NORTON ROSE FULBRIGHT

International Restructuring Newswire

A quarterly newsletter from the global restructuring team at Norton Rose Fulbright

Q1 2023

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To our clients and friends:

As restructuring professionals, we are all aware of the numerous factors that are weighing down the global economy: inflation, the war in Ukraine, rising interest rates, and the COVID-19 pandemic. Now it's time to add to that list the threat of the United States running out of money and defaulting on its debts. This inconceivable event could occur when the country hits its debt ceiling, something that could potentially come to pass this summer.

Breaching the debt ceiling is avoidable as Congress could increase the statutory limit on US debt, but at a moment of heightened partisanship and divided government accomplishing that will be challenging. As suggested by the New York Times, "the cost of not raising the borrowing cap could be catastrophic, causing a deep recession in the United States and potentially prompting a global financial crisis."

While we all hope the US Congress figures a way out of this crisis, staying current on restructuring options around the world remains essential. We help you do that in our current issue as we review hot topics in a variety of jurisdictions around the globe where our lawyers practice.

And I would be remise in not congratulating those same lawyers in recently being recognized as one of the top 10 law firms for cross-border restructuring work in 2022 by the *Global Restructuring Review* (GRR)!

Good reading,

Howard Seife
Global Co-Head of Restructuring
New York

Scott Atkins
Global Co-Head of Restructuring
Sydney

In the news

Dealsourcing 2022 – German Financial Think Tank

September 13, 2022
Oliver Sutter, Sylwia Maria Bea and **Karsten Kühnle** participated at the Dealsourcing2022, one of the biggest network events in the corporate finance community. NRF was also a sponsor of the event.

2022 Central District of California Judicial Conference

November 3, 2022
Rebecca Winthrop was a featured speaker on the US Supreme Court's latest decision on the standard for appellate review at the US Bankruptcy Court Central District of California Board of Judges Meeting and Annual Conference.

SARIPA National Conference

November 10, 2022
Scott Atkins delivered the keynote address at the Annual Conference for the South African Restructuring and Insolvency Practitioners Association (SARIPA), the peak insolvency association in South Africa. The Conference was attended by over 300 delegates. Scott spoke on the economic challenges currently facing South Africa, the disruptive trends shaping the insolvency profession, and the opportunity for restructuring and insolvency law and policy reform to underpin future economic and financial stability in the African region.

Asia Pacific Loan Market Australia (APLMA) Conference

November 15, 2022
Laura Johns participated on a panel exploring the impact of an economic downturn on the loan markets at the APLMA Loan Market Conference.

Singapore Global Restructuring Initiative (SGRI) Inaugural Conference

November 14–15, 2022
Scott Atkins spoke on a panel on the use of alternative dispute resolution (ADR) to support more efficient insolvency processes and more effective informal and formal restructuring outcomes for distressed entities at the SGRI's Inaugural Conference. The Conference explored the latest trends and developments in cross-border insolvency and was attended by well-known judges, lawyers and academics from around the world.

Grant Thornton Bankers Boot Camp

November 2022
Less Pascoe (Sydney), Alex Mufford (Sydney), Natasha Toholka (Melbourne) and **Kellie Link (Perth)** participated in a national series of events focused on the key industries driving the Australian economy. Each participant shared their views on the short to medium term outlook for bank customers operating in the Australian restructuring market.

Securitization Insight Podcast

December 2022
Eric Daucher joined host **Patrick Dolan** where they discussed the FTX bankruptcy filing and alleged fraud in the crypto industry on Norton Rose Fulbright's *Securitization Insight* podcast.

ABA Forum on Air and Space Law

December 8, 2022
David Rosenzweig teamed up with Doug Walker of Seabury Capital Group on a panel at the annual ABA Forum on Air and Space Law concerning lessons learned and re-learned in the COVID -19 era aviation restructuring cases.

Conference on Strengthening Insolvency Systems in Asia and the Pacific – Manila

December 15-16, 2022
Scott Atkins and **John Martin** participated in panel sessions as part of this Conference, jointly hosted by the Asian Development Bank, INSOL International, Singapore Management University, the Singapore Global Restructuring Initiative, the University of Chicago Law School's Centre on Law and Finance and the University of Cambridge's Centre for Corporate and Commercial Law.

Scott spoke on panels which explored strategies to effectively promote workouts and the design of best practice formal and informal restructuring processes. John chaired a panel on the regulation of insolvency practitioners and spoke on a panel which examined approaches to insolvency processes for micro, small and medium sized enterprises (MSMEs).

A Construction Webinar Series

February 2, 2023
Norton Rose Fulbright will host a webinar featuring **David Barksdale (Real Estate), Jason Boland (Restructuring), Tim Walsh (Construction),** and **Luke Maher (Construction)** who will discuss the looming potential for recession-caused troubled projects and assets and how to guard against and mitigate such problems.

Annual Review of Insolvency Law

February 2023
Jennifer Stam will be a speaker at the the Annual Review of Insolvency Law in Calgary in February. She is also co-author of a paper entitled "Putting it in Reverse: A Possible Path to US Chapter 15 Recognition of Reverse Vesting Orders and Cannabis Filings" which will be published in connection with the conference.

Law Society of Singapore

Kei-Jin Chew has been conferred with this year's C C Tan Award by the Law Society of Singapore. This is the highest award presented by the Law Society and recognises the recipient's virtues of honesty, fair play and personal integrity.

German Lawyers Association

Sylwia Maria Bea was nominated as "Lawyer of the Year" for 2023 by the German Lawyers Association (Section on Restructuring & Insolvency Law). This is newly established award initiated by the Association.

Turnaround Management Association

Jennifer Stam joined the Board of Trustees of Turnaround Management Association (Global) effective January 1, 2023. The TMA is the most professionally diverse organization in the corporate restructuring, renewal, and corporate health space. Established in 1988, TMA has almost 10,000 members in 54 chapters worldwide, including 34 North American chapters.

International Insolvency Institute - NextGen Amsterdam Conference Committee

The Annual Conference of International Insolvency Institute (III) will take place in Amsterdam in 2023. **Prof. Omar Salah** is one of the CoChairs of the III NextGen Organizing Committee.

Law360

David Rosenzweig co-authored an article with Doug Walker of Seabury Capital Group for *Law 360* entitled "Lessons Learned from Pandemic- Era Aviation Co. Restructurings" published on December 22, 2022.

M&A Community

Prof. Omar Salah was featured in an article by *M&A Community*. In the interview, he discusses the Dutch pre-pack, recent EU case law in this respect and future legislation. He also calls upon the Dutch legislature to introduce the pre-pack in Dutch insolvency law soon.

Global Restructuring Review

Sylwia Maria Bea and Omar Salah were quoted among other top restructuring professionals in an article in the December 8, 2022 edition of the GRR on the proposal of a new EU-directive on harmonization of European insolvency law regimes.

South Square Digest

Scott Atkins co-authored an article, "The Interests of Creditors in the Zone of Insolvency", with Felicity Toube KC and Hilary Stonefrost, which was published in the *South Square Digest* on November 22, 2022. The article examines the implications for director liability in the United Kingdom and Australia following the landmark decision of the UK Supreme Court in *Sequana*.

Mr. Magazine

Prof. Omar Salah was interviewed about his practice at Norton Rose Fulbright and his academic work at Tilburg University by *Mr. Magazine*, a leading law journal in the Netherlands. The interview also focused on his professional career, his personal life and the feature of insolvency law in the Netherlands.

United Nations Working Group V 61st Session – Vienna

December 16, 2022

Scott Atkins spoke on an expert panel in Vienna to commemorate the 25th anniversary of the introduction of the UNCITRAL Model Law on Cross Border Insolvency. The panel was held as part of the 61st Session of the United Nations Working Group V on Insolvency Law, which Scott attended in his capacity as an Australian representative to Working Group V appointed by the Australian Attorney General.

This was a high-profile event which was broadcast globally. It provided an opportunity to reflect on the significant contribution the Model Law has made to achieving more efficient, cost-effective cross-border restructuring and insolvency processes through consistent recognition and cooperation protocols. The panel also discussed the continued challenges in cross-border restructuring and insolvency matters, and the potential for greater coordination and harmonisation through the new Model Law frameworks on enterprise groups and the recognition of insolvency-related judgments, as well as the use of ADR.

Ten reasons to restructure under Canada's *Companies' Creditors Arrangement Act*

Jennifer Stam and Meghan Parker

Cross-border filings between the United States and Canada have been common place for many years and parties are fortunate that Canadian and US courts share a respectful, cooperative and deferential approach to one another. Even prior to the adoption of the UNCITRAL Model Law by the United States in 2005 and Canada in 2009, options for foreign recognition proceedings were available in both countries.

Debtors and creditors are often faced with gating decisions as to the appropriate forum(s) for cross-border filings and there often many good reasons to consider a chapter 11 filing with a Canadian ancillary proceeding. Although the general factors that determine COMI, or the centre of main interest, often drive the analysis, it is also important to consider some of the substantive legal remedies available under each respective statute when deciding where to file a main proceeding versus an ancillary proceeding.

Chapter 11 certainly gets its fair share of restructurings and remains a very popular venue for distressed enterprises. However, Canada's CCAA also offers a viable path that can be beneficial to debtors and creditors. In fact, chapter 11 and the CCAA share many "big picture" attributes and both are intended to allow distressed companies to restructure their debt. That said, there are also some key and positive differences that the CCAA offers. Below, we set out ten reasons why a main proceeding under the CCAA in Canada may be advantageous:

1. *Third Party Stays*: The initial stay granted generally includes all of the debtors and their property as well as directors and officers. Stays of proceedings under the CCAA can also extend to third parties (with certain limitations, such as guarantee actions) – such as a debtor's non-insolvent affiliates or in respect of third party litigation. CCAA courts have broad discretion to grant stays and have frequently extended stays to third parties where doing so supports the restructuring process.
2. *Third Party Releases*. The CCAA jurisprudence on the availability of third party releases is well developed, with Canadian courts disposed to grant broad releases. There is a noted history of chapter 15 courts recognizing the granting of third party releases where such releases may not have been available in a chapter 11 . This is in distinction to the challenges that third-party releases have faced in chapter 11 cases, including several recent decisions in which such releases were rejected by US courts.
3. *Appointment of a Monitor*. The existence of the court-appointed monitor in a CCAA case is generally seen to be a significant benefit to debtors that undergo a restructuring. The Monitor (a qualified trustee in bankruptcy) is an officer of the court and oversees the restructuring but works closely with the debtor to assist in the restructuring. The Monitor's written recommendation is highly persuasive with the court and, other than in the Province of Quebec, the Monitor is rarely able to be cross-examined on its reports.
4. *Fewer Committees*. There are rarely official court approved or appointed unsecured committees in CCAA proceedings, and with no automatic requirement for an official unsecured creditors' committee, the result is often an economically more efficient restructuring.
5. *The "RVO"*. We have written in past issues about "reverse vesting orders". The availability of the "reverse vesting order" (or RVO) in applicable cases is a critical tool in Canadian restructuring cases. Under the RVO, instead of vesting good assets out into a newco or to a purchaser, the unwanted assets and liabilities of a debtor are vested out into a "residualco", leaving the clean assets behind to the debtor and allowing it to emerge from the CCAA through an equity acquisition without a creditor vote under a plan. The transaction is approved by the court and thus protected from challenge. Recently, the recognition of an RVO was granted by the United States Bankruptcy Court for the Southern District of Texas in the chapter 15 proceedings of *re Just Energy Group Inc.* [Case No. 21-30823].
6. *Structurally Less Adversarial*. Other than in the Province of Quebec, live witness testimony is seldom offered in court hearings and most evidence, even in contested matters,

is submitted in writing. Extensive cross-examination and discovery on specific motions relating to the restructuring itself is also minimized given, among other things, the role and voice of the Monitor in the proceeding. The voidable and fraudulent preferences mechanisms under the CCAA are also generally less expansive and more targeted.

7. *Cost & Time Efficiency*: CCAA proceedings are often more cost effective and shorter in part given the overall fewer court filings, less direct noticing/mailings required, fewer objections and adversarial motions and oversight by the Monitor.
8. *Flexible time limits*. The CCAA has no prescribed timelines for filing a plan.
9. *Court Ordered Charges*. Charges under the CCAA are available for interim lenders and key employee retention (or incentive) plans, and the evidentiary case for securing such charges tends to be less rigorous than for equivalent charges under chapter 11. The CCAA-restructuring company can also secure a charge in favour of directors and officers to secure compensation for liability claims, which is unique to the Canadian restructuring regime. The rules for assuming and rejecting contracts under the CCAA are less strict.
10. *Cannabis-specific Restructurings Permitted*. Cannabis companies can be restructured under the CCAA, including with respect to US operators with Canadian parent companies.

The above factors are some of many "arrows in the quiver" to aid in corporate restructuring under Canada's CCAA. While there are many factors that will be considered when deciding if, when and where restructuring proceedings will be commenced, we hope that the factors above will assist parties in understanding some of the ways in which the CCAA is a favorable venue and can be beneficial to achieving a restructuring.

Jennifer Stam is a partner in our Toronto office and Meghan Parker is an associate in our Ottawa office. Both are in the firm's restructuring group.

Riding or breaking the wave – Is Germany's crisis legislation more than good intentions?

Dr. Sylwia Maria Bea, Florian Rieser (Head of Restructuring, KPMG Munich), David J. Schrader, Lorenz Scholtis

It has been three years since the pandemic began to tighten its grip on the global economy, marking the onset of an unsparing sequence of disruptions that left certain global markets in shambles. Economists, legislators, journalists and restructuring professionals alike seemed to have engaged in fierce competition over the '*Nostradamus of the year*'–trophy, proclaiming week after week the imminent arrival of the infamous "insolvency wave" – which never happened in Germany. Even though the warning '*this time it's different!*' seems to have lost its potency entirely, a recent uptick in German insolvency filings indicates that it very well may be different this time. While the fact that none of the sombre prophecies have materialized sooner is likely to be equally attributed to the profound legislative countermeasures on one hand and the self-regulating capacities of the markets on the other, lawmakers in Berlin have left nothing to chance. Germany ramped up its crisis legislation once again before heading into the winter months with a large question mark over central Europe's energy dilemma and with lingering distress in supply chains and the skilled labour market. The result is another patchwork solution bill with – as German tradition commands – a rather cumbersome title: "*Sanierungs- und insolvenzrechtliches Krisenfolgenabmilderungsgesetz*" (SanInsKG), which is of course merely the short form of "*Gesetz zur vorübergehenden Anpassung sanierungs- und insolvenzrechtlicher Vorschriften zur Abmilderung von Krisenfolgen*"[1], which replaces its predecessor with an even more melodious name, the "*Gesetz zur vorübergehenden Aussetzung der Insolvenzantragspflicht und zur Begrenzung der Organhaftung bei einer durch die COVID-19-Pandemie bedingten Insolvenz*"[2] or for short: "*COVID-19-Insolvenzaussetzungsgesetz*" (COVInsAG). Let that sink in.

While the COVInsAG – which primarily implemented a partial suspension of directors' duties to file for insolvency – was widely considered to be an appropriate reaction to the initial impact of the COVID-19 pandemic, the recently enacted SanInsKG received mixed reactions among restructuring professionals. We take a closer look at these new regulations and assess whether they will materially assist companies that are facing the potential of a global recession.

Core of the new legislation

The SanInsKG did not come as a brand new bill, but rather in form of various changes to the existing COVInsAG - along with a name change. The name change was merely a reflection of the fact that the original title no longer appropriately depicted the legislators' current reasoning and intent behind the provisions. Unlike its predecessor, the SanInsKG does not include another suspension of the duty to file for insolvency when a company becomes illiquid (*zahlungsunfähig*) or over-indebted (überschuldet). Rather, the new SanInsKG choses a different approach in order to counteract the noticeable increase[3] in insolvency filings with the German local courts (*Amtsgerichte*), which serve as dedicated courts for insolvency and restructuring proceedings.

For the period from **9 November 2022 until 31 December 2023**, the SanInsKG modifies the dedicated time frames for financial forecasts required in connection with the commencement of proceedings under the German Insolvency Code (*Insolvenzordnung* – **InsO**) and the German Restructuring Act (*Stabilisierungs- und Restrukturierungsgesetz* - **StaRUG**). The modifications come in the form of significant shortenings of relevant forecast

1 Act for the temporary adaption of insolvency- and restructuring law provisions for mitigation of effects of crisis.
2 Act for the temporary suspension of the duty to file for insolvency and for the limitation of managers' liability in the event of insolvency caused by the COVID 19-pandemic.
3 +18% in August 2021.

periods and thus reflect the rather limited capacities currently of managers and directors to reliably make assumptions relating to the financial prospects of their businesses. The shorter forecast periods enable companies to focus their outlook on what they can - to an extent - plausibly predict. While uncertainty is the inherent flaw of any forecast, lawmakers acknowledge that this holds true all the more in times of exploding energy prices, currency devaluation and impaired supply chains.

Specifically, the modifications to the forecast periods made by the SanInsKG are as follows:

- The length of the period for the going-concern forecast as part of the over-indebtedness test is shortened from **12 months** to only **4 months**
- The forecast period for a positive finance (cash flow) plan required for a petition to enter into debtor-in-possession insolvency proceedings (*Eigenverwaltungsplanung*) is shortened from **6 months** to **4 months**
- The forecast period for a positive finance (cash flow) plan required for a petition for a moratorium under the StaRUG (*Restrukturierungsplanung*) is shortened from **6 months** to **4 months**

On top of that, the SanInsKG grants businesses, which have already entered over-indebtedness, more time to coordinate their restructuring efforts:

- In the event of over-indebtedness, the period within which directors must file for insolvency is extended from **6 weeks** to **8 weeks**

As a consequence, companies are given an additional two weeks in which they can – theoretically – engage and align with their stakeholders and advisors to adequately approach the situation or find other solutions to resolve the over-indebtedness.

It is noteworthy however that in the event of illiquidity (*Zahlungsunfähigkeit*) – the other and by far most prominent reason for insolvency under German law – things remain as they were. Likewise, the parameters under which to conduct the liquidity forecast within the test for imminent illiquidity (*drohende Zahlungsunfähigkeit*) remain untouched by the SanInsKG. Imminent illiquidity does not trigger a duty to file for insolvency. However, it allows companies to optionally file for either insolvency proceedings, preferably in debtor-in-possession proceedings, or utilize the tools of the *StaRUG restructuring framework* at their earliest convenience. A concept that has proven to be a key factor for preventive, effective refinancings and reorganisations.

Over-indebtedness – a never ending story

Years of declining borrowing costs led to increased borrowings and often heavy over-leveraging, thus leaving many companies in a constant state of balance sheet over-indebtedness, where the value of their assets at liquidation valuation do not cover their liabilities. From the perspective of German insolvency law, this already checks one of the two boxes of the over-indebtedness test according to Sec. 19 InsO and – at least in theory – has one foot out the door on the way to the insolvency court. However, the second box to be checked is the absence of a positive going-concern forecast (*Fortführungsprognose*), which in practice features a cash flow-based prognosis of the probability of a company becoming illiquid within the next 24 months. Hence, insolvency under the premise of over-indebtedness requires balance sheet over-indebtedness *and* a negative going-concern forecast.

While restructuring lawyers and researchers may insist to the contrary, auditors and financial advisors have acknowledged for years that – at least in practice – there is no material distinction between the going-concern forecast within the scope of the over-indebtedness test and the liquidity forecast within the test for imminent illiquidity. Take it from the German Institute of Auditors (IDW) and its 'Gold Standard' IDW S 11 principles: The planning methodology is identical[4]. On a side note, certified auditors must use — and other advisors and consultants broadly and willingly opt to use — the IDW S 11, as the principles specified therein have proven over many years to be practical and are constantly updated to reflect the most recent financial learning on this matter. Using "S 11" is playing the safe card for a company's management and board.

Meanwhile, even the legislator has discerned, that in times when virtually all businesses are balance sheet over-indebted, imminent illiquidity (Sec. 18) and over-indebtedness (Sec. 19 InsO) have become indistinguishable, and therefore grounding decisions based on purported differences between these two symptoms are impractical for business operators as well as insolvency professionals. The expectations were high when the draft bill for the further development of German insolvency and restructuring law (*SanInsFOG*[5]) was launched in late 2020. Apart from the implementation of the StaRUG framework, many restructuring professionals anticipated that it would entail the eventual abolishment of over-indebtedness as a mandatory ground for insolvency filing.

All the greater was the disenchantment, when it turned out that the over-indebtedness test remained in place. From 2021, the formerly identical[6] prognosis periods for the going-concern forecast and the illiquidity forecast have been dissected. The illiquidity forecast must cover the coming 24 months, whereas the going-concern forecast must generally span only the coming 12 months – not considering the SanInsKG modifications. This legislative masterpiece, however, cannot change the fact that, after all, a petition to file for insolvency solely based on over-indebtedness remains a mythical creature: often spoken about, never seen by anyone. With remarkable consistency, years of ex-post evaluations by insolvency administrators and insolvency forensic experts have yielded the result that – even when the debtor bases its insolvency filing on over-indebtedness - there are virtually no cases of over-indebtedness without the concurrent presence of illiquidity as well.

4 IDW S 11, 23 Aug. 2021, recital 95 and Draft IDW S 11, 27 Sept. 2022, recital 98.
5 The last one for today: *"Gesetz zur Fortentwicklung des Sanierungs- und Insolvenzrechts".*
6 Formerly, both entailed a forecast of the running and the following financial year, hence 1-2 years.

The softening of over-indebtedness alone as a trigger for insolvency filing is unlikely to break the wave

Can we conclude from this that over-indebtedness is, in fact, irrelevant for anything but serving the intents and purposes of insolvency administrators when pursuing claw back claims? Well, the answer to that question shall be left to everyone's own verdict. As for the time being, over-indebtedness is here to stay. However, as restructuring practitioners, we do have to pose the question whether or not the shortening of the prognosis period of a mandatory ground for an insolvency filing, which in practice is a mere shadow of the mighty juridical theory it adheres to, can actually provide a benefit for businesses in peril.

The majority of market participants affected by the current crisis catalysts – the production industry, supply chain dependents and energy intensive businesses – face urgent liquidity shortages; hence, insolvency by illiquidity (Sec. 17 InsO) by far is the more imminent threat. The illiquidity test requires that based on a rolling 13-week liquidity forecast, a company is not able to fulfil its outstanding liabilities within the following three weeks. The SanInsKG does not provide any relief in that regard. In contrast to the government's response to the COVID-Pandemic, large scale direct or state backed financial aids are not part of the current governmental strategy. However, small and medium sized enterprises may at least benefit from the so-called *"Gaspreisbremse"*, a mechanism to implement price caps for natural gas under certain circumstances.

Where businesses struggle to maintain the necessary liquidity to operate, four months seems like an awful long time to present a reliable financial forecast. The law generally expects business leaders to monitor projected cash-flows for the next 24 months at all times.[7] A requirement rarely complied with. Even if businesses identify liquidity deficits some months down the road – with no feasible plan to remedy those – they are scarcely inclined to take a walk to the insolvency court right away and claim over-indebtedness due to the lack of a negative going-concern prognosis. At that point, directors and shareholders frequently begin to evaluate options to make a continuation of business at least 'predominantly probable' (see Sec. 18 para. 2 InsO). The virtual lack of insolvency petitions based on over-indebtedness not only indicates this observation to be true, but suggests that these efforts are, in most instances, carried above and beyond the threshold of six weeks, after which an insolvency petition must be filed in the event of over-indebtedness outside of the scope of the SanInsKG. When considering that this phenomenon has been observed for years, even outside of times of universal recession, it should dawn on us that it certainly will not change now, due only to the further shortening of the prognosis period. In other words, if the average director refuses to file for insolvency due to over-indebtedness in spite of civil and criminal liability risks under normal circumstances, the shortened prognosis period of the SanInsKG won't convince them otherwise.

Taking the sole perspective of the 'average director' of any small or medium sized business might seem like a gross oversimplification in order to make this argument, and it may also disregard the many business leaders that are very aware of the risks associated with a failure to file for insolvency in due course. Point taken. However, when speaking about the lawmakers' aim to prevent the much proclaimed 'wave of insolvencies' and to mitigate the consequences of crisis factors on the national economy, these diligent business leaders are not exactly the reference group by which to cast a verdict on the quality of the legislation. It is self-evident that – fortunately – a large fraction of businesses are becoming increasingly sensitized to restructuring and distress prevention related issues and – again, fortunately – we can observe a widespread professionalization of crisis management in businesses. But there is a whole other argument to be made in this regard: businesses possessing sufficient capacity and awareness to engage into early stage, preventive restructuring measures will likely not find themselves in a situation where the shortening of the prognosis period for over-indebtedness serves their ability to avoid insolvency. Those businesses frequently work with cash-flow projections much longer than four months and are far more prone to utilize the various in- and out-of-court restructuring tools available to them. Namely the tools under the StaRUG framework, e.g. a court ordered moratorium (*Stabilisierungsanordnung*) or the implementation of a restructuring plan, or the tools made available by the InsO, e.g. debtor-in-possession insolvency proceedings (*Eigenverwaltung*), potentially in connection with an insolvency plan (*Insolvenzplan*). All of these tools can be utilized at a sufficiently early stage, in particular, when the business is imminently illiquid (Sec. 18 InsO), and thus as soon as an argument can be made that, within the next 24 months, the continuation of the business is not 'predominantly probable.' As a result, the reasoning behind softening the over-indebtedness test becomes even less convincing.

7 Hence, the 24 month liquidity forecast within the imminent illiquidity test in conjunction with every director's duty to constantly monitor developments which could threaten the continuation of business, see Sec. 1 StaRUG.

Can we expect some benefits from the remaining SanInsKG provisions?

In light of their negligible value, the shortening of the prognosis period provides for businesses in distress and the effects of the extension of the period by which directors must file for insolvency from six weeks to eight weeks are equally underwhelming. As no significant increase in insolvency petitions based solely on over-indebtedness is to be expected, directors now have been granted an extension of a deadline, which most did not have much concern for to begin with. Besides, whether 'unpredictable developments' actually provides a sound reasoning to further prolong the period in which to file for insolvency is doubtful to say the least.

In spite of all that, from the perspective of restructuring advisors, the shorter prognosis period for over-indebtedness must not be disregarded. Over-indebtedness, irrespective of the criticism, remains hard, positive law. Consequently, when advising companies in distress, the shortened prognosis period is an essential parameter in the assessment of the going-concern prognosis, as it can provide comfort in regard to more distant liquidity threats. Notwithstanding the SanInsKG provisions, the prognosis period in fact may remain longer for other purposes, in particular in order to obtain an unqualified audit opinion for financial statements. In that regard the management is still required to prove that the company will remain liquid for at least twelve months from the date of the audit opinion.

The provisions to shorten the prognosis period for the finance (cash flow) plans required, for either a petition to enter into debtor-in-possession insolvency proceedings or for a moratorium under the StaRUG from six months to four months, may turn out to be rather helpful. When applying for the aforementioned restructuring tools, the respective forecasts have to be submitted directly to the relevant restructuring or insolvency court. Hence, the finance plans indeed must be comprehensible and sufficiently reliable in order to convince the court to approve the proposed restructuring instrument. As mentioned above, four months can already be shockingly long. Consequently, a forecast spanning six months would likely require the debtor to come up with pages of unsubstantiated prose grounded on bold assumptions. By shortening the prognosis period, the courts are at least spared the dubious pleasure of reading through lengthy and inherently subjective predictions of future events. If this helps a few businesses to successfully enter into fruitful restructuring proceedings, we should consider this a victory.

Conclusion

Whatever height the wave of insolvencies may reach, just like every wave, it may eventually break or fade before it meets the shoreline. In either case, the recent amendments to the German crisis legislation alone are unlikely to serve as an effective breakwater, but rather as balm to the troubled minds of legislators concerned in the face of an unforeseeable general crisis. The facts are that whether or not a business manages to 'ride the wave', and thus proceed to thrive long after the waters have settled, will largely depend on three factors. The ability to rethink and adapt an existing business model, the confidence to approach shareholders and financial backers at the earliest possible stage and the foresight to partner with competent advisors to help navigate through these rough waters. No legislation can meaningfully accomplish that.

Sylwia Maria Bea is a partner in our Frankfurt office in the firm's restructuring group. Florian Rieser is Head of Restructuring at KPMG Munich. David Schrader is counsel and Lorenz Scholtis is an associate in our Frankfurt office in the firm's restructuring group.

Make-whole provisions: Impact of the *Hertz* and *Ultra Petroleum* decisions in US chapter 11 cases

Julie Harrison and Mitchell Benson

Make-whole clauses are pervasive in high-yield financings and are designed to protect the anticipated interest-rate yield that lenders bargain for when extending credit over a specified term (or a part of such term). These clauses provide protection by compensating lenders for interest payments lost on debt redeemed or prepaid before the stated maturity date. The compensation is usually in the form of a lump-sum premium that is paid by the borrower upon an early redemption or prepayment.

Arguments in US chapter 11 cases over the propriety of make-whole provisions are nothing new, but two recent decisions in the *Hertz* and *Ultra Petroleum* chapter 11 cases have cast doubt on the enforceability of these provisions against bankrupt entities. *See Wells Fargo Bank N.A. v. The Hertz Corp. (In re The Hertz Corp.)*, Case No. 1:21-ap-50995, Dkt. No. 71 (Bankr. D. Del. Nov. 21, 2022); *In re Ultra Petroleum Corp.*, 51 F. 4th 138 (5th Cir. 2022). In November 2022, a Delaware bankruptcy judge presiding over the *Hertz* case ruled that the make-whole premium was statutorily disallowed as "unmatured interest" under the US Bankruptcy Code. Similarly, in October 2022, the Fifth Circuit Court of Appeals in *Ultra Petroleum* found that claims rooted in make-whole provisions can be disallowed as "unmatured interest" in a bankruptcy proceeding of an insolvent debtor.[1] The decisions in *Hertz* and *Ultra Petroleum* point to a bankruptcy system that is increasingly hostile toward make-whole provisions.

A brief history of make-whole provisions in chapter 11 cases

Prior chapter 11 cases involving allowance of make whole provisions focused on a contractual interpretation of the loan agreement. These cases, including cases out of the Second and Third Circuit Courts of Appeal, resulted in conflicting decisions concerning the validity of make-whole provisions, with a focus on specific contract terms rather than the import of the US Bankruptcy Code. In the *Momentive* and *AMR* cases, for example, the Second Circuit found that the make-wholes were not payable under the contract terms where the debtors' bankruptcy filings triggered defaults that automatically accelerated the debt, preventing an optional note redemption under the contracts. *See, e.g.*, *Momentive Performance Materials Inv. v. BOKF, N.A. (In re MPM Silicones, LLC)*, 874 F.3d 787 (2d Cir. 2017); *US Bank Trust Nat'l Ass'n v. AMR Corp. (In re AMR Corp.)*, 730 F.3d 88 (2d Cir. 2013). By contrast, the Third Circuit in the *EFH* case held that the debtor made an optional redemption under the contractual language by refinancing, rather than reinstating, the notes, therefore triggering the make-whole provision. *See In re Energy Future Holdings Corp.*, 842 F.3d 247, 251 (3d Cir. 2016). While addressing enforceability of make-whole provisions pursuant to the terms of the relevant contracts, none of these cases evaluated allowance under the US Bankruptcy Code.

Recent chapter 11 decisions disallowing make-whole premiums

In *Ultra Petroleum*, the Fifth Circuit took a different approach, first considering whether the make-whole premium was the "economic equivalent" of "unmatured interest," which is disallowed by section 502 of the US Bankruptcy Code. In determining that it was, the Fifth Circuit commented that the make-whole provision at issue was "*both* liquidated damages *and* the 'economic equivalent of unmatured interest"—as the very purpose of the make-whole provision is to "liquidate fixed-rate lenders' damages" resulting from a default. The Fifth Circuit therefore held that make-whole premiums are unenforceable in an ordinary case against an insolvent debtor. In conducting its analysis under the US Bankruptcy Code, the Fifth Circuit was the first appellate level court to directly assert the invalidity of make-whole provisions on the grounds

1 The Fifth Circuit, however, required the debtor to pay the make-whole premium under the solvent-debtor exception, as discussed below.

that the premium constitutes unmatured interest that is not allowed under the US Bankruptcy Code.[2]

The Delaware bankruptcy court in the *Hertz* case reached the same decision as the Fifth Circuit after evaluating the "economic substance" of the make-whole provision, rather than the "formalistic labels or dictionary definitions of the terms used." The Delaware bankruptcy court, noting that its decision was fact-intensive and not controlling in all circumstances, found that the make-whole provision was the "equivalent of unmatured interest" and, therefore, not allowable against Hertz under the US Bankruptcy Code. However, the Delaware bankruptcy court agreed to certify an appeal of its decision directly to the Third Circuit, so the effect of this ruling remains uncertain during the pendency of that appeal.

2 The Fifth Circuit's decision in the *Ultra Petroleum* case is significant not just for its finding that the make-whole premium is disallowable unmatured interest, but also that Ultra nevertheless was required to pay the make-whole premium due to the fact that Ultra was solvent. In a typical case involving insolvent debtors (as is usual in chapter 11 cases), the Fifth Circuit's analysis would have been complete after finding the make-whole provision was disallowable unmatured interest. However, because Ultra regained solvency during the bankruptcy cases (due to rising natural gas prices), the Fifth Circuit next looked to the "solvent-debtor exception," a pre-Bankruptcy Code doctrine requiring a debtor to pay its creditors contractual interest on unpaid obligations if it is able. In construing "traditional bankruptcy practice" against the codification of the US Bankruptcy Code, the Fifth Circuit ultimately determined that the solvent-debtor exception is alive and well, a holding consistent with the Ninth Circuit's August 2022 holding in *PG&E Corp. See In re PG&E Corp.*, 46 F. 4th 1047, 1054 (9th Cir. 2022). In then evaluating New York contract law, the Fifth Circuit held that Ultra had a contractual obligation to pay the make-whole premium and the premium was not an unenforceable penalty under New York law. Thus, the solvent-debtor exception allowed for the payment of the make-whole premium against Ultra, despite the Fifth Circuit's characterization of it as an unmatured interest.

Practical effects and possible solutions

The material sums that make-whole provisions protect (over $200 million in both *Hertz* and *Ultra Petroleum*), combined with their ubiquity, means that uncertainty regarding the validity of make-whole provisions in chapter 11 cases could significantly impact lending practices, particularly if other courts begin to follow the *Hertz* and *Ultra Petroleum* decisions.

Debtors and lenders would be wise to evaluate jurisdictional differences when considering where a chapter 11 case may be filed. Well advised insolvent-debtors will choose to file for bankruptcy in jurisdictions that disallow make-whole provisions. Concentrating bankruptcy proceedings in jurisdictions that disallow make-whole provisions will lead to smaller recoveries for high-yield lenders when the debtors they lend to become insolvent.

It is important to note that make-whole provisions continue to be enforceable and valuable tools when bonds with a call option or similar feature are called before maturity. Thus, make-whole provisions are unlikely to see diminished use any time soon. The issue becomes how to prepare lenders and fixed-rate investors for the impact of the disallowance of make-whole provisions. Lenders could, for example, price-in the risk of a bankruptcy court disallowing the recovery of a make-whole premium, raising the cost of credit for high-yield capital users. Lenders might use probability of insolvency to calculate precise interest rate adjustments for each borrower, but a more likely outcome is across the board increases in rates for high-yield borrowers.

Alternatively, an insurance-like product might represent a more attractive solution if the market can be coaxed into offering it. Third parties could step in and insure against make-whole disallowance risk. The debtor would pay a premium upfront to cover the cost of insurance, and the lender would be protected in the event of an insolvent-debtor bankruptcy in a jurisdiction that disallows make-whole provisions. Lenders would seek make-whole premiums directly from the insurer rather than the debtor or seek payment of compensation if the premium is disallowed. This solution offers two distinct advantages to raising rates across the board to compensate for the risk of disallowance. First, an insurer could tailor the cost of its product to the unique risk profile that each debtor presents. This would allow for more competitive pricing of loans. Second, this solution would limit the impact of bankruptcy courts on high yield financing. Lenders and fixed rate investors would no longer be subject to as much uncertainty with respect to bankruptcy courts and make-whole provisions. The question is whether financial markets will provide a product like this.

Stay tuned for further case law on this important topic and potential market reactions.

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Directors’ liability under French insolvency law and tools to prevent it

Guillaume Rudelle

Directors of French companies can be exposed to personal liability in connection with insolvency proceedings pursuant to an ancient and relatively strict legal regime. Recent case law developments, however, show that this legal regime is mostly applied with a view to incenting directors to address difficulties as soon as possible, in line with the objectives of the French and European legislatures.

Historical legal framework

Directors of French companies are subject to a string of obligations and potential liability whenever their companies face financial difficulties.

First and foremost is the obligation to file for insolvency proceedings within 45 days of the occurrence of the so-called suspension of payments.[1] Failing to file for insolvency within this deadline can result in liability for directors, including damages[2] and injunctions prohibiting them from serving as directors or managing companies.[3]

This obligation is sometimes difficult to meet because of the definition of the “suspension of payments.” It corresponds to cash flow insolvency, i.e., the inability to repay debts as they fall due with available assets. This is somewhat a subjective matter. Indeed, whenever a company has both large receivables and trade debt, it may be particularly tricky to determine the extent of available assets and the due and payable debts at any given time.

Depending on how strictly this obligation to file a proceeding is interpreted, it could potentially result in systemic director liability in periods of crisis. At the outset of the COVID-19 pandemic, this issue was acknowledged by the French legislature, which relieved directors from their obligation to file for insolvency after the first lockdown.[4] The obligation has since then been fully reinstated.

Common directors’ duties are also worth mentioning as they may lead to liability in the event that management wrongdoing causes a liquidation. The law is particularly focused on accounting, inventory of the company’s assets, and high-risk transactions (that may in hindsight be seen as potentially ruinous).

Finally, once an insolvency proceeding (not liquidation) is commenced, the directors will remain in charge of the company under the supervision of the administrator and bankruptcy judge appointed by the court. This leads to a series of additional and new obligations, including the prohibition on paying pre-petition debts, entering into certain transactions for which prior judicial authorization is required, and agreeing claims on behalf of creditors.[5]

Failures to respect those obligations can entail different types of liability and sanctions.

Civil liability, including a judgment to compensate for the shortfall of assets at the end of the liquidation, can be incurred by directors who have committed mismanagement that caused the insolvency.[6] It should be noted that, since 2016, mere negligence is not sufficient to tag directors with civil liability.[7] As revealed by the legislative debate when this change was introduced into the law, this exclusion was meant as a favor to directors, affirming a “right to make mistakes.”

Criminal prosecution and administrative sanctions (in particular the prohibition to hold a directorship position) are also at stake when directors’ duties have not been properly performed,[8] although those types of sanctions are reserved for serious wrongdoing and fraudulent behavior.

1 Article L.631-4 of the French Commercial Code
2 Cour de cassation, commercial chamber, 5 February 2020, no. 18-15.062
3 Article L.653-8 of the French Commercial Code
4 Article 1 of Ordinance no. 2020-341 dated 27 March 2020
5 Article L.654-8 of the French Commercial Code
6 Article L.651-2 of the French Commercial Code
7 Article 48 of Law no. 2016-1691 dated 9 December 2016
8 Articles L.653-5 and L.654-2 of the French Commercial Code

However, it should be noted that certain sanctions have been removed from French law over time, in particular claims against directors to recover corporate debt[9] or ordering their personal bankruptcy.[10]

Those possible grounds for liability are similarly available against either registered or *de facto* directors and can even target companies holding a director's position when authorized by the law.

While the historically severe legal regime for directors' liability has evolved to align with a more relaxed global framework, it is important to note recent developments in case law, which show that directors are still under pressure when their companies face difficulties and must therefore be very diligent and quick to react in order to manage their risk.

Recent case law: pressure on directors remains high

Court decisions rendered over the past three years show that litigation against directors following an insolvent liquidation continue to generate an important flow of cases and that judges are working to find a balanced approach to distinguish between mere negligence and willful mismanagement.

One of the main insights is that judges are not obliged to base their decisions on a purely arithmetic approach as to profits and losses . For instance, abusively pursuing a loss-making activity has been recognized as willful mismanagement even if the company had some profitable years over a considered period of time[11] and regardless of the fact that the company may not have been in suspension of payments.[12] Generally, directors were found liable because they had not taken any steps to turn the situation around after the difficulties began.

This approach could cause issues for enterprises pursuing an activity despite suffering losses, even if the losses are eventually covered by shareholders loans. Should a French subsidiary end up in liquidation, the directors could still be at risk for pursuing a loss-making activity with an abnormal use of intragroup indebtedness.

With regard to the failure to comply with the obligation to file for insolvency within the 45 days of the suspension of payments, France's highest court seems to have established a construct that breaks free from automatically sanctioning directors for failing to initiate insolvency proceedings within 45 days of the suspension of payments.

It has indeed recognized in two different cases (with opposite outcomes) that knowledge by the director of the existence of the suspension of payments was irrelevant:

- The fact that the director knew about the suspension of payments but still failed to file for insolvency within the 45 day deadline was not considered to be willful mismanagement that would result in the director's liability,[13]
- Where the company had already been unable to pay social contributions, taxes and salaries for several months, the director was found to have willfully breached the obligation to file for insolvency within 45 days of the suspension of payments, even though the director did not know the precise date on which the suspension occurred.[14]

These differing rulings could potentially challenge the very nature of the deadline. Although directors would be less exposed to purely "technical" breaches, this leads to a great level of uncertainty, with a need to monitor the situation very closely.

On the other hand, business decisions taken by directors are more likely to be considered mere negligence and not willful mismanagement.

For instance, the arguably reckless behavior of the director not diversifying its client portfolio and relying on a single customer, which eventually terminated the business relationship, was considered mere negligence and not willful mismanagement.[15]

On a different note, the payment of dividends has recently been subject of scrutiny by the courts, particularly in the context of a leveraged buy-out when the target subsequently becomes insolvent and is eventually liquidated.

9 Former article L .652-1 of the French Commercial Code
10 Former article L .654-6 of the French Commercial Code
11 Douai Appeal Court, 2nd chambrer, 2nd sect., 19 May 2022, no. 21/00019
12 Cour de cassation, commercial chamber, 29 June 2022, no. 21-12.998
13 Cass. com., 3 February 2021, no. 19-20.004
14 Cass. com., 12 January 2022, no. 20-21.427
15 Cass. com., 13 April 2022, no. 20-20.137

The payment of dividends to the holding company in order to repay the acquisition loan, without consideration of the cash position of the target, can amount to willful mismanagement by the directors.[16] Indeed, even though the decision rests with the shareholders, directors can propose and induce the distribution of dividends.[17]

This same result was also found in the context of intercompany advances from the subsidiary to the holding company, with the court noting that the interest of the group as a whole does not exonerate the director from their liability.[18]

In summary, the assessment of the elements that could lead judges to characterize liability for willful mismanagement on the part of the director remains highly dependent on the facts. Generally, the underlying message of these decisions is that directors should act with caution and take the appropriate measures as early as possible to avoid aggravating the situation.

The need for anticipation and early action resonates with the different reforms undertaken by the French legislature in order to foster the resolution of difficulties through amicable frameworks.

Protection for directors arising out of the use of amicable restructuring frameworks

French law provides for two different amicable frameworks for the resolution of difficulties: the ad hoc mandate and the conciliation. They are deemed amicable as there is no general and automatic stay on claims and creditors called to participate cannot be compelled to waive or reschedule their debts.

The ad hoc mandate is a very light touch legal process with minimal court supervision, virtually no effect on third parties, and very little legal protection for the debtor. The conciliation, on the other hand, has been developed by the legislature and utilized by practitioners to become the preferred tool in France to successfully implement restructuring agreements.

It should be noted that French courts have refused to grant directors any kind of safe harbor in relation to the ad hoc mandate, notably by stating that it does not preclude the subsequent liability of the director if the opening of the ad hoc mandate was not appropriate considering the seriousness of the company's situation.[19] On the other hand, the conciliation provides a much more secure framework for directors.

The main objective of a conciliation is to encourage participants to reach an agreement without imposing restructuring measures on creditors as part of a judicial proceeding. By pursuing this objective, the conciliation will de facto protect the directors from incurring liability in certain cases.

In particular:

- The opening of a conciliation will effectively satisfy the obligation to file for insolvency within 45 days of the suspension of payments and therefore prevents director liability on this ground,[20]
- The conciliation is confidential.[21] Its existence or content cannot be disclosed by any of the participants (debtor, creditors called to participate, conciliator) or by third-parties[22] that may have obtained non-public information about the conciliation. This principle has been affirmed several times in very strict terms by France's highest court, including by dismissing the ability of the debtor to use elements of the conciliation as part of subsequent and distinct judicial proceedings.[23] This confidentiality protects directors, since the limited circumstances in which the conciliator's report may be disclosed should not permit its use for the purpose of lawsuits against the directors,[24]
- As a consequence of the approval of the conciliation agreement by the commercial court, which can be requested by the debtor company, the company is deemed not to be in suspension of payments at the date of the judgment[25]. This once again prevents any subsequent criticism against directors for not filing for insolvency in due time.

16 Cour de cassation, commercial chamber, 9 September 2020, no. 18-12.444, *Finadvance*
17 Cour de cassation, commercial chamber, 8 avril 2021, no. 19-23.669
18 Chambéry Appeal Court, civil chamber, 1st sect., 15 February 2022, no. 21/01781, *Technipac*
19 Cour de cassation, commercial chamber, 17 June 2020, no. 19-10.341
20 Articles L.631-4 of the French Commercial Code
21 Article L.611-15 of the French Commercial Code
22 Cour de cassation, commercial chamber, 15 December 2015, no. 14-11.500
23 Cour de cassation, commercial chamber, 5 October 2022, no. 21-13.108
24 Article R.611-44 of the French Commercial Code
25 Article L.611-8 of the French Commercial Code

Incentives for directors to use amicable frameworks to prevent insolvency proceedings

In addition to those protections, the conciliation is without a doubt the less dispute focused tool in reaching a restructuring agreement and is therefore a very effective mechanism to avoid any ulterior legal actions that may target directors in the context of formal insolvency proceedings.

This aspect has been reinforced with the last reform of French insolvency law in 2021.

Among the amendments introduced to the conciliation, the company, assisted by the conciliator, can now try and obtain orders from the judge supervising the conciliation staying claims against it.[26] This is meant to prevent non-cooperative creditors from disrupting negotiations conducted with other creditors.

Also, when a restructuring plan has been negotiated as part of a conciliation, but is not agreed to by a minority of creditors, the debtor can request the opening of an accelerated safeguard process in order to have the plan voted on and adopted by creditors[27] and imposed on the dissenting creditors – akin to a cram down.

This tool has been available since 2014 for large companies and specific cases of complex financial indebtedness but has now been extended to small and medium sized enterprises and improved to fulfil the objectives set by European law.[28]

Quite significantly, therefore, the introduction of classes of affected parties for the purpose of voting on the restructuring plan includes the ability to impose a plan -- which has been agreed upon by the main parties involved -- on minority dissenting creditors or classes of creditors.

This bridge between conciliation and safeguard acts as a powerful mechanism for the debtor company and prevents creditors from adopting intractable positions that would otherwise prevent the implementation of a restructuring agreement supported by a large majority of claims as part of a conciliation.

Conclusion

The latest statistics on the number of conciliations, which continues to grow and has been used in many high profile and complex restructuring matters confirms that the legislature's objectives, usefully seconded by judges, have been achieved in significant part.

The incentives for directors to use these additional mechanisms as a way to manage their risk by offering some protection and flexibility, and by ensuring the effectiveness of these tools, are now strongly established. Yet, they should always be used in accordance with their credo: as an early intervention tool to prevent financial illness rather than a cure after the collapse.

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26 Article L.611-7 of the French Commercial Code, as amended by Ordinance no. 2021-1193 dated 15 September 2021

27 The adoption of the restructuring requires a two-third majority vote in a class. The criteria deciding the repartition of voting rights among creditors in a class (e.g. claim value, number of claims, headcount) are proposed by the administrator and can be challenged by creditors before courts.

28 Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks

Update: *Petrowest Corporation v. Peace River Hydro Partners*: Enforceability of arbitration clauses challenged in Canadian receivership proceedings

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In the Q4 2021 Edition of the International Restructuring Newswire, our article Enforceability of arbitration clauses challenged in Canadian receivership proceeding reported on a decision of the British Columbia Court of Appeal in Petrowest Corporation v. Peace River Hydro Partners (Petrowest).

The Petrowest decision was affirmed by the Supreme Court of Canada in November 2022.

As a result of the Petrowest decisions, parties may not be able to rely upon arbitration clauses to ensure claims advanced by a receiver of an insolvent Canadian counterparty are handled through the agreed arbitration process rather than through the insolvency court.

Background and lower court decisions

Arbitration clauses were included in various agreements, subcontracts and purchase orders involving Peace River Hydro Partners and various Petrowest entities as supplier and subcontractor.

A receiver subsequently appointed over the Petrowest entities filed a civil claim against Peace River and related entities to recover amounts allegedly owed to Petrowest by Peace River under the subcontracts and purchase orders. Instead of defending the receiver's civil claim, Peace River applied to the court to stay the receiver's civil claim under the *Arbitration Act* (British Columbia) based on arbitration clauses in the parties' agreements that directed these disputes to arbitration.

The British Columbia Supreme Court and the British Columbia Court of Appeal each denied Peace River's stay application, determining instead that the receiver's claims should be determined in the civil litigation process by the insolvency court notwithstanding the arbitration clauses agreed between the parties.

Supreme Court of Canada decision

On November 10, 2022, the Supreme Court of Canada upheld the decisions of the British Columbia Supreme Court and British Columbia Court of Appeal.

The decision of the Supreme Court of Canada confirms that a receiver is generally required to abide by arbitration agreements. **However, a court may decline to require that a receiver pursue a claim by way of arbitration in accordance with an arbitration agreement if doing so would conflict with objectives of the *Bankruptcy and Insolvency Act* (*BIA*), such as expediency and efficiency.**

The majority of the Court noted that the *Arbitration Act* permits a court to determine a claim should not proceed by arbitration if the arbitration agreement is "void, inoperative, or incapable of being performed". The majority held that insolvency, on its own, is not a basis to not enforce an arbitration agreement and an arbitration agreement should be enforced in all but the clearest of cases; however, Canada's *BIA* does provide statutory jurisdiction for a court to hold that an arbitration agreement is "inoperative" if the arbitral process would compromise the orderly and efficient conduct of a receivership. This assessment is highly factual and potentially subjective. In this case, the majority of the Court determined that the stay was rightly denied because the "chaotic nature" of the contemplated arbitral process would undermine the expediency and efficiency objectives of the insolvency legislation.

The Court's three judge minority agreed with the majority's result but on the basis that the arbitration clauses were to be treated as separate agreements that the Receivership Order authorized the Receiver to disclaim. Indeed, the minority held that the Receiver had implicitly disclaimed the arbitration clauses by suing in Court, rather than arbitrating.

Implications

The Supreme Court of Canada's majority decision confirms that a debtor's arbitration agreements are presumptively binding on a receiver. However, a receiver may not be bound to arbitrate if the arbitral process would compromise the orderly and efficient conduct of the receivership.

The Court's minority decision reached the same ultimate result but on a basis that would permit a receiver to avoid an arbitration clause and the necessity of arbitrating in substantially every case, using the power of disclaimer that is ubiquitously granted by the court upon the granting of a receivership order.

With the Court's majority decision in mind, a contracting party with a strong interest in the arbitration of any claims that may be brought by the receiver of an insolvent counter-party should negotiate arbitration clauses that operate expediently and efficiently, to be in harmony with *BIA* objectives.

The Court's majority decision emphasizes that the application (or not) of arbitration clauses to civil claims by receivers is highly fact-dependent, thereby inviting future disputes about the propriety of arbitrating on a case-by-case basis.

Future cases may determine the circumstances in which arbitration clauses will (or will not) be enforced in other insolvency contexts, such as restructurings under the *Companies' Creditors Arrangement Act*.

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Cross-border insolvency between Mainland China and Hong Kong: First steps; ready to jump?

By Bob Wessels

Mainland China and Hong Kong fall under the so-called "one country, two systems" principle. Accordingly, the Mainland and Hong Kong can retain two different legal systems under one sovereign state. In this case, it's a bit like oil and water – it doesn't mingle, as the Mainland is a civil law jurisdiction, while Hong Kong is a common law jurisdiction. With the significant growth in cross-border business between the two, there has been an increasing need for cross-border judicial assistance among these systems.

The relationship between Mainland China and Hong Kong Special Administrative Region (HKSAR) is prescribed in the Constitution of the People's Republic of China and the Basic Law of the HKSAR, which dates from 1997. Article 95 of the Basic Law states that "the Hong Kong Special Administrative Region may, through consultations and in accordance with law, maintain juridical relations with the judicial organs of other parts of the country, and they may render assistance to each other." However, with regard to the process of creating a legal framework for cross-border insolvency matters, there has been a deafening silence.

And then, suddenly, in the midst of 2021, it was there! On 14 May 2021, the Supreme People's Court (SPC) of the People's Republic of China (PRC or Mainland) and the Government of HKSAR published a "Record of Meeting on Mutual Recognition of and Assistance to Bankruptcy (Insolvency) Proceedings between the Courts of the Mainland and of the Hong Kong Special Administrative Region" (Record of Meeting), accompanied by:

- the SPC's "Opinion on Taking Forward a Pilot Measure in Relation to the Recognition of and Assistance to Insolvency Proceedings in the Hong Kong Special Administrative Region" (Opinion); and
- the HKSAR's "Procedures for a Mainland Administrator's Application to the Hong Kong SAR Court for Recognition and Assistance Practical Guide" (Practical Guide).

The 2021 arrangement

What does this "2021 arrangement" entail? In short, the new Record of Meeting lays down the bedrock for future cooperation in insolvency matters. Yet the 2021 arrangement is just a rough charcoal sketch, without considering necessary details. It should be noted that the 2021 arrangement is limited in territorial scope. The Opinion designates three cities – Shanghai, Xiamen, and Shenzhen – as the pilot areas, where the intermediate courts in these cities are empowered to take forward pilot measures on recognition and assistance to Hong Kong insolvency proceedings. The Practical Guide issued by HKSAR is a reference guide for Mainland administrators to file applications to the Court of First Instance of the High Court of the HKSAR. As a result, selected courts in the Mainland and HKSAR courts may mutually recognise and give assistance to insolvency proceedings opened in the other jurisdiction, which only governs cross-border cases having been opened in the Mainland and the HKSAR respectively.

"Recognition" as such has a limited basis in the 2006 Chinese Enterprise Bankruptcy Law (EBL), which is the major legislation governing Chinese insolvency systems. In its article 5, the EBL says that a Chinese court can recognise a foreign insolvency judgment, on the condition that: (a) the rendering jurisdiction has an international agreement with Mainland China; or (b) there exists reciprocity between the rendering jurisdiction and Mainland China, subject to the conditions that:

- recognition would not violate the basic principles of Chinese law;
- recognition would not jeopardise the State sovereignty, security or public interest; and
- recognition would not undermine the interests of Chinese creditors.

Since the enactment of the EBL, there has not been a case in which a Mainland court has recognised a Hong Kong insolvency judgment.

This is of course a bothersome, uncertain legal situation that is now addressed with the 2021 arrangement in which intermediate Mainland courts in selected cities are equipped with the authority to recognise Hong Kong proceedings or give assistance to such proceedings. The SPC's Opinion seems to follow the well-developed doctrine in international insolvency law; in particular, the "modified universalism" principle. Accordingly, recognition can be granted to Hong Kong proceedings in which Hong Kong is the debtor's centre of main interests (COMI), and the COMI has been in Hong Kong continuously for at least six months.

Hong Kong insolvency proceedings eligible for recognition include compulsory winding up, creditors' voluntary winding up, and schemes of arrangement promoted by a liquidator or provisional liquidator and sanctioned by a court of the HKSAR. Subsequent to recognition, relief can be granted to Hong Kong administrators who can then perform the same duties within the territory of the Mainland as those of Mainland administrators. Also, upon the request of Hong Kong administrators, a court may appoint a Mainland administrator to assist the case. Additional relief that may be granted include the realisation of bankruptcy property, the distribution of bankruptcy property, a debt restructuring arrangement and termination of bankruptcy proceedings. The Opinion seems to mirror principles from the 1997 UNCITRAL Model Law on Cross-Border Insolvency (MLCBI), which serves as the basis for similar rules in the UK and the US and sets out a more comprehensive and detailed framework when compared to article 5 of the EBL.

Seven flaws

Compared to cross-border insolvency systems in other jurisdictions, including the European Union's system laid down in its European Insolvency Regulation of 2015 (EIR 2015), the 2021 arrangement still leaves many issues unaddressed; outlined here as the "seven flaws".

COMI

First, the SPC's Opinion adopts the concept of COMI. The Opinion applies to Hong Kong insolvency proceedings, where the HKSAR is the COMI of the debtor. In the Opinion, COMI "generally means the place of incorporation of the debtor," which is the registration place of the debtor. In addition, the courts shall consider other factors, such as the place of the debtor's principal office, principal place of business, and principal assets, "etc". The concept of COMI and the determination of this norm is based on an assessment of circumstances which seems to be unlimited (through the use of the term "etc"). It notionally appears to be in line with the MLCBI and the EIR 2015. However, the MLCBI and the EIR 2015 also require the COMI of a debtor to be "ascertainable by third parties," being especially creditors. This is not clearly stated in the Opinion. Further, the adoption of the concept of COMI is only set out in the SPC's Opinion, but not in the HKSAR's Practical Guide.

Establishment

Second, the Record of Meeting does not mention the possibility of opening, based on a debtor's "establishment," a non-main/secondary proceeding, nor does the Practical Guide. Such an establishment acts as a basis for a court's international jurisdiction to open such a non-main/secondary proceeding, though the Opinion confirms that there might be parallel proceedings in both the Mainland and Hong Kong. However, it does not make a distinction between main and non-main/secondary proceedings. The opening of parallel proceedings seems to be beyond the scope of the 2021 arrangement.

In contrast, under the EIR 2015, an "establishment" requires the presence of a structure consisting of a minimum level of organisation and a degree of stability necessary for the purpose of pursuing an economic activity. The presence alone of goods in isolation or bank accounts does not, in principle, meet that definition. So, in such a case with just real estate as property owned by a Mainland debtor, non-main proceedings in HKSAR cannot be opened.

Applicable law

Third, the Record of Meeting seems to follow the MLCBI framework without stipulating the applicable law, unlike the EIR 2015 where the applicable law is stipulated to be that of the country where the insolvency proceeding is opened. Applicable law is, indeed, a complex theme. But it is presently on UNCITRAL's global agenda. In the context of the 2021 arrangement, it may be one of the next steps to consider.

Communication and cooperation

Fourth, cross-border (although within one country) cooperation is highlighted in the Opinion. For example, insolvency practitioners in the two jurisdictions should strengthen their communication and cooperation. Without further detail, this provision is, however, rather abstract. A reference to a recommended use of cross-border insolvency protocols is lacking. While courts in the pilot areas in the Mainland "shall actively communicate and take forward cooperation with the courts" in HKSAR, without further elaboration, the obligation to cooperate is a rather empty one. The MLCBI and the EIR 2015 provide that, in implementing cross-border cooperation with insolvency proceedings pending in EU Member States, the respective insolvency practitioners shall:

- as soon as possible communicate to each other any information which may be relevant to the other proceedings;
- explore the possibility of restructuring the debtor and, where such a possibility exists, coordinate the elaboration and implementation of a restructuring plan; and
- coordinate the administration of the realisation or use of the debtor's assets and affairs.

Group of companies

Fifth, the Record of Meeting does not mention group insolvency, which is added in the EIR 2015. The insolvency of a group of companies or enterprises requires much deeper cooperation and coordination. This subject may have been allocated for further consideration on a future agenda.

Public policy exception

Sixth, the Opinion generally provides that the People's Courts shall refuse to recognise or assist Hong Kong proceedings if the basic principles of the law of Mainland China are violated, or public order and good morals are offended. This is similar to article 6 of the MLCBI and the EIR 2015, which also prescribe a "public policy" exception. However, the Opinion stipulates many more circumstances where refusal of recognition can be

made, including on the basis of other circumstances in which the People's Courts consider that recognition or assistance should not be rendered. It seems that the Opinion grants Mainland judges overly broad powers to refuse recognition of Hong Kong insolvency proceedings. In theory, already this last possibility may create a barrier to effective cross-border recognition of insolvency proceedings.

Equal treatment of creditors

Finally, the Mainland maintains strong powers that are contrary to the principle of equal treatment of creditors. If a Mainland court recognises and assists the Hong Kong insolvency proceedings, "the bankruptcy property of the debtor in the Mainland shall first satisfy preferential claims under the law of the Mainland. The remainder of the property is to be distributed in accordance with the Hong Kong Insolvency Proceedings provided that creditors in the same class are treated equally." This rule of protecting "own" Mainland first is against the fundamental tenet to treat creditors on the basis of equality before the law.

In all, the 2021 arrangement misses key terms and constituent elements, lacks detailed implementation guidance for judges, and does not align with globally accepted approaches. How will courts handle complex issues without a well-considered solid basis in cross-border insolvency regulation?

Improving the 2021 arrangement

The conclusion is, in mild words, that the present arrangement is unfinished and contains inadequacies. To start to think about improving the present mechanism, I propose five recommendations for the reforms of future Mainland-Hong Kong cross-border insolvency.

Learn from other "mixed legal" systems

The Mainland and Hong Kong maintain a "one country, two systems" political regime that also forms the basis of two different legal systems; the Mainland being a civil law jurisdiction and Hong Kong being a common law jurisdiction. On a global scale, the Mainland-Hong Kong situation is not unique. There many jurisdictions with mixed legal systems in the world that can set examples for enhanced mutual understanding or stimulate alignment between rules. For example, Canada (Quebec), South Africa, Scotland, and Malta are countries which include political entities where two (or more) legal systems apply cumulatively or interactively to a certain extent. Evidently, the social-cultural environment, the social-economic policies and the economic scale of certain cases may differ greatly. However, the way the "mix" of systems work, or can work, for example, in training and educating role players (insolvency practitioners and judges), in aligning procedural matters, and in understanding each others' legal terminology, could set examples for further developing the 2021 arrangement. Global insolvency is unique, in that it has several non-binding sets of guidelines to have courts cooperate together, such as the Judicial Insolvency Network "Guidelines for Communication and Cooperation between Courts in Cross-Border Insolvency Matters."

Better alignment with UNCITRAL Model Laws

The 2021 arrangement has its feet in the sand of the MLCBI. The concept of COMI, the definition of the public policy exception and the possibility of having a parallel non-main/secondary proceeding opened because the company has an "establishment" in the other jurisdiction, as well as the system for cross-border cooperation, should be brought in line with the MLCBI. Interestingly, in the 2022 landmark case of *Re Global Brand Group Holding Ltd*, the Hong Kong Court officially adopted COMI as a formal test for cross-border insolvency. The elements that the Hong Kong Court adopted were based on the SPC's Opinion, common law, the EIR 2015 and the MLCBI, which are practically in line with each other. The windows, therefore, are open for winds of change, coming from international developments.

China's inter-regional cross-border insolvency arrangement (CICIA)

In literature, six years ago, it has been recommended to create a China inter-regional cross-border insolvency arrangement (CICIA). Such a regime includes basic rules for any regulation's overriding objectives, rules for international jurisdiction, recognition and relief, the public policy exception (limited), a stay/moratorium, protocols, a standing judicial committee, a functional dispute settlement system, and an inter-regional case register. Some of the rules are similar to global practices. References can be made to the 2012 American Law Institute (ALI)-International Insolvency Institute (III) "Global Principles for Cooperation in International Insolvency Cases and Global Guidelines."

The recommendation includes the establishment of a standing judicial committee which can serve as a functional dispute settlement system and provide proper interpretation of present and future provisions of a cross-border cooperation mechanism. Members of the judicial committee should be internationally recognised experts on cross-border insolvency matters and can provide consistent and predictable clarification on the rules. Evidently (sensitive) details (for example, the selection and appointment of judges and their

independent position) should be negotiated. The role of the judicial committee is to make decisions in specific cases, which should be binding, unless the judges hearing the cases disagree or the SPC or the Hong Kong Court of Appeal rule otherwise.

Light legislative regime for small and medium enterprises (SMEs)

Special attention should be given to SMEs. Given the close geographical relation and close economic ties, there are a large number of companies involved in cross-border businesses. It is proposed that automatic recognition should be granted for insolvency proceedings of SMEs of a certain size. It would take away some formal, costly, and time-consuming burdens. Evidently, courts *ex officio* should have some measures to test the fairness of the system, including a limited public policy exception.

A hybrid approach

My final suggestion is that a hybrid approach could be adopted, combining both a CICIA type of regime and specific agreements with a targeted/tailor-made *ad hoc* protocol for each individual large cases. Apart from the standing judicial committee that may deliver opinions, case-specific agreements or protocols may also be an option to further regulate and detail judicial coordination and insolvency practitioner/debtor-in-possession cooperation. Inspiration can be taken from European Model Protocols developed in 2021.

Conclusion

The current Mainland-Hong Kong 2021 arrangement is still a rough one due to its lack of necessary detail and comprehensive implementing rules. Inspired by other examples from all over the world, additional rules should be formulated that can provide clearer and more certain guidance for debtors and insolvency practitioners, as well as judges. For courts, it is acknowledged that their direct communication can be quite challenging, since normally judges may have strong reservations about being included in discussions about personally adhering to agreements with judges of another jurisdiction. There may be constitutional and procedural objections. However, in other areas in the world, courts are getting an open eye for the interests of global business, and they understand their crucial role in taking a pragmatic approach.

I do not doubt that in Asia there will be an equivalent of the Dutch saying: "A lot of water still has to run through the Rhine before something will happen."

The Mainland China-Hong Kong relationship in cross-border insolvency has been silent for over two decades. Efficient and effective courts, including in matters of (cross-border) restructuring and insolvency, serve the general interest of smooth business transactions, which are global "by nature." For this reason, the aforementioned proposals may provide some ideas to leap into the future.

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References

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