.

A CVA is initiated by company directors

The procedure is initiated by the company directors. They must make a written proposal to an insolvency practitioner on whether to convene a meeting of shareholders and creditors to consider the proposal.

There is no stay, except for small companies

Since the Insolvency Act 2000, there has been a provision for a company entering a CVA process to obtain a stay on proceedings, but this only applies for a "small company", i.e. a company which meets two of the following three criteria: a turnover less than £5.6mn, assets worth not more than £3.26mn and no more than 50 employees. Initially the stay is for 28 days but with creditor consent it can be extended to up to three months. There is no stay for large companies.

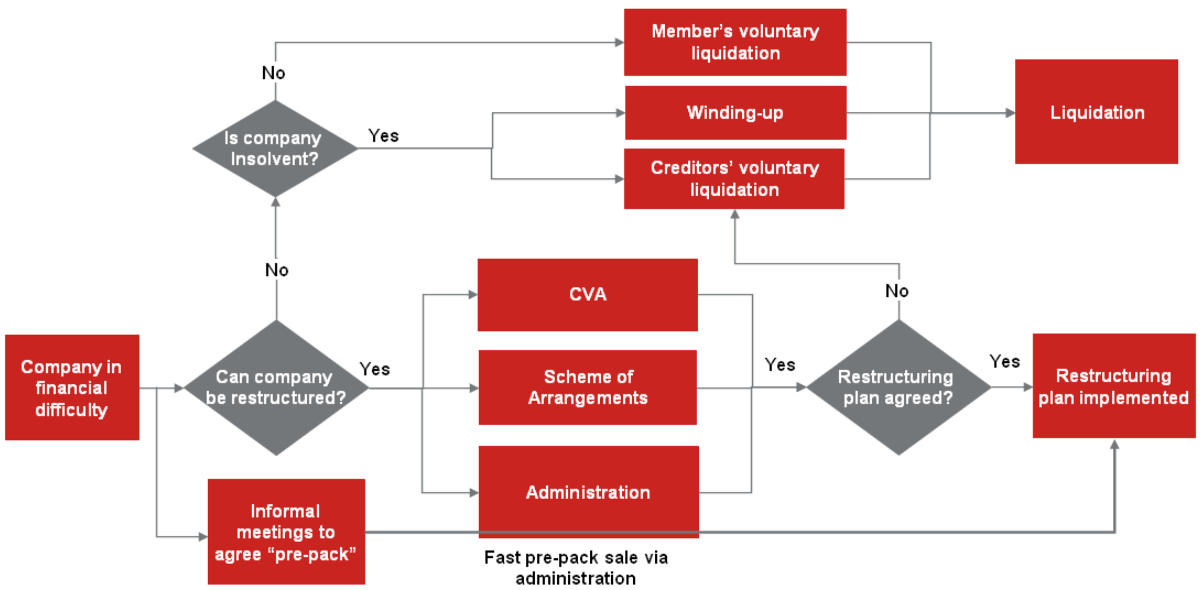
Approval of the proposal requires a vote in favour by 75% by value of unsecured creditors and a majority of shareholders

Approval of the CVA debt restructuring proposal requires a vote in favour by a majority exceeding 75% by value of all of the creditors excluding secured creditors, and subject to certain limitations on the voting rights of creditors who are connected to the company. The creditors vote without being split into classes. This may be seen as a way to encourage creditors at different levels of the capital structure to engage in discussion and ensures that the rights of at least 75% of all unsecured creditors are taken into consideration. At the same time it can allow out-of-the-money creditors with no economic interest to block a restructuring.

The CVA binds all creditors but may not affect the rights of secured creditors or preferential creditors without their consent

The resulting agreement binds all creditors but may not affect the rights of secured creditors or preferential creditors without their consent. The proposal also requires approval by a simple majority of shareholders. However, if the decisions of the creditors and shareholders differ, the result of the creditors' meeting will prevail subject to a contrary order of the court. Creditors can challenge the agreement if they believe they have been unfairly prejudiced. If the proposal is accepted, its implementation is then supervised by the insolvency practitioner. The role of the court is effectively confined to resolving any disputes.

Figure 17. Flowchart for insolvency processes in England and Wales



Source: Nomura

The CVA can be used for a company in any EEA state as long as it has its COMI in the European Union

The CVA can be implemented for a company in any EEA state as long as it has its COMI in the European Union[24]. There have been numerous examples of European companies using the CVA due to their having a UK COMI as discussed in section 9.8.

Scheme of arrangement

A "scheme" is a court-supervised restructuring procedure

A scheme of arrangement, or "scheme", is a court-supervised restructuring procedure contained in the 2006 Companies Act. There is no entry test of insolvency. As a result this procedure has been employed in a wide variety of corporate reorganisation contexts where the company may or may not have been solvent.

Can be voluntary or involuntary but management stays

A scheme can be initiated by the company or any creditor making an application to the court for an order to convene a meeting of creditors. Unlike other procedures, no insolvency practitioner is appointed and management stays in place throughout the process. Approval of any compromise is binding if 75% or more by value and a majority in number of each class of creditors and/or shareholders summoned to the meeting vote in favour.

The convenor decides which classes of creditors and members it wishes to summon for approval of the scheme

It is up to the convenor of the meeting, usually the company, to decide which classes of creditors and members it wishes to summon for approval of the scheme. Identifying the correct creditor classes required to approve the scheme is not straightforward and failure to constitute the classes correctly will mean that the scheme will not be sanctioned as this requires the approval of the court.

There is no stay on secured creditors

There is no stay during this procedure so secured creditors are free to exercise their security at any time and unsecured creditors retain the ability to take proceedings against the company. This is one aspect of the scheme of arrangement procedure which is viewed as detrimental to the restructuring effort. However, these rights may be displaced by the terms of the scheme itself, but those limitations will only come into force once the scheme is approved and receives court sanction. If the scheme is approved, it is implemented under the supervision of the directors of the company.

A flowchart showing the entire English and Welsh insolvency process is given in Figure 17.

9.1.4 Priority in liquidation

The priority of payments is used to determine whether distributions under restructuring procedures satisfy the necessary standards of fairness

The Insolvency Act sets out the priorities of distribution that apply in the cases of administration or liquidation. These are important not just in the context of these procedures but also because they may be relevant in determining whether distributions made under other procedures (such as a scheme or a CVA) satisfy the necessary standards of fairness needed to obtain court approval. The general position is that a scheme or a CVA should not give a creditor a lower recovery than the creditor could have achieved in a liquidation. Therefore, understanding the liquidation priorities is important even if liquidation can be avoided by implementing a restructuring.

The distribution in declining order of priority is as follows:

1. Fixed charge holders (as secured assets are excluded from the estate).
2. General expenses and the costs of the liquidation, including the liquidator's remuneration.
3. Preferential creditors which generally relate to employee rights such as accrued pay and pension rights.
4. A fund for unsecured creditors (up to a maximum of £600,000) from the realisation of assets subject to a floating charge.
5. Floating charge holders.
6. Unsecured creditors.

Similar priorities apply in the case of administration. In both cases, the order of distribution is subject to complex rules which exempt certain categories of rights and assets such as allowing creditors' right of set-off.

[24] The exception is Denmark.

9.1.5 Case studies

IMO Carwash

IMO Carwash is the world's largest car-wash company with 857 sites across Europe. It was bought out by Carlyle from JP Morgan Partners in 2006. This transaction was financed by a £120 million term loan A, a £120mn term loan B and a £30mn capital expenditure line plus an £85mn mezzanine line.

In 2007 the company began to see a drop in revenue and, by early 2009, was experiencing serious financial difficulties and preparing a debt restructuring. To this end, IMO appointed a senior and mezzanine steering committee. In August 2009, a court was asked to rule on whether to sanction a scheme of arrangement. At the time the company had a senior debt liability of £313 million and mezzanine debt of £119 million.

At issue was the question of whether the mezzanine holders, which would not receive any recovery under the scheme, were allowed to vote on the scheme, in which case they would be able to veto it. The mezzanine was fully subordinate to the senior debt and so whether the scheme was fair with regards to them required a valuation of the company to measure whether they had an economic interest in the scheme.

Valuation exercises by the company showed that the mezzanine lenders were out of the money. However, the mezzanine holders had conducted their own valuation of the company which showed that there was economic value in their holding. The judge ruled against the mezzanine investors, claiming that their methodology was "unconvincing".

The use of a scheme of arrangement was essential as it allowed the 75% or more senior lenders in favour of the deal to cram down the minority group of senior lenders opposed to it. It also highlighted the fact that the junior creditor loans had given away intercreditor release rights and so lost bargaining power once the value of the firm fell below the value of the senior debt. In the end, the senior creditors saw a 40% write-off and the mezzanine holders a 100% write-off, reducing the overall debt of the company to £185 million.

La Seda

In March 2010, Spanish chemicals business La Seda de Barcelona implemented its Spanish restructuring via procedures in the UK. Its intention was to use the provisions of an English scheme of arrangement to cram down the senior secured bank lenders, something which is not possible in the Spanish insolvency procedures where only unsecured lenders can be crammed down. This was achieved in late May 2010.

Interestingly, this move was not done using a COMI shift under the European Insolvency Regulations. Schemes of arrangements fall under the Companies Act rather than the Insolvency Act 1986 and so are not recognised by the European Insolvency Regulations.

The reason for permitting the UK procedure was based on Section 221 of the Insolvency Act, which states that any company incorporated and domiciled outside England may be wound up in England if there is "sufficient connection" within England. In this case the company had significant subsidiary operations in the UK. Further supporting the UK link was the fact that the finance documents were based on English law.

Because the company was liable to be wound up in England, it followed that there was jurisdiction for the English court to allow for a section 425 scheme to be implemented in England for La Seda. A necessary majority of over 75% of creditors approved the scheme which consisted of a €150mn debt for equity swap and maturity extensions on the remaining €450mn of debt. The debt-for-equity swap is conditional on a €150mn equity injection which is currently pending.

9.1.6 International

For cross-border bankruptcy proceedings within the European Union, the UK is subject to the European Insolvency Regulation which came into force in May 2002.

The UNCITRAL model law on cross-border insolvency was adopted by Great Britain[25] through the Cross-Border Insolvency Regulations 2006.

[25] England, Wales and Scotland, i.e. the UK without Northern Ireland.

9.1.7 Summary of procedures

Figure 18 summarises the main features of the English and Welsh insolvency procedures.

Figure 18. Summary of insolvency regimes in England and Wales

Criterion	Administration	CVA	Scheme of Arrangement
Purpose	Rehabilitation	Rehabilitation	Restructuring
Condition for entry	Insolvent or close to insolvency for in-court procedure	No insolvency condition	No insolvency condition
Stay on creditors	Yes, on secured and unsecured but there are several exceptions	No (except for small companies for which it is 28 days to a maximum of three months)	No
Control	Administrator	Management	Management
Approval for plan	More than 50% by value of unsecured creditors	More than 75% by value of unsecured creditors and a majority of shareholders (subject to creditors overriding the shareholders' decision if conflicting)	A majority by number and 75% or more by value in each class of creditors and (if relevant) members.
Binding	All creditors (subject to protection of secured and preferential creditors)	Cannot bind senior or preferential creditors without consent It is possible to cram down dissenting creditors	All creditors in each class approving the scheme. It is possible to cram down a class of creditors
Average procedure (time estimate)	The statutory time frame provides for a one year duration, which can be extended by the court. In practice, it is necessary to distinguish between a pre-pack administration from the more common trading administration. While a prepack can be concluded in a matter of weeks, a trading administration might usually last one or two years, although in complex cases this could be prolonged for considerably longer.	The formal processes for a CVA can be completed within a timetable of one or two months. As with schemes of arrangement however, there will be considerable lead time in the preparation of the CVA proposal, particularly if the proposal is to be launched on an effectively pre-packed (or pre-arranged) basis, ie: with prior commitments of creditors in sufficient numbers to ensure that the proposal will be passed when it is launched.	The formal process for a scheme of arrangement can be concluded quickly, in as little as five or six weeks. This will depend on the availability of court dates, because two court applications are required. In practice, in complex financial restructurings there will be at least several months' preparation time until the scheme process is ready to be initiated.
Court involvement	Can be commenced in court or out of court. The process is generally run out-of-court subject to the ability of an aggrieved person to apply to the court to intervene	Out of court, subject to application of any aggrieved person	Court approval is required at certain stages of the process, but generally out-of-court implementation
Enhanced priority financing	Yes	No	No
Recent uses	Lehman Brothers International (Europe) (insolvent winding down of estate), Countrywide, Credit Nicholson, IMO Carwash (pre-pack administration sales following an agreed restructuring)	JJB Sports, Deutsche Nickel,Schefenacker	Crest Nicholson, Countrywide, British Vita and IMO Carwash.

Source: Nomura, L&W

9.1.8 Commentary

In England and Wales, the choice of procedure depends on the nature of the creditors, the form of the restructuring and the need to obtain agreement

We have shown that England and Wales has three main procedures for liquidation and three for company restructuring. In the case of restructuring, each of the procedures has its own specific advantages and disadvantages. To know which is best depends on the nature of the creditors, the form of the restructuring and ultimately the need to obtain agreement. We have summarised the main features of each in Figure 18. Given their differences, it is important to understand why a company or creditor may prefer one of these procedures over another.

Administration is not generally favoured as a restructuring procedure since management usually has to give up control of the company

Administration is not generally favoured as a restructuring procedure since management usually has to give up control of the company and the procedure can be value-destructive due to the imperfections of the stay. For example, the stay does not stop creditors from terminating contracts with the company. However, in recent years it has been used to achieve fast and effective pre-pack sales where the terms of the restructuring have been fully agreed before administration is entered into. The main reason for the popularity of administration for implementing pre-pack sales is that it allows management to hand over the sale of the assets to the administrator, rather than have to take the sales decisions themselves in what may be contentious circumstances.

The CVA is used more in genuine cases of business insolvency rather for restructuring

The CVA is used more in genuine cases of business insolvency, rather than as a mechanism for restructuring pure financial debt. This is because, unlike schemes of arrangement, it cannot bind secured creditors without their consent. Despite this, it remains a useful tool for restructuring traded debt mainly because unsecured creditors vote as a single class and this makes it simpler to implement a CVA with regard to unsecured creditors than a scheme of arrangement. A recent example is that of JJB Sports which used a CVA to restructure its business which was subject to onerous lease commitments.

The lack of a stay in the CVA procedure has been highlighted by the European High Yield Association

The lack of a stay in the CVA procedure has been highlighted by the European High Yield Association[26] who have expressed their view to the UK Government stating that "The absence of a stay allows customers and suppliers to walk away, or extort punitive amendments, which can severely compromise the restructuring effort"[27]. It remains to be seen whether the lack of a stay in the UK CVA will be amended in the short term since some market participants have counter-argued that now is not a good time to amend and add to the uncertainty of an existing well-used and well-understood procedure.

Schemes of arrangement are the main implementation mechanism for large financial restructurings

Schemes of arrangement are the main implementation mechanism for large financial restructurings. The advantages over other procedures are that management stays in place, dissenting secured creditors can be bound by the scheme (provided a majority of secured creditors vote in favour), and there is a relatively robust case law developed by the courts to allow the company to disregard creditors who are out-of-the-money. The flexibility to summon only specific classes of creditors (e.g. financial creditors) means that other creditors (e.g. trade creditors) can be left out of the process and remain unaffected by it. This makes schemes very useful for companies that wish to continue to operate as normal but wish to restructure the balance sheet. Finally, provided there are no disputes, court involvement is minimal and the whole process typically takes two to three months from the date of the first hearing.

The UK restructuring procedures have a number of disadvantages compared with the US Chapter 11 procedure

Compared with Chapter 11 of the US Bankruptcy Code, these procedures nevertheless have a number of disadvantages. The stay on creditor enforcement is not as robust as that of Chapter 11. In the case of administration, management is replaced unlike in the US where management becomes the debtor-in-possession. There are limitations on the ability of the administrator to obtain super-priority funding. Finally, the ability of the UK procedures to cram down dissenting creditors is extremely limited and often contentious as evidenced by the IMO Carwash restructuring.

The choice of which procedure to use has to be made on a case-by-case basis

For these reasons, there is no "one size fits all" procedure to achieve restructuring in England and Wales. The choice of which procedure to use has to be made on a case-by-case basis and will require considerable advance planning with a careful assessment of all of the options.

9.1.9 Acknowledgements

We would like to thank lawyers John Houghton and Jackson Taylor for their comments and assistance on this section. Their contact details are as follows:

John Houghton/Jackson Taylor
LATHAM & WATKINS
99 Bishopsgate
London EC2M 3XF
United Kingdom
john.houghton@lw.com / jackson.taylor@lw.com
+44 20 7710 1000

[26] The European High Yield Association is now known as AFME/EHYA where AFME is the Association for Financial Markets in Europe.
[27] Letter from the European High Yield Association to HM Treasury, April 2007

9.2 Germany

The stated aim of the German insolvency regime is to provide best possible satisfaction of the creditors

The current German insolvency regime is based on the 1999 German Insolvency Act. Known as the *Insolvenzordnung*, this act applies to both companies and individuals. Formally, the stated aim of the Insolvency Act is to provide best possible satisfaction of the creditors by liquidating the debtor's assets and distributing the proceeds, or by agreeing an insolvency plan procedure to enable the enterprise to continue[28]. The two insolvency procedures in Germany are:

1. Insolvency proceedings leading to liquidation; and
2. Insolvency proceedings leading to an insolvency plan.

These two procedures are roughly analogous to the US Chapter 7 and Chapter 11 proceedings respectively. Both processes are court-based where the relevant court is the lower court of the district in which the company is based.

The main security type is the mortgage and land charge; for moveables it is the retention of title

The main types of security for real estate assets are the *hypothek* (mortgage) and the *grundschuld* (land charge). For moveable items there are a number of types of security. These include retention of title (similar to a fixed charge), fiduciary transfers of assets/receivables and a pledge of chattel. Set-off is usually allowed as long as the position arose before the initiation of the insolvency proceedings.

The German code has a cash flow and a balance sheet test for insolvency

The German code defines the state of insolvency using two tests. The first is illiquidity and tests whether the company has the ability to pay obligations when due. The second test is over-indebtedness. This occurs when the value of the debtor's assets do not cover its obligations.

9.2.1 Pre-insolvency

Debtors and creditors are free to reach an agreement pre-insolvency

There is nothing to stop debtors and creditors agreeing a restructuring informally while the company is solvent without going via one of the formal procedures. Indeed, this is a popular route but it is only possible if it is consensual.

9.2.2 Insolvency

Management must file within a maximum of three weeks of becoming aware of insolvency

If management recognises that the company is or is about to become insolvent, it must file for insolvency without undue delay. Management must not wait more than three weeks from the moment at which it should have become aware that the company is in a state of illiquidity or over-indebtedness. The three weeks is intended to give management time to carry out any actions which have a realistic hope of avoiding insolvency. Failure to comply with the obligation to file within the three-week limit is a criminal offence under German insolvency law.

Insolvency proceedings for liquidation or restructuring both begin in the same way

Insolvency proceedings, whether the intention is liquidation or restructuring, begin with an application to enter the preliminary process. Proceedings can be initiated by the company or a creditor filing an application. In the latter case, the company has a right to be heard before any petition can be granted. Up to six months may then pass before a decision is taken by the creditors' committee to pursue a liquidation or a restructuring.

Following a filing, a preliminary administrator is appointed

It is possible for a company to file voluntarily for insolvency even if there is doubt about the insolvency status of the company. In this case the insolvency court may appoint a preliminary administrator to produce an expert report on the financial status of the company.

The court decides whether the temporary administrator should be granted powers of a "weak administrator" or "strong administrator"

The court may decide that the preliminary administrator's role includes monitoring the management of the company which remains in control. In this case, the court may decide that certain transactions may require the consent of the administrator but does not impose a general prohibition on asset sales. This is known as "weak administrator" status. The court can also grant the administrator the status of "strong administrator". In this case the court prohibits asset sales and extends the administrator's role to include running the entire business. This situation lasts until the court decides whether or not to open proceedings.

[28] Even without the Insolvency Plan creditors have the possibility of allowing the administrator to at least temporarily continue the business (Article 157 of the German Insolvency Code).

There is a stay on moveable assets; a stay on real-estate may be obtained from the court

During the preliminary proceedings, the court usually imposes a stay on moveable assets. Real estate assets may also be stayed following an application to the court by the temporary insolvency administrator. Within a maximum period of three months, the court must determine whether the company is insolvent and whether its assets are sufficient to cover the costs[29] of the proceedings, the proceedings are opened.

Once formal proceedings are opened management loses control and there is an automatic stay on ordinary creditors

If proceedings are opened, the court appoints a formal insolvency administrator who may or may not replace the preliminary administrator. Both the debtor and creditors can express a view on who the administrator should be, though the final decision belongs to the court. Management is no longer in charge of the company. There is then an automatic stay on ordinary creditors. Secured creditors are able to enforce their security rights over immoveable assets. They can also enforce security rights over moveable assets provided the assets are in their possession.

The administrator maintains the company as a going concern until the creditors' meeting

The main aim of the administrator is keep the company as a going concern until the first creditors' meeting. This must occur within three months of the opening of the proceedings. Employee wages are covered by the state for the first three months following the initial filing.

Post-insolvency loans obtain preferred creditor status

The insolvency administrator is allowed to borrow money to continue the company's business operations provided the creditors consent. These loans will have a privileged status as preferential debts of the estate.

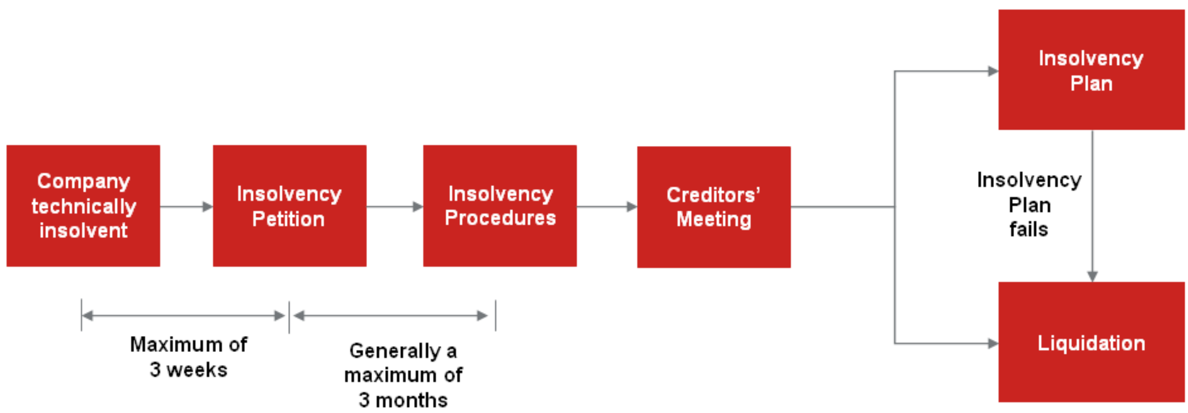
The creditors' meeting is where the creditors' committee is elected

A meeting of creditors must be convened to decide whether to set up a creditors' committee or to maintain the preliminary creditors' committee if one has already been set up. The creditors' meeting consists of all creditors, both secured and unsecured, the administrator and the insolvent company. The creditors' committee consists of certain creditors elected by the creditors' meeting which must represent a majority of claims.

The creditors' committee decides whether to liquidate or restructure the company

The administrator needs the approval of the creditors' meeting or, if a creditors' committee has been formed, of the creditors' committee for any significant transaction. The administrator also needs to compile the list of creditor claims. The creditors' committee then decides whether to liquidate or restructure the company.

Figure 19. Flowchart of the German bankruptcy procedure



Source: Nomura

9.2.3 Liquidation

If the creditors' meeting decides upon a liquidation a meeting is called to verify the amount and the rank of each claim

If the creditors' meeting decides upon a liquidation of the company a verification meeting is called to verify the amount and the rank of each claim. After this meeting, the administrator can begin the liquidation. Employees can be laid off and the assets sold. The distribution of the proceeds begins in accordance with the priority of payments set out in section 9.2.5. Once complete the court will terminate the insolvency proceedings.

[29] The proceeding costs include court fees, remuneration and expenses of the administrators (temporary and final) and the costs of the creditors' committee.

9.2.4 Restructuring

This restructuring process is known as the insolvency plan

This process is one of the new aspects of German bankruptcy law known as the insolvency plan. It is primarily intended to preserve, rehabilitate and reorganise the company. However, it can also be used to sell the company (subject to shareholder consent), for example using some pre-packaged plan, or to enable liquidation.

The plan must set out the treatment of different classes of creditor

The insolvency plan can only be proposed by the company or the administrator (instructed by creditors) and must, among other things, set out the treatment of the different classes of creditor where each class of creditors must be clearly defined, e.g. employees, secured creditors, and so on.

Post-insolvency loans are granted enhanced priority in liquidation

The insolvency administrator is able to borrow funds to allow the company to continue its business operations. In this case the lender becomes a preferred creditor and ranks after court fees and administration costs, and before claims from pre-insolvency order contracts if the administrator chose to maintain the contract. So although these loans are senior to ordinary insolvency creditors, they are not the same as a super-priority status since the lender ranks behind other preferred creditors as shown in the priority of payments below.

Plan approval requires a majority vote in each creditor class but failure to get approval does not automatically mean that the plan fails

There are a number of conditions which determine whether the plan is approved. For a start, a majority in number and value of the voting creditors in each class must vote in favour of the insolvency plan before it can be adopted. If one or more class does not achieve a simple majority, this does not automatically mean that the plan fails. A class cannot prohibit the adoption of the plan. In addition, the majority of the classes must have supported the plan.

The law allows for a cramdown mechanism

The law therefore allows for a cramdown mechanism. If the plan has been accepted by the majority, but not all of the classes, then the insolvency court may still approve the plan provided that it can be shown that the creditors of the non-approving class or classes are not treated worse by the plan than they would be without the plan and the recovery is fair and equitable compared with the recovery of the other creditors. There must also be no unequal treatment of creditors within the same class. Furthermore, there is a requirement that the non-approving creditors be given a reasonable share of the economic value available under the plan.

The debtor must also support the plan

The debtor must also support the plan. If he is not treated worse by the plan than he would be without the plan then his opposition is irrelevant. The plan must also be confirmed by the court and only then can it be implemented, usually under the supervision of the administrator. Once the court has formally approved the insolvency plan, the function of the administrator expires and the management of the company regains control.

Failure to approve a plan can result in liquidation

If the restructuring plan is not agreed to by creditors or the court decides against it, the court will then resume the usual insolvency proceedings leading to sale or liquidation.

A provision in the law called self-administration allows management to stay in control during the restructuring

Note that there is an additional provision in the insolvency procedure which allows company management to apply for self-administration. This allows the management to continue to control the insolvent company under the supervision of a custodian who is appointed by the insolvency court. This procedure is similar to Chapter 11. In recent cases when this provision has been used, existing management has been replaced with a new management which specialises in corporate restructurings.

A flow chart showing all of the German insolvency procedures is provided in Figure 19.

9.2.5 Priority of payments

The order of distribution in insolvency proceedings, unless an insolvency plan states otherwise, is as follows:

1. Secured creditors
2. The following rank equally and so are paid *pro-rata*:
    a. Cost of insolvency proceedings including court fees and administration costs.

   b. Post-order and post-filing claims resulting from the actions of a preliminary administrator with complete control over the company's assets. This includes so-called "DIP-style" loans made to the company after the filing.

   c. Claims resulting from pre-order contracts if the administrator chose performance of the contract.

3. General unsecured creditors

4. Subordinated unsecured creditors

5. Equity (according to shareholders' rights)

9.2.6 Case studies

Monier

Monier, formerly Lafarge Roofing, is a German roofing company which was bought by PAI partners in February 2007 for €2.4bn backed by €2.07bn of debt financing. This included senior debt consisting of a €125mn seven-year revolving credit facility, a €175mn seven-year capital expenditure facility, a €200mn seven-year term loan A and a €622.5mn eight-year term loan B. There was also junior debt consisting of €325mn of a nine-and-a-half year second-lien loan. In March 2008, PAI bought[30] back some of its second-lien debt at 55% of face value.

The increase in raw material costs during 2008 combined with the slump in US, UK and German property markets had negative implications for Monier's business. By October 2008, Monier was starting to draw down on its revolving credit facility. A decline in available liquidity resulted in very tight headroom under its leverage covenant test. Due to negative forecasts for 2009 and 2010, and expecting that it would breach a covenant at the end of December 2008, Monier advised lenders of its intention to pursue a debt restructuring. PAI delayed filing Monier's covenant compliance certificate[31] while it worked with Monier to develop a rescue plan. This delay prevented an acceleration of the debt and so prevented the company from becoming technically insolvent.

By early 2009, a syndicate of investors including Apollo Global Management, Towerbrook Capital Partners and York Capital Management (ATY) had built a position in Monier's debt through the secondary loan market. They encouraged Monier to take part in a debt restructuring. Since Monier was domiciled in Germany, it could take advantage of the insolvency plan. However, since the company was not technically insolvent, management and creditors attempted to reach a consensual agreement out-of-court.

In May 2009, PAI submitted a first restructuring plan for Monier. This plan was rejected by senior lenders on the basis that it gave PAI too big a stake in the restructured business and would cause too many debt holders to lose out. A new plan was then produced by ATY which proposed better terms for creditors. PAI also returned with a new restructuring plan but this was rejected. By July 2009, the ATY plan was accepted, and was eventually approved by 99% of Monier's creditors. The debt restructuring was completed by October 2009.

It is worth noting that at one stage in the restructuring process, serious consideration was given to a change of COMI to the UK in order to use a scheme of arrangement. This would have been needed to adjust some of the senior debt – a scheme of arrangement can cram down a specific class of creditors using a simple majority provided 75% of all creditors vote in favour. However, this was rejected once it became clear that the acceptance of the ATY plan was near unanimous. Furthermore, as a scheme of arrangement is not recognised by EU regulations, there was a concern that the creditors would still have been able to enforce their claims in Germany.

---

[30] See *Loan-to-own: Coming to Europe?* by Orlando Fernandez of PLC Cross-Border.
[31] Failure to file a covenant compliance certificate did not in this case qualify as a covenant breach and so did not cause acceleration of the debt and a state of insolvency for Monier.

Ihr Platz

Ihr Platz [32] is an example of a German company which achieved a successful restructuring using the insolvency plan process. The company is one of Germany's largest drugstore retailers and in 2005 it was suffering from almost five years of losses, bad acquisitions and changes in management.

An initial out-of-court restructuring occurred in 2004 when its lenders, mostly German banks, agreed to write off 40% of the outstanding debt and forced shareholders to pledge their shares which were placed in a trust. New management was brought in to restructure and sell the company. By March 2005, the company was once again in financial distress and restructuring specialist Alvarez & Marsal (A&M) was appointed to lead a restructuring.

It quickly became apparent that an out-of-court restructuring would be time-consuming and costly due to the unwillingness of the various creditors, i.e. lenders, workers, suppliers and landlords, to agree to the plan since this proposed the closure of some of its retail outlets. It was therefore decided that the company could only be restructured through an in-court insolvency process. This was viewed by A&M as the best way to protect jobs and minimise costs. The company filed for insolvency in Germany. The filing included a draft of the restructuring plan which explained why A&M believed that the company could be rescued as a going concern using the proposed restructuring plan.

During the first three months of the preliminary insolvency period the salaries of all employees continued to be paid by the labour agency. The law also permitted the company to reject long-term contracts and leases and to reduce long-term liabilities such as pensions[33].

At the end of the three-month period the formal insolvency period began. The preliminary administrator had recommended a "self-administration" for Ihr Platz, a little-used provision which can be combined with the insolvency plan procedure to allow management to stay in place to oversee the restructuring. The plan also showed how creditors would receive more in a self-administered insolvency plan than otherwise.

The Osnabrueck court approved this request and Ihr Platz's self-administration was approved on 1 September 2005. Within a couple of months, Ihr Platz management, with the help of the court order, was able to close loss-making outlets, streamline its logistical chain by shutting down one warehouse, and increase efficiency by removing a layer of management. Overall, these decisions resulted in 10% of its total staff losing their jobs.

With improved finance and operations, a restructuring plan was voted on and passed by creditors in November 2005 and Ihr Platz emerged from insolvency in mid-January 2006 a more efficient and focused company than before with a much improved financial strength. It had spent only eight months in insolvency. The ability of the insolvency procedure to rehabilitate companies had been shown. It remains to be seen whether it will be used more frequently.

9.2.7 International

For cross-border bankruptcy proceedings within the European Union, Germany is subject to the European Insolvency Regulation which came into force in May 2002.

The UNCITRAL model law on cross-border insolvency has not been adopted in Germany.

[32] The case study presented here relies on the description provided by Alvarez and Marsal at http://www.alvarezandmarsal.com/en/news/article.aspx?article=5754
[33] Long-term contracts and leases generally survive the initiation of insolvency proceedings but may be terminated in compliance with statutory notice periods.

9.2.8 Summary of procedures

Figure 20 summarises the main features of the German insolvency procedures.

Figure 20. Main insolvency procedures in Germany

Criterion	Liquidation within Insolvency Act	Insolvency Plan
Purpose	Best possible satisfaction of creditors by liquidating assets and distributing proceeds	Enabling enterprise to continue as going concern
Condition for entry	Insolvent (consists of a cash flow and balance sheet test). Directors must file within a maximum of three weeks of after they should have become aware of insolvency. Creditors meeting must vote to liquidate	Insolvent (consists of a cash flow and balance sheet test). Directors must file within a maximum of three weeks after they should have become aware of insolvency. Creditors meeting must vote to restructure
Stay on creditors	Court usually imposes stay during initial proceedings. Once proceedings open this becomes an automatic stay on unsecured creditors but not mortgagees or pledges of immovable assets (including in particular shares). Different rules apply for security over moveable assets and receivables.	
Control	Insolvency Administrator	Insolvency Administrator Self-administration is possible on the discretion of the court. In this case the management stays in control
Approval for plan	N/A	A majority of creditors in terms of value and number in each class need to vote in favour for the class to approve the plan. The majority of classes must support the plan.
Binding	N/A	Yes. If it is (i) approved by the court, (ii) adopted by dissenting creditors and (iii) provides for recovery to dissenting creditors which is not worse than their recovery without the insolvency plan and is fair and adequate compared with the recovery of the other creditors and there is no unequal treatment of creditors within the same class.
Court involvement	Yes. Court approves entry to procedure and imposes initial stay	Yes. Court approves entry to procedure, impose stay and approves plan
Enhanced priority financing	N/A	Yes, achieves preferred creditor status
Average procedure time (estimate)	Without an insolvency plan, the administrator may sell the insolvent company as a going concern within a few months. If the company goes through the whole process of liquidation, it is likely to take two to five years depending on the size of the company and the number of claims which are disputed between the creditors and the insolvency administrator	The average time for the insolvency proceedings by employing an insolvency plan is six months if you have a pre-arranged plan and otherwise about eight to ten months. The time needed for the preparation of a plan prior to the filing for insolvency is about two months. Time is also needed for the implementation of the plan after insolvency proceedings have been terminated
Recent uses	TMD Friction, EDSCHA	Ihr Platz, Herlitz AG, Llloyd Werft Bremerhafen, Senator Entertainment AG, Sinn Leffers GMBH, Karstadt

Source: Nomura, L&W

9.2.9 Commentary

The insolvency plan has not been used widely as there seems to be an emphasis on liquidation

Despite Germany's introduction of an insolvency plan for facilitating restructurings, it is not widely used for companies in financial distress. Most companies, including those with the potential to be restructured, still end up going into the liquidation process where they are sold or split up. Indeed, obtaining a recovery for creditors from the proceeds of the liquidation rather than restructuring the company is the primary focus of the current insolvency law.

However the insolvency plan has a number of features which encourage restructuring

This is unfortunate as the insolvency plan has a number of features which make obtaining a restructuring more likely, including its speed, its stay and its cramdown mechanism. Together with the fact that insolvency proceedings also allow for wage costs to be covered by the state for up to three months, these provisions mean it is possible to enact quick restructurings with minimal job losses.

The requirement to file within three weeks of becoming insolvent limits management's ability to agree a restructuring plan informally

Out-of-court restructurings are difficult to arrange in Germany since they require full consensual agreement from all of the creditors which is often difficult to obtain. Also there are no legal tools to use pre-insolvency. Management has to bear in mind that a failure to file for insolvency within three weeks of becoming insolvent can make it criminally liable. This limits the amount of time management has to negotiate with creditors before it has to file. For these reasons, another approach used by German companies is to move their COMI to the United Kingdom in order to benefit from the out-of-court procedures such as the CVA and schemes of arrangement, or to the US to make use of Chapter 11 proceedings.

The alternative for some German companies is to migrate their COMI to the UK

What the Monier example shows is that despite the introduction of the insolvency plan, most restructurings in Germany are conducted out-of-court, and that when a cramdown is needed, a COMI switch to the UK is often considered. In the Monier case this was not necessary. The Ihr Platz example showed that "self-administration", combined with the insolvency plan, creates a Chapter 11-style approach that can work well. However, it has only been used in a small number of cases so far.

9.2.10 Acknowledgements

We would like to thank lawyer Frank Grell for his comments and assistance on this section. His contact details are as follows:

Frank Grell
LATHAM & WATKINS LLP
Warburgstrasse 50
20354 Hamburg
Germany
frank.grell@lw.com
+49 40 4140 30

9.3 France

France has recently revised its insolvency laws in order to encourage rehabilitation

In recent years France has made important efforts to address the criticism that it is creditor unfriendly and does not do enough to encourage the rehabilitation of companies in financial distress. In 2005, the French government passed the new Safeguard insolvency law which then came into force in January 2006. It was subsequently refined in 2008 and these changes came into effect in February 2009.

The Safeguard procedure was partly inspired by the US Chapter 11 procedure

These reforms were partly inspired by the US Chapter 11 procedure and were intended to promote voluntary arrangements between debtors and creditors which anticipate financial problems by allowing insolvency proceedings to begin before the traditional insolvency test is failed. The reforms were also intended to simplify and speed up proceedings. The procedures currently available in France for companies in financial distress are:

a) Liquidation proceedings (liquidation judiciaire)

b) Mandat ad hoc proceedings;

c) Conciliation proceedings;

d) Safeguard proceedings; and

e) Redressement judiciaire.

These are all described below.

The court responsible for bankruptcy proceedings is the commercial court where the company has its registered office

In almost all cases, the court with responsibility for bankruptcy proceedings is usually the commercial court where the company has its registered office. Security for immoveable assets usually takes the form of a mortgage or a lien. For moveable assets, security usually takes the form of a pledge or retention of title. There is no concept of a floating charge in French bankruptcy law. Set-off occurs automatically for reciprocal debts which both occurred either before or after the opening of proceedings.

In France, insolvency is defined as a debtor being in a state of *cessation des paiements*

In France, insolvency is defined as a debtor being in a state of *cessation des paiements*. This means that the debtor is unable to pay debts as they fall due with cash or readily saleable assets. There is no balance sheet test. Failure to file for bankruptcy once this state has been reached can expose the management to personal financial risk as it can be considered an act of mismanagement.

9.3.1 Pre-insolvency

Debtors and creditors are free to reach an agreement pre-insolvency

There is nothing to stop debtors and creditors agreeing a restructuring informally while the company is solvent without going via one of the formal procedures. In addition, France has a number of restructuring procedures. Some can be used if the company is solvent, some which can be used if the company has not been insolvent for more than 45 days and some which can be used only if the company is insolvent. We discuss all of these below in section 9.3.3.

9.3.2 Liquidation

Some insolvency procedures must begin within 45 days of becoming insolvent

In France, any company must file a request to begin *conciliation*, *redressment judiciaire* or liquidation proceedings within 45 days of the company becoming insolvent. If the company has ceased trading, and recovery is impossible, then liquidation proceedings (*liquidation judiciaire*) will commence.

Liquidation proceedings can also be started by a creditor

The same process can be started involuntarily, i.e. a creditor who has not been paid when payment was due and can prove that the company is in a state of *cessations des paiements* can start liquidation proceedings. The creditor needs to prove to the court that it has tried to receive payment and has been refused by the debtor. The creditor must also prove that the company has ceased business or that recovery is impossible.

Management is replaced with a liquidator

A liquidator will be appointed who takes over the management of the company. He will sell the company in parts if it is no longer being operated as a going concern. If the company is viable as a going concern then the court may open a three-month period, extendable to six months, to sell the company. A judicial administrator may be appointed to handle the sale. Creditors of the company need to file a statement of claims within two months of the publication of the liquidation order in the Official Gazette if they are based in France, or four months if they are not.

There is a stay on all creditor actions including enforcement of security

Both secured and unsecured creditors are stayed at the start of proceedings. This stay may be lifted for secured creditors in two cases. The first is if the court has not authorised the company to continue to operate as a going concern but the liquidator has failed to sell the secured assets within three months of the order to begin the liquidation. The second is if the court has authorised the company to continue as a going concern but at the end of the three- (or six-) month period, the collateral has not been included in the sale of the company.

Following a liquidation of assets or the entire company, the proceeds are distributed according to the priority defined in section 9.3.3. The average liquidation procedure lasts three to four years.

9.3.3 Reorganisation

There are four different reorganisation procedures. Some can be used only while the company is still solvent, i.e. before the *cessation des paiements* test is triggered, while others require the company to be in a state of insolvency. We describe them below.

Mandat ad hoc proceedings

Mandat ad hoc is an informal and confidential process for solvent companies

The simplest of the pre-insolvency rehabilitation mechanisms is an informal and confidential process known as the *mandat ad hoc*. It can only be used if the company is still solvent, i.e. it has not violated the *cessations des paiements* test. It can only be initiated by the company.

Management retains control and a mediator is appointed to assist the formulation of a rescue plan

Management remains in control and the court, upon request of the debtor, appoints a professional mediator or *mandataire ad hoc* who is expert in reorganisation and insolvency to assist management in formulating a negotiated rescue plan with creditors. However, the decisions of the *mandataire ad hoc* are not binding. The court may, on a case-by-case basis, impose on aggressive creditors a two-year rescheduling of amounts due during which their ability to enforce their collateral is stayed. There is no time limit for the procedure which can last for as long as the court authorises.

There is no cramdown mechanism and approval requires unanimous consent from the creditors

Creditors cannot be forced to accept a reduction or a rescheduling of their claims. Approval of the rescue plan requires the consent of all of the creditors. Since there is no cramdown mechanism in this proceeding, achieving this unanimity may require junior out-of-the-money debt holders to receive some recovery, often in the form of equity. Failure to agree a rescue plan can result in either a liquidation proceeding or the opening of any of the other reorganisation proceedings depending on the situation of the company.

Conciliation proceedings

The conciliation procedure can only be used if the company has been insolvent for less than 45 days

The conciliation procedure is another restructuring procedure which can only be used if the company is solvent or has been insolvent for less than 45 days. It can only be initiated by the company. It is intended to allow management and its main creditors to reach a restructuring agreement. To use this procedure, the company needs to provide the court with information about its financial, economic and social situation and the court needs to be satisfied that the company's financial difficulties can be overcome.

Management remains in control and a conciliator is appointed to facilitate the negotiation of an agreement

Management remains in control and a conciliator is appointed whose role is to facilitate the negotiation of a voluntary agreement with the creditors. There is no automatic stay on the enforcement of security. The court may on a case-by-case basis impose a two-year maximum deferral period on the payment of debt to creditors who, during the course of the conciliation procedure take action against the company for the payment of their claims.

Plan approval requires the consent of all creditors

The process allows for a four-month negotiation period which can be extended for a further month. The consent of all of the creditors is required to approve the plan. Creditors cannot be forced to accept a reduction or a rescheduling of their claims.

Post-insolvency financing is permitted as long as the exit from the plan is public

One important feature of conciliation is that, provided the exit from the conciliation is public (see below), it allows for the use of new post-insolvency financing and this has priority over existing debt claims, including secured claims (although it does rank junior to employee salary claims, court fees and court expenses).

The agreement can be privately certified or it can be publicly ratified by the court

Once a restructuring agreement has been reached, there are basically two exit choices. Either, the agreement can be certified by the president of the court, in which case the process and the agreement remains confidential. Otherwise court approval may be sought in order to ratify the agreement, make it public, and give it the legal strength of a court judgment. This requires that the company is solvent, is a going concern and that the restructuring agreement does not unduly prejudice the interests of creditors who are not party to it.

Safeguard proceedings

Safeguard is a pre-insolvency rehabilitation procedure

The safeguard procedure is a rehabilitation procedure which is allowed only if the company is not insolvent at the moment of filing. To qualify, the company must be able to demonstrate that it faces insurmountable difficulties that it cannot overcome. Amendments to the safeguard procedure introduced in 2008 mean that it is no longer necessary for the company to demonstrate that the difficulties facing it will cause it to become insolvent.

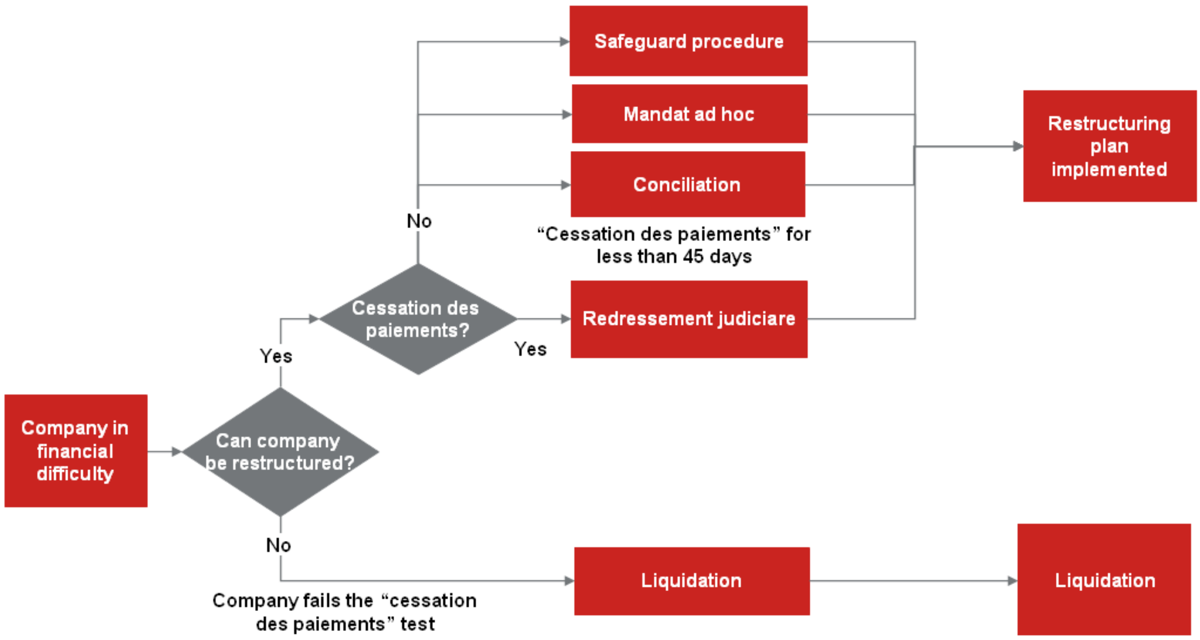
The company files a petition with the court which must then decide that there is a likelihood of saving the business

To start the procedure, a petition must be filed with the appropriate court. The procedure can only be initiated by the debtor company and not by a creditor. The decision on whether the company can take this route is made by the judge who has to determine whether there is a likelihood of saving the business. The procedure and the decisions of the court are made public.

Management retains control; an administrator may be appointed to assist the negotiations

Management remains in control. However, an administrator may be appointed to supervise or assist management in its attempt to reach an agreement with its creditors. Recent amendments in the law allow the company to suggest to the court the name of an insolvency administrator to perform the role of administrator.

Figure 21. Flowchart for French insolvency procedure



Source: Nomura

The company has at least six months to negotiate a plan

The safeguard proceedings open a maximum six-month "observation period", which can be renewed and last up to 18 months. This period gives the company time to negotiate a plan which involves a restructuring or cancellation of its debt.

There is a comprehensive stay on the enforcement of security

During this period there is a stay on the enforcement of security which applies to secured and unsecured creditors. There is also a freeze on debt payments and on acceleration. Creditors need to send a statement of their claims to the court. All non-ordinary transactions need approval from the court.

Holders of bank debt purchased in the secondary markets sit on the credit institutions committee

For companies with more than 150 employees and/or more than €20mn of annual revenues, two creditors' committees are formed by the administrator. One is for "credit institutions" and the other is for "main suppliers". Investment funds which have purchased bank debt in the secondary loan or bond market sit on the credit institutions committee. For smaller companies, the committees may also be formed at the request of the company or of the administrator.

Plan approval requires a majority of 66% from both creditors' committees

The restructuring plan is presented to the committees by the company with the assistance of the administrator. A creditor who is also a committee member can also make proposals to the company or the administrator with respect to preparing a plan. To approve a plan and make it binding, both committees must be in favour with a two-thirds majority by claim size of the voting members of the committee.

Plan approval also requires a vote in favour by at least 66% of all bondholders by claim size

If the company has issued bonds, a majority vote by two-thirds (by size of claim) of all bondholders is also required for approval of the plan. This happens at a general meeting of all bondholders once the creditors' committees have approved the plan. The court can then approve the plan which will become binding on the members of the committees[34] and the bondholders.

If there is no court approval proceedings may continue but creditors are consulted individually

If there is no court approval, the proceedings may continue but the creditors must then be consulted individually[35] on the company's debt repayment proposals. In this case the plan cannot force debt forgiveness and the duration of the plan cannot last for more than 10 years.

If insolvency occurs then the proceedings convert into a redressement judiciaire

If insolvency occurs at any time during or after the safeguard proceedings and the company can still be reorganised, the proceedings can be converted to a *redressement judiciaire* procedure which we now describe.

Redressement judiciaire

Redressement judiciaire is a rehabilitation procedure for companies already in a state of insolvency

The final rehabilitation procedure is known as *redressement judiciaire*. It is similar to the safeguard proceedings except that it is used if the company is already insolvent. It can also be initiated by a creditor who must show that it has already attempted to seek repayment of its debt and also that the company has therefore failed the *cessations des paiements* test.

The company must not have ceased activities

To enter this procedure, the company will not have ceased its activities and so has a chance of being rehabilitated. A maximum six-month observation period is opened during which the court assesses whether the company should go through a restructuring process or should be liquidated. This period can be extended to up to 18 months.

There is a stay on creditors; approval of the rescue plan has the same conditions as a safeguard procedure

The same restrictions apply to creditors as in the safeguard procedure, i.e. there is a stay on enforcement by secured creditors and non-ordinary transactions require the approval of a court-appointed administrator. A *redressement judiciaire* rescue plan has the same approval requirements as a safeguard procedure, i.e. two creditor committees and a general meeting of bondholders must vote with more than 66% in favour.

At the end of the procedure, if agreement has not been reached, the court can impose a plan. In some cases, the stay on assets can last for as long as ten years. Otherwise the company can enter the liquidation procedure.

A flow chart showing all of the French insolvency procedures is provided in Figure 21.

9.3.4 Priority of payments

Since a number of different laws address the priority of payments, it is not possible to state a precise order that will always be valid. However, roughly speaking, the payments to creditors are made in the following order starting with the highest priority:

1. Unpaid amounts due to employees (e.g. wages, amounts due with respect to accrued and untaken holidays) for the 60 days before opening of proceedings
2. Judicial costs
3. New post-insolvency financing (see the conciliation process)
4. Perfected mortgages and pledges with retention rights
5. Post-judgment claims incurred in the course of the insolvency process (fees, claims)

[34] Creditors who were not members of the committee or part of the group of bondholders are consulted individually by the *mandataire judiciaire*. The plan cannot force debt forgiveness on them and the duration of the plan cannot exceed 10 years.
[35] The consultation with bondholders, where a bond trustee or representative with sole power to act for the bondholders has been appointed, is made through this trustee/representative who has to convene a bondholders' meeting to vote on the debt repayment proposals made by the company.

6. Pledges without retention rights
7. General privileges, including tax and social security claims
8. Unsecured debts which arose before the start of proceedings.

9.3.5 Case study

Belvedere

Belvedere, a French drinks company based in Dijon, filed for bankruptcy protection in July 2008. Prior to the filing, the company had triggered a technical default by executing a share repurchase which breached limitations on such repurchases. However, the company was still solvent. The company said that it would take it until September 2008 to compensate bondholders for this breach. However, at the request of the company, the French court agreed to push this date back.

The deadline for submitting a rescue plan within the framework of the French safeguard procedure was January 2009 which was subsequently extended to July 2009. At a court hearing in April 2009, the company and creditors both proposed a company restructuring plan. The creditors' plan provided for a debt-to-equity swap which was rejected by company management due to its dilution of its existing shareholding. The company plan involved a 10-year term-out period to repay debt and the sale of various assets.

The company also argued that the claims of buyers of foreign-domiciled holders of €375mn of senior secured floating rate notes issued in 2006 were not permitted since they did not comply with the applicable French law. In July 2009, bondholders challenged Belvedere's opening of safeguard proceedings a year earlier arguing that the company was not at that time facing difficulties that would lead it to an insolvency situation. The challenge was rejected without a hearing from the bondholders who, being distressed investors based outside France, were not recognised by the court.

However, this was appealed since in the same week the French High Court ruled on an earlier decision which had said that bondholders of the company Eurotunnel such as hedge funds which had bought the debt in the secondary market were third parties and so could be admitted to the court. The decision said that bondholders based in another jurisdiction cannot be denied the right to challenge the jurisdiction of that member state's courts.

On 10 November 2009 the commercial court in Dijon approved the safeguard plan. This plan allowed for the 10-year term-out period requested by the company to repay its debt. The company also claimed that some of the FRN debtholders had not submitted their claims correctly and so were not to be repaid at all. However, a ruling on 10 December 2009 stated that all of the FRN debt should be included in the restructuring.

9.3.6 International

For cross-border bankruptcy proceedings within the European Union, France is subject to the European Insolvency Regulation which came into force in May 2002. The UNCITRAL model law on cross-border insolvency has not been adopted in France.

9.3.7 Summary of procedures

Figure 22 summarises the main features of the French rehabilitation procedures.

Figure 22. Main rehabilitation procedures in France

Criterion	Mandat Ad Hoc	Conciliation	Safeguard	Redressement judiciaire
Condition for entry	In financial difficulty but not insolvent	Not insolvent or insolvent for less than 45 days	Not insolvent but facing insurmountable difficulties	Insolvent
Stay on creditors	Not automatic, may be imposed by court for a maximum of two years to individual creditors	Not automatic, may be imposed by court for a maximum of two years to individual creditors having taken action for the payment of their claim	Yes, automatic and comprehensive	Yes, automatic and comprehensive
Control	Management assisted by insolvency practitioner	Management retains control and a conciliator is appointed	Management with supervisor	Management under supervision of court-appointed administrator
Approval for plan	Consensual 100%	Consensual 100%	Two creditors committee and bondholder general meeting to vote in favour (two-thirds by size of claim required). If the plan is not approved the court can impose a plan but cannot impose debt forgiveness	Two creditors committees and bondholder general meeting to vote in favour (two-thirds by size of claim required). If the plan is not approved the court can impose a plan but cannot impose debt forgiveness
Binding	All creditors	All creditors	Yes	Yes
Court involvement	Minimal and Informal	Some. Appoints conciliator and may approve any agreement	Yes. Court approves agreement and can impose a plan	Yes. Court approves agreement and can impose a plan.
Enhanced Priority Financing	No	Yes, but junior to salary claims, court fees and expenses	Limited	No
Average procedure time (estimate)	Variable. No statutory maximum time limit. In practice, generally between three and nine months.	The statutory maximum is five months. Generally between two and five months.	The maximum is 18 months. In practice, the more the proceeding is preceded by negotiations with creditors, the shorter it is (7 weeks for Autodistribution and 10 weeks for Technicolor (ex-Thomson)). If it is not preceded by negotiations with creditors, it is generally between 12 and 18 months (16 months for Belvédère and 14 months for Orco Property Group)	The statutory maximum is 18 months. In practice, generally between 6 and 18 months.
Other comments	Confidential	Post-insolvency financing is granted priority status if conciliation exit is public.	Closest of reorganisation procedures to Chapter 11. Plan could result in a stay of up to 10 years	Plan could result in a stay of up to 10 years.
Recent uses	The procedure is confidential	The procedure either remains confidential or becomes public. Autodistribution and CPI are examples of conciliations that became public	Eurotunnel, Autodistribution, Belvedere, Thomson	Since safeguard proceedings entered into force in France on 1 Janary 2006, all major restructurings have been done under safeguard proceedings. There are a few on-going attempted restructurings under redressement judiciaire such as Heuliez and Christian Lacroix

Source: Nomura, L&W

9.3.8 Commentary

France's insolvency framework was viewed as being unfriendly to creditors due to the long stay and limited influence

Despite the changes in France's bankruptcy laws, it remains a debtor-friendly bankruptcy regime. For example, secured creditors are restricted from exercising their security during insolvency proceedings and the stay may last for up to 10 years, as shown in the Belvedere case study. Creditors also have limited control over the insolvency process with a lot of the important decisions being taken by the court. Creditors are not allowed to start a conciliation procedure or a safeguard procedure but have to wait for the company to first become insolvent.

The safeguard procedure has been an important improvement for creditors and is becoming increasingly popular

However, the situation is better than it was. The introduction of the safeguard procedure has been an important step forward for creditors' rights in France. The use of creditors' committees and the vote by foreign bondholders has granted secured and unsecured creditors a direct influence over the restructuring plan. An increasing number of high profile restructurings, including Eurotunnel, Belvedere, Autodistribution and Thomson have chosen this procedure and we expect this trend to continue.

9.3.9 Acknowledgements

We would like to thank lawyers Hervé Diogo Amengual and Xavier Farde for their comments and assistance on this section. Their contact details are as follows:

Hervé Diogo Amengual / Xavier Farde
LATHAM & WATKINS
53, quai d'Orsay
75007 Paris
France
herve.diogoamengual@lw.com / xavier.farde@lw.com
+33 1 40 62 20 00

9.4 Italy

Italy has revised its insolvency laws in the past 10 years to better facilitate rehabilitation

Italy has revised its insolvency laws significantly in the past 10 years and by doing so has shifted the focus of insolvency from punishment of the debtor to facilitating the rehabilitation of failing companies. Some of the changes were prompted by specific events, especially the 2003 default of Parmalat which we discuss in the case study in section 9.4.5. This encouraged legislators to give companies more flexibility to reach agreement with creditors.

The most recent changes occurred in 2009

Italian bankruptcy law is set out in the Bankruptcy Act of 1942 which was added to in 1999 with a new decree on the extraordinary administration of large insolvent companies. This was then amended by the Marzano law in 2003 and then again in 2004. Further laws were also passed in 2005 on claw-backs and rescue procedures with further amendments passed between 2006 and 2010.

The insolvency procedures available in Italy are:

a) Liquidation proceedings (*fallimento*);

b) Compulsory administrative liquidation;

c) Reorganisation plan (Article 67);

d) Debt restructuring agreement;

e) Pre-bankruptcy agreement;

f) Bankruptcy agreement (*concordato fallimentare*); and

g) Extraordinary administration (Prodi and Marzano).

These are all set out in detail below.

According to Italian law, a company is insolvent when it is no longer able to meet its obligations in an ordinary manner

According to Italian law, a company is insolvent when it is no longer able to meet its obligations in an ordinary manner. Insolvency is also triggered when a company sells asset for less than the market price in order to obtain cash or when a debtor pays its creditors in an unusual manner, e.g. payments in kind. Failure to declare insolvency can expose the directors of the company to criminal liability if the delay results in losses.

Security over immoveable assets takes the form of a mortgage; for moveable assets security is taken using pledges

In Italy, credit can be secured by immoveable or moveable assets. Security over immoveable assets takes the form of a mortgage (which can be legal, judicial or conventional). Mortgages are perfected by filing with the real estate property register in the place where the property is situated. Security over moveable assets can take the form of pledges. The pledge includes a "revolving pledge" (*pegno rotativo*) which is usually created over shares and which has similarities to the UK concept of the floating charge. Set-off is permitted.

The court which handles insolvency cases is the court of first instance located in the place where the company has its principal place of business. In some jurisdictions, especially the larger ones, there is a court section dedicated to insolvency-related matters.

Italian law provides several different procedures which can be used depending on the nature of the company, its state of solvency and whether the aim is liquidation or restructuring. We begin with pre-insolvency restructuring procedures.

9.4.1 Pre-insolvency

The law provides two pre-insolvency procedures which increase the chances of a successful restructuring plan

Creditors have the ability to negotiate an out-of-court restructuring agreement with management and shareholders. However, this can only succeed if there is unanimous agreement from all creditors, which is often not achievable. There is also a risk that acts or payments made as part of the agreement may be clawed back. However, Italy does provide some pre-insolvency procedures which increase the chances of agreeing a plan. We now present two pre-insolvency restructuring procedures which have been central to the recent reforms of Italian insolvency law. They differ in the precise way they require court approval of the out-of-court restructuring plan.

Reorganisation plan (Article 67)

The reorganisation plan is a rapid, confidential, out-of-court procedure

The first restructuring procedure is the "reorganisation plan" (*piano attestato*) which is based on Article 67 of the Bankruptcy Act. This is a rapid, confidential and almost exclusively out-of-court procedure which has the aim of reorganising the company and restructuring its debt. It is based on a reorganisation plan prepared by the company which must be assessed and validated by an independent expert. The expert is usually appointed by the company, although in some cases, the courts have decided to appoint the expert themselves.

It excludes acts and payments made in accordance with the plan from subsequent claw-back actions

One advantage of this procedure is that it excludes acts and payments made in accordance with the plan from subsequent claw-back actions, thereby removing one important source of uncertainty in the implementation of the plan. The nature of the plan which has to be assessed and validated by the expert is fairly unconstrained and can include all sorts of debt-restructuring options. However, it is only binding on those creditors who are mentioned in it and who have accepted it. There is therefore no cramdown for the other creditors.

There aim of the procedure is to be fast and flexible and there is no court sanction

The aim of this procedure is to be fast and flexible. There is no court sanction and it is hoped that the business impact of the process will be limited. It has already been used in a number of cases including Ferretti (see case study below), Tiscali, Arcotronics and Pininfarina.

Debt restructuring agreement

The debt restructuring from Article 182 bis of the Bankruptcy Act is a pre-pack restructuring

The debt restructuring agreement (*accordo di ristrutturazione*) from Article 182 bis of the Bankruptcy Act is another informal pre-insolvency procedure for company restructuring. Since 2009, it has become increasingly used in Italian restructurings. It can be thought of as a pre-packaged restructuring procedure since the plan is agreed pre-insolvency between debtor and creditors with the intention of putting it into immediate effect following court approval.

The first step of the process is for the debtor and creditors to reach an agreement

The first step of the process is for the debtor and creditors to reach an agreement. The company then prepares a reorganisation plan and the independent expert writes a report to be included in the agreement. These documents are then published by filing them with the competent Companies' Register. Creditors then have up to 30 days to file objections. The court then decides whether to approve the agreement.

It is possible for the stay period to begin 60 days prior to publication of the agreement

Until recently, there was an immediate and automatic 60-day stay against enforcement actions which began at the time of the publication of the agreement at the register of enterprises (*registro delle imprese*). However, a recent change[36] in the law makes it possible for the stay to begin before the agreement is published as long as a petition has been filed with a bankruptcy court informing it that restructuring talks are under way with creditors representing at least 60% of the total credits negotiating. An expert's appraisal must also be filed attesting that the creditors who are not part of the restructuring agreement will be paid as normal. The petition must be approved by a judge. This change is intended to protect the company from aggressive creditors while the restructuring agreement is being negotiated.

Plan approval requires at least 60% of creditors by value to vote in favour

In this procedure, approval of the plan by the creditors requires at least 60% of participating creditors by value to vote in favour. To obtain the necessary court approval, the plan must be accompanied by a report stating that parties who have not entered into the agreement will be fully repaid.

The law permits certain loans to obtain super senior status

Another recent change in the law permits loans provided by banks and authorised financial intermediaries in connection with a request to the court to ratify a restructuring agreement to obtain super senior status (see section 9.4.4) if the court grants the ratification. This also applies to loans provided in the execution of a restructuring agreement which has been court-ratified. These creditors cannot be included in the majorities required for the approval of the agreement by the court.

[36] Law Decree no. 78/2010 which was published in May 2010.

Super senior status can also apply to 80% of the value of loans provided by the shareholders of the company

Super senior status can also apply to 80% of the value of loans provided by the shareholders of the company, for example to cure a covenant breach. In all cases the loans must not prejudice pre-existing senior secured claims and must be part of the ratified restructuring plan. As above, these creditors cannot be included in the majorities required for the approval of the agreement by the court.

This process has been used in a number of cases including Caffaro Flexible Packaging.

Pre-insolvency agreement

Pre-insolvency agreement is a procedure for a company in a state of crisis

Under the formal pre-insolvency agreement procedure (*concordato preventivo*), also known as pre-insolvency composition, a company can be placed into a pre-insolvency procedure when it is in a state of crisis on the condition that it presents a plan to its creditors which seeks to restructure its debts and repay claims in any form.

It is initiated by the debtor but must be supported by an expert's report

The procedure is initiated when the debtor files a plan with the court where the company has its registered office. The plan's viability must be supported by an expert's report and the filing must include a list of creditors.

If the court rules that the company satisfies the conditions to file then an immediate stay comes into effect

Once filed, the court will first rule on whether the company satisfies the conditions to file for the procedure. If the court finds that the company is insolvent and the creditors or the public prosecutor require it, bankruptcy proceedings will be opened. There is an immediate stay on actions by all creditors which typically lasts until the end of the procedure.

Management remains in control under the supervision of the commissioner

A judicial commissioner (*commissario giudiziale*) is then appointed to liaise with the creditors and to inform them of the details of the plan and the date of the hearing at which creditors will be asked to vote on the plan. Management is allowed to remain in control of the business under the supervision of the commissioner.

Minority creditors who vote against the plan can be crammed down

Recent changes allow the debtor to divide the creditors into different classes. At the creditors' meeting, if the majority of creditors, or, in the case of different classes of creditors, the majority of classes vote in favour of the plan, then it is approved and is binding on all creditors. There is therefore a cramdown of classes of creditors, who do not support the plan.

The plan can propose that secured creditors are not fully repaid subject to some conditions

Note that priority claims which are expected to be paid in full do not have voting rights unless they waive their right of priority. It is also possible for the plan to propose that secured creditors are not fully repaid. This is only allowed if they do not receive less than the market value of the secured assets and that they do not receive worse treatment than unsecured creditors. Transactions carried out as part of the court-approved agreement are exempt from claw-back.

Loans provided by banks and financial intermediaries can obtain super senior status

The very recent changes in the law published in May 2010 also apply to this procedure. They permit loans provided by banks and authorised financial intermediaries in connection with a request to ratify a pre-insolvency restructuring agreement to obtain super senior status (see section 9.4.4), as long as the court grants the ratification. These claims cannot be included in the majorities required for the approval of the agreement.

This also applies to 80% of loans provided by shareholders

This also applies to 80% of the value of loans provided by the shareholders of the company. In all cases the loan must be part of the agreed restructuring plan. As above, these claims cannot be included in the majorities required for the approval of the agreement.

The procedure must be completed within six months (with a possible extension of 60 days)

The pre-insolvency agreement procedure must be completed within six months (with the possibility of an extension of 60 days) of the date of the initial filing. If this is not achieved, the court may declare the company bankrupt. This procedure is intended to be quick, taking between six and nine months to complete. It has already been used in a number of cases including Favini, Kartogroup, Gio Style, Faber Factor and Bear.

9.4.2 Post-insolvency liquidation

There are two liquidation procedures.

Liquidation proceedings

Liquidation proceedings (*fallimento*) are used to liquidate an insolvent company

The liquidation procedure (*fallimento*) is used to liquidate an insolvent company in a way which respects the rights of the creditors and removes the company from the market. The debtor or one or more creditors are entitled to file a petition with the appropriate court. The procedure may also be initiated by the public prosecutor.

The company must be greater than a certain size

This procedure only applies to insolvent companies above a certain size. The size limits are expressed in terms of the value of a company's assets, annual revenues and current level of indebtedness. The thresholds are fairly low, for example current indebtedness has to be greater than €500,000 to use these proceedings.

Management loses control to a court-appointed trustee

If the court has verified that the company does qualify for bankruptcy proceedings, management will lose control of the company. The company will then be directed by a court-appointed trustee (*curatore fallimentare*) and supervised by a court and a creditors' committee of three to five creditors who are appointed by a judge and each represent the different kinds of claim.

There is also a stay on enforcement of all claims during the procedure

There is also a stay on enforcement of all claims during the procedure. This procedure also allows the trustee to bring claw-back actions. To avoid these claw-backs, the counterparty must demonstrate that it had no knowledge that the company was insolvent when these transactions were entered into. Transactions undertaken as part of the restructuring procedures are not usually subject to claw-back.

The trustee liquidates or sells the company as a going concern

The trustee's task is to liquidate the company's assets or to sell the company as a going concern. Recent reforms have enhanced the role of the creditors' committee but in practice it does not usually have an active role.

Compulsory administrative liquidation

Compulsory administrative liquidation applies to supervised companies such as banks and insurance companies

Compulsory administrative liquidation (*liquidazione coatta amministrativa*) is a special administrative procedure which only applies to supervised companies such as banks and insurance companies. The process is initiated by a petition filed by creditors, the debtor or the relevant public authority. If the company is found to be insolvent then proceedings will be opened by a court decision.

Management loses control and there is a stay on all creditor actions

The effects of the court decision are that management is no longer in control and the company must stop its business activity. There is an immediate stay on all actions. A liquidator (*commissario liquidatore*) is appointed by the competent administrative authority. The liquidator has to inform all creditors of the size of their claims against the company. The creditors can then file their observations and claims.

A liquidator prepares a plan for creditor approval which may be a debt restructuring

The liquidator prepares a plan which has to be approved by creditors. This plan may not necessarily be a liquidation but may also be a debt restructuring. Failure to agree the plan results in the company's assets being sold and the proceeds distributed to creditors in the same order of priority as in a standard bankruptcy.

9.4.3 Post-insolvency restructuring

There are two post-insolvency restructuring processes.

Bankruptcy agreement (*concordato fallimentare*)

Bankruptcy agreement is a post-insolvency procedure

Bankruptcy agreement (*concordato fallimentare*) is an in-court procedure only available after the declaration of bankruptcy. It can be initiated by the creditor or even a third-party proposing a plan during bankruptcy proceedings. Management loses control of the company which is run by a court-appointed trustee.

Approval of the plan requires a majority of creditors by value to be in favour and the support of the creditors' committee

Approval of the plan requires a majority of creditors to be in favour and the support of the creditors' committee. The plan can allow for the restructuring of debts and this may involve splitting the creditors into different classes. If the creditors' committee is split into different classes, approval requires a majority of creditors in a majority of classes to vote in favour. Once the plan is approved, it is binding on all creditors. There is therefore a cramdown on the non-consenting creditors.

Extraordinary administration is a restructuring process for large insolvent companies which has two forms: Prodi's law and Marzano's law

Extraordinary administration (Prodi's and Marzano's)

The other main mechanism for post-insolvency restructuring of large companies is known as extraordinary administration (*amministrazione straordinaria*). There are two versions of this procedure known by the names Prodi and Marzano.

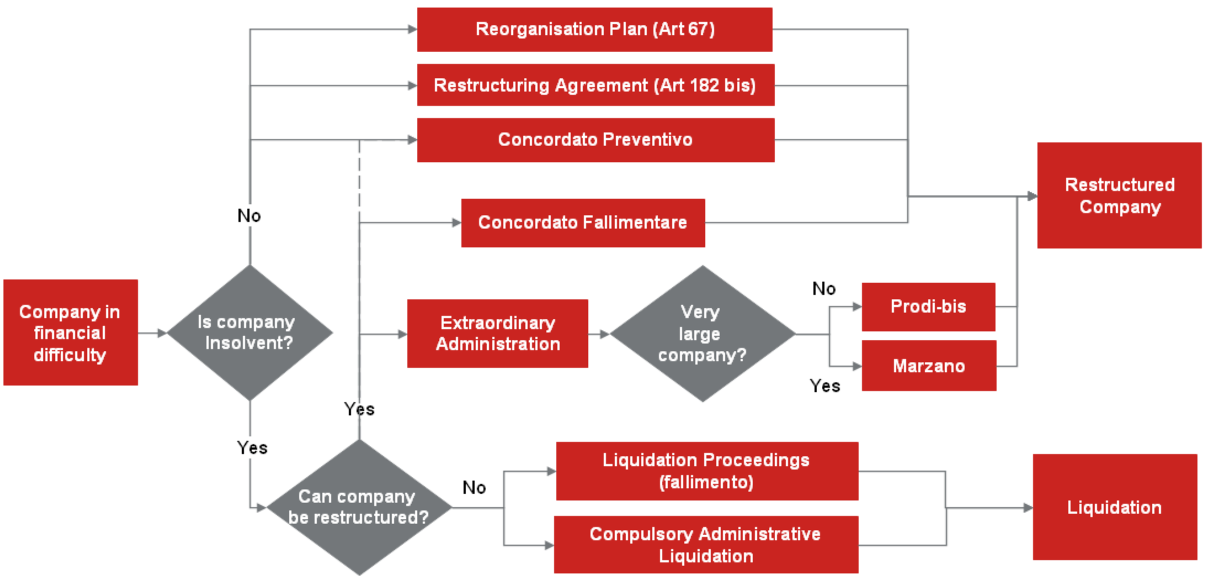
Prodi's law applies to companies with more than 200 employees and total indebtedness of more than two-thirds of the sum of the total assets, and more than two-thirds of the revenues during the previous financial year. Marzano's law applies to companies with more than 500 employees and a total indebtedness of more than €300 million.

In both cases, a large insolvent company can benefit from this procedure if it guarantees the continuance of the business due to (i) a sale of the business within one year, or (ii) a restructuring plan that is no longer than two years.

We focus on the Marzano Law for large insolvent companies

In the following, we will focus on the Marzano Law version of the extraordinary administration procedure as it sets out the appropriate procedure for large insolvent companies and these are generally the companies which issue corporate bonds into the capital markets.

Figure 23. Flowchart showing the Italian insolvency process



Source: Nomura

To initiate the Marzano procedure the company must apply to the Minister of Economic Development

To initiate the Marzano variation of the extraordinary administration procedure, the company must apply to the Minister of Economic Development and at the same time to the appropriate court in order to be declared insolvent. It is the Minister who has the ultimate responsibility for supervising the procedure.

The Minister decides whether or not to approve this procedure and the court is informed

The Minister can quickly decide to approve this course of action and the court is informed of the decision. The Minister appoints an extraordinary commissioner who has to present a plan for the economic and financial restructuring of the company to the Ministry of Economic Development within 180 days of his appointment.

There is a stay on actions by all creditors

During the period of extraordinary administration there is a stay on actions by all creditors. The actions of both secured and unsecured creditors are stayed without exception. The extraordinary commissioner has the right to initiate claw-back actions.

An extraordinary commissioner takes control of the company

The extraordinary commissioner takes over the management of the company and its assets as soon as his appointment. Some transactions need to be approved by the Minister. Debts incurred during this period in connection with the continued operation and management of the assets of the business are given priority over existing claims and rank as *credito prededucibile* (see section 9.4.4 for more details).

The restructuring plan has to be approved by the minister

The restructuring plan has to be approved by the Minister. The plan may include an insolvency agreement (*concordato*) in which the creditors can be divided into classes; in this case the proposed agreement must be voted for by the majority of creditors or, in the case of different creditor classes, by the majority of such classes. Once it has been approved by the creditors and the court, the agreement is binding on all creditors. There is therefore a cramdown on non-consenting creditors.

The Marzano version of extraordinary administration has been used in a number of high-profile cases including Alitalia.

Figure 23 shows a flowchart of the entire Italian insolvency procedure.

9.4.4 Priority of payments

Due to the various laws, the actual priority of payments is complex and can depend on the specific procedure. In rough terms, the order starting with the most senior debt is as follows:

1. Super senior claims such as expenses and fees incurred in insolvency proceedings and other credits specified by the law (*crediti prededucibili*). Among these there are post-insolvency financing and 80% of the shareholder's loans within the debt restructuring agreement (*accordo di ristrutturazione*) and the pre-insolvency agreement (*concordato preventivo*) procedures subject to the conditions described earlier in the respective sections. Following Article 111-bis of the Bankruptcy Act, *credito prededucibile* is a junior claim to claims secured by a pledge or a mortgage to the limits of the proceeds rising from the sale or execution on the assets which are the objects of the pledge or mortgage.
2. Privileged claims of government for judicial expenses
3. Secured claims from general liens
4. Claims secured by a pledge or a mortgage
5. Unsecured claims which are paid *pro-rata* in line with equal treatment of creditors.

9.4.5 Case studies

We introduce two case studies. The first is the collapse of Parmalat at the end of 2003 which was a seminal event for Italian bankruptcy law since it led to the creation of the pre- and post-insolvency agreement/composition restructuring procedures – *concordato preventivo* and *concordo fallimentare* which were introduced in 2005 and 2006. The second is the more recent case of Ferretti which used the Article 67 out-of-court restructuring procedure.

Parmalat

In 2003, Parmalat was one of the leading Italian food companies with 32,000 employees and operations spread across over 30 countries. Questions first arose in early 2003 concerning its financial statements and by year-end 2003 the supervising authorities were asking for clarification about its liquidity position.

In early December 2003 a turnaround specialist, Enrico Bondi, was hired by the board of Parmalat. Following a large fall in its share price and actions by its bankers, the Italian government enacted an emergency bankruptcy law designed specifically for very large companies. The aim of this law was to prevent the company, which was believed to have a viable business, from being liquidated resulting in the loss of up to 32,000 jobs. The aim was also to allow the sale of the business as a going concern to its creditors.

Following the passing of this law, Parmalat immediately filed for bankruptcy protection and Bondi was appointed the commissioner. The law was amended over the next year. These amendments included allowing the financial restructuring to use a debt-equity swap. By the end of 2005, agreement on a plan was reached with the creditors of 16 of the companies within the Parmalat group. Recovery rates on the debt of the different companies ranged from 100% down to close to zero. According to this plan the creditors ended up as shareholders in a new company which had almost no debt.

One of the related cases which arose in the Parmalat insolvency process was that of Eurofood. This is an important case with regard to COMI shifting and is discussed in detail in section 9.8.

Ferretti

Ferretti is an Italian luxury yacht maker which was acquired by Candover in January 2007. This acquisition was funded by raising €773mn of senior debt, €125mn of second-lien debt and €200mn of mezzanine finance. Following an acquisition in mid-2008, a sudden drop in orders and an increase in cancellations, Candover was forced to request a 90-day standstill period in anticipation of missing a debt payment on its mezzanine debt in January 2009.

Using the out-of-court restructuring process (Article 67), a restructuring proposal was presented in February 2009 which involved an equity injection and a number of write-downs. A one-year covenant holiday and amortisation suspension until May 2011 was also requested. The company was unable to obtain unanimous support and this proposal was rejected by creditors.

A second and separate proposal was then presented by the senior management and Mediabanca. This was finally approved by lenders in April 2009. The result of the plan was to reduce long-term debt from roughly €1.1bn to roughly €550mn, with a conversion of debt into non-voting hybrid instruments and an injection of new funds through a €85mn capital increase. In addition, €65mn new medium-term working capital was provided along with extension of the term of short-term bilateral credit lines to medium-term bilateral credit lines.

It was claimed that use of the out-of-court procedure encouraged agreement as creditors wished to avoid going through a court-based process which would take longer, possibly be more expensive and in which they could be crammed down.

9.4.6 International

For cross-border bankruptcy proceedings within the European Union, Italy is subject to the European Insolvency Regulation which came into force in May 2002. The UNCITRAL model law on cross-border insolvency has not been adopted in Italy.

9.4.7 Summary of procedures

Figure 24 summarises the main features of the Italian rehabilitation procedures.

Figure 24. Main rehabilitation procedures in Italy

Criterion	Reorganisation Plan (*Article 67*)	Debt Restructuring Agreements (*Article 182 bis*)	Pre-Insolvency Agreement / Composition (*concordato preventivo*)	Post-Insolvency Agreement /Composition (*concordato fallimentare*)	Extraordinary Administration
Purpose	Rehabilitation	Rehabilitation	Rehabilitation	Rehabilitation	Rehabilitation
Condition for entry	Not required to be insolvent	Not required to be insolvent	Not required to be insolvent	Insolvent	Insolvent
Stay on creditors	No	A stay can begin once restructuring talks are underway. Court approval is needed. See text for details.	Yes	Yes	Yes
Control	Management stays in control. No publicity.	Management stays in control.	Management stays in control under supervision.	Court-appointed trustee runs insolvent company both before and after concordato fallimentare	Only available to large companies. Business is run by judge- then government-appointed commissioners
Approval for plan	Exemption from claw-back actions. Needs unanimous support from creditors who will be affected. No cramdown	Court approval needed. Exemption from claw-back actions. Approval representing 60% of creditors by value required No cramdown	Exempt from claw-back actions. Needs majority creditor support and then court approval. Cramdown possible	Rescue plan requires majority of creditors to support it and then court approval. No claw-back exemption Cramdown possible	Tribunal approval. No claw-back exemption. Immediate stay on all creditors Cramdown possible
Binding	No	No	Yes	Yes	Yes
Court involvement	Out-of-court	Quasi-out-of-court (but court supervises, validates and publicises agreement)	In-court procedure	In-court procedure	Both in-court procedure and administrative procedure
Enhanced priority financing	No	Yes, super priority status on certain loans and 80% of shareholder loans	Yes, super priority status on certain loans and 80% of shareholder loans	No	No
Average length of proceedings (estimate)	Short	Few months	Several months	Years	Years
Recent uses	Ferreti, Tiscali, Arcotronics, Pininfarina	Caffaro Flexible Packaging, Global Garden Products, Risanamento	Favini, Kartogroup, Gio Style, Faber Factor and Bear		Alitalia, Parmalat, Volareweb

Source: Nomura, L&W

9.4.8 Commentary

The Italian bankruptcy regime contains a broad range of procedures, several of which are new or newly amended. These changes tend to have a common theme which is to restructure and reorganise the business as a going concern rather than to break it up and sell the assets.

The procedures can be viewed as being fairly friendly to debtors as the actions of secured creditors are generally stayed. However, debtors do not always fare well. For large companies, the extraordinary administration procedures mean that management is usually displaced and replaced with an administrator.

9.4.9 Acknowledgements

We would like to thank lawyers Riccardo Agostinelli and Andrea Novarese for their comments and assistance on this section. Their contact details are as follows:

Riccardo Agostinelli / Andrea Novarese
LATHAM & WATKINS
Corso Matteotti, 22
20121 Milano
Italy
riccardo.agostinelli@lw.com / andrea.novarese@lw.com
+39 02 3046 2000

9.5 Spain

Due to the dominance of its banking sector, Spanish companies have traditionally liquidated rather than restructured

Spain has traditionally been a jurisdiction in which companies that have filed for bankruptcy have almost always been liquidated rather than restructured. This is partly due to the dominance of the banking sector in the provision of corporate debt. Since bank loans are usually secured, it has often been preferable for the banks to liquidate the company and enforce their security rather than seek to preserve the business by restructuring the company and its debt.

In 2003, Spain passed a new insolvency act with the aim of simplifying the insolvency process and encouraging restructuring

Inspired by recent changes in German insolvency law, and the US Chapter 11, the Spanish parliament passed a new Insolvency Act (*ley concursal*) in July 2003 which came into effect in September 2004. It has been updated as recently as April 2009 and the government is already working on an in-depth review of the act. This law simplified the previous insolvency framework by replacing it with a single entry point (*concurso de acreedores*) which can lead to either liquidation or restructuring. It also aimed to shorten the amount of time companies spend in liquidation and restructuring and so reduce the associated costs.

The insolvency procedures available in Spain are as follows:

a) Solvent winding up;

b) Common entry leading to anticipated creditors' agreement;

c) Common entry leading to ordinary creditors' agreement;

d) Common entry leading to liquidation.

These are all described below.

Insolvency cases are heard in courts specially created by the 2003 Insolvency Act

Insolvency cases are heard in new commercial courts specially created by the Insolvency Act of 2003. The commercial court used is the one in the region where the company has its centre of main interests. In additional to insolvency matters, these courts can also deal with almost all related disputes.

In Spain, insolvency is defined as the inability to meet liabilities on a regular basis

In Spain, insolvency is defined as the inability to meet liabilities on a regular basis. It is just a cash flow test – there is no balance sheet test. If the company is in financial difficulties and the directors continue to trade in a way which causes or worsens the insolvency of the company then they may be liable for penalties ranging from disqualification, or damages, to prison. Which penalty applies depends on the specifics of the case.

The main form of security in Spain for immoveable assets is the mortgage

The main form of security in Spain for immoveable assets is the mortgage. This must have been granted in a public deed and registered with the corresponding land registry. The security over intellectual property and inventories may adopt the form of a chattel mortgage and also requires registration with the corresponding registry for moveable objects, the *Registro de Bienes Muebles*.

For moveable assets, the main form of security is the pledge

For moveable assets, the form of security is the pledge. In this case the physical assets are held by the creditor or a third-party until the debt is repaid. Ownership is not transferred. Pledges must also be granted via a public document. A mortgage can also be used for certain moveable assets. Set-off is only allowed if the appropriate conditions have been met before the insolvency declaration, or if the credit is governed by a foreign law which permits set-off.

9.5.1 Pre-insolvency

Debtors and creditors can always agree informal restructurings pre-insolvency. However, unanimous agreement is needed to bind creditors. There are also a number of formal pre-insolvency procedures.

Solvent winding up

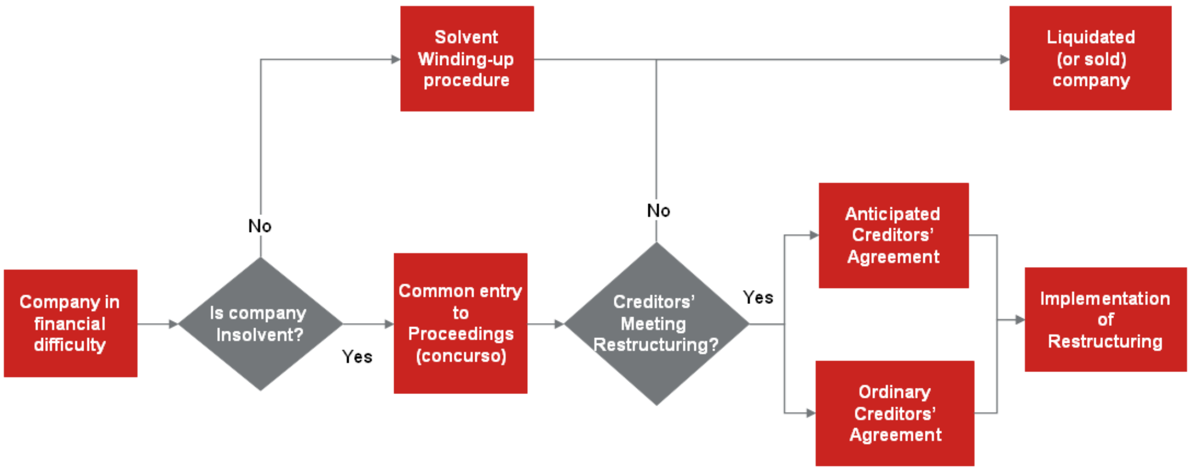
Solvent Spanish companies can apply for liquidation voluntarily

Solvent Spanish companies can apply for liquidation voluntarily. To do so, the company shareholders must pass a resolution to wind the company up. Management usually loses control and one or more liquidators will be appointed and tasked with selling the company's assets.

If the financial condition of a company has deteriorated then shareholders can vote to inject capital

In addition, if the financial condition of a company has deteriorated to the extent that the net asset value of the company is in danger of falling below half of the value of its share capital (known as the "capital impairment test") as a result of accumulated losses, the board of directors of the company must call a general shareholders meeting. This should decide, after determining that no obligation to file for the declaration of insolvency exists, whether to increase or decrease the share capital of the company.

Figure 25. Flowchart showing the Spanish insolvency process



Source: Nomura

The law now exempts pre-insolvency refinancing transactions from being annulled

To assist with the refinancing of companies in financial distress, the law was amended in April 2009 to exempt pre-insolvency refinancing transactions from being annulled. However, to qualify for this exemption the financing agreement must be approved by 60% or more of creditors by value, must be approved by an independent expert and must be formalised in a public document.

A debtor can also apply for an insolvency order before becoming insolvent if it thinks that insolvency is imminent. This will enable the debtor to enter into the post-insolvency procedure described in the next section.

9.5.2 Insolvency

Liquidation

Liquidation is the last resort and emphasis is on selling the business as a going concern

Liquidation is seen as the last resort of the insolvency process, when none of the two restructuring routes described below is possible. It is not a strict liquidation since the emphasis is on selling the business as a going concern. The aim is to preserve the economic value of the company. The administrators must prepare a liquidation plan which does not need debtor or creditor approval.

There is a limited stay on assets – holders of mortgages and pledges can initiate proceedings

There is a limited stay on assets – holders of mortgages and pledges can initiate proceedings to recover their security provided the asset is not essential to the continued functioning of the business until either a settlement is reached or a year has elapsed without the liquidation phase beginning

Out-of-court restructuring

Banks are making greater use of out-of-court informal restructuring rather than liquidation

Traditionally most court restructurings have ended up in liquidation. This has usually been at the insistence of their bank creditors who dominate most corporate lending. However, banks recently seem to have switched their strategy towards the out-of-court renegotiation of debt. In some cases this has involved banks foreclosing their guarantees and becoming the shareholders of the debtor. In other cases the banks agree to a restructuring of the debt in order to avoid the actual bankruptcy process.

The *concurso de acreedores*

The Spanish insolvency proceeding has a single entry point

The new Spanish insolvency proceeding is called the creditors' meeting (*concurso de acreedores*) and is a single entry point which can lead to either liquidation or restructuring. It can be applied for by the debtor or its creditors.

A debtor must apply for voluntary insolvency proceedings within two months of becoming insolvent

A debtor must apply for voluntary insolvency proceedings within two months of becoming insolvent. If this is not done, the directors can face personal liability for losses incurred. This requirement can be suspended for an additional three months in order to allow creditor negotiations to continue, provided the situation has been communicated to the court in the first two months. After the three-month period has elapsed, the company must file for insolvency within the following month. The debtor may also apply for this procedure if the company is solvent only if insolvency is imminent.

To permit the procedure, the judge only has to satisfy himself that the company is insolvent or will be imminently

The application for insolvency must be accompanied by a financial report of the company's assets and a list of creditors and annual accounts for the previous three years. The judge will examine this evidence and decide whether to grant the insolvency order. To permit the procedure, the judge only has to satisfy himself that the company is insolvent or will be imminently.

If a creditor applies for involuntary insolvency proceedings and the debtor contests this, a hearing will take place to permit the debtor to contest the application. Creditors have to prove that one of the following is true: the debtor has stopped making payments, the debtor's assets have been seized, the debtor is liquidating assets in a harmful way or certain obligations such as wages are not being paid.

The first creditor to file benefits from 25% of his claim being promoted to privileged status

In an involuntary insolvency, the first creditor to file benefits from 25% of his claim being promoted in the priority of payments to privileged status. In addition, a creditor who buys the debt after it has become due has to wait six months before he can initiate an involuntary insolvency.

Management usually remains in control under the supervision of three court-appointed administrators

If the judge approves the application then management usually remains in control under the supervision of three court-appointed administrators. The three administrators usually consist of a lawyer, a representative for the unsecured creditors and an accountant or economist. Their duty is to determine the debtor's estate and existing debts. They also must agree on all actions of the company. The decision to open insolvency proceedings must be published in the Public Registries and on the government website www.publicidad.concursal.es.

A stay is imposed on unsecured creditors for the period of insolvency proceedings

A stay is imposed on unsecured creditors for the period of insolvency proceedings. There is also a suspension of interest accrual on all debts. The judge may impose a stay on secured assets to ensure that the business can continue to operate. Once the insolvency order has been issued by the judge, creditors have just one month in which to lodge their claims, although the administrators are also obliged to include all creditors appearing in the corporate documentation of the company, even if they have not been notified by the holders of these claims.

The use of claw-backs is now limited, with some exceptions which include transactions deemed "harmful" to the insolvent estate which took place up to two years before the declaration of insolvency. However, the most recent reforms to the law remove "claw-back" risk in relation to new security granted within a pre-insolvency refinancing.

After a common period there is a creditors' meeting to decide between liquidation and restructuring

Once the insolvency process has begun, the process has a number of stages. The first is a common period. This ends when a report is produced by the administrators detailing the inventory of the estate and the list of creditors. At this point a creditors' meeting is called to decide which course of action to take. More than half of all unsecured creditors need to be present for the meeting to be quorate. Based on this decision there will then be either a restructuring or a liquidation period.

9.5.3 Court restructuring

There are three specific procedures within the Insolvency Act 2003 whose aim is to rescue some or all of the business as a going concern.

Anticipated creditors' agreement

The anticipated creditors' agreement is a form of pre-packaged agreement which is first reached by at least 20% of creditors

The anticipated creditors' agreement or composition agreement (*convenio anticipado*) is a form of pre-packaged agreement which is first reached by at least 20% of creditors (senior and subordinated) by value before the end of the common period. Indeed, an amendment to the law introduced in April 2009 also allows the debtor to apply for this procedure before the requirements of the common period have been completed. If the anticipated proposal is presented at the start of the insolvency proceedings then only 10% of creditors are needed to qualify for this procedure.

There are no constraints on the plan other than it allow for continuation of the business

There are no legal constraints on the form of the plan other than it must allow for continuation of the business. For example, it can include debt cancellation, exchanges of debt for equity and mergers. The plan can then be proposed to the remaining creditors soon after the start of the insolvency proceedings.

Over 50% of the ordinary unsecured creditors must vote in favour of the plan

To be approved, over 50% of the ordinary unsecured creditors must vote in favour of the plan. This is therefore a path which can be used to quickly restructure the company out-of-court and can encourage the agreement of minority creditors as they can be crammed down.

Post-insolvency goods and services have a higher priority than similar pre-insolvency debts

There is no provision for full Chapter 11-style DIP lending in Spain. However, there is a provision in the law which means that payments to a company for goods and services provided post-insolvency have a higher priority than similar pre-insolvency debts.

Ordinary creditors' agreement

The ordinary creditors' agreement is the fall-back to the anticipated creditors' agreement

The ordinary creditors' agreement (*convenio ordinario*) is the fall-back restructuring procedure if no pre-packaged plan has been possible via the anticipated creditors' agreement procedure or if it has not been possible to get the 50% majority required. It is a plan which is submitted by the debtor or by creditors holding more than 20% of total debt at the general meeting called at the end of the common period.

Unlike the anticipated creditors' agreement, there are limits on the form of the ordinary creditors' agreement

Unlike the anticipated creditors' agreement, there are limits on the nature of the plan allowed by the ordinary creditors' agreement. For example, it does not allow changes in the priority of creditors, debt cancellations beyond five years or a write-down of more than 50% on the creditors claim. This last condition applies to unsecured creditors and while it may be seen as protection for unsecured creditors, it may actually make it more difficult to reach a restructuring deal.

The insolvency plan must be approved by senior creditors, secured and unsecured

The insolvency plan must be approved by senior creditors, secured and unsecured. Subordinate creditors do not have a vote on the plan. Privileged creditors do not have to take part in the plan but can vote in favour if they wish in which case they will be bound by it. Creditors who have acquired the debt after the declaration of insolvency do not have a say in the approval of the insolvency plan. This restriction has discouraged the creation of a Spanish distressed debt market.

A flow chart of the Spanish insolvency procedures is provided in Figure 25.

9.5.4 Priority of payments

The Spanish Insolvency Act distinguishes between claims against the estate and claims in the insolvency

The Spanish Insolvency Act distinguishes between claims against the estate (*créditos contra la masa*) and claims in the insolvency (*créditos concursales*). Claims against the estate cover claims such as legal costs, administrators' fees, debts incurred during insolvency and salary claims for the 30 days before the declaration of insolvency subject to a limit of twice the minimum salary. Claims against the estate have priority over all claims in the insolvency.

The classification and ranking of claims in the insolvency is as follows:

1. Privileged claims:

  a. Specially privileged. This covers creditors secured by real estate, mortgage or pledge and credits secured by securities.

  b. According to Spanish law, secured creditors are paid out of the proceeds of the sale resulting from the enforcement of their security. Where the security does not entirely cover the debt, the secured creditor has a claim on the remainder at the level of an ordinary creditor.

  c. Generally privileged. This includes salaries up to certain limits, certain taxes and 25% of the claim of the creditor who was the first to file for insolvency where applicable.

2. Ordinary claims. Claims which are neither privileged nor subordinated.

3. Subordinated claims. Claims which are contractually subordinated, interest (other than on secured debt) and related-party debt. Related-party debt covers:

a. claims of shareholders having over 5% of the share capital of listed companies and 10% of non-listed companies provided such shareholders held these stakes on the date when the loan was granted;

b. claims of directors, shadow directors, liquidators and attorneys of the debtor and those who held such positions within the two years before the declaration of insolvency of the debtor; and

c. group companies of the debtor and, under certain circumstances, their shareholders.

9.5.5 Case study

Martinsa-Fadesa

Martinsa-Fadesa is a Spanish real-estate company which filed for protection from its creditors on 15 July 2008 after failing to secure a €150 million loan from Spain's official credit institute. This loan was needed as part of a €4bn refinancing agreed in May 2008. The financial problems of Martinsa-Fadesa were due to the end of the boom in the Spanish property market and the beginnings of a recession in Spain.

A first creditors' meeting was held at the end of July and creditors were given until 1 October to prove the debt owed to them. Administrators were appointed to produce a report and in early December they did so. They set out the company's assets and liabilities, valuing the assets of the insolvent company at €7.34 billion and the liabilities at €7.156 billion. These liabilities were shared across just under 10,000 creditors. The report also ranked the creditors.

The intention of the company was to propose a restructuring plan which would require approval from at least 50% of creditors. Therefore, in January 2009, the company presented a reorganisation and debt repayment plan (*convenio anticipado*) to the court in La Coruna. It proposed repaying €4.3 billion of ordinary (senior) debt over the next eight years. Of the company's total debt, about €2 billion was "privileged debt" which could also be repaid.

However, in February 2009 it was reported that the insolvency proceedings could take another year due to the large number of creditors challenging the administrators' report regarding the size and ranking of their claims. As of April 2010, the court is still working through these claims.

This case highlights one of the criticisms of the new Spanish process which is that the requirement to first establish the size and rank of each claim can prove time-consuming and prevent a speedy resolution. A similar problem occurred following the filing by the real estate promoter Llanera in October 2007. It then took almost two years to the first creditors' meeting.

9.5.6 International

For cross-border bankruptcy proceedings within the European Union, Spain is subject to the European Insolvency Regulation which came into force in May 2002.

The UNCITRAL model law on cross-border insolvency has not been adopted in Spain. However the model law was taken into consideration by the drafters of the Insolvency Act which came into effect in 2004.

9.5.7 Summary of procedures

Figure 26 summarises the main features of the Spanish insolvency procedures.

Figure 26. Main insolvency procedures in Spain

Criterion	Solvent Winding Up	Anticipated Creditors' Agreement (convenio anticipado)	Ordinary Creditors' Agreement (convenio ordinario)	Liquidation
Purpose	Liquidation	Restructuring	Restructuring (fall-back to anticipated creditors' agreement)	Liquidation
Condition for entry	Company pass resolution to wind up	Company insolvent and agreement reached by 20% or more of creditors (10% if applied for at start of proceedings)	Plan submitted by debtor holding more than 20% of total debt	Insolvent company without prospects for restructuring
Stay on creditors	N/A	Yes on unsecured creditors. The judge may impose a stay on secured creditors if needed to enable continuation of business		Limited stay on assets. Secured creditors can enforce security if asset is not essential to business until a settlement is reached or a year passes
Control	Liquidator	Debtor	Debtor	Administrator
Approval for plan	N/A	50% of unsecured creditors must vote in favour	50% of unsecured creditors must vote in favour	Liquidation plan does not require debtor or creditor approval
Binding	N/A	Yes. Unsecured creditors can be crammed down.	Yes. Unsecured creditors can be crammed down.	N/A
Court involvement	Yes	Yes	Yes	Yes
Enhanced priority financing	No	No	No	No
Average procedure time (estimate)	Depends on the size of the company, the diligence of the liquidators. Normally they last six months and in any event less than a year to avoid the obligation to file annual accounts	Depends on the court running the insolvency proceeding and the number of claims brought against the classification of the claims. A fast proceeding could last almost a year.		Depends on whether the winding-up is requested by the debtor or is determined ex-officio, the court running the insolvency and the number of claims brought against the classification of claims. One year is reasonable
Recent uses	Lineage Power	Habitat	Llanera	Forum Filatélico SA

Source: Nomura, L&W

9.5.8 Commentary

Spanish use of the insolvency regime is quite limited and restructuring often occurs informally and out-of-court

Spanish use of the new insolvency regime is still fairly limited. When restructuring is a viable path, it often occurs informally and outside any court-based procedure. There are a number of reasons for this. First is the lack of familiarity with the new insolvency regime. Also, banks are required to make substantial provisions against losses if they enter into a formal insolvency procedure. The dominance of banks in the corporate lending sector also tends to limit the number of parties needed for a unanimous agreement and so may not be so difficult to achieve. There is also a stigma associated with a formal declaration of insolvency that is not associated with an informal agreement.

We expect that over time debtors will try to use the stay on creditors provided by the Ley Concursal

However, given the current recession and the significant downturn in the real estate sector, we think the stay on creditors provided by the Ley Concursal, the need for only a majority of creditors to approve a plan and the removal of most claw-back risk may make it a more popular route.

One criticism of the new law is that the process can be lengthy

For creditors, the main criticism of the new laws is that, in enhancing the restructuring chances of the company, they limit the ability of the creditors to enforce their rights. As seen in the case of Martinsa Fadesa, the process is also seen by some as lengthy. Their fear is that a company's value will be eroded long before the restructuring can be agreed and implemented.

9.5.9 Acknowledgements

We would like to thank lawyers Ignacio Pallarés and Xavier Pujol for their comments and assistance on this section. Their contact details are:

Ignacio Pallarés / Xavier Pujol
LATHAM & WATKINS LLP
María de Molina 6, 4th Floor
28006 Madrid
Spain
ignacio.pallares@lw.com / xavier.pujol@lw.com
+ 34 91 791 5000

9.6 Greece

Greece's bankruptcy laws have been completely updated in recent years

Greece's bankruptcy laws have been updated in recent years in an aim to create a more transparent and efficient procedure which gives more control and a fairer treatment for creditors in the case of a liquidation, and attempts to preserve the economic value of the company in a restructuring.

The new law, known as the bankruptcy code, came into effect in September 2007

The new law, known as the bankruptcy code (Law 3588/2007) came into effect in September 2007 and governs the bankruptcy of merchants including trading corporations e.g. partnerships, limited companies, co-operative societies and companies which pursue a financial objective. Public sector entities, local authorities and public organisations are exempt from bankruptcy. Banks and insurance companies are not declared bankrupt in the same way as merchants but are instead subject to a special administration process[37].

The new law has introduced a single entry point to restructuring or liquidation

The new law has streamlined the previous framework by introducing a common entry point for insolvent firms which can lead to either restructuring or liquidation. It has also introduced a pre-insolvency procedure designed to encourage companies to reach a court-approved restructuring agreement before insolvency hits.

The insolvency procedures available in Greece are:

a) Mediation / conciliation;

b) Bankruptcy proceedings; and

c) Reorganisation.

These are all described in detail below.

In Greece, the main form of security for immoveable objects is the mortgage. Mortgages must be registered at the local cadastral office or land registry. Another form of security for immoveable assets which is less expensive to create and so is preferred by banks is the "prenotation of mortgage". For moveable items there are a number of different devices including the pledge, retention of title and the fiduciary transfer of assets.

The law also permits set-off, but only if the preconditions of set-off were fulfilled before the declaration of bankruptcy. Some types of financial transactions are excluded from this restriction and so can be set off without any conditions.

The relevant court for bankruptcy proceedings is the multi-member first instance court of the district where the debtor has his centre of main interests (COMI). The COMI is presumed to be the place where the debtor conducts the administration of his business and this should be ascertainable by third parties. Until proven otherwise, it is assumed to be the location of the company's registered office.

According to the bankruptcy code, the test for insolvency is based on a "cessation of payments"

According to the bankruptcy code, the test for solvency is a "cessation of payments". A company which is unable to make payments that have fallen due fails the cessation of payments test. It may then be declared bankrupt by the competent court following a petition by the company or any of the creditors of the merchant or the district attorney. The threat of a cessation of payments also constitutes grounds for a bankruptcy order if requested by the company. A company which fails the "cessation of payments" test is only bankrupt following a court decision to that effect.

The bankruptcy court determines the exact date on which the cessation of payments test was met by the debtor who is then adjudged bankrupt, and so sets the start of the so-called "suspect period". This may go back as far as two years before the date of the court decision. Legal acts of the debtor which occurred during the suspect period and which may be detrimental to the interests of the bankruptcy creditors are either automatically voided or can be voided by the bankruptcy administrator.

9.6.1 Pre-insolvency

Greek insolvency law provides a procedure for companies which are in financial difficulties but not yet insolvent in order to obtain some protection from creditors.

[37] This Bankruptcy Code applies to these institutions for any matters not covered by the special administration process.

Mediation / Conciliation

The mediation/conciliation procedure is intended to assist the formulation of a pre-insolvency agreement

The mediation (also known as conciliation) procedure is one of the new insolvency procedures introduced by the 2007 bankruptcy code to assist the formulation of a pre-insolvency agreement for a company which is in financial difficulties but is still solvent. It is set out in Articles 99 to 106 of this code and applies to companies which are in a state of financial weakness, either currently or foreseeable, but which are not currently in a state of cessation of payments. It is a voluntary process, i.e. it can only be applied for by the debtor.

To initiate the procedure, a petition must be filed with the multi-member first instance court where the company's centre of main interests is located. The petition must include a description of the company's financial condition, the size of the company, its social importance in terms of employment and the suggested financing plan. The submission also includes a deposit of funds to cover the costs of the expert and mediator.

The procedure can only be opened if the court is convinced that the company is in a state of financial weakness

The procedure can only be opened if the court is convinced that the company is in a state of financial weakness and is not currently in a state of cessation of payments. If the court thinks it necessary, it may appoint a financial expert to prepare a report on the company's financial status. This report has to be submitted within 20 days of the expert's appointment. If the court then decides to open proceedings, this decision must be made public.

A mediator is appointed to work with management and to suggest restructuring solutions

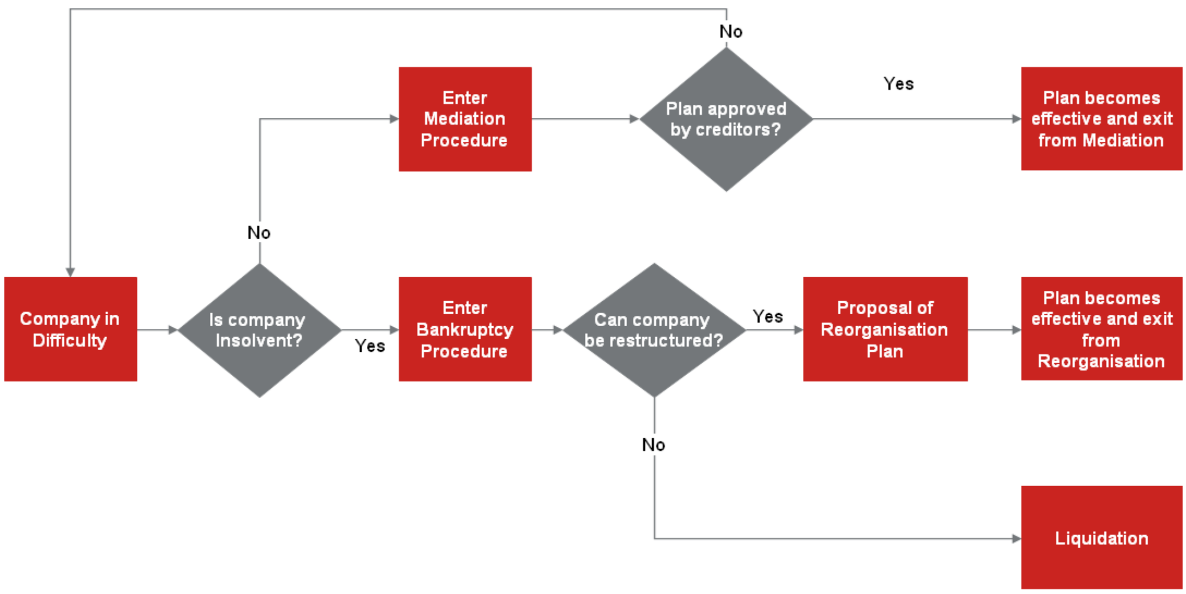
A mediator is then appointed to assist and oversee negotiations. The mediation process opens for a two-month period and can be extended by another month. During this time there is a stay on all creditors. The role of the mediator is to work with the company management and to suggest solutions which can include a reduction of claims, maturity extensions, restructuring of the company, debt-for-equity swaps and sale of the company. The mediator has the right to receive all of the necessary financial information from credit and financial institutions which relate to the debtor.

Management stays in charge of the company during this procedure – neither mediator nor the financial expert have any participation in the operations of the company.

New financing is granted a statutory enhanced level of seniority

To encourage the introduction of new financing during this procedure, the bankruptcy code grants a statutory enhanced level of seniority. In fact, the law extends beyond just financing as it states that any third parties that have provided financial support, goods or services to ensure the continuation of the company as a going concern on the basis of the conciliation procedure become privileged creditors and their claims rank more highly than other general privilege creditors.

Figure 27. Greek bankruptcy procedure



Source: Nomura

Any agreement requires a simple majority for it to go before the court and is not binding on creditors who did not sign up to it

During the mediation period, creditors and the debtor are supposed to work with the mediator to reach an agreement. These discussions should involve creditors representing the majority of claims as well as smaller creditors. Any agreement only requires a simple majority in order for it to go before the court. However, any agreement is not binding on creditors who do not sign up to it. The mediator must inform the court immediately if no agreement can been achieved.

The law sets out four reasons why an agreement will not be ratified

The agreement needs to be put before the court within 10 days of its approval by a majority of creditors by value. The court has no power to amend the agreement. It can only decide whether or not to ratify it. The law sets out a number of reasons why an agreement will not be ratified. These are: (i) the debtor is currently in a state of cessation of payments; (ii) the agreement does not ensure a viable business; (iii) creditors who have not signed the agreement are impaired in some way; and (iv) the term of the agreement is for more than two years. Court ratification of the agreement signals the end of the conciliation process and the end of the work of the mediator. At this point the agreement must be implemented.

Ratification results a suspension of legal actions by individuals for the term of the agreement

The ratification of the agreement has a number of important consequences. These include a temporary suspension of legal actions by individuals for the term of the agreement (up to two years) and a suspension of collective claims for six months. These conditions apply to all creditors including those who did not sign up to the agreement.

The mediation procedure has no provision to cram down any group of creditors

The mediation procedure has no provision to cram down any group of creditors. As a result, it can create a hold-out incentive for some groups of creditors. At the same time, the debt moratorium which arises from the agreement provides some encouragement for creditors to participate in the negotiation and approval of the agreement.

If there is a failure to reach an agreement and the company enters a state of cessation of payments, it is possible to convert the procedure into a reorganisation procedure (described below) which does allow for a cramdown of dissenting creditors.

9.6.2 Insolvency

There are two main procedures for a company in a state of insolvency, although they have a common entry point. This is the filing of a petition for a judgement of bankruptcy. This can lead to the sale of the company's business, liquidation, or it can be the first step in a reorganisation procedure.

Bankruptcy proceedings

The bankruptcy procedure is a procedure for winding up an insolvent firm

The bankruptcy procedure is first and foremost a procedure for winding up an insolvent firm, selling its assets and distributing the proceeds to the creditors. The procedure is entered into by filing a petition at the multi-member court of first instance which then declares the debtor bankrupt and sets the applicable suspect period. The petition may be filed by the company, any creditor or third party with a legal interest, e.g. a creditor of a creditor of the company may also file if the direct creditor delays filing for some reason.

The debtor is required by law to file for bankruptcy within 15 days of the company becoming insolvent

The debtor is required by law to file for bankruptcy within 15 days of the company becoming insolvent. Failure to do this can expose management, and third parties who urged management not to file on time, to a civil liability for additional losses which arise in the period between becoming insolvent and a subsequent filing for bankruptcy. Criminal liability can also be triggered.

The new bankruptcy code introduced the option of a debtor foreseeing the failure of the cessation of payments test to voluntarily file for bankruptcy even if the test was not failed. Following a bankruptcy order by the court the debtor's assets are sealed and will only be released following the appointment of a liquidator who will be responsible for the administration of the estate. Creditor claims have to be submitted within three months of the bankruptcy order.

Secured claims continue to be stayed after the appointment of the liquidator

Secured claims usually continue to be stayed even after the appointment of the liquidator. This is done in order to safeguard the assets until a decision can be taken about whether to restructure, sell or liquidate the company. This decision is taken at the creditors' meeting. The court sets a date for an initial meeting which must be within four months of the bankruptcy order. At this meeting the liquidator presents a report which sets out the debtor's financial situation and the causes of bankruptcy. If there is a prospect of keeping the company in business, the report will examine the viability of any reorganisation plan and the consequences for the creditors.

The creditors' committee must vote on whether to restructure, sell or liquidate the company

During the initial meeting, or at a subsequent meeting, the creditors' committee must vote on whether to restructure, sell or liquidate the company. The result must be ratified by the court. If the decision is to restructure then the process converts to a reorganisation procedure discussed below. Otherwise the business is sold or liquidated in line with the priority of claims set out in section 9.6.3.

Reorganisation plan

The 2007 bankruptcy code introduced a post-insolvency reorganisation procedure

One of the most extensive reforms of the 2007 bankruptcy code was the introduction of a post-insolvency reorganisation procedure. This can be found in Articles 107 to 131 of the bankruptcy code. The entry point for the reorganisation procedure is a filing for a bankruptcy order by either the debtor or the liquidator.

Management stays in control in this procedure

The reorganisation plan can be filed at same time. If not, it must be filed within four months of the bankruptcy order. The court can approve an extension of this deadline by three months as long as the delay is not detrimental to creditors. The company's management stays in control in this procedure.

There is a stay on unsecured creditors and a partial stay on secured creditors

Until the plan can be examined by the court and ratified, there is a moratorium on unsecured creditors. Secured creditors cannot enforce their security if the secured assets are vital to the continuation of the business until after any reorganisation agreement has been ratified. The law specifies that the reorganisation plan must contain:

1. a detailed description of the financial situation of the company including its assets and funds,
2. a description of the measures already taken or to be taken to restructure the company's debts,
3. a description of the rights of the different classes of creditor under the plan – creditors in the same class must be treated equally by the plan.
4. an analysis showing that the continuation value of the business for creditors is more than they would get in liquidation. The law also states that the proposed recovery for a creditor cannot be less than 20% of the aggregate claim which has to be paid with a single payment or in instalments within one year. This means that out-of-the-money creditors cannot be wiped out by the reorganisation plan.

The rights of secured creditors are not affected by the plan unless stated in the plan

The rights of secured creditors are not affected by the plan unless stated in the plan. The plan must be examined by the court within 20 days of its submission. The purpose of this is to ensure that the plan satisfies the set of conditions just described. If the plan passes this stage, a creditors' meeting must be held within three months.

As with the mediation procedure, the reorganisation plan also allows the introduction of post-insolvency financing which obtains a priority ranking in liquidation.

Approval requires 60% of all claims and 40% of secured creditors

At the creditors' meeting there is a debate and vote on the plan. Approval of the plan requires a majority of creditors to vote in favour. The creditors voting in favour must account for at least 60% of all claims and at least 40% by value of the secured creditors.

If the plan is ratified by court it becomes binding on all creditors

If the plan is ratified by the court it then becomes binding on all creditors. It limits their rights to enforce security to what is set out in the plan. If the plan does not restrict the security rights of secured creditors they can enforce their collateral.

If the plan is passed, the reorganisation procedure finishes. An administrator must report every six months to the creditors' committee on the state of progress of the plan and this continues for a period of three years, unless specified otherwise by the plan.

Figure 28. Summary of Greek insolvency procedures

Procedure	Bankruptcy Proceedings Liquidation	Mediation / Conciliation	Bankruptcy Proceedings Reorganisation Plan
Purpose	Winding-up procedure for companies in a state of insolvency	To appoint a mediator to help creditor and debtor reach agree a restructuring plan	Restructuring procedure for an insolvent company
Condition for entry	Insolvency, i.e. cessation of payments	Not in a state of “cessation of payments”	Insolvency, i.e. cessation of payments. A reorganisation plan must be filed with the court.
Stay on creditors	Stay of all creditors until appointment of liquidator. The stay may continue after the appointment of the liquidator.	Yes.	Yes on secured creditors if assets are essential to continuation of business
Control	Liquidator	Management	Management
Approval for plan	Majority of creditors by claim must vote to pursue a liquidation	Majority of creditor claims	Majority of creditors representing at least 60% of claims and at least 40% by value of secured creditors
Binding	N/A	Not binding on those who do not agree.	Binding on all creditors. If plan does not limit rights of secured creditors then they are free to enforce
Court involvement	Yes	Court opens proceedings and decides to ratify any agreement	Court opens proceedings, examines plan and ratifies agreement
Enhanced priority financing	N/A	Yes	Yes
Average[38] procedure time (estimate)	The hearing of the petition and the issuance of the court decision usually take between a few months up to a year and a half. The meeting of the creditors should take place within four months of the declaration of bankruptcy. In the past, the procedure took several years to complete. It is expected that the introduction of the new Bankruptcy Code will help speed up the proceedings.	The hearing of the petition and the issuance of the court decision usually take between six months to up to a year and a half. The conciliator is appointed for a term of up to two months, which may be extended for up to one month. The term of the conciliation agreement as its ratification by the Court may not exceed two years.	The debtor may file a reorganisation plan together with the bankruptcy petition within four months of the declaration of a state of bankruptcy, a term that may not be extended for more than three months. Assuming the debtor does not submit a plan within the above term, the administrator may submit a reorganization plan within three months. The creditors have a deadline of up to three months to approve or reject the plan. The implementation of the plan may be supervised by the administrator for up to three years.
Recent uses[39]	BETANET		None

Source: Nomura

9.6.3 Priority of claims

In declining order of priority, we have:

1. Legal and administration expenses of bankruptcy.
2. Generally preferred creditors. This includes claims arising in relation to the financing of the company during its period of distress, employee claims arising in the two years before the bankruptcy filing, taxes on property income and social security funds that arose in the two years before bankruptcy.
3. Secured creditors, having special rights over the assets on which the security has been created.
4. Unsecured creditors.
5. Subordinated creditors (the classification of contractually subordinated claims as a category of claims of lower rank was introduced by the new bankruptcy code).

[38] The length of the proceedings is heavily dependent on the course such proceedings shall take. Due to the very recent enactment of the Greek Bankruptcy Code, the significant delays as regards the judicial procedures before Greek Courts, frequent postponements, discrepancies as regards the timeframes among the various courts of different cities and continuances due to lawyers or clerks sometimes abstaining from their duties, a meaningfully reliable timeframe may not be provided.
[39] Due to restrictions on the publication of decisions of Greek Courts containing the names of the parties involved in the proceedings and given the very recent enactment of the Greek Bankruptcy Code, the number of names of companies that may be provided is limited.

9.6.4 Case study

The very recent introduction of the new insolvency procedures combined with restrictions on the publication of the names of parties involved in proceedings means that it has not been possible to provide representative case studies.

One company which has used the conciliation procedure is the Greek construction company Betanet AEV. Following financial difficulties it chose to enter the conciliation/mediation procedure set out in Article 99 of the Bankruptcy Code in October 2008. The aim was to reach an agreement to restructure its debt with its creditors while continuing its operations. However, its small size means that it is not a representative example.

9.6.5 International

For cross-border bankruptcy proceedings within the European Union, Greece is subject to the European Insolvency Regulation which came into force in May 2002.

The UNCITRAL model law on cross-border insolvency was adopted by Greece in 2010.

9.6.6 Commentary

The Greek bankruptcy code has brought Greek's bankruptcy law into line with many of the changes occurring in other parts of Europe. At the same time, it has removed certain of the previously useful procedures, such as liquidation, without replacing them. It is still too early to comment on whether the new procedures will be a success.

9.6.7 Acknowledgements

We would like to thank lawyer Nikos Salakas for his comments and assistance on this section. His contact details are as follows:

Nikos V. Salakas
KOUTALIDIS LAW FIRM
4, Valaoritou Str.,
Athens, 106 71
Greece
nsalakas@koutalidis.gr
+30 210 3607 811

9.7 Ireland

Irish insolvency law is based on the Companies Acts 1963-2006

The Irish insolvency framework is based on the Companies Acts 1963-2006 which has been supplemented with case law. It contains a number of procedures for the formal rescue and winding up of insolvent companies. These are:

a) Creditors' voluntary liquidation;

b) Compulsory court liquidation (official liquidation);

c) Receivership;

d) Examinership; and

e) Schemes of arrangement.

These are all outlined below.

Jurisdiction to manage insolvency cases in Ireland lies with the High Court

The jurisdiction to manage insolvency cases in Ireland lies with the High Court and Supreme Court in Dublin, although small cases[40] can be handled by the Circuit Court. The term "bankrupt" in Ireland is used to refer to personal bankruptcy. For corporate bankruptcy, the term "insolvency" is preferred.

Immoveable property is secured using a mortgage or fixed charge

Immoveable property is secured using a mortgage or fixed charge. However, since the Land and Conveyancing Law Reform Act of 2009, it is no longer possible to use a mortgage to secure immovable property in Ireland. This new act does not affect pre-existing mortgages and nor does it prevent a company from placing a fixed charge on immoveable property. The 2009 act has also introduced some restrictions on the ability of a debenture holder to enforce its security. However, it is possible to expressly exclude most of these restrictions in the deed of debenture itself.

The Irish legal system recognises the security concept of the floating charge which can apply to moveable or immoveable assets

As in the UK, the Irish legal system recognises the security concept of the floating charge which can apply to moveable or immoveable assets. A floating charge effectively "floats" over the company's present or future property until moment of crystallisation, i.e. the appointment of a receiver (liquidator), when it attaches to specific assets. It does not have the same priority as a fixed charge or mortgage. Other forms of security more typically associated with moveable assets include the pledge and the lien. Set-off is also recognised in Ireland.

Irish law defines insolvency using a cash flow test and a balance sheet test

Irish law defines insolvency using both a cash flow test, which asks whether the company is able to pay its debts as they fall due, and a balance sheet test, which asks if the value of the assets exceeds the value of the liabilities. If a company fails to pass either of these tests then the company is deemed to be insolvent.

Directors of a company will not automatically be guilty of an offence if the company continues to trade while insolvent

Directors of a company will not be guilty of an offence if the company continues to trade while it is insolvent as long as the directors hold the reasonable belief that the company is able to trade out of present difficulties. However, they may be exposed to personal liability for all or part of the company's debts if they are found guilty of fraudulent or reckless trading or misfeasance.

If the court decides that they have not acted responsibly and honestly in conducting the affairs of the company then they can be restricted from acting as directors of a company for up to five years. They may also be disqualified from acting as directors of a company for the same period if they have been found guilty of fraud or dishonesty in relation to the company's affairs.

9.7.1 Pre-insolvency

All of the procedures described here are available to companies which are either technically insolvent or about to become technically insolvent. There are therefore no formal and exclusive pre-insolvency procedures.

---

[40] A small examinership could be handled by the Circuit Court where the total liabilities of the company in examinership do not exceed €317,434.52.

9.7.2 Liquidation procedures

In Ireland, the treatment of liquidation is governed by the Companies Act 1963, the Rules of the Superior Courts 1986 plus a substantial body of case law. The winding up of a company can be triggered in various situations but usually arises when a company is unable to pay debts as they become due or the company's assets are worth less than its liabilities.

Creditors' voluntary liquidation

CVL is an out-of-court procedure initiated when the directors determine that the company can no longer pay its debts as they fall due

This is an out-of-court procedure for an insolvent company which is initiated when the directors determine that the company can no longer pay its debts as they fall due and they advise the company to pass a resolution to wind up the company. Creditors' voluntary liquidation (CVL) is the most commonly used insolvency procedure in Ireland. In 2009, 1139 companies were placed into CVL compared with 106 which were wound up by order of the court using the compulsory court liquidation procedure outlined below.

The CVL procedure is independent of the court

The CVL procedure is independent of the court. To commence the procedure, a resolution to wind up the company must be passed by its members at an extraordinary general meeting. The company is then required to hold a creditors' meeting on the same, or the following day.

There is no stay on creditors' actions unless one is granted on application to the court

At this meeting, creditors vote to appoint a liquidator and the power of the directors will cease. There is no stay on creditors' actions unless one is granted on application to the court. The liquidator then sells off the company's assets, distributing the proceeds according to the priority of payments set out below in section 9.7.4.

Compulsory court liquidation

Compulsory court liquidation is a court-supervised liquidation procedure

Compulsory court liquidation, also known as official liquidation, is a court-supervised liquidation procedure for an insolvent company. It can be initiated by a range of parties including the debtor company itself or any creditor. In order to wind up a company, a petition is usually presented by a creditor in the High Court. As the process is supervised by the High Court, it is traditionally more expensive than a creditors' voluntary liquidation and can take longer to complete.

Creditors are prohibited from issuing proceedings against the company without court permission

During the process, creditors are prohibited from issuing proceedings against the company in liquidation without seeking permission from the High Court. Assets subject to a fixed charge fall outside the liquidation and so do not form part of the liquidation fund. It may be more cost effective for a charge holder to appoint a receiver to realise the secured assets if the debt is large as all of the sums realised by a liquidator in an official liquidation are subject to tax at 4%.

Receivership

In receivership the holder of secured debt appoints a receiver to take control of an asset to repay a debt

This is a process in which the holder of secured debt (e.g. a debenture which contains a fixed and/or floating charge) appoints a receiver, or a receiver and manager, to take control of the assets in order to repay the debt owed. The courts also have the ability to appoint a receiver to a company.

A receivership is not a formal collective insolvency procedure

A receiver has a duty to exercise all reasonable care to obtain the best possible price for the assets at the time of the sale. A receivership is not a formal collective insolvency procedure. However, it can be used to effect the sale of a company's assets as a going concern.

Receivership can be used to block the appointment of an examiner

Once a receiver has been appointed for at least three continuous days, an examiner cannot then be appointed to the company and so the examinership restructuring procedure (described below) is blocked. The fact that the secured creditor can choose to appoint an independent receiver and thereby avoid the delay in enforcing its security associated with the examinership process means that secured creditors have a significant amount of control if they opt for this procedure.

9.7.3 Restructuring procedures

Examinership

Examinership is a restructuring procedure introduced in 1990

Examinership is a restructuring procedure that was introduced in the Companies (Amendment) Act 1990 to rescue ailing companies which are unable to pay their debts or are likely to be unable to do so. Entry to examinership is based on the recognition that the company is unable or unlikely to be able to pay its debts as they fall due and there is a reasonable prospect of rehabilitating the company as a going concern.

Examinership is initiated by the presentation of a petition to the High Court

Examinership is initiated by the presentation of a petition to the High Court. This petition can be presented by the company, its directors, its creditors or members of the company who at the date of the presentation hold at least one-tenth of the paid-up voting capital in the company. It should be accompanied by an independent accountant's report setting out the survival chances of the company and what steps need to be taken to ensure the company's emergence from the examinership procedure as a going concern.

An examiner is appointed to the company following the presentation of the petition

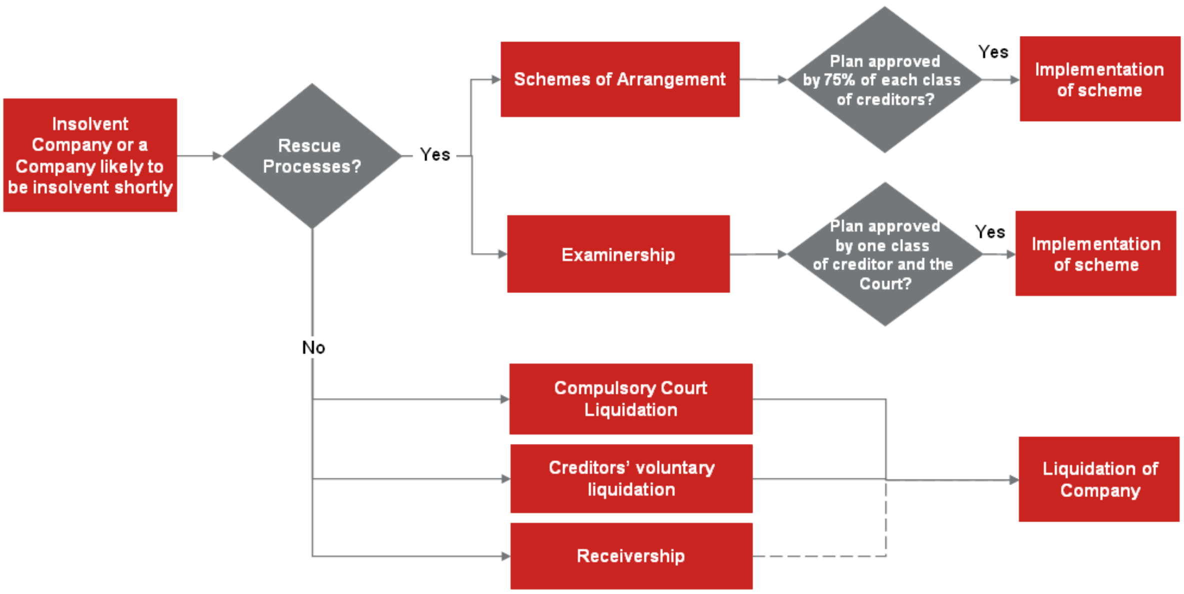
An examiner is appointed to the company following the presentation of the petition. However, the court may not appoint an examiner if it is not satisfied that the company has a reasonable prospect of surviving as a going concern. Even if the petitioner is able to satisfy the court that the company has a reasonable prospect of survival, the court has the discretion to refuse the petition.

In exceptional circumstances outside the control of the petitioner, the independent accountant's report may not be available. In this case the court can appoint an examiner for a period of up to 10 days pending the preparation of an independent accountant's report.

During the examinership procedure the company is protected from creditor action

During the examinership procedure the company is protected from creditor action. This gives the company the "breathing space" for the examiner to look into the affairs of the company, and, if there is a reasonable prospect of survival of some or all of the company as a going concern, the examiner will formulate a scheme of arrangement to facilitate this survival. Typically, the scheme of arrangement involves a new investor acquiring most or all of the shareholding in the company together with a write-down of debt across the various classes of creditor.

Figure 29. Flowchart for Irish insolvency procedure



Source: Nomura

The stay on enforcement actions by creditors is for between 70 and 100 days

The stay on enforcement actions by creditors is initially for 70 days. The legislation envisages that the examiner will have had an opportunity to formulate a proposal for a scheme of arrangement and to convene a meeting of creditors and shareholders to consider the proposals of the scheme of arrangement within 35 days from the date of his appointment. In practice, the examiner is rarely in a position to adhere to this timeframe, and in such circumstances may seek an extension from the court. The maximum period for the stay is 100 days.

The examiner can sell assets which are subject to a fixed or floating charge where this is likely to facilitate the survival of the company

The examiner can sell assets which are subject to a fixed or floating charge where this is likely to facilitate the survival of the company. In addition, he or she can dispose of assets subject to retention of title claims or hire-purchase and lease-finance agreements. The examiner must seek the leave of the court prior to selling these assets unless the affected creditor consents to the sale. If the assets are subject to a fixed charge, the examiner must use the net proceeds to pay down the debt secured by the asset. If the assets are subject to a floating charge then the creditor is deemed to have a charge over the proceeds of the sale.

To obtain approval for the scheme, the examiner must convene meetings of each class of creditor

To obtain approval for the scheme, the examiner must convene meetings of each class of creditor and meetings of the shareholders to consider the proposals. Creditors are separated into distinct classes (employees, preferential creditors, secured creditors, floating-charge holders, retention of title creditors, leasing creditors, unsecured creditors) and they vote as classes.

Provided certain conditions have been satisfied the court can impose the scheme on dissenting creditors

Provided that at least one class of creditor whose interests would be impaired under the terms of the scheme of arrangement votes in favour of accepting the examiner's proposals, the examiner may proceed with an application to the court for an order confirming the scheme of arrangement, thereby making it binding on dissenting parties. The voting by creditors at the meeting is by a majority in number and a majority in value of those claims represented at the meeting. The court has discretion over the approval of the proposals and can modify or reject them at the hearing. Any creditor or member whose claim or interest would be impaired by the proposals has a right of audience at this hearing. It is therefore possible, subject to court approval, to use the examinership procedure to cram down a dissenting class of creditors.

If the scheme is not approved then a receiver and/or liquidator will usually be appointed

If the scheme of arrangement is not approved by at least one class of creditors and so is not approved by the court, or the court decides to reject the proposal despite the approval of one class of creditor, a receiver and/or a liquidator would usually be appointed to the company.

This procedure can also be used to implement a "pre-pack"

Although not specifically catered for, this procedure has been used to implement a fast "pre-pack" solution. This requires the examiner to quickly become familiar with the details of the scheme and be satisfied that the scheme is in the best interests of the creditors and that the court will also approve the scheme on this basis.

Schemes of arrangement

A company can propose a scheme of arrangement with creditors with the help of the court

Irish insolvency law provides a mechanism, known as a scheme of arrangement, whereby a company can propose a compromise or arrangement between itself and its members and creditors with the help of the court. To initiate this process, it is necessary for the company or a creditor to make a preliminary application to the High Court for directions regarding the meeting of both the members and creditor classes.

It is not necessary to show that the company has a reasonable prospect of survival

It is not necessary to show that the company has a reasonable prospect of survival for the court to make orders following section 201 of the Companies Act 1963. However, in order for a proposal or compromise to be approved, it must be approved by a majority in number and by at least 75% in value of the creditors. This is a much higher level of support for the proposal than required by the scheme of arrangement used in the examinership process.

There is no automatic stay; the stay is at the discretion of the court

The court has discretion over whether or not to impose a stay or restrain proceedings against the company. The automatic stay available under examinership is not present here. For all of these reasons, this process is rarely used.

9.7.4 Priority of payments

All remuneration, costs and expenses of the examiner sanctioned by the court will rank in priority not only to claims secured by floating charges but also in priority to claims secured by fixed charges. The examiner's remuneration, costs and expenses must be paid from the company's revenue or from its assets when realised. If the scheme of arrangement is unsuccessful and a liquidator is appointed to the company then the priority of payments is as follows:

1. Examiner's costs, remuneration and expenses
2. Payments to holders of fixed charges
3. Approved, certified expenses due to creditors which were incurred during the examinership period
4. Costs and winding-up expenses
5. Fees due to the liquidator
6. Some social insurance contributions

7. Preferential debts (employee liabilities and other taxes such as VAT, corporation and income tax)

8. Payments to holders of floating charges

9. Unsecured creditors

9.7.5 Case study

Structured Credit Company

Structured Credit Company (SCC), an unlimited Irish-registered company, provided credit risk transfer services to a number of financial institutions. It was an early victim of the US sub-prime crisis and saw the mark-to-market value of its positions in August 2007 drop to the extent that counterparties requested $438mn of collateral to be posted. However, its entire capital which had already been posted was worth only $195mn. The Irish Netting Statute which allows set-off protected the collateral that counterparties had already received.

The Irish High Court put SCC into examinership in September 2007 having been convinced that the company was in a state of insolvency as it had been stated in court that an immediate liquidation would result in a loss of about $300mn for creditors. The court granted the examinership as it was persuaded that the firm could re-emerge as a going concern. This was based on the shareholders of SCC offering to put up an additional $125mn and creditors suggesting that they would be willing to consider a restructuring of SCC's liability.

A scheme of arrangement was approved by creditors within the examinership procedure. Of the 12 counterparties, only one decided to continue to trade with SCC which was able to continue as a smaller company which was a going concern.

9.7.6 International

Ireland is subject to the European Insolvency Regulation which came into force in May 2002. It applies to both liquidation and examinership proceedings.

The UNCITRAL model law on cross-border insolvency has not been adopted in Ireland although section 250 of the Companies Act does provide for recognition of certain foreign courts. To date only Great Britain and Northern Ireland have been included.

9.7.7 Commentary

Ireland is a friendly jurisdiction for secured creditors

Ireland is a friendly jurisdiction for secured creditors. This is shown clearly in Figure 30 where we see that the law presents a number of procedures which do not impose a stay on creditors. When there is a stay, the length of the stay is usually quite short. In particular, secured creditors with a fixed and/or floating charge can use the receivership procedure to enforce security quickly and without court involvement.

Examinership provides a lot of useful features which can assist a restructuring

The examinership process does provide a 70- to 100-day period of protection for the company from its creditors. It also allows for a cramdown of creditors. As a result of the short moratorium period, the examinership process is usually quite fast and if it does not succeed in an agreement, will immediately result in the appointment of an official liquidator and/or receiver. As a result, use of the examinership process has increased as companies, creditors and lawyers have become more familiar with the benefits it presents.

Figure 30. Summary of Irish insolvency procedures

Procedure	Compulsory Court Liquidation	Creditors' Voluntary Liquidation	Receivership	Scheme of Arrangement	Examinership
Purpose	Court-supervised winding up of insolvent company	Out-of-court procedure to wind up insolvent company	Out-of-court enforcement mechanism for secured creditors	Restructuring	Restructuring procedure
Condition for entry	Insolvent. Petition to High Court	Insolvent plus a resolution to enter process by members at EGM	Fixed charge and/or floating charge holder appoints receiver to sell assets or company	Court discretion	Insolvent (or likely to become insolvent shortly)
Stay on creditors	Yes, a stay on creditors issuing proceedings but no stay on the enforcement of security	No, but at stay on creditors issuing proceedings may be granted by the court. Again there is no stay on the enforcement of security.	No	Not automatic. May be imposed by court	Yes for 70 days (can be extended to 100 days)
Control	Liquidator subject to court supervision	Liquidator appointed by creditors'	Receiver	Management	Examiner
Approval for plan	N/A	N/A	N/A	Scheme requires a majority in number representing 75% in value of the creditors or class of creditors	Court approval of scheme of arrangement can be sought provided at least one class of creditors by majority in number and value vote in favour of the scheme
Binding	N/A	N/A	N/A	Yes if sanctioned by the court	Yes if sanctioned by the court
Court involvement	Yes	No	No	Yes	Yes
Enhanced priority financing	N/A	N/A	N/A	No	No
Average procedure time (estimate)	Depends on the facts and circumstances pertaining to each individual case	Depends on the facts and circumstances pertaining to each individual case	Depends on the facts and circumstances pertaining to each individual case	Depends on the facts and circumstances pertaining to each individual case	100 days
Recent uses	Budget Travel Limited Vantive Holdings Morston Investments Limited	International Screen Limited Hughes & Hughes Limited	The Macredin Club Plc Redcorn Limited	Millstream Recycling Limited McInerney Properties Plc	Structured Credit Company International Securities Trading Corporation (ISTC)

Source: Nomura, Mason Hayes+Curran

9.7.8 Acknowledgements

We would like to thank Maurice Phelan and Fleur O'Driscoll for comments and assistance on this section. Contact details are as follows:

Maurice Phelan
MASON HAYES+CURRAN
South Bank House
Barrow Street
Dublin 4
Ireland
mphelan@MHC.ie
+353 1 614 5000

9.8 EU Insolvency regulations

Before 2002, there was a lack of clarity about how to handle multi-national bankruptcies in Europe

Prior to 2002, there was a lack of clarity in Europe concerning the question of which law should apply to the liquidation or restructuring of a company with interests in more than one European jurisdiction. This resulted in the phenomenon of distressed companies "forum shopping" in order to select the optimal jurisdiction, chosen mainly to protect the rights of debtors. This led to disputes and created uncertainty.

Issues of jurisdiction were addressed by the EC Regulation on Insolvency Proceedings

In an attempt to establish some clear rules for the treatment of cross-border insolvencies, the EC Regulation on Insolvency Proceedings 2000 came into effect at the end of May 2002. This regulation applies to all EU member states except Denmark[41]. The law does not attempt to harmonise the insolvency frameworks of different EU member states. Its main aim is create a mechanism to allow EU member states to recognise the insolvency regulations of other EU member states.

The regulation only applies to collective insolvency proceedings

The regulation only applies to collective insolvency proceedings and excludes private and informal procedures. Nor does it apply to insolvencies involving insurance companies and credit institutions as these are covered by separate EU directives.

The regulation distinguishes between the main proceedings and secondary proceedings

The regulation creates two tiers of insolvency proceeding – the main proceedings and the secondary proceedings. The concept of the main proceedings is based on the idea that the insolvency proceedings should be driven by the insolvency laws of the country where the main proceedings take place. To achieve this, main proceedings – and their effects under the laws of the State in which those proceedings are opened – are accorded recognition throughout the EU. Then there are secondary proceedings. Secondary proceedings may be opened in any number of EU member states in which the debtor has sufficient presence. However, they are limited in scope and in many but not all instances they are subordinate to the main proceedings.

The main proceedings take place in the country where the centre of main interests (COMI) is located

To establish the location of the main proceedings, it is first necessary to establish the company's centre of main interests (COMI). This is necessary to establish the true "centre of gravity" of a company given that it may have activities and assets distributed across several EU member states. The EC Insolvency Regulation sets out the rules used to determine where the COMI lies. The legislation provides two main criteria:

- The COMI should be presumed to be the location of the registered office, in the absence of any proof to the contrary; and
- It should correspond to the place where the company conducts the administration of its interests on a regular basis and is therefore ascertainable by third parties.

Companies have been able to exploit the definition of the COMI to move it to other more favourable jurisdictions

The qualifying phrase "in the absence of any proof to the contrary" has left it open not only for disputes over the location of a company's COMI, but it has also permitted companies to actively take steps to change the COMI from the location of its registered office. It has been left to the local courts in the jurisdiction in which the main proceedings are sought to be opened to determine any disputes about COMI, including the success of the attempted COMI migration. The court needs to resolve the location of the COMI if the place of incorporation of the company is not the same as the place where the company conducts the administration of its business. We will discuss the practice of moving the COMI in greater detail below.

The first party to open main proceedings establishes which state will control the process

The main point of the new rules is to allow a company to start the main insolvency proceedings in the country where the COMI is located, and by doing so, pre-empt the opening of main proceedings in other jurisdictions. Indeed, the first party to open main proceedings establishes which state will control the process. The primacy of the local courts opening the main proceedings extends even to the determination, under that state's appeal processes, of whether the COMI was properly found to exist in that jurisdiction. Appeals are ultimately heard by the European Court of Justice. The "first-mover" advantage in opening main proceedings is considerable.

[41] References to EU member states in the remaining text should be understood to be subject to the qualification that we do not include Denmark. Although Denmark was unable to adopt the EU Insolvency protocols, it is expected that it will apply the same rules via a bilateral agreement with the European Community.

Secondary proceedings can be opened in a non-COMI country

Secondary proceedings are usually concerned with the winding-up of the local activities and the realisation of the company's assets in the member states other than where the main proceedings are taking place. There can be simultaneous secondary proceedings open in multiple member states. The requirement is that the company must have an "establishment" in that state. Secondary proceedings can be opened either at the request of the office holder in the main proceedings or by any person who can customarily petition for the opening of proceedings under the local insolvency laws. Under most European insolvency laws, this would typically allow creditors to petition for secondary proceedings.

The regulations seek to address the situation of a single company registered in one EU member state but with operations in other jurisdictions

This combination of main and secondary proceedings allows the regulation to address the scenario of a single company registered in one EU member state but with operations in other jurisdictions. For example, consider the case of a corporate structure consisting of one company registered in the UK with operations in France, Germany and Italy. The choice of COMI determines the insolvency regime used for the main proceedings and in this case it would be the UK regime. However, secondary proceedings in France, Germany and Italy would be permitted which would determine how the assets in each country are treated. This is shown in Figure 31.

Figure 31. Example of EU insolvency regulations where COMI is in England

Location of company	Type of proceedings	Resulting situation
England	Main	Insolvency proceedings initiated in English court from where the process is controlled
France	Secondary	French courts apply local law to French assets
Germany	Secondary	German courts apply local law to German assets
Italy	Secondary	Italian courts apply local law to Italian assets

Source: Nomura

The regulation is aimed at companies at an entity level and is not directed at corporate groups

As this example shows, the regulation is aimed at companies at an entity level, including the company's operations across EU jurisdictions. The regulation is not directed at corporate groups. In the case of a corporate group with a holding company in one jurisdiction and multiple subsidiaries in other jurisdictions, each entity in the group will have its own COMI and this (together with any question of any secondary proceedings) will be determined on an entity level basis for each company.

This raises the possibility that each entity in the group will have its own main proceedings within a different jurisdiction. In practice, it is often found that if there is a centralised management and control of the subsidiaries at the level of the group head office, each entity in the group will have its COMI in the same centralised location. There have been numerous prominent examples of "group filings" for main proceedings occurring all at once in the same jurisdiction, essentially for this reason[42].

The definition of the COMI gives companies more clarity about what is needed to move COMI

Despite the fact that one of the intentions of the EU regulations was a wish to reduce the amount of forum shopping, there have been a number of notable cases where European companies have moved their COMI, usually to the UK. The goal for these companies was to take advantage of particular procedures which exist in the UK insolvency regime. However, it is worth noting that the EU regulations only apply to collective insolvency proceedings. In the UK this includes compulsory winding-ups, administration and CVA proceedings but it does not include schemes of arrangement[43].

Companies can ensure their COMI is in a favourable jurisdiction

Companies have also sought to organise their affairs so that they can be sure that their COMI is located in a favourable jurisdiction. Lenders must also be attentive to this when negotiating "COMI covenants" in a borrower's finance documents. Factors which support the declaration of a specific jurisdiction as the COMI include:

[42] Examples include the English administrations of the European group companies Collins & Aikman and MG Rover.

[43] The applicable rules for schemes of arrangement are equally (if not more) permissive of foreign companies establishing jurisdiction in England. However, those rules exist separately from and independently of the EU insolvency regulations and one of the effects of this is that schemes of arrangement do not therefore have the benefit of the EU-wide recognition that applies to insolvency proceedings governed by the EU insolvency regulations.

- It has the registered office and is incorporated there;
- Assets and operations are located there;
- Management holds its board meetings there;
- Meetings with creditors (including banks) occur there; and
- Finance and funding are provided there.

We now present some examples of multi-jurisdictional insolvencies which have occurred in the past few years.

9.8.1 Case studies

Daisytek ISA

Daisytek ISA, a retailer and wholesaler of computer peripherals, was a group of companies with headquarters in Bradford, England, and trading subsidiaries in Germany, France, Italy, Scandinavia and the UK. The English company was a subsidiary of its US parent Daisytek Inc. which filed for Chapter 11 bankruptcy proceedings in May 2003. Although the European operation was profitable, suppliers common to it and the US operation halted their deliveries and the European business began to suffer and was approaching insolvency.

Management sought a sale of the company and petitioned the English court for French and German subsidiaries to be placed in English administration alongside the English company. Based on evidence, it was decided by the court that the German and French companies were managed to a large extent from the head office in the UK. For example, 70% of supply contracts to the French and German companies were negotiated from Bradford. It was determined that the UK was the European COMI for Daisytek.

However, creditors in France and Germany also sought to open main proceedings for the subsidiaries in their respective countries. While the commercial court in France decided to open main proceedings, this decision was reversed by the court of appeal in Versailles on the grounds that main proceedings had already been opened in the UK. The same situation occurred in Germany, i.e. a decision by one court to open main proceedings was overruled by a higher court. The English proceedings were then the agreed main proceedings.

Eurofood

Eurofood was a wholly owned subsidiary of Parmalat with its registered office in Ireland. Its main business was raising financing for companies in the Parmalat group. In December 2003 Parmalat entered the extraordinary administration procedure in Italy. A month later, a petition was presented to the High Court of Ireland to wind up Eurofood on the basis that it was insolvent. Two weeks later, the Italian Minister in charge of Parmalat's procedure admitted Eurofood into the extraordinary administration procedure. On 20 February 2004 the Italian court opened proceedings declaring that the COMI was in Italy.

On 23 March 2004, the Irish High Court ruled that the insolvency proceedings had been opened in Ireland and that the COMI was therefore located in Ireland stating that it should be wound up. The Italian administrator appealed and the Irish Supreme Court referred the matter to the European Court of Justice which ruled in December 2005 that the COMI was in Ireland. Key to the ruling was the statement "that the COMI of that subsidiary is situated in the member state where its registered office is situated, can be rebutted only if factors that are both objective and ascertainable by third parties indicate that a different situation exists". Since the registered office was in Dublin, and, furthermore, this was where the company's activities occurred, it was not possible to insist that another location should be used. The court rejected the arguments of Parmalat who claimed that the COMI should be based in Italy on the grounds that the Italian parent had the ability to control the economic policy of the Irish subsidiary.

Schefenacker

In early 2006, Schefenacker, a German manufacturer of automobile rear-view mirrors with 7,900 employees in 33 locations worldwide, found itself being squeezed by the costcutting activities of the major automakers. In the second half of 2006 it began to talk to its creditors about moving its COMI from Germany to England.

There were a number of reasons for this: (i) it had been advised by German legal experts that the English process would be advantageous concerning its treatment of debt-for-equity swaps; (ii) the use of an English CVA to bind all creditors with a 75% majority vote was viewed as making the restructuring more likely to succeed in England rather than in Germany where a small minority of creditors can hold out; (iii) it avoided the German requirement for management of an insolvent company to file within three weeks of insolvency or face criminal sanctions; and (iv) the German insolvency regime was seen as untested compared with an English CVA.

The change of the COMI was facilitated because the holding company was not the employer of the German employees or the owner of the German factories. This strategy had already been used in 2004 by Deutsche Nickel AG which did a similar COMI switch to England in order to complete a debt-equity swap.

Wind Hellas

Wind Hellas, the second largest operator of fixed line internet and mobile telecommunications services in Greece, was bought by Weather Investments SpA, a privately held company, in 2007 for €3.4bn. The purchase was financed by an array of high yield bonds ranging from senior secured floating rate notes (originally €925mn) to structurally and contractually subordinated PIK notes (€200mn). The parent of Wind Hellas Telecommunications SA (the Greek operating company) was Hellas II, a Luxembourg finance company which was the issuer of €1,170mn of subordinated notes.

Financial difficulties became increasingly apparent from the end of 2008 as increased price competition, a reduction in roaming and mobile termination rates and rising interest costs impacted the company's cash flows. Management began working with advisors in May 2009 to address the amount of debt in its capital structure, which needed to be re-cut before much-needed new liquidity could be injected. Management (i.e. the equity sponsor Weather) and its advisors wanted to take advantage of the restructuring flexibility provided by the English courts and so began to plan shifting the COMI of Hellas II from Luxembourg to England.

This plan was put into action in August 2009 when an English "newco" Hellas Telecommunications (UK) Ltd was established as the general partner of Hellas II, and a new head office was opened in London. Hellas II was registered at Companies House as a foreign company and all negotiations between Hellas II and its creditors were held in London, thereby strengthening its legal position that the COMI had been shifted for Hellas II. It is worth noting that the Greek operating company and its subsidiaries were not part of the move.

The next step was to "mark the capital structure to market" via an auction which began in August, prior to new cash being injected. Based on this, it became apparent that market participants believed that the subordinated notes were "out-of-the-money" as their prices dropped below 20 cents on the dollar at the start of September. It also became apparent that interest payments due in October would not be paid.

Two bids were received. Of these it was Weather's bid[44] that was chosen by the creditors for various reasons. Waivers were received in November from senior creditors to avoid default being triggered by Hellas II entering administration in the UK. A pre-pack administration sale of Hellas II's assets (for €125mn) to a "Newco" Weather Finance was used to enforce the agreement, much to the frustration of the holders of the company's subordinated and PIK notes who were left behind.

At the hearing, it was noted that Wind Hellas had only moved its COMI to England in August. However, the court was satisfied that the COMI was in London at the time of the administration filing and that this fact was ascertainable by third parties – one of the main legal tests that need to be satisfied. The court permitted the administrator E&Y to complete the pre-pack administration sale which completed on 27 November 2009.

[44] The new capital structure consisted of a revolving credit facility, senior secured loans and senior notes over the subordinated bondholders.

9.8.2 Commentary

The requirements needed to establish the location of the COMI have become clearer but still provide some leeway for dispute

Due to the number of COMI switches that have occurred in the past few years, the requirements needed to establish the location of the COMI have become clearer but still provide some leeway for dispute. The Daisytek and Eurofood examples show that different courts (initially) came to different conclusions about the location of the COMI. To resolve this problem, some countries have tried to reduce the uncertainty. For example, Germany has ruled that if another court has refused to grant COMI jurisdiction on the basis that the COMI is in Germany, then a German court cannot refuse jurisdiction.

The regulation is concerned with where the COMI is situated at the start of proceedings without regard to when it was shifted

The intentional movement, or “migration”, of COMI has been permitted in a number of cases, most notably Schefenacker and Wind Hellas. In the latter case, the key factor is that the regulation is concerned with where the COMI is situated at the start of proceedings without regard to when it was shifted. Consequently, recent shifts of the COMI for the purpose of benefiting from the insolvency regime of another jurisdiction have been permitted. However, this is only possible if it can be shown that the change exhibits some element of “permanence” and is not just illusory. While the examples given above provide a useful guide, in practice each case is different and each decision depends very much on the details.

As the COMI move is driven by management, it will generally be to a regime which minimises its displacement and crams down creditors

Since the movement of the COMI can only be performed at the instruction of the debtor, it can generally be assumed that the switch of the COMI will be to a regime which either allows management to retain control, or, if it displaces management (as in the case of the English administration) its follows an agreed restructuring process supported by management. It will also generally be to a regime which facilitates a court-approved restructuring agreement which will involve some cramming down of creditors, which in the case of Schefenacker, may be one of the main reasons for migrating the COMI.

The well-used procedures which exist in England make it a favoured COMI destination

The set of well-used procedures which exist in England make it a favoured COMI destination. For companies whose COMI is not firmly established, and which would otherwise be subject to an unfamiliar or debtor-unfriendly jurisdiction, shifting their COMI to the UK has obvious attractions.

However, there are practical issues to consider regarding how easy it is to move the COMI

However, there are practical issues to consider. For example, a switch of COMI may be easier and more likely for a company with a pure finance or treasury function than for a manufacturing operation. It would also make it easier to move management and creditor interactions to this new location. Considerations like these underscore the importance of performing restructuring in a controlled manner if the underlying business can be saved. There will also generally be significant advantages in attempting to confine any necessary proceedings to the holding company level, thereby keeping local operating subsidiaries out of the formal proceedings.

9.8.3 Acknowledgements

We would like to thank John Houghton and Jackson Taylor for their comments and assistance on this section. Their contact details are as follows:

John Houghton / Jackson Taylor
LATHAM & WATKINS
99 Bishopsgate
London EC2M 3XF
United Kingdom
john.houghton@lw.com / jackson.taylor@lw.com
+44 20 7710 1000

10 ASIA

10.1 Japan

US common law was the legal culture for the Corporate Reorganisation Act adopted in 1952

Historically, the insolvency laws used in Japan were based on a mixture of German and French law adopted in the modernisation period after the Meiji Restoration at the end of the 19th century. Following World War 2, Japanese law was supplemented with US common law and this was the legal culture for the Corporate Reorganisation Act adopted in 1952.

Japan has introduced changes to its insolvency laws to encourage the early recognition of business distress and assist rehabilitation

More recently, Japanese insolvency laws have seen a number of important changes which have been introduced in order to encourage the early recognition of business distress and to make company rehabilitation more likely. Of these the most important was the introduction of the Civil Rehabilitation Act in 2000. A Japanese court also implemented debtor-in-possession (DIP) procedures under the Corporate Reorganisation Act in 2009. The insolvency procedures in Japan, which are all described in detail in this section, are:

a) Bankruptcy proceedings;

b) Special liquidation proceedings;

c) Civil rehabilitation;

d) Corporate reorganisation;

e) DIP corporate reorganisation; and

f) Private arrangements.

Security for immoveables usually takes the legal form of a mortgage; for moveables the pledge, lien and reservation of ownership are used

In Japan, security for immoveable assets usually takes the legal form of a mortgage (*teito ken*). This must be registered with the Land Registry. Moveable assets can be secured using a range of devices including a pledge (*shichi ken*) which for tangible assets means that the creditor has physical possession of the assets. Other forms of security include collateral assignments (*joto tanpo ken*), statutory liens (*ryuchi ken* and *saikodori tokken*) and reservation of ownership. Set-off is permitted for debts that were already in existence when the bankruptcy procedure began.

Jurisdiction for insolvency cases generally belongs to the district court of the district where the company has its main business office in Japan. The Bankruptcy and Civil Rehabilitation Petition (for cases with a large number of creditors (over 1000)) and the Corporate Reorganisation petition may be filed at the Tokyo District Court or the Osaka District Court.

The insolvency test in Japan consists of a balance sheet test and a cash flow test

In Japan, the general test for insolvency comprises two elements: (i) a balance sheet test, i.e. the company is insolvent if its total liabilities exceed the value of its assets; and (ii) a debt payment test, i.e. the company is insolvent if the company is unable to pay its debts generally. The conditions for entry into the different insolvency proceedings depend on the procedure being used as we describe below.

In practice, companies tend to wait until the cash flow test is triggered before they file for insolvency proceedings

Insolvency proceedings are usually initiated by a voluntary petition by the debtor. However, in practice, even if the balance sheet test is met, companies are hesitant to file an insolvency petition until and unless they anticipate a failure to pay their debts generally in the near future. It is possible but rare for an involuntary petition to be filed. Creditors are informed of the petition by an individual notice to the creditors that are known to the debtor as well as a public notice which is published in an official gazette.

10.1.1 Pre-insolvency

The Civil Rehabilitation and Corporate Reorganisation procedures can be used for a company that is not currently insolvent

There is no specific pre-insolvency procedure although the Civil Rehabilitation and the Corporate Reorganisation procedures can be used for a company that is not currently insolvent when there is a risk of an event that will cause the company to become insolvent, or if the company cannot pay its obligations as they fall due without creating a significant burden on the continuation of the business. These procedures are described in detail below.

A solvent company may also initiate a winding-up after passing a shareholders resolution

A solvent company may also initiate a voluntary winding-up after passing a shareholders resolution to dissolve the company. If the company becomes insolvent during the procedure then the procedure converts to the special liquidation procedure described below.

10.1.2 Liquidation

Bankruptcy proceedings

An insolvent company can be admitted into bankruptcy proceedings

A company can be admitted into bankruptcy proceedings (*hasan tetsuzuki*) if the company fails the insolvency test described above. The company is presumed to have failed the debt payment test when it has suspended payments generally.

Bankruptcy proceedings are generally initiated by the company or a creditor filing a petition

Bankruptcy proceedings are generally initiated by the debtor or a creditor filing a petition at the district court. In the case of corporations, directors and liquidators may also file a petition. If the company is insolvent, then the process will start with the court appointing a trustee in bankruptcy. The directors lose control of the company and the trustee acquires the authority to administer and dispose of the company assets.

Secured creditors are not considered to be party to bankruptcy proceedings and so are free to enforce their security

Secured creditors are not considered to be a party to bankruptcy proceedings and so are free to enforce their security outside the proceedings. Certain pre-filing unsecured claims, including tax and wage claims have preferential status. At the end of the process, all of the company's assets will be monetised and the proceeds are distributed to the creditors according to the priority of payments set out below and the company is dissolved.

Special liquidation proceedings

Special liquidation proceedings are used to dissolve an insolvent company

Special liquidation proceedings are used to dissolve an insolvent company. We described above how the shareholders of a company can vote to voluntarily dissolve the company on the assumption that it is solvent. However, if the company then suspects that it is actually insolvent, the liquidator has a duty to file a petition for special liquidation proceedings. Creditors and shareholders can also file for this procedure.

A special liquidator is appointed who will liquidate the company and prepare a plan to pay the creditors which must be approved at a creditors' meeting

If the court finds that the company is reasonably suspected to be insolvent, a special liquidator is appointed who will liquidate the company and prepare a settlement plan to pay the creditors which must be approved at a creditors' meeting. Approval requires a majority in number and more than 66.7% in value of the unsecured creditors present. If a settlement plan is not approved and the company is actually insolvent then the court commences the bankruptcy procedure. Unless stayed by the court, secured creditors will be able to enforce their security.

10.1.3 Restructuring

Civil rehabilitation

Civil rehabilitation has become the most popular of the three Japanese restructuring procedures

The restructuring procedure known as civil rehabilitation (*minji saisei*) came into effect in April 2000 and replaced the repealed Composition Act. It has become the most popular of the three Japanese restructuring procedures. It was initially intended for the successful rehabilitation of small and medium-sized companies but is now used for large companies due to its relative simplicity and speed.

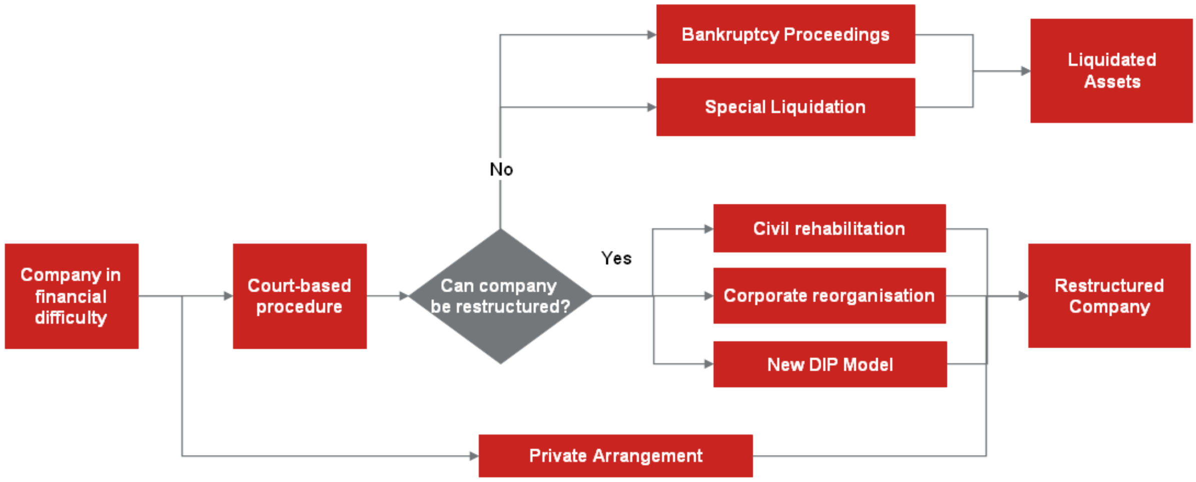
A petition to start this procedure can be filed by the debtor or a creditor provided the debtor is insolvent

A petition to start this procedure can be filed by the debtor or a creditor provided the debtor is insolvent. It is also possible to use this proceeding pre-insolvency if there is a risk that the company will become insolvent or cannot pay its obligations as they fall due without creating a significant burden for the continuation of the business. In all cases, the final decision rests with the court.

Although a supervisor is generally appointed by the court, the management stays in control

Although a supervisor is generally appointed by the court, the company's management stays in control. It can administer and dispose of assets in the ordinary course of business. For significant transactions, including the disposal of assets outside the ordinary course of business, approval of the court-appointed supervisor is necessary. In certain cases, the court may remove management and replace it with a trustee.

Figure 32. Flowchart of Japanese insolvency process



Source: Nomura

The stay on claims only grants protection from actions by the non-secured creditors and not the secured creditors

Management (or the trustee) does not have full control over the debts of the company since the stay on claims against the company only grants protection from actions by the non-secured creditors and not the secured creditors. The debtor has to negotiate with the secured creditors outside the process to achieve a final agreement for all secured creditors. However, it is possible to file a petition for a temporary stay to preserve the assets of the debtor from being seized by a secured creditor. The court may also allow the debtor to exchange certain security rights for their cash value if the assets are necessary for the debtor to continue its business.

It is possible to obtain preferential priority for new financing

It is possible to obtain preferential priority for new financing obtained during the insolvency procedure on the approval of the supervisor. Such financing obtains common benefit claim status meaning that it is senior to other claims.

The debtor must submit a plan which is realistic and treats fairly the different classes of creditor

After the start of the procedure the court announces the period in which creditors must submit their claims which is typically around one month. Once this period is over, the debtor is required to submit a rehabilitation plan within a second period also specified by the court. This plan must be realistic and fair in terms of how it treats the different classes of creditor.

Plan approval requires a simple majority in the number of unsecured creditors present or voting by post and a majority of unsecured creditors by value

A meeting of the creditors is then held where the plan is discussed and approved. Approval requires a simple majority in the number of unsecured creditors present or voting by post and a majority of unsecured creditors by value. Where subordinated claims exist, approval by class voting of both general unsecured creditors and subordinated creditors is required, although the court can cram down either class. The plan must be approved by the court before it can be implemented. If the plan is rejected then the court can convert the process to bankruptcy proceedings.

Corporate reorganisation

Corporate reorganisation is a more formal procedure than civil rehabilitation and is used by large companies

Corporate reorganisation (*kaisha kosei*) is an older and more formal procedure than civil rehabilitation. It can only be used by corporations (*kabusihiki kaisha*), not LLCs or non-profit organisations, and is generally used by large companies when compared with civil rehabilitation. It was established in the Corporate Reorganisation Act. It is more powerful than the civil rehabilitation procedure in that it subjects both secured and unsecured creditors to a stay on their claims.

Corporate reorganisation can be initiated by the debtor, shareholders or a creditor subject to certain thresholds

Corporate reorganisation can be initiated by the debtor, shareholders owning 10% or more of the shares carrying voting rights, or by a creditor whose claim represents 10% or more of the debtor's stated capital. The conditions to enter into the process are that the company is, or threatens to be insolvent in the sense described above, or that it has become unable to pay its debts without causing a significant burden on the continuation of the business.

A trustee is appointed to replace management

Unlike the civil rehabilitation procedure, management does not remain in control (except in the DIP procedure described below). At the time of filing a provisional trustee, usually a practising insolvency lawyer, is appointed by the court to manage and control the company's assets until the court orders the start of the procedure. The time between filing and the opening of proceedings is known as the preservation period. Once this order has been given the procedure begins with the appointment of the trustee (usually the provisional trustee continues as trustee) who will take the company through the whole procedure. The trustee has the power to manage the operations of the company. However, actions that go beyond the ordinary course of business need approval from the court.

Post-filing financing is possible subject to the court approval and obtains priority status

As with civil rehabilitation, post-filing financing entered into by the provisional trustee is possible during the preservation period and after the start of the procedure. However, the approval of the court is required. Such financing obtains common benefit claim status meaning that it is senior to other claims.

The trustee must submit a reorganisation plan to the court

Within a court-specified period the trustee must submit a reorganisation plan to the court. In the Tokyo District Court the deadline for submitting the plan is typically 10 months after the start of the procedure. The plan must be fair and allow the company to continue as a going concern. It must also distinguish between different classes of creditors.

The degree of secured creditor approval required depends on the severity of the proposed plan

Approval of the plan requires 66.7% of secured creditors by value if it simply proposes to extend the maturity of secured claims. If the plan does more than this (e.g. it applies a haircut) then the majority required rises to 75% of secured creditors. If it abolishes the whole business then the threshold rises to 90%.

Approval by unsecured creditors needs only a simple majority by value

Unsecured creditors need only a simple majority of unsecured creditors representing more than 50% of unsecured claims by value. If the debtor does not meet the balance sheet test, approval of the plan also requires a simple majority of shareholders who own more than 50% of shares with voting rights.

There is also more flexibility in the scope of the reorganisation plan in this procedure than in civil rehabilitation

The level of approval required from the secured creditors is one important way in which corporate reorganisation differs from civil rehabilitation since in that procedure, secured creditors are outside the process. There is also more flexibility in the scope of the reorganisation plan in this procedure than in civil rehabilitation. For example, it could include significant structural changes such as a proposal to split up the company without requiring the approval of a shareholders meeting held outside the procedure.

Corporate reorganisation generally takes longer than civil rehabilitation

In general, corporate reorganisation is a lengthier process than civil rehabilitation with typical procedure times (up to approval of the plan) of one year compared with about six months for civil rehabilitation.

Debtor-in-possession corporate reorganisation

Tokyo District Court launched the new DIP corporate reorganisation procedure in early 2009

In January 2009, the Tokyo District Court launched a new procedure, known as the debtor-in-possession (DIP) corporate reorganisation, which has already been used in a number of important restructurings. Legally, the DIP procedure is based on the corporate reorganisation procedure described above. However, rather than having a third-party trustee assume control of the company, a member of the existing management is appointed as trustee under the supervision of a third-party examiner.

The DIP procedure is based on corporate reorganisation

The DIP procedure is a variation on the corporate reorganisation procedure but can only be used if all of the following four additional requirements are met:

1. There is no risk of liability concerning unlawful actions by the management of company;
2. The company's major creditors do not object to the management staying in control;
3. If a prospective sponsor exists, they do not object to the procedure being used; and
4. No circumstances exist which indicate that the management will interfere with a fair reorganisation proceeding.

The court determines if these conditions are met by examining the behaviour of the management.

There are three important differences between the DIP and the corporate reorganisation procedure

The development of the DIP procedure means that together with the civil rehabilitation procedure, management has two procedures to choose from which allow it to remain in control. However, there are some important differences. They are:

1. The DIP procedure stays the secured creditors while they are not stayed in the civil rehabilitation procedure;
2. The DIP procedure can include a haircut and/or a maturity extension of secured claims; and
3. The DIP procedure allows more possibilities for the restructuring plan including mergers and spin-offs.

The DIP requires the debtor to submit a reorganisation proposal within 18 weeks of the start of the procedure

The Tokyo District Court has also announced a standard timeline for the DIP procedures. According to this the court determines whether to start the procedure within three weeks after the filing of a petition and requires the debtor to submit a proposal of the corporate reorganisation procedure within 18 weeks of the start of the procedure. Voting for approval of the plan takes place five weeks after the submission of the proposal. The total period from the filing of a petition to the approval of the plan is approximately six months.

This DIP procedure has already been used in a number of major corporate insolvencies

This procedure has already been used in a number of major corporate insolvencies including the Japan General Estate Co. Ltd., Creed Corporation and AOMI Construction. These companies all filed for the procedure in January or February 2009 and have since obtained approval to go down the corporate reorganisation path.

Private arrangements

Public and formal legal proceedings are often bypassed by using private arrangements

In many cases, these public and formal legal proceedings are often bypassed by the debtor and creditors using private arrangements (*shiteki-seiri*). The advantage is that it is a private procedure so it is used when a public restructuring could prevent the company from recovering from its financial difficulties, e.g. where a filing of any formal legal proceeding accelerates loans and bonds.

They are a speedier alternative to formal proceedings but there is no ability to cram down creditors

Another aim of this process is to promote out-of-court restructuring as a more efficient and speedier alternative to court-supervised proceedings. However, there is no ability to cram down creditors and creditors who do not agree with the restructuring plan are not bound by it. We now describe two procedures which have been adopted to enable organised private arrangements.

The BRADR is a procedure designed to encourage consensual restructuring

The first is called the business rehabilitation alternative dispute resolution (BRADR) procedure. This was launched in 2007 by a statute which licenses a private organisation approved by the Minister of Justice (MOJ) and the Minister of Economy, Trade and Industry (METI) to be the dispute resolver for distressed companies seeking to agree a restructuring with their financial lenders. The private organisation licensed for this task is the Japanese Association of Turnaround Professionals (JATP).

There is a non-binding stay and government assistance with regards to financing

At the start of the procedure, the organisation sends a notice of stay to lenders. Although it is non-binding, lenders are usually expected to respect this notice of stay. A loan-restructuring plan requires unanimous consensus among affected lenders. The government assists the procedure by providing preferential tax treatment and governmental guarantees for bridge financing. This proceeding does not involve corporate bond holders and, to restructure bond debt together with loan debt, the debtor needs to seek the bond holders' consent separately.

The second procedure, special mediation, is a court-administered proceeding where the court may order a stay or propose a plan

The second procedure is called special mediation (*tokutei-chotei*). This is a court-administered proceeding which facilitates the restructuring of loan debt based on an agreement with lenders. As with the BRADR, the special mediation procedure requires the unanimous consent of the affected lenders. However, unlike the BRADR, the court may issue an order for a stay of foreclosure on the debtor's assets and, where unanimous consent by lenders cannot be obtained, the court may propose a restructuring plan. If no lender makes a formal objection within two weeks, the proposed restructuring plan becomes legally binding.

10.1.4 Priority of payments

In Japan the exact order of priority depends on the procedure being used. Therefore, any attempt to set out a priority of payments can only be approximate. The following list is therefore not exact – indeed we will follow it with some examples of where it is not correct.

1. Secured claims.

2. Common benefit claims: Includes expenses for the proceedings, claims in relation to business operations arising after commencement of the proceeding, DIP-style financing;
3. General priority claims: Includes unpaid wages, tax claims, social security insurance premiums, secured first lien debt;
4. General unsecured claims; and
5. Subordinated claims.

Note that this order of priority of payments does not apply to all proceedings

We now set out some reasons why this order of priority of payments does not apply to all proceedings. For example, in the case of corporate reorganisation, common benefit claims have the highest priority, whereas in the case of bankruptcy and civil rehabilitation, secured creditors may foreclose their collateral and get repaid even before common benefit claims are paid. Wage claims obtain common benefit claims status only for the amount equal to three months of salary in the bankruptcy procedure and for six months of salary in the corporate reorganisation procedure.

10.1.5 Case studies

Japan Airlines

Japan Airlines (JAL) is the Japanese national flag carrier and the third biggest airline in the world after Delta and United. By the end of 2009, its business was in serious difficulty, having lost ¥131 billion ($1.4bn) in the second half of 2009. It also had ¥2.3 trillion ($26bn) of debt.

Following a change of government in September 2009, the Japanese Democratic Party formed the JAL Rehabilitation Task Force. In October 2009, the task force issued an advisory opinion that JAL should be bailed out using taxpayer money. The plan was to use private arrangements with its lenders to enable creditors to take a haircut and permit a debt-for-equity swap.

The creditors objected strongly to this opinion and JAL's rehabilitation became a political topic. In November 2009, JAL filed for the BRADR with its non-binding temporary stay. However, discussions among JAL, the government and the creditors did not succeed and, in January 2010, JAL filed for the corporate reorganisation procedure.

At the start of the procedure, Tokyo District Court issued an unusual order that claims owed by trade creditors of JAL are not subject to a stay if, and only if, such creditors continue business with JAL pursuant to past practice. The submission of JAL's corporate reorganisation plan is due on 31 August 2010.

Nova

Before its bankruptcy in 2007, Nova was the largest English-language school in Japan employing approximately 15,000 teachers. It was publicly traded at the JASDAQ exchange. In 2007, it was suffering serious financial difficulties after a series of losses and because of problems incurred as a result of a penalty imposed by the government for false advertising.

The company's CEO had a 72% stock ownership and was hesitant to file for insolvency protection. However, in late October 2007, its board of directors dismissed the CEO and filed for the corporate rehabilitation procedure with ¥44 billion ($386 million) of debt and more than 300,000 students as creditors. The court-appointed provisional trustee immediately took over administration of the company and announced that it was looking for a sponsor to acquire the Nova business. The provisional liquidator said that if a sponsor could not be found within one month it would liquidate the company.

In early November 2007, the provisional trustee entered into an agreement to sell part of the business to another English-language school upon the court's approval. The court dismissed the petition for corporate reorganisation on 15 November, commenced the bankruptcy proceedings and appointed the corporate reorganisation provisional trustee as bankruptcy trustee on 26 November 2007.

Aiful

Aiful is a Japanese consumer lender which in September 2009 said that it would delay an interest payment on some of its ¥280 billion ($3.1bn) of debt. Aiful's difficulties were because a court ruling that allowed consumers to claim for the return of overpaid interest payments which had been set at interest rates violating Japanese usury laws. This was worsened by a significant increase in such claims and also the anticipation of government-imposed restrictions on lending practices which were due to become effective in 2010.

The company filed for the BRADR procedure to delay payment of interest and principal payment on its loans. In December 2009 Aiful obtained unanimous consent from approximately 70 lenders for a restructuring plan allowing for such an extension. Bond debt is not subject to the restructuring.

10.1.6 International

A statute based on the UNCITRAL model law on cross-border insolvency was adopted by Japan in 2000.

10.1.7 Commentary

Japanese insolvency law provides a broad range of procedures which generally tend to favour the rights of the secured creditor. Recent developments, especially the recent DIP extension of the corporate reorganisation procedure shift the balance towards the debtor by imposing a stay on all creditors and letting management remain in control.

Figure 33. Comparison of Japanese rehabilitation procedures

Criterion	Civil Rehabilitation (*Minji-Saisei*)	Corporate Reorganisation (*kaisha kosei*)	DIP Corporate Reorganisation
Purpose	Rehabilitation	Rehabilitation	
Condition for entry	Assets worth less than liabilities or company cannot pay obligations as they fall due without significant burden on business	Assets worth less than liabilities or company cannot pay obligations as they fall due without significant burden on business	
Stay on creditors	Yes, automatic stay on unsecured creditors. Court decides for secured	Yes automatic stay on both secured and unsecured creditors	
Control	Management or a court-appointed trustee	Court-appointed trustee	Management (under supervision)
Approval for plan	50% of those present and voting and 50% or more by value of unsecured creditors	Secured creditors need to approve by between 66.7% and 90% depending on the plan. Unsecured creditors need to vote in favour by a simple majority representing more than 50% of claims by value. When the debtor does not satisfy the balance sheet test shareholders also need to vote in favour by a simple majority in the number of shares which have voting rights	
Binding	Yes	Yes	
Court involvement	Yes	Yes	
Enhanced priority financing	Yes. Obtains common benefit status	Yes. Obtains common benefit status	
Average procedure time (estimate)	Six months	One year	Six Months
Recent uses	Sogo, Lehman Brothers	Japan Airlines, WILLCOM	CREED Corporation, Japan General Estate, Spansion Japan, AOMI Construction

Source: Nomura. L&W

This dominance of bank lending in Japan and the underdevelopment of the high-yield bond market have effectively simplified the borrowing structure of most companies, with little use of features such as subordination. This should in theory improve the chances of restructuring failing companies. However, this must be countered with the fact that companies have traditionally been slow to recognise and respond to financial difficulties, leaving the possibility of restructuring until the last moment when there may not be a lot to salvage.

Finally, as noted above, companies have traditionally been slow to recognise and respond to financial difficulties. Such companies typically jump into formal procedures at the last minute. On the other hand, companies seeking pre-insolvency turnaround typically try private arrangements first despite the range of restructuring procedures which offer protections and a cramdown mechanism.

Acknowledgement

We would like to thank Hiroki Kobayashi for his comments and assistance on this section. His details are as follows:

Hiroki Kobayashi
LATHAM & WATKINS
Latham & Watkins Gaikokuho Joint Enterprise
Marunouchi Building, 32nd Floor
2-4-1 Marunouchi, Chiyoda-ku
Tokyo 100-6332
Japan
hiroki.kobayashi@lw.com
+813 6212 7800

10.2 Hong Kong

Hong Kong's insolvency law has many similarities with the insolvency laws of England and Wales

Since 1997, Hong Kong has been a Special Administrative Region of the People's Republic of China. Those laws in force in June 1997 were adopted as laws following the handover except for those in contravention of the Basic Law[45]. As a result, Hong Kong's insolvency law has many similarities with the insolvency laws of England and Wales.

The specific laws relating to corporate insolvency are the Companies Ordinance (Chapter 32), the Companies (Winding-up) Rules (Chapter 32H) and the Bankruptcy Ordinance (Chapter 6). These are supplemented by case law. The insolvency procedures include the following:

a) Members' voluntary liquidation;

b) Creditors' voluntary liquidation;

c) Section 228 application;

d) Compulsory winding up; and

e) Schemes of arrangement.

We also discuss receivership below. This is not a formal insolvency procedure but a mechanism by which the holder of a charge can recover his debt in the event of a default.

There is no dedicated formal rehabilitation procedure under Hong Kong insolvency law

Despite the large number of procedures available, there is no dedicated formal rehabilitation procedure under Hong Kong insolvency law, although the Financial Services and Treasury Bureau of Hong Kong issued a consultation paper proposing such a law in October 2009. As a result, a company in financial distress but with the potential to be rehabilitated can either choose an informal restructuring or enter into a scheme of arrangement. This is discussed in more detail below.

In Hong Kong, immoveable property can be secured using a mortgage (legal or equitable), a fixed charge or retention of title. The most common forms of security for moveable assets are mortgages, fixed and floating charges, pledges and liens. Companies may grant security over many assets using a debenture which will contain both fixed and floating charges. Charges over an asset must be perfected in the Companies Registry in Hong Kong within five weeks of creation. Charges over land must be registered in the Land Registry and those over ships with the Shipping Registry of the Marine Department. In relation to charges over airplanes, it is best to notify the Civil Aviation Department of the creation of the charge, but such notification is not statutorily required.

There is no legal requirement for directors of an insolvent company to enter an insolvency procedure

Although entry to most of the liquidation procedures described below is based on the company being in a state of insolvency by being unable to pay its debts, there is actually no legal requirement for directors of an insolvent company to enter an insolvency procedure. For instance, there is no law in Hong Kong against wrongful or insolvent trading. However, there is a law against fraudulent trading but the evidential requirements mean that charges are difficult to prove.

There is no separate insolvency court system in Hong Kong. Instead it is the Court of First Instance of the High Court which has jurisdiction to wind up any company. Unopposed winding-up petitions are dealt with by the Registrar of the High Court. Appeals are made first to the Court of Appeal and then to the Court of Final Appeal.

10.2.1 Pre-insolvency

The lack of a formal restructuring procedure means that companies seek to negotiate an informal restructuring

Since Hong Kong does not have a formal restructuring procedure, companies often seek to negotiate some form of informal restructuring or "workout" in order to prevent liquidation. This is not always successful, especially as it requires the unanimous agreement of all of the creditors. Without this unanimity, there is the risk that a dissenting creditor may initiate a winding-up proceeding.

In some cases there may be a "bank workout". This involves a group of bank creditors forming a steering committee to negotiate an agreement with the company. Guidelines

[45] The Basic Law is a national law of the People's Republic of China.

issued by the Hong Kong Monetary Authority and the Hong Kong Association of Banks encourage the banks involved to act quickly and to use experienced personnel with the necessary authority to expedite the procedure. These guidelines also encourage dissenting banks which are in a minority to review their position. The implementation of the agreement is monitored by the steering committee.

Members' voluntary liquidation (winding up)

The purpose of a members' voluntary liquidation is to wind up a company that is not insolvent

The purpose of a members' voluntary liquidation is to wind up a company which is not insolvent but whose shareholders have decided they no longer wish it to continue. The creditors are all paid off in full and any remaining proceeds are distributed among the shareholders. The procedure is well-used, for example 920 members' voluntary liquidation procedures were commenced in 2009[46].

The company must be capable of paying all its creditors within 12 months of when the liquidation begins

To enter into this procedure, the company must be capable of paying all its creditors within 12 months of when the liquidation begins. A majority of the company directors must declare the company insolvent and an extraordinary general meeting (EGM) must be called with at least 21 days' notice. At this meeting 75% or more of members entitled to vote at such meetings must pass the resolution to wind up the company and a liquidator (usually an insolvency practitioner) must be appointed to wind up the company. If at any time during the process the liquidator discovers that the firm is no longer solvent, a creditors' meeting must be called and the procedure converted to a creditors' voluntary liquidation as described below.

10.2.2 Insolvency

Creditors' voluntary liquidation

The purpose of this procedure is to wind up a company that shareholders agree will not be able to satisfy the demands of the creditors

The purpose of this procedure (also known as the creditors' voluntary winding up) is to wind up a company which shareholders agree will not be able to satisfy the demands of the creditors. Although the company may still be solvent, in general this procedure is used when it is insolvent. The procedure is out-of-court. Although it is known as a creditors' voluntary liquidation (CVL), there is actually no creditor involvement in the initiation of the procedure. Recent statistics for the period from 2005 to 2008 show that on average 170 CVLs were commenced each year, although this rose to 255 in 2009.

This begins when the company's directors convene an EGM of the company at which at least 75% of the members entitled to vote at such meetings must vote in favour of a special resolution to wind up the company. Unless they can show that the directors have acted in bad faith, creditors of the company cannot dispute this decision.

A creditors' meeting is held at which a liquidator is appointed

A creditors' meeting is then held on the same or following day at which a liquidator, who is usually an insolvency practitioner, is appointed. A committee of inspection (consisting of up to five creditors) may also be appointed by the creditors to assist with the administration of the liquidation. The proceeds of the liquidated assets are distributed to the creditors following the priorities set out below in section 10.2.3.

Section 228A application

A section 228A application is a procedure for winding up an insolvent company

This is a similar procedure for winding up an insolvent company and is set out in Section 228A of the Companies Ordinance. The condition for entering this procedure is that the majority of directors agree that a company cannot continue its business by reason of its liabilities. They must also be of the opinion that it is not reasonably practicable for the winding up to occur in any other way.

Unlike the creditors' voluntary liquidation there is no need to call an EGM

Unlike the creditors' voluntary liquidation there is no need to call an EGM. Once the resolution has been passed by the majority of directors, one director must sign a "winding-up" statement to this effect. This statement must also explain why winding up cannot be done under some other provision of the Companies Ordinance.

The proceedings begin when this statement is delivered to the Registrar of Companies. Directors then appoint a provisional liquidator who acts to protect the assets until the creditors' meeting. Within 28 days there needs to be a meeting of debtors and creditors to confirm the provisional liquidator or to appoint another. The company is then liquidated

[46] See the Hong Kong Companies Registry website at www.cr.gov.hk

and the proceeds distributed to the creditors in accordance with the priorities set out in section 9.2.3.

Compulsory winding-up

A compulsory winding-up is used to have the company dissolved

Compulsory winding-up is the most commonly used liquidation procedure in Hong Kong. In 2009, 573 winding-up orders[47] were granted compared with the 255 creditors' voluntary liquidations which were commenced. The purpose of compulsory winding up is to ensure that the company's affairs have been dealt with properly and to have the company dissolved. Unlike creditors' voluntary liquidation it requires the involvement of the High Court.

The main grounds for this procedure is that the company is unable to pay its debts

The compulsory winding-up procedure can be initiated by the company, its creditors or certain government officials filing a winding-up petition with the High Court. There are six grounds on which the company may use this procedure (excluding those which apply on a winding-up application made by the Registrar of Companies). Of these, the most important from a creditor's perspective is that the company is unable to pay its debts. It is stipulated by Section 178(1) of the Companies Ordinance that a company is deemed unable to pays its debts if any one of the following three situations arises:

1) The company fails to pay a debt greater than or equal to HK$10,000 within three weeks of the issue of a demand notice;
2) Where a judgement order for a debt is returned unsatisfied; or
3) Where it appears to the court that the company is not able to pay its debts taking into account the contingent and prospective liabilities of the company.

As a result, this procedure is usually initiated by one or more unsecured creditors who have not received payment on a debt, i.e. situation (1). A court may also grant a winding-up order on the grounds that it is justifiable and equitable to do so.

There is no automatic stay on creditors but one can be applied for

There is no automatic stay on creditors. However, the company or any creditor or shareholder can apply to the court to stay any action or proceeding against the company. Even if this is granted, it does not prevent secured creditors from enforcing their security.

A provisional liquidator may be appointed by the court to protect the assets of company

If the petitioner believes that the assets of the company are in jeopardy, a provisional liquidator[48] (the Official Receiver) may be appointed by the court to protect the assets of company in the period between the filing of the petition and the granting of the order. After this no actions or proceedings may be taken against the company without the approval of the court. Even if this happens, the stay will not apply to secured creditors who wish to enforce their security.

The presentation of a winding-up petition provides employees with access to the Protection of Wages on Insolvency Fund (PWIF)

The presentation of a winding-up petition provides employees with access to the Protection of Wages on Insolvency Fund (PWIF). This fund was established by legislation to allow the employees of a company that goes out of business to claim wages and severance payments. The funds in the PWIF are financed by an annual levy on business registration certificates and the trigger for allowing these payments to be made is the presentation of a winding-up petition. It is important to note that this fund is not accessible if the insolvency does not involve a winding-up order, i.e. if the liquidation procedure is a creditors' voluntary liquidation or a members' voluntary liquidation.

It is also common for provisional liquidators to be appointed to maintain the company in its existing position in order to facilitate a restructuring proposal. Such a proposal is negotiated between the creditors and the company in the period between the filing of the petition and the granting of the winding-up order.

If the winding-up order is granted, the company's directors lose their powers

The hearing at which the winding-up order may or may not be granted usually occurs within two months of the filing of the petition. If the petition was filed by a creditor, the company can oppose it. If the winding-up order is granted, the company's directors lose their powers. If no provisional liquidator has been appointed, the Official Receiver is appointed as the provisional liquidator until a liquidator is appointed.

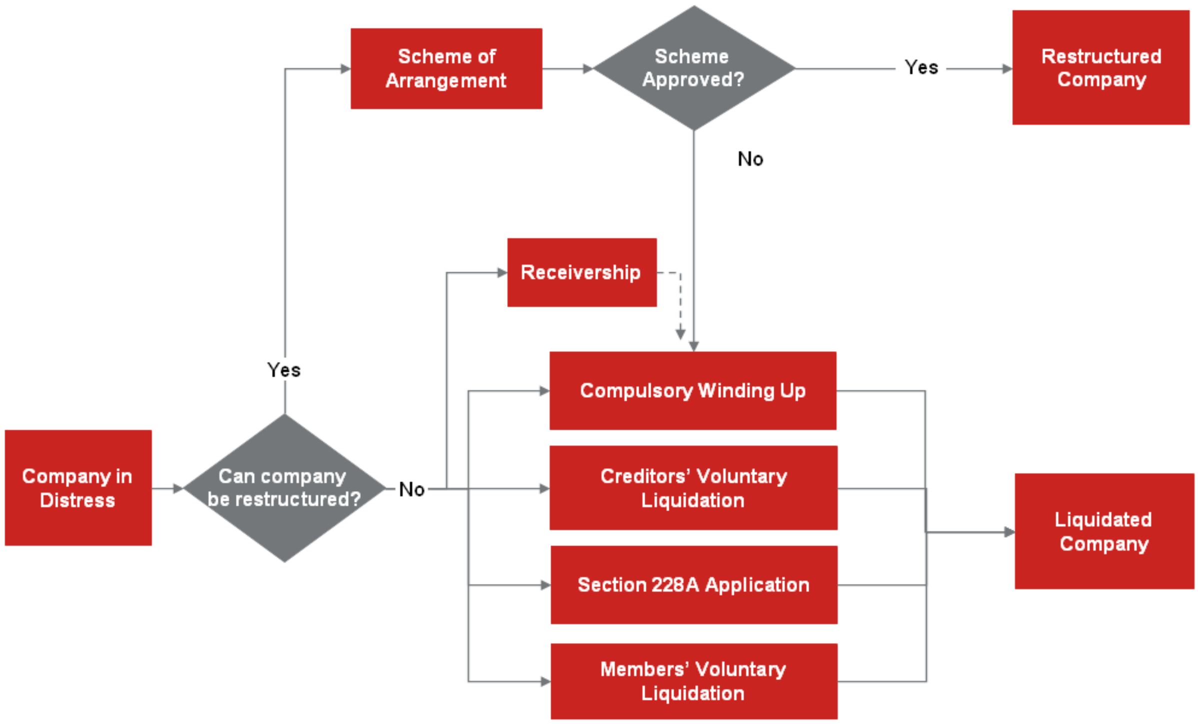
[47] See the Hong Kong Official Receiver's Website at www.oro.gov.uk
[48] For companies with assets worth more than HK$200,000 the liquidator is chosen from a panel of experienced private practitioners appointed to a panel established by the Official Receiver. For smaller companies the Official Receiver may appoint any private practitioner as liquidator in his place.

In special circumstances, the court may, on the application of the Official Receiver, liquidator or any creditor order that the liquidation proceedings take place under a regulating order. The difference between this and a compulsory winding up is that no meeting of creditors is needed to appoint the liquidator or the committee of inspection. These decisions are taken by the court. An example of such circumstances would be if the number of creditors is very large in which case it might not be easy or cost-effective to bring them all together.

The liquidator convenes a creditors' meeting within three months of the granting of the order

The liquidator then convenes a creditors' meeting within three months of the granting of the order. Beforehand, creditors must provide formal proof of their claims. At this meeting a liquidator is appointed, replacing the provisional receiver, and is charged with investigating the affairs of the company, winding up the business, selling the assets and distributing the proceeds to the relevant parties. The creditors' committee, which was elected at the first creditors' meeting and usually comprises between two and five of the creditors, supervises the liquidator. It must also approve any agreements with creditors.

Figure 34. Flowchart of Hong Kong insolvency procedures



Source: Nomura

This court may convert the compulsory winding-up process to a creditors' voluntary liquidation

This court may, at the request of the creditors or the liquidator, convert the compulsory winding-up process to a creditors' voluntary liquidation. This is typically done to avoid the fees levied by the liquidator (Official Receiver). However, there are strict conditions on when this conversion can be done and so this power is used only rarely.

The liquidation of the company then takes place in accordance with the priority of claims set out in section 9.2.3. When completed, a public notice is published in the Government Gazette. At the end of the process the court orders that the company be dissolved.

Receiverships

Receivership is not a winding-up procedure but is simply a foreclosure procedure

Receivership is not a winding-up procedure but is simply a foreclosure procedure which works in accordance with the provisions set out in a security document, usually a debenture. Following a failure-to-pay, this document typically will have legal provisions to allow the secured creditor to ask the court to appoint a receiver. In some cases the secured creditor can appoint the receiver out-of-court. The precise powers of the receiver are also specified by the security document along with the form of security which supports the debt which may take the form of a fixed charge, a floating charge or a combination of the two.

A manager may also be appointed to assist with the operation of the company if the intention is to sell the business as a going concern

In some cases a manager may also be appointed to work alongside the receiver. The security document usually specifies that the receiver and any manager are agents of the company. The receiver is tasked with the specific aim of taking possession of the security, and either receiving any income from it or selling it in order to repay the debt owed to the secured creditor who appointed him. The manager assists the receiver with the operation of the company if the intention is to sell the business as a going concern.

There is no requirement for the company to be wound up after the secured creditor has been paid

There is no formal requirement for the company to be wound up after the secured creditor has been paid. The company could, if it is still financially viable, continue to operate its business as a going concern. However, the appointment of a receiver is usually the first step in an eventual compulsory winding-up procedure.

If the security takes the form of a floating charge then the receiver must take care to first pay any claims that rank above the holders of floating charges. These are the preferential creditors listed in the priority of payments section 10.2.3.

Scheme of arrangement

Schemes provide a mechanism by which a compromise agreement may be reached between the company and its creditors

A Scheme of arrangement provides a mechanism by which a compromise agreement may be reached between the company, its creditors and possibly also its shareholders in order to prevent its liquidation. As a result, it is the only formal corporate rescue procedure in Hong Kong insolvency law. Importantly, if the scheme is approved by the court it becomes legally binding on all creditors.

The procedure is described in Section 166 of the Companies Ordinance. It begins when the company, its creditors and/or its shareholders file apply to the High Court for an order to convene a meeting of creditors and shareholders with whom the compromise must be reached. There is no requirement for the company to show that it is unable or even that it is likely to be unable to pay its debts in order to enter into this procedure.

The scheme can propose one or more of a broad variety of restructuring approaches

Part of the filing must include an explanatory statement which must be sent to all known creditors. This will usually have been prepared by the company and the creditors' committee together with the assistance of their respective financial and legal advisers. This will set out information about the company's assets. It must give enough information to the creditors to enable them to make a decision on whether or not to approve the scheme. It must also clearly define the different classes of creditor. Those creditors not mentioned in the scheme are not affected by it and retain their original rights after the scheme has been implemented. The scheme can contain a variety of restructuring approaches including debt-equity exchanges and the freezing of payments of interest and/or principal.

The scheme must be approved by a majority in number representing at least 75% of creditors by value or at least 75% of the members

The scheme must be approved by a majority in number representing at least 75% of creditors (or class of creditors) by value or at least 75% of the members (or class of members) who are entitled to attend the vote and be present in person or by proxy at the scheme meeting. If the scheme is approved by the creditors then there must be a general meeting of the shareholders to approve the scheme. The court, which has the ultimate discretion, must then be satisfied that the majority of creditors proposing the scheme are acting in good faith and that the agreement is fair to all creditors given the circumstances. If the order is granted by the court then the agreement becomes binding on all creditors in each class approving the scheme.

Schemes of arrangement provide no stay on actions against the company

Schemes of arrangement provide no stay on actions against the company. As a workaround, a trend began in 2002 of companies working on a scheme seeking a winding-up order and appointing a provisional liquidator in order to benefit from the resulting stay on actions. The combination of a scheme combined with creditor protection was viewed as having some of the benefits of a formal restructuring procedure. However, this new approach was cut back by the Hong Kong Court of Appeal in 2006 which stated that the appointment of a provisional liquidator can occur only in cases where the company's assets are in jeopardy. A provisional liquidator cannot be appointed simply to assist an ongoing scheme of arrangement.

The scheme of arrangement procedure therefore has a number of important weaknesses. It is not possible to use a scheme to compel an unwilling secured creditor to negotiate. There is also no stay to prevent secured creditors from realising their security or unsecured creditors from bringing actions against the company. All of these can create a lot of uncertainty with respect to the likely success of the plan. A scheme is also quite a slow and complicated procedure and this can result in high costs.

10.2.3 Priority of payments

Secured creditors can obtain payment through a foreclosure which occurs outside the winding-up procedure. Equitable mortgages rank behind legal mortgages. For the unsecured creditors, proceeds are distributed in the following order of priority:

1. Cost and expenses of the insolvency proceedings. This includes the cost of the winding-up petitions and the receiver's or the liquidator's fees and expenses.
2. Preferential creditors (e.g. certain debts due to employees and the government).
3. Floating charge holders are only paid once the preferential creditors have been fully repaid.
4. Unsecured creditors.
5. Shareholders.

10.2.4 Case studies

Asia Aluminum Group (Compulsory winding-up)

Our first case study relates to four companies which together form part of the Asia Aluminum Group. They consist of Asia Aluminum Holdings Limited ("AAHL"), AA Investments Company Limited ("AAICL"), China Steel Development Company Limited ("CSDCL") and Asia Aluminum Manufacturing Company Limited ("AAMCL"). Asia Aluminum Group is a substantial group of aluminium-processing companies, with AAICL as the ultimate holding company of the group. Winding-up petitions were presented against these four companies on the grounds of insolvency.

Both AAHL (which was listed in Hong Kong but was subsequently privatised) and AAICL presented the petitions against themselves. The petitions against CSDCL were presented by AAHL on the basis of intercompany debt; and the petition against AAMCL was presented by a third party petitioner (a creditor). Liquidators were appointed in Hong Kong over the group on 16 March 2009.

AAHL issued senior notes and AAICL issued senior PIK notes to finance a management buyout. Both companies then made cash offers to the noteholders, in order to stabilise their financial positions following falling sales, rising costs and reduced access to working capital, but the offers were not accepted by the requisite percentage of shareholders.

Also, demands were made against AAHL by various banks pursuant to company guarantees given by AAHL as security to three separate subsidiaries. Various group subsidiaries had also provided guarantees or share pledges to the senior noteholders. AAHL and AAICL were unable to satisfy the relevant guarantees and could not raise the required financing through the offers to purchase.

CSDCL was unable to pay an intercompany loan which was accelerated, under the terms of the intercompany loan, as soon as the principal amounts on the notes became due and payable, which occurred once AAHL presented the winding-up petition against itself causing an event of default under the notes and accelerating the principal amount. CSDCL therefore became liable for principal and interest under the intercompany loan, in an amount equal to such amounts due on the notes.

AAMCL could not pay the loan payable to the third-party petitioner when due and payable and following a demand for repayment.

The court therefore granted winding-up orders against all four companies, as each company had insufficient assets to meet its liabilities and/or was unable to pay its debts as they fell due.

Peace Mark (Holdings) Ltd. (Scheme of arrangement)

Peace Mark Holdings (a Bermuda incorporated company) was a holding company in a large group of retail companies operating throughout Asia. It had a Hong Kong subsidiary called Peace Mark Ltd. Liquidators were appointed in Hong Kong over Peace Mark Holdings on 10 September 2008, and a winding-up order was granted against Peace Mark Ltd., placing the company in liquidation on 23 February 2009 (on the basis that the company's assets were insufficient to meet its liabilities following significant drops in

Peace Mark Holdings' share price and the withdrawal by lenders of various facilities made available to the group).

The Hong Kong courts also ordered a creditors' meeting in order for them to consider approval of a scheme of arrangement. At the same time, the Bermuda courts ordered a creditors' meeting for the consideration and approval of a scheme of arrangement under Bermuda law, and a company creditors' arrangement was proposed in the British Virgin Islands (where some of the group's subsidiaries were incorporated).

The purpose of both the Hong Kong and the Bermuda schemes was to provide for the efficient distribution to the group's creditors of certain funds held in trust which had been received from the sale of certain of the group's distressed businesses to a third party (New Flow Group Ltd). The schemes arranged for the distribution of proceeds to creditors based on the hypothetical individual liquidation of each of the business entities sold to the New Flow Group Ltd, in order to determine the level of funds to be distributed to the remaining group entities and then on to the creditors.

Both the Hong Kong and Bermuda schemes were sanctioned by the relevant courts, on 15 September 2009 and 11 September 2009 respectively, and the scheme in Hong Kong became effective on 16 September 2009. The relevant liabilities were crystallised once the final date for submission of creditors' claims had passed (16 October 2009), and the liquidators proceeded to distribute the funds to the creditors pursuant to the schemes.

10.2.5 International

The UNCITRAL model law on cross-border insolvency has not been adopted in Hong Kong. However, Hong Kong courts do generally recognise foreign liquidators.

10.2.6 Commentary

The most notable feature of Hong Kong's insolvency framework is the absence of any restructuring procedure. As a result, restructurings in Hong Kong are either conducted informally and are contractual, requiring unanimous agreement, or they are conducted using schemes of arrangement. This means that companies do not have the benefit of any stay of enforcement on secured creditors which reduces the chances of a successful rehabilitation.

For this reason, and the fact that the stay on the other liquidation procedures is fairly limited, Hong Kong is considered to be a friendly regime for secured creditors who are mostly free to enforce their security by appointing a receiver.

Companies tend to wait until the last moment to file for one of the insolvency procedures

The fact that there is no law against insolvent trading means that companies tend to wait until the last moment to file for one of the insolvency procedures, if at all. Indeed, we find that the creditors' voluntary liquidation which is initiated by the company is only used half as many times as the creditor-initiated compulsory winding up.

Figure 35. Main insolvency procedures in Hong Kong

Criterion	Creditors' Voluntary Liquidation	Compulsory Winding-up	Scheme of Arrangement
Objective	Wind up company	Wind up company	Restructure debt to rehabilitate the company
Condition for entry	Directors convene an EGM and require 75% of members to approve a resolution to wind up company. Creditors' meeting then held.	Company, creditors or certain government officials. In practice it is initiated by unsecured creditors following a default. Court needs to grant winding-up order.	No conditions for entry. Company, creditors or shareholders must file an application with the High Court
Stay on creditors	None	An automatic stay on proceedings occurs when the winding-up order is made or if a provisional liquidator is appointed. The company or any creditor or shareholder may apply to the court for a stay on proceedings. Secured creditors are not prevented from enforcing security.	None
Control	Liquidator and potentially a committee of inspection are appointed by creditors.	Court and liquidator and creditors' committee	.
Approval for plan	N/A	N/A	Scheme must be approved by a majority in number representing 75% of creditors or members by value to become binding.
Binding	N/A	N/A	
Court involvement	None	Yes	Yes.
Other	Employees not eligible for access to PWIF	Employees can seek wages from PWIF	Can be a lengthy and expensive procedure. If it fails, a compulsory winding up will usually take place.
Enhanced Priority Financing	N/A	N/A	No
Average procedure time (estimate)	Normally quicker than a compulsory winding up as there is no court involvement. Generally takes six to eight months.	One to two weeks to file and commence proceedings. Usually completed within six months. If creditors' meeting is called then the process can take an additional three to four months.	Negotiating, drafting and distributing the scheme can take about six months. Obtaining approval from the creditors adds another three months. The implementation timetable depends on the scheme.
Recent uses	Krispy Kreme Hong Kong Ltd. (2009), Uni-Arts (Hing Kong) Ltd., Maxtime Marine Products Ltd. (2008)	Uniross Batteries (HK) Ltd., Dianoor International Ltd., Dianoor Jewelcraft Ltd., Memory Devices Ltd.	PCCW Limited (2008), Shaw Brothers (HK) Ltd., Stock Exchange of HK Ltd. and HK Futures Exchange Ltd. (companies merged)

Source: Nomura, L&W

10.2.7 Acknowledgements

We would like to thank Jane Ng for her comments and assistance on this section. Her contact details are as follows:

Jane Ng
LATHAM & WATKINS
41st Floor
One Exchange Square
8 Connaught Place
Central Hong Kong
jane.ng@lw.com
+852 2522 7886

10.3 Singapore

Singapore's legal framework is based on English common law

Singapore is generally considered to be one of the more friendly jurisdictions for creditors in Asia. Its legal framework is based on English common law and the main legislation covering corporate insolvency is the Companies Act (Chapter 50) and the Companies (Winding Up) Rules. This has a number of similar features to the UK insolvency regime. Indeed, it is based on the now obsolete UK Companies Act 1948.

The Singaporean insolvency law is administered by the Accounting and Corporate Regulatory Authority (ACRA) and the Insolvency and Public Trustee's Office.

The main insolvency procedures in Singapore are:

1. Members' voluntary liquidation;
2. Creditors' voluntary liquidation;
3. Compulsory winding up;
4. Judicial management; and
5. Schemes of arrangement.

Receivership, although not a true insolvency procedure, also exists as a way for holders of a charge to foreclose out of court.

The main objective is to maximise the value of the company's assets

The main objective of the corporate insolvency regimes is to maximise the value of the insolvent company's assets and to ensure orderly collection and equitable distribution of them. Proceedings are split into liquidation proceedings and rehabilitative proceedings.

Singapore recognises mortgages (legal and equitable) and charges as the main forms of security over immoveable, i.e. real estate, property. Other forms of security used in Singapore include the pledge and lien. Certain securities must be registered with the ACRA within 30 days of creation failing which the charge will be void against the liquidator and any other creditor.

Singapore's insolvency law recognises the concepts of the fixed and floating charge

The law also recognises both the fixed and floating charge. As in the UK, a floating charge is one that is created over a class of assets and which crystallises to specific assets following a default. However, a floating charge created in the six months before the insolvency is void unless it can be shown that the company was solvent at the time that the charge was created.

The definition of solvency depends on whether the company can pay its debts as they fall due

Generally, the definition of solvency depends on whether the company can pay its debts as they fall due. Past transactions can be set aside if they give an unfair preference and the "claw-back" period starts six months before the beginning of the liquidation proceedings. This can be extended to two years if the transaction was with an "associate".

There is no dedicated insolvency court in Singapore. Instead, jurisdiction for insolvency cases resides with the High Court, with appeals going to the Court of Appeal.

10.3.1 Pre-insolvency

As in other jurisdictions, companies which are solvent but in financial difficulties are free to enter into contractual agreements but such agreements usually require unanimous creditor support. However, they do have the advantages of secrecy and flexibility.

Members' voluntary liquidation

Members' voluntary liquidation is initiated if the company is solvent

Members' voluntary liquidation is a voluntary form of insolvency procedure which is initiated if the company is solvent. The directors make a declaration which is lodged with the registrar of companies, stating that the company will be able to pay off all of its debts within 12 months of the start of the winding up.

An extraordinary general meeting is called at which the company seeks to pass a resolution to wind up following Section 293(1) of the Companies Act. This requires a 75% majority of shareholders. The date on which the resolution is passed is the date on which the winding up commences.

After the resolution has been passed, a liquidator is appointed by the company to wind it up by selling its assets or selling it as a business. If the liquidator comes to the conclusion that the company is insolvent then he will convert the process to a creditors' voluntary liquidation.

10.3.2 Insolvent liquidation

Creditors' voluntary liquidation

The creditors' voluntary liquidation is a liquidation procedure for a company which is insolvent

The creditors' voluntary liquidation is a liquidation procedure for a company which is insolvent. To initiate the procedure the company must pass a resolution to wind up following Section 290(1)(b) of the Companies Act. It then calls a creditors' meeting.

The company can nominate a liquidator but the choice of liquidator can be overridden by creditors. There is a stay on actions against the company unless it is approved by the court.

Other than that there is minimal court involvement as this procedure is usually undertaken when there is little dispute between the parties and no suspicion of misconduct which would otherwise require investigation.

Compulsory winding-up

Compulsory winding-up is used for liquidating an insolvent company that is unable to pay its debts as they fall due

Compulsory winding-up, also known as winding up by the court, is the commonly used procedure for liquidating an insolvent company. The main condition for entry to this procedure is that the company must be unable to pay its debts as they fall due.

The process can be initiated by a number of parties including the company, a creditor and a judicial manager presenting a winding-up petition to the court. If it is at the request of a creditor, then evidence must be presented to prove that the company has been unable to pay its debts. One form of evidence is that a company has failed to pay a debt of more than S$10,000 within 21 or more days of the serving of a statutory demand.

Creditors may request a provisional liquidator to be appointed even before the order to start proceedings is granted if they are concerned that the company will be mismanaged between the application for liquidation and the granting of the winding-up order. This period typically lasts about one month. If the court agrees to the appointment of a provisional liquidator then there is a stay which means that no action or proceeding can be initiated against the company without the approval of the court.

Management loses its responsibilities and a liquidator is nominated by the creditor and takes possession of the company's assets

The decision on whether or not to grant the winding-up order usually occurs within two months of the filing. At this point the company ceases its activities and the company begins to be liquidated. Management loses its responsibilities and a liquidator is nominated by the creditor and takes possession of the company's assets with the aim of realising their value for the benefits of the creditors. There is no automatic stay. However, the court generally imposes an indefinite stay on all creditor actions.

There is no automatic stay

The liquidator has extensive powers of investigation and has a duty to determine if there has been any misconduct and to examine past transactions. A committee of inspection can be nominated. The liquidator sells the assets or the company as a whole. After the proceeds of the sales are distributed according to the priority set out in section 10.3.4 the company is formally dissolved.

Receivership

Receivership is a procedure by which secured creditors can enforce their security

Receivership is a procedure set out in the security document or debenture by which secured creditors can enforce their security by appointing a receiver following an event of default. The receiver acts on behalf of the secured creditor who appointed the receiver.

If the form of security is a floating charge, then following the event of default, this will convert or "crystallise" to a fixed charge on a specific asset or group of assets. The receiver will simply realise the asset and pass the proceeds minus any liquidator's fees and expenses, to the secured creditor.

Receivership is not a formal insolvency procedure but a way for a secured creditor to foreclose. Because it is triggered by a default, it is usually a precursor to one of the other insolvency procedures described here.

10.3.3 Post-insolvency restructuring

Judicial management

Judicial management is a court-supervised rehabilitation procedure for companies in financial difficulty

Judicial management is a court-supervised formal procedure for companies in financial difficulty. It is designed to allow viable companies a chance to rehabilitate themselves in order to return to profitability.

To initiate it, a company, its directors or creditors petition the court to appoint a judicial manager. Before the court will make the order to allow the company to use this procedure it must be satisfied that the company is in a state where it is unable to pay its debts and that the procedure would be likely to achieve one or more of the following:

(i) A rescue and rehabilitation of the company as a going concern;

(ii) A better realisation of the assets of the company than that possible from a winding-up; or

(iii) To enable a scheme of compromise or arrangement to be approved.

Unsecured creditors have the right to oppose a judicial management order

Following the application there is a moratorium. If a secured creditor has already appointed a receiver or a creditor objects to the opening of the judicial management proceedings then the order will not be granted unless the court decides that it is in the public interest. The courts have also recognised that unsecured creditors have the right to oppose a judicial management order.

The court may appoint a judicial manager who replaces management

The judicial management order is usually made three to five weeks after the initial filing. The court may appoint a judicial manager who replaces management and takes custody of the company's assets. The judicial manager must act in the interests of all the creditors. Although the judicial management order initially lasts for 180 days, it may be extended by the court at the request of the judicial manager.

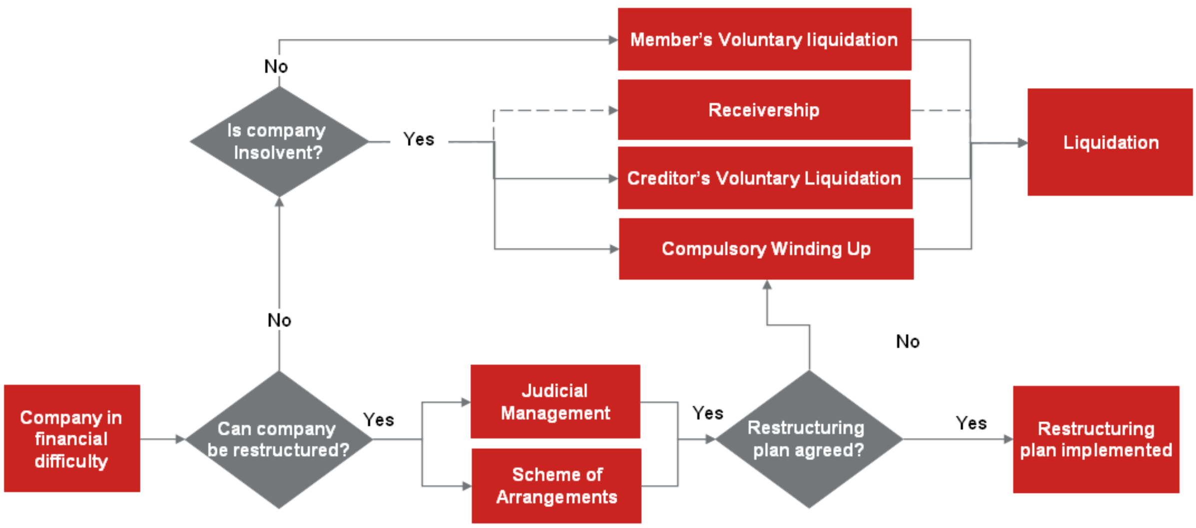
There is an automatic stay on all legal proceedings against the company which begins on the filing of the petition

There is an automatic stay on all legal proceedings against the company which begins on the filing of the petition. Any receiver who had already been appointed is removed from office and any winding-up petition is dismissed. During the proceeding there is a stay on all enforcement actions by creditors, except those with the consent of the judicial manager or with the permission of the court. However, set-off is allowed.

The role of the judicial manager is to propose a rescue plan or other proposal

The role of the judicial manager is to propose a rescue plan or other proposal, which is normally required within 60 days of being appointed. This is presented at a special meeting of the unsecured creditors. A secured creditor is not allowed to vote unless he surrenders his security or part of the debt owed to him is unsecured. Approval of the plan requires a majority of creditors in number representing at least 75% in value to vote in favour. If obtained, the judicial manager must then proceed to implement the proposals.

Figure 36. Flowchart of Singaporean insolvency regimes



Source: Nomura

There is no provision for priority treatment of post-insolvency financing unless approved contractually by all of the company's creditors.

Judicial management is not a popular procedure for debtors since they lose control

Judicial management is modelled on the pre-Enterprise Act form of UK Administration which has now been superseded in the UK. It is not a popular procedure for debtors since they lose control which is one reason why the following procedure of "schemes of arrangement" is more widely used for corporate restructuring.

It is also important to note that a scheme of arrangement can be pursued as one of the objectives of the judicial manager. Indeed, one of the objectives of judicial management can simply be the implementation of a scheme of arrangement.

Schemes of arrangement

The main restructuring tool in Singapore is the scheme of arrangement

The main restructuring tool in Singapore is the scheme of arrangement found within section 210 of the Companies Act. This is a procedure which has the aim of rehabilitating a financially distressed company using a compromise or arrangement with the creditors which, if approved, has the benefit of binding all creditors and members of a company.

To initiate the procedure, an application must be made to the court to obtain permission to call a meeting of creditors and shareholders to approve a scheme of arrangement. Notice of the meeting must contain a full description of the scheme and its effect on the different parties.

There is no automatic stay although one may be applied for

There is no automatic stay in a scheme of arrangement. However, the company may apply for a court order restraining legal proceedings. This is usually done at the same time as the filing of the initial application.

Management remains in control

One of the attractions of a scheme of arrangement compared with the judicial management procedure is that management remains in control. There are also few, if any, limitations on the form of the scheme which may be proposed and so these may include maturity extensions, moratoriums and debt for equity conversions.

Approval requires that a majority in number and at least 75% or more of creditors by value in each class vote in favour

Once the meeting of creditors has been convened, the next stage is to seek approval for the scheme. To do this, creditors must be split into classes (where necessary due to dissimilar rights) and separate meetings need to be held for each. Approval requires that a majority in number and at least 75% or more of creditors by value in each class vote in favour. As a result, minority dissenting creditors can be crammed down. Secured creditors do not normally vote and so are unlikely to be crammed down.

The last stage is to obtain court sanction of the scheme

The last stage is to obtain court sanction of the scheme. The court may not sanction the scheme if the creditors or members were not given sufficient notice of the meeting or if the classes of creditors or members were defined incorrectly. The court may also allow the scheme but only on condition of some alterations which the court thinks are just and equitable. If the scheme is approved by the court, and lodged with ACRA, management is then allowed to put the scheme into effect.

10.3.4 Priority

Secured creditors with a fixed charge get to enforce security outside the insolvency process and so effectively rank first

Secured creditors with a fixed charge get to enforce security outside the insolvency process and so effectively rank first. Secured creditors are ranked as unsecured creditors with regard to any shortfall between the size of the claim and the proceeds of selling the securing asset. Secured creditors with a floating charge rank behind the fees and expenses of the liquidator. As a result, the order of payment in a liquidation is approximately as follows:

1. Secured debts with a fixed charge;
2. Preferential debts consisting of
    a. Costs and expenses of the winding up;
    b. Employee wages and salaries up to S$7,500 or five months' salary per employee, whichever is the lower, plus some other employee expenses;
    c. Compensation under the Workmen Compensation Act;
    d. Certain funds owed to the Central Provident Fund;
    e. Remuneration relating to vacation leave;
    f. All taxes incurred before the start of the winding-up period;
3. Debts secured by a floating charge; and

4. Unsecured creditors.

The set-off of mutually offsetting debts is allowed.

10.3.5 Case study

Asia Pulp and Paper Co. Ltd (APP)

Asia Pulp and Paper Co. Ltd was the Singapore-incorporated holding company of one of the largest paper producers in the world. The company had no business operations in Singapore, and was the holding company with shareholdings in a number of companies across a number of countries including Indonesia, China and Malaysia. Its owners were based in Indonesia.

By 2001 APP had run up debts of $13.9 billion and was in a state of default when in March 2001 it announced a debt moratorium. It attempted to implement a debt restructuring. Two of its creditors, Deutsche Bank and BNP Paribas, were owed $193mn and $20mn respectively. They sought to require APP to use judicial management in order to replace the existing management at APP and pursue a restructuring.

This was opposed by the management of APP. The case came to court and the court had to rule on whether to let judicial management proceed or to let management run the process. The court decided not to allow judicial management to proceed for the following reasons:

1) The costs incurred by using judicial management would be high and would therefore deplete the value of the estate;

2) The local knowledge of the managers controlling the company subsidiaries was necessary and this may be lost if management were replaced; and

3) Judicial management would result in litigation if judicial managers were to try to take control of entities in foreign jurisdictions.

This case shows that the replacement of management in a judicial management procedure can be detrimental to the economic value of a company if management's specialist knowledge is important to the survival of the company. The fact that Singapore was not party to any cross-border treaties (see next section) with Indonesia and China also complicated the insolvency process by creating uncertainty and the risk of litigation.

It is worth noting that even if Singapore had adopted the UNCITRAL model law on cross-border insolvency, it would not have helped in the case of APP since neither China nor Indonesia has adopted this model law. As a result a judicial manager appointed in Singapore would not be recognised in China or Indonesia. The court also recognised the fact that the creditors would require the cooperation of IBRA and Chinese banks to enable a successful restructuring and that this would not be forthcoming in a judicial management.

10.3.6 International

Singapore has not signed any treaties with any other state although it does recognise insolvency proceedings in Malaysia[49]. The UNCITRAL model law on cross-border insolvency has not been adopted in Singapore.

However, under the Companies Act any foreign corporate body, association or partnership may be wound up in Singapore. One condition is that there must be sufficient connection with the foreign jurisdiction and a reasonable possibility of benefit accruing to the creditors from winding up.

Judicial management does not apply to foreign companies regardless of whether they have substantial assets or operations in Singapore. Schemes of arrangement are the preferred restructuring mechanism. This was highlighted above in the case study of APP.

[49] Bankruptcy Act (Sections 151 and 152).

10.3.7 Summary of procedures

A summary of the main characteristics of the different insolvency procedures in Singapore is provided in Figure 37.

Figure 37. Summary of Singapore insolvency procedures

Criterion	Members' Voluntary Liquidation	Creditors' Voluntary Liquidation	Compulsory Winding Up	Judicial Management	Scheme of Arrangement
Purpose	Liquidation of company	Liquidation of company	Liquidation of company	Rescue and rehabilitation of the company	Restructuring
Condition for entry	Company is solvent and members have voted by a majority of 75% or more to wind up the company	Company passes resolution to wind up and then calls a creditors' meeting	Company insolvent. Can be initiated by company, creditor, liquidator and judicial manager presenting petition to court	Company is a state where it is unable to pay its debts and can be applied for by the company, its directors or a creditor	Debtor requests permission from the court to convene a meeting of creditors or members
Stay on creditors	N/A	N/A	Immediate stay if provisional liquidator appointed No automatic stay is liquidator is appointed although one is generally imposed by the court	Automatic stay on all proceedings except for those allowed by judicial manager or court following filing of petition.	No automatic stay but the court may restrain proceedings on a case by case basis
Control	Liquidator	Liquidator	Provisional Liquidator / Liquidator	Judicial Manager takes control	Management retains control
Approval for plan	N/A	N/A	N/A	If the plan is a scheme then it requires at least 75% of creditors in value and more than 50% in number of creditors Otherwise for a sale of assets or other proposal a simple majority in value and numbers is sufficient.	At least 75% of creditors in value and more than 50% in number of creditors in each class
Binding	N/A	N/A	N/A	Yes. Minority creditors are crammed down	Yes. Minority creditors are crammed down
Court involvement	Minimal	Minimal	Approves order	Opens process and approves relaxation of stay. Then performs supervisory function.	Approving the terms of the compromise and dispute resolution
DIP Financing	N/A	N/A	N/A	No	No
Average procedure time (estimate)	Typically takes about one month to put a company into voluntary liquidation.	Typically takes about one month to put a company into voluntary liquidation.	Generally and subject to court schedule a winding-up order may be granted within four to six weeks of the filing of an application to wind up.	Judicial management order remains in effect for 180 days and can be extended by court on application by the judicial manager Judicial manager has 60 days to present proposals	The time period for the entire Scheme will depend on the complexity of the Scheme and the time needed to negotiate with the stakeholders. If the scheme requires equity restructuring and regulatory approval the whole process may take nine months to two years. If it is only a debt restructuring then this can be completed in three to nine months.
Recent uses		Econ Corporation, Lehman Brothers (Singapore)	Armada Shipping	Barings Bank, Sogo Department Store, Alliance Technology Holdings Ltd.	China Aviation, Oil Corporation, Raffles Town Club

Source: Nomura, Rajan & Tann LLP

10.3.8 Consolidation

In Singapore, each company has a "legal personality" and it is therefore not possible to consolidate the assets and liabilities of affiliated companies.

10.3.9 Commentary

In Singapore secured creditors have strong rights

In Singapore, as in most English law-based jurisdictions, secured creditors have strong rights. They can use receivership to foreclose on their security and, where stays occur, most are for relatively short periods. The insolvency procedures are also relatively speedy and efficient and this may be thought to favour unsecured creditors since a fast process is more likely to preserve any economic value the company may have. The high threshold for approval for both judicial management and schemes also protects creditors.

Despite the existence of the judicial management procedure with its automatic stay, schemes of arrangement tend to be the main procedure used for restructuring

Despite the existence of the judicial management procedure with its automatic stay, schemes of arrangement tend to be the main procedure used for restructuring. There are a number of reasons for this. First and foremost, schemes are more attractive to management because they allow them to remain in control rather than be displaced by a judicial manager. Second, there is a lower stigma attached to a scheme of arrangement than to judicial management, partly because a scheme is less public. Third and last, entry to judicial management requires a forecast of the company's future financial strength in order to satisfy the entry requirements. A scheme has no such requirement.

The Company Legislation and Regulatory Framework committee has recommended the introduction of an omnibus insolvency law, known as the Omnibus Law and modelled on the UK Insolvency Act. One aim of this law would be to introduce a CVA type of procedure as well as administrative receivership.

Overall, Singapore is viewed as a jurisdiction with a well-developed legal system, and a competent judiciary, which is reasonably predictable.

10.3.10 Acknowledgements

We would like to thank Patrick Ang for his comments and assistance with this section. His contact details are as follows:

Patrick Ang
Rajah & Tann LLP
9 Battery Road #25-01
Straits Trading Building
Singapore 049910
patrick.ang@rajahtann.com
+65 6232 0400

10.4 Australia

The law for corporate insolvency in Australia is to be found in the Corporations Act 2001 (Cth), supplemented by the Corporations Regulations 2001 (Cth).

Australian insolvency law is largely based on English insolvency law

Australian insolvency law is largely based on English insolvency law (with the exception that England has a unified personal and corporate insolvency regime, whereas in Australia, these remain separate) and includes many of the same concepts such as administration, schemes of arrangement, receivership and floating charges, with some important differences. The insolvency procedures are:

- Members' voluntary liquidation.
- Creditors' voluntary liquidation.
- Compulsory Court liquidation.
- Voluntary administration and Deeds of Company Arrangement.
- Schemes of arrangement.
- Receivership.

The main emphasis of the procedures is the winding up of companies and the realisation of security

The main emphasis of the procedures is the winding up of companies for the purpose of satisfying the claims of creditors and the maintenance and realisation of property secured under a security. There is a procedure for the winding up of solvent companies plus two procedures for insolvent liquidation. The only commonly used rehabilitation procedure is voluntary administration and Deeds of Company Arrangement. Schemes of arrangement are rarely used for insolvent restructuring and really suit only large and complex insolvencies.

The relevant court is the Federal Court of Australia and the supreme court of each state and territory. Oversight is provided by the Australian Securities and Investment Commission (ASIC) which regulates the activities of insolvency practitioners.

The main type of security on immoveable property is the Torrens system of mortgage

The main type of security on immoveable property (i.e. real estate) is the Torrens system of mortgage. This form of security is regarded as being a legal mortgage. However, unlike other legal mortgages which take effect as a transfer of title, a Torrens system mortgage does not involve a transfer of title but takes effect as a security. To be perfected, a Torrens mortgage must be registered at the land registry in the state or territory in which the real estate is located.

For other types of property, the forms of security include mortgages, pledges, liens and charges. Mortgages and charges granted by Australian companies over assets other than real estate are generally perfected by registration at ASIC. However, the Commonwealth has recently passed new legislation (Personal Property Securities Act 2009 (Cth)) which will significantly alter the law relating to securities (for instance, one reform is to abolish the distinction between fixed and floating charges). This is described below.

Similarly to the UK, both fixed and floating charges exist as forms of security

Similarly to the UK, the fixed charge is attached to a specific asset or assets of the company. A floating charge is attached to a specific class of assets and only attaches itself to specific assets (known as crystallisation) on a default.

Allowing a company to trade while insolvent can lead to civil or criminal liability

In Australia, a company is insolvent if it is unable to pay all its debts as they become due and payable. There are no explicit provisions or laws requiring companies to enter into insolvency proceedings but there is a duty on directors not to engage in insolvent trading. Allowing a company to trade while insolvent can lead to civil or criminal liability. In addition, the directors can be held personally responsible for any debts incurred. The insolvent trading provisions are quite onerous and mean that companies and directors need to closely monitor solvency and take immediate action if they believe the company to be insolvent.

A consultation paper released by ASIC in late 2009 proposed guidance to directors on their duty to avoid insolvent trading setting out four key principles:

1. Directors must inform themselves on a continual basis about the health of the company and not just rely on year-end financial statements.
2. Directors should investigate financial difficulties.

3. Directors should seek professional advice from a suitably qualified, competent and reliable adviser.

4. Directors should act in a timely manner.

These principles may be amended following any feedback received on this consultation document.

10.4.1 Pre-insolvency

As in other jurisdictions, companies in Australia which are solvent but in financial difficulties are free to enter into contractual agreements with creditors in order to give the company time to restructure its business, reschedule debt payments etc. In terms of pre-insolvency liquidation, there is one procedure.

Members' voluntary winding-up

A members' voluntary winding-up is initiated where a company is not necessarily insolvent

A members' voluntary winding-up is a procedure initiated by the members where a company is not necessarily insolvent and will occur when the members pass a resolution to wind up the company. This resolution must be passed by a special resolution (75%) of members. In addition, the directors of the company must make a declaration that the company is solvent, meaning that it can discharge its debts in full within 12 months from the start of the winding-up. If the directors cannot make this declaration, and the company is insolvent, the members may resolve by special resolution that there be a creditors voluntary winding-up.

The powers of the directors cease and reside in the liquidator

During a members' voluntary winding-up, the powers of the directors cease and reside in the liquidator. The liquidator is under an obligation, should it discover that the company is in fact insolvent, to order a meeting of the company's creditors and the company will most likely enter into a creditors winding-up process (discussed below).

10.4.2 Insolvent liquidation

The Corporations Act allows for the winding-up of a company without a need to apply to a court. There are therefore two procedures, one voluntary and one involuntary, which we now describe.

Creditors' voluntary liquidation – Part 5.5 of the Corporations Act

A creditors' voluntary liquidation is initiated if a company is insolvent and members wish to pass control to the creditors

A creditors' voluntary liquidation is a procedure initiated by the members where a company is insolvent and they wish to pass control to the creditors. Despite the name, this form of liquidation is actually initiated by the members of the company, but it permits the creditors some control over the process of the liquidation, including the power to replace the liquidator (section 497(11)). The procedure works as follows:

- Subject to section 490[50], a company may be wound up voluntarily by a special resolution of members (section 491(1)), with the members appointing a liquidator;
- Following this, the liquidator of the company must cause a meeting of the company's creditors within 11 days of the passing of the member's resolution (allowing the creditors at least seven days' notice) (section 497(2)); and
- At this creditors meeting, the creditors may resolve to replace the liquidator with another of their choice. It also allows the creditors to inspect a summary of the affairs of the company and a complete list of other creditors.

This process allows the creditors to the company greater input into how the liquidation is managed and therefore how distributions are made to unpaid creditors.

Compulsory court liquidation – Part 5.4–5.4B of the Corporations Act

Compulsory court liquidation is most commonly initiated by a creditor

This is a court-based procedure which starts when a creditor, director, liquidator or ASIC lodges an application with the court to wind up a company. However, it is most commonly a creditor who commences this process. Section 459A provides that if a company is insolvent (i.e. it is unable to pay its debts as they fall due), it may be wound up. This is the most common ground on which an application is made to wind up a company.

[50] If a court process to wind up the company with a compulsory court liquidation has already begun, the voluntary method cannot be used (section 490(a)).

The court will exercise its discretion in whether or not to grant a winding-up order

There are a set of assumptions a creditor can rely on to establish that a company is insolvent. The most common is a failure to comply with a statutory demand under section 459E within 21 days. This failure will create an assumption that the company is insolvent. In all cases, the court will exercise its discretion in whether or not to grant a winding-up order, and may allow the company some time to demonstrate its solvency.

A provisional liquidator may be appointed by the court to manage the company's assets while the court decides whether or not to grant a winding-up order. The powers of the directors cease (although they technically remain in office) and they must provide all of the books and records of the company to the liquidator. The company terminates as a going concern.

A liquidator is appointed to realise the company's assets in order to distribute them to creditors

The main duty of the liquidator is to realise the company's assets in order to distribute them to creditors. During a winding-up, legal proceedings cannot be commenced or continued against the company without court approval. However, secured creditors are usually exempted from this condition and can realise their security. Creditors must submit their claims before a date set by the liquidator.

In addition to realising the value of the assets of the company, the liquidator may also call a meeting of creditors to keep them informed of the progress of the winding-up. At the end of the winding-up process the proceeds of the estate are then distributed pro-rata according to the priority of payments set out below.

Receivership

Secured creditors use receivership to enforce their security outside court proceedings

Secured creditors can enforce their security over the assets of a company outside court proceedings. There are a number of ways of doing this but the most common is by the secured creditor appointing a receiver who is a licensed insolvency practitioner. This right is usually set out in the security documents pursuant to which the security was granted and typically can be exercised following an event of default.

The purpose of a receivership is to realise the secured assets of the company

The purpose of a receivership is to realise the secured assets of the company in order to discharge the debt owing to the secured creditor. The receiver acts mainly in the interests of the creditor who appointed him or her and lasts until the purpose of the receivership is fulfilled. However, the receiver also has a secondary duty to unsecured creditors which is an obligation to take reasonable care to sell the secured property for not less than its market value or, if there is no market value, the best price reasonably obtainable.

Figure 38 shows a flow chart of the liquidation and rehabilitation regimes used in Australia. We have omitted schemes of arrangement for the reasons described in the text.

10.4.3 Rehabilitation procedures

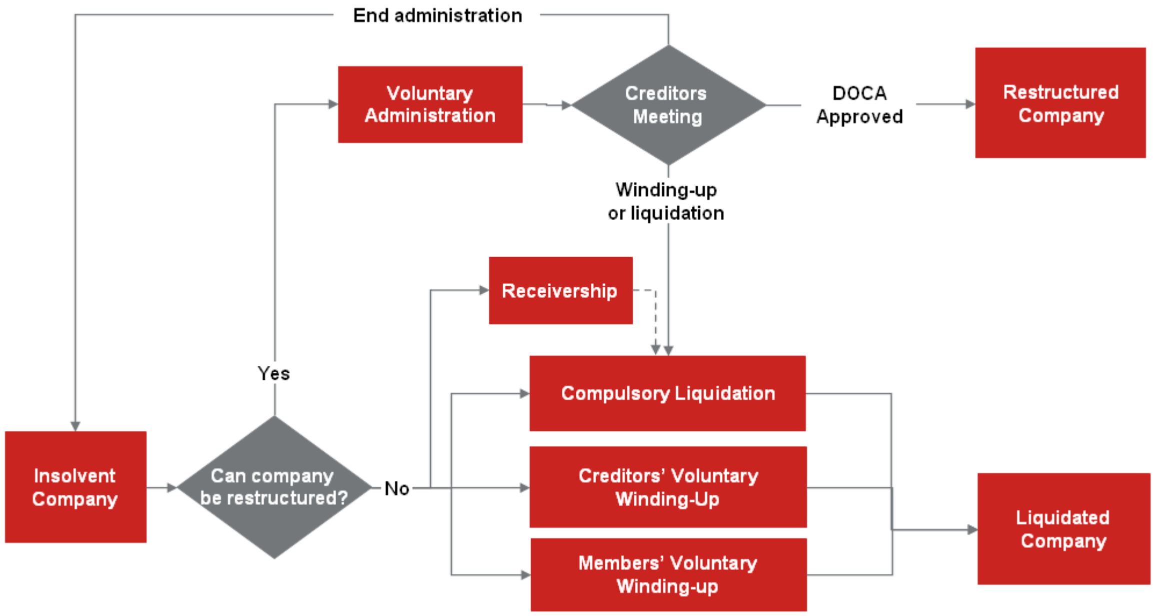
The Corporations Act 2001 provides for two mechanisms for corporate restructuring and rehabilitation – voluntary administration and schemes of arrangement.

Schemes of arrangement

Schemes of arrangement provide a mechanism for a company to enter into a legally enforceable compromise with its creditors

Schemes of arrangement provide a mechanism by which a company can enter into a legally enforceable compromise with its creditors. Schemes of arrangement are initiated by an application to the court for a creditors' meeting to be convened. This can be done by the company, a creditor or a liquidator. There is no requirement for the company to be insolvent.

Figure 38. A flowchart showing the main insolvency procedures used in Australia



Source: Nomura

During the formulation of the scheme management remains in place. The scheme must be approved by a majority of creditors voting on the scheme and 75% of the creditors by claim value. Once approved by the creditors, additional approval is also required from the court.

Management stays in control in a scheme

The main advantage of a scheme of arrangement is that management stays in control. However, court approval is needed for schemes of arrangement and this can make the procedure lengthy and expensive compared with voluntary administration.

Schemes of arrangements are only used for specific forms of corporate restructuring

Schemes are therefore only used for insolvency purposes in specific cases. They are more commonly used to implement specific forms of corporate reorganisation such as changing share structures or amalgamations. This can happen when a merger or acquisition forms part of the restructure.

Voluntary administration

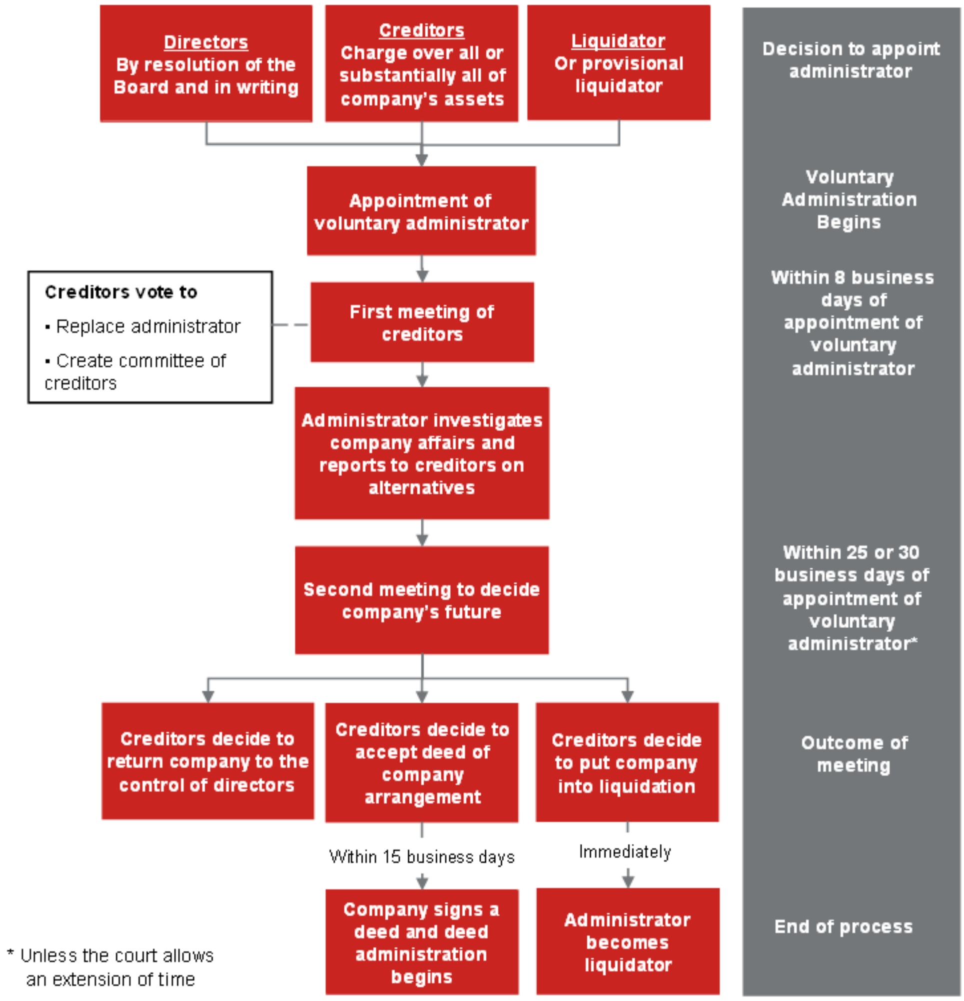
Voluntary administration is the only rehabilitation procedure in Australian insolvency law

Voluntary administration is the only rehabilitation procedure in Australian insolvency law. Its aim is to avoid liquidation and to provide a mechanism which can return a company back to financial health. The process, shown in Figure 39, is usually initiated by the directors of the company following a resolution by the board. It can also be initiated by a secured creditor who holds a charge over substantially all of the company's assets, or by a liquidator or provisional liquidator. The first step of the procedure is the appointment of an administrator.

As soon as the administrator has been appointed, a statutory moratorium or stay comes into effect

As soon as the administrator has been appointed, a statutory moratorium or stay comes into effect on new and ongoing legal proceedings. Specifically, unsecured creditors are prevented from enforcing their claims without the approval of the administrator or the court. Owners of property used by the company are also stayed and there are restrictions on the transfer of shares in the company. Secured creditors are also subject to the stay except for a secured creditor with a charge over the whole (or substantially the whole) of the company's assets who is allowed to enforce the charge within the "decision period". This currently stands at the first 13 business days of the voluntary administration. The usual practice of major banks that hold such a charge is to act quickly and appoint a receiver.

Figure 39. Voluntary administration procedure with time-line



Source: ASIC

The administrator assumes control of the company, maintaining its business activities

The administrator assumes control of the company, maintaining its business activities, investigating the company's affairs and advising creditors on their alternatives. Although the administrator can be appointed by the directors of the company, he must act fairly and impartially. The administrator has a number of important powers, including to carry on the business and to dispose of assets. This can include assets which are subject to a lien, pledge or retention of title clause if it is in the ordinary course of the company's business or with the written consent of the security holder or with the leave of the court.

The administrator can obtain new loans with security over company assets

The administrator can also obtain new loans with security over the company's assets and these loans have the priority of expenses of the administration. These rank above ordinary unsecured creditors in a liquidation.

One of the duties of the administrator is to convene two creditors' meetings. The first must occur within eight business days of the start of the administration. Creditors need to be given five business days of written notice before the meeting. The purpose of the first meeting is to determine whether a committee of creditors should be appointed and if so, who should be on the committee. Creditors can also choose to replace the administrator. While creditors cannot direct the administrator, they can require the administrator to keep them informed of progress. They also approve the administrator's fees.

Two creditors' meetings need to be convened; the first determines who should be on the creditors' committee if one is appointed

In the period between the first and second creditors' meeting, the administrator's main duty is to investigate the affairs of the company. The second meeting should occur within 20 business days (or 25 business days if Easter or Christmas intervenes) from the start of the administration. However, this period can be extended by the court if the case is complex and more time is needed by the voluntary administrator to be ready to report to the creditors. The administrator must send the creditors a copy of his report at least five business days before the meeting.

At the second creditors' meeting, the creditors will determine the company's future by passing one of the following resolutions:

1. the company executes a Deed of Company Arrangement (DOCA) to which all of the creditors will become bound (pursuant to Part 5.3A of the Corporations Act);
2. administration should cease and the directors should regain control of the company and pay off all of the debts – this rarely happens;
3. the company should be wound up or liquidated in which case the voluntary administrator become the liquidator.

The voluntary administrator's report sets out the administrator's analysis of the three choices noted above as well as the administrator's recommendation.

The creditors can choose to allow the company to enter into a DOCA, which is a binding agreement between the company and its creditors

The first option noted above is for the company to enter into a DOCA, which is a binding agreement between the company and its creditors setting out how the company's affairs will be dealt with. The creditors can only vote on a DOCA if one if proposed by the administrator. Its aim is to maximise the chances of the company or as much as possible of its business continuing. If this is not possible then it aims to provide a better return for creditors than an immediate winding up. The DOCA will usually set out how the company plans to repay its debts. While the company is under the DOCA, the committee of creditors becomes known as the committee of inspection.

A majority of creditors voting in number and value is needed to approve one of these options

A majority of creditors voting, both secured and unsecured, in number and value is needed to approve one of these options. It is also possible for creditors to pass a resolution to adjourn the meeting until a later date if it is believed that more information is needed or they wish to negotiate features of the DOCA. A creditor who is aggrieved by a DOCA has the ability to apply to the court to have the arrangement stopped.

If the creditors pass a resolution stating that the company should implement a DOCA then this must be executed within 15 business days of the resolution. Failing this, the company automatically goes into voluntary winding-up. A correctly approved DOCA will bind all creditors whether they voted for it or not.

If the DOCA is not approved then the creditors may vote for the company to be wound up

If the DOCA is not approved at the second creditors' meeting then the creditors may vote for the company to be wound up or to return the company to its directors so ending the administration. In the first case, the administrator becomes the liquidator as a compulsory court liquidation procedure begins. It is rare for creditors to vote for the company to be returned to its directors.

10.4.4 Priority of payments

Starting with the highest priority, payments on liquidation are made in the following order:

1. Secured creditors who hold a fixed charge can usually enforce security via a receivership and obtain the proceeds minus receivership costs.
2. Priority payments which include:
    a. costs and expenses of the administrator or liquidator
    b. legal costs of the applicant who brought the winding-up order
    c. debts of the administrator including post insolvency financing assumed by the administrator
    d. employee wages and superannuation contributions
    e. other employee-related costs
3. Floating charge holders.
4. Debts to the commonwealth government, other unsecured creditors and certain shareholders rank equally[51].
5. Other shareholders.

[51] NB. This will apply to certain shareholder actions preceding the enactment of the Corporations Amendment (Sons of Gwalia) Bill 2010 (Cth), upon which time, all actions by shareholders (in that capacity) should rank equally behind unsecured creditors.

10.4.5 Case studies

Sons of Gwalia

Sons of Gwalia (SGW) was a Western Australian mining company that was Australia's third largest producer of gold as well as other important metals before it entered voluntary administration in 2004.

After some acquisitions in 2001, SGW had to take some write-downs and also encountered some operational difficulties. In early 2003 the company's managing director resigned suddenly and the company entered into a restructuring which involved raising capital by issuing new shares. In August 2004 the company went into administration following a restatement downwards in reported gold reserves and hedging losses.

In February 2006, in an landmark decision, and one which has implications for unsecured creditors, the High Court of Australia ruled that shareholders of SGW who had bought their shares in the secondary market were assigned ordinary unsecured creditor status because the company had breached disclosure obligations or mislead them about the financial status of the company. By August 2006, SGW had been de-listed from the Australian Securities Exchange.

An initial report in December 2008 by the Corporations and Markets Advisory Committee (CAMAC) commissioned by the Australian government concluded that the effect of this decision should not be overturned by legislative means.

Despite this, a draft of proposed amendments to the Corporations Act 2001 was published in April 2010 which proposed that all claims relating to the trading of shares in a company should rank equally and be subordinated to all other claims against the company. A bill, Corporations Amendment (Sons of Gwalia) Bill 2010 (Cth), consisting of these amendments was introduced to the Australian Parliament on 2 June 2010 and should become law this year. This should remove the uncertainty created by the initial court ruling in favour of the shareholders.

Henry Walker Eltin Group

The Henry Walker Eltin Group was an Australian company with interests in a number of businesses including contract mining, civil engineering, land development. In early 2005, the company was experiencing some difficulties and had been expecting an investment of A$100mn from Swiss-based commodities trader Glencore to help it to get through a cash crisis. At the time, the largest creditor group were US noteholders who were owed roughly A$180mn. There was also syndicated bank debt and A$55mn of bank guarantees. However, the actual leverage of the company was low.

The Glencore deal had a range of conditions to it and in late January the proposal to invest was withdrawn. The following day, on 31 January 2005, the company entered voluntary administration and a voluntary administrator was appointed. Eight days later a first creditors' meeting was held and creditors were elected to a creditors' committee. On the same day the CEO resigned.

On the 16 February the court extended the period required before the second creditors' meeting giving a new date of the 23 May, which was subsequently pushed back until 8 July 2005. Over the next three months various interests and subsidiaries were sold off by the administrator. In June 2005 the administrator released a report stating that there would probably be no return to the shareholders and this was then confirmed on 25 October. A sale of the contract mining business of HWE group was then completed by the administrators.

A creditors meeting was then held on the 3 March 2006 at which a DOCA was voted on proposing that financial creditors would be paid in full, major creditors would receive around 65 cents on the dollar and small creditors about 20 cents on the dollar. However it was later announced that all creditors would be repaid in full with all losses being taken by the shareholders.

It may be argued that the full recovery paid to the creditors reflects the fact that although HWE was technically insolvent when it filed for voluntary administration, it was not in a position where the creditors were exposed to losses. As a result, the decision to file was primarily done by the directors in order not to fall foul of the laws against insolvent trading.

Without this requirement, it might have been possible to restructure HWE consensually and without having to go via the voluntary administration procedure.

10.4.6 Summary of procedures

Figure 40 summarises the main features of the Australian insolvency procedures.

Figure 40. A summary of the insolvency procedures in Australia

Criterion	Members' Voluntary Liquidation	Creditors' Voluntary Liquidation	Compulsory Court Winding Up	Voluntary Administration
Purpose	Liquidation of company	Liquidation of company	Liquidation of company	Restructuring
Condition for entry	Company is solvent and members have voted by a majority of 75% or more to wind up the company	Company passes resolution to wind up and then calls a creditors' meeting	Company insolvent.	Insolvent
Stay on creditors	N/A	N/A	Yes for unsecured creditors.	Automatic stay (with limited exception for secured creditors – see text)
Control	Liquidator	Liquidator	Liquidator	Administrator
Approval for plan	N/A	N/A	N/A	Majority in number and value
Binding	N/A	N/A	N/A	Yes. Minority creditors are crammed down
Court involvement	Minimal	Minimal	Approves order	Yes. Minimal
DIP Financing	N/A	N/A	N/A	Yes
Average procedure time (estimate)	Dependent on: (a) type of assets; and (b) who the parties are.	Dependent on: (a) type of assets; and (b) who the parties are.	Dependent on: (a) type of assets; and (b) who the parties are.	Dependent on: (a) type of assets; and (b) who the parties are. (Note that if a DOCA is accepted, two separate administrations take place)
Recent uses	N/A (rarely occurs in large or high-profile insolvency)	Octaviar	Octaviar	Sons of Gwalia, Henry Walker Eltin Group, Pasminco, Anaconda Nickel

Source: Nomura, HerbertGeer

10.4.7 Future changes - Personal Property Securities

In December 2009, the Commonwealth government enacted the Personal Property Securities Act 2009 (Cth) (PPSA). This Act, when it comes into operation (expected to be May 2011), will result in significant changes to the law relating to the taking, enforcement and registration of security interests. It is intended to be broadly consistent with similar regimes in New Zealand, Canada and the US.

The PPSA includes "insolvency vesting provisions" which regulate whether, if an insolvency event occurs, the assets of a company would vest in the grantor of the security interest or the secured party. The main rule is that if a security interest is not perfected under the PPSA when an act of insolvency occurs, the assets subject to the security will 'vest' in the grantor company (and not the secured party).

In addition, as part of the changes to be introduced with the PPSA there is currently before parliament legislation which will amend the Corporations Act to be consistent with the PPSA. This Bill, if passed in its present form, would change some of the law in relation to how assets of a company are treated in an insolvency. For instance:

a) assets subject to retention of title, hire purchase, consignment and leasing arrangements, which under the current law may be treated as assets of the seller, hirer, consignor or lessor (and therefore the outside of the assets subject to the administration or liquidation), may, in certain circumstances, vest in the company, and will therefore be able to be dealt with by administrators and liquidators; and

b) property over which a person retains title under retention of title arrangements will be treated as secured property for the purposes of the Corporations Act thereby enabling the creditor to appoint an administrator in certain circumstances.

10.4.8 Discussion

The Australian insolvency regime grants strong protections to secured creditors

The Australian insolvency regime grants strong protections to the interests of secured creditors as they have the ability to enforce their security through the appointment of a receiver. This can even be done in the early decision period stage of a formal voluntary administration procedure. This treatment of secured creditors reflects the dominance of the banking sector as the main provider of corporate financing in Australia, especially versus capital market financing. This may be changed over the coming years as hedge funds and other forms of distressed debt buyer become more prominent players in the Australian credit markets.

A recent case has had a negative impact on market perceived recoveries of unsecured creditors – this may be amended soon

The High Court ruling in the case of the Sons of Gwalia case in which shareholders were granted creditor status (see the case study for details) due to the actions of the company has had a materially negative impact on the perceived recoveries of unsecured creditors. However, it is expected that forthcoming legislative changes will reassert the priority of creditors over shareholders in all cases.

The onerous potential liabilities which directors face may soon be lessened

One criticism of Australian insolvency law has been the onerous potential liabilities which directors face if they continue to trade while the company is insolvent. These liabilities exist even if the directors are behaving in the interests of creditors or are in the process of negotiating a consensual agreement. In March 2010, the Australian government published new proposals for amendments to the rules governing insolvent trading. One proposal would protect directors who discharge their duties of due care and diligence but in doing so violate the insolvent trading provisions while seeking a workout (the so-called safe-harbour concept). Another proposes a moratorium on insolvent trading while an informal workout is attempted. It is too early to say if any of these proposals will become law.

10.4.9 International

The Cross Border Insolvency Act which was passed in 2008 implemented the UNCITRAL model law on cross border insolvency in Australia. Note that receivership is not incorporated into cross-border insolvency as it does not fit within “collective proceedings” as contemplated by the Model Law.

10.4.10 Acknowledgements

We would like to thank Peter Kay for his comments and assistance with this section. His contact details are as follows:

Peter Kay
HerbertGeer
Level 20/385 Bourke Street
Melbourne VIC 3000
Australia
+61 3 9641 8665
pkay@herbertgeer.com.au

11 A COUNTRY COMPARISON

We present a country-to-country comparison of both of these types of procedure

In each of the country chapters, we have set out in detail the individual liquidation and rehabilitation procedures. Here, we present a country-to-country comparison of both of these types of procedure. A comparison of liquidation procedures can help tell us which countries favour secured creditors versus unsecured creditors. A comparison of rehabilitation procedures can help us to understand which countries have the provisions needed to successfully retain the economic value of a company in financial difficulty while its debt is being restructured, and which are more likely to achieve an equitable restructuring agreement.

11.1 Liquidation procedures

Most of the liquidation procedures detailed in this report have been fairly straightforward

In most cases, the liquidation procedures detailed in this report have been fairly straightforward. They all involve a controlled wind-up of the company, usually by an appointed liquidator, who distributes the proceeds from the sale of the company or its assets respecting any lien, payment and structural subordination within the corporate structure and between its various layers of debt. The distribution must also respect the local priority of payments for that jurisdiction as specified by the local insolvency law.

To make a comparison of liquidation procedures we compare different priority of payments

To help us make a comparison of the different rules of priority, we have attempted to tabulate each country's priority of payments. For ease of presentation, we have divided these into the tables in Figure 41 and 42. The first of these shows North American and certain Asian jurisdictions, and the second just the European jurisdictions covered in this report.

The comparison is sufficiently accurate to allow us to draw conclusions about the main features of each jurisdiction

In order to allow us to make a rudimentary comparison, we have had to simplify the specific priority of payments set out in the individual country sections, omitting some of the finer details and exceptions. As a result, this comparison is not exact but is sufficiently correct to allow us to draw conclusions about the main features of each country's treatment.

The most important difference between regimes is the priority they assign to:

- Secured creditors;
- Insolvency procedure expenses (i.e. court, expert, legal and administration costs);
- Employee wage claims (this can include unpaid wages and pensions); and
- Post-insolvency financing.

As stated previously, we have had to simplify the categorisations in order to assist the comparison. Based on this table we can make the following general observations concerning the jurisdictions covered by this report:

- The only jurisdictions which place secured creditors first in the priority of payments are England and Wales, Germany, Japan, Hong Kong, Singapore and Australia. In many of these jurisdictions, the enforcement of security takes place separately from the distribution of assets done according to the statutory priority of payments. In these countries, the holders of secured claims do not even have to contribute towards the liquidation costs or unpaid employee wages. Their rights are well protected and their recovery should, *ceteris paribus*, be higher than those of secured creditors in other jurisdictions.
- A number of regimes grant employees the highest priority in liquidation. These include Canada, France and Spain who place them (joint) first. The US also grants limited wage claims priority over secured claims. This reflects a view by legislators that employees are stakeholders in a company who should have an enhanced position in liquidation. Where the jurisdictions differ is in the size of the claim, e.g. the number of days of unpaid wages, they allow to be granted this priority status.
- The jurisdictions which place the expenses of the insolvency procedure first are Canada, Italy, Spain, Greece and Ireland. These are therefore the regimes where the recovery of secured creditors and all subordinated creditors are most exposed to the fees and expenses of the liquidation procedure. It is therefore in the interests of all creditors to have as rapid and simple a liquidation process as possible or to avoid it altogether.

Figure 41. The priority of payments in liquidation in North America and Asia

US	Canada	Japan	Hong Kong	Singapore	Australia
Post-insolvency financing	Employee wages, post-insolvency financing, insolvency procedure expenses	Secured claims	Secured claims with fixed charge	Secured claims with fixed charge	Secured claims with fixed charge
Insolvency procedure expenses, certain taxes	Government taxes	Insolvency procedure expenses, post-insolvency financing	Insolvency procedure expenses and post-insolvency financing	Insolvency procedure expenses, employee wages, all taxes incurred before winding-up	Insolvency procedure expenses
Limited wage claims	Secured claims	Wages, taxes, secured debt	Debts to employees and government	Secured creditors with floating charges	Post-insolvency financing
Secured claims	Other expenses and municipal taxes	Unsecured claims	Secured creditors with floating charges	Unsecured claims	Wages
Unsecured claims	Unsecured claims	Subordinated claims	Unsecured claims		Secured creditors with floating charges
					Unsecured claims and certain shareholders[52]

Source: Nomura, L&W

Figure 42. The priority of payments in liquidation in Europe

England and Wales	Germany	France	Italy	Spain	Greece	Ireland
Secured claims with fixed charge	Secured claims	Employees wages	Insolvency procedure expenses and post-insolvency financing[53]	Insolvency procedure expenses, post-insolvency debts and wages	Insolvency procedure expenses	Insolvency procedure expenses
Insolvency procedure expenses and post-insolvency financing	Insolvency procedure expenses, post-insolvency financing, claims from pre-insolvency contracts	Insolvency procedure expenses, post-insolvency financing	Privileged claims of government for judicial expenses	Secured claims	Post-insolvency claims, taxes and certain expenses	Secured claims with fixed charge
Employee wages and pension rights	Unsecured claims	Post-insolvency financing (conciliation process)	Secured claims	Limited employee wages, taxes and 25% of the claim of first creditor to file for insolvency	Secured claims	Other costs and expenses
Limited fund for unsecured creditors		Secured claims	Unsecured claims	Unsecured claims	Unsecured claims	Taxes
Secured creditors with floating charges		Post-insolvency claims				Secured creditors with floating charges
Unsecured claims		Pledges without retention rights				Unsecured claims
		Taxes, unsecured claims				

Source: Nomura, L&W

- A number of regimes, most notably the US, allow for post-insolvency financing to have enhanced priority. Indeed, in the US it has the highest priority. Other countries that grant it priority, though not top-priority status, include Canada, Germany, France (but only in the case of the *conciliation* procedure), England and Wales, Singapore, Hong Kong, Italy, Japan and Australia.

---

52 See section 10.4.4 for details.
53 Priority financing can only be obtained in Italy for specific insolvency procedures.

- Fixed and floating charges, which appear in England, Ireland, Hong Kong, Singapore and Australia, have a significantly different ranking in liquidation. Typically, once fixed-charge claims have been paid, the expenses of the procedure and preferential claims must be subtracted from the value of the debtor's estate before floating charges can be paid. The recovery of floating-charge holders can therefore be substantially lower than that of fixed-charge holders.

11.2 Rehabilitation procedures

The details of the different rehabilitation procedures can have a major impact on recovery prospects

Although insolvency regimes have the same aim – either a fair and orderly liquidation of a company, or a rehabilitation of the company as a going concern – they differ greatly in terms of the details of the procedures designed to achieve these aims. To enable a comparison, we have simplified the main features of each rehabilitation procedure into six main criteria:

1. the condition for entry to the procedure;
2. the nature of the stay;
3. who has control of the company during the procedure;
4. the level of majority needed to pass a restructuring plan (subject usually to court approval);
5. whether a cramdown is possible; and
6. whether priority post-insolvency financing is permitted.

We examine the main rehabilitation procedure in each jurisdiction. For jurisdictions with multiple procedures, we choose the one that is most commonly used

This is by no means a comprehensive list, but we view these as capturing the principal factors that contribute to a successful rehabilitation procedure. Figure 43 sets out these factors in each of the 12 jurisdictions discussed in this report. In some cases, in particular the case of England and Wales, it was not easy to determine which of the available rehabilitation procedures is the main one. Because schemes of arrangement, administration and CVAs are widely used procedures, often accessed via COMI-shifting, we have included all three. In other jurisdictions with multiple procedures, we attempted to choose the one that is most commonly used.

For the purpose of comparison, we have simplified the precise details of each provision

For the purpose of comparison, we have simplified the precise details of each provision. So for example, we do not specify that a Canadian company needs to have debts greater than C$5mn to enter the CCAA plan of arrangement procedure, we simply state that the company has to be insolvent. The precise details can be found in the individual country sections. We now list the different criteria and discuss how different countries perform.

- **Entry condition:** Most countries require that the company be insolvent before it can enter a rehabilitation procedure. In some cases, such as the US, Italy (Article 182bis) and Hong Kong, there is no requirement for the firm to be insolvent to enter the main rehabilitation procedure. In France and Greece, the firm must be solvent in order to make use of the corresponding rehabilitation procedure.
- **The stay:** Most countries impose a stay on unsecured creditors during the rehabilitation procedure. In many cases the stay is automatic, as in the US and Singapore. In other cases it needs to be applied for to the court and is almost always granted. In many countries the stay is comprehensive as it extends to cover secured creditors also. In other countries such as Australia, there may be no stay on secured creditors in the early stages of an insolvency, granting significant advantages to secured lenders. Of the three restructuring procedures available in the UK, only administration, which displaces management, has a formal stay on creditor actions.
- **Control:** Most rehabilitation procedures allow for management to remain in control with the main exceptions being Germany[54], the England and Wales administration procedure, Ireland and Australia.
- **Voting threshold:** The level of agreement between creditors needed to approve a restructuring plan can take a broad range of values. At the very least, it must be a majority vote in terms of the number of creditors and the size of the claims. In the

[54] Except for self-administration which is only used in a small fraction of insolvency procedures.

England and Wales administration procedure, Germany, Spain, Greece and Ireland, this is all that is required. In the US, Canada, France and Japan, the threshold rises to a two-thirds majority by value. The highest thresholds are 75% in the UK scheme of arrangement and 75.1% in the CVA procedures. There is no clear explanation for this disparity in the level of the thresholds needed to approve a plan. However, it must certainly be true that a higher threshold makes it more difficult to approve a plan of restructuring.

- **Cramdown:** A cramdown occurs when a class of creditors who may be considered to be out-of-the-money can have their vote against a restructuring plan overruled or ignored. In the US, where the term “cramdown” originated, this can occur provided the court decides that the class of dissenting creditors has not been treated unfairly and the APR has been applied.

  Such a comprehensive cramdown is uncommon in other jurisdictions. There is a another “softer” form of cramdown however, where disparate creditors vote all in the same class. While technically there is no other class to cramdown, the end result is similar in that the will of the majority can be imposed on dissenting creditors. There is a third potential category of cramdown, although it might be better described as a “cram-in”. This occurs in an English scheme of arrangements where the majority within any class of creditor can bind a dissenting group within that class. The issue is that they cannot bind other classes of creditors. However, in certain cases a robust approach has been taken as to whether junior classes can hold up a scheme.

  This was shown clearly in the IMO Carwash case study where the mezzanine creditors were crammed down on the basis of a valuation showing that they were out-of-the-money. Cramdowns are also possible in a number of European jurisdictions including Germany, France, Spain and Ireland. However, the uncertainty in the implementation presents risk for stakeholders, which underlines why COMI-shifting to the more predictable UK jurisdiction is often chosen to effect a cramdown.

- **Priority post-insolvency loans:** The provision of allowing post-insolvency loans to obtain a preferential and priority status in any subsequent liquidation has become more common. In addition to the US, it also occurs in Canada, England and Wales, Germany, France, Italy, Spain, Greece, Japan, Hong Kong, Singapore and Australia. However, the exact position in the priority of payments can vary significantly between these different countries. For example, the priority afforded to post-petition finance in England is limited to priority over floating-charge and unsecured assets. As these may constitute only a small proportion of a company’s value, there is frequent insistence from restructuring practitioners in England that there is a need for a US-style DIP finance regime.

Some view the US Chapter 11 procedure as the “gold standard” against which other regimes should be compared

For those who view the US Chapter 11 procedure as the “gold standard” against which other regimes should be compared, it is possible to use these six criteria as the basis for such a comparison. For example, at a first glance the French Safeguard procedure seems to share many of the characteristics of Chapter 11, with its ability to enter the procedure pre-insolvency, the automatic and comprehensive stay, management remaining in control, almost identical approval thresholds and some ability for a cramdown.

Care must be taken as first-glance similarities of a regime to Chapter 11 may be misleading

However, care needs to be taken in such comparisons since the French procedure grants employees and shareholders a larger role than in the US as described in section 11.1. It also does what many consider to be a poor job in recognising seniority. There is also the element of uncertainty since the French procedure is relatively new and does not benefit from the case law that has been built up in the US bankruptcy courts. As a result, we must be very careful when analysing what in theory looks like a Chapter 11 procedure since it may not be so alike in practice.

Figure 43. Comparison of the main rehabilitation procedures in each jurisdiction

Country	Rehabilitation Procedure	Entry Condition	Stay	Control	Voting Threshold	Cramdown	Priority post-insolvency loans
US	Chapter 11	None	Yes, automatic and comprehensive	Management	50% by number 66.7% by value	Yes	Yes
Canada	CCAA Plan of Arrangement	Insolvent	Yes, but not automatic. Usually comprehensive	Management	50% by number 66.7% by value	No – all classes must vote in favour	Yes[a]
England & Wales	Scheme of Arrangement[b]	None	No	Management	Majority in number and 75% by value	Yes	No
	Administration	Insolvent	Yes, automatic and comprehensive	Administrator	50% by value	Yes	Yes
	CVA	None	No[c]	Management	More than 75% by value	Yes	No
France	Safeguard	Solvent company facing difficulties	Yes, comprehensive and automatic	Management	66.7% by value of two committees	Yes	Limited
Germany	Insolvency Plan	Insolvent	Not automatic for preliminary period. Stay automatic when main proceedings open. Not comprehensive	Insolvency Administrator[d]	50% in number and value	Yes subject to some conditions on fairness	Yes, not super priority status but preferred creditor status
Italy	Extraordinary Administration	Large company insolvent	Yes, comprehensive	Judge/ government-appointed commissioners	Tribunal approval	Yes	Yes
	Restructuring Agreement (Article 182bis)	None	Yes, comprehensive[e]	Management	60% by value	No	Yes[f]
Spain	Anticipated Creditors' Agreement	Insolvent	Yes, only on unsecured creditors	Management	50% of unsecured creditors	Yes	Yes, but limited
Greece	Mediation/ Conciliation	Not yet insolvent	Yes, only on unsecured assets and certain secured assets vital to business	Management	Majority of credit claims	No	Yes
Ireland	Examinership	Insolvent	Yes, only on unsecured claims	Examiner	At least 50% by number and value in at least one class	Yes	No
Japan	DIP Corporate Reorganisation	Insolvent	Yes, comprehensive	Management	50% of unsecured creditors 66.7% or more of secured creditors	Yes	Yes
Hong Kong	Scheme of Arrangement	None	None	Management	75% of creditors (or class of creditors)	Yes	No
Singapore	Judicial Management	Insolvent	Yes, automatic and comprehensive	Management	75% of creditors by value and more than 50% in number in each class	Yes	No
Australia	Voluntary Administration	Insolvent	Yes, on unsecured creditors. Stay on secured creditors[g] begins after 13 days	Administrator	Majority of creditors voting in number and value	Yes	Yes

(a) Based on new provisions introduced in September 2009. (b) We choose this as the most similar procedure to Chapter 11. (c) Except for small companies. (d) It is possible but unusual for self-administration to be allowed in which case management stays in control but this is the exception rather than the rule. (e) After petition has been filed with a bankruptcy court informing it that restructuring talks are under way with the creditors representing at least 60% of the total credits. (f) Recent revisions in the code allow for loans provided by banks and financial institutions to have priority status. (g) Charge must be over all or substantially all of the company's assets.

Source: Nomura, L&W

Some approaches which do not resemble Chapter 11 may nonetheless be well used and successful

Some approaches which do not resemble Chapter 11 may nonetheless be well used. This becomes clear if we consider the case of England and Wales. None of its individual procedures share many of the main characteristics of Chapter 11. For example, neither schemes of arrangement nor the CVA provide for a stay. Administration displaces management and none of them provide for comprehensive priority post-insolvency financing. Despite these shortcomings these procedures are well used. Indeed, non-UK based companies frequently seek to move their centre of main interests to the UK to make use of them. The reason is that these procedures are all tried and tested, so that participants may have a reasonable degree of confidence in the outcome where particular procedures are used. Some of the procedures are out-of-court so can be executed rapidly, cheaply and with minimal interference. Also, all of these procedures allow for a cramdown, at least in some of the different forms described above, and this can be a vital part of making a complex restructuring work since it can be used to exclude creditors and shareholders with no real economic interest from the process and allow those who do have an interest to come to an agreement.

12 CONCLUSIONS

The past 10 years have seen a marked increase in the complexity of capital structures

The past 10 years have seen a marked increase in the complexity of corporate capital structures. As banks have become increasingly disintermediated from the corporate lending business, new more complex forms of debt and new types of creditors have appeared in these capital structures.

These changes have transformed the restructuring process

These changes have transformed the restructuring process, which in the past was often informal, consensual and out-of-court and typically involved just company management and its senior banks lenders. The limited number of parties and their aligned, if not identical, interests made restructuring a procedure that was generally more likely to result in agreement.

Debt instruments and their holders have all changed

Nowadays, distressed corporate borrowers can find themselves with capital structures consisting of a combination of senior bank debt, second-lien and mezzanine loans, high-yield bonds and PIK instruments. They can also find that they are no longer negotiating the restructuring with just banks but also with hedge funds, distressed debt funds, CLO managers and more traditional credit funds.

Nowadays, restructurings are more complex as the different parties are more likely to have conflicting interests

Nowadays, restructurings are more complex as these different parties need to obtain unanimous approval on a restructuring package if conducted informally. The different risk appetites of these creditors and possible cross-holdings of different levels of the capital structure also complicates the negotiation process as they may wish for different outcomes and therefore have conflicting interests. These changes have made a fair and workable rehabilitation procedure more necessary than before.

The CDS market has also made it possible for creditors to privately hedge their credit exposure

The growth of the credit default swap market has also impacted the rehabilitation process by making it possible for creditors to privately hedge their credit exposure, whether in bond or loan form. This can change the incentives of these parties in a restructuring procedure as it means that they may not be aligned with other members of the same class of creditor. In at least one documented case, this has encouraged the creditor to push for a liquidation rather than a rehabilitation process, thereby making it harder to reach agreement with the other creditors.

It is encouraging that the main trend has been towards making corporate rehabilitation work

It is therefore encouraging that the main trend that has emerged is that legislators across most of the jurisdictions covered have already begun efforts towards making corporate rehabilitation work. Some of this effort actually started over a decade ago, and some was spurred on by the events following the “dot com” boom. What is fortunate is that these reforms have come into being just as we are entering a more fragile period for global corporate credit.

The general theme of all of these reforms has been legislators’ willingness to re-cast insolvency as the fault-free event

The general theme of all of these reforms has been a willingness by legislators to re-cast insolvency as the fault-free consequence of a free market rather than an event to be stigmatised and penalised. Much of the inspiration for the specific changes in rehabilitation procedures have come from Chapter 11 of the US Bankruptcy Code. The attraction of Chapter 11 is that, for many, it seems to strike the right balance between protecting the rights of creditors and maximising the chances of a successful rehabilitation.

Many of the new and amended insolvency procedures have borrowed from Chapter 11

Our analyses have found that while many of the new and amended insolvency procedures used in the countries covered by this report are now closer to Chapter 11 than they were, all have stopped short of a full copy of Chapter 11. In some cases this reflects a different cultural view of the role of the company in society and of employee and shareholder rights in the insolvency procedure. In other cases it reflects the differing legal traditions. For example, the legal codes in Southern Europe are based on the extensive Napoleonic code which has a very different philosophy from the US common law system. There is also an issue of complexity. In most jurisdictions, corporate law is a comprehensive body of codes or precedents which have been formed over hundreds of years. Jurisdictions need to tread carefully when amending whole areas of this law and examine all of the potential knock-on effects.

Another impetus for the convergence of insolvency procedures is globalisation

Another impetus for the convergence of insolvency procedures is globalisation. Companies that are able to move their business to different countries will clearly prefer to settle in a regime that has a developed legal framework for resolving disputes, rather than one that does not. Legal systems therefore have to be responsive to global business demands if they are to attract the best companies and this drives change as legislators seek to copy what is perceived as best practice.

Companies sometimes have the option to initiate insolvency proceedings in another jurisdiction

In many countries, companies that wish to be rehabilitated but which do not like any of their local rehabilitation procedures have an option – to switch the rehabilitation to another jurisdiction, known generically as “forum shopping”. We described in this report how it is possible in Europe for a company to move its centre of main interests to another European jurisdiction to benefit from a more favourable procedure. It is also possible for non-US companies to use the US Chapter 11 procedure since the entry requirements for a foreign company to use this procedure can simply be the existence of a US bank account or any dollar-based borrowings.

This can make it easier for the management of a company to put through a restructuring plan

Forum shopping can make it easier for the management of a company to put through a restructuring plan since it enables it to select a jurisdiction which allows management to retain control over the operations of the firm, and to force through a restructuring plan which may not be possible in their original centre of main interests, for example if the local procedure does not permit a cramdown. However, it is not clear if forum shopping is always a positive factor for creditors. At the very least it adds to the uncertainty around estimates of the final recovery value.

Global efforts to create a framework for the recognition of foreign bankruptcy proceedings have had some success

Another international aspect of insolvency law has been an attempt by international bodies to create a framework for the recognition of foreign bankruptcy proceedings. This was done using the UNCITRAL model law published in 1997 which has since been adopted by a number of major jurisdictions including the US, the UK and Japan. However, as its adoption has been minimal in terms of the number of countries covered, the UNCITRAL model law has not yet had a major impact on cross-border insolvencies. Further widespread adoption of this model law could reduce the need for forum shopping. For example, the UNCITRAL rules permit a freeze on debtor or prejudicial creditor action following an insolvency filing, allowing the business to continue its operations until the courts decide how to proceed. With these rules in place a company may have to switch COMI to benefit from such protections.

Good rehabilitation procedures are now more necessary than ever and their success can only be measured by their usage

In summary, the different forms of debt in modern capital structures, the many different types of creditor and their sometimes conflicting interests have all made good rehabilitation procedures more necessary than ever. As a result, the many recent amendments to insolvency regimes have been encouraging. As in the US where Chapter 11 is an almost automatic choice for companies in financial difficulty, the success of these new regimes can only be determined by their usage. It remains to be seen whether the rehabilitation procedures discussed in this report become as much a part of the corporate scene as Chapter 11 has in the US. The fear is that if they do not, companies may be forced to rely on consensual restructuring which is not always optimally suited to the successful rescue of large complex multinational businesses.

13 GLOSSARY

Term	Definition
Absolute priority rule (APR)	The rule that a junior creditor cannot receive any payment in liquidation until a more senior creditor has been repaid in full.
Adequate protection	This is a condition which states that if the value of the collateral falls, a secured creditor is then granted compensation which could be in cash or could be the addition of new liens over other assets of the company.
Acceleration	This is the mechanism by which a creditor requires the debtor to immediately repay in full the outstanding debt. The size of the claim is usually the face value of the debt and will include any accrued interest.
Arranger	The bank that leads the structuring and syndication of a loan. Also known as the lead arranger.
Asset-backed loan	A loan that is secured by specific assets.
Automatic stay	An injunction which comes into effect without any court order immediately after a bankruptcy filing. Depending on the jurisdiction, it prevents specified classes of creditors from pursing their claims to collect their debts.
Charge	A charge is a claim on an asset or assets which prevents them from being sold and the proceeds being passed to the owner without the charge holder's debt being paid off first.
Claw-back	In certain jurisdictions, certain transactions which were made in a specific period before the filing for insolvency may be voided by the bankruptcy procedure. If these were payments from the company, they may be clawed back from the recipient.
Centre of main interests (COMI)	In the context of the European Insolvency regulation, for a company with assets in a number of European jurisdictions, the COMI is the European jurisdiction in which the main bankruptcy proceedings are carried out. The starting point for determination is the location of the company's registered office. It also determines the main proceedings under the UNCITRAL model law.
Commitment fee	This is the fee paid by the borrower in a revolving credit facility to the lender for keeping the un-drawn facility available.
Contractual subordination	Subordination of debt that arises as a result of the credit agreements entered into by the creditors. It includes lien and payment subordination. It does not include structural subordination which arises due to where in the corporate structure of the company the debt is issued.
Covenant	A covenant is a condition written into a loan agreement which if broken can trigger an event of default. There are generally two sorts of covenant: maintenance covenants and incurrence covenants.
Covenant-lite	Most loans have both incurrence and maintenance covenants. Covenant-lite loans have bond-like incurrence covenants instead of the maintenance covenants traditionally found in loans.
Cramdown	The legal sanctioning of some plan despite opposition from dissenting creditors. It takes weaker or stronger forms depending on the jurisdiction. Also known as cramming down creditors.
Credit agreement	This is the main document for a loan entered into between a borrower and a lender. It sets out the details of the loan and any obligations and requirements of the borrower.
Credit bidding	Creditors buying the assets of the company using their outstanding debt claims against the company.

Debenture	The exact definition of a debenture depends on the jurisdiction. In the US, it refers to an unsecured corporate bond. However in the UK it is usually secured.
Default	A contractually specified event which enables a lender to demand repayment (accelerate) subject to a grace period and right to cure.
DIP	This stands for Debtor in Possession and is the legal term for the company management in the course of a US style Chapter 11 restructuring. The term is used by analogy in other jurisdictions to represent the trustee or manager of a company in a restructuring process.
DIP financing	Financing provided to a company while it is in a restructuring phase which is typically but not always granted priority over other debt. The best known example is the DIP loan facility in US Chapter 11 procedures which has priority over existing debt and other claims.
EBITDA	Earnings before interest, tax, depreciation and amortization. A simple measure of cash flow used by credit analysts to determine the ability of companies to service their debts. It is also used in the financial ratio tests found in maintenance and incurrence covenants.
Exemption	A right granted to a debtor to exclude certain assets from being taken by the creditor in satisfaction of debt.
Event of default (EoD)	A specific event set out in the credit agreement which has not been remedied or waived after any grace period and which allows creditors to accelerate their debt.
First-lien loan	A loan that has the first claim over a borrower's assets. This can be because it was perfected first.
Fixed charge	A fixed charge is a security over a specifically designated asset. The creditor does not own or possess the asset, but the owner must obtain the consent of the creditor before it can be dealt with. If the debtor defaults then the creditor can apply to the court for an order to sell the asset or appoint a receiver to take ownership.
Floating charge	A floating charge is one which does not link to any specific asset, but is over a class of assets, both current and future, which the debtor is allowed to buy and sell. It is only when a default occurs on a debt payment (or in certain other circumstances) that the floating charge "fixes" as the debtor is no longer allowed to buy and sell assets without the permission of the debtor.
Forbearance	An agreement between the debtor and the creditor to delay the repayment of a loan or to reduce the interest rate.
Foreclosure	The process by which a creditor enforces a lien following default of the debtor. The collateral is seized and sold with the proceeds used to satisfy the debt.
GAAP	Generally agreed accounting principles.
Guarantee	An agreement for one entity to become liable for the debts of another. A subsidiary (e.g. OpCo) guaranteeing the debt of a parent company (e.g. HoldCo) is called an "upstream" guarantee.
High-yield debt	Bonds which have a sub-investment grade credit rating.
Immovable property	Real estate assets used for security.
Incurrence covenant	A covenant which is tested on the occurrence of some legally specified event.
Indenture	This is the main credit document for a bond.

Insolvency	The state of a company which has failed a solvency test. This may be an inability to pay debts as they fall due or it may be due to the company debt exceeding its assets. Which test is used depends on the jurisdiction.
Intercreditor agreement	An agreement entered into by creditors, that sets out how different classes of creditors will manage their rights and remedies set out in the credit agreement. For example, first- and second-lien creditors will enter into an intercreditor agreement which sets out their respective rights.
Involuntary bankruptcy	A bankruptcy filing initiated by one or more creditors which may be opposed by the debtor.
Leveraged buyout (LBO)	The purchase of the shares of a company using debt secured against the assets of the company.
Leveraged loan	A loan which is perceived as having a weak credit risk. There is no one formal definition but it generally includes loans paying a spread over Libor above 200bp where the issuer is rated BB or below.
Lien	This is a security granted to a creditor against some debtor property. If the debtor defaults, the creditor with the lien can retain the property until some legal duty has been fulfilled.
Maintenance covenant	A bond or loan covenant that, unlike an incurrence covenant, is checked periodically or at all times.
Margin grid	A margin grid, also known as a pricing grid, links the spread paid on the loan to the credit rating of the company or agreed financial ratios (e.g. Net Debt/EBITDA). If the rating improves or the ratio improves from a credit perspective, the margin will also fall.
Moratorium	A period during which a debtor’s obligation to make interest and principal payments is suspended.
Moveable assets	Assets which are not real-estate property.
Pari passu	A term used to describe that obligations have the same degree of priority between themselves.
Perfection	An act, often by means of public registration, by which a security interest will become effective against subsequent interests.
Payment in kind (PIK)	PIK stands for payment in kind and means that in certain circumstances, rather than pay a coupon in cash, the coupon will be paid in the form of new bonds which are added to the total amount to be repaid in cash at maturity.
Pledge	In English law a pledge is a form of security which gives the creditor a possessory right to a pledged asset. It is usually created by delivering the pledged asset to the creditor.
Priming	This term refers to the procedure whereby new loans obtain a priority over existing loans which become subordinate or “primed”. The best example of priming occurs when DIP loans are created in a US Chapter 11 procedure.
Rehabilitation	A procedure undertaken by a company in bankruptcy which usually includes a restructuring of the company’s debt and a reorganization of its business activities with the aim of the company emerging from insolvency as a going concern.
Retention of title	A form of quasi-security over moveable assets in which the supplier of an asset to a debtor retains ownership of the assets until they paid for.
Revolving line of credit	Also known as a “revolver”, this is a loan which allows the borrower to borrow repay and borrow again up to a certain limit at a pre-agreed interest rate and for a pre-agreed period.

Second-lien loans	Loans which are secured by collateral of the issuer but which are only covered by what is left once the first-lien loan holders have been full repaid. They also may have weaker maintenance covenants than first-lien loans.
Secured debt	A debt which is secured by some lien on some asset of the debtor company which can be seized and sold in satisfaction of the debt. The debt is secured only to the value of the asset.
Set-off	The application of mutual debits and credits in reduction of each other. It may be mandatory following bankruptcy in some jurisdictions.
Standstill	A period during which creditors agree not to engage in any enforcement action in order to allow the debtor and creditor to work on a plan of restructuring.
Stay	A legal constraint which halts any actions by unsecured creditors seeking payment on their claims in the courts. If the stay is comprehensive it also includes secured creditors as it prevents them from enforcing their security.
Structural subordination	Structural subordination is a form of subordination different from the contractual subordination usually set out in the credit documentation and is concerned with how much recovery a creditor receives based on his position within a company structure consisting of a holding company, financial company and operating companies.
Term loan	This is typically a senior secured bank loan which may be syndicated and which is for a specific period at the end of which it is repaid in full. It typically pays interest as a margin or spread over Libor.
Voluntary bankruptcy	A bankruptcy filing initiated by the debtor.
Waiver	A waiver can be granted by a majority of creditors to a debtor on request following an event of default and means that the creditors agree to forego their right to accelerate the debt. Once agreed to, this event of default cannot be used to accelerate the debt.
Winding up	A termination of the business activities of a company and a liquidation of the assets of a company with the proceeds being distributed to creditors in the appropriate order.

Online availability of research and additional conflict-of-interest disclosures:

Nomura Japanese Equity Research is available electronically for clients in the US on NOMURA.COM, REUTERS, BLOOMBERG and THOMSON ONE ANALYTICS. For clients in Europe, Japan and elsewhere in Asia it is available on NOMURA.COM, REUTERS and BLOOMBERG.

Important disclosures may be accessed through the left hand side of the Nomura Disclosure web page http://www.nomura.com/research or requested from Nomura Securities International, Inc., on 1-877-865-5752. If you have any difficulties with the website, please email researchportal@nomura.co.uk for technical assistance.

The analysts responsible for preparing this report have received compensation based upon various factors including the firm's total revenues, a portion of which is generated by Investment Banking activities.

DISCLAIMERS

This publication contains material that has been prepared by the Nomura entity identified on the banner at the top or the bottom of page 1 herein and, if applicable, with the contributions of one or more Nomura entities whose employees and their respective affiliations are specified on page 1 herein or elsewhere identified in the publication. Affiliates and subsidiaries of Nomura Holdings, Inc. (collectively, the "Nomura Group"), include: Nomura Securities Co., Ltd. ("NSC") Tokyo, Japan; Nomura International plc, United Kingdom; Nomura Securities International, Inc. ("NSI"), New York, NY; Nomura International (Hong Kong) Ltd., Hong Kong; Nomura Financial Investment (Korea) Co., Ltd., Korea; Nomura Singapore Ltd., Singapore (Registration number 197201440E, regulated by the Monetary Authority of Singapore); Nomura Australia Ltd., Australia (ABN 48 003 032 513), regulated by the Australian Securities and Investment Commission and holder of an Australian financial services licence number 246412; P.T. Nomura Indonesia, Indonesia; Nomura Securities Malaysia Sdn. Bhd., Malaysia; Nomura International (Hong Kong) Ltd., Taipei Branch, Taiwan; Nomura Financial Advisory and Securities (India) Private Limited, Mumbai, India (Registered Address: Ceejay House, Level 11, Plot F, Shivsagar Estate, Dr. Annie Besant Road, Worli, Mumbai- 400 018, India; SEBI Registration No: BSE INB011299030, NSE INB231299034, INF231299034, INE 231299034).

This material is: (i) for your private information, and we (together with the firms contributing to this report, Latham & Watkins LLP, Koutalidis, Mason Hayes + Curran, Rajan & Tann LLP and Herbert Geer (together, including their respective affiliates, the “Contributors”)) are not soliciting any action based upon it; (ii) not to be construed as an offer to sell or a solicitation of an offer to buy any security in any jurisdiction where such offer or solicitation would be illegal; and (iii) based upon information that we and the Contributors consider reliable, but neither we nor the Contributors can represent that it is accurate or complete, and it should not be relied upon as such. NEITHER NOMURA GROUP NOR THE CONTRIBUTORS WARRANT OR REPRESENT THAT THE PUBLICATION IS ACCURATE, COMPLETE, RELIABLE, FIT FOR ANY PARTICULAR PURPOSE OR MERCHANTABLE, AND DO NOT ACCEPT LIABILITY FOR ANY ACT (OR DECISION NOT TO ACT) RESULTING FROM USE OF THIS PUBLICATION AND RELATED DATA. TO THE MAXIMUM EXTENT PERMISSIBLE ALL WARRANTIES, DUTIES OF CARE AND OTHER ASSURANCES BY NOMURA GROUP AND THE CONTRIBUTORS ARE HEREBY DISCLAIMED AND EXCLUDED AND NEITHER NOMURA GROUP NOR THE CONTRIBUTORS SHALL HAVE ANY LIABILITY FOR THE USE, MISUSE, OR DISTRIBUTION OF THIS INFORMATION.

THIS PUBLICATION HAS BEEN PREPARED BY NOMURA WITH THE ASSISTANCE OF THE CONTRIBUTORS FOR INFORMATIONAL PURPOSES ONLY AND DOES NOT CONSTITUTE LEGAL ADVICE. THIS INFORMATION IS NOT INTENDED TO CREATE, AND RECEIPT OF IT DOES NOT CONSTITUTE, A LAWYER-CLIENT RELATIONSHIP WITH NOMURA OR ANY OF THE CONTRIBUTORS. READERS SHOULD NOT ACT UPON ANY STATEMENT CONTAINED IN THIS PUBLICATION WITHOUT SEEKING ADVICE FROM PROFESSIONAL ADVISERS

Opinions expressed are current opinions as of the original publication date appearing on this material only and the information, including the opinions contained herein, are subject to change without notice. Nomura and Contributors are under no duty to update this publication. If and as applicable, NSI's investment banking relationships, investment banking and non-investment banking compensation and securities ownership (identified in this report as "Disclosures Required in the United States"), if any, are specified in disclaimers and related disclosures in this report. In addition, other members of the Nomura Group may from time to time perform investment banking or other services (including acting as advisor, manager or lender) for, or solicit investment banking or other business from, companies mentioned herein. Further, the Nomura Group, and/or its officers, directors and employees, including persons, without limitation, involved in the preparation or issuance of this material may, to the extent permitted by applicable law and/or regulation, have long or short positions in, and buy or sell, the securities (including ownership by NSI, referenced above), or derivatives (including options) thereof, of companies mentioned herein, or related securities or derivatives. In addition, the Nomura Group, excluding NSI, may act as a market maker and principal, willing to buy and sell certain of the securities of companies mentioned herein. Further, the Nomura Group may buy and sell certain of the securities of companies mentioned herein, as agent for its clients.

Investors should consider this report as only a single factor in making their investment decision and, as such, the report should not be viewed as identifying or suggesting all risks, direct or indirect, that may be associated with any investment decision. Please see the further disclaimers in the disclosure information on companies covered by Nomura analysts available at www.nomura.com/research under the "Disclosure" tab. Nomura Group produces a number of different types of research product including, amongst others, fundamental analysis, quantitative analysis and short term trading ideas; recommendations contained in one type of research product may differ from recommendations contained in other types of research product, whether as a result of differing time horizons, methodologies or otherwise; it is possible that individual employees of Nomura may have different perspectives to this publication.

NSC and other non-US members of the Nomura Group (i.e., excluding NSI), their officers, directors and employees may, to the extent it relates to non-US issuers and is permitted by applicable law, have acted upon or used this material prior to, or immediately following, its publication.

Foreign currency-denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of, or income derived from, the investment. In addition, investors in securities such as ADRs, the values of which are influenced by foreign currencies, effectively assume currency risk.

This publication has been approved for distribution in the United Kingdom and European Union as investment research by Nomura International plc ("NIPlc"), which is authorised and regulated by the U.K. Financial Services Authority ("FSA") and is a member of the London Stock Exchange. It does not constitute a personal recommendation, as defined by the FSA, or take into account the particular investment objectives, financial situations, or needs of individual investors. It is intended only for investors who are "eligible counterparties" or "professional clients" as defined by the FSA, and may not, therefore, be redistributed to retail clients as defined by the FSA. This publication may be distributed in Germany via Nomura Bank (Deutschland) GmbH, which is authorised and regulated in Germany by the Federal Financial Supervisory Authority ("BaFin"). This publication has been approved by Nomura International (Hong Kong) Ltd. ("NIHK"), which is regulated by the Hong Kong Securities and Futures Commission, for distribution in Hong Kong by NIHK. This publication has been approved for distribution in Australia by Nomura Australia Ltd, which is authorised and regulated in Australia by the Australian Securities and Investment Commission (“ASIC”). This publication has also been approved for distribution in Malaysia by Nomura Securities Malaysia Sdn. Bhd. In Singapore, this publication has been distributed by Nomura Singapore Limited (“NSL”). NSL accepts legal responsibility for the content of this publication, where it concerns securities, futures and foreign exchange, issued by its foreign affiliate in respect of recipients who are not accredited, expert or institutional investors as defined by the Securities and Futures Act (Chapter 289). Recipients of this publication may contact NSL in respect of matters arising from, or in connection with, this publication. NSI accepts responsibility for the contents of this material when distributed in the United States.

No part of this material may be (i) copied, photocopied, or duplicated in any form, by any means, or (ii) redistributed without the prior written consent of the Nomura Group member identified in the banner on page 1 of this report. If this publication has been distributed by electronic transmission, such as e-mail, then such transmission cannot be guaranteed to be secure or error-free as information could be intercepted, corrupted, lost, destroyed, arrive late or incomplete, or contain viruses. The sender therefore does not accept liability for any errors or omissions in the contents of this publication, which may arise as a result of electronic transmission. If verification is required, please request a hard-copy version.

This publication has not been approved for distribution in the Kingdom of Saudi Arabia or to clients other than 'professional clients' in the United Arab Emirates by Nomura Saudi Arabia, Nomura International plc or any other member of the Nomura Group, as the case may be. Neither this publication nor any copy thereof may be taken or transmitted or distributed, directly or indirectly, by any person other than those authorised to do so into the Kingdom of Saudi Arabia or in the United Arab Emirates or to any person located in the Kingdom of Saudi Arabia or to clients other than 'professional clients' in the United Arab Emirates. By accepting to receive this publication, you represent that you are not located in the Kingdom of Saudi Arabia or that you are a 'professional client' in the United Arab Emirates and agree to comply with these restrictions. Any failure to comply with these restrictions may constitute a violation of the laws of the Kingdom of Saudi Arabia or the United Arab Emirates.

Additional information available upon request.

NIPlc and other Nomura Group entities manage conflicts identified through the following: their Chinese Wall, confidentiality and independence policies, maintenance of a Stop List and a Watch List, personal account dealing rules, policies and procedures for managing conflicts of interest arising from the allocation and pricing of securities and impartial investment research and disclosure to clients via client documentation.

Disclosure information is available at the Nomura Disclosure web page: http://www.nomura.com/research

Nomura International plc. Tel: +44 20 7521 2000
Nomura House, 1 St Martins-le-Grand, London EC1A 4NP