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Osservatorio
Crisi
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Imprese

Contractualised Distress Resolution

in the Shadow of the Law

Effective judicial review and oversight of insolvency and pre-insolvency proceedings

FINAL REPORT

PROVISIONAL VERSION

DRAFT OF 3 JULY 2018

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The present Final Report of the research project* Contractualised distress resolution in the shadow of the law *is put forward in a provisional version with the purpose of inviting comments and inputs for further development.

Hence, this document is made available to the speakers and the attendees of the Conference* Best Practices in European Restructuring *that is taking place in Brussels on the 5th of July 2018 (at CEPS). The document will be also published on the website www.codire.eu.

The Final Report is currently composed of seven chapters, structured reflecting the key moments and matters in a typical restructuring: timely identifying and addressing the crisis, the fairness of the process, the typical structure of restructuring plan, drafting high-quality plans, negotiating on plans, confirming, implementing and monitoring plans.

The comments, inputs, and remarks received as a result of a wide dissemination of the draft versions of the Final Report will be used to develop the present document in its content and structure.

The present Final Report, when completed in its final version, will be made available for the public at www.codire.eu by the end of September 2018.

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INTRODUCTION

In recent times, National legislators and policymakers have been increasingly seeking to facilitate **contractual and quasi-contractual agreements** between distressed businesses and their creditors, **with very limited court involvement**. The same trend is now embraced by the proposed **Directive on preventive restructuring** (COM(2016) 723 final), some variant of which looks set shortly to be implemented.

This **move away from formal insolvency proceedings**, on which States had been relying for several centuries, opens up a vast area to private ordering, with all the associated opportunities and risks. Businesses and their advisors have access to new devices to deal with distress and insolvency intended to enable faster and more effective restructuring. At the same time, the reduction in court involvement and other formalities **creates new risks for participants and third parties**, and perhaps, even for the economic system as a whole.

The cost of entering into this 'new deal' in insolvency law is, in the short term, a high degree of uncertainty for all actors, with the usual resulting costs of additional advice, new drafting, higher risk premia, and foregone opportunities. **Reducing uncertainty in this 'light touch' area of insolvency law is paramount**. Guidance on best practices can serve to fill this newly opened space in an adaptive and flexible manner.

The research project *Contractualised distress resolution in the shadow of the law: Effective judicial review and oversight of insolvency and pre-insolvency proceedings* takes up this challenge. The project has been carried out by a partnership of several universities: **Università degli Studi di Firenze** (Project Coordinator), **Humboldt-Universität zu Berlin** (Partner) and **Universidad Autónoma de Madrid** (Partner), supported by the **Consejo General del Poder Judicial** (Associate Partner), **Banca d'Italia** (Associate Partner) and **Entrepreneurship Lab Research Center** (Associate Partner).

The research is based on a sound conceptual framework and is supported by **broad and deep empirical evidence** from four EU jurisdictions (Germany, Italy, Spain, and the U.K.) gathered between 2016 and 2018. The project also addresses several key issues highlighted in the **Recommendation on a new approach to business failure and insolvency** (2014/135/EU), and considers the proposed **Directive on preventive restructuring**.

The national findings of the four jurisdictions have led to the development of:

(i) ***guidelines addressed to key players in the restructuring process*** (in-court and out-of-court procedures and measures);

(ii) ***recommendations*** **addressed to policymakers** at the European and national level.

The main recommendations addressed to European policymakers have been transformed in fully-fledged proposals for ***amendments to the current draft of the proposed Directive*** COM(2016) 723 final. Such proposals have been incorporated in a separate document.

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Chapter 1
Timely Identifying and Addressing the Crisis

1. On the "crisis" and on triggers for insolvency proceedings and restructurings

Traditional insolvency laws have developed over literally millennia more or less reliable and exact indicators for the beginning of the common pool problem such as acts of bankruptcy (flight of the debtor, non-payment of an adjudicated claim, etc.) or general definitions (over-indebtedness, illiquidity, etc.). In more recent years, the reach in time of insolvency (and hybrid) proceedings has, in many countries, widened (and blurred), so that insolvency proceedings can be triggered already during earlier, often less clearly defined stages of the debtor's crisis (e.g. imminent insolvency, likelihood of insolvency, unsurmountable difficulties and similar). In some important instances, proceedings that are considered to address insolvency may (save for cases of abuse) even be started by the debtor without having to prove or even just assert their insolvency or crisis.

CoDiRe is focusing primarily (though not exclusively) on institutionalised plan-based restructurings outside of formal insolvency proceedings that often allow a majority of stakeholders (usually acting in concert with the debtor's management) to effectively overrule a minority. On one hand, these proceedings are commonly considered – e.g. in the European Insolvency Regulation and the Directive Proposal on Preventive Restructuring Frameworks (hereinafter: Directive Proposal) – as such to avoid liquidation (and in effect other more formal and cumbersome proceedings), so they have the potential to be commenced and conducted during even earlier stages of the debtor's crisis than liquidation proceedings, but, on the other hand, they frequently subject creditors and other stakeholders who have not (e.g. in bond terms or a company's articles of incorporation) contractually agreed to such treatment to a stay and/or a majority vote with regard to their claim or other stake in the debtor. Any such encroachment on stakeholder's rights may make a proceeding attractive to debtors not only for its intended purpose but also for abuse.

In other words, a mere (moderated, else assisted or unassisted) renegotiation process requiring unanimity and not enforcing any restrictions (e.g. a moratorium) on its participants or a process agreed-upon by all participants in advance may be initiated at any point in time, as early as the relevant parties please, and without the necessity of judicial control whereas other proceedings will require some form of a gatekeeper. The precise requirements and even the general approach (abstract criteria of eligibility [crisis threshold] and/or good faith to prevent abuse; general judicial commencement order or review of individual measures, whether *ex ante* or *ex post*, etc.) will hugely depend on the respective country's legal and judicial culture, constitutional and else legal framework, and the specifics of the proceeding in question, its effects and its initiator(s) (solely debtor driven vs. options of creditor initiative). It is, thus, outright impossible to make "one-fits-all" recommendations. However, in general and relying on the practical experiences in particular in the USA and the UK, a restructuring as such – unlike certain measures interfering with, e.g., creditor rights – should not necessarily require any specific degree of crisis or likelihood of insolvency. We recommend, therefore, to open semi-formal restructuring proceedings to debtors without them having to cross any threshold of crisis or financial difficulties and show this to any judicial or administrative authority. This approach allows for non or minimally invasive proceedings

without court involvement and promises a reduced stigma connected to the process. The – not very high – risk that debtors commence such proceedings while not in any financial difficulty or need of restructuring, possibly wasting resources of other involved stakeholders, can be combatted with a mechanism to quash the proceedings by authoritative order in the case of abuse on the application of a quorum of stakeholders. The more likely scenario that debtors with evidently non-viable businesses apply for restructuring proceedings instead of an out-of-court or insolvent liquidation, only further diminishing the estate, can be counteracted by a similar mechanism (in addition to involuntary insolvency petitions and/or a duty to file for insolvency; possibly after having a stay lifted).

Thus, if this chapter deals with "timely identifying the crisis", this does not so much refer to the eligibility criteria of any one national pre-insolvency / insolvency proceeding or of a future proceeding according to the Directive Proposal. Nor does it refer to an exactly und universally defined status of "crisis". We feel that, here, crisis simply refers to any situation in which there is a need for action to safeguard or restore a debtor's viability, value or any stakes in the business, ideally by means of financial and/or operational restructuring. This called-for action frequently will (at first) be no more than a thorough assessment of the debtor's situation or a negotiation with individual creditors, clients or potential investors – but can (in the worst case) culminate in filing a petition to commence insolvency proceedings.

Policy Recommendation #1.1 ***(Requirements to begin restructuring proceedings)***
Restructuring proceedings started by the debtor should be accessible without any threshold, such as crisis or likelihood of insolvency. Such requirements should be introduced only for specific tools or measures directly affecting stakeholders' rights and (if provided for) for proceedings initiated by creditors. On an application by a creditor quorum, an authority should ascertain whether a proceeding has been started abusively and, if so, terminate it.

2. On the importance of early and effective triggers

A particularly important cause[1] for the legislative "trend" (*supra*, par. 1) to earlier triggers for proceedings of any kind is the insight that there are more means to react to crisis, to insolvency and to a common pool problem than to liquidate and distribute the debtor's assets amongst their creditors. Efforts to sell the debtor's business as a going concern or to restructure and "turn around" the debtor as a business entity, however, are (a) less invasive and final and (b) best undertaken as soon as possible before all the debtor's credibility on the market and all the (tangible and intangible) assets ensuring the debtor's viability have been wagered and lost. Our research in all four considered jurisdictions shows that restructuring and insolvency professionals widely (if not unanimously) consider late reaction to a crisis to be the single most important reason for businesses becoming unsustainable and heading for liquidation.

[1] Another reason, that is somewhat connected to the one mentioned above, is to be found in the usually minimal returns to the stakeholders from conventional liquidation proceedings – that tend to further diminish the later an insolvency proceeding is triggered.

This in particular seems to affect MSMEs, and here especially owner-managed and family businesses, because of inferior monitoring and resources, lack of management competence and experience, absence of professional advisors and the special financial (as owners) as well as emotional investment of the management in the business's future that may result in irrational evaluations and decisions and a general lack of professional distance. One particular challenge for all legislative and other efforts in the field of restructuring is and will thus be to make MSMEs timely notice and acknowledge a crisis and the need to react.

For the avoidance of doubt, this chapter does not only concern itself with restructuring or insolvency proceedings and their triggers but also – and to some extent even especially – with out-of-court and merely contractual / negotiation-based restructuring efforts as they are usually the first tool to be examined before even considering to start any legal proceeding that, depending on its design in the respective law, may create additional costs, unwanted publicity, insecurity, loss of control, or any other adverse effects. Thus, for the purpose of this chapter, we presume that there is a more or less extensive array of different restructuring (and liquidation) tools available, and look at ways to:

- facilitate the timely recognition, identification and acknowledgment of the crisis (par. 3),
- incentivise the debtor and/or other stakeholders to act upon this information and (assumed viability) pursue a restructuring (par. 4), and
- remove disincentives (par. 5).
- In an annex, we will make some very brief remarks regarding the perceived lack and the desirability of a restructuring-friendly legal environment (par. 6).

3. Recognition of the crisis

3.1. What the law (and thus the legislator) can do

The law can mainly provide for monitoring and early warning systems that are supposed to ensure that a company's directors are – without too much of a delay – made aware of any adverse development of business and the company's financials, in particular key accounting figures (turnover, profits/losses, etc.),[2] depletion of (statutory or optional) capital reserves, potential issues with key clients, and especially any concerns regarding the company's liquidity/solvency. Many countries' ("hard" or "soft") laws on corporate governance already demand that at least certain companies (e.g. by size or form of incorporation [public companies]) install such systems (e.g. in Italy the *collegio sindacale*); in other companies, it will still usually be a general duty for directors to keep abreast of the business and to watch out for any developments that require an intervention for the benefit of the company.

The Directive Proposal also contains a provision to this effect: Article 3 calls – at least for MSMEs – for access to (not further specified) early warning tools which can detect a

[2] According to Getseva/Wolf, The European Commission's Approach to 'Early Warning Signs', 2018, publication forthcoming, a set of profitability and solvency ratios usually provides a particularly apt – accounting – early warning sign.

deteriorating business development and signal the need to act as a matter of urgency as well as for access to information about the availability of such tools and also restructuring tools. Recital 13 shows that the installation and use of these early warning tools should be inexpensive, and recital 16 names, as examples, accounting and monitoring duties for the debtor or their management, reporting duties under loan agreements as well as incentives or obligations for third parties to flag negative developments. While it may be considered very creative and in fact euphemistic to call personal or management duties "tools" that debtors should be given access to and receive concise information about, this approach seems (in theory) sensible.

Its problems lie on the practical side – insolvency and restructuring professionals report (with considerable differences in detail between the countries) that, in many cases in particular with MSMEs, the debtor's accounting is a mess (frequently likened to a shoebox of receipts), there are no adequate performance audits and that directors are not all too rarely unaware of the status of their company's daily affairs as well as incompetent regarding business and finances. In addition to that, even debtors and directors who are fully aware of the facts often refuse to draw the obvious conclusions but clutch at any straw to justify why the situation is not as dire as suggested by the company's accounts. Both aspects threaten the effectiveness of early warning systems – especially with the very debtors that need them the most and that the Directive Proposal has in mind.

Strengthening, broadening or simply better enforcing the already existing duties and corresponding civil or criminal liabilities or, e.g., requiring entrepreneurs or directors to show certain basic qualifications in accounting and finance before starting or managing a business would furthermore increase the transaction costs of doing business and could possibly interfere with entrepreneurship and economic growth. To strike the right balance has proven and will continue to prove a delicate task for legislators.

In any case, however, general[3] early warning systems should be inexpensive and easy to apply. Management shall be under a general duty to constantly keep an eye on the business and its development, in particular with regard to transactions above a certain threshold in relation to the business's size, key customer and supplier accounts and terms, as well as the cashflow and liquidity and to compile (or have compiled) regular reports / accounts for the shareholders and/or the (in particular: tax) authorities. Regular audits of the accounts will likely be too expensive to be made a universal requirement. External accountants, tax consultants, auditors, and similar professionals commissioned by the debtor as well as (in particular) the employees – who are in closer touch with day-to-day business than directors and will almost invariably learn of problems sooner – should be under an obligation to alert (at least) management of any developments they notice[4] that can endanger the business's viability. The management should have to inform the employees of this obligation and issue guidelines – where the law does not already provide for them – naming certain events that always constitute such a detrimental development, specific to the debtor's business. In particular with MSMEs, these guidelines – unlike "living wills" for banks – will not require,

[3] As opposed, possibly, to special, more sophisticated early warning systems that the law may require for bigger and/or public companies, in particular where the shareholders' or partners' liability is legally (as in limited liability companies) or factually limited (as in companies like the German GmbH & Co. KG where the legally unlimited liability lies, in turn, with a limited liability company).

[4] An unwritten obligation to actively search for such developments, however, would probably go too far at least with MSMEs as it would hugely affect the costs of the services provided by external auditors and consultants or the cost of labour.

at all, a high level of sophistication, regular updates, professional accounting, compliance departments, etc., so that they do not put much of a financial or organisational burden on the debtor.

These events triggering an instant warning might be called "events of crisis". Notable examples could be losses beyond a certain threshold (also in relation to the company's capital reserves), loss or insolvency of a main customer or supplier, loss of key employees, change in price of supplies, or in general loss of favourable terms of business with main customers or suppliers, drop in orders made by main customers, termination of loan agreements, overdue receivables of a certain sum, liquidity issues resulting in overdue commitments, in general any form of default on the business's obligations, foreclosures, other forced sales or acts of debt enforcement, negative development of credit scores or ratings, etc. Any such warning should have to result in management thoroughly assessing the business's situation, viability and need of restructuring.

An intriguing and important question legislators have to address when providing for such early warning tools or notification systems is whether the warning should only be addressed to the debtor or the management respectively or whether shareholders, employees, creditors or, for example, a public or semi-public entity like a court or a professional body should at this point have to become involved (cf. the French *procédure d'alerte* or the Italian draft legislation) either directly or by way of the management. The involvement of third parties might act as an incentive for management to not ignore the warning (see also *ultra*, par. 4.), thus increasing the systems' effectiveness. On the other hand, any resulting publicity could endanger the debtor further (reputational effects as well as more immediate commercial and financial effects of a potential crisis becoming public knowledge), invite abuse by (e.g.) competitors or disgruntled employees, involve expenses either for the debtor or the taxpayer and impair any collective proceedings to resolve a crisis. Obligations for employees, in particular, to inform on their employer would also give rise to a series of conflicts, and thus seem at least problematic.

Overall, we believe that management should be – in addition to current obligations of traded companies to "*ad hoc*" publish inside information – under an obligation to inform shareholders of the developments on regular shareholders' meetings and, in case of massive losses or other developments making insolvency highly likely or inevitable, on an extraordinary shareholders' meeting or by written communication. In all other cases, the information of shareholders should – like always the information of creditors[5] – be left to the management's discretion. The compulsory involvement of courts or other authorities might be very useful, especially to help the management of MSMEs to better assess the situation; with regard to the additional costs and the questionable enforceability, we hesitate, however, to define it as a policy recommendation. We encourage, however, initiatives to offer management of MSMEs free or affordable (voluntary) counselling regarding the debtor's state of affairs and assessing the crisis and viable reactions,[6] with the sole *caveat* that public funding must not create a moral hazard or unduly externalise costs to the taxpayers. An alternative would be a voluntary or compulsory insurance for restructuring (and in particular counselling) costs.

[5] Unless a duty to inform the creditor derives from, e.g., the contract between the parties, or the law, as may for example be the case with employees (cf. § 106 German Works Constitution Act [BetrVG]), or unless the creditor asks a specific question (e.g. a financial creditor to update their documentation of credit risks).

[6] In Germany, for example, the local Chambers of Commerce and Industry and the KfW (state-owned development bank) offer programs for subsidised crisis-assessment (round tables) and turn-around counseling.

We do, after intense and controversial discussion, not advocate legal obligations (other than incentives and encouragements) for institutional creditors – public or private – to flag negative developments as mentioned in recital 16 of the Directive Proposal. Creditors are the ones most suffering from the crisis, they should not also be subjected to obligations (and possibly liability or other detriments in case of a breach) in the efforts to resolving the crisis.

Policy Recommendation #1.2 ***(Early warning systems)*****. The law should provide for universal early warning systems and obligations of management to constantly monitor and have monitored the business's affairs for indications of a crisis. This should apply – with possibly additional requirements for big and/or public companies – to all businesses, regardless of legal status or size.**

Policy Recommendation #1.3 (***Duty to define events of crisis)*****. The law should define general and provide for a duty of the management to define specific "events of crisis" that trigger warnings by employees and, e.g., auditors, accountants and consultants. A particularly important general "event of crisis" shall be any default of the debtor.**

Policy Recommendation #1.4 ***(Role of management with regard to early warning)*****. All warnings are to be addressed to the management that shall generally have to consider how to best safeguard the interests of creditors as a whole and decide, at its discretion, whether to involve third parties (shareholders, creditors, courts, other authorities). Such discretion may be limited by laws to protect, e.g., the market or the employees, by contractual obligations or by the management's general duty towards the shareholders.**

Policy Recommendation #1.5 ***(Affordable counselling for MSMEs to prevent and address crisis)*****. Public or professional bodies, such as the chambers of commerce and trade, should look into offering free or affordable advice to MSMEs in setting up early warning systems and in assessing a crisis and the appropriate reaction.**

3.2. What the debtor/debtor's management and hired professionals can do

Obviously, the debtor and its management can and must adhere to the law ("compliance"), observe soft law (e.g. codes on corporate governance), install a prescribed early warning system and direct their employees accordingly. Furthermore, even in the absence of the legislation suggested above (*supra*, I.), entrepreneurs and directors can and should voluntarily (or to avoid potential liability for general negligence) adopt the outlined early warning systems – in particular encourage or direct employees to promptly alert them of potentially detrimental and dangerous events and developments in the course of day-to-day business – and keep themselves informed on the current state of their business's finances and in particular cashflow/liquidity forecasts.

Even to the extent it is not a requirement by law, entrepreneurs and directors should equip themselves with a general working knowledge of basic accounting and finance, should keep their books current and in order and ensure that reporting and auditing obligations

(including the timely filing of tax returns) are met. We recommend to support such efforts by providing public funding for offering entrepreneurs and directors of MSMEs affordable training regarding their obligations and general business knowledge and acumen, e.g. through professional bodies (namely chambers of commerce and trade etc.).

Entrepreneurs and directors should constantly be aware of their own limitations and avail themselves (while being mindful of the costs and their impact on the business's finances) of counselling and support – by employees or hired advisors and professionals like lawyers, business or tax consultants, auditors. Hired professionals should be supplied with current and accurate information, given full access to the relevant data and employees and tasked also with keeping an eye on the status of the business and its viability and prognosis. Even where such a duty cannot already be derived from the law, professional standards or individual contracts,[7] the hired advisors or auditors should assess the information made available to them (as well as the absence of certain information) for evident indications of a crisis and the need for restructuring, alert management of their findings or any reasonable doubts, and advise management on options to further assess and to address the situation. Any such communication has to be candid and unambiguous, and should be documented – management may, after all, not want to face or accept the threat of insolvency and look for alternative interpretations. In this case, advisors have to stand their ground and must not be prepared to "explain away" the crisis. Our research shows that, with MSMEs, many if not most restructuring efforts have been initiated by tax consultants or auditors alerting management to a (potential) crisis.

Guideline #1.1 ***(Voluntary early warning systems).*** **Even in the absence of legal duties or recognised standards, debtors should install adequate early warning systems monitoring the business for indicators of a crisis / "events of crisis". Most importantly, they should instruct and direct employees to recognise such indicators and promptly alert management.**

Policy Recommendation #1.6 ***(Basic training on accounting, business and finance).*** **Entrepreneurs and directors should have access to training on accounting, finance and business basics and their legal obligations.**

Guideline #1.2 ***(Access to current and accurate information for advisors).*** **Professional advisors hired by the debtor should be given access to current and accurate information and tasked to assess it also for signs of a crisis and advise management accordingly.**

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[7] For Germany, cf. Federal Court of Justice (Bundesgerichtshof), 26 January 2017, case IX ZR 285/14, ECLI:DE:BGH:2017:260117UIXZR285.14.0, outlining the duties of a tax consultant hired to draft the annual financial statements to (a) assess the viability of the business and (b) alert management of material insolvency and the corresponding directors‘ duties when the information made available to them clearly support such finding.

3.3. What the creditors and shareholders can do; role of financial creditors in particular

As stated above (*supra*, par. 1), creditors should not, normally, be under an obligation to keep themselves informed on the financial status, business success, or viability of their debtors, let alone actively alert their debtors or public entities to perceived issues within the debtors' businesses.

The most pronounced exception to this general rule concerns banks and other financial institutions. They are under legal obligations to assess and mitigate their exposure to risks. In this context, at least with loans or other forms of credit above a certain threshold, they have to request from the debtor the disclosure of very detailed information about their financial and economic situation and assess the debtor's viability. This is not just an initial control obligation either but an ongoing duty for the entire course of the exposure to the debtor's credit risk. Moreover, a number of additional monitoring requirements have been introduced by the European regulators in response to the financial crisis and the massive increase in non-performing loans it has contributed to generate. Many of these new requirements seem to be capable of playing an important role in promoting a timely identification and management of crisis situations.

An organizational measure which is particularly recommended by supervisors is the establishment of dedicated NPL workout units, separated from the loan granting functions, so as to eliminate potential conflicts of interest and ensure the presence of staff with dedicated expertise and experience.

Supervisory guidelines prescribe that dedicated units of lenders should engage with the borrower along the full NPL lifecycle; they also indicate what the focus of their activities should be during each phase of that cycle. This should result in an active role of lenders in making the debtor timely aware of difficulties and the triggering of early actions. Supervisory guidelines, in particular, require banks to internally implement a number of credit monitoring tools and early warning procedures and indicators (at both portfolio and borrower level) so as to promptly identify signals of client deterioration. Banks are also recommended to develop specific automated alerts at the borrower level to be activated in case of breach of specific early warning indicators. When such breaches occur, banks should involve dedicated units to assess the financial situation of the client and discuss potential solutions with the counterparty.

The system of early warning mechanisms to be established at the lenders' level, coupled with wider financial assessments to be conducted on a portfolio and loan segments basis, should enable banks to develop customized recovery solutions at a very early stage.

Our findings show that in the current context banks, like tax consultants and auditors (*supra*, II.), are already very frequently the main initiators of restructuring efforts and negotiations.

It is worth to recall, however, that both prudential requirements and supervisory expectations on NPL management are aimed at promoting efficient and prudent conducts by intermediaries in the management of credit risks; banks' action or their lack of appropriate initiatives in this respect will be assessed by supervisors and might trigger supervisory actions. They should not – very much in line with *supra*, par. 1 – be interpreted as imposing on banks specific duties to inform debtors or to take any initiative in substitution of inactive debtors. Banks may offer their assistance or require borrowers to engage in finding solutions and are recommended to do so for prudential reasons, but borrowers only are responsible to manage distress, as part of their entrepreneurial activity, and may consequently be held liable

towards stakeholders for the lack of prompt action. Banks, on their side, should avoid any form of interference with the business management of their clients, both in good and bad times.

Thus, and even regardless of special obligations of the debtor to disclose information, financial creditors – in particular a "*Hausbank*"[8] – are (together with certain institutional public creditors like tax authorities and social security creditors) often in a more or less privileged situation because of the extent of the information on and insight into the debtor's situation and finances readily available to them. In addition to that, loan and other financing agreements of a certain size almost invariably contain various "financial covenants", among them control mechanisms and reporting duties, both regular and in case of certain events (loss of capital, endangered liquidity, growing debts, etc.). Provided that the debtor fulfils their obligations under these covenants, the respective creditor receives crisis warnings and can – even where the debtor does not take them seriously or plainly disregards them – engage in a dialogue with the debtor and (if necessary) put pressure on the debtor to act upon the crisis and pursue a restructuring by threatening to accelerate loans or terminate the financing. Our qualitative research through expert interviews, in particular but not exclusively in Germany, shows that financial covenants providing for contractual reporting duties of (probably in particular medium sized)[9] businesses play an important and beneficial role in this context.

Even though it – normally – is not a creditor's obligation to monitor the debtors' financial situation or look for signs of a crisis, it usually is still in its best self-interest to recognise the crisis as it gives them options to adjust their current and future business with the debtor accordingly (e.g. by not extending trade credit but requiring cash transactions) and to actively encourage and support the debtor's restructuring efforts or other ways to address the crisis – without unduly influencing the debtor and interfering with its business. Probably the only – however very important – potential downside of this knowledge can result from an increased exposure to (mostly civil) liability and in particular later avoidance / claw-back of payments still received from the debtor (cf. *ultra*, par. 5).

The "normal"[10] creditors' means to monitor a debtor's finances, however, are very limited; for the most part, the simplest, yet best available tools are to observe the debtor's payments (are they made timely and in full?), to pursue outstanding receivables, at some point to start asking for plausible explanations of delays and to not accept vague, evasive or non-answers. From our experience, inquiries with credit agencies providing credit scores and other commercial information on debtors are of limited value as they are relying on publicly available information and on reports by other creditors so that they will usually work on a certain (often considerable) delay – if such an inquiry returns a red flag, it should be taken seriously, while a decent or good credit score should not be considered a definite all-clear.

Just like the creditors, or initially even more so, shareholders should be very interested to effect an early restructuring should "their" company head towards crisis because their

[8] I.e. a financial institution through which the debtor conducts most of their business (current and checking accounts, loans, guarantees, etc.); traditionally common in Germany, and still most likely a somewhat relevant concept to explain certain peculiarities in the German restructuring landscape.

[9] With big enterprises, it rarely seems to require this external catalyst, whereas micro and (very) small enterprises do not often take out loans of a size warranting sophisticated financial covenants.

[10] As opposed to financial institutions and other institutional creditors with special insight into the debtor's finances or business, cf. the immediately preceding paragraphs.

shares in the equity are affected and devalued even before the creditors' claims.[11] In an insolvent liquidation, whether piecemeal or by going concern sale, they will almost always walk away with empty hands. Despite this, our qualitative research shows that, in particular, shareholders of MSME family businesses as well as private equity investors tend to delay restructuring efforts. Depending on the company's form of incorporation, its statutes and bylaws, the equity distribution, and the shareholders' involvement in managing the company, the degree of insight shareholders have into the debtor's financials and the viability of its business hugely varies. Thus, there are no universal guidelines for shareholders' best practices at this stage – other than to take an interest in the business, make use of the shareholders' rights and encourage management to address a recognised crisis promptly.

Guideline #1.3 ***(Banks' assessment of debtor's financial condition).*** **Financial institutions and other institutional creditors with privileged access to financial information regarding the debtor should assess it for clear indications of a potential crisis. In appropriate cases, loan and financing agreements should contain financial covenants providing for regular as well as – in case of certain events – ad-hoc reporting by the debtor.**

Guideline #1.4 ***(Discussion of financial condition of the debtor on the initiative of a creditor or other party).*** **In case a creditor (or shareholder) gains knowledge of sufficiently strong indicators for a debtor's crisis, they should contact the debtor with the perspective to openly discuss the situation and options to address it.**

4. Incentives to pursue restructuring

Experience shows that debtors and directors are often reluctant to admit to the crisis and to address it openly – in particular by filing for an insolvency proceeding or any proceeding with similar effects (in particular on their reputation, their control over the company or, especially with family businesses, their investment). External impulses by advisors (*supra*, par. 3.2) or creditors (*supra*, par. 3.3. may help but are by no means a guarantee that management will accept the situation and its seriousness and act upon it.

Incentives can come in the form of the proverbial carrot or the stick – the currently predominant approach of the law in various jurisdictions when it comes to the debtor's directors is a stick called "liability". This liability can come in various shapes and forms – general or restricted to certain types of companies; criminal or civil; the latter towards the company or the creditors directly, based on "wrongful trading", failure to restructure, failure to timely file for insolvency or manifold other failures; an obligation to advance the costs of an insolvency proceeding, etc. According to our research, the most common denominator of these liabilities appears to be that they do not *reliably* work as effective incentives, in

[11] This, in turn, means that the situation for shareholders changes completely once they are „out of the money" and have little or nothing to lose. From this point on, they are likely to be indifferent or even interested in keeping the business going, holding out and/or gambling for resurrection, whereas they would likely be divested more or less entirely in a restructuring. One way to address this concern is to allow shareholders to retain some of their interests in the business even after restructuring – the „relative priority rule" recommended herein (cf. Chapter 2) serves this purpose.

particular considering MSMEs.[12] They do, however, work in some cases – especially (but not only) for bigger companies with professional directors that are not (considerable) shareholders, and they commonly add an extra layer of protection for creditors by either giving them direct claims or allowing the estate to (more easily) raise claims against reckless or at least negligent directors.

Thus, the liability does have its place in the law. So it makes perfect sense if Article 18 of the Directive Proposal requires the Member States to institute directors' duties where there is a likelihood of insolvency to, *inter alia*, take reasonable steps to assess the crisis, the companies viability, – if reasonable – avoid such insolvency and to not endanger the business's viability in the interests of creditors and other stakeholders. Such a duty will usually come with – at least – a civil liability attached. Informed by our research as well as general considerations, though, we do recommend changes to Article 18 to focus the liability and clarify the directors' duties.

However, the carrot in form of positive incentives may overall be the superior – or at least, accompanying liability, an equally valuable – approach. The most valuable positive incentive probably is one the law cannot offer, i.e. the positive recognition of management's crucial role in turning the business around and averting the crisis, countering the negative impact / stigma of being in charge when a crisis started. Another positive incentive that the law can dispense more easily is granting access to certain – else restricted – (moderation, conciliation, restructuring or similar) proceedings if management applies for them during an early stage of crisis as long as these proceedings are regarded preferable by management, e.g. because they are more predictable or less invasive (with regards to supervision or replacement of management, interference with day-to-day business, etc.), when compared to the alternatives (and in the last instance formal insolvency proceedings). In particular with single entrepreneurs or partner-led partnerships, privileged discharge of debts could function as a carrot incentivising management to enter restructuring or insolvency proceedings sooner.

We also discussed thoroughly whether to allow creditors or other stakeholders[13] to bypass a reluctant debtor (i.e., for corporate debtors, their management) and effectively initiate restructurings regardless of the debtor's (at least initial) approval. We encourage legislators to carefully consider this approach but have decided – other than with the creditors' option to propose a competing plan – not to recommend a change in the draft Directive to this effect or make a corresponding policy recommendation because, overall, an effective restructuring will not work with (or against) a reluctant debtor and while the threat of a (practically unlikely) competing plan may well counterbalance the debtor's leading role in the process, the creditors' right to initiate a proceeding could not have this effect. As long as the debtor is not materially insolvent – at which point the creditors can file an involuntary petition –, the initiative should generally rest with the debtor. However, for certain proceedings that mostly provide for moderated negotiations and are not cumbersome or prejudicial on one hand and for certain situations of qualified default/non-performance or otherwise close to insolvency on the other hand, a case could be made for allowing creditor initiative. This decision should be made by the national legislators. Short of that, creditors are

[12] Another possible negative incentive is the disqualification of directors neglecting their duties from leading another business venture for a certain period of time. It does not, however, appear to be any more effective than liability with regard to the current business – its effect mostly is preventive, keeping incompetent and/or reckless persons away from future (official) management roles.

[13] Shareholders can potentially use their ownership (provided they garner the necessary majority or can exercise relevant minority rights) to replace or order management to act according to their requests.

basically limited to communicating with and advising/convincing the debtor to pursue a restructuring attempt, also by exercising their bargaining power and threatening to enforce their claims.

<u>Guideline #1.5</u> *(Debtor should address crises timely)*. Debtors should address a crisis in a timely fashion by properly assessing it and, given the business's viability, taking action to avert it with a view of minimising the risks to creditors as a whole by, for example and as appropriate, making operational changes and/or initiating negotiations with key creditors, customers, suppliers or potential investors.

<u>Policy Recommendation #1.7</u> *(Incentives to prevent and address crises)*. The law should create both positive and negative incentives for directors to safeguard their creditors' and other stakeholders' interests by monitoring the business, assessing its viability in a crisis, and take appropriate steps (e.g. restructuring or liquidation).

<u>5. Reduction of disincentives</u>

In particular with regards to creditors, it appears crucial that the law does not create adverse incentives (disincentives) to collect and communicate information regarding a crisis (see *supra*, 3.3.) and, e.g., to enter into restructuring negotiations with the debtor, to reschedule debt and/or to supply fresh money to finance what appears to be a promising restructuring attempt. By far the most relevant disincentive in this regard appears to lie in the avoidance powers in case of a subsequent insolvency proceeding.

The Directive Proposal recognises this and provides, in Articles 16 and 17, for protection of new and interim financing and of other restructuring-related transactions. However, in addition to other shortcomings, this only covers transactions in the context of a formalised restructuring proceeding (modelled after the Directive Proposal) and does not affect the avoidability of any payment received outside of such proceedings but after, e.g., the creditor gained knowledge of the debtor's crisis.

Creditors should not be encouraged to collude or bargain with the debtor to the detriment of other creditors, or to use their superior knowledge of a crisis to put undue pressure on the debtor resulting in preferential treatment compared to other creditors. However, up until at least the point of material insolvency, it should be regarded as legitimate to pursue (with the mechanisms provided for by the general law) one's claims even when suspecting or having positive knowledge of a crisis. Taking sensible precautions, paying attention or being alert should not work against a creditor, nor should the law favour radical enforcement of claims impairing restructuring prospects over (sensibly) cooperative behaviour.

Avoidance and lenders' liability regimes have been considered a big obstacle for restructurings in our research, especially in the expert interviews with advisors to both debtors and creditors. In Germany, for example, the very strict avoidance regime (in particular in its interpretation by insolvency practitioners and some courts) creates certain incentives for creditors to distance themselves from the debtor, not communicate with the directors, not

negotiate or accept part-payment on overdue claims but to enforce them judicially and have assets seized.

Illustration. Simplified, according to sec. 133 German InsO, payments made by the debtor during the last four years before a petition to commence insolvency proceedings can be avoided if the debtor acted with the intention to disadvantage their creditors and the recipient was aware of this intention. The latter is presumed if the recipient was, at the time of the payment, aware of the debtor's (in some cases: imminent) insolvency. While these requirements (which have already been tightened only in 2017 because of excessive avoidance claims) for avoidance read very restrictive, courts (with hindsight bias) tend to construe them extensively. For example, if a director is aware of facts constituting insolvency, it is more or less presumed that all subsequent payments were made with the intention to disadvantage the creditors as a whole, and, similarly, the debtor's non-performance over a considerable time, erratic payment of instalments and/or similar evidence often leads insolvency practitioners and judges to presume the recipient's knowledge of said intention – all the more so if the recipient had even the faintest knowledge of the debtor's strained financial situation. On the other hand, if creditors successfully enforce their claims with the help of the authorities, the enforcement actions are (usually) not considered payments made by the debtor so that they are unavoidable unless made in close proximity (three months) to filing. Thus, it may appear prudent for creditors to not negotiate with debtors in crisis, to not consider participating in restructuring efforts but to directly enforce their claims and hope the debtor – while then almost inevitably headed for insolvency – will not file within three months.

Other German rules and their excessive interpretation create a certain risk that far-reaching financial covenants can result in the creditor being treated as a (subordinated) shareholder-lender. While the courts accept an (all-too-narrowly construed) privilege for payments in the context of restructuring attempts, overall, the avoidance rules – especially but by far not only in Germany – pose not only a huge obstacle to actual restructurings but also a disincentive for creditors to engage in negotiation with the debtor and keep their eyes open for crisis signals.

Policy Recommendation #1.8 ***(Disincentives to creditors' cooperation and overly harsh avoidance regimes).*** **Creditors and other stakeholders must not be discouraged by the law and its application from monitoring the debtor's financial situation and engaging in communication and negotiations with the debtor regarding a crisis and its resolution. Avoidance regimes and lenders' liability, in particular, should be appropriately curtailed and – outside of the debtor's material insolvency – restricted to cases of abuse and collusion.**[14]

[14] Cf. the French example of shielding lenders (in particular banks) – albeit only in the context of institutional restructuring proceedings – from liability found in C. com., art. L 650-1, allowing only for three avenues to liability: (1) fraud, (2) interference with management, (3) excessive securities.

Annex 1: A restructuring-friendly environment

Closely connected to the last point, national laws contain several obstacles for restructuring attempts and do not – always – provide for sufficient tools and reliefs to allow for the restructuring of viable businesses.

To stick with the example of Germany: In addition to the obstacles mentioned before (avoidance and lenders' liability), qualitative research identified further obstacles, for example the tax regime (with the main concern "taxation of restructuring profits") and the subordination of shareholder loans even if they were extended with the sole purpose of financing a worthwhile restructuring attempt (see also Chapter 3, par. __ and __ on these issues)[15]. German law, currently, also does not provide for any statutory priority of fresh money provided by non-shareholders to finance a restructuring attempt, and lacks tools facilitating going-concern sales (whether in insolvency or beforehand). For example, if a business heavily relies on certain contracts or licenses, a going-concern sale is not possible without the approval of the other party or the licensor.

Policy Recommendation #1.9 ***(Restructuring-friendly legal environment).*** **Legislators should take steps to create a generally restructuring-friendly legal environment by creating sensible privileges for worthwhile restructuring attempts (whether merely contractually and out-of-court or in the form of a restructuring proceeding), e.g. priorities for fresh money, by facilitating going-concern sales and by abolishing or curtailing existing obstacles.**

Annex 2: Promoting a co-operative approach between debtor and banks

Banks must implement structured monitoring systems for prudential/supervisory purposes. Such systems are aimed, *inter alia*, at capturing the occurrence of specific events (e.g. initial arrears) that may signal the deterioration of the loan. Nothing, however, prevents a debtor from taking initiatives prior to the occurrence of those specific events, which cause lenders to send alerts and take preliminary contacts. A debtor, indeed, might always be aware of other sensitive events unknown to creditors that may affect the business's financial soundness, and they should start to plan remedies on their own, possibly with the assistance of financial advisors.

Under these circumstances, however, a debtor might be exposed to the risk of wasting time and resources in devising a plan which might envisage concessions that a financial creditor would not accept due to regulatory/operational constraints, or as a consequence of its own NPL strategy or internal assessments on the prospects of the specific exposure or the segment of exposures to which the latter belongs (on this specific point, see also Chapter 5). To prevent this, debtors should timely approach – i.e. at very initial signs of distress – their financial creditors to verify with them the existing (regulatory or operational) boundaries within which any negotiation would have to take place in case the situation gets worse.

[15] The rule in sec. 39 para. 4 sent. 2 InsO only exempts situations in which creditors for the first time acquire (sufficient) shares during restructuring but not situations where existing (qualified) shareholders extend loans.

Banks, in turn, should be encouraged to share with interested debtors the result of internally conducted financial assessments, including sectorial analyses, that may anticipate the evolution of the crisis and may help the debtor in identifying the most effective and feasible remedies. This type of assistance may be beneficial, in particular, to small and medium enterprises, which might not have in place adequate risk monitoring mechanisms or may not avail themselves of the assistance of qualified financial advisory services.

In order to promote a cooperative approach by banks in this respect, debtors should be ready to provide, in turn – subject to proper confidentiality arrangements – any information that may impact their creditworthiness and might be useful for a prompt assessment by lenders of the financial situation of the debtor and the possible activation of early warning mechanisms (this topic has obvious implications on the negotiation phase, for which see Chapter 5).

Chapter 2
Fairness

1. Introduction

1.1 Substantive and procedural goals

In order to understand how plans might be fair, it is useful to distinguish between the substantive and the procedural goals of insolvency law.[1] *Substantive goals* are the ends or objectives of this law, pursuit of which shows why it is desirable to have this law at all. At a prosaic level, insolvency law's substantive goals include identifying those distressed businesses that remain viable and facilitating their preservation as going concerns, recycling the assets of non-viable distressed businesses to fresh uses, and in each case, returning the maximal feasible value from the process to those entitled to it. *Procedural goals* relate to the methods the law adopts in seeking to pursue substantive goals. Efficiency is an important procedural goal, and requires minimising the waste of social resources and mitigating perverse incentives.

1.2 Imperfect information and how not to respond to it

In relation to distressed businesses, it is often a critical and disputed question whether the business remains viable and ought to be preserved as a going concern, or whether instead it is non-viable and ought to be liquidated. In the former case, there are also questions, equally critical and disputed, as to *how* the business should be restructured in order to rescue it from distress, who should manage it through and beyond the restructuring, and how the value thereby preserved or created should be distributed.

From the 'God's eye view', from which truth is discerned perfectly with no limitations inherent to the observer, these questions would be readily answerable.[2] The God's eye view is not, needless to say, accessible to mere mortals engaged in insolvency proceedings. No court or expert has privileged insight into the competence and integrity of present and potential future management; the loyalty and goodwill of key employees, suppliers, and customers; the prospects for the economy as a whole and the particular sector in which the business in question and its competitors operate; or the relative contribution to a successful rescue of the various parties and of factors beyond the parties' control. In the absence of any such God's eye view, the substantive goals of the law cannot be pursued directly. They must instead be sought by proxy, through the very process of formulating, proposing, voting on, approving, and implementing a plan. The process should involve parties with the best knowledge of the debtor, its business, management, and prospects; who hold a legal stake in the outcome; and who have personal incentives to get the restructure-or-liquidate decision right. Such parties must be armed with appropriate information, be

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[1] Mokal, *Corporate Insolvency Law – Theory and Application* (Oxford: OUP, 2005), 20-26.

[2] While the notion of a God's Eye view dates back to Xenophanes of Colophon c. 500 BC, its modern formulation is owed to Hillary Putnam, *Reason, Truth and History* (Cambridge: Cambridge University Press, 1981), 50.

accorded cost-effective access to expert evaluation of the proposed plan, and then be asked to vote on it. (For the reasons explored below, the parties paradigmatically fitting this description are creditors as a group.)

A restructuring plan proposes how the assets, operations, and affairs of the business would be arranged so as to effect a rescue, who would helm this process, and how the resulting value would be distributed. The approval of a restructuring plan represents the decision that the business remains viable, may appropriately be entrusted to the management proposed in the plan, and that the proper distribution of the resulting value has been identified. The rejection of all proposed plans indicates that, for some combination of reasons bearing on the foregoing issues, the business is fit only for liquidation.

1.3 Fairness of process and fairness of outcome

Fairness is a key attribute of the processes for formulating, proposing, voting on, approving, and implementing plans. It requires vesting decision-making at each of these stages in the parties – primarily creditors but also equity holders and possibly others – in a way that is commensurate with their stake in the outcome; by facilitating the availability to them of information and expertise bearing upon their decisions, by ensuring that there is due accountability as to the exercise of decision-making power, and by doing so in a cost-effective (which is to say, least wasteful) manner. Understood thus as concerned with due respect for legal rights, availability of information and expertise, due accountability, and cost-effectiveness, fairness is a key procedural goal of insolvency law, best enabling pursuit of the law's substantive goals (identified above).[3] A plan inherits the fairness of the process from which it results.

This chapter considers the requirements of fairness at each significant step in the plan proposal, consideration, approval, and implementation process. It begins by clearing the ground of certain endemic confusions regarding the treatment of equity claims.

2. Treatment of equity claims

2.1 The 'debt/equity bargain'

It is important to bear in mind the fundamental nature of what may be called the debt/equity bargain.[4] Creditors are restricted to principal plus interest at the stipulated time, may in principle only claim against the debtor's assets where it is a limited liability entity and have no recourse to its equity holders, do not stand to gain additional benefit even if the debtor is spectacularly successful in its use of the sums it has borrowed, stand to suffer losses in the debtor's insolvency, but are entitled to be paid *before* equity receives anything. By contrast, equity holders' claims have no upper limit and they stand to capture any upside from the debtor business once fixed (i.e. debt) claims have been paid in full.

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[3] This draws on Ronald Dworkin, Law's Empire (Cambridge MA; Harvard University Press, 1986), 164-5; Mokal, 'On Fairness and Efficiency' (2003) 66(3) Modern Law Review 452, 452 and 457-462.

[4] See Mokal, 'An Agency Cost Analysis of the Wrongful Trading Provisions: Redistribution, Perverse Incentives and the Creditors' Bargain' (2000) 59(2) *Cambridge Law Journal* 335, 345-346.

Correspondingly, however, equity holders are residual claimants not entitled to *any* particular return at all, any such return being contingent, precisely, on the prior satisfaction of debt claims.

This debt/equity bargain defines the essential context of any restructuring plan. Definitionally, creditors' legal rights are violated if and to the extent that they are not paid at the time and in the manner and quantum of their entitlement. Fully solvent restructurings apart, this is true of all scenarios in which a plan is proposed or contemplated. Even 'preventive' procedures that become available where there is merely a likelihood of insolvency characteristically involve overriding creditor entitlements to provide interest payment holidays, extended principal repayment periods, and more. That is to say, creditors' legal rights are forcibly rewritten in a way that is detrimental to them at least prima facie.

In all such scenarios, then, the debt/equity bargain is in play. Since creditors are not to receive their entitlements, their interests supersede and trump the interests of equity holders, who are not entitled to any particular return and not entitled to be paid at all unless creditors receive their entitlement, or else agree otherwise by consenting to a restructuring plan by requisite majorities.

2.2 The treatment of equity holders in the absence of the God's eye view

This implication of the debt/equity bargain troubles some commentators in three scenarios in particular.

2.2.1 The 'still solvent' scenario

The first concerns the aforementioned 'preventive' or 'pre-insolvency' scenario where a restructuring process is invoked before the debtor has missed any debt repayment. Here, insolvency is not established and the question is whether creditor interests should nevertheless trump equity ones. In the absence of universal creditor agreement that the debtor remains solvent, the response must be in the affirmative. There is *ex hypothesi* a conflict between equity, which asserts the debtor's solvency, and debt, which denies it. Which side had the truth would be easy to ascertain from the God's eye view. Lacking omniscience, legal actors including judges and legal processes are exactly in the position described above: a plan is being proposed non-consensually to rewrite creditors' legal entitlements. Since creditors are not to receive that to which they are legally entitled, equity holders are not entitled to any value in the debtor's estate. The only way in which they ought to be permitted to receive some such value is by persuading at least the requisite majorities of creditors to a plan that provides as much. Not only do creditors have legal rights at stake and personal incentives to get the restructure/liquidate decision right, they have dealt with the debtor, its management, and the part of the market in which the debtor and its competitors operate. They rather than a judge or anyone else are best placed to take the leading role in the restructure/liquidate decision, and thus in voting on the plan. There is no reason to believe that a plan that has failed to obtain requisite creditor majorities would permit the business to continue only if it is viable, nor that it would allocate the value in the estate fairly, i.e. respectfully of legal rights, duly informed by debtor-specific knowledge, and in a cost-effective manner.

2.2.2 The 'micro, small and medium enterprises' scenario

The second scenario in which some may challenge the implications of the debt/equity bargain concerns micro, small and medium enterprises ('MSMEs'). The viability of some MSMEs may depend on the same person(s) combining the role of manager and residual risk-bearer (i.e. equity holder). Given the size, nature, and/or location of the business and its turnover, the business may not be viable unless the same persons were both managers and equity owners, thereby effectively cross-subsidizing the two roles. Further, the viability of some MSMEs may turn on the continuing goodwill of certain of its suppliers, customers, and/or key employees, which in turn may be contingent on pre-distress managers retaining ongoing control.[5] In relation to a business characterised by one or more of these factors, it might be thought that the retention of the pre-distress equity holding management should have independent weight even against the wishes of creditors. Again, however, this assumes access to the God's eye view from which it is just evident *both* that the business is viable and ought therefore to be continued *and* that it may only continue with the old equity-holding management in place. In the absence of omniscience, the question is how to decide whether and how best to continue the business. Who should have decisive say? Not the old equity holders, who have clear incentives to favour their own retention. Nor a court, which has no direct knowledge of or expertise bearing on the business, its affairs, managers, competitors, or prospects. Creditors as a group are better placed than any other to make these decisions.

2.2.3 The 'irrational creditors' scenario

Third, some may worry that creditors should only be entrusted with the primary role in the plan approval process if and insofar as they are rational, but that creditors may often act irrationally. This concern with irrationality should, however, be in principle symmetrical between creditors on the one hand, and equity holders, courts, and others on the other. In the absence of reasons for thinking that creditors are particularly prone to irrationality in a manner that does not hold for these other actors, there is no basis for stigmatising creditor decision making and favouring decision making by others. Creditors may sometimes be rational and at other times irrational, but so may these others. Creditor irrationality provides no reason for departing from the analysis in the previous portion of this section.

> **Policy Recommendation #2.1** (***Approval of plan requires creditors' support***)**. A plan should only be approved if it receives requisite support from creditors whose rights are to be affected. This should be the case in preventive restructuring and in cases concerning micro and small enterprises.**

3. Notification and information provision

Notification of steps in the plan formulation and approval process may be provided electronically and/or online where this is the usual mode of communication with the relevant stakeholder group.

All those affected, including creditors and equity holders, must be given individual notice of the meeting at which the plan is to be voted upon, and provided with ready access to

[5] Both these situations receive detailed consideration in Mokal, *Corporate Insolvency Law*, Ch 7.

the plan and appropriate information about it. Where individual notice cannot be provided, the debtor should be required to take all reasonable steps to provide notification, and should be required to satisfy the court both that individual notification was not practicable and that it has done everything reasonably practicable to provide notification. Two to four weeks of notice should be required, unless the Court permits an abridged or requires an extended period.

Policy Recommendation #2.2 *(Notice to creditors).* Intended parties to a restructuring should be provided with adequate notice of steps in the plan formulation and approval process. Two to four weeks of notice should be provided unless the Court approves an abbreviated or extended period.

Policy Recommendation #2.3 (*Electronic or online notice*). The notification may be provided electronically and/or online where this is the usual mode of communication with the relevant stakeholder group.

Policy Recommendation #2.4 (*Individual notification*). Each affected stakeholder must be provided with individual notification unless the Court is persuaded that such notification is not reasonably practicable and that all reasonably practicable steps have been taken to notify the stakeholders in question.

Those whose vote is sought should be provided with sufficient information about the effect of the plan and the benefits provided under and collateral to the plan to stakeholders, including the debtor, its affiliates and decision-makers.

The information should enable the parties reasonably to consider the pros and cons of the plan and whether voting for or against it would better advance their interests.

The information should be up to date. If material changes have occurred between the provision to parties of the plan etc. and the date of the meeting, this should be disclosed to the parties with reasonable promptness.

In cases of a complex plan, a list of questions and answers should be included as may a list of advisory organisations.

The law should require the debtor to err on the side of excessive rather than insufficient disclosure of information.

Policy Recommendation #2.5 (*Adequate information to be provided to stakeholders*). Stakeholders whose vote is sought should be provided with sufficient information about the effect of the plan, the allocation amongst stakeholder groups of benefits and burdens under it, any collateral benefits offered or provided to some but not all stakeholders, the intended treatment of management. The information should be up to date, and if necessary, should be updated.

4. Comparator

Stakeholders should be provided with analysis of the comparator for the plan, that is, the scenario most likely to materialise in the absence of the implementation of the proposed plan. Stakeholders should be informed of what they are likely to receive in both the plan and the comparator scenarios.

Stakeholders' liquidation returns set the absolute floor for plan viability. That is to say, a plan under which any stakeholder receives less value than under a liquidation is highly unlikely to be justifiable except with that stakeholder's consent.

Even if the debtor were to be placed in insolvent liquidation proceedings, it remains possible in principle either for its business to be broken up and disposed of piecemeal ("**piecemeal sale**") or else for it to be sold off wholly or in significant part as a going concern ("**going concern sale**"). The plan should explain why piecemeal or going concern sale is the correct comparator.

Policy Recommendation #2.6 (*No-plan scenario*) The plan should provide information about the debtor's prospects and the stakeholders' likely returns in the event that the plan is not approved. This may require information in the event, as appropriate in the circumstances of the particular case, of the debtor's entry into insolvent liquidation or other proceedings or else the debtor's continuation in business with no modification of its obligations. If the correct comparator is insolvent liquidation, the plan should explain whether the debtor's business would be subject to a going concern sale or a piecemeal sale. In each of these scenarios, the plan should explain why it is in the affected stakeholders' interests to approve it.

5. Competing plans

There is a question whether stakeholders may be presented with more than one plan on which to vote. There are broadly three alternatives.

First, only the debtor may be permitted to place a plan before stakeholders. This important element of control over the restructuring process would tend to incentivise the debtor to commence that process, and capitalises on the debtor's private information about the enterprise, its assets, affairs, and prospects. It also, however, opens up the potential for expropriation of stakeholders shut out of the indubitably advantageous plan formulation process at the behest of the debtor and favoured stakeholders.

The second option is for any creditor to be permitted to draw up their own plan, to present it to stakeholders, and to invite the debtor to place the plan for the stakeholder vote. The debtor, however, retains the right to choose whether to do so. To the extent that stakeholders are persuaded of the superiority of the creditor plan, they would be less likely to support that presented by the debtor. Further, the Court would have a possible alternative comparator against which to assess the debtor's plan. How realistic it proves for creditors to exercise this information- and resource-intensive option to formulate a plan that might never be put to a vote is very much open to question.

The third alternative is for one or more creditors to be permitted to formulate and put their own plan forward for the stakeholder vote. If that plan attracts the requisite support and

proves more popular with stakeholders than the plan formulated by the debtor, then it rather than the debtor's plan should be presented to the Court for confirmation. The option for creditors to formulate a competing plan is likely to remain theoretical in most cases given the costs and debtor-specific information required to formulate a credible plan. Besides possibly disincentivising the debtor to commence the restructuring process, there is also a perceived risk that the availability of this option would open up possibilities for abuse by creditor coalitions who would illegitimately expropriate the rights of equity holders. This abusive scenario is highly implausible, given that the debtor could pay creditors off from its own resources or by obtaining new funding; or else could persuade the Court to exercise its independent judgment to reject the offending plan. In general, it is difficult to think of any jurisdiction in which courts have a reputation for being overly ready to disentitle equity holders at creditors' behest, and easy to think of several whose courts are regarded as overly reluctant to do so. The significant advantage of this option is to incentivise creditors to consent to the continuation of the business because they have confidence in the plan presented by one or more of their own number rather than by the debtor. In marginal cases, this option may preserve wealth and employment through the continuation of the business.

A variant on the third alternative described above, familiar from US restructuring practice, is for the debtor to be afforded an initial exclusivity period within which only it may propose a plan. If no plan has been proposed when the period expires and is not extended by the court, creditors and the bankruptcy trustee may also propose plans that end up competing with that put forward by the debtor. The exclusivity period is intended to incentivise the debtor to formulate and table a plan with due promptness. Its efficacy turns, however, on knowledgeable specialist bankruptcy judges able to assess whether to extend the period on the basis that the debtor is making due progress in formulating its plan or else to refuse any extension on the ground that there is no sufficient prospect of the debtor putting forward a credible plan if allowed additional time. In the absence of such judicial expertise, as in the large majority of EU jurisdictions, the existence of an exclusivity period risks adding to the length of proceedings as debtors are given but do not make due use of it, and, what is worse, are then able to persuade judges to extend the period.

Policy Recommendation #2.7 (*Competing plans*). Any creditor or a group of creditors should be permitted to formulate their own plan and to place it before relevant stakeholders for their consideration and vote.

6. Class constitution

Stakeholders must be placed in classes to enable a collective, mutually informed consideration of the plan based on shared interests. Classification involves a balancing exercise. To place stakeholders in the same class who do not have sufficiently common interests is to negate the reason for classification. At the same time, since each class is entitled to distinct consideration when assessing the appropriateness of a plan, to place some stakeholders in a separate class is to provide them with some degree of veto power in relation to it.

It is for the party proposing a plan (characteristically, the debtor) to identify the stakeholder groups(s) to whom it seeks to propose the plan. The plan proposer must also propose how to categorise the stakeholders into classes.

Each class should be constituted of stakeholders with legal rights that are not so dissimilar as to make it impossible for them to consult together with a view to their common interest.

The dissimilarity of rights is a function jointly of pre- and post-plan rights. Stakeholders X and Y may belong in separate classes if either or both of the rights they currently hold and those they would hold if the plan were to be put into force are so dissimilar as to make it impossible for them to consult together with a view to their common interest.

What matters *for the purposes of classification* is the legal *rights* of the stakeholders, and not their private *interests*, i.e. interests not derived from their rights against the debtor. The private interests of some stakeholders may, however, diverge so significantly from those of other members of the class that the court should discount or disregard those stakeholders' votes as unrepresentative of the class.

The mere fact that stakeholders' rights are different does not necessitate that they be placed in separate classes. What matters is dissimilarity so significant that those stakeholders cannot consult together with a view to their common interest, as mentioned above. For example, it may be appropriate to place in the same class stakeholders whose respective rights are subject to different contingencies as at the date of the proposed approval of the plan, so long as they are valued in a transparent, consistent, and defensible even if rough and ready manner.

Stakeholders whose rights are not affected by the plan need not be asked to vote on it.

Policy Recommendation #2.8 (*Classification of stakeholders for voting purposes*). The party proposing the plan should also propose how stakeholders are to be classified for voting purposes.

Policy Recommendation #2.9 (*Class formation: commonality of interest*). Stakeholders should be placed in the same class if their legal rights both, prior to, and as amended if the proposed plan were to be implemented, are not so dissimilar as to make it impossible for them to consult together with a view to their common interest.

Policy Recommendation #2.10 (*Class formation: relevance of legal rights, not private interests*). What matters for classification purposes are the parties' legal *rights against the debtor*. Their private interests, and any rights they might hold against third parties (such as guarantors) should generally be irrelevant to classification, though it may be taken into account by the court in considering whether their vote should be discounted.

7. Conduct of meeting

There should be an appropriate link between the stake each voter has in the outcome and the value accorded to their vote. Creditors should be entitled to vote the face value of their claim even if they had acquired such claim at a discount.[6]

> **Policy Recommendation #2.11 (*Value of claim for voting purposes*). Creditors should be entitled to vote the face value of their claim.**

In general, where no one present at the meeting objects to the manner in which it is conducted, the Court should not entertain subsequent objections on the issue.

The purpose of the meeting is to enable consideration and debate of the merits of the plan. However, the law should not require a physical meeting but instead should permit voting by proxy or virtual meetings. When the meeting is virtual, the communication tools, possibly digital, used to allow creditors to cast their vote should ensure adequate certainty about the identity of the creditor, while not requiring them to incur any additional costs.

Where stakeholders are represented by proxy or are content with a brief or even no discussion, that in itself should not be a basis for challenge.

> **Policy Recommendation #2.12 (*Voting procedures not requiring a physical meeting*). The law should permit voting by proxy and virtual meetings at which to vote on a plan. The means of communication, preferably digital, used to allow the creditors to vote on the plan should ensure certainty on the capacity as creditors of those taking part to the virtual meeting.**

> **Policy Recommendation #2.13 (*Presumption of properness of stakeholders' meeting*). There should be a rebuttable presumption that the meeting at which stakeholders voted was conducted properly and that the parties voted in a valid manner. The paucity of a debate at the meeting should not be a basis for rebutting this presumption.**

8. Court's review and approval

In general, parties given sufficient information about the plan and sufficient time to consider its implications for them are in a better position than the Court to consider whether the plan is in their interests. Their votes should be sufficient to deem that the class has approved the plan, unless there is reason to doubt that they were representative of their class.

[6] Certain 'loan-to-own' scenarios, in which specialist funds acquire distressed debt claims with a view to converting them to a controlling share of the debtor's equity, can be problematic. In relation to the fairness of restructuring plans, this issue is addressed through the design of the 'relative priority rule', discussed below. Broader concerns, such as the abuse of loan covenants so as to facilitate acquisition of control over the borrower, fall beyond this project's scope.

The court must not simply rubber-stamp a plan approved by the requisite majorities, but must exercise its own judgment to satisfy itself that the plan meets the requirements of the law. It should consider the following:

a. Was the information provided to the stakeholders, and the time given for considering it, adequate? In answering these questions, the Court should consider the level of sophistication of those asked to vote.
b. Were the majorities in each class acting bona fide in the interests of the class? There should be a rebuttable presumption that they were. This test would not be met if those in the majority were promoting private interests not deriving from the legal rights against the debtor held by each class member. The court should discount or disregard votes of those with personal interests adverse to those of the class, or personal interests not shared with other members of the class such that they would not have voted for the plan in the absence of those collateral interests. The votes of stakeholders connected with the debtor, its affiliates or decision makers would often be worthy of such treatment. So would the vote of a party with the benefit of a credit default swap or similar that entitled it to a greater return in the debtor's liquidation than if the proposed plan were to be approved.
c. Are there any circumstances in the context in which the plan was formulated, proposed, voted upon, or proposed to be implemented, that might impair its appropriateness? Examples include where the plan is unnecessary, involves a serious breach of contract with a third party, is ultra vires of the debtor, is subject to significant conditions that remain unmet, or is likely to be ineffective (for example, where part of the plan is to be implemented in another jurisdiction and it is more likely than not that the courts of that jurisdiction would refuse it recognition and effect) See also Chapter 4, par. 5.4.2 on conditions to the plan.
d. Is the plan manifestly non-feasible? In general and as explained above, it is the affected stakeholders rather than the Court who are in the best position to assess whether the distressed debtor remains viable, and if so, how best to afford it a chance to trade out of its difficulties. The Court should be restricted to satisfying itself that it is more likely than not that the debtor would not enter liquidation or require further restructuring if the plan were to be approved (unless the plan itself envisages such liquidation or further restructuring). Further discussion of this issue is in Chapter 6, par. 4.4.
e. Is the plan in the best interests of dissenting creditors ('**the best interests test**')? This requires dissenting creditors to receive at least as much under the plan as they would in the comparator scenario, that is, one most likely to materialise if the plan were not approved. In all cases, this would require the plan to provide at least as much to dissentients as they would receive in the debtor's piecemeal sale. A piecemeal sale would not be the comparator where, for example, the plan itself contemplates a going concern sale; or the court is satisfied on the basis of credible evidence that a going concern sale would likely result if the plan were not approved; or if a different plan was also put to the vote, has received adequate support, and is likely to approved if this plan were not. In any such case, the best interests test would require the plan to match or exceed dissentients' return in that alternative; meeting or exceeding returns in the event of a piecemeal sale would not be sufficient.

The Court may adjourn the hearing to enable stipulated steps to be taken, require the plan to be subject to another vote, impose preconditions for its approval, or reject the plan outright.

Policy Recommendation #2.14 (*Conditions for approval of the plan by the court*). The Court should approve a plan if satisfied that:

1) adequate information was provided to affected stakeholders, taking into account their level of sophistication;

2) majorities in each approving class were acting bona fide in class interests, there being a rebuttable presumption that they were;

3) there are no circumstances in the circumstances in which the plan was formulated, proposed, voted upon, or proposed to be implemented that impair its appropriateness:

4) the plan is not manifestly non-viable; and,

5) the plan is in the best interests of dissenting creditors, in that it provides them with at least as much as they would receive if the plan were not approved.

Policy Recommendation #2.15 (*Conditions imposed by the court*). The court should be allowed to impose conditions on its approval of the plan.

9. Dissenting stakeholder classes

Where a plan that affects the rights of a stakeholder class has failed to attract the requisite support amongst class members, it might nevertheless be approved so long as it treats the class fairly. In addition to the requirements described above, the plan must be appropriate and must show due respect for the legal rights of class members. This would at a minimum entail fulfilment of each of the following three conditions:

a. The best interests test is satisfied.

b. At least one class of creditors whose rights are to be impaired under the plan has approved it by the requisite majority.

c. The '**relative priority rule**' is observed.[7] This requires that (i) each dissenting class is to receive treatment at least as favourable as other classes with the same rank; (ii) no class of a lower rank is to be given equivalent or better treatment than it; and (iii) higher ranking classes must receive no more than the full present economic value of their claims.

The relative priority rule is a preferred alternative to the 'absolute priority rule' familiar in US restructuring practice. The absolute priority rule makes it a precondition for approval of a plan rejected by one or more classes of affected stakeholders that members of each dissenting class would receive the full face value of their claims before the members of a lower class receive, or retain, anything. This approach is defective. It incentivises dissent from the plan so long as the dissentients expect the plan to receive sufficient support from claimants in other classes. Such dissentients would expect to free-ride on others' sacrifice by

[7] A good discussion of underlying principles is Madaus, S., "Leaving the Shadows of US Bankruptcy Law: A Proposal to Divide the Realms of Insolvency and Restructuring Law", Eur Bus Org Law Rev (2018), particularly Section 5.2. https://doi.org/10.1007/s40804-018-0113-7.

being paid in full while those others accepted a haircut. This makes approval of the plan less likely, however, since each class might in this way have some such incentive to dissent.

The relative priority rule provides a more realistic alternative, ensuring fairness for dissentients by protecting their relative position against all other affected stakeholders but without creating hold-out incentives. The relative priority rule also makes it more feasible for plans to be approved that permit equity holders to retain a stake in the debtor or its business, which in turn is likely to incentivise greater and more timely use of restructuring proceedings and the option of drawing on equity's debtor-specific knowledge, expertise, and goodwill. The rule also provides a measure of protection against improper 'loan-to-own' strategies by which acquirers of distressed debt seek to acquire a share of debtor's equity greater than the present economic value of their debt claims.

Policy Recommendation #2.16 (*Conditions for cross-class cram down*). The Court should approve a plan that has not received adequate support of the members of one or more affected classes if satisfied that:

1) the plan is in the best interests of dissenting creditors, in that it provides them with at least as much as they would receive if the plan were not approved;

2) at least one class of creditors whose rights are to be impaired under the plan has approved it by the requisite majority; and,

3) the relative priority rule is observed, in that (i) each dissenting class is to receive treatment at least as favourable as other classes with the same rank; (ii) no class of a lower rank is to be given equivalent or better treatment than it; and (iii) higher ranking classes must receive no more than the full present economic value of their claims.

Chapter 3

The Goals, Contents, and Structure of the Plan

1. Introduction

The restructuring plan is the key element in the proposal, approval, and implementation of the restructuring of a distressed company or group of companies.[1] It aims to inform the stakeholders and the court about the need for and rationale of the restructuring and about how the restructuring would affect parties' rights and obligations. A well-drafted plan would provide an overview of the affected (and non-affected) parties of the restructuring (and classes, if necessary).

Restructuring usually requires claimants to make significant concessions of some kind and therefore the restructuring plan includes important distributive consequences for the parties involved and the value of their individual claim. A restructuring plan formulated in a sophisticated restructuring environment can bind all types of capital providers, including secured and preferential creditors and shareholders and may also be limited to a subset of creditors, e.g. financial creditors. Parties who are not included or involved in the adoption of the restructuring plan are not bound by its terms, although they may be indirectly affected by the legal effects of the plan (for a more in-depth discussion, see Chapter 6).

In order to provide transparency for all parties, the restructuring plan should include the valuation of the present value of the debtor or the debtor's business as well as a reasoned statement on the causes and the extent of the financial difficulties of the debtor. The key principles of the plan should also include the proposed duration, the measures that ought to be implemented with the plan and its effects. The plan also needs to include an opinion or reasoned statement by the management or party responsible for proposing it about the viability of the business, the purpose of the restructuring plan in supporting the going concern by avoiding insolvency and necessary pre-conditions for the successful implementation of the restructuring plan.

A word on terminology. In this document, the term 'plan' is used expansively to refer to both the contractual or quasi-contractual provisions that amend the rights and obligations of the parties, and to the other documents (referred to as the 'disclosure statement' in US practice and the 'explanatory statement' in the UK scheme of arrangement context) that provide the parties and the court with all requisite information as part of the restructuring process.

[1] A group of companies may undergo simultaneous restructuring. In this case, the restructuring may occur through a single plan, or else through a plan in relation to each participating entity, depending on applicable law and practice and on what is envisaged by stakeholders in a particular case. Our discussion is intended to address both possibilities.

This chapter describes the goals, contents, and structure of a well drafted restructuring plan. It also considers valuation issues, which are amongst the most difficult and contentious in many restructurings.

Policy Recommendation #3.1 (*Scope of plan*) A plan should be capable of binding the full range of capital providers, including secured and preferential creditors, tax authorities, and equity claimants.

Policy Recommendation #3.2 (*Applicability to claimant subset*) The law should permit the plan to bind only a subset of any given category of claimants. For example, it may only affect financial lenders, leaving all other claimants out of its scope, not bound by it and therefore with the benefit of their existing rights.

2. The Restructuring Plan

A restructuring plan characteristically proposes to restore the viability of the debtor, which is to say, it proposes a way to enable the debtor to pay its way in the medium to long term.[2] The plan does so by proposing one or both of the following ways:

1. a restructuring of the assets and operations of the debtor ('operational restructuring'); and/or,

2. by restructuring the debtor's capital structure and liabilities ('financial restructuring').

Experience from multiple jurisdictions indicates that most debtors would require an appropriate combination of both operational and financial restructuring to render the business viable once again. Operational restructuring requires real-world changes, however, such as the closure of facilities, disposal of assets, and redundancy of employees, and tends thus to be more painful to implement. For this reason, there is often a tendency particularly on the part of the debtor's managers and owners to downplay the need for it. By contrast, financial restructuring tends to place the burden of restoring the debtor's viability on the creditors, and is thus likely to be favoured by debtors.

The restructuring plan should provide the stakeholders and the court with all the information that is reasonably required to enable them to assess the plan. This would include, without limitation:

[2] Some plans presented in restructuring proceedings are aimed at liquidating the business in a way expected to be more value-preserving than would be practicable under the applicable liquidation regime. Subject to observing the safeguards set out in this report, there would appear to be no real objection to such use of the restructuring process.

1. explaining why the restructuring is required, in particular by showing how, in its absence, the debtor would be unable to meet its obligations as they fell due;

2. explaining the assumptions and projections on which the restructuring is based, showing how these are reasonable;

3. describing how the restructuring plan would operate on the debtor and its liabilities, identifying the assets to be disposed of, the operations to be discontinued, the changes proposed to the management, the liabilities to be modified, and any new rights created;

4. disclosing the steps taken by the debtor and any other parties in the restructuring proceess to date, including in particular whether some stakeholders have been offered inducements to agree to the restructuring; and,

5. indicating the outcome for the debtor and its business if the plan were to be approved, and also if it were not.

Guideline #3.1 (***Operational and financial restructuring***) **The party proposing the plan should consider whether, in order to provide the debtor with the best chance of restoring its viability, both the assets as well as the liabilities side of the debtor's balance sheet requires restructuring.**

3. Possible Measure of the Restructuring Plan

There are different measures to be proposed in the restructuring plan, either affecting the assets or the liabilities side of the debtor's balance sheet.

3.1 Measures on the asset side

3.1.1 Sale of the business

The restructuring plan may propose the sale of the entire business. The intended buyer may be owned by an entirely new set of investors, in which case the outcome is substantively identical to liquidation, though undertaken in a manner that stakeholders evidently consider to be superior to that likely from placing the debtor in the formal liquidation process. Alternatively, the intended buyer's owners may include some of the debtor's existing investors (creditors, shareholders, or both). This would be the case when stakeholders take the view that it would be better for tax, regulatory, or other similar reasons to continue the business through a new entity.

3.1.2 Sale of non-strategic assets

Through the sale or liquidation of non-strategic assets, the company may be able to secure liquidity, which may be key to the survival of its core business as a going concern. The law should not deem the sale of non-strategic assets, including business units running

operations that are to be discontinued according to the plan, as amounting at law to a liquidation.

3.1.3 Changes in workforce

Reducing the number of people employed by the debtor may be critical to restoring the debtor's viability. The present employment levels may be excessive in view of the reduced demand for the debtor's product, and/or the liabilities associated with continued employment may no longer be affordable. This kind of operational change is often one of the more difficult to negotiate. In big businesses there may be political pressure to avoid layoffs. In micro and small businesses there may also be personal ties that make this kind of measure difficult to carry out for incumbent managers (see also Chapter 7 on the implementation of the plan).

The law often provides for specific procedures which make reduction of the workforce easier or less expensive in the course of a restructuring. Given the importance of this measure, the plan should take into account the applicable laws and regulations or collective agreements and take into specific account whether the chosen restructuring tools is in the best interest of creditors, given the situation.

Policy Recommendation #3.3 (*Sale of business as going concern*) The law should permit the sale of the debtor's business in whole or part as part of the restructuring process.

Policy Recommendation #3.4 (*Changes in workforce*) The law should provide for specific measures by which the debtor's workforce may be reduced as part of a restructuring process.

Guideline #3.2 (*Assets-side measures*) The party proposing a plan should consider whether operational changes such as sale of assets or of the business or reduction in the workforce are necessary in order to afford the debtor the best chance of restoring its viability.

3.2 Measures on the liabilities side

There are certain measures on the liabilities side that are easier (and quicker) to implement than others. Depending on the financial situation of the company or group of companies, some of these measures may already be executed prior to the negotiations of a restructuring plan to have sufficient breathing space to actually begin negotiations.

3.2.1 Change in the financial terms of credit exposures

In general, the first aspect to consider is to renegotiate with creditors – especially financial creditors – renewed and less onerous terms for current exposures.

3.2.2 Change in interest rates

One of the simplest ways to provide the company in distress with a breathing space would be adjusting the interest rate (fixed or variable) because debts with a high interest rate (as fixed costs) are a burden to a company in distress. The alteration of interest rates may be (re)negotiated in the restructuring plan.

3.2.3 Postponement of debt

An important restructuring technique would be for creditors to agree for the debtor to make some or all payments later than currently required. Such postponement of payments may apply to the principal in whole or part, and/or to interest payments.

3.2.4 Debt write-downs ('haircuts')

Another important measure is reduction of outstanding debt, often referred to as a 'haircut'.

Empirical evidence shows that in out-of-court restructurings the prevailing measure with regard to indebtedness is mere postponement, seldom coupled with write-downs, whereas in formal insolvency procedures the norm is write-down, with the exception of some long term secured debts. However, it is not uncommon for a business to undergo multiple rounds of restructuring: this may indicate that the first measures applied were insufficient (see Chapter 4, par. 5.3) or that the debtor is no longer viable. Care should therefore be taken to ensure that the business is capable of servicing its restructured debt. This raises important issues of the feasibility of the plan, which are considered in Chapters 2 and 6.

3.2.5 Treatment of loan covenants

The plan would provide for whether the debtor is required to cure any existing covenant violations or whether the creditors' remedies in right of such violation are to be waived. It would also indicate which of the existing covenants would be maintained post-restructuring, which got rid of, and whether any new ones would be imposed.

3.2.6 New contributions by shareholders or third parties

A form of new contribution by shareholders and third parties are capital injections to the company in distress to either increase the company's capital or decrease the company's debt. The plan should address whether any pre-emption or other rights of the current shareholders would be respected or, where the law permits – as we believe it should in the context of a restructuring – overridden.

Contributions (including new finance; see below) are usually made conditional upon confirmation of the plan and may or may not confer the right to obtain shares or other equity instruments in the business. Depending on the jurisdiction, new contributions may be freely allocated amongst creditors, without respecting absolute or even relative priority, because the monies involved do not come from the business estate. This is to be contrasted with the *restructuring surplus* – the positive difference between the value of the restructured business and the liquidation value – which should only be allocated in accordance with restructuring

law priorities. New contributions are therefore one of the instruments used in practice to give flexibility to the plan waterfall.

3.2.7 Exchange of debt for equity

The plan may provide for certain debt claims to be extinguished in whole or part in return for equity in the debtor or a successor entity. This reduces the debtor company's debt load without exposing its business to the hazards of a market sale, which may not realise full value for the benefit of stakeholders.

A useful method for preserving some interest in the existing equity holders is to vest preferred equity in the erstwhile creditors while allowing the existing equity holders to retain their now more junior interests. The benefit of this method is to resolve disputes about the value of the debtor's business between creditors and existing equity holders. Time can tell whether subordinated common shares still have a value, and speculative evaluations are mostly dispensed with.[3]

Another technique aiming at the same goal is for the plan to provide certain creditors, often junior claimants, with warrants or options to acquire equity at a later date. Again, the plan should address the extent to and the manner in which existing shareholders would be diluted, subordinated, or wiped out, etc.[4]. A crucial point is, of course, setting the exercise price of the option or setting the circumstances in which warrants can be used.

If the creditors (characteristically, senior claimants) are not willing to exchange their debt for equity at the point where the restructuring agreement is negotiated, the plan may provide for the conversion of their debt into convertible debt, leaving them with an option to give up their debt for equity. The option may either become available at a specific time or else be available throughout the life of the debt. The creditors will then carry the risk on the development of their claims. It should be noted, however, that convertible debt is still debt and the financial plan will have to take this into account, for the case creditors decide not to convert.

In relation to each of these techniques, the valuation of the business, discussed below, would be critical.

3.2.8 New financing

A successful restructuring may require fresh financing for the debtor in two phases.

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[3] See also Chapter 2, par. 2.1, on the 'debt/equity bargain' and its implications: in particular, for equity holders to retain an interest in a business that is unable to pay its debt there must be good reason, either on the grounds of setting appropriate incentives (shareholders will not restructure if they get to keep nothing), or on the grounds of uncertainty (although cash-flow insolvent, equity interests still may retain some value).

[4] Drafting these plans may be costly and complex, especially for SMEs. Although one might risk losing some nuances, it may be the case to provide for templates for such cases (see Chapter 8 on SMEs). The American Bankruptcy Institute has suggested some standard measures for equity retention in SMEs undergoing restructuring under Chapter 11.

The first, interim financing, enables the debtor to operate while a restructuring plan is developed, negotiated, put to the vote, and placed before the court for approval. Given its being instrumental to the negotiation of a plan, interim financing is dealt with in Chapter 5. The second type of new money, usually labelled as 'new financing', enables the debtor to operate as it seeks to implement the duly approved plan.[5] For this reason it is dealt with here.

This second tranche of funding, which the plan itself would usually provide for, only becomes available if an existing or a new lender is induced into providing it. This would occur if the debtor's assets, if permitted to continue to operate as a going concern, have sufficient surplus value after meeting the liabilities that the debtor is envisaged in the restructuring plan as carrying upon the plan's approval. This surplus can be pledged in return for the new funding. Alternatively, if there is no such surplus, then the new funding may only be obtained by offering 'priority', that is, by subordinating existing unsecured creditors. In some circumstances, applicable law may permit 'super-priority', *i.e.* the 'priming' of existing secured creditors if such creditors consent, or else if the court can be satisfied that the interests of such creditors are adequately protected. In any scenario, the lender must be protected against the risk of avoidance actions in case the plan fails and the debtor is later subject to insolvency proceedings. Many jurisdictions consider voidable transactions in which the third party has knowledge of the debtor financial difficulty, and in case of new financing this is the case almost by definition. Hence, this risk must be deactivated lest impeding new financing at all.

Many jurisdictions provide some form of subordination for financing provided by shareholders (e.g. loans when the company was overindebted). If such is the case, then an exception should be provided at least for shareholders who have become such by way of a debt/equity swap in the restructuring. Absent such exception, creditors may be unwilling to accept swaps and then extend credit, for the fear of subordination. Another exception could be made for existing shareholders, although this should be weighed against the opportunity to encourage them to contribute equity, rather than debt.

The second point to be noted is that current bank prudential regulations may possibly hinder new financing by banks who are already creditors. If a bank has categorised an exposure towards a debtor as non-performing, and the debtor undergoes a restructuring in which the debt remains with the same entity or its group (and hence cannot be derecognised under applicable accounting standards), then, since categorisation is debtor-based for non-retail clients (EBA ITS 226, referring to Art. 178 CRR), it follows that any exposure, including a new one, should be placed in the same categorisation. Exiting non-performing status when the exposure had forbearance measures, as is the case with restructured debt, requires a cure period of 1 year (EBA ITS 231), plus 2 years to exit the forborne status (EBA ITS 256). It can therefore be very costly, in terms of prudential capital, to extend new finance to a restructured debtor that was already a client (see also Chapter 5, par. 3.2).

[5] Both kinds of financing are envisaged in the draft Restructuring Directive (Art. 16; see also Art. 10(1)(b)).

<u>Policy Recommendation #3.5</u> (*Allocation of new funding*) The law should permit any new funds obtained by or promised to the debtor to be allocated outside the application of ranking of existing claims.

<u>Policy Recommendation #3.6</u> (*Debt-for-equity swaps*) The law should permit the restructuring plan to effect an exchange of debt for equity claims.

<u>Policy Recommendation #3.7</u> (*Preferred equity and convertible debt*) The law should permit the restructuring plan to provide for (i) different classes of equity claims, and (ii) creditors to exchange debt claims for equity claims at a future date upon the materialisation of a contingency stipulated in the plan.

<u>Policy Recommendation #3.</u>8 (*Non-subordination of loans of claimants who swap debt claims for equity*) Claimants who give up debt claims in return for equity should not be subject to any rule requiring the subordination of loans provided by equity holders.

<u>Policy Recommendation #3.9</u> (*New financing*) The law should exempt new financing from avoidance and provide for priority over unsecured creditors under court control, when new financing is necessary for the success of the plan. In some circumstances, applicable law may permit priority over existing secured creditors, if such creditors consent or else if the court can be satisfied that the interests of such creditors are adequately protected. The lender should be exempted from the associated risk of liability, provided that the new financing falls within the scope of one of the exemptions and is extended in good faith.

<u>4. Valuation issues</u>

This section discusses the valuation of the debtor's business or of its relevant constituents.

4.1 Objectives and uncertainties

Valuation of a business is a challenging process at the best of times, and these challenges become acute when the debtor is distressed. In principle, the valuation exercise should arrive a value approximating the '*fundamental value*' of the business, which is the

discounted present value of the business's future cashflows.[6] In practice, this may not happen for a combination of *structural* and *strategic* reasons.[7]

Structural uncertainty arises because the restructuring may not require the business to be exposed to market valuation — the most common valuation methodology — and because market valuation may in any case be unsatisfactory. A 'forced sale', which is one in which the seller needs to sell in order to meet its own obligations,[8] virtually always involves an imbalance of bargaining power in the buyer's favour. Since the sale of a distressed business is almost definitionally a forced sale, it is likely not to yield the business's fundamental value. The problem is compounded if the sale is a 'fire sale', that is, a forced sale in a depressed market.[9] Here, sectoral distress would be causing similar businesses to be being offered for sale while at the same time stressing potential buyers. Again, a market valuation would undershoot fundamental value, perhaps significantly. Stakeholders' appreciation of reasons similar to these may indeed have persuaded them that a market sale would not be in their interests.

Strategic uncertainty arises because stakeholders would still have only partially overlapping interests. Senior claimants have incentives to undervalue the business, since that enables them to claim a greater proportion of its post-restructuring value, whereas junior claimants have corresponding incentives to overvalue it. For example, suppose total senior and junior debt each amounts to €1 million. If the business is valued at €1 million, then 100% of it belongs to senior creditors; junior debtors and equity are wholly underwater and entitled to nothing. However, if the business is valued at €2 million, senior and junior debtors are each entitled to 50% of its post-restructuring value. And if the plan places a value in excess of €2 million on the business, it *ipso facto* entitles the pre-distress equity to a post-restructuring share. Along similar lines, the debtor's senior management has incentives to undervalue the business if it stands to obtain equity in the plan. Suppose €0.5 million of management reimbursement is to take the form of equity. Then the lower the valuation of the business, the higher the proportion of post-restructuring equity that would need to be allocated to the management.

Against this background, and given that there is no access--by the parties, experts, or the court to the God's eye view to which these uncertainties are no matter and from which fundamental value may unerringly be discerned (see Chapter 2, par. 1.2 and 2.2), a key role of the restructuring plan is to identify something approximating the fundamental value of the business and to provide for this value to be fairly and efficiently allocated amongst stakeholders.

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[6] See Rizwaan J. Mokal, 'Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts' (2015) 10 *Brooklyn Journal of Corporate, Financial & Commercial Law* 15, 25.

[7] This discussion draws on Michael Crystal QC and Rizwaan J. Mokal, 'The Valuation of Distressed Companies' (2005) *International Corporate Rescue* 63-68 and 123-131, which also provides full referencing of sources.

[8] Mokal, 'Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts' (2015) 10 *Brooklyn Journal of Corporate, Financial & Commercial Law* 15, 27, citing Andrei Shleifer & Robert Vishny, 'Fire Sales in Finance and Macroeconomics', (2001) 25 Journal of Economic Perspectives 29, 30.

[9] Mokal, ibid, 30, citing Shleifer & Vishny, ibid, 30.

4.2 Techniques

Great care should be taken in accepting book values for the debtor's assets, since they may bear little relation to the going concern value of the assets kept together, and further, may also be unrealistic in the context of the debtor's distress. Instead, use should be made of one or more of the valuation techniques have become well established in sophisticated restructuring practice.

4.2.1 Discounted Cash Flow (DCF) method

The method seeks most directly to identify the business's fundamental value. It seeks to estimate the discounted present value of all future cash flows. The two sources of cash used in the methodology come from the future cash expected to be generated by the debtor's assets and operations, and the future tax shields generated by interest payments on debt, calculated to present value using a discount rate. The identification of the best discount rate to use is itself a highly contested issue, and good practice is to arrive at it in a transparent manner in consultation with stakeholders.

4.2.2 Market Value Multiples

The Market Value Multiples (MVM) valuation is used to compare values of publicly traded companies through a multitude of different financial ratios and make a determination of whether the value in question is overvalued, undervalued or appropriately valued with its publicly traded peers.

This valuation is predicated on the efficiency of the capital markets to value the profit earned by the company the same as it values the profits of other companies in the same peer group. A peer group is, ordinarily, a group of publicly traded companies that are competitors in the same industry and are of comparable financial size in terms of market capitalization or top line revenue. Choosing a proper peer group when conducting a MVM valuation is vital to the accuracy and effectiveness of the overall computation.

4.2.3 Precedent Transactions

Precedent Transaction valuations are the easiest to perform because this method looks at the values attributed to the equity, assets or debt in previous transactions within the company's peer group as an indicator of how the company's equity, assets or debt should be valued in this transaction. It should be noted that every transaction is unique and that sometimes a premium is paid to acquire control of a company in order to obtain a strategic business advantage. Conversely, sometimes companies are sold at a discount due to the publicly-known distressed nature of a company or, on a broader scale, the uncertainty in the industry or financial markets moving forward.

Guideline #3.3 (*Valuation methods)* When a valuation of the business is required, use should be made of one or more well-established valuation techniques. Relevant parameters should be chosen in a transparent manner, if possible in consultation with stakeholders.

5. The explanatory (or disclosure) statement

A well drafted plan proposed in the context of a mature restructuring regime would tend to include an explanatory statement together with the quasi-contractual documents that would amend the parties' rights and obligations so as to (start to) give effect to the restructuring.

The explanatory statement seeks to explain to the creditors and other stakeholders, and eventually the court, all aspects of the proposed restructuring. To enable all stakeholders with a claim in the company to exercise a reasonable judgement as to whether the restructuring is in their interests, the explanatory statement provides them with detailed information, including as to the substance of what is proposed, the process by which the proposals came to be formulated, the manner in which they would be put to formal stakeholder vote, and the process and timeline for the proposed implementation of the restructuring, should it be approved.

The primary elements of the explanatory statement are described below. The plan would usually by accompanied by copies of any other legal instruments that would need to be executed in order for the plan to take effect.

5.1.1 Context

This includes the reasons for the debtor's distress, consideration of the viability of the business, and its medium- to long-term prospects. The section may describe:

- the debtor's business and business model
- group structure and ownership
  - effect on parent, subsidiaries
- reasons for current situation:
  - market conditions and current environment
  - impact on the group and effect on financial situation (e.g. compliance with covenants, ability to repay or successfully refinance existing indebtedness at maturity)
- consequence: necessary steps through restructuring to manage liquidity and to stabilise the business
- managing the debtor through the restructuring process:
  - existing management
  - appointment of restructuring (financial) consultant

    - specialist independent managers or monitors

- overview of debt with detail (outstanding debt, interest, collateral)
- restructuring discussions to date with stakeholders
- identification of the jurisdiction(s) governing the proposed restructuring

5.1.2 Consequences of failure to implement the restructuring

This part describes the consequences of failure to implement the restructuring plan. It explains the obligations that, absent restructuring, the debtor would be unable to meet, and the consequences – characteristically, insolvent liquidation – that would then ensue. The emphasis here tends to be on destruction of value to the detriment of creditors as a group, for the following reasons, amongst others:

- potential repercussions on customer relationships and contracts
- loss of synergies from being a member of a corporate group
- difficulty and cost of replicating the existing services and expertise provided to other entities of the group to entities
- potential value leakage from any claims the remaining members of the group (or their insolvency office-holders) may assert against each other

A critical element is the 'comparator analysis', which shows the estimated value that would be obtained from the debtor's business or assets in case the plan is not implemented. This comparator would characteristically be the debtor's liquidation on a forced or indeed fire sale basis. The comparator analysis would explain (by way of example):

- the likelihood of secured creditor actions and their likely consequences
- the effect for creditors if the debtor ends up in the comparator scenario. This would usually be significantly lower returns, possibly over a more protracted timeframe, than if the restructuring were successfully implemented
- any market testing undertaken and the market value and expected recovery rates thereby revealed
- why restructuring therefore preferable to the comparator

5.1.3 Overview of existing indebtedness

The includes all information about the financial situation of the debtor, including:

- existing debt (overview of debt borrowed and issued)
- effect of the restructuring on the existing debt
- effect of the restructuring on existing share capital and ownership
- overview of restructuring measures affecting financial debt

5.1.4 Timeline

The timeline lays out the different milestones prior to and during the implementation of the restructuring plan, including:

- conditions upon approval and consequence for failure of approval
- approval, voting upon and confirmation of the restructuring plan
- filing date
- restructuring effective date and conditions
- longstop date, i.e. the latest date by which the restructuring plan must become effective or else be withdrawn from consideration
- actions to be taken by restructuring plan creditors

5.1.5 Financial projections and feasibility

The purpose of the financial projections is to evaluate the ability to satisfy the debtor's financial obligations post-restructuring while maintaining sufficient liquidity and capital resources over an extended (or prolonged) period. The plan typically includes a formal confirmation from the debtor, its management, and/or independent experts, that the implementation of the restructuring plan would allow the company or group of companies to avoid liquidation, to continue the going concern, and to be in a position to meet future obligations as they fall due.

The financial projections are prepared on the assumptions of an effective restructuring date, the viability of the post-restructuring company or group of companies, and operations substantially similar to the current business by representing selected cash flow projections and credit metrics for the post-restructuring company or group of companies on a consolidated

basis, usually for no longer than 10 years; this is about the limit for credible projections. The projections should be developed on an appropriately detailed basis and should incorporate multiple sources of information. Projections should also incorporate assumptions related to general economic conditions as well as industry and competitive trends for a sufficiently long forecast period. These assumptions are based upon historic industry experience as well as market perspectives derived from experts regarding projected industry supply/demand/capacity indicators and the estimated directions of specific markets.[10]

The plan should substantiate the ways in which the assumptions and projections underlying it are credible. One way of doing so would be to explain that it has been subjected to scrutiny by independent experts instructed by the debtor itself or a group of creditors. Such expert would review the plan's assumptions and projections for reasonableness and to ensure that they are in line with the expected market conditions. A review would include steps such as the following:

- review and analysis of the financial projections in order to consider and confirm whether the assumptions used were reasonable
- the undertaking of meetings with the debtor's management and its advisers to discuss key assumptions used
- review and analysis of the assumptions used, in particular, the sector specific costs and the industry market conditions and outlook.

The assessment of a proposed plan would characteristically conclude that the plan:

- was realistic and could feasibly achieve the goals of the restructuring plan
- was in the best interests of the debtor/s
- if implemented would enable the creditors to recover more than they would in the comparator scenario (usually a liquidation and/or enforcement by secured lenders)
- was fair in that an intelligent and honest stakeholder, being a member of the class concerned and acting in respect of its interest, might reasonably vote in favour of it

5.1.6 Valuation and allocation of the value amongst claimants

The plan should explain the valuation methodologies, chosen from amongst those described above, justify their choice over alternatives, and demonstrate why its implementation would be in the best interests of creditors and, if appropriate, other stakeholders.

[10] The financial projections should consider different assumptions, depending on the company's business model, among other, assumptions about revenues, cost, special items and carryover costs, general and administrative (G&A) costs, restructuring and transaction as well as existing cash and debt assumptions.

The valuation should have been carried out by an expert (generally a financial consultant or accounting firm), delivering a comparison between recovery rates for creditors of the restructuring plan under the different scenarios in consideration (e.g. new shares, debt-equity-swap) as the going concern value and recoveries in liquidation (piecemeal asset sale or business sale) or other comparator.

As a rule, the valuation should demonstrate that the value available to the creditors pursuant to the plan implementation would be greater than under the comparator scenario, which would often be an insolvent liquidation.

The value of the creditors' claims (present or future, contingent or certain, disputed or undisputed) should be assessed in accordance with their quantum and rank. The helps the parties, and eventually the court, to determine whether the creditors receive value under the plan equal to the amount they would expect to receive in the absence of the plan's implementation.

5.1.7 Legal pre-conditions for restructuring

The plan would characteristically be subject to the satisfaction of certain legal pre-conditions, which may include:

- the approval (sanction) order of the restructuring plan
- the restructuring documents have been executed and either becoming effective in accordance with their terms or being held in escrow pursuant to the terms of the restructuring plan
- the debtor's decision makers having executed any such documents that the plan requires them to
- the organisational documents of any connected entities have been amended as required by the restructuring plan

5.1.8 Actions to be taken by affected stakeholders

Characteristically, the plan if duly approved would itself bring about changes to the rights and obligations of the affected claimants, often without requiring any step on their part other than to participate in the voting if they so choose. In some cases, however, the plan may require some claimants positively to take certain steps, such as the execution of contractual documents or the delivery up of titular ones. In the latter case, the plan should set out the manner and timing for the performance of such steps.

5.1.9 Objections to proposed plan

A well drafted plan would proactively address objections to its viability, approval, and implementation that have been drawn to the plan proposer's attention. It would explain why the objections do not meet their mark, so that the affected stakeholders should still vote for plan and the court should approve it.

5.1.10 Fund/s to address contingencies

Where certain relevant claims are likely to be contingent at the time that the plan is expected to be approved, the plan may propose the creation of a ring-fenced fund to meet them if and when they arise. The plan would address the basis for considering that the fund was adequate to meet such claims. It would also set out the destination for whatever value remains in the fund after any relevant claims have been met.

5.1.11 Intercompany claims

The plan would need to address any relevant claims between the debtor and any connected entities. It may do so, for example, by providing, conditional upon plan approval, for such claims to be subordinated to the claims of unconnected creditors, by their extinguishment in part or whole, or by assignment or novation.

5.1.12 Position of directors, senior management and corporate governance

The positions of directors and senior management will also have an effect on the restructuring so it is important to provide transparency about their positions.

The overview should include a description of the current senior management and directors, their backgrounds, their terms and possible termination, and their existing and/or proposed compensation. It should also include an overview of the different committees that the company or group of companies (if any) have implemented, e.g. an audit committee, a compensation committee and/or a nominating and corporate governance committee, and whether these are comprised of independent directors.

The plan should state if there are any service contracts between the group or any of the group's subsidiaries and any of the group's directors providing for benefits upon termination of their employment or service, or whether they are/were any related party transactions and directors' interests and the effects post-restructuring.

Where the plan envisages the debtor waiving potential claims against a director whether departing or remaining, it should provide adequate disclosure of the actual or likely existence of such claims and the rationale for the proposed waiver. Importantly, however, the court should in principle not withhold its approval of the plan on the basis that it objects to the

waiver, unless there is real concern about the adequacy of such disclosure or other impropriety in the manner of seeking creditor consent. Such waivers may be an important part of the overall bundle of rights and obligations that the requisite majorities of stakeholders are willing to accept, and it would be commercially inappropriate and unfair for the court to upset this distribution of costs and benefits by seeking removal of one element of it. Further, it is the stakeholders themselves who would generally be better placed than the court to assess the value to be attached to the waiver as a way of inducing the relevant director to depart or stay, as the case may be.

5.1.13 Tax issues

Tax issues are often crucial to the feasibility and acceptability of a plan. As a matter of restructuring policy, haircuts and other debt relief should not be considered a taxable benefit to the debtor, since to do so causes the tax authorities (rather than the debtor) to be the primary beneficiaries of the sacrifice of the creditors who have provided debt relief, and in turn disincentivises them from making that sacrifice in the first place. Similarly, creditors should be incentivised to agree to debt relief by being permitted to use such relief as a deductible loss.

Ideally against such a legislative background, the plan should explain how what it proposes would affect the debtor's tax position. It may also draw attention to the tax consequences for affected stakeholders and encourage them to obtain independent advice.

In order to ease the creditors' comprehension of the plan, it may be the case to illustrate also the possible tax consequence for the creditors, clarifying that such illustration may not apply to all creditors and may depend on certain applicable rules.

5.1.14 Professional costs associated with plan formulation and approval

The plan may inform the affected parties about the costs that the company or group of companies have incurred in in relation to the restructuring over the course of time since the commencement of negotiations. It may also provide an estimate of the total costs and expenses payable in relation to the restructuring until the restructuring effective date and which costs are included in that estimate. This should again provide transparency to all constituencies about the costs associated with the plan proceeding.

5.1.15 Jurisdiction

The plan should identify the court with jurisdiction over the restructuring, and may also identify any other courts with jurisdiction over collateral issues, such as in relation to real property located abroad.

Guideline #3.4 *(Content of the plan)* The plan and the explanatory documents should include all necessary information, accompanied by relevant documents, for stakeholders to assess and decide whether or not to support the plan. At a minimum, the plan should address (1) the context of the restructuring, (2) the consequences of the failure to implement the restructuring; (3) an overview of existing indebtedness; (4) the timeline of the plan; (5) financial projections and a feasibility analysis; (6) the valuation and allocation of the value amongst claimants; (7) legal pre-conditions for restructuring; (8) actions to be taken by affected stakeholders; (9) objections to the proposed plan arisen in negotiations; (10) provisions to address contingencies; (11) the treatment of intercompany claims; (12) a discussion on the position of directors and senior management and of the corporate governance of the debtor entity; (13) tax issues; (14) professional costs associated with plan formulation and approval; (15) jurisdiction.

Policy Recommendation #3.10 *(Director liability and its effect on the plan)* The law or the courts should not bar plans which provide for a waiver of directors' liability on these sole grounds, as long as there is appropriate disclosure and there is no impropriety in seeking the stakeholders' consent.

Policy Recommendation #3.11 *(Taxation in restructuring)* Write-downs and other debt relief should not be considered a taxable benefit to the debtor. Creditors should be permitted to use such relief as a deductible loss.

Chapter 4
Drafting High-Quality Plans and the Role of Professionals

1. Introduction

Restructuring a distressed enterprise is a complex endeavour, which usually requires the agreement of many parties (the debtor and, according to the specific tool that has been chosen, all or some creditors). In some cases, it also requires the assessment of an external expert or examiner and the confirmation of the court.[1]

The debtor and the creditor will have to reach a common understanding of two critical points:

(a) what the assets and liabilities of the debtor are and what the economic, financial and situation is;

(b) how to address the situation of distress in the best interest of the affected parties.

Debtor and consenting creditors usually need to agree on a certain set of actions, to be implemented in the course of a pre-established time frame. For instance, they will have to agree on the sale of certain assets or of the business (in whole or in part), on the reduction and rescheduling of certain debts, and/or on the extension of new financing. All these actions have to be coordinated and aimed at achieving the sustainability of the business afterwards.

To this purpose, a high-quality restructuring plan is a key element. A well-drafted plan should be:

- based on the correct assessment of the present situation (hence based on an accurate review)

- realistic as regards the future (hence based on correct assumptions and appropriate forecasts and, where applicable, projections).[2]

Moreover, when drafting a plan, one should consider that the restructuring plan is not an "ordinary" business plan:

(a) when in distress, the enterprise, and its managers' actions, are subject to significant legal constraints. The plan must take into account these constraints;

[1] A notable exception is the UK administration used with the so called pre-packed plans, which is a means of restructuring with an external expert and court confirmation, but no creditor consent is required. On the various aspects of this kind of restructuring *see* the UK National Report.

[2] "A 'forecast' means prospective financial information prepared on the basis of assumptions as to future events which management expects to take place and the actions management expects to take as of the date the information is prepared (best-estimate assumptions)", while "A 'projection' means prospective financial information prepared on the basis of: (a) Hypothetical assumptions about future events and management actions which are not necessarily expected to take place (...), such as when some entities (…) are considering a major change in the nature of operations; or (b) A mixture of best-estimate and hypothetical assumptions" (see International Standard on Assurance Engagements (ISAE) 3400, "The Examination of Prospective Financial Information"). As a consequence of managerial actions expected to take place in the course of the plan, restructuring plans may contain both kinds of financial information with respect to the future of the business.

(b) the restructuring plan describes a series of actions that have a precise legal significance and content (e.g., debt reduction or rescheduling);

(c) the implementation of the plan purports to affect not only the equity holders, but also creditors and other third parties, either directly (e.g., in case of stay of individual enforcement actions or cram-down of dissenting creditors) or indirectly (e.g., authorized sale of assets that results in creditors not being satisfied, exemption from avoidance or liability actions).

The plan will be read and examined by a number of people with different backgrounds and expertise, not all of them knowledgeable in business and finance (non-financial creditors, lawyers, judges). Therefore, besides being accurate, the restructuring plan must be clear, readable and unambiguous. The plan aims at convincing every reader that it is adequate to successfully restructure the business, and that the debtor is not merely trying to postpone the occurrence of other, more drastic, measures, such as, typically, insolvent liquidation. It is a delicate task.

The importance of the restructuring plan is relevant at various levels:

- obtaining the creditors' consent;

- obtaining, where required, the opinion of the expert and/or the confirmation of the court;

- guiding the proper implementation of actions and measures aiming at restoring viability, by enabling proper monitoring and, if necessary, corrective actions;

- being able to resist challenges, not only during the possible confirmation proceeding, but also in case of *ex-post* judicial review (e.g., in case of failure during execution and subsequent insolvent liquidation).

In this Chapter, we will address methodological issues relating to devising and drafting restructuring plans. Other equally (and possibly, more) important issues (e.g., the treatment of specific categories of claimants, fairness, abuse, negotiation and confirmation of plans) are the subject of other Chapters.

Further, in line with the scope of our research, in this Chapter we will focus on restructuring plans. Liquidation plans, by which debtor and creditors opt out of insolvent liquidation with a view to maximising asset value (e.g., by providing for market sales instead of auctions), play an important role in dealing with business distress.[3] However, such plans pose different sets of issues and problems that fall outside our analysis, which focuses on semi-formal tools aimed at rescuing distressed, but economically viable, businesses.

[3] For instance, our empirical research shows that, in Italy, the judicial composition with creditors (concordato preventivo) is purported to achieving a piecemeal liquidation in the vast majority of cases (69 percent of the cases): see an analysis of the data of this research in A. Danovi, S. Giacomelli, P. Riva, G. Rodano, *Strumenti negoziali per la soluzione delle crisi d'impresa: il concordato preventivo*, in Banca d'Italia, Questioni di Economia e Finanza, forthcoming.

2. The critical role of advisors

2.1. Professional qualification and experience

Debtors in distress should resort to adequate industrial, financial and legal advice. Restructuring a distressed business requires conducting a sound and thorough assessment of the situation of the debtor and suggesting the appropriate steps to be taken in order to ensure the success of the restructuring process; all this, while at the same time taking in due consideration all the relevant risk factors and, to a certain extent, the interests of the parties involved. Professional qualification and significant experience are necessary. Qualitative data from the empirical research show that the lack of adequate professional qualification and experience can be a critical aspect in restructuring and can cause the debtor to choose inadequate or inappropriate courses of action[4]. Although not directly concerning advisors, it should be noted that quantitative empirical research shows a staggering positive effect of the insolvency practitioner being a major accounting firm[5].

Different enterprises require different professional advice. The advisors' profile and experience should be proportionate to the kind of restructuring that is envisaged (e.g. continuation of the business vs. sale of the business as a going concern), different financial structures, the number and heterogeneity of creditors, the existence of cross-border issues – in other words, the complexity of the case, also in order to ensure cost effectiveness of professional assistance. In some cases, a single financial advisor may suffice; in other cases, it may be necessary to hire a separate industrial advisor and in other cases it may be expedient to hire a chief restructuring officer. Legal advisors are almost always necessary, given the intrinsically legal nature of any restructuring plan.

Before accepting a case, advisors should assess whether their competence and experience is adequate. It is appropriate for debtors to require advisors a statement in writing that they have performed such self-assessment.

Advisors should also have an adequate structure and staff and should only accept cases to the extent that they will be able to perform all necessary tasks in a competent, timely, and efficient manner (the positive impact of experience and organisation seems confirmed also by the above mentioned results with regard to major accounting firms being appointed as insolvency practitioners).

Guideline #4.1 (*Professional qualification and experience of the advisors*). It is advisable for the debtor to achieve at the earliest the clearest possible representation of the situation of the distressed business and of the general context in which the restructuring is expected to take place. Such representation should guide the selection of the advisors and be shared with them at the earliest stage, requiring the hired advisors to state in writing that they have the required expertise and resources.

[4] See evidence from Italy _____

[5] See evidence from the UK ___

<u>Policy Recommendation #4.1</u> (*Professional qualification and experience of the advisors*). The legal framework should ensure that advisors possess an expertise adequate to the cases they advise on.

2.2. Position and independence of advisors

Advisors should be sufficiently independent. While it is common for the law to require independence of insolvency practitioners, either appointed by the debtor, by a third party, or by an administrative or judicial authority (see also Art. 25 of the draft Restructuring Directive), there is usually no such requirement for advisors, who are hired by the debtors and are, from a formal point of view, mere consultants to the debtor.

When the debtor is in distress and is seeking to devise a restructuring plan, however, the situation is different from the ordinary course of business. As mentioned above, the plan may affect, either directly or indirectly, creditors and other third parties and may involve actions that may give rise to civil and criminal liability and to other adverse effects (voidable acts, etc.). Therefore, advisors should have a detached and dispassionate perspective on the case and should not lend their reputation and expertise to the drafting of a plan that is not purported to be in the best interest of all parties involved.[6] On the other hand, given that debtors (and directors of the debtor company, in particular) should conduct business in a way that protects the interests of creditors (or, at least, is not prejudicial to them – see Recital 36 and Art. 18 of the draft Restructuring Directive), advisors should not aid directors to take any action that is not in line with their duties towards third parties or the public interest. Finally, the cost of advisors (except in the rare cases in which someone other than the debtor is paying them) is ultimately borne by the creditors, to the extent that creditors are not paid in full.

In general, a rule of thumb is that advisors should have the ability to say "no" to a request of the debtor, and maintain such ability throughout the whole process. This ability could be impaired for various reasons.

Firstly, when the advisors selected for the restructuring process are the same advisors of the debtor in the ordinary course of business their detached and dispassionate perspective may be impaired. In this case, besides the inevitable cognitive biases, they may be prone to capture due to self-review, possible involvement in past actions that may result in a liability risk, or financial constraints (e.g. for past due fees). On the other hand side, however, previous consultants may have invaluable insights into the business which may be lost, or recreated at a high cost, by changing consultants entirely, so a balance must be sought.

Secondly, independence of judgment could be impaired by personal or professional links with persons other than the debtor. In some cases, this may be self-evident and prevented by legal or professional rules on conflicts of interests: e.g., when there are connections between the advisors and one or more creditors. There may be, however, more subtle links that may be not be prohibited as a matter of law but may nonetheless threaten the ability of the advisor to suggest the best restructuring plan: e.g., connections with creditors, whose adverse effects might not be neutralized by the consent of both such creditors and the debtor (such consent does not eliminate the risk for the other creditors); connections with directors or officers, or controlling shareholders (risk for all shareholders or for minority

[6] In this perspective, the plan is in the best interests of a party if such party is not worse off under the restructuring plan than it would be in the event of liquidation, whether piecemeal or sale as a going concern (see also Article 2(9) of the draft Restructuring Directive). This issue is addressed in Chapter 2 of this Report.

shareholders respectively or, more frequently, risk of actions that may be prejudicial for creditors).

The degree of "independence" is a matter to be discussed and should probably be weighed against the kind of restructuring process. When there is an independent ex ante review, as happens in formal judicial proceedings, independence may be less of an issue. When there is not, independence may be more important to avoid that the restructuring process is used in order to favour the interests of parties that, under the law, are not entitled to a preferential treatment (e.g., the full payment, at the expense of other creditors, of a claim assisted by a director's personal guarantee). In all cases, however, the minimum requirement to have a well-drafted plan is that advisors should be in a position to conduct an independent evaluation of the situation and an assessment of the necessary measures.

Advisors are not gatekeepers, however. If the debtor, after the advisors' evaluation and notwithstanding the advice to the contrary, intends to pursue a restructuring attempt, advisors should seriously consider refusing the assignment.

It should also be noticed that, depending on the applicable law, advisors risk incurring liability (as the debtor and its directors and officers) and may have their fees disallowed, or clawed back, in case an insolvency proceeding is opened following the unsuccessful restructuring attempt.

Guideline #4.2. (*Independence of the advisors*). The quality and effectiveness of a restructuring plan, both from an ex ante and an ex post standpoint, is positively affected by the capability of the advisors to preserve a detached and dispassionate perspective, thereby being able to draft a fair restructuring plan based on accurate assessments and realistic predictions. In general, it is appropriate to hire advisors that have not been counselling the debtor in the ordinary course of business, possibly in addition to previous consultants.

2.3. The advisors' approach

The role of advisors is to:

- assess the debtor's condition;

- suggest the actions to be taken and the proposal to be made to creditors.

The two activities are linked but separate.

When assessing the situation of the debtor, advisors should conduct a review of the debtor's assets and liabilities and analyse carefully the causes of the distress. Advisors should be able to rely on existing reports and surveys but should for no reason defer blindly to them and should always exert their professional scepticism *vis-à-vis* the assurances of the debtor. The scope and depth of the review, as well as the reliance on existing data or third-party reports may depend on many factors, e.g. the size of the debtor, the completeness, accuracy and trustworthiness of internal reporting and control systems, whether or not there are any red flags; in some areas which are typically more critical and tend to be overstated in the balance sheet (accounts receivables, inventory) examination should be more thorough. When relying on internal data and on existing reports (if unrelated to the restructuring), advisors should state that they are confident on the accuracy of data; if they are not, or do not have time or

resources to make an assessment, they should state this clearly. However, the ability to avoid an assessment should be restricted to peculiar and normally transitory circumstances.

In fact, a plan cannot be drafted properly if it is based on incorrect or insufficient data and, indeed, it should be a duty of any advisor to draft a plan that is not only theoretically adequate, but is also reasonably apt to a successful outcome of the envisaged restructuring. For this reason, disclaimers to the effect of not taking responsibility on whether or not the data on which the plan is based are accurate should not be the norm. Advisors should accept full responsibility for the plan and especially for the data upon which it is based.

As regards the perspective profile of the plan (assumptions, forecasts and projections), advisors should be cautious, if not conservative. In particular, when making an assumption based on information from the debtor, advisors should be particularly thorough in checking its plausibility.

It is important to clarify that advisors should be able to rely in full on reports drafted by specialised experts appointed by the debtor, in view of the restructuring, when their expertise is necessary to complement that of the advisors' and in the view of the restructuring process (e.g. evaluation of real estate assets, machinery, goods or materials, financial instruments; legal opinions with regards to special issues). Such reliance is anyway conditional upon the fact that the expert is independent (in the meaning above) and adequately qualified.

Guideline #4.3 (*Review of financial and economic data*). Advisors should draft the restructuring plan on the basis of data that have been subject to a thorough review by the same advisors or by other professionals specifically hired with a view to restructuring the distressed business. Internal data or data resulting from reports unrelated to the business restructuring should be used only exceptionally, provided that they are considered accurate and that the advisors expressly state that they have relied on unverified data.

2.4. The issue of costs

A very general and recurring issue is the cost of advisors (as well as insolvency practitioners), which tends to be high, given the skills and time required and the responsibility shouldered by advisors. Given the undisputed scaling effect, for SMEs in particular these costs may become excessive. Expert advice, however, is promptly needed when the situation of the debtor has deteriorated (but before the moment when the situation becomes not remediable). The issue, and the possible solutions (including insurance), will be dealt with in Chapter 8 ("Devising Special Rules of MSMEs").

The draft Restructuring Directive considers costs only with regard to insolvency practitioners (Art. 27(2)) and sets a very general principle by which fees should be "governed by rules which incentivise a timely and efficient resolution of procedures".

A similar principle should apply also to compensation agreements with advisors. Agreements should be drafted in a way that, at least to some extent, links compensation to the ultimate success of the plan. There are many caveats that should be pointed out, however. It should also be noted that empirical evidence from different jurisdictions shows that compensation of advisors is, on average, usually not disproportionate and lower than that of court-appointed insolvency practitioners (Italy).

Firstly, there is a risk of adverse selection of advisors if the success-based compensation is pushed too far. High-level advisors will not accept a payment which is disproportionately success-based, because, for whatever reasons, the doubts concerning the actual possibility of getting to a restructuring plan are often not negligible and advisors will comprehensibly refuse to bear a (part of) the risk they cannot control at all. Qualified advisors could, therefore, be disincentivised from contributing to the rescue of viable businesses if offered such compensation packages.

Secondly, when opting for success-based fees one must make sure that too strong incentives towards pushing the plan through do not result in favouring the interests of parties that do not deserve a preferential treatment to the detriment of other creditors or stakeholders: it is therefore an open question whether success-based fees are appropriate. While the answer in general is probably positive, the issue here is to define correctly what is "success" and how to measure it. Ideally, compensation should be linked to success in the sense that, at the end of its foreseen course, the plan has been correctly implemented. Of course, deferment of payment until the complete implementation of the plan is not possible (see below, par. 5.2, for the duration of the plan): it will therefore be necessary to strike a correct balance between the competing needs of timely payment and correct incentives.

Thirdly, in some cases it may be necessary to hire advisors in order to know whether or not the business is viable and, more generally, whether it is possible to draft a feasible plan. In this case, success-based compensation is not appropriate.

Policy Recommendation #4.2 (*Costs of advisors*). The law should ensure that advisors' fees are reasonable and designed in a way that, in general, links compensation to the success of the plan. Exceptions to success-based fees should be made for advice relating to preliminary analysis of the case.

3. The peculiarities of restructuring plans

3.1. The peculiarities of restructuring plans *vis-à-vis* ordinary business plans

We can assume that the drafter of the plan, in evaluating the debtor's business and prospects for recovery, will employ the best practices in the fields of due diligence reports and of business and financial plans, with a particular focus on plans concerning distressed businesses (see also par. 4.1). Such best practices will not be examined here.[7] The focus here will instead be on:

(a) the peculiarities linked to the fact that the plan concerns a business in distress;

(b) the specificity lying in the fact that the plan must be designed to be judicially reviewable, either *ex ante* (in case judicial confirmation is necessary) or *ex post*.

On the first point, the plan must pay adequate attention to a set of essential elements that should always be present but, according to the results of our empirical research, are sometimes overlooked or not adequately dealt with. Particular attention, for instance, should

[7] See, e.g., for an excellent set of indications, Consiglio Nazionale dei Dottori Commercialisti ed Esperti Contabili (National Council of Business Consultants and Certified Accountants), Principi per la redazione dei piani di risanamento, September 2017.

be given to cash flow forecasts, contingent liabilities and to the impact of future and uncertain events (see below, Par. 6).[8]

On the second point, unlike "ordinary" business plans, that if proven unrealistic may give rise to a loss of managerial reputation (and only seldom to liability of directors), restructuring plans cut in the flesh of creditors and other stakeholders. In case of non-execution, it is quite likely that disputes arise and, possibly, an insolvent liquidation is opened in which what has been done will be reviewed (often with hindsight bias). Even before implementation, creditors who do not believe in the restructuring plan will try to oppose it, either by voting against it or, when applicable, by challenging it in court during the confirmation process.

For the avoidance of doubts, this Chapter deals with restructuring plans drafted when the enterprise, although is not insolvent, has reached a relatively high degree of distress. "Internal" restructuring plans, those who are simply concerned with recovering (or increasing) profitability of a business without affecting creditors, for our purpose fall into the category of "ordinary" business plans.

3.2. Drafting restructuring plans in the shadow of judicial reviewability

Given the reasons above, the plan must be drafted in such a way that the court can understand it, not with a view to second-guessing the findings of the business experts, but with a view to reviewing its completeness, accuracy, and internal consistency. In particular, under the applicable law, the court usually has all or some of the following powers:

(a) following a *prima facie* review, denying confirmation of a restructuring plan should that plan lack of the reasonable prospect of preventing the insolvency of the debtor and ensuring the long-term viability of the business (see, in the same vein, Art. 8(3) of the draft Restructuring Directive, which mandates the attribution of such power);

(b) monitoring the proper implementation of a restructuring plan, authorising, as the case may be, deviations and taking redressing actions where necessary;

(c) if requested, evaluating the effects of the implementation of a failed restructuring plan against the backdrop of the information available to the parties involved. In fact, acts implementing a restructuring plan are usually exempt from avoidance actions (see also Arts. 16 and 17(4) of the draft Restructuring Directive),[9] but, on the one hand, there may be exceptions for acts carried out "fraudulently or in bad faith" or with gross negligence, and, on

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[8] According to the draft Restructuring Directive (Art. 8), a restructuring plan submitted for confirmation by a judicial (or administrative) authority must contain information on the "present value of the debtor or the debtor's business as well as a reasoned statement on the causes and the extent of the financial difficulties of the debtor", on the identity of affected and of the non-affected creditors, on the proposed duration of the plan, on any proposal by which debts are rescheduled or waived or converted into other forms of obligation, and on any new financing anticipated as part of the restructuring plan.

In addition, the plan must include "an opinion or reasoned statement by the person responsible for proposing the restructuring plan which explains why the business is viable, how implementing the proposed plan is likely to result in the debtor avoiding insolvency and restore its long-term viability, and states any anticipated necessary pre-conditions for its success".

[9] A similar provision is present in Italian law (Arts. 67 par. 3(d) and (e), and in Spanish law arts. 71 bis and Additional Norm 4th IA.]

the other hand, such acts may give rise to personal (civil, administrative and criminal) liability.

The last profile is particularly critical, as the prospect of being prosecuted *ex post* has powerful *ex ante* effects, discouraging honest people from taking part in business rescues. To this purpose, it is advisable that the applicable law provides for clear exemptions also from civil, administrative and criminal liability to everyone involved in a restructuring attempt and acting in good faith.[10]

It may be argued that since the exemption of an act from avoidance actions is due to its being beneficial to creditors, the same act cannot give rise to liability actions. This is reasonable, but cannot automatically be considered valid for all Member States. Hence the importance of a well-drafted plan, that will protect against challenges and accusation of such kinds.

To facilitate judicial reviewability, the plan should be *clear*, also by drawing summary conclusions from necessarily complex economic and financial analyses, *unambiguous*, using an appropriate legal terminology, and if possible *concise*, if necessary by making ample reference to annexes.

Qualitative empirical research has shown that in some cases judges find plans inadequately drafted and supported by ambiguous assertions or accompanied by extensive disclaimers.[11] Unclear or ambiguous plans make it more difficult for the judge to exert his or her review and cause suspicion among readers, which may lead to read the whole restructuring attempt under a negative light.

Guideline #4.4 (*Focus on judicial reviewability*). The restructuring plan should be drafted with a view to facilitating ex-ante and ex-post judicial review. Therefore, the plan should be clear, unambiguous and concise to the extent possible.

4. The content of the restructuring plan

4.1. The restructuring plan: the past, the present and the future of the business

Albeit being a single document, a properly drafted restructuring plan is composed by a business part and a financial part. The first is more properly concerned with the business, and illustrates how the causes of the distress will be eliminated and profitability will be restored. The second is concerned with the financial position of the firm, and illustrates how the debt burden will be reduced to a sustainable level, i.e., a level that the debtor can sustain in the

[10] To this purpose, while the draft Restructuring Directive provides an explicit exemption from “civil, administrative and criminal liability” to the grantors of new financing and interim financing (Art. 16(3)), it does not grant the same exemption either:

(a) to the debtor *receiving* new and interim financing;

(b) to the person(s) carrying out “any transaction, payment, debt-equity swap, guarantee or security carried out to further the implementation of a restructuring plan confirmed by a judicial or administrative authority or closely connected with such implementation”: such acts are merely shielded from avoidance actions (Art. 17(4)).

[11] See, e.g., the empirical research for Italy, __________.

ordinary course of business (i.e., when cash flows from operations, net from maintenance investment and taxes, allow serving the debt).[12]

The restructuring plan should include a summary and synthetic description of the main actions that must be implemented to pursue the strategy chosen in the plan. Its goal is to translate strategic goals into specific actions, which facilitates the valuation of consistency between goals, strategies and actions. This summary, often labelled "Action Plan", should describe the projected actions and their impact on the organisation, the responsible person(s)/unit(s) for each action and the necessary resources, the time frame[13].

The plan as a whole must deal with three different sets of issues:

- why the business is currently in distress and why it can be restructured;

- what exactly is the present situation with respect to assets and liabilities;

- how the business will be run in the future and how (and in which measure) the creditors will be satisfied.

Each set of issues poses unique challenges, which will be analysed in the following subparagraphs. Specific attention will be devoted, in a separate paragraph, to the third one, and particularly focusing on the problem of uncertainty.

Guideline #4.5 (*Summary and description of main actions*). The restructuring plan should include a summary and synthetic description of the main actions that must be implemented to pursue the strategy chosen in the plan.

4.2. The past: explaining the causes of distress and why they can be overcome

The restructuring plan aims at convincing third parties that the business, notwithstanding its current distress, should continue.

Therefore, a properly drafted restructuring plan must deal with the causes of distress (in this light, see Art. 8 of the draft Restructuring Directive, which states that a restructuring plan must contain "a reasoned statement on the causes and the extent of the financial difficulties of the debtor"). Why did the business end up in the present situation? Was it a normal, albeit adverse, business circumstance (e.g., all the business in a certain sector may be affected), or rather was it bad luck (specific adverse factors affected the business), managerial incompetence (clear business mistakes) or, even worse, fraud?

Transparency on the causes of the distress is a requirement that goes beyond the immediate consequences for the prospect of the restructuring plan.[14] The creditors, indeed,

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[12] See, e.g., Consiglio Nazionale dei Dottori Commercialisti ed Esperti Contabili (National Council of Business Consultants and Certified Accountants), Principi per la redazione dei piani di risanamento, cit., par. 2.2.5.

[13] See Consiglio Nazionale dei Dottori Commercialisti ed Esperti Contabili, cit., Sec. 8. A Gantt Chart may be a useful tool.

[14] We assume that the law of Member States does not bar companies affected by managerial incompetence or fraud from accessing the applicable restructuring tools. The fate of the managers and that of the company may well be separated. In Italy, in formal insolvency proceedings there must be a full disclosure of possible causes of liability of directors, so that the creditors' best interest test can take into account also possible recoveries from damages awarded against them. In Spain, an opinion about the causes of insolvency must be

may be perfectly rational in consenting to a restructuring plan of a company whose managers have been clearly incompetent or even dishonest, but they will need to know it, in order to assume an informed business decision. They may decide that consenting to the plan is the best option to recover their money, but they would probably want to know if the managers have been dismissed and, when applicable, whether they have been called to restore the damage.

Exposing the causes of distress allows the debtor to explain why the future, although probably still difficult, looks brighter than the past. The restructuring plan, with a view to convincing the creditors and, when applicable, the judge, will therefore explain the actions that mark a clear discontinuity with the past, which are a precondition to its success.

Guideline #4.6 (*Transparency on the causes of the distress*). The restructuring plan should identify the specific causes that have led to the distress of the enterprise, with a view to (i) facilitating the creditors' assessment on whether the plan adequately deals with such causes and prevents them from arising again, and (ii) allowing creditors to make an informed decision on the proposal.

4.3. The present: valuating assets and liabilities

No plan can credibly project for the future without an evaluation of its own basis. A complete assessment of the business data is preliminary to any evaluation on the effectiveness of the plan for the solution of the crisis.

The restructuring plan must therefore devote specific attention to the reliability of the initial data on which it is based, both on the assets side and on the liabilities side. This is one of the fields in which advisors can significantly contribute to the overall quality of the restructuring plan.

A few remarks are necessary:

(a) assets must be evaluated according to the specific structure of the plan. With this respect, accounting value (especially if based on historic cost) is no longer *per se* an indication of the value of an asset. The value of an asset depends on what its destiny is under the plan: if it is meant to be liquidated (e.g., is a non-strategic asset), then its value will be the asset's liquidation value; if instead it is meant to remain part of the business as a going concern, its value will be a part of the value of the whole business;

(b) liabilities must be evaluated at their face value, even if they were trading on the market at a lower value due to the debtor's distress[15];

included in the general report of the insolvency practitioner. On a different note, when the *concurso de acreedores* opens a liquidation stage or a plan is agreed that is burdensome to creditors, the court and the IP will look into the possible liability and disqualification of directors. There is, however, as such, no previous calculation of amounts that directors may be liable to compensate. It must be remembered that Spain´s formal insolvency proceedings do not include a best interest of creditors test. In Germany, according to s. 156(1) InsO, the insolvency administrator's report to the creditor shall contain a statement regarding the causes of the insolvency. The insolvency administrator has to assess and pursue claims against the directors. [REFERENCE TO UK].

[15] A lower trading value of the enterprise's liabilities, although generally having no relevance in the perspective of the restructuring, may represent an opportunity for the business to strengthen its economic situation by buying (if allowed under the applicable law) its own liabilities on the market at a lower price than the relevant face value (usually defined "liability management exercise"), ultimately generating a windfall gain.

(c) interests due to accrue in the future and the amount of the principal must be evaluated according to the applicable law (e.g., the law may or may not stop the accrual of interests, and the law or the contract may or may not provide for the acceleration of deferred payments);

(d) contingent liabilities must be properly accounted for, providing for adequate resources for the case they eventuate in actual liabilities (see also par. 6).

A full review during the process of drafting the plan, carried out according to generally accepted auditing principles and practices, would be ideal. Especially for large businesses, however, it is impossible to assess all the business data within a reasonable time and without excessive costs. Therefore, in such cases, as mentioned above, the plan can be built on the data yielded by the internal reporting system, as long as:

(a) there are no “red flags” that may raise doubts on the correctness and reliability of the reporting system;

(b) the main items, with particular regard to the items of the working capital (in consideration of the importance of expected cash flows), have been verified.

The plan may be supplemented by external appraisals, assessments and opinions by qualified parties, which may be deemed necessary according to the circumstances.

4.4. The future: the business plan and the satisfaction of claims

As said above, the restructuring plan is a project for the future, in two directions:

(1) it provides for a set of coordinated actions aimed at resolving the distress, and projects the resulting cash flows;

(2) it allocates such cash flows to the creditors, for each of which (or for each *class* of which) it must provide for a specific treatment (schedule of payments for principal and interests, waiver of amounts, conversion into other forms of obligation or into equity). The plan may provide for some flexibility in satisfying the creditors (as of time and/or amount), to allow for uncertainty.

A critical part of the restructuring plan is dealing with the value of the distressed business. If the value of the assets is higher when sold piecemeal (i.e., separately, rather than all together), then the business is not only financially, but also *economically* distressed. In this case, the quicker the business is discontinued and the assets are sold, the better is for the creditors.[16]

If, however, the value of the assets is higher if all or some of them are kept together and used in running the business, instead of being sold piecemeal, then the business is *financially distressed but economically viable*, and has a going concern surplus.[17] In this case, it is in the best interests of the creditors to preserve the value of the business by allowing it to continue

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Apart from this situation, in which the liabilities are effectively extinguished, the enterprise cannot benefit from a lower trading value of its liabilities, which must be accounted for (and dealt with in the plan) at face value.

[16] We here consider the creditors as a coherent group, whose interests are aligned. In fact, we know that creditors whose claims are entirely underwater always have an interest in extending the time of reckoning, to keep the option value of their claims alive.

[17] M. Crystal, R.J. Mokal, The Valuation of Distressed Companies — A Conceptual Framework, (2006) 3 *International Corporate Rescue*, Issues 2 and 3.

trading. Such value can be transferred to creditors either by a going concern sale (which yields more than a piecemeal liquidation) or by giving the creditors part of the future cash flows generated by the direct continuation of the business, either by paying (in whole or in part, and in various forms) the pre-existing debt once the viability of the company is recovered, or by giving the creditors equity in the restructured company.[18]

The restructuring plan must therefore clearly and credibly state why the assets are worth more kept together than sold piecemeal. It must, in other words, explain why restructuring is a better solution for the creditors than insolvent liquidation. Articulating the reasons why the business is deemed economically viable is important both in perspective of providing elements to the creditors' assessment on the plan and in the perspective of judicial reviewability.

Guideline #4.7 (***Assessing and stating the economic viability of the distressed business***). **The economic viability of the distressed business needs to be accurately ascertained by the advisors drafting the plan. It is advisable to make explicit in the plan the positive assessment on the economic viability of the business so as to allow an informed assessment on the plan by the creditors and, if applicable, by the court.**

4.5. The focus on cash flow forecasts

The viability of the restructuring and, even before, the practicability of the negotiation process relies on the ability of the debtor to pay debts as they fall due. Absent this, creditors will probably foreclose, invoke acceleration and/or file for insolvency. In some jurisdictions, moreover, the debtor is required to file for insolvency in case of illiquidity.

Financial distress implies, by definition, that the debtor is not able to pay its obligations as they fall due. There are several tools to deal with this problem (mainly, the stay on creditors and interim and new financing: see also Par. 5.2). A high-quality restructuring plan devotes particular attention to cash flows and how the enterprise plans to keep a financial balance throughout the whole process (confirmation, if applicable, and implementation).

Detailed forecasts of cash flows must be made and included in the restructuring plan. The chosen interval (week, month, quarter) depends on the nature and size of the business, ideally being shorter at the beginning (when the business is more fragile) and may become longer over the time frame of the plan. Such intervals must be sufficiently short to show the viability of the process and allow almost instant monitoring on the evolution of the financial position of the enterprise.

It should be noted that cash shortage is, according to qualitative empirical evidence, the main trigger to restructure, thus denouncing a lack of cash-flow planning in "ordinary" times. Cash-flow projections in restructuring are even more critical considering the frequent inability of businesses, especially M-SMEs, to plan adequately on the point.

[18] See also Par. 5.2. criticizing the draft of the Restructuring Directive with respect to the choice of limiting the scope of the restructuring tool provided therein to "*sales of assets or parts of the business*", therefore excluding the sale of the whole business.

Guideline #4.8 (*Preparing accurate cash flow forecasts*). The success of a restructuring plan may be jeopardised by inaccurate cash flow forecasts that, setting the rescued enterprise in the position of being unable to satisfy claims as they fall due, often leads to insolvent liquidation of the business. Therefore, the plan should include accurate cash flow forecasts, which should be comprehensively illustrated in the restructuring plan so as to allow an informed assessment on the plan by the creditors and, if applicable, by the court.

5. Dealing with uncertainty

5.1. Uncertainty as an unavoidable component

A restructuring plan is, at its essence, an articulated set of actions and measures whose implementation is due to occur in the future and is expected to solve the enterprise distress. As any planning activity, the scope of the time frame taken into account affects the quality and reliability of the plan: the longer the plan, the greater the chance that there be obstacles to its implementation and/or the effects of its implementation be different from those expected. Nonetheless, as better clarified below, uncertainty is intrinsic to restructuring plans and needs to be adequately dealt with.

The nature of such uncertainty is related to the circumstance that any plan requires that one or more actions be executed in the (near or distant) future. Therefore, even the most accurate and complete restructuring plan cannot provide with certainty as to the following circumstances:

(i) that all the actions or measures provided in the plan will actually be implemented as scheduled, and

(ii) that the plan, if implemented, will indeed allow for the complete recovery of the enterprise.

There are endless factors that may come into play and interfere with what the plan envisages. Some factors are unpredictable and independent from the control of those involved in the business distress (e.g., the evolution of the relevant market, changes in the legal framework affecting the business). Quite often, deviations from the forecasts and projections made in the plan depend on an imperfect or incomplete perception of the situation of the enterprise and/or of the relevant context. Many deviations are, indeed, originated by the limits to human capability of predicting the future or fully understanding the present (e.g., a sudden collapse of the real estate market when the restructuring plan is based on the ex-ante reasonable assumption that the sale of some properties will generate a certain amount of proceeds).

In order to devise a high-quality and effective plan, such physiological uncertainty associated with the business restructuring should be reduced as far as possible and, most importantly, properly governed.

Of course, a restructuring plan that has very few chances to succeed should not be allowed (more properly, it should not be allowed in terms directly or indirectly affecting those who have not consented to the plan). To the opposite, a plan that brings with it some well-

defined elements of uncertainty, even if significant, may still be a quality plan when it properly and effectively deals with such elements.

Particularly, in that perspective, the plan should acknowledge the uncertainty always associated to the restructuring of a business and, thus, be drafted:

1) clearly stating the fundamental assumptions on which the plan is based on, identifying for each of them the factors that may interfere with their occurrence and quantifying the relevant risk that such assumptions be eventually not matched, also by means of carefully drafted stress tests (see below, subpar. 5.5.2);

2) choosing a structure that facilitates monitoring by the relevant stakeholders (i.e., creditors, shareholders) and/or by the court (e.g., setting milestones that help to evaluate the performance of the plan during its implementation);

3) providing for adjusting mechanisms, either automatic or subject to creditor consent, that allow the plan to reach its ultimate goal (namely, rescuing the business), even though one or more of the assumptions are not matched.

The following paragraphs address the structure and content that appear optimal in the perspective of properly and effectively governing uncertainty. However, before analysing the most common tools to minimise and govern the uncertainty associated with restructuring plans, it is appropriate to focus on the time frame taken into account by restructuring plans and, in that respect, distinguish three different levels.

5.2. The time frame of the restructuring plan

The process of restructuring a business may be ideally divided into three parts, whose objective and duration may differ significantly.

First, during the negotiation (and, if applicable, confirmation) phase, the financial equilibrium of the enterprise must be kept. If this is not the case, the value of the assets may quickly diminish, due to the inability to manage the firm in an orderly fashion and/or to the aggression of creditors. Such equilibrium must be achieved either via a stay on creditors (automatic or imposed by the court, according to the applicable law) or via an interim financing, aimed at keeping the business alive while the best solution is negotiated.[19] The draft Restructuring Directive facilitates this task, both by allowing a short stay of individual enforcement actions (Art. 6), and protecting interim financing (Art. 16). Particular attention should be dedicated to this issue, as cash flow insolvency during negotiations may make the whole effort of restructuring worthless.[20] Therefore, the obligations arisen during the negotiation phase must be satisfied as they fall due.[21]

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[19] Interim financing is defined as the "short-term funds that are necessary for the debtor to cover administrative expenses after the commencement of restructuring or insolvency proceeding until either the implementation of the restructuring plan or the sale of the debtor's business as a going concern": B. Wessels, S. Madaus, Instrument of the European Law Institute - Rescue of Business in Insolvency Law, cit, p. 58.

[20] For instance, the applicable law may provide for an obligation to file in case of cash-flow insolvency: see Art. 7 of the draft Restructuring Directive: "1.Where the obligation of the debtor to file for insolvency under national law arises during the period of the stay of individual enforcement actions, that obligation shall be suspended for the duration of the stay (…). 3.Member States may derogate from paragraph 1 where the debtor becomes illiquid and therefore unable to pay his debts as they fall due during the stay period (...).

[21] A thorny issue is that of "critical vendors", i.e., suppliers and counterparties of the debtor that will not perform their obligations unless they are paid also for the preexisting debts. The draft Restructuring

Second, an approved (and, if applicable, confirmed) restructuring plan needs to quickly restore the financial balance of the enterprise. The plan should provide for actions and measures that ensure that, while pre-existing liabilities may be rescheduled or reduced, those claims arisen after the conclusion of the plan be promptly satisfied as they fall due. To this purpose, the plan should expressly state how the expected cash-flows will be matched (e.g., obtaining a new financing allowing the enterprise to gain enough time to implement the business plan that is expected to increase the revenues and/or reduce the costs).[22]

Third, a restructuring plan generally needs to provide for a set of actions and measures aimed at remedying to those circumstances that have caused the crisis (particularly, to those that are internal to the firm, e.g. the exercise of unprofitable business lines). This part of the restructuring plans may be implemented in a longer term than the one mentioned above, and it is ultimately purported to restore the economic and financial value from a long-term standpoint (e.g., allowing the enterprise to generate enough revenues to honour the liabilities pre-existing to the plan that had been rescheduled).

The actions and measures falling in what we have called the "third phase" of a restructuring plan are further in time and, thus, exposed to a greater risk of interference coming from unforeseen factors. Such interference could result in making action and measures provided under the plan not implementable or unsuitable to produce the expected effects.

In light of the above, plans providing for a shorter time frame for implementation are those having more chances to be fully implemented and to lead to the expected results (e.g., in terms of creditors recovery rate). However, it should be considered that a longer duration of a restructuring plan is intuitively associated with greater chances to rescue the business. A plan that has a short horizon may not always be pursuable (e.g., a purchaser for the business may not always be available) or anyway unsuitable to offer a sufficient probability concerning its capability to rescue the distressed enterprise (e.g., being based on highly speculative investments that, in case of a quite likely failure, would deepen the enterprise insolvency).

The existing trade-off between, on the one hand, a long time horizon offering more chances to rescue the enterprise and, on the other hand, the obvious limits to the possibility of accurately forecasting long-term trends requires that a proper balance be stricken. The indications coming from well-established professional practices suggest that a restructuring plan should not provide for an implementation time frame longer than 3/5 years.[23] That time

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Directive does not deal with this directly, but leaves some flexibility to Member States: see Art. 7, Par. 4, which states "Member States shall ensure that, during the stay period, creditors to which the stay applies may not withhold performance or terminate, accelerate or in any other way modify executory contracts to the detriment of the debtor for debts that came into existence prior to the stay. Member States may limit the application of this provision to essential contracts which are necessary for the continuation of the day-to-day operation of the business".

[22] Structuring a plan suitable to (almost) immediately restore the financial balance should be possible for any viable business, if we assume that (i) lenders are completely rational, are free to negotiate the interest rate and there is no information asymmetry, and (ii) suppliers are available to agree a longer period for payments. Indeed, the empirical research performed show that this is not the case (INSERT REFERENCE). Furthermore, the Italian legal system does not allow for the free negotiation of interest rates on financings beyond a certain threshold, therefore not allowing distressed debtor to obtain financing at a price that reflect their real risk.

[23] For Italy, references to A. Danovi, S. Giacomelli, P. Riva, G. Rodano, *Strumenti negoziali per la soluzione delle crisi d'impresa: il concordato preventivo*, cit. _____. In Spain, however, plans may include a rescheduling of the debts, bit in court and out of court, that extends up to 10 years. This has not been a concern

frame is the period usually necessary to restore a business, as commonly recognized by well-founded industry practices, and it would allow to preserve a reasonable degree of reliability concerning the forecast and projections made in the plan.

A restructuring plan having a longer horizon should still be possible, although its quality would be negatively affected. However, there are certain measures that can be put in place to reduce the quality deterioration resulting out of a long implementation phase. We refer particularly to the adjusting mechanisms described in par. 6.2 below.

Conversely, for the same reasons stated above, a restructuring plan based on the sale to a third party of the entire business as a going concern may often be an effective solution. In that case, when the purchaser is identified in the plan, the plan is implemented almost instantly, resulting in significantly limiting uncertainty (which, anyway, still exists since, for instance, the sale could be invalid and/or avoided should the purchaser become insolvent and be subsequently liquidated).

In light of the above considerations, the draft of the Restructuring Directive draws criticism with respect to the choice of limiting the scope of the restructuring tool provided in it to "*sales of assets or parts of the business*". The empirical analysis conducted has evidenced that restructuring based on the sale of the entire business is common in several jurisdictions (namely, Italy, UK, Spain and, with limitations, in Germany[24]) and has proven to be, in certain cases, an effective response to a business distress[25]. Further, we have not identified any justified reasons (which cannot be dealt with otherwise) that suggest banning the restructuring of a distressed enterprise through the sale of the entire business as a going concern.

Guideline #4.9 ***(Time frame of the plan).*** **The restructuring plan should pursue the goal of rescuing the distressed business through a set of actions and measures due to take place within a period of time not exceeding 3/5 years. Unless justified on the basis of specific circumstances, a longer implementation period is not advisable due to the increasing risk of unforeseeable events.**

5.3. Time frame of the restructuring v. time frame for paying creditors

On a different note, it is important to clarify that the maximum time frame recommended for the implementation of a restructuring plan does not include the payment of all the liabilities existing at the moment when the plan is drafted. Two considerations are necessary.

by stakeholders interviewed. On the contrary, repeat creditors such as financial creditors seem to strongly favour lengthier plans, with a shorter write down of the debt (mainly to heavy large provisioning in their balance sheets). OTHER JURISDICTIONS

[24] In German law, neither in nor outside of insolvency can contracts and licenses be transferred without the counterparty's consent.

[25] For Italy see A. Danovi, S. Giacomelli, P. Riva, G. Rodano, ibid. Spain offers a different and somewhat more complex scenario. Going concern sales work well within formal insolvency proceedings, where special rules have been included to facilitate this type of transactions (eg, the automatic transfer of contracts or licenses). A going concern sale of business units is a possibility within out of court proceedings, but not of the whole business. A similar result can be achieved by means of a debt for equity swap, and it happens with relative frequency. OTHER JURISDICTIONS

First, we should remember that restructuring does not aim to pay all the debts, but to reduce them to a sustainable level (see above, par. 4.1). No business is debt-free, and a certain level of indebtedness is physiological and efficient. This said, it must be noted that the empirical experience shows that, to achieve the consent of creditors on the restructuring plan, distressed businesses almost always deleverage too little, and that they are left with an excessive burden of debt after the restructuring is (at least formally) completed[26].

Second, even the payment of the excessive debt may well occur beyond the 3/5-year period suggested, rather being only necessary that all the "extraordinary" measures (such as the disposal of assets, the transfer or rationalisation of business lines, the placing of workers on redundancy schemes, etc.) have already been put in place and that the relevant corrective effects have occurred. In other words, the enterprise's debts may well be satisfied as originally scheduled, or as rescheduled by the restructuring plan, beyond the term of 3/5 years, without any adverse effect on the quality of the restructuring plan.

In this regard, however, the case where the enterprise is required to pay a relevant debt, in a single instalment ("bullet payment"), at a date beyond the suggested implementation time frame should be carefully considered (such debt may either result from a new financing awarded in the context of the restructuring or from claims existing at the time of the restructuring). That circumstance needs to be properly addressed in the restructuring plan, so as to ensure that the debtor has regained the ability to pay (or refinance) the "bullet" at maturity, and that the plan is not merely disguising the fact that the existing debt burden is not properly reduced to a sustainable amount.[27]

Empirical evidence shows that it is common for business to undergo consecutive rounds of restructurings, often using a more "invasive" tool in the second or third round. One possible explanation is that measures in the first attempt were insufficient, both on the asset side and on the liability side (inadequate rescheduling, rescheduling instead of write-downs,

[26] For Italy, the empirical research on contractual resolution of distress (accordi di ristrutturazione dei debiti) shows that within [2] years from completion a high percentage of firms either undergoes a new restructuring, or files for concordato preventivo [INSERT DATA AND REFERENCE TO OTHER JURISDICTIONS]. The situation is similar in Spain, when a restructuring of the restructured debt has taken place in ----- . Even taking into account the lack of pre-insolvency tools, the situation appears slightly different in Germany. The empirical research shows that it does happen that a few years after an *Insolvenzplan* there is a second insolvency proceeding (usually ending in liquidation); no reliable statistics on the frequency exist, but it should not concern (even remotely) a majority of cases. Regarding the sustainability of out-of-court agreements, experts admit that re-negotiations are frequent (if maybe less frequent than apparently in Italy); however, they still believe the majority of agreements to be more or less sustainable.

[27] Indeed, although a long rescheduling of significant liabilities improves the suitability of the plan to reinstate a proper financial balance for the enterprise (which benefits from a reduced cash flow in the short term), it poses a significant threat to the long-term effectiveness of the plan. The enterprise is required to find an adequate amount of resources to duly satisfy the claim when it falls due and this may be challenging. Particularly, the enterprise needs either to obtain a new financing by a bank or be able to accumulate, over the years while implementing the plan, enough resources to satisfy the claim. If the enterprise is not able to achieve either of those results, the restructuring plan ends up to only hide, for a certain number of years, a crisis that, in fact, has not been solved, but rather just postponed. Therefore, with a view at reducing the above-described element of uncertainty, the restructuring plan should clearly describe how the debtor plans to obtain the resources necessary to honour such long-deferred claims (e.g., disposing of one or more important assets, setting aside the proceeds of the continuation of the business). Should the plan provide for the satisfaction of the long-deferred claims by refinancing them at maturity, in whole or in a significant part, the restructuring plan should contain an analysis of the actual probability of receiving such refinancing in light of the expected creditworthiness of the enterprise at the relevant maturity date.

inadequate write-downs, etc.). Particular care should be given when assessing what a "sustainable" level of debt is.

<u>Guideline #4.10</u> *(Reduction of the indebtedness to a sustainable level).* The restructuring plan should illustrate the level of debt that the debtor may serve in the ordinary course of business and how the debtor will achieve such level. Particular attention should be devoted to plans in which a significant part of the debt is merely rescheduled and left payable at a certain future date.

5.4. Setting out clear assumptions, forecasts and projections

5.4.1. The case for clarity

As mentioned above, all restructuring plans are meant to be read, examined and assessed by many persons: creditors, other third parties, the insolvency practitioner and the judge. Therefore, special care should be taken to make the plan comprehensible to persons with different backgrounds and expertise and to make its assertions (both of facts and of hypotheses) easy to be checked.

An educated reader should be able to understand and check assertions with relative ease and should be in the position to ask the advisors (or any expert in charge of checking technical aspects of then plan) to assess the impact on hypothesised scenarios of the variation of one or more elements of the plan.

As also mentioned above, advisors should take responsibility for the plan also as a matter of concrete fact and not only as a theoretical exercise. Disclaimers on factual aspects should be limited and should never be of such an extent that the advisors can avoid this responsibility.

5.4.2. Conditions to the plan

The feasibility of the restructuring plan is often determined by specific future and uncertain events, that might make the plan feasible or, on the contrary, undermine its feasibility. When there are necessary preconditions for the success of the plan (e.g., the consent of creditors x, y, z or the consent of a certain percentage of creditors) this should be clearly stated. The occurrence of such precondition should be readily ascertainable, so that the readers of the plan can understand whether or not the plan is effective and ready to be implemented.

It should be noticed that, when stating a precondition for the success of the plan, there are two possible options, whose structures and consequences are totally different.

The first situation occurs when a relevant event, although subject to uncertainty, is considered more likely than not to occur and therefore is an integral part of the plan (e.g., the disposal of a non-strategic asset at a price no less than X within the next 12 months).[28] In this

[28] The level of likelihood of the relevant event is a very important issue and is subject to debate. An example will clarify the problem.

The success of the restructuring plan of a very famous and ancient distressed porcelain manufacturer, Richard Ginori, relied (also) on the extraordinary income deriving from the possibility to extinguish the tax liabilities through the transfer of a corporate museum of recognised historical value to the Italian State, a

case, the plan can be immediately implemented, but the plan must state clearly that the non-realization of the event will endanger (in terms to be described) the further implementation of the plan, so that those who are called to evaluate the plan can make an informed business decision on whether to accept/confirm the plan or not.

The second situation occurs instead when the plan does *not* state that an event key to the plan is highly likely to occur (e.g. the condition that an agreement with banks, in substantially the terms described in the plan, is executed within the next four weeks). In this case, the plan cannot be implemented until the conditioning event occurs, and it will become feasible only if, and when, the event takes place.

If the advisor has chosen the second option and the plan is subject to an expert's assessment or to court confirmation, the condition must occur before (or at the moment in which) the expert or the court issue their statement, because until the condition is met there is no proper and effective plan. Also, the plan can be considered effective only when such condition has taken place (e.g., for the purpose of protection from avoidance actions under Art. 17(4) of the draft Restructuring Directive).

Guideline #4.11 ***(Distinction between conditions for the success of the plan and preconditions for its implementation).*** **The restructuring plan should clearly distinguish between events that, although subject to uncertainty, are considered more likely than not to occur and therefore do not preclude the plan from being implemented, and events that should occur for the plan to come into effect.**

5.5. Governing uncertainty

The plan is projected in the future and is subject to inevitable uncertainty. However, some measures may help minimise the impact of such uncertainty on the plan: stress tests, monitoring devices, adjustment mechanisms and provisions. First of all, however, one must take into account the need to describe the actions to be carried out under the plan.

5.5.1. Describing the actions to be carried out pursuant to the plan

In certain jurisdictions, and soon in the whole of the EU as a matter of principle (see Art. 16 and especially Art. 17 of the draft Restructuring Directive), restructuring plans can have the effect of exempting from avoidance or liability actions (and from criminal liability).

It is therefore important that the main acts and transactions to be implemented with third parties under the plan are described (e.g. sale of one or more assets, new financing, new

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possibility that the law expressly allowed. The expert certifying the feasibility of the plan declared that no agreement had been reached so far, but while the *"denial by the Ministry of Finance of the possibility of the transfer [could] not be ruled out, due to the elements of seriousness and concreteness that [had] emerged so far, a denial [could] be deemed remote"*. The Tribunal of Florence, refusing to open the composition proceeding, ruled that *"the Court and the creditors must rely on elements that are certain and on which they can with good reason evaluate the satisfaction of their claims"* (Tribunal of Florence, 7 January 2013). Requiring certainty, or almost certainty, of future events that determine the success of the plan, however, would deprive the debtor and the creditors of the possibility of a successful restructuring, which is worthwhile pursuing if the plan, although subject to failure, is sufficiently serious, *i.e.*, if the determinant event is more likely than not to occur. This is why we advocate the position expressed in the text.

guarantees, etc.). The requirement is more stringent than the mere best practice of having a summary of the main actions (Action Plan: see above, par. 4.1), as third parties may need to contract with the debtor by relying on the circumstance that the transaction they are entering into is exempted from avoidance and may not give rise to liability.

Should the plan fail (and the debtor go into insolvent liquidation), a detailed description of the acts and transactions implementing the plan will make it easier for interested parties to defend the plan or its effects by proving the tight connection between the plan and the act, payment, pledge or transaction carried out within its implementation in an ex post review, in which hindsight bias is the norm.

Somewhat intuitively, the level of detail in the description of the single transaction should be proportional to the importance for the success of the plan of the act to be carried out.

Guideline #4.12 ***(Description of acts to be implemented on the basis of the plan).*** **The plan should describe in a detailed manner the acts to be carried out on its basis. The level of detail should be proportional to the importance of the act to be carried out.**

5.5.2. Testing for the variation of assumptions

As mentioned above, as a matter of method and style the plan should be drafted in a way that allows any reader to check the validity of assumptions and to measure the impact of any variation.

This aspect is also very relevant from the point of view of the contents of the plan. In order to minimise the impact of the inevitable uncertainty of the future, the plan should consider different scenarios. Advisors should run stress tests on, at a minimum, the main assumptions and forecasts of the plan, in order to assess whether and to what extent the results indicated in the plan remain stable when changing variables. Expressly providing stress tests in the plan will demonstrate to what extent the hypotheses are sensitive to the variations, and, *ex ante*, may lead to increase the robustness of the plan by encouraging the provision for adjustment mechanisms.

Plans on which stress tests have been performed tend to be more robust; even if the hypothesised stress event does not actually take place, experience shows that other unforeseen events always take place and a robust plan may withstand unanticipated events better than plans that do not take into account possible negative events.

Robustness increases with adjustment devices and, especially, appropriate provisioning (see below).

Guideline #4.13 ***(Assumptions and the effect of their variations).*** **In order for third parties to be able to check and assess its robustness, the plan should clearly state the assumptions and include tests that describe the effects of their variation.**

5.6. Deviations from the plan and adjustment mechanisms

The plan is the starting point of the restructuring process and it therefore requires implementation and continuous monitoring (see Chapter 7). The implementation of a restructuring plan may face unforeseen problems and, in all cases, forecasts may not all become reality.

When there is a significant deviation between forecasts and reality, the plan cannot be further implemented as originally intended and the debtor should take the appropriate steps to cure the issues that may have arisen. The deviation should be considered significant when the hypothesis included in the plan as a milestone can no longer be implemented or can be implemented only at conditions that, from a financial or a timeliness point of view, are different from those assumed in the plan.

The achievement of the milestones through means other than those set forth in the plan (e.g. selling a different asset that the one anticipated) should not be considered an implementation of the plan; rather, the whole plan would no longer be implementable, or anyhow not implementable as previously foreseen; possible protective effects of the plan (see e.g. under Art. 17 of the draft Restructuring Directive) would not be applicable. The debtor will have to amend the plan in the light of the new circumstances. As said above, the debtor should take into account the events that actually took place, rather than the events that were previously forecasted, while the new plan should not be grounded on the same assumptions that prevented its implementation.

In order to avoid that the plan becomes unfeasible, the plan itself could include internal adjustment mechanisms or alternative solutions. E.g., the plan remains feasible when it states that, if transaction A (e.g. sale of an asset for a price higher than X) cannot take place, option B shall be implemented (e.g. a further reduction of credits, already accepted by creditors for the case that a certain event takes place). The plan is, therefore, self-adjusting.

Covenants that are usually agreed with financial creditors may be considered as examples of milestones embedded in the plan. Compliance to such covenants, especially when they include ratios or indexes, may therefore be used as an indirect tool to assess the implementation of the plan: non-compliance with the covenant may be considered as a deviation from the plan, whereas the creditors' waiver on enforcement may actually serve as an adjustment mechanism.

<u>Guideline #4.14</u> ***(Deviation between forecasts and reality).*** **When a significant deviation between forecasts and reality occurs, the plan cannot be further implemented as originally intended and its protective effects no longer apply with respect to subsequent acts. All the acts implemented prior to the deviation are unprejudiced.**

5.7. Provisions for adverse contingencies

Provisions can be seen as one peculiar type of self-adjusting mechanism: if event A does not occur, the lack of financial coverage deriving from this event can be taken care of by appropriate provisioning, without the need to modify the plan.

Good plans should, if possible, make adequate provisions. Provisions should be reasonable: if too small, they do not give any appreciable degree of protection to the plan. If

excessive, they subtract resources to current creditors without being (entirely) justified by the need to take care of potential negative effects.

Provisions should also be made for non-consenting creditors that oppose the plan, for contingent creditors, for known but untraceable creditors and, if it is appropriate, for unknown but foreseeable creditors (see Chapter 3, par. ___). Plans should provide for mechanisms by which resources tied up in provisions are appropriately distributed once the contingent event does not take place, in order to avoid opportunistically excessive provisioning by debtors. In complex cases and in some industries it may be necessary to resort to actuarial analyses in order to assess risks of future claims originating from the business.

Guideline # 4.15 ***(Provisions for adverse contingencies).*** **The plan should include provisions for adverse contingencies, including alternate routes to achieve the goal of restructuring.**

Chapter 5
Negotiating on Plans

1. Negotiations and stay on creditors' actions

1.1. Negotiations on restructuring plans: the need for good practices

The restructuring plan aims at obtaining concessions from the creditors, or some of them, with the goal of making them better off than the available alternatives (being most commonly the insolvency liquidation of the business). The debtor, therefore, must convince them that accepting the plan is both in their best interest as a group, and in the best interest of each affected creditor. This is a difficult task, since it implies verifying and sharing complex information on the present situation and agreeing on the likelihood of future scenarios.

Negotiations are necessary whenever the plan must be agreed upon through an expression of consent. No sensible creditor would accept a plan without being adequately informed and, possibly, without having negotiated a counterproposal, or one or more amended proposals, that, in the creditor's view, yield a better outcome.

However, negotiations with certain creditors (most commonly the main creditors) are common also in procedures in which the acceptance or rejection of a restructuring plan is done through a vote, which binds also dissenting creditors. In such procedures, it is usually the debtor who submits its proposal, which must meet the applicable standards of disclosure (set by the law and implemented by the court), and stakeholders vote on such proposal.[1] Even though in such a setting it is not necessary to envisage a negotiation before the vote, very often the plan put to the vote is the result of a process by which an initial proposal is modified in order to secure the required approval by the requisite majority.

In some cases, a negotiation phase is necessary for the debtor to choose the right tool to restructure its indebtedness. For instance, the debtor may approach its main creditors with a view of achieving a purely out-of-court restructuring, only to realize that this path is not practicable due to the opposition by, and/or the passivity of, some of those creditors, resulting in the non-feasibility of a purely out-of-court solution.

This makes the negotiation phase extremely important. It must be noted, however, that there is seldom any written rule, besides general contract law, that states how the debtor and the stakeholders must deal with each other while negotiating a restructuring plan: is there a duty to share with the other parties *all* information available (for instance, how much a creditor has provisioned against the claim that the debtor asks to restructure), or just the information that, if missing or misleading, would make a party's consent invalid? Is there a duty of the creditors to cooperate with the debtor in good faith? The answer to both questions is probably that, unless otherwise provided under the law, each party is entitled to act selfishly (see below, par. 2.3). This just renders more pressing the need for good practices applicable to the negotiations of contractual and quasi-contractual preventive restructurings.

[1] The applicable law establishes the required majority and how to count the votes (by value of claims only, or by value *and* number of claims) and how to consider those who have not voted (dissenting, consenting or simply non-voting). Some of these issues have been addressed in this Chapter, below.

1.2. Negotiations and stay on creditors

Negotiating with creditors does not require *per se* a stay on creditors' claims. Financial distress, which is the very cause for which the debtor engages in negotiations with its creditors, can have different levels of severity. In fact:

(1) financial distress may not be yet so serious as to prevent the debtor from paying its debts as they fall due. In those cases, the debtor aims at timely tackling future cash-flow tensions. It must be noted, however, that the time before such tensions begin to emerge may well be shortened by the creditors' reaction to the start of negotiations (banks, for instance, may stop rolling credit lines over). In this case, and until the situation deteriorates, a stay on creditors' enforcement actions is not necessary if not to prevent the opportunistic behaviour of one or more specific creditors;

(2) in other cases, financial distress may prevent the debtor from paying *all* its current debts, but some creditors (usually, financial creditors) have agreed on a "standstill" and/or to interim financing so as to allow the debtor to remain solvent during the negotiations, e.g., by paying suppliers and workers in order to maintain the business as a going concern, with benefits for all the creditors. In this case, a sufficient number of creditors deems in their own interest to sustain the debtor's efforts to restructure, and therefore a stay on creditors' enforcement actions is not necessary;

(3) finally, financial distress may be so serious as to prevent the debtor from paying its current debts, an insufficient number of creditors (or no creditor) have agreed on a standstill and no interim financing is available on purely contractual terms. In this case, a stay on creditors' enforcement actions may be necessary to preserve the business value in the interest of the creditors as a whole and thus sustaining the debtor's efforts to restructure.[2]

The difference between the situation in (2) and (3) is that, while in the former the creditors have reached an interim conclusion that the debtor's efforts to restructure are worth upholding and are bearing the risk for doing so, in the latter the creditors have *not* reached such conclusion. Therefore, granting a stay on creditors is done on the (not unrealistic, but not obvious) assumption that the creditors have not reached the conclusion that the debtor's efforts to restructure are worth upholding due to collective action problems and/or transaction and coordination costs, and they would have done so if they were acting as a cohesive and informed group.

Requesting (or availing of the legal possibility of) a stay on creditors requires responsibility by the debtor, which must be reasonably convinced that by doing so it is preserving value for the creditors, and it is not merely worsening the situation. This is due to the fact that a stay directly impinges on creditors' legal and contractual rights, limiting them. The level of necessary confidence in the beneficial effect of the stay is directly proportional to

[2] In this sort of cases, the conflict existing between the individual interest of each creditor and the interest of the creditors as a whole is a well-known collective action problem, often labelled as the "tragedy of the commons". It is a well-established view that, from the perspective of each individual creditor of an insolvent debtor, the most rational course of action would be to act as quickly as possible to grab the firm's assets (or its equivalent liquidation value) and satisfy its claim, even though this would disrupt the business going concern to the detriment of all the other creditors.

the length of the stay: the longer the stay, the higher the confidence in the fact that the stay is maximizing value for the creditors should be.

As seen above, the issue of the stay on creditors is strictly linked to the issue of interim financing. A debtor may not need a stay if it receives financing specifically aimed at keeping the business solvent. The conditions and effects of such financing will be examined in the next paragraph.

Two remarks are necessary:

(1) a significant degree of uncertainty is unavoidable, and while keeping the business going is reversible, stopping the business may be not. Therefore, at an initial stage, a stay on creditors may be useful merely to preserve the *possibility* of maintaining value for the creditors, a possibility that must be verified as soon as possible to avoid an unnecessary destruction of value. Such a verification should be made by someone independent having an adequate business expertise, most commonly an external examiner (appointed by the court, by the creditors or by the debtor, provided that the examiner is independent);

(2) there might be cases in which, although the business is worth more as a going concern than liquidated, a stay on creditors does not solve the problem, as the short-term cash outflows, relating to expenses that must be incurred after the moment when the stay would take effect, exceed inflows and no interim financing is reasonably available. In this situation, liquidation is unavoidable. Such cases make the case for timely coping with distress particularly strong.

Guideline #5.1 (*Requesting a stay on creditors*). The debtor must be clearly aware of the cost of the stay, both in terms of limitation of creditors' rights and in terms of potential losses for all the stakeholders deriving from continuing a loss-making business. Therefore, the debtor must be reasonably convinced that there is going concern value to preserve, a conviction that must be stronger when the stay requested or, when automatically granted upon request by the debtor, effected has a long duration and/or has been extended after a previous request.

Guideline #5.2 (*Projecting cash-flows during the stay*). Before requesting a stay, the debtor must draw a cash-flow projection showing in detail what the cash-flow inflows and outflows will be during the period creditors are stayed. Such projection must take into account the likelihood of harsher commercial terms by suppliers (possibly, dealing with the firms only if paid upfront) and, if available, interim financing.

Guideline #5.3 (*Avoiding a harmful stay on creditors*). If the projected short-term cash outflows exceed inflows and no interim financing is reasonably available, the debtor should abstain from requesting a stay and should quickly resort to the best available option to preserve the business value, either as a going concern or as a gone concern.

Policy Recommendation #5.1 ***(Independent verification of the beneficial effects of the stay)*****. The law should provide for an independent verification, possibly conditional upon the request of one or more interested creditors, of the beneficial effects of the stay for the creditors as a whole.**

1.3. Negotiations and protection of transactions connected to negotiations

Regardless of the granting of a stay, the continuation of the business pending negotiations requires that the debtor be able to carry out transactions in the ordinary course of its activity (e.g., paying workers and suppliers) as well as transactions specifically aimed at furthering negotiations (e.g., paying reasonable fees and costs to the advisors). To this purpose, the counterparties to the debtor should be able to rely on the protection of such transactions, if equitable, in the scenario of a subsequent insolvency proceeding following the failure of the restructuring attempt. In certain jurisdictions, this comes from the requirements envisaged for avoidance actions, which are such as not allowing to void payments by the debtor made in close timely connection to receiving an equitable consideration (e.g., a certain service or an asset)[3]. Whereas, in other jurisdictions where also such transactions could be voided should the restructuring not succeed[4], it is important for the law to provide an express exemption covering these cases as well.

This is important to avoid third parties refraining from dealing with the firm as soon as the distress has come to light, once the firm has started negotiations. No one would rationally assume the risk of the success of the restructuring attempt, unless he or she is already exposed to the firm and/or obtains contractual terms remunerating such a risk. As a result, engaging in negotiations would cut most firms, even if still cash-flow solvent, out of the market, thereby preventing the continuation of the business during negotiations, making impossible to obtain the required professional advice, and ultimately determining the non-viability of the restructuring attempt.

In light of the above, the law should provide for safe harbours and/or mechanisms allowing third parties to rely on the effects of the transactions carried out during restructuring negotiations. It is advisable for the law to directly set forth exemptions of certain types of transactions that are clearly aimed at making restructuring negotiations possible (e.g., payments of workers and strategic suppliers, reasonable fees and costs in seeking professional advice). The law should include also a provision creating a more general safe harbour (as a result of either the requisites for avoidance actions or an exemption to avoidance) for all other transactions that, although not specifically exempted, are carried out to further negotiations on a restructuring attempt that does not appear *prima facie* non-viable.[5]

[3] This is the choice made by the German legislator. See s. 142 InsO.

[4] This is the case of Article 67(2) of the Italian Insolvency Act, providing that equitable transactions occurring six months before the beginning of the insolvency liquidation are declared void, if the trustee provides evidence showing that the counterparty was aware (or should have been aware) of the debtor insolvency.

[5] An alternative would be to provide that the judicial or administrative authority, upon the debtor request, may grant an exemption for any transactions not expressly exempted by the law, if the debtor provides evidence of the fact that the transaction is useful to further negotiations on a restructuring attempt that does not appear *prima facie* non-viable. However, such a solution appears suboptimal, since it might either clog the courts further or (also given the urgency of these decisions) become a rubberstamping of transactions without proper scrutiny, inviting abuse.

It is not advisable for the law to make the exemption from avoidance actions and/or unenforceability conditional on the confirmation of the restructuring agreement by the competent judicial or administrative authority. Such a solution, which has been adopted by certain jurisdictions and may be the one chosen by the European legislator,[6] only partially neutralises the risk born by third parties for the success of the restructuring attempt. Indeed, those dealing with the firm during negotiations continue to share the risk, beyond their control, that the restructuring negotiations be aborted or, anyway, do not lead to a confirmed agreement, while being discharged only of the risk of non-implementation of the restructuring agreement once confirmed.[7]

The legitimate purpose of allowing the avoidance and/or unenforceability of transactions carried out when there was no reasonable perspective of achieving a restructuring agreement and obtain its confirmation should be pursued otherwise. Invalidating the protection of all transactions reasonably carried out to further a restructuring agreement, which eventually is not reached or confirmed, would be "overkilling". The exemption from avoidance and/or unenforceability should be lifted only with respect to those transactions that are deemed fraudulent or, anyway, carried out in bad faith.[8]

Policy Recommendation #5.2 *(Protection from avoidance and unenforceability)*. The law should provide protection from the risk of avoidance and/or unenforceability of reasonable transactions carried out during negotiations and clearly aimed at making restructuring negotiations possible, by either providing exemptions or designing the requirements for avoidance and/or unenforceability accordingly.

1.4. Negotiations and interim financing

[6] Pursuant to Article 17, par. 1, of the proposed Directive on preventive restructuring "*transactions carried out to further the negotiation of a restructuring plan confirmed by a judicial or administrative authority or closely connected with such negotiations are not declared void, voidable or unenforceable as acts detrimental to the general body of creditors in the context of subsequent insolvency procedures*". It is not clear from the language of such provision whether the transactions "*closely connected with such negotiations*" may not, in any case, be *"declared void, voidable or unenforceable*", regardless of confirmation by the judicial or administrative authority.

The provision of the Proposed Directive, which appears to subordinate the protection of "*restructuring related transactions*" to the (later) judicial or administrative confirmation of the restructuring plan (Article 17), seems inconsistent with the provision on "interim financing" (Article 16), which does not qualify judicial or administrative confirmation as a condition for granting protection, even though interim financing is just one particular case type of restructuring related transaction.

[7] Granting protection to third parties regardless of the plan adoption and confirmation could be, at first glance, perceived as unfair to those creditors that are impaired as a result of the transaction (*i.e.*, those creditors whose recovery would have been higher if the restructuring-related transaction had been avoided raise concerns. However, should the law allow for the avoidance of such transactions, the third parties suffering an additional risk would either *(i)* not negotiate with the debtor, since it would be irrational for them not to be remunerated for such additional risk, or *(ii)* pretend that this additional risk be remunerated, to the result of carrying out transactions that would be regarded as unequitable and, thus, would be more likely voided.

[8] The proposed Directive on preventive restructuring already provides that the exemption should concern only transactions that have not been *"carried out fraudulently or in bad faith*" (Article 17, par. 1), thereby making the case for removing the provision of the judicial or administrative confirmation of the restructuring agreement as a condition for the protection of the transactions carried out during the negotiations.

Interim financing helps keeping the business solvent while the debtor is negotiating with its creditors. As mentioned, interim financing shares the same goal of the stay, namely preserving value for the creditors, and may be obtained by the debtor independently from a stay or in combination with it.

Financing a distressed debtor, however, entails serious risks:

(1) the financing may destroy value, giving a hopeless debtor new fuel to burn. Liquidation may then occur with less assets left for the creditors and/or more debts to satisfy out of the debtor's estate;

(2) the lender can incur the risks of recovery, as the debtor may not be able to reimburse the financing received and the security, if any, may be declared voidable.

Therefore, from the debtor standpoint, interim financing should be sought only when the debtor is confident that it is in the best interests of creditors. Such belief must be strong and founded on data and independent analyses when the amount of the financing is likely to affect the outcome of a liquidation.

From the lender standpoint, granting interim financing ordinarily entails a recovery risk. Except for the case when the law reduces or neutralizes the lender recovery risk (see below), no sensible creditor, be it a creditor already exposed or an external market player, would grant new financing unless it is reasonably confident the debtor will be repaying it (admittedly, creditors already exposed have a utility function more inclined to granting financing than external creditors). The lender is a market player that does not assess just the debtor's estate from a static perspective, but also the future prospects of the business once restructured. Hence, when a lender grants interim financing, it strongly signals that the restructuring attempt is worth sustaining.

As interim financing may contribute to preserve the business value, the law may help the debtor in obtaining it by reducing the risk borne by the lender. To this purpose, the law may give the grantor of interim financing an exemption from avoidance and liability actions and/or provide for priority to its claim (see e.g. Art. 16 Draft Directive).

However, shielding the lender extending interim financing from the recovery risk may yield some undesired results, namely the loss of the above-described signalling value and allowing for the continuation of a business that should instead be ceased, since the restructuring attempt is not viable/credible. These undesired effects are partially tempered by the circumstance that, according to certain general legal principles common to most jurisdictions, the above measure protecting the lender would not operate when there is evidence that the interim financing has been extended fraudulently or in bad faith.[9]

Guideline #5.4 (*Existence of the conditions for interim financing*). Interim financing should be sought only when the debtor assesses, on the basis of sound data and,

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[9] The Proposed Directive expressly set forth that "*new and interim financing shall not be declared void, voidable or unenforceable as an act detrimental to the general body of creditors in the context of subsequent insolvency procedures, unless such transactions have been carried out fraudulently or in bad faith*. (…). *The grantors of new financing and interim financing in a restructuring process shall be exempted from civil, administrative and criminal liability in the context of the subsequent insolvency of the debtor, unless such financing has been granted fraudulently or in bad faith*" (Article 16, paragraphs 1 and 3).

if possible, expert advice, that this is the best interest of creditors, especially to preserve the business value.

2. Information and cooperation

2.1. The need for a complete "information package"

An issue that has consistently surfaced in the qualitative empirical study is the need for the debtor to present creditors with adequate information in order for them to be able to decide in an informed and timely manner.

In general, reliable and updated information is necessary in order to draft a correct plan. Businesses should have adequate reporting systems (see Ch. 1), which are able to allow detection of distress in a timely fashion and provide updated data at a level of granularity that is sufficient to design the plan in a suitably sophisticated manner.

However, *having* the data is not enough. When drafting a restructuring plan, debtors should always be aware that they are relating to creditors and other third parties (advisors, insolvency practitioners, courts, as the case may be) that may not be immediately aware of all the business's details and the plan's aspects and implications. Information regarding the business and the plan, therefore, should not only be reliable, updated and complete, but should also be presented in a way that is easily comprehensible and deal with all aspects relevant for the creditors and the other third parties.

Completeness of the information package touches upon another key aspect, that is timeliness of creditors' response. Restructuring plans almost always require consent of at least some creditors, as a prerequisite of the plan. However, completeness of the information package, although being always of great importance, becomes pivotal when negotiation occurs outside formalised proceedings. When there is a formal proceeding, with set timelines and a moment in which creditors can cast their vote or otherwise express their position, the proceeding itself solves the issue of timeliness. To the contrary, outside of a formal proceeding, it is even more important for the debtor to spontaneously adopt a timely and transparent approach since the beginning, especially with regard to the information they provide to creditors.

An issue that is commonly raised is the difficulty for businesses to receive comprehensive and final responses in a reasonable time, especially from banks and other financial creditors. Almost any restructuring implies, of course, the involvement and participation of institutional creditors, in particular of banks. These difficulties increase: *(i)* when there are several creditors or, in any case, the average value of each claim is not large, which is frequently the case in some jurisdictions (typically, in Italy, Spain, and ____, where usually businesses resort to various banks on equal footing also for credit facilities in the ordinary course of business and there is no leading bank, as it is instead common elsewhere, e.g. Germany, and there are more micro and small enterprises), and *(ii)* in times of crisis, when banks are flooded by requests. In this respect, regulatory rules setting requirements for

banks on NPLs provisioning may exert a significant influence on the incentives to the lender banks and the debtor during negotiations.[10]

It should be noticed that timeliness is of the essence not only for the debtor, but for the whole restructuring process. Time plays a crucial role in the reliability and effectiveness of the plan: it is not uncommon that, due to defects and delays in the negotiation process, plans that were drafted taking into account a certain time horizon are no longer current when creditors consent to the plan, because the underlying situation has changed. The implementation of the plan is, of course, immediately affected as well.

The availability of high-quality, complete and comprehensibly presented information (a) is prerequisite for the drafting of a good plan and (b) may facilitate obtaining positive, or at least timely, responses by creditor, and in particular by financial creditors.

Timely responses from creditors have a positive effect to the extent that they make it possible to:

(1) abandon plans which appear defective or for any reason unfeasible from the beginning, avoiding further costs and prejudice to creditors, and facilitating the filing for formal insolvency proceedings;

(2) correct and improve the plan, when it is feasible, or at least appears as such theoretically (of course, in order to be useful, such amendments should be carried out timely and fast);

(3) increase the certainty on the possibility of success of a feasible and well-balanced plan.

The exact content of the information package to be provided to creditors and third parties will vary from case to case. However, some basic information should not be missing:

- the causes of the crisis, highlighting, if possible, whether the crisis has a mainly financial origin or not;
- the initial situation: all information and data on the debtor must be clearly and objectively outlined. Such data should rely upon some form of professional review;
- a summary description of the plan which is proposed;
- a more detailed description of key aspects, with a focus on key elements (such as the minimum amount of write-offs or rescheduling, the minimum amount of creditor acceptance, whether the plan envisages the direct continuation of the business, etc.) and risks (including legal risks);
- financial information;
- prospective financial information, including the assumed cash flow projections;
- key assumptions of the plan.

[10] See paragraph 3, below, for an assessment of the effects of the incentives posed by regulatory rules on NPLs provisioning. It is worth to mention that such incentives would operate fostering a quick reaction by the bank but, at the same time, creating an incentive for the debtor to slow down negotiations, as the time increases its leverage in negotiating with the banks.

A more detailed description of some of the elements of the plan outlined above is contained in Art. 8 of the draft Restructuring Directive.

In the phase of negotiations, the plan need not to be complete and an outline will be enough. It is important, however, that the basic information is given since the beginning so that creditors can immediately form an opinion about the plan. Any delay in that respect may result in postponing the restructuring and, thus, engaging in negotiations when a turnaround is not anymore possible, or anyway when the debtor's conditions have deteriorated.

Once negotiations have started, the debtor should as soon as possible:

(a) prepare information to be disclosed to creditors, especially financial creditors, and related supporting documentation;

(b) carry on negotiations in good faith; creditors should, in return, promptly and critically evaluate the information received and ask for further information and documents, when needed;

(c) define the plan in all its details, fine-tune it and define the proposals to be made to creditors;

(d) if the plan includes the business continuing as a going concern, highlight whether standstill agreements or additional financing are necessary for the plan to go forward. Special attention should be given to the reasons why new financing is needed (with regard to the best interest of creditors);

(e) highlight possible contributions provided by shareholders or third-party investors (in the form of risk capital or credit facilities) or show the reasons why asking for these contributions is not feasible.

In more general terms, the debtor should be able and ready to provide all necessary supporting documents to creditors or other interested parties that may request them.

2.2. Disclosure and good faith

When a restructuring plan is needed, the debtor is in distress. This causes the usual relationship between the debtor and its creditors or contractual counterparties to be altered. The extent to which this happens, however, depends primarily on how deep the crisis is.

Directors have a duty, in general, to minimise losses for creditors (and, says Art. 18 of the draft Restructuring Directive, for workers, shareholders and other stakeholders).[11] How does this translate into a duty do disclose all relevant information? In other words, can directors, acting in the interest of shareholders (who have appointed them), engage strategically with creditors and fail to disclose information which they are not required to disclose by the law? Does negotiation with creditors follow the same pattern of negotiation when the company is not in distress?

The answer is probably no. Creditors are captive counterparties to the debtor and are asked to give up something they had bargained for. The debtor is often already breaching the credit contract or may be about to do so; the only issue in a restructuring is how big this

[11] It should be noted that the goal of minimizing losses, being referred to stakeholders having very different interests, is only seemingly unitary. Indeed, due to the provision of Article 18, directors may often be subject to conflicting duties, whose importance is not graded by the proposed Directive. In this respect, see the amendments proposed to the draft Directive.

breach will be. Creditors have no proper alternative to negotiating, because enforcement of the claim is not an option as a matter of law (when there is a stay and a collective proceeding) or as a matter of fact (the debtor is already underwater). Given that this negotiation is not between parties free to choose their counterparty and is therefore somewhat coercive, and given that there is also a collective action problem when there are many creditors, it is fair to say that an adequate procedure and disclosure are proper tools to mitigate these issues.

There are, however, some nuances. There is no doubt that debtor must negotiate in good faith, even more than what would happen in ordinary negotiations. Many national laws provide for a similar duty either specifically to restructuring or, more commonly, as a general principle (this is the case, for instance, of Article 1375 of the Italian Civil Code). It is not self-evident, however, whether debtors owe a duty of complete candour to creditors – which they certainly would not owe if not in distress. If the equity has not been completely wiped out, directors continue having a duty to maximise shareholder value, whilst not causing further losses to creditors; therefore, it is arguable that directors do not have to reveal their "reserve price" when bargaining with creditors. But even assuming that equity *has* been completely wiped out, directors may have a duty not to reveal *all* circumstances to all creditors, because this could frustrate the optimal overall outcome of the restructuring plan, especially when negotiating without the protection of a stay on creditors' actions, but not only. Revealing too much information to creditors could cause negotiations to fail due to opportunistic behaviour of some creditors or just due to lack of coordination among them.

These cases are likely not to be so frequent. As a general rule, therefore, one can say that debtors have a duty to disclose all relevant information to creditors and other interested parties, and to do so in a clear and complete manner.

2.3 Cooperation by creditors?

Creditors should negotiate in good faith with the debtor. It is debatable, however, whether creditors have a duty to cooperate also when the law does not provide for coercive instruments. For example, can a creditor behave opportunistically absent a cram-down mechanism? Can a creditor refuse to accept (and sink) a restructuring plan that would make him better off, just because he wants to uphold his notoriety as a hard player?

Probably, good faith does not mean that creditors should actually *cooperate* with the debtor. As long as they do not take advantage of a position they may have acquired during negotiations and of information gleaned from the debtor during negotiations and they are not conflicted, creditors should be free to pursue their personal interest, which may differ from a standard definition of what their interest should be (*i.e.*, the interest of an average creditor in the same position). Opportunistic behaviour should probably only be prevented by majority decision coupled, as the case may be, by a creditors' best interest test, and perhaps by specific interventions to make sure that creditor voting (or participation in decision making) is "sincere", *i.e.* making sure that the creditor has no "external" interests but is acting in its own interest *as a creditor of that debtor*.[12]

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[12] It is very difficult to exactly draw a line between legitimate external interests (*e.g.,* for repeated players, such as banks, conveying a message to the market that would maximise the recovery on the entire portfolio, even though impeding the adoption of a viable restructuring plan and, thus, having a negative effect on the recovery rate in that specific case) and external interest that may not be legitimately pursued to the detriment of other creditors (*e.g.,* willingly pushing the firm into insolvency with the purpose of triggering credit default swaps).

Apart from these limits, there is a risk that, by broadening the scope of good faith and deriving from it a duty to cooperate with the debtor, curbing all forms of dissent from what is a (supposed) average creditor's best interest, too much discretion is given to courts or to authorities that oversee plans. Courts should, instead, always defer to a free and unconflicted decision of those whose interests are at stake, even if this entails a suboptimal outcome in the specific case.

Guideline #5.5 ***(Relationships with creditors).*** **Especially when the restructuring plan requires the creditors' individual consent, the debtor should timely provide the creditors involved with adequate and updated information about the crisis and its possible solutions. Information should be provided concerning the causes of the crisis, a description of the plan and its key elements and assumptions, financial information both past and prospective.**

3. Dealing with banks and credit servicers

3.1. The special role of banks in corporate restructurings

Banks are a special category of creditors. They often hold a remarkable share of the company's indebtedness, which makes them a key counterparty in the negotiation of restructuring plans. They may also act as providers of new money, whose decision to financially support a restructuring attempt through interim or ex-post financing may be crucial for its success and, ultimately, for the survival of the distressed debtor.

Banks' approach to restructuring can therefore deeply influence the outcome of a crisis management strategy. However, decisions of financial creditors in this field are not fully discretionary and debtors need to be aware of the various elements (factual and regulatory) that – given the present regulatory context – may affect banks' willingness to engage in constructive negotiation for a restructuring plan.[13]

The banking environment has changed markedly following the financial and sovereign crises in the EU. Concerns have arisen about forbearance policies and non-performing exposures, (NPE) management across the EU, as the then existing rules on these matters were seen as having prevented banks from timely recognizing impairment of outstanding debt and contributed to the huge increase of risky exposures in banks' financial statements.

In particular, the EU has been enacting a set of new standards and rules to ensure that banks pursue timely strategies in managing NPEs and derecognize bad loans from their financial statements, with a view at mainly coping with the existing non-performing loan (NPL)[14] burden, under an 'emergency' prospective – amplified in number and size by the

[13] Banks' "specialty" is primarily rooted on the fact that extending loans is the core business of these entities and an activity subject to regulatory constraints due to its connection with public interests. As credit exposures incorporate elements of risk, applicable regulations impose on lenders to reflect such risks at balance sheet level (e.g. capital ratios, provisioning) and to adapt their internal organization to effectively monitor and contain credit risks. This, in turn, affects the manner in which banks may react when dealing with counterparties in distress.

[14] In the ECB NPL Guidance and addendum "*NPLs and NPEs are used interchangeably*".

stagnation of the corporate loan market – and preventing a further increase in the amount of deteriorated loans by applying the same emergency approach. In this respect, the most relevant recent changes concern:

(i) the introduction of new accounting standards to increase transparency of banks' financial statements[15],

(ii) a convergence across Europe, in part still to be achieved, around the notions of 'forbearance' and 'non-performing exposures',[16]

(iii) setting out new legislative requirements to ensure the fulfillment of common regulatory provisioning levels for NPLs (*i.e.* amounts of equity capital that loans, depending on the risk category, are to be backed by).[17]

In the meantime, EU supervisors have issued guidelines – drawn from best practices relating to NPL management – to urge banks to monitor their credit exposures in the entire course of their relationship with borrowers, and to adopt prompt measures when signs of distress emerge.[18]

Finally, the Commission has recently proposed a directive on credit servicers, credit purchasers and the recovery of collateral with the aim at developing a EU secondary market for NPLs and ensuring a more efficient value recovery for secured creditors through accelerated out-of-court enforcement procedures (from now on, *Credit Servicers Directive*).[19]

In this transforming landscape banks' willingness to participate in corporate workouts and, more generally, their attitude towards restructuring attempts has been deeply impacted

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[15] The International Accounting Standards Board (IASB) in 2014 published IFRS 9 *Financial Instruments*, which includes a new standard for loan loss provisioning based on "expected credit losses" (ECL).

[16] Definitions convergence has been achieved so far for supervisory reporting purposes, pursuant to Commission Implementing Regulation (EU) No 680/2014 of April 16, 2014, laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013 of June 26, 2013 on prudential requirements of institutions (CRR). Convergence, however, is expected to be soon extended to the prudential framework within a package of measures to be adopted to tackle the problem of NPLs in Europe (see Commission communication of October 11, 2017 on completing the Banking Union). In particular, a Commission proposal for a Regulation on amending Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures – COM(2018) 134 final; from now on, *CRR Amending Regulation* - provides for the introduction in the CRR of a new definition of NPE, which is largely based on the current framework set forth in Commission implementing Regulation (EU) No 680/2014. Provisions will be added in the CRR to define the notion of "forbearance measures" as well as in relation to cases where NPEs subject to forbearance measures shall cease to be classified as NPEs. It is worth noting that the CRR Amending Regulation does not deal with legacy NPLs, differently from the ECB Guidance, but still it questionably imports the 'emergency approach' under the Guidance to 'ordinary' credit management.

[17] Proposed *CRR Amending Regulation* will impose a "Pillar 1" minimum regulatory backstop for the provisioning of NPEs by EU banks – which is meant to apply to all exposures originated after March 14, 2018. Any failure to meet such provisioning floor will trigger deductions from Common Equity Tier 1 ("CET1") items.

[18] On March 20, 2017 the ECB published its *Guidance to banks on non-performing loans* addressed to credit institutions it directly supervises under the Single Supervisory Mechanism ('significant institutions'). Such *Guidance* presents ECB's expectations and best recommendations on dealing with NPLs. In the context of the published requirements, banks should reduce their NPL portfolios by applying uniform standards, thereby improving the management and quality of their assets. An addendum to the *Guidance* has been published in March 2018 dealing with loss provisioning expectations. For 'less significant institutions' some national supervisors (e.g. the Banca d'Italia) have adopted or are adopting guidelines consistent with ECB *Guidance*.

[19] Proposal for a directive of the European parliament and of the Council on credit servicers, credit purchasers and the recovery of collateral - COM(2018)135 published on March 14, 2018.

and is expected to change further. This trend is confirmed by national findings. They show that prudential rules on NPLs have become the major driver for banks in evaluating restructuring plans, as keeping NPLs on balance sheet is increasingly costly for banks.

3.2. Legal constraints to forbearance and prudential requirements for NPLs provisioning

Intensified regulation on the management of NPLs (notably stricter supervisory guidance and regulatory capital requirements) will likely reduce banks' leeway to give concessions without an immediate pay-out (*i.e.*, without tangible effects on their balance sheet). In the light of the current regulatory landscape it may be expected that banks would be primarily led to consider how to quickly free up their balance sheet from the burden of risky exposures, even though such solutions would not entail the maximization of the present value of the exposure.

The risk of such a sub-optimal outcome is amplified by a high degree of uncertainty about the scope of the envisaged prudential provisions. The rules proposed by the Commission in the draft CRR Amending Regulation are partially inconsistent with the ECB expectations laid down in the 2018 Addendum. Namely, the ECB guidelines apply to the existing credit stock, *i.e.* those classified as NPE after April 1, 2018, while the parallel provisions of the proposed Regulation will only apply to exposures arising after March 14, 2018.

In addition, it is worth to recall that the regulatory framework on NPL is deeply affected by the fact that it is conceived as an emergency discipline (created in response to an extraordinary situation), whose draconian severity would no longer be justified in an ordinary, post-recession scenario. The fact remains that at this stage - and regardless of any reservations one may have on the content of the rules and standards at hand - this is the regulatory background with which operators have to deal and whose implications with respect to preventive restructuring need to be assessed.

The bank attitude in the context of restructuring may be influenced by a number of factors, which are to a great extent over the control and even the perception of the debtor. Particularly, the behavior of the bank in restructuring negotiations is, indeed, affected not only by the amount at stake or the nature of the claim (e.g. secured or unsecured), but also by the overall financial situation of the bank, the composition and soundness of its credit portfolio, and the internal NPL strategy it has in place.

Pursuant to recent supervisory guidelines, banks are also solicited to implement several organizational changes and operational arrangements to achieve a more effective handling of 'problematic' exposures (*i.e.*, not only of exposures for which an insolvency proceeding or a foreclosure proceeding has already been initiated, but also for those which could still be remedied, in full or in part through an out-of-court restructuring or other measures). Such organizational changes and operational arrangements exert an remarkable impact on the banks' approach to restructuring negotiations.

For instance, supervisors strongly recommend:

- the adoption of NPL strategies and the implementation of operational plans setting out the options for NPL management;[20]
- the establishment of dedicated NPL workout units, which need to be separated from the loan granting units and would engage with the borrower along the full NPL lifecycle and take on, according to the guidelines, a different focus during each phase of that cycle. This measure would eliminate potential conflicts of interest and the risk of any bias in assessing the best strategy to deal with a problematic exposure, ensure the presence of staff with dedicated expertise and experience, and somewhat proceduralise the approach to credit management in debtors' distress scenarios. The other, less direct, consequences of such measure are making the bank-firm relationship more impersonal in case of distress and replacing, to a large extent, soft information with scorings and other risks assessment techniques in assessing and addressing the firm's distress;[21]
- the internal implementation of a number of credit monitoring tools and early warning procedures and indicators (at both portfolio and borrower level), so as to promptly identify signals of client deterioration. Banks are also recommended to develop specific automated alerts at borrower level to be activated in case of breach of specific early warning indicators. When such breaches occur, banks should involve the dedicated NPL workout units to assess the financial situation of the borrower and develop customised recovery solutions at a very early stage.[22]

Of course, the existence of a sophisticated system for managing problematic exposure internal to the banks does not prevent a debtor from taking autonomous initiatives prior to the occurrence of those triggering events (e.g. initial arrears), which would activate the bank NPL workout unit and cause it to take preliminary contacts. A debtor, indeed, might always be aware of other sensitive events unknown to creditors that may affect the soundness of the credit relationship, and he should start to plan remedies on his own, possibly with the assistance of financial advisors.

[20] By way of example, 'hold and forbearance' approaches might have to be combined with portfolio reductions and changes in the type of exposures (e.g. debt to equity swapping, collateral substitution, foreclosure); moreover, the operational plan might allow only certain activities to be delivered on a segmented portfolio.

[21] This approach may be perceived as causing a decrease in the likelihood of debt restructuring compared with cases in which lending units are involved and relationship banking prevails. International experience (like that gained in the case of Royal Bank of Scotland) and economic analyses on the effects of separate decision-making on debt restructuring and systematic use of scoring techniques show that these practices, on the contrary, can substantially improve financial restructuring of viable companies (see Micucci-Rossi, Debt Restructuring and the Role of Banks' Organizational Structure and Lending Technologies", J Financ Serv Res (2017).

[22] It's worth to recall that these supervisory expectations are aimed at promoting efficient and prudent conducts by intermediaries in the management credit risks; banks' action or the lack of appropriate initiatives in this respect will be assessed by supervisors and might trigger supervisory actions. They cannot be interpreted, however, as imposing on banks specific duties to inform debtors or to activate any initiative in substitution of inactive debtors. Banks may offer their assistance or require borrowers to engage in finding solutions and are recommended to do so for prudential reasons, but borrowers only are responsible to manage distress, as part of their entrepreneurial activity, and may consequently be held liable towards stakeholders for the lack of prompt action. Banks, on their side should avoid any form on interference with the business management of their clients, both in good and bad times.

However, under the abovementioned circumstances, a debtor might waste time and resources in devising a plan envisaging concessions that a financial creditor would not accept, due to regulatory/operational constraints, to its own NPL strategy or to the results of internal assessments on the recovery prospects of that segment of exposures or, in some cases, specific exposure.

Therefore, it is important for the debtor to timely approach (*i.e.* at very initial signs of distress) their financial creditors to verify with them the existing (regulatory or operational) boundaries within which any negotiation would have to occur, should the situation get worse. Banks, in turn, should be available and willing to provide any relevant information in this respect. This would not mean that financial creditors should disclose in advance their negotiation strategy before sitting at the bargaining table. However, it would be good practice for lenders to promptly share with the debtor (already in preliminary contacts, whenever feasible) any concern (either deriving from specific supervisory measures or connected to internal NPL policies and operational plans), which would impact on their agreement to certain measures to turnaround the firm.[23]

Guideline #5.6 ***(Awareness of the regulatory constraints specific to the banks involved in the restructuring).*** **The introduction of strict standards for the safe and prudent management of credit exposures will most likely cause banks to tighten up their approach in the negotiation process. In this context, it is key that a debtor gains a timely awareness of the regulatory considerations their lenders would make, including in connection with elements of their NPL strategy and operational plan that under given circumstances may materially affect their approach to workout.**

To achieve such awareness, a debtor should timely approach its lenders and share with them, under appropriate confidentiality arrangements, any relevant information which might adversely affect the soundness of its business or the value of a given collateral and require, in turn, to be promptly informed, at the outset of any negotiation and to the extent possible, of elements of the lender's NPL strategy and other general constraints that might influence the willingness of the latter to make concessions, or certain types of concessions, in a given crisis scenario.

Guideline #5.7 ***(Internal financial assessments conducted by the bank on the debtor).*** **Banks should be willing to share with interested debtors (upon reasoned request from the debtor and to the extent possible) any results of internal**

[23] As we have pointed out in Chapter 1, it is important to promote a co-operative approach between debtor and banks, which may lead to the early identification of crisis and, therefore, to more value-maximising solutions. In this vein, banks should share with interested debtors the results of financial assessments, including sectorial analyses, that have been internally conducted in the context of their NPLs management activity, whenever such results may anticipate the evolution of the crisis and may help the debtor in identifying the most effective and feasible remedies. This would be particularly beneficial to MSMEs, which might not have in place adequate risk monitoring mechanisms or may not avail themselves of the assistance of qualified financial advisory services. On the other hand, debtors should be ready to provide, in turn, – subject to proper confidentiality arrangements – any information that may impact their soundness and might be useful for a prompt assessment by lenders of the financial situation of the debtor and the possible activation of early warning mechanisms.

financial assessments conducted on the debtor's situation or on the status of a specific loan segment, which might favour a better understanding by the debtor of the seriousness of the crisis and a reasoned identification of its possible remedies.

As earlier described, NPLs are also subject to rigid reporting and supervisory expectations aimed at favoring earlier recognition of actual and potential credit losses as well as ensuring a capital structure that gives adequate coverage to them.[24]

NPLs are classified by reference to their riskiness, calculated as a function of both the severity of their situation (distress, crisis, non-viability or insolvency) and the banks' initiatives, or lack thereof, to overcome such situation.

In general terms, exposures are qualified as non-performing (NPLs) when:

(a) the bank deems them to be unlikely to pay in full without recourse to security realization, regardless of past due amounts;
(b) they are past due more than 90 days, provided that exposures are material as defined by competent regulators to reflect a reasonable level of risk (in Italy 5% of the overall exposure);
(c) the debtor is insolvent, *i.e.* it is not able to pay its debts as they fall due, irrespective of loss estimates (bad exposures).

Regardless of their performing or non-performing status, exposures may be classified as forborne if the debtor, while experiencing (or about to experience) difficulties in meeting its financial commitments, benefits from concessions (typically made in the form of loan modifications and/or refinancing).[25]

Banks indeed enjoy a margin of discretion, in certain cases, as to whether exposures that benefitted from concessions should be classified as non-performing loans or (performing) forborne credit.[26]

[24] Exposures are balance sheet assets that banks must weight by reference to the underlying risk (typically a credit and counterparty risk) under the applicable regulatory framework. Risk weighted assets count within capital ratios as the quantitative reference for calculation of the own funds banks must hold, as a minimum, in order to absorb potential losses. For that purpose, banks must classify exposures by reference to their riskiness, i.e. their un/likeliness to be paid in full at due date: this is the micro-prudential perspective of each bank. Risky exposures are also periodically reported to supervisors for macro-prudential supervision purposes, i.e. monitoring of systemic risks, if any, to the financial sector as a whole or the real economy.

[25] By way of example, banks *must* use the 'forbearance' category at least for debtor-friendly amendments to loan agreements or write-offs. They *are expected*, *but they are not held, to* do so when existing concession clauses are triggered to cure or prevent more than 30-day past-due exposure or when modifications are made due to actual or potential more than 30-day past dues for performing exposures. Also, when a pool of banks temporarily 'freezes' credit facilities in anticipation of restructuring, this is not *per se* a forbearance measure, even though the freeze period must however be counted as days past due.

[26] Some examples may help considering the practical situations banks may face. In particular, the applicable credit classification may not always be crystal-clear. This typically happens when it is disputable whether certain exposures have the features to be classified as unlikely to pay; or when exposures are past due more than 90 days, but it is debatable whether such exposures are 'material'. In those instances, banks choosing to use the 'performing forbearance' category must make sure that their choice does not instead delay a required loss recognition, nor conceals the actual asset quality deterioration.

In other cases of restructuring through concessions, exposures are to be identified as forborne non-performing; however, in the case of a Court-approved *business sale* to a non-related third party on a going-concern basis, the exposure that is taken up by the transferee is to be reported as performing.

However, with respect to forborne non-performing exposures, consistently with the present regulatory framework it would be essential to identify the conditions under which restructured exposures may exit from the non-performing category and enter into the forborne performing. Only when the conditions for a restructured exposure to exit from the non-performing category are met, the bank will be able to free up resources and reflect the classification change in its balance sheet. The shift of a forborne exposure from non-performing to performing status is neither immediate, nor automatic, although it is essential the issue of the debtors' capability to repay, *i.e.* reinstating a situation where the repayment is sustainable for the borrower. Such an effect depends on whether both *(i)* the bank deems that no more defaults/impairments exist after one year from the forbearance, and *(ii)* either regular payments are made to the bank or the debtor has otherwise demonstrated its ability to comply: a long and difficult path.

The regained performing status of a restructured exposure does not affect its classification as forborne, which remains and has its own implications as well. During the forbearance phase, in fact, the bank is expected to perform strict monitoring over the exposures and, in addition, the forborne status has repercussions for asset quality assessments. In this perspective it would be essential, therefore, to identify when it ceases. Pursuant to the ITS Standards, a performing restructured exposure can be classified as purely performing (*i.e.*, exit even from the forborne performing status), when it was deemed performing during an additional probation period of 2 years, within which regular payments were made for at least half of the time, and provided that at the end of the probation period no exposure of the debtor is more than 30 days past due.

The above-described rules on the classification regime of NPLs have a significant impact on the banks' approach to restructuring negotiations. Debtors should thus be aware that any concession they intend to request has to be conceived having regard, *inter alia*, to the reporting implications for lenders. This requires, in particular, that restructuring measures have to be drafted under sound and credible terms, especially with regard to their attitude (in combination with other remedies, if needed) to restore the debtor's financial soundness and ensure that his ability to regularly perform is maintained in the medium-long term. In particular, current rules imply that a time horizon of at least one year of regular performance (or of 'no concern' about the debtor) should be granted, as a minimum, because this is the length of time necessary for the exposure to cease being qualified as non-performing. Banks, however, would likely pursue a more ambitious goal, *i.e.* the restoration of a full (not forborne) performing status, for which a three-year time horizon would be the minimum standard. Even such a standard might, indeed, not be sufficient, as financial creditors might reasonably expect the debtor to pursue a longer term viability, so as to avoid – in particular – the risk of recurring to forbearance more than once, as this might be an obstacle to the exit from the non-performing status. [TBC]

Guideline #5.8 (*Minimum duration of expected regular performance under the plan*). When negotiating concessions with banks, it is advisable for debtors to consider the feasibility of the proposed distress resolution actions in the light of their predictable effects for lenders in terms of exposure's classification and reporting requirements.

To this aim, any restructuring measure proposed by the debtor should be conceived under credible terms and on the basis of a sound assessment as to the ability of the measure to restore and maintain the financial soundness and

ability to perform of the debtor in the long run and, in any case, for a time horizon that should exceed three years.

Based on exposures' classification and related risk weighting, banks are also required to set aside minimum levels of capital to cover losses caused by loans turning non-performing in order to meet supervisory expectations. In case a bank does not meet the applicable minimum level, deductions from own funds would apply.

In this regard, recent supervisory guidelines set forth substantially rigid quantitative common levels of provisioning.[27] These supervisory expectations have been devised for the purpose of *de facto* eliminating the degree of discretion that credit institutions still have in determining NPE coverage levels, thereby achieving convergence of provisioning practices among banks.

According to the recently issued guidelines, the levels of provisioning expected by the supervising authority depend on:

(i) whether the loan is collateralised (in full or in part) or otherwise incorporates forms of credit risk mitigation, and

(ii) time passed since the exposure has been classified as NPE.

In particular, the bank is expected to provide full provisioning coverage for secured exposures (or portions thereof) after 7 years from the moment when they became non-performing, and for unsecured exposures (and portions thereof) after 2 years from the moment when they became non-performing. The provisioning coverage for secured exposures must progressively increase according to vintage, i.e. 40% after 3 years, 55% after 4 years, 70% after 5 years, and 85% after 6 years. These supervisory expectations apply to all exposures of significant banks classified as new NPEs since April 2018, but the ECB will start monitoring compliance with these requirements only from 2021 onwards.[28]

It is reasonable to expect that these harsh measures will increase significantly the volume of NPLs disposals by banks, as keeping NPLs on their books will ultimately result in a higher cost of capital. Recourse to massive sales – with high depreciation effects - will likely be more severe for credit institutions established in EU Member States suffering from time-consuming/inefficient insolvency and debt recovery regimes.[29]

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[27] A similar approach is followed by the draft *CRR Amending Regulation*. While the proposed Regulation is aimed at introducing common provisioning requirements applying to all credit institutions established in all EU Member States (as the aforesaid EBA draft guidelines), the ECB Addendum – as said - specifies the ECB's (non-binding) supervisory expectations for significant credit institutions directly supervised by the ECB under the Single Supervisory Mechanism.

[28] The statutory prudential backstop under the proposed Regulation would instead apply only to exposures originated after March 14, 2018, and not to prior legacy exposures.

[29] Level playing field concerns caused by this divergence in the effects of common provisioning requirements across Europe would be mitigated – in the intention of European institutions - by the impact of other reforms that are being devised to tackle the problem of NPLs. The proposed Directive on restructuring and second chance, first of all, with its aim to lead to the establishment in all Member States of common preventive rescue measures, should contribute to improve the efficiency of restructuring procedures within the EU. In addition, the performance of collateral foreclosures should considerably benefit from the introduction of out-of-court accelerated enforcement procedures, such as the one envisaged in the proposed *Credit Servicers Directive*.

What seems to be clear at this stage is that the role and involvement of banks in restructurings is anyway likely to be deeply impacted by the new prudential rules on calendar provisioning.

Banks, indeed, would likely be interested in engaging in the negotiation of restructuring plans[30] provided that the restructuring process and the implementation of the plan be expected to occur before full provisioning coverage is required (i.e., within 2 or 7 years, respectively, for unsecured and secured exposures after the claim is classified as NPL). After full impairment is made and bank's capital is affected so as to absorb the loss, banks might not have strong incentives to actively participate in the negotiation and may be interested in collecting whatever recoverable amount on the impaired exposures is available, being ordinarily more inclined to pursue the easiest way outs, irrespective of whether they may be detrimental to debtors' chances to recover.

Further, it is worth to note that, even before the moment when the bank is required to ensure full provisioning, the rules on provisioning may significantly alter the incentives for the bank to engage in restructuring negotiations. Unless the plan provides a write off and immediate repayment of the debt, the bank may not have a strong interest for restructuring (at least with respect to unsecured exposures), to the extent that the 1-year probation required to exit the non-performing category could hardly occur before the 2-year term for full provisioning.

As a result, a proposed restructuring, as far as unsecured exposures are concerned, is more appealing for the banks from a prudential perspective, if it is reached and brought into effect at the latest within 1 year since the classification of the loan as non-performing. In fact, any forbearance agreed thereafter would not prevent the full provisioning effect at the 2-year deadline (as mentioned, the loan may exit the NPE category only after 1 year of regular payments, unless the debtor has otherwise demonstrated its ability to comply). If a restructuring plan cannot be reasonably expected to be adopted and implemented, the bank would likely be mainly interested in an immediate partial payment, rather than other concessions (e.g. a rescheduling) that would anyway result in full provisioning.

With respect to secured exposures, banks would factor in the effects of partial provisioning from the third to the sixth year of vintage, thereby being more inclined to accept – in principle – sacrifices that already incorporate the percentage of partial provisioning required. Again, however, any forbearance agreement should be reached at the latest 1 year before the deadline for full provisioning (*i.e.* within the end of the sixth year of vintage), as after that moment the financial lender might no longer be willing, at least in principle, to grant concessions that would aim at preventing the insolvency liquidation of the debtor without however affecting the NPL status of the exposure (which would remain non-performing until the deadline for full provisioning).[31] TO BE FURTHER CHECKED

The new classification regime and the recommended operational practices for the management of NPLs, coupled with the severe provisioning regime, seem clearly oriented to convey the message that problematic loans should be addressed at a very early stage and trigger prompt action by banks in their own interest. Indeed, any negotiation, to be usefully

[30] Unless they have a strong incentive to help the survival of a debtor, in order to maintain a long-term relationship with a strategic client that they consider still viable.

[31] Still, it has to be recognized that, for secured exposures, a restructuring agreement due to become effective a year before the full provisioning deadline would also not be much appealing for banks, since at that point in time they should have provisioned already 85 per cent of the exposure.

undertaken by a debtor, should start in advance of the entry of the loan into the NPL category, i.e. as soon as tensions emerge. After that moment room for concessions by banks would be, in fact, considerably limited.

However, in general terms, imposing a rapid full provisioning of NPLs will likely induce banks to pursue short-term solutions that may be detrimental to debtors' chances to recover.

Furthermore, due to the described prudential rules, a debtor could have incentives, in certain cases, to engage in strategic delay, since the bank could be deemed more inclined to grant concessions after the classification of the loan as non-performing, under the threat of full provisioning. However, on the one hand, this might be true, as highlighted above, only to the extent that the delay would not affect the possibility to adopt and implement (at least with respect to the bank claim) a credible restructuring plan within the 1-year period required to enable the exposure to exit from the non-performing category before full provisioning is required. On the other hand, debtors should consider that banks, because of legal constraints, might implement an 'exit strategy' by selling the NPLs to third parties, as soon as they deem a timely and satisfactory restructuring not feasible. In such a case, the purchaser, a new contractual counterparty, would sit at the bargaining table with the debtor.

Also, the aforesaid incentives for banks might however be less significant in respect of loans secured by collateral under the form of movable or immovable assets benefitting from "*accelerated extrajudicial collateral enforcement*" (AECE), which could be envisaged in the proposed *Credit Servicers Directive* currently under discussion. Indeed, secured financial lenders that have included an AECE clause in their credit agreements could decide to activate that clause, rather than participating in negotiations with the debtor. The current text of the proposed Directive clarifies that the AECE cannot be activated, if a preventive restructuring proceeding has been initiated and a stay of actions has been granted. However, this would not prevent lenders to activate the AECE despite pending negotiation of an out-of-court workout, thereby hindering a debtor's attempt for rescue. Any workout strategy including financial creditors that could avail themselves of that special enforcement clause should therefore consider that it would be hard to obtain their consent, unless they are granted recovery of the full market value of the collateral as quick as in an extrajudicial enforcement.

Guideline #5.9 (*Early start of restructuring negotiations*). The negotiation of workout strategies should start when first signals of distress emerge and, to the extent possible, before a credit exposure is classified as non-performing. These strategies should be designed so as to ensure that concessions be agreed and brought into effect no later than 1 year before the moment when the bank is expected to ensure full provisioning.

The introduction of stricter provisioning requirements, as said, will give incentives to banks to sell NPLs more frequently to reduce the costs of handling problematic exposures. This outcome may be justified in the short term, as long as the aforesaid emergency approach is necessary to solve the problem of the extraordinary NPL volume in banks' financial statements. However, continuing to abide to such an approach in the future with respect to NPL management in the context of ordinary bank operations would be questionable from a policy standpoint.

Banks, however, might still play an important role in all cases in which discussions with debtors start at very initial stages of distress, *i.e.* when, in the light of the framework described above, prompt action by the banks could prevent the deterioration of a credit exposure and its entry into the NPL category. In these situations (which might occur, essentially, in the first 90 days of non-performance, and only if banks do not already deem the exposures to be unlikely to pay), the banks' approach should aim at supporting the debtor in restoring the long-term viability of the business, rather than granting concessions on a purely bilateral debtor-creditor relationship, let alone increasing their protection (collateral/guarantees). To achieve this in the short time span above might be difficult when the distressed debtor has a large and complex structure and has to deal with a multitude of lenders. Under those circumstances coordination might be extremely problematic and costly and a prompt sale to professional credit purchasers might again be a more efficient solution.

In this regulatory framework, banks might then be forced to simply deem unrealistic the perspective of a timely restructuring, and just refuse to engage in (prospective or actual) negotiations. This would pave the way for credit servicers as the main actors of restructuring, which is probably not a consequence to welcome, given that they are less equipped to serve (e.g., through interim or simply with the rollover of existing credit lines) exposures that, while problematic, might still undergo a positive evolution. The unintended result would be that less firms would be able to overcome a temporary situation of financial distress.

3.3. Handling coordination and hold-out problems in negotiating with banks

The intense regulation to which banks are subject and the specific requirements they have to fulfill in managing distressed debts substantially differentiate the position of banks from that of other categories of creditors. The financial creditors tend to share in most cases similar constraints and, at least in broad terms, similar interests.

In light of the above, legislators may consider to regulate restructuring procedures or measures specifically devised for financial creditors or, at least, permitting to restrict the group of affected creditors exclusively to financial creditors.[32] These restructuring agreements – commonly negotiated out of court and limited to financial creditors as to their effects[33] – should be aimed at overcoming a situation of liquidity distress and preventing insolvency, while protecting all the involved parties from claw-back actions for the case of a subsequent insolvency proceeding[34].

However, although financial creditors tend to have aligned interests, there may be circumstances where certain creditors oppose a restructuring pursuing the best interests of the creditors as a whole, either opportunistically (so-called "free riding") or on the basis of different economic interests and constraints.[35] This sort of misalignments is obviously more

[32] This is the case of the UK scheme of arrangement that, even though not specifically devised to deal with financial creditors (and, indeed, not even a restructuring procedure from a formal standpoint), may be used to push through a restructuring affecting only certain categories of creditors, including financial creditors.

[33] See the Italian "*accordo di ristrutturazione con intermediari finanziari*" and the Spanish "*Acuerdo de Refinanciación con Homologación*").

[34] As shown by empirical evidence in all involved jurisdictions, financial creditors are usually more inclined to agree on a restructuring than the other type of creditors.

[35] For instance, different lenders may have a different relationship with the debtor (some may have an interest in continuing doing business with the debtor in the future, others may have a short-term interest to

likely when there is a high number of banks involved in the restructuring process. The existence of different interests and constraints may, indeed, hinder financial creditors' coordination and may give rise to hold-out issues capable of compromising the restructuring process. For this reason, it is important to have legal mechanisms in place whereby an agreement can be reached with a defined majority of financial creditors and made binding over dissenting or non-participating lenders, subject to fair and reasonable terms and conditions.

In addition, in order to facilitate negotiations with banks (and, actually, also negotiation among banks) on a restructuring, banks should be encouraged to agree on codes of conduct or common procedural protocols (somehow inspired by the so-called London Approach). This would bind banks to a set of procedural rules to foster cooperation, such as:

- appointing a lead coordinator steering dialogue among banks in view of pre-defined objectives and abiding to scheduled deadlines;
- basing discussions on reliable information to be verified by an independent expert;
- holding a duty of fairness to the other banks involved (*e.g.* not consciously selling claims to a purchaser that would impede restructuring, and requiring the purchaser to continue participating in coordination committees established by the banks and take a cooperative approach with the banks' coordinator).

Policy Recommendation #5.3 (*Restructuring limited to financial creditors*). The law should provide for restructuring procedures or measures producing effects on, or allowing a limitation of their effects to, financial creditors, without affecting non-consenting non-financial creditors.

Guideline #5.10 (*Adoption of codes of conduct by banks*). Banks should converge towards the adoption of codes of conduct to foster coordination among lenders, independent verification of information and fairness during negotiations.

3.4. Dealing with credit servicers

Indeed, the EU institutions are basing the strategy to address the problem of NPLs on, among the other things, encouraging the development of efficient secondary markets for those loans.

In this vein, the proposed *Credit Servicers Directive* provides for a common set of rules regulating specialized credit purchasers that will be authorized to operate within the EU. Their plausible more active presence in the market for distressed debt is expected to change further the scenario in which restructuring negotiations can take place. On the one side, professional NPL funds/investors might have a more speculative and less cooperative approach *vis-à-vis*

recover their claim); they may also find themselves under a different level of pressure to resolve a problematic loan, due to certain features of their credit portfolio or their exposure to the specific corporate sector in which the debtor operates. In addition, if any of the financial creditors have credit protection – credit insurance or credit default swaps – their interest may conflict with the rest of the group, and they may have incentives to force the restructuring into a form that triggers their rights against hedge counterparties or even push the debtor into formal insolvency.

debtors during restructuring negotiations; on the other side, however, these specialized actors could be better positioned to support the debtor in a crisis situation, as compared to banks. They could act with more flexibility, as they are not subject to the regulatory constraints that limit the leeway of banks. In addition, by investing in "single name" corporate NPLs, with the goal of gaining control over the restructuring process, they may improve the likelihood of a successful turnaround. Private funds are also better equipped than commercial banks (due, *i.a.*, to less intrusive regulatory constraints on share ownership) to invest in shares allocated under debt-equity swaps as they are more likely to be committed to overhauling the companies concerned.

4. Dealing with other kinds of creditors

4.1. Diversification of creditors incentives and preferences

As mentioned above while discussing the duty to act in good faith (par. 2.3), creditors may have very different incentives and preferences. The traditional view that creditors, as a whole, are driven by the goal of maximising the present value of their claim is a simplification, indeed very useful but still not conveying the wide array of utility functions of creditors.

For example, it is apparent that banks are motivated by the goal of maximising their entire portfolio of distressed loans, rather than maximising recovery with respect to a specific case of business distress. As a result, banks may sometimes take positions that are ineffective from the perspective of a certain restructuring deal but are regarded by the bank as efficient with a view at maximising the present value of the distressed portfolio as a whole (e.g., sink a restructuring to convey to the players in the market a certain internal policy that is deemed suitable to allow a higher recovery from an aggregate standpoint). Further, workers may be inclined to accept solutions that are not providing them the best possible recovery, if they allow the continuation of the business. In this vein, the possible examples of legitimate creditors' interests diverging from the apparently inflexible purpose of maximising the present value of claims are countless.

As a result of such heterogeneity of the incentives and preferences of the creditors, the debtor should assume a different approach in conducting negotiations over the restructuring plan according to the different kinds of creditors.

4.2. Dealing with workers

In any crisis, effectively negotiating with workers is very important for the success of the restructuring attempt, due to their particular role and position.

On the one hand, workers are generally strongly in favour to the restructuring, since its success is often essential to allow them to retain their workplace. They could consider unfavourable to take a strong stance in the restructuring, threatening to dump a restructuring, even though opposing the plan would, in certain cases, allow for higher recovery (especially due to the circumstance that several jurisdictions, including Italy and Spain, grant to the

workers' claims priority on the business estate).[36] Workers would inevitably factor in their decisions the risk of losing their workplace and the likelihood of finding a suitable alternative workplace. Further, particularly in small and medium firms, workers may also have personal bonds to the entrepreneur that discourage them from turning down the restructuring proposal.

On the other hand, workers are virtually always "suppliers" of strategic inputs in view of the continuation of the business, making therefore their consent to the restructuring extremely important. In other words, the successful implementation of the restructuring strongly depends on retaining on-board key employees, who incidentally are those employees that are more likely to dissent on the restructuring plan since they probably have suitable alternatives to reaching a deal with the entrepreneur.

It should also be noted that negotiations with workers are usually regulated under the law more heavily than with respect to other categories of creditors. The most relevant feature is that such negotiations in many jurisdictions cannot normally take place on an individual basis, but rather should be conducted on a collective basis, involving, for example, trade unions.[37]

In order to effectively negotiate with workers, the debtor should focus on offering attractive incentives that could divert the most skilled employees from accepting alternative work offers. This is important to neutralise, or at least reduce, the risk for adverse selection, which would lead the firm to retain only less qualified/productive workers once the restructuring plan has been adopted, thereby significantly undermining its chance of survival. Such a risk is particularly strong with respect to businesses heavily relying on highly specialized competences, where intangible assets are represented by the workers' know-how and capabilities. This is the reason why, paradoxically, when the firm is in distress and restructuring negotiations are started, there comes the very moment when implementing an effective incentive scheme is crucial. With a view at retaining the best employees, it is also very important to conduct negotiations in a transparent and fair manner, so as to preserve the value of trust in the relationship between the debtor and its employees.

The restructuring plan may envisage, as noted in Chapter 3, the reduction of the workforce, which could be temporary or permanent. This is often a very important measure to achieve a turnaround of the business: deferring industrial corrective actions, such as not addressing redundancies, may result in a further round of negotiations, or even in the non-viability of the business. This may be a very delicate issue and the debtor, when informing the workers about the fact that the plan envisages such a measure, should very carefully reflect on the best communication strategy[38].

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[36] The priority granted to workers' claims is well-grounded on both social and economic arguments (such as the fact that workers are not free to diversify their investment).

[37] In Italy, trade unions are involved in negotiations whenever future claims would be affected by the restructuring. Instead, when the restructuring would only affect workers' individual claims that are already existing, trade unions are entitled to negotiate on behalf of the workers only when so designated by the interested workers.

In Germany trade unions play no *formal* role in restructuring negotiations with workers, whenever a works council (*Betriebsrat*) exists. The explanation lies on the circumstance that the works council in practice usually consists (also) of unionists, and they turn to the trade union for representation and advice.

[38] In the context of the interviews conducted in Germany, several experts have recommended to be as open as possible with employees and to share plans regarding redundancies as soon as possible.

The reduction of the workforce may take place either by incentivising voluntary resignation by certain employees (most commonly through offering a certain amount of money as a compensation or an alternative job)[39] or by unilaterally dismissing certain workers. In this latter case, most jurisdictions require the debtor to conduct a negotiation with the trade unions or other collective bodies representing workers' interests. When engaging in this sort of negotiations, the debtor should be adequately informed on the existing social safety nets, such as long or short-term public redundancy schemes, ordinary unemployment benefits and early retirement. The debtor's proposals should, indeed, be shaped in such a way to increase the chance of approval, in light of the possible effects of the existing social safety nets in place.

In light of all the above, it is worth considering that, in certain cases, workers, in their capacity as creditors of the firm, might be interested in filing for insolvency: when no perspective of retaining the workplace is available (either because of an envisaged reduction of the workforce, the apparent non-viability of the business), benefitting from safety nets is enough attracting (e.g., for workers close to retirement), the workers have no claims left unpaid (or such claims enjoy priority that would in any case lead to full satisfaction), and/or there is a strong conflict between the entrepreneur and the workers, pushing the firm to insolvency liquidation may be an option for the workers. Although this is not very common and may sound theoretical, the number of involuntary petitions filed by employees have significantly increased in Italy over the recent years. [40]

Guideline #5.11 ***(Dealing with workers during negotiations).*** **The debtor should devote particular attention to dealing with workers during restructuring negotiations, possibly providing incentive mechanisms and, in any case, dealing with them in a transparent way with a view at preserving or gaining their trust.**

4.3. Dealing with tax authorities

Dealing with tax authorities has become increasingly important in light of the huge amount of tax claims that many troubled firms have accrued. This phenomenon is particularly severe in those jurisdictions where tax authorities are quite slow in recognising and enforcing tax claims. Such a delay, indeed, sets an incentive for distressed firms to withhold payments to the tax authorities, thereby dealing with the cash-flow tension (at least in the short term, before the slow, but unavoidable, reactions of the tax authorities come).

Where tax claims enjoy a strong priority, such it is the case in Italy, the passive approach of tax authorities is well justified from their perspective. A delay in reacting to the debtor withholding tax duties does not affect recovery, since the distressed firm's estate is devoted primarily to the satisfaction of tax claims, whereas monitoring actions entails a cost

[39] It is quite common practice in Germany, mostly in the case of large insolvency cases, to incentivise voluntary resignation by certain employees offering another workplace at a different firm (often founded by the debtor itself, with or without public subsidies). This allows the transferred employees of the debtor and pay a reduced salary for a certain amount of time giving the employees an opportunity to qualify for, and look for, other jobs without being formally unemployed and while receiving a remuneration, although often reduced.

[40] The reasons underlying this trend are not easily detectable, although we might assume that it be partially generated by a greater number of firms that, in a context of diffuse economic crisis, are not suitable to be turned around and, thus, the restructuring attempt is seen, by the same workers, as frivolous.

(even though such cost would be quite neglectable for tax authorities, since tax authorities are anyway required to monitor all taxpayers to curb tax evasion). However, the undesired effect is building up a significant stock of unfulfilled tax claims that become relevant when the firm engage in restructuring negotiation.

Although there might be concerns on the efficiency of the policy choice of granting priority to tax claims, such choice, where it is made, is related to a diffuse and deeply-rooted understanding of public interests as prevailing over private interests, which goes well beyond the issue of business restructuring.

In any case, even though with a stronger or weaker position according to the existence or not of a priority for tax claims in the applicable legal framework, tax authorities should be involved in restructuring negotiations. With a view at not preventing efficient restructuring, the legislator should provide for the possibility for tax authorities to reduce or waive claims, if this would allow maximising the long-term interest of the tax authority (which is not limited to maximising the present value of existing claims, but includes also keeping in business a firm that would generate other revenues by continuing to operate)[41]. It might be the case to require that an independent party examines the situation and concurs with the assessment of the tax authority(/ies) willing to reduce or waive the claims.

In order to facilitate the negotiation of the restructuring plan and make it effective, it would be advisable to provide that the decision on the restructuring proposal be taken by few, ideally only one, entities that are competent for all tax claims.[42] Such rule would allow having only a single counterparty, facilitating the procedure. Even when the claim may indeed be waived, there should be safe harbours for tax authority employees agreeing on a write off or a rescheduling.

Policy Recommendation #5.4 ***(Effective negotiation with tax authorities).*** **The debtor should be able to negotiate the restructuring with the least possible number of tax authorities, possibly just one, which should be aimed to maximise the interest of tax authorities, as a whole, in the long term. The responsible employees of tax authorities should be able to take an objective decision on whether reducing or waiving certain tax claims would pursue the above-mentioned goal. To this purpose, responsible employees should be made exempt from any risks, possibly upon receiving confirmation of their assessment by an independent professional.**

[41] As mentioned, tax authorities should inspire their decisions in the context of restructuring negotiations to the purpose of maximising their interest in a long-term perspective (which is the one that tax authorities should adopt considering that there are, by definition, repeated players). It would not be appropriate for tax authorities to pursue a more general public interest (*e.g.,* preserving jobs, supporting the economy of less-developed areas), even when this would conflict with the economic interest of tax authorities. Indeed, tax authorities lack the democratic legitimacy and technical standing to adopt this sort of decisions (*i.e.*, how to employ public funds in the public interest), which would better be taken through more transparent decisions affecting everyone, instead of decisions taken case-by-case that could raise issues of unlawful discrimination.

[42] Identifying one or few decision makers for all tax authorities, although advisable, may not be feasible in certain jurisdictions because of impediments related to their constitutional order or to other national features. This would be the case, for instance, of Germany, which has a federal system that would not make possible to concentrate the power to decide on the restructuring in one or few decision makers.

5. The role of external actors: mediators and independent professionals

5.1. Facilitating the negotiation through external actors

The negotiation between the debtor and its creditors may be facilitated through involving external actors, such as independent professionals examining the plan and/or mediators assisting the parties in the negotiations.

These two types of figures play significantly different roles in the context of restructuring negotiations. As a result, their respective qualifications and, especially, their attitudes to negotiations should be different.

As will be more extensively discussed in Chapter 6, the professional entrusted with the task of examining the restructuring plan is demanded to provide an independent assessment on the best interest for creditors of what the debtor has proposed in the plan.

This assessment entails the following evaluations: *(i)* whether the plan is feasible in the terms described by the debtor and, thus, whether it would eventually lead to its expected results, and *(ii)* whether the plan allows for a better outcome than the one creditors could expect in the context of the most likely alternative scenario should the plan not be approved (this being either an ordinary or insolvency liquidation, or the continuation of the business without any deleveraging, but instead excluding the scenario of a merely hypothetical further restructuring plan).[43]

As a pre-requisite of the first evaluation, the independent professional is also required to ascertain that the plan is based on reliable and accurate data, thereby checking assets and liabilities of the business or, where so provided by the law, certifying the data under her or his own responsibility. In short, the role of the independent professional is to reduce the information asymmetry between the debtor and creditors and provide creditors with guidance on whether it is in their best interest to support, or rather to oppose, the restructuring plan. The role of the examiner is particularly important when a significant number of creditors lacks the required competences to assess the proposed plan and/or, due to the size of their claims, lacks adequate incentives to perform such an assessment. The empirical evidence gathered in the context of the present research clearly shows that independent professionals' opinions exercises a significant influence on creditors, who are noticeably more inclined to approve the proposed plan when a favourable opinion has been issued[44].

The mediator is entrusted with a very different task. Her or his tasks will be discussed in par. 5.2 below; however, it is worth noting that the mediator has a far deeper involvement in the negotiations than the examiner. The mediator's main undertaking is to facilitate the reaching of an agreement between the debtor and its creditors on the terms and content of the restructuring plan. To effectively carry out such an undertaking, the mediator must be granted full access to all information, included that information that the debtor and the creditors wish to keep confidential. In order to make it possible for the parties to reveal such information to the mediator, it is pivotal to grant her or him a strong and wide professional privilege, similar to the one that exists between the attorney and her or his client.

[43] With respect to the "best interest test", see Chapter 2.

[44] TO BE COMPLETED WITH DATA COMING FROM THE EMPIRICAL RESEARCH

In light of the above, the role of the independent professional and the role of the mediator should not be coupled into one single person, otherwise either the examiner would lack the required independence, or the mediator would be ineffective due to the foreseeable resistance of the parties, particularly the debtor, to openly share all relevant information.

The coupling of the two roles may be considered only in the case of micro and small enterprises, where the increase in cost of retaining two different professionals involved may well outbalance the resulting benefit.

5.2. The mediator

Negotiating a plan could be challenging because of the involvement of different stakeholders often having competing interests, thus making their coordination difficult. Further, the parties' emotional reaction to the firm's distress, especially for MSMEs where on average the parties are less sophisticated, makes them act selfishly, instead of cooperating, thereby causing delays and expensive litigation (this is a quite well-known collective action problem). The more time that is spent in building trust during the negotiation phase, the better the chances are that participants will reach an agreement on an effective and fair solution. To this regard, the appointment of an independent professional with skills and substantial expertise in facilitating interaction among multiple parties is strongly beneficial.

Thus, over the past years, certain jurisdictions have introduced rules that allow debtors to seek the appointment of a mediator both in pre-insolvency situations and after the commencement of insolvency proceedings. Mediation is well established in the United States, where a mediator is often involved to facilitate plan negotiations (*e.g.* in the practice of the Chapter 11 proceedings). American bankruptcy judges can even mandate mediation (and any party can ask the judge to make such an order) to resolve contested disputes and claim objections which can hamper insolvency proceedings.[45]

A different approach has been adopted by those European countries that have enacted rules on mediation in the context of business restructuring. In Europe, the intervention of a mediator is regarded as limited to the context of pre-insolvency procedures and purported to help the parties to reach an agreement on the terms of the restructuring;[46] further, the appointment of a mediator, or a conciliator, is deemed mainly useful in the context of out-of-court restructurings.[47] It should be noted that, however, also in-court restructurings would benefit from mediation: negotiations are common also in those procedures and the

[45] On the U.S. experience, *see*, L. A. Berkoff *et al*., *Bankruptcy Mediation*. American Bankruptcy Institute, Alexandria, VA, 2016.

[46] Insolvency mediation is spreading across the world as demonstrated in recent comparative studies, *see*, L.C. Piñeiro K.F. Gomez, TDM, *Special Issue*, "*Comparative and International Perspectives on Mediation in Insolvency Matters: An Overview*", Vol. 4, 2017; B. Wessels and S. Madaus, *Instrument of the European Law Institute - Rescue of Business in Insolvency Law*, pp. 127-131, 2017, available at: ssrn.com/abstract=3032309.

[47] The use of mediation to facilitate plan negotiation finds clear endorsement in the European Commission Recommendation, *see*, Recital 17 and Section II B (2014/135/EU) and in the draft Restructuring Directive, which introduces two new insolvency professionals in the context of insolvency and business restructurings: a mediator and a supervisor, *see*, Recital 18 and Article 5 of the Restructuring Directive Proposal (COM/2016/723 final). Mediation is also echoed in the World Bank Principle B4 (Informal Workout Procedures), that encourages the involvement of a mediator in the pre-insolvency, informal workout period. *See*, the World Bank *Principles for Effective Insolvency and Creditor Rights Systems*, 2016, available at: pubdocs.worldbank.org/en/919511468425523509/ICR-Principles-Insolvency-Creditor-Debtor-Regimes 2016.pdf.

appointment of mediator may be helpful to speed up the process by coordinating creditors in voting on the restructuring proposal.

Qualitative interviews conducted with professionals advising debtors and creditors show that the parties very seldomly choose to involve professionals with specific skills and expertise in facilitating restructuring negotiations. This is mostly due to a widespread unawareness amongst those involved in restructuring negotiations about what exactly a mediation procedure is and how it works and, above all, the beneficial effects determined by the presence of the mediator in this context. [48] As well, legal provisions mandating for the appointment of a mediator in the context of business restructuring are quite uncommon in Europe.[49] Only in isolated cases, as in the Spanish out-of-court payment agreement (*acuerdo extrajudicial de pagos*), the law explicitly designs a mediation process to restructure small business (MSMEs') and identifies the specific requirements to act as a *mediador concursal* (who is often an expert in turnaround, insolvency or related aspects) as well as the tasks that are entrusted to her or him.[50]

The appointment of the mediator should be made by the judge,[51] although taking into account suggestions coming from the debtor or other parties bearing an interest in the restructuring. The professional appointed as an insolvency mediator must have the ordinary professional qualifications required to act as a mediator,[52] possibly in addition to specific competences in insolvency law and related expertise. The mediator may be in fact required also to advise the parties concerning the choice of the measures to be included in the plan.[53] In

[48] The idea of having a mediator involved to facilitate negotiations between the debtor and the creditors still meets considerable limits in the culture of the entire business community. The prevention of insolvency is still perceived, to a large extent, as a matter for courts and judicial procedures. Besides, professional rarely advise the parties to appoint a mediator, who should be adequately informed on the opportunities associated with the appointment of a mediator.

[49] The 2014 Commission's Recommendation, Recital 32, only provides that: (*a*) the mediator functions consist in assisting the parties in reaching a compromise on a restructuring plan; (*b*) a mediator may be appointed *ex officio* or on request by the debtor or creditors where the parties cannot manage the negotiations by themselves. Most Members States have not yet enacted national rules purported to fulfill the 2014 Commission's Recommendation with respect to the appointment of a mediator.

[50] Insolvency mediation was established in Spain in 2013, by the Spanish Insolvency Act (*Ley 14/2013, de 27 de septiembre, de apoyo a los emprendedores y su internacionalización*) arts. 231 et seq. Later, the Spanish Royal Decree-Law 1/2015, enacted on February 27th, called the second opportunity Law, introduced some amendments both in the extra judicial procedure "Out of court payment agreement" (*Acuerdo Extrajudicial de Pagos*) regulation, as well as in the mediator role.

[51] The judicial appointment of the mediator should not be always mandatory, whereas being decided case-by-case according to the specific circumstances. *See*, article 9 of the 2014 European Commission Recommendation and article 2 of the Restructuring Directive Proposal.

[52] See the European Mediation Directive 2008/52/EC of the European Parliament and of the Council of 21 May 2008, which provides that the mediator must have specific training and to be insured to cover the civil liability derived from her or his activities. Member States are left free to decide on the professional requirements and other regulations applicable to mediators' training, although more requirements are likely to be introduced as a result of the revision of the same Directive that is currently underway.

[53] In order to facilitate the activity of the parties devising a plan, the mediator's role often goes beyond resolving disputes and facilitating communication among the parties. The mediator, indeed, should also engage in several technical activities such as: (*i*) checking the existence and amount of the credits; (*ii*) preparing a payment plan and, where appropriate, a business viability plan; and (*iii*) coordinating creditors' meetings to discuss and settle the agreement proposal. Those activities are typically addressed to the *mediador concursal* in Spain, *see*, C. S. Motilla, *The Insolvency Mediation in the Spanish Law*, in L. C. Piñeiro, K. F. Gómez, cit., 5. Also in Belgium, out-of-court restructurings often involve a *company mediator* to assist parties in the

other terms, the mediator should have specific mediation skills (e.g., listening and communication skills, ability to gain the trust of the parties to make them more confident in sharing private information), which should be preferably combined with those competences typical of insolvency lawyers and other advisors involved in the restructuring process. [54]

The appointment of a mediator may be advisable in light of the importance of a complete information package and of cooperation between the parties (see par. 2) coupled with the following considerations (*a*) mediation responds better to the specific private nature of negotiations; (*b*) when mediation occurs at an early stage, the mediator can aid the parties in identifying the causes of the distress and becoming more receptive to making concessions in the context of the negotiations (one of the most common techniques to achieve this latter result is raising questions about the circumstances that have complicated relationships between the creditors and their debtor); (*c*) the involvement of a mediator at an early stage of the business distress reduces cost by allowing for a more timely selection of the appropriate tool, thereby avoiding the destruction of value associated to delays; (*d*) the mediator facilitates adequate sharing of preliminary information between the parties before they begin to discuss the substance of the plan; (*e*) while managing negotiations the mediator often resorts to specific trust-building strategies to help parties to move closer to the mediator and together; (*f*) business relationships are preserved and they could even grow.[55]

The mediator encourages the parties to find their own solutions to the business distress by asking questions that could help identifying the issues that form barriers to negotiations and, possibly, making suggestions or asking whether the parties have considered certain possible solutions that would facilitate the advancement of the negotiations. To this purpose, the mediator would organize an initial conference that permits the parties to share their views on the issues that are to be negotiated. Later separate meetings (caucus) will be useful to establish a common ground for cooperation with respect to specific issues and to open the channel for the transmission of information necessary for effectively conduct the negotiations over the restructuring plan. While managing meetings, the mediator often resorts to specific brain-storming strategies and activities with the intent of increasing trust.

Among the others, the most important mediator's skill consists precisely in constructing a consistent set of information provided by the group of stakeholders involved in negotiations[56]. The parties indeed will often share their sensible data with the mediator, who becomes the vehicle of communication between the different groups and the "guardian" of information. Therefore, the entire mediation process should be covered by confidentiality so

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preparation of the restructuring plan, *see*, Art. 13, Law on the Continuity of Enterprises of the 31st. January 2009 (*Loi relative à la continuité des enterprises*).

[54] In those jurisdictions where mediation in insolvency does exist (e.g. Spain, Belgium, France) the mediator usually is a professional with specific knowledge and skills in facilitating negotiations combined with substantial expertise in restructurings.

[55] In order to realize the latter goal, the mediator's contribution should consist in: (1) letting the parties craft creative solutions that might, for instance, increase debtors' resilience to business crises; (2) encouraging the parties to communicate effectively

[56] This means that not all data transferred by the parties to the mediator will immediately and directly reported to the other parties. Confidentiality of those information indeed is protected by the mediator and they will only be used upon the consent of the interested party when (s)he realizes - thanks to the contribution of the mediator - that it is reasonable to trust in the other partners. Trust indeed is very linked with the possibility to build a complete set of data, which represents the basis for a plan that maxims the satisfaction of all the parties involved.

as to keep the process private and preserve a sense of trust and substantive fairness between all the parties involved (*e.g*. confidentiality is one of the significant features of the French *Mandat ad hoc* and *Conciliation Procedures*),[57] whereas the Spanish *mediador concursal* does not enjoy such a strong confidentiality duty.[58]

The issue of confidentiality is indeed crucial. Drafting a correct plan requires reliable and updated information. An issue that was commonly raised by professional assisting debtors and creditors is the difficulty in quickly creating a comprehensive set of information: debtors and creditors, especially at the first stage of negotiations, refrain from sharing private information that are required to find an agreement on a restructuring plan, since they are concerned with the risk that any statements or concessions made during the negotiation process can then be used to their detriment. In this regard, the involvement of a mediator may be most beneficial: the mediator could facilitate the adequate sharing of information between the group of stakeholders, organising separate meetings with each party (*i.e.* debtor, creditors, or other third parties) and acquiring information with the reassurance of full confidentiality. The mediator should then obtain express authorization by the interested party to disclose the information deemed necessary with a view at rapidly getting to a restructuring agreement (it is important to note that such information, being necessary to reach an agreement, most certainly would have been eventually circulated by the relevant party). Besides the information arisen out of or in connection with the mediation process, also the mere circumstance of the occurrence of a mediation process should be treated, in certain cases, as privileged.

Policy Recommendation #5.5 (*Appointment of an insolvency mediator. Duty of confidentiality*). Whenever the law mandates or allows the appointment of a mediator, the latter should hold those qualifications and skills specifically required to act as a mediator, in addition to being competent in restructuring and insolvency matters.

In order to facilitate the creation of an adequate set of information at an early stage, thereby avoiding delays, the parties should be able to share with the mediator all the information relying on a strict duty of confidentiality. If the mediator deems that certain information would better be shared among the parties in order to advance negotiations, (s)he should require the party revealing the relevant information to waive the confidentiality. If no waiver is expressly granted, the mediator must not disclose the information under any circumstances.

[57] *See*, Art. D611-5 of the French *Code de commerce*.

[58] A limitation to the mediator's duty of confidentiality was adopted in the revised version of the Spanish extrajudicial settlement of payments, providing that the confidentiality duty is overcome in case mediation fails and the mediator take the role of insolvency practitioner in the "consecutive insolvency proceedings" (Art. 242.2-2ª of the Spanish Insolvency Act). This limited confidentiality of the insolvency mediator is perceived as problematic, *See*, C. S. Motilla, *cit*., 5.

6. Consent

6.1. Passivity in negotiations

The creditors' decision not to participate to the restructuring negotiations may be commonly ascribed to one of the following situations:

(i) the inactive creditor has examined all the circumstances of the case and assessed that staying inactive is a value-maximizing strategy (*e.g.*, when the creditor may rely on the fact that a restructuring plan not envisaging a cram down would expectably be adopted notwithstanding the lack of that creditor's consent);

(ii) due to the size of the claim and the absence of any other interest (*e.g.,* for employees, keeping their workplaces; for suppliers relying on the business relationship with the distressed company, keeping this latter in business), the inactive creditor may find it costlier to actively participate in the negotiations – thereby investing resources and time – than accepting the outcome of the negotiations whatever this may be.

The behaviour described first is motivated by opportunistic, yet informed, considerations by the creditor and is considered a case of so-called "free riding". This strategy is unavailable when the restructuring is carried out through tools that bind dissenting or non-participating creditors (in other words, whenever some form of cram down is available). Therefore, when the debtor could opt for a procedure or measure envisaging a cram down, the debtor has a tool that it may use, or simply threaten to use, to pose a limit on creditors' "free riding". In light of the nature of the phenomenon that has just been described, the passivity in negotiations ascribable to opportunistic considerations can effectively be dealt with by providing under the law procedures and measures envisaging cram-down mechanisms (see Chapter 2).

The behaviour described second is commonly labelled "rational apathy". It may occur in the context both of consensual and of compulsory restructurings, when certain creditors do not have an incentive to engage in negotiations. Indeed, from the perspective of an individual creditor having a small stake in the distressed company's turnaround, there are no, or few, incentives to actively take part to the negotiations or to cast its vote on the plan. The cost of seeking professional advice and/or investing time in understanding and assessing the situation may well outbalance the cost of bearing the risk, and possibly suffering the cost, of a disadvantageous solution to the business distress (*e.g.,* an insolvency liquidation of the company when a turnaround was possible; a restructuring allocating relatively more value to other creditors).

In the paragraphs below, we are focusing on this second type of creditors' passivity.

6.2 Consequences of creditors rational apathy in negotiations

Although inactivity appears a rational behaviour for an individual creditor having a small stake in the distressed company, this behaviour severely affects the efficiency of the business restructuring process. The negative effects of creditors' passivity in negotiations are different according to the compulsory or voluntary nature of the restructuring tool at issue (i.e., providing or not any form of intra- and/or cross-class cram down).

In case of a compulsory restructuring tool, if the creditors' inactivity is deemed under the law as a consent or a dissent, creditors' passivity may respectively open the door to inefficient plans, which would be deemed approved notwithstanding only a minority of

creditors actually cast a vote and making it virtually impossible for dissenting creditors to prevail, or, to the contrary, prevent efficient business turnarounds, although in the best "collective" interest of creditors.[59] The third option to the strict alternative between deemed consent and deemed dissent is to count towards the majority required to adopt the plan only those creditors that have actually casted a vote. This would sterilize the influence of passive creditors, making their inactivity irrelevant (see par. 6.4, below).

In the case of fully consensual restructurings, the effects of creditors passivity are twofold:

(i) since the non-participating creditors are not bound by the terms of the restructuring, their inactivity has the effect of putting the burden of the business restructuring on a smaller group of stakeholders that, thus, are required to bear a greater sacrifice. As a result, there is less space to strike a deal between the debtor and the creditors participating in the process, thereby making it sometimes more convenient for active creditors to go through an insolvency liquidation (although inefficient from a collective perspective), rather than supporting a restructuring. When such a deal is, indeed, entered into by a limited number of creditors bearing the entire cost of the reorganisation, it is statistically more likely that the restructuring plan, although assessed as feasible by the Court, may eventually not be successfully implemented:[60] a possible explanation is that, due to the reduced bargaining space, the security buffers provided by in the plan may often be significantly shrunk;

(ii) there may be significant and unpredictable deviations from the *pari passu* principle (e.g., claimants having the same ranking may enjoy very different recovery rates due to the possibility or not of relying on the fact that other creditors will consent to the restructuring agreement and bear the cost thereof). This would make it difficult for lenders to quantify *ex ante* their loss given default (so-called "LGD") of the debtor. It is anecdotally well known that uncertainty is a cost for investors and, in this specific respect, such an uncertainty expectably increases the interest rate required by lenders to the detriment of the entire economy.

6.3. Measures to tackle passivity in negotiations

Tackling rational apathy requires that the information to creditors be provided in the clearest possible way and made easily accessible for creditors substantially at no cost (see also paragraph 2 above).

In this vein, the information package that is made available to creditors should be complete and accessible also digitally, without providing any burdensome procedures that

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[59] The results of our empirical research highlight that the deemed consent rule in force in Italy until July 2015 for the in-court restructuring agreement ("*concordato preventivo*") allowed for a certain number of abuses perpetrated to the detriment of creditors. On the other hand, after the deemed consent mechanism was repealed and replaced with a deemed dissent rule (and other limiting measures were adopted), the Italian system has faced a sharp decline in the number of in-court restructuring agreements ("*concordato preventivo*"), which is reasonable to assume that resulted in the winding up of a certain number of viable companies that, just a few years before, would have been saved. The repealing of the deemed consent rule has also translated into a lower rate of creditor consents to out-of-court restructuring agreements ("*accordo di ristrutturazione dei debiti*"), evidencing the nexus between creditors' opportunistic behavior and the threat of the recourse to compulsory restructuring tools. **[TBC]**

[60] This has been clearly evidenced by the results of the empirical research conducted in Italy on out-of-court restructuring agreements ("*accordi di ristrutturazione dei debiti*"), which are fully consensual restructuring tools. Indeed, the greater the share of indebtedness held by the creditors consenting to the agreement, the more the possibility (___%) of the restructuring plan to be confirmed by the Court.

may discourage creditors, if not required with a view at protecting relevant interests (such as, for instance, the confidentiality on certain data regarding the debtor's business).

Also, an incentive to small creditors to take a stance in the process may come from the provision of an examination phase of the restructuring plan (see Chapter 6, where the possible features of such procedural phase and the relevant costs and benefits are analysed). The independent examiner, when there is any, should express, clearly and concisely, her or his opinion on the convenience of the restructuring plan for the company's creditors, avoiding precautionary formulas purported to soften her or his position that may raise uncertainties among creditors.[61]

Guideline #5.12. (*Opinion on the restructuring plan by the independent professional appointed as the examiner*). In order to reduce the cost for creditors of actively participating in the restructuring negotiations, the independent professional appointed as the examiner, if any, is required to concisely and clearly express her or his opinion on whether the restructuring plan is in the creditors' best interest. The opinion should be made promptly and easily available to all creditors. Any disclaimer or other expressions having the effect of making the opinion of the examiner on the restructuring plan equivocal should be avoided.

Besides reducing the cost born by creditors for getting informed, tackling passivity in negotiations requires also to facilitate the process for creditors to express their consent or dissent on the proposed restructuring plan. The procedures that creditors are required to fulfil to cast their vote on a plan, or consent to a restructuring agreement, should be streamlined as much as possible. Proxy voting and virtual meeting should be always allowed (see Chapter 2).

The law may also envisage active measures to contrast creditors' passivity in restructuring negotiations, in form of penalties or rewards for creditors based on their timely and active participation to negotiations.

Such type of measures, especially when they operate through a penalty imposed on inactive creditors (*e.g.*, making their priority ineffective), are applicable only to sophisticated creditors, particularly banks and other financial creditors. It would be unfair to penalise inactive creditors that do not engage in negotiations due to the absolute lack of the required tools, as may be the case for small suppliers.[62] Therefore, these sort of measures most often tackle opportunistic passivity (see above), rather than rational apathy.

[61] The empirical research showed very different attitudes of the examiners across jurisdictions. In Spain, professionals appointed as examiners most commonly express a negative opinion on the restructuring plan, sharing concerns on the fact that the plan be compliant with the creditors' best interest. The prominent professionals interviewed ascribed this to the threat for the professional of incurring civil liability, should eventually the plan be not fully implemented. [TBC TEAM SPAIN] To the contrary, in Italy, court-appointed examiners most commonly (86% of cases) express a positive opinion on in-court restructuring agreements ("*concordati preventivi*"). It is worth to note that only 4% of those plans that have been positively evaluated by the examiner are then rejected by creditors, thereby providing evidence of the influence of the examiner's opinion on creditors' vote. The abovementioned data draw attention to the importance of setting adequate incentives for examiners, so as to ensure that their evaluation be as much as possible objective, see Chapter 6.

[62] Although outside of the scope of the present research, it may be worth to mention the mechanism provided in the Kazakhstan insolvency framework. When the debtor informs the banks and other financial lenders about its distress, these latter have ___ days to accept the debtor's invitation to start discussions on a

6.4 Measures specific to restructuring tools that aim (or allow) to bind dissenting creditors

As mentioned, with respect to creditors not casting a vote on the restructuring proposal, there are in theory three possible rules:

(i) a "deemed consent" rule, which favours the adoption of the restructuring plan at the risk of allowing some restructurings that are not efficient and, in case of a high passivity rate, making it virtually impossible for dissenting creditors to have the proposal turned down;

(ii) a "deemed dissent" rule, which instead could result in the rejection of efficient plans due not to the dissent of the creditors, but merely to their rational apathy that, under the law, is considered tantamount to a negative vote;

(iii) a rule imposing to count only those votes that are actually cast.

In general terms, this latter rule seems the most effective one. It does not excessively favour an outcome to the detriment of the other and responds to a common idea of democracy, which requires that the opinion of those that decide to express it prevails. From a more reasoned standpoint, the third rule listed above would allow the outcome (adoption or rejection) to prevail that is deemed best by those creditors that, in light of the specific circumstances, have decided not to stay passive. Although this may be only a subset of the creditors of the distressed firm, it is reasonable to assume – in a context where no deemed dissent or consent rule exists – that the determination taken by the majority of the creditors actually participating in the voting be a good proxy of the determination that would have been taken by all creditors.

As a second best, it is worth to note that a deemed consent rule is preferable to a deemed dissent rule: among the two types of negative consequences resulting from the application of these rules, the threat of having some inefficient restructuring plans approved by creditors is less severe than the risk of preventing firms from pursuing efficient restructuring. Indeed, while the first consequence may well be handled otherwise, particularly through the role of court confirmation,[63] the second consequence is final and results in the destruction of value for good.

In certain cases, such as for micro and small enterprises, the deemed consent rule may even be superior to a rule imposing to count only those votes that are actually casted. In that case, basically all creditors have claims of small value and it is reasonable to expect that very few creditors would have an incentive to actively participate in the restructuring negotiations. As a result, the outcome of the restructuring proposal may often be determined by a very limited number of creditors, whose active participation could be grounded on interests other than those they legitimately hold as creditors of that firm. See Chapter 8.

When the legislator opts for a deemed consent rule, the following provisions could mitigate the effects of its application:

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possible restructuring plan. Should a bank or a financial lender remain inactive notwithstanding the debtor's communication, the priority assisting their claims, if any, becomes ineffective in the possible subsequent insolvency. **[TBC BY SPAIN, WHO MENTIONED THIS PROVISIONS]**

[63] Indeed, the court is already entrusted in several jurisdictions with the task of assessing the plan feasibility and, under certain conditions, also whether it is in the creditors' interest (see Chapter 6). In sum, an implicit consent rule would solely result in a larger number of cases subject to the court evaluation.

(i) strengthening the judicial or administrative scrutiny with respect to those cases where the restructuring plan would not be deemed approved, but for the application of the deemed consent rule;

(ii) allowing proxy voting and reducing the cost of soliciting proxies; in this respect, the rules and customary practices in place for shareholders' proxy voting could be taken as a significant model;[64]

(iii) clearly informing creditors, in a direct and concise way, that lack of a vote on the proposal would be tantamount to consenting to it.

Policy Recommendation #5.6. (*Exclusion of non-participating creditors from the calculation of the required majorities*). The majorities required for the adoption of a restructuring plan should be determined without taking into account those creditors that, although duly informed, have not voted on the restructuring proposal.

Policy Recommendation #5.7. (*Provisions mitigating the adverse effects of a deemed consent rule*). When abstentions of creditors are deemed consent, the law should provide for a more thorough judicial or administrative scrutiny of restructuring plans that would not have been adopted, but for the application of the deemed consent rule.

[64] In theory, creditors bringing a challenge against the restructuring plan that proves ultimately successful could be given a priority claim towards the distressed business for the reasonable and proper expenditures incurred in order to solicit proxies, subject to the scrutiny of the Court when duly challenged. In practice, this may prove difficult to introduce in many Member States.

Chapter 6
Examining and Confirming Plans

1. Introduction

This Chapter provides a detailed analysis of two steps that are often found in the path that leads to the implementation of a plan: *examination* and *confirmation*. It also includes considerations concerning the vote and the decision making process, but the main substantive matters in this part (e.g., class formation or cram down) are to be found elsewhere in the report (see Chapters 2 and 3).

Typically, a debtor-drafted plan (on the face of it, the most common case) will be initially designed with no or only informal interaction between the debtor and its target creditors; and this incipient consultation is perhaps rarer when one or more creditors take openly the initiative of drafting the plan. This first draft is often followed by a set of contacts between the debtor and the relevant creditors, when everyone will be required to provide an input. A negotiation, of different intensity and at disparate timing depending on the case, shall follow, and amendments to the plan will normally be incorporated. Sometime between the informal drafting and the completion of the initiatory negotiation, the plan is frequently examined by third parties. This examination may happen later in the process, or repeat itself several times during the path leading to the final approval.

In a normal case scenario, once the plan has been finalised, examinations completed and doubts clarified, a vote takes place. When the legally required majorities are met, some jurisdictions include the need for a final confirmation of the plan by a judge (or, more generally, by the competent Court –which sometimes includes more than one judge). As will be examined later in this chapter, this confirmation finds its main justification in the need to protect relevant stakeholders (e.g., minority creditors or, in some cases, shareholders and other stakeholders) from abusive plans. The judicial analysis leading to confirmation (or to the rejection of the plan) tends to protect bound dissenting and non-participating creditors, but, in some instances, also creditors not bound by the plan. This will particularly be the case when the plan, as is the case generally, includes not only a financial restructuring, but also structural changes to the operating business.

Examination and *confirmation* are thus complementary and pursue similar aims. As we will see, neither of the two are strictly necessary, but at least one of them is present in every formally regulated system aimed at tackling the financial distress of businesses that we know of. Examination operates *ex ante*, and seeks to provide the parties with independent information on the plan[1]. Confirmation takes place *ex post,* once the plan has been passed, and seeks to ensure compliance with formal legal requirements as well as to exert some degree of control over the content of the plan with a view to protect certain stakeholders. The complementarity stems from the fact that examination (i.e., enhanced information) facilitates the analysis leading to confirmation. But there is a degree of potential trade-off between both institutions. This is clear, for example, when the examination is conducted by independently appointed experts and the analysis includes compliance with predefined legal requirements (e.g., the necessary majorities having been met out of court). The stronger and more wide-

[1] Examination may also operate *after* the plan has been agreed and voted favourably, but *before* confirmation, whenever the Court seeks additional expert advice on the whole or part of the content of the plan.

encompassing the examination, the less necessary it becomes to have a mandatory *ex post* judicial confirmation; and, conversely, confirmation turns almost necessary when *ex ante* controls are weak. In any case, and independently of the model chosen, it cannot be said that examination and confirmation may be mutually exclusive. The jurisdictional nature of confirmation (the "*potestas*" function and the legal effects of the decision) as well as the type of analysis conducted by the court/administrative agency make both institutions inevitably different from a qualitative point of view and hence both may be necessary.

Policy Recommendation #6.1 (*Examination and confirmation of the plan*). Examination and confirmation of the plan are essentially complementary and it is good practice to include both in the same out of court regulated procedure. Under particular circumstances, one of the two may be formally excluded. Never both.

In the following sections we shall address examination and confirmation separately, considering the different models existing in the jurisdictions analysed in this report and others existing – or susceptible to exist.

2. Examination

By *examination*, we mean the analysis and opinion about all –or, at least, the main– elements of a plan drafted by one or more experts [2]. The analysis normally results in a report or memorandum provided to the parties in written form. These reports may focus on separate parts of the plan (eg, analysing the legal part, the valuation of assets and/or guarantees, future cash flows, etc.) or cover its entirety. The examination ought to provide an assessment on all the parts of the plan that may be relevant for its effective implementation. While the report may have a descriptive part, it should be mainly analytical and expressly state the expert's opinion on the validity of the assertions contained in the plan. Since the report is often the key informational tool of the out-of-court procedure, it ought to concentrate on those parts of the plan which are –on its face– more difficult to be self-gauged by creditors: the causes of the financial distress, the commercial reasonableness of the business restructuring measures proposed, and the link between the latter, the predicted cash flows and the effort required from creditors (ie, the rescheduling time and –if applicable– the amount of debt write-down included in the plan proposed). While an independent assessment of legal compliance may be useful, it would not seem so relevant in those cases where an ex post judicial confirmation is mandatory. [3] In all other cases, its relevance stands alongside the financial component of the plan.

For taxonomic purposes, we can consider two types of examinations: those which take place voluntarily in the context of the negotiation process between the parties, and which

[2] The examination of the plan is not to be confused with the mandatory intervention of other professionals which may be envisaged in the law. Some jurisdictions, for example, make it necessary for a notary public to give faith and certify the plan; in other systems, the Registrar of companies, certain professional bodies/agencies or chambers of commerce are involved. The involvement of these additional institutions all too often respond merely to the lobbying of the said professional bodies with the law maker, and add unnecessary complexity and costs to the out-of-court procedure. This is a problem especially relevant in the restructuring of small and medium enterprises.

[3] See Chapters 3 and 4.

most often corresponds with non-regulated out of court restructurings (albeit not only), and those examinations required by the law. We will briefly consider them separately.

2.1. Voluntary examination

In the late stages of the negotiation process or –more frequently– when a first full version of the plan has been completed, the debtor or one or more creditors may task professionals with the analysis of the plan, in a context where such assessment is either not required by the law or the parties are conducting a purely contractual out-of-court restructuring that does not already require a mandatory examination. There may be more than one examination; the different reports are then used as a negotiation instrument by the parties to fine-tune the plan. The examinations may take place purely *ex parte*, in which case their credibility and usefulness are limited. In these cases –more common in the larger restructuring operations– there is a risk of a waste of time and resources. It is not uncommon that, at some point, the debtor is made to pay for such examinations, even when the experts have been retained by one or more creditors, worsening the debtor's financial position as a consequence. It is more efficient when the parties agree *ex ante* to have the plan analysed by an independent expert, retaining a professional agreeable to the different sides of the negotiation.

In the context of purely contractual out-of-court agreements, with no express legal protection and institutional control, the parties may seek an examination for purposes other than the transparency in the negotiation. Company directors may seek to justify their proposal *vis-à-vis* their shareholders or other companies of the group; and, more frequently, directors, managers (or majority shareholders) and/or creditors may seek to reduce the risk of liability towards third parties (ie, non-participating creditors). This is especially the case when the plan envisages a business restructuring alongside a debt or financial restructuring. The examination may also be requested with a view to reduce the probability of an ex-post avoidance action in case the unsuccessful restructuring has led to formal insolvency proceedings. Although it will depend on the case and the jurisdiction, the addition of a voluntary expert opinion may make the case for negligence of the parties more difficult to prove, but it seems highly unlikely for it to be considered enough to rule it out. Although, per se, there is obviously nothing wrong in the practice of requesting plan examinations for purposes other than the increase in the transparency of negotiations, it does create additional costs to an already financially distressed debtor hence damaging the interests of non-participating stakeholders. An eye ought to be kept for abusive behaviour in this regard [4].

2.2. Mandatory examinations

As stated in the introduction to this chapter, jurisdictions that regulate out-of-court proceedings and confer upon their successful completion a number of legal effects that go beyond the mere effect between the parties often envisage the mandatory inclusion of an independent examination of the plan. To be sure, there are sound reasons for this imperative requirement, since examinations:

i) reduce the transaction costs by adding transparency to the negotiation;

[4] The issue of cost is essential in out of court proceedings, as it is within formal proceedings. Any legislative decision to include additional informational tools must be adopted considering this limit. The problems of cost have arisen in the surveys of all jurisdictions.

ii) facilitate the decision-making process and help creditors –whom, with the exception of professional lenders and others of similar kind– may not have the ability to properly gauge the validity of the plan;

iii) protect dissenting and non-participating creditors bound by the plan, by ensuring compliance with legal requirements, influencing the ex-ante behaviour of the drafting parties and by providing the said stakeholders with relevant information in case they decide to oppose the plan or take any other course of action to defend their interests [5];

iv) ease the work of the court at the time of the confirmation of the plan, by providing the court with an expert opinion on the material content of the plan.

Despite its many positive externalities, examinations can be costly; and, usually, the more reliable the expert, the more expensive the fees. While this might not be a significant problem in the large restructuring operations, it is to be taken into serious consideration in the process leading to an out-of-court workout of small and medium enterprises. In the light of this, mandatory examinations could be deemed only "potentially" mandatory: the analysis of the plan would be contingent upon the request of a creditor, or, more generally, of an affected interested party [6]. Thus, there can be two kinds of mandatory examinations: potential or obligatory. In the former, the examination may take place or not, depending on the parties, who are legally empowered to request it; in the latter, the efficacy of the plan would always depend on the issuance of the examination report. Which of the two solutions is more correct shall depend on a number of factors. No doubt, the potential examination solution adds flexibility, may limit the costs of the procedure without undermining the rights of the parties, and seems like the preferred solution for the smaller debtors. Conversely, it may also delay the proceedings when the request for the examination takes place at a late stage or when there are several requests and the system does not allow for a streamlined coordination. A purely mandatory system benefits from legal certainty, which is the most common victim of flexibility. In any case, a preference for one or the other model (or a combination of both) would depend on how the examination is regulated. We shall briefly consider some of the most relevant parts of its regulation.

- The *appointment* of the expert that conducts the examination is one of the elements that needs to be carefully considered. Who makes the formal appointment is not as relevant as who actually selects the appointee. The formal appointor may be the Court (not necessarily the judge, but, given the merely procedural nature of the act, it can be issued by order/decision of court officials), an independent third party (for example,

[5] The fact that examinations add transparency and aid creditors in gauging the validity of the plan does not mean that, in every jurisdiction, the professionals drafting the reports owe duties to every participant in the process. Naturally, things will be different depending on whether the report is mandatory or voluntary, and also other circumstances such as who has made the appointment and who pays the fee. In any case, in some jurisdictions there would usually not be privity of contract between the expert and anyone other the party commissioning the expert. Further, exclusions of contractual and tortious liability are common in such reports. Therefore, the extent to which third-party creditors may place reliance on the expert's examination report may be questionable. It is beyond the scope of this work, given that this depends also on the structure of the civil liability system of each Member State, ascertaining whether the examiner is liable directly to third parties with regard to the information contained in the examination report, or to suggest the introduction of such kind of liability. The same applies with regard to possible criminal or administrative liability.

[6] This is the case of the Spanish system. According to art. 71 bis of the Spanish Insolvency act, the debtor or any creditor may request the appointment of an independent expert that shall issue an opinion about "the reasonable and feasible nature of the viability plan, about the proportionality of the collateral/guarantees provided (…)", etc.

the Registrar of Companies, or a notary public), or the debtor or its creditors legally empowered to do so. The first two options (Court/independent third party) underpin the independence of the experts, or, at least, its objective external appearance of independence (a benefit that cannot be understated). This type of appointment is usually coupled by a random selection process, according to which the appointor follows the order of a pre-defined list of experts or simply follows a random raffle procedure. Naturally, the negative part of this type of appointment is its rigidity and the inability to select the most appropriate expert for a given case. Unless the list of experts only includes highly –and similarly– skilled professionals or entities, there is a chance that the appointee may not have enough knowledge for a big case or experience/specialisation to analyse the business plan of a business operating in a complex sector of the market. Because these risks are minimal in the case of financial distress of small businesses, this system might seem more suited for these cases. The alternative is the selection by the parties [7]. The advantages of this solution are the disadvantages of the former model, and vice-versa. A proposal by the debtor may undermine the appearance of objectivity and independence of the appointee, especially in those cases where creditors have not had a say. This could generate a lack of trust and render the examination useless for creditors. The proposal by creditors may also have problems of objectivity between differently ranked classes of creditors or between creditors whose interest might not be aligned (for example, because of the different type of security rights held) and, at such early stage, may pose logistic problems (which creditors may propose? Should all –relevant- creditors be allowed to weigh in? How is the decision to be adopted?); however, the appointment by creditors has proven successful in international experience, especially for large cases and developed jurisdictions, and is more in line with the general appointment of professionals in a market economy. The selection by the parties may trigger the appointment of several experts and the issuance of several reports. If this is the case, the law ought to include a rule to ensure that the debtor´s estate is not unduly burdened (for example, by allocating the costs amongst the interested parties, setting a cap that should be the expert fees of only one examination [8]).

- Legal systems usually include a list of grounds to exclude the appointment of professionals that may have a conflict of interest. The conflict is often deemed existing when the professional has acted professionally for the debtor or for its main shareholders within a reasonable period of time before the assessment. The conflict may also exist when such relationship has existed with the main creditors, although the mere existence of a previous professional link should not suffice to exclude the appointment [9]. A much more close and permanent connection ought to be established and a case-by-case analysis considering all circumstances should be required. It must be remembered that the examination concerns the situation and prospects of rescue of the debtor, not of creditors. While we understand that a rigid rule to avoid conflict is

[7] As stated in the text, the selection by the parties may be also followed by their formal appointment when they are so empowered by the law, or it me consist of their ability to formally propose an expert for appointment by the Court (or, less frequently, by an independent third party).

[8] This would be the rule applicable to the general examination of the plan. In case it is necessary to conduct the appraisal of special assets, additional reports might be necessary.

[9] In some countries, there exist "bright-line rules" and a general standard of independence. In Italy, for example, previous relationships with the debtor or the creditors exclude independence (Art. 67(3)(d), Bankruptcy Act).

very much a part of procedural systems in continental Europe, consideration should be given to the adoption of a different approach: one that places the weight on transparency, rather than on outright prohibition. Appointed professionals would have a strong rule of disclosure concerning any activity or circumstance that may impair the objective professional judgment. It would from then on be up to the parties to avoid selecting those that would have no credibility: why select an expert whose examination is going to be ignored by the relevant stakeholders? This approach could reduce costs and would increase the information available. The solution, though, may be less convincing in the smaller cases, where the passivity of many stakeholders reduce the possibility of control on the appointee.

- A different, prospective conflict may also exist in those systems where the examination takes place by a mediator or any other type of professional that is competent to execute more tasks than just the valuation of the plan within the out-of-court procedure. An example would be Spain's "*mediador*" in the procedure designed for MSMEs or, in Italy, the judicial commissioner who can become the bankruptcy trustee. Although there are indeed benefits to appointing the same person for the out-of-court procedure and, should the attempt fail, for the formal insolvency case as insolvency representative, the professional may be tempted to act in a way that increases her chances of extending her work. This problem may be tackled merely by creating adequate incentives in the out-of-court stage (eg, increased fee in case a plan is approved and successfully implemented, etc.).
- The system should include a clear rule concerning who *bears the cost* of the examination. Experience shows that, in most occasions, the costs are borne by the debtor. This is evidently the case when the examination happens at the initiative of the debtor. It must be considered, however, that not infrequently the initiative of the debtor masks a previous agreement with the main creditors, that dictate the expert to be selected (when possible). In truth, there is little alternative to the treatment of the examination as a cost inherent to the procedure and, therefore, its payment out of the assets of the financially distressed business. Absent abusive practices, this seems like the correct solution: if the debtor is already insolvent, the assumption of the cost by the debtor will be more apparent than real, since it will ultimately be paid out of the moneys available for the repayment of creditors [10]; and, if the debtor is merely undergoing cash flow hardships, there is no reason to impose the costs on third parties. The rule ought to be different when more than one examination is requested. Any additional reports should be paid by the ones who request it. As to the amount of the fees, they should be determined by the professional market. There is no reason to create a system of pre-determined fees, as is the case in some countries (for example, in Italy, Germany and Spain) for insolvency representatives. This lack of pre-definition of the criteria to establish the fees should be coupled with the possibility of the relevant parties to oppose when the fees have been abusive (see also Chapter 4, par. __, on advisor's fees)[11].

[10] Indeed, in the case of an already insolvent debtor, the costs may therefore be borne by creditors (each penny paid to the expert is *ceteris paribus* a penny less for creditors as a group). This, together with the fact that the plan would allocate the value in the estate, creates the risk that the costs would be borne by minority claimants.

[11] There may be a problem if the debtor and appointed professional cannot agree on the fee. The debtor surely cannot block the appointment this way, whereas the professional should not be allowed to request

Policy Recommendation #6.2 (*Examination of the plan*). Although a professional examination of the plan is not always necessary, it is advisable in most cases. Only when the debtor is a micro-entity with a basic business model, the examination may be excluded *ab initio*.
The examination report may be mandatory for all cases or be only potentially mandatory, when the debtor or creditors request it. Although both systems are acceptable, the latter adds flexibility and may limit the costs of the procedure.

Although more than one examination may be a possibility, it should not be the rule, and, more importantly, a rule should be included to allocate the cost of additional reports on those who request it.

The examiner should be a capable professional, adapted to the specificities of the case and independent from the parties. Pre-existing professional relationships with creditors is not to be deemed an automatic cause for exclusion of the expert, as long as these relationships do not prevent the examiner to exert an independent judgment. A case by case analysis must be conducted.

The examination report should be comprehensive and pay particular regard to the financial assessment concerning the viability of the business and the chances of successful implementation of the proposal.

Examination plans must be subject to control ex post.

3. Participation and plan approval

This section will briefly address the main issues encountered in our research concerning the participation of creditors in the process leading to a restructuring plan: the determination of participants, the main aspects of negotiations and some salient elements of the vote will be covered. It must be noted that several topics that would fall within the scope of this chapter are treated elsewhere [12].

3.1. Participants in the restructuring procedure

In formal, in-court insolvency proceedings, all creditors are called to participate in the procedure. No one with a claim –real or contingent– against the debtor may be left out. The situation may well be different in out-of-court proceedings. No doubt, purely voluntary, informal out-of-court agreements do not have any mandatory rule in this regard: the debtor will freely decide who should participate in the negotiations. This poses no problem, since these proceedings stay within the strict boundaries of contract law –and hence of privity of contract, taking only effect on those who voluntarily agrees to engage with the debtor, and the

extortionate fees because the debtor has to hire them anyways in the end. However, a mechanism to challenge abusive fees, as mentioned in the text, is likely to solve issues when the debtor's and the expert's views are irreconcilable.

[12] INCLUDE CROSS REFERENCE

legal framework does not attach any special effect to the agreement. However, things are very different in *regulated out of court proceedings*: by "regulated" we mean those proceedings which comply with certain legally established requirements as a consequence of which protection for the agreement reached against ex post avoidance actions is granted, a priority for financing provided is given or dissenting/non-participating creditors are bound by the plan.

A view of the European jurisdictions offers a very open landscape: (i) there are out-of-court proceedings where all creditors are mandatorily given the opportunity to participate; (ii) procedures according to which the debtor may select the creditors involved at discretion; and (iii) proceedings here the restructuring is limited to only one or more types of creditors[13].

- **Type (i)** proceedings (out-of-court proceedings where all creditors are mandatorily given the opportunity to participate) are the most common ones. They constitute an out-of-court replica of formal in-court insolvency proceedings. Because of this, it is essential that the design of the procedure offers incentives for its use, instead of the in-court alternative. The entry gate to these proceedings must be wide and lax to allow for its early use: either open or including the possibility to file based on imminent insolvency. Full out of court proceedings which are made available only in case of insolvency make little sense: it is often too late, and the ratio of success is much lower; it is not infrequent that this sort of proceedings are merely an excuse to procrastinate and delay the solution to the distress. These proceedings must be "useful" to the debtor, and hence a stay of actions/executions must be at least a possibility, an agreement reached ought to be protected against ex post avoidance, debtors should be left in possession of the management and dissenting creditors must be bound by the agreement. Without those "carrots", the procedure will not be used. Another element of the utmost importance is consistency with the requirements to approve a plan in formal proceedings: it must not be more costly or lengthy out of court, and, especially, the majorities should not be higher. Experience in Spain has shown that higher thresholds in "universal" out-of-court proceedings drive debtors away from its use. This is particularly the case when –another clear mistake– the failure to successfully approve a plan leads straight -and inevitably- to liquidation. Again, Spain was the prove of this. Both flaws have been amended by the legislator.
- **Type (ii)** proceedings **(**procedures according to which the debtor may select the creditors involved at discretion) are less frequent and also have different designs. The model's main advantage is, evidently, its flexibility. The debtor -a sophisticated debtor- may tailor the restructuring to its own context, maximizing the probabilities of success, both in the approval and in the plan´s implementation. But these agreements require technical skills and an adequate level of information (which must be reliable), and are not always useful absent those characteristics (as is often the case with MSMEs). Naturally, this type of agreement will only bind the participating creditors. Protection against ex post avoidance or priority for new financing should only be granted in case the plan is objectively favourable to the debtor [14], or when certain

[13] The restriction may also concern the debtor. This is typically the case where the jurisdiction creates a specific procedure for MSMEs. This is given detailed consideration in Chapter 8 of this report.

[14] Spain has included a type of refinancing agreement that is protected against avoidance actions without any majority requirement, because the content of the plan -defined by the law- is so clearly favourable to the debtor -and hence to other creditors- that it merits a safe harbour. However, the required content of the plan is so generous that there is no evidence of it ever having been used.

majorities of the total amount of claims are reached. The contrary would externalise the risk of the agreement on non-participating creditors and other relevant stakeholders.

- **Type (iii)** agreements (workouts where the restructuring, as a matter of law, is limited to only one or more types of creditors), restricted to one or more groups of creditors, have proven successful when involving sophisticated creditors, with experience in the practice of restructuring and aware that full repayment of other creditors (ie, operational creditors) increases their expected returns when the business is viable. These creditors are also best placed to gauge which businesses have a positive going concern value and therefore merit further investment (or, at least, support in the form of additional time to repay). Limiting the scope of the negotiation to a few repeat players also facilitates agreements: there is a greater likelihood that creditors will behave professionally; the parties often know each other and are familiar with the environment; the rules tend to be clear (not infrequently there is not even a need for a standstill agreement when the regulated procedure does not envisage a stay); and misbehaviour is rare due to the risk of reputational damage. Moreover, having fewer people to negotiate reduces transaction costs. Banks and other professional lenders tend to have better information about the debtor that anyone else (perhaps with the exception of the tax authority), and this fact also increases the likelihood of an adequate agreement being reached. From the research conducted concerning this type of proceedings, however, two risks transpire: on the one hand, the subjective scope of the procedure must be clearly defined[15]; on the other, there is an additional problem when debtors are too small, since financial creditors show little or no interest in getting involved. This latter problem ought to be tackled by means of banking supervision, codes of conduct and other rules that create incentives for financial creditors to avoid passivity [16]. The research conducted also shows that flexibility in the definition of the subjective scope could be welcome: in some cases, large commercial creditors may be as sophisticated as banks, and share most of the characteristics that make the latter adequate restructuring counterparties. Finally, the analysis conducted in some jurisdictions reflects that excluding public claims from these agreements may undermine the system. By being left out, public claimants are given an unjustified *de facto* priority which may even deter financial creditors from agreeing to rescue an otherwise viable business (the main concern being the lack of willingness to provide new money "for it to end in the pockets of the Tax agency" -sic-). This problem seems more acute in the smaller businesses, which are the ones that tend to accumulate more public arrears[17]. O I

[15] In the case of Spain, the use of the expression "financial creditors" has proven too vague; for example, it is unclear what the law is when there is an assignment of claims, or if guarantees are covered by the agreement.

[16] See, at length, Chapter VIII on special considerations concerning MSMEs.

[17] The inclusion of public creditors (tax, social security) in the agreements does not in any way intend to express support the distorted system by which, as is common in some jurisdictions (e.g. Italy), business finance themselves by not paying taxes and, in particular, do not pay withheld taxes or social security contributions.

3.2. The vote

The decision on the approval of a plan may be adopted by means of a written procedure or in a meeting of creditors. There is no real difference in this point between out-of-court and in-court proceedings. The feedback received in the surveys on this topic and the analysis of the different systems shows few results. The main one is that flexibility seems to be a very positively valued factor. Due to the alleged little efficiency and high cost of creditors' meetings, an open system, with a period to cast a vote (or adhere to the plan in any other adequate manner), seems like the preferable option. The larger the case, the more clear this preference is.

The vote should be structured in classes. Classes may be freely defined or determined ex ante by the law. In both cases, it is essential that the classes cluster creditors whose claims have an identical economic value [18]. If the design of the classes is left to the parties, the definition of each class should ensure a sufficient level of homogeneity. There seems to be a positive reaction to the inclusion of shareholders as a class, in so far as there are safeguards that ensure a sound system of priorities is respected. The use of classes seems less relevant in proceedings concerning MSMEs, given the small number of creditors. But classes are not the only element that must be considered. It is not infrequent to experience problems in the determination of the value of collateral held by creditors (directly affecting the participation of creditors). Similarly, it might make sense to create rules that coordinate the vote in case of enterprise groups: when there are joint and several guarantees within a group, the guaranteed creditors gets to vote as many times as his guarantees, de facto multiplying his influence of what is, in effect, one single restructuring process (a bank lends 200 to the mother company, and receives a guarantee from three different subsidiaries: unless a rule exists to coordinate the voting process, the bank will have a vote for 200 in each of the company´s assembly); on the other hand, this is the consequence, as for voting, of insolvency rules by which creditors have a claim for the full amount of their credit towards each debtor, including guarantors[19].

The system of majorities must strike a balance between the need to ensure a strong support for the plan and the need to make the plan effectively possible. In general, majorities beyond 75% should be envisaged only exceptionally. Some jurisdictions tend to differentiate the thresholds depending on the content of the agreement: the more detrimental to creditors, the higher the threshold will be. It is very important to mirror the system of majorities with the one applicable within formal proceedings to avoid strategic choice of restructuring tools; on the other hand, in certain circumstances it could be justified to allow for lower majorities when there is a more pervasive control and, hence, a lower risk of abuse.

<u>Policy Recommendation #6.3</u> (*Participation and plan approval*) In formal insolvency proceedings, all creditors must be given the possibility to participate. This is not the case for out of court proceedings, where different options can be considered.

Where a jurisdiction includes an out-of-court procedure which concerns all creditors, special attention should be paid to creating incentives for its use and

[18] On class formation and the treatment of classes, see Chapter --- of this report.

[19] This is a common rule in many jurisdictions. E.g. in Germany, Art. 43 InsO: A creditor holding claims against several persons for the whole of one single payment may file the full amount in insolvency proceedings against any debtor until he is fully satisfied if he had a claim to such full amount on the date when the insolvency proceedings were opened.); see also Art. 61, Bankruptcy Act (Italy).

avoiding a worse treatment than the parties would get in formal in court proceedings.

Out of court proceedings may be regulated to allow debtors to select which creditors should participate. This adds flexibility. However the efficacy of these plans is limited and rules must be included to safeguard the interest of non-participating creditors in case the agreements are to be protected.

Out of court proceedings involving only some creditors may be an adequate solution, so long as:

***(i) the scope of the procedure is adequately defined,**

***(ii) the creditors involved are sophisticated, professional creditors,**

***(iii) the exclusion of other creditors is founded on adequate grounds, such as suppliers or non-adjusting creditors. The exclusion of public claims creates a de facto priority in favour of public creditors, undermines the chances of success of the agreement and run against best international practice.**

The decision may be taken in a meeting of creditors or by allowing creditors to cast a vote during a period of time. This latter method should be favoured for larger cases. The majorities required in out of court proceedings should, in general, not be different to those foreseen for in court procedures.

The thresholds should only very exceptionally be higher than 75%

4. Confirmation

4.1. Definition of the scope of the confirmation

An agreement between a debtor in financial distress with some or all of its creditors alters contractual and property rights of the latter. This alteration takes place through a collective action process, and hence there may be dissenting minority creditors; moreover, even non-participating creditors, whose contractual or property rights suffer no direct change, will often be affected by a plan that commonly will include a business restructuring and therefore a change in the risk profile of their debtor and are indirectly affected by protection afforded by the law to new finance and acts implementing the plan, which are protected from ex post avoidance or liability. As a consequence of all of the above, most systems designed to tackle business financial distress -be it out of court or in a fully formal procedure- include some sort of control over the content of the plan by an independent institution, either by a court or by a public agency. In this section we shall briefly discuss the different models and propose recommendations.

In this chapter, by "confirmation" we are referring to the approval by a competent court or by the relevant administrative agency to a plan previously agreed upon by a debtor in financial distress and its creditors. The plan needs to be aimed at tackling the situation of financial distress, independently of the type of exit (be it a reorganization agreement with the same owners, with different ones, or a liquidation of any sort). It does not concern mere business restructuring plans, with no changes envisaged for the business's debts. Further, we understand "confirmation" as including some sort of analysis of the merits by the confirming body, either a material check of the legal requirements or a more in-depth analysis of the viability of the plan. A mere formal, external control of the requirements envisaged in the law

is not deemed a confirmation for the sake of this chapter (e.g., the simple notification of the debtor to a Spanish court that negotiations are being conducted with a view to reach an agreement -ex art. 5 bis IA- does not qualify as a confirmation by the court).

4.2. Pros and cons of judicial or administrative plan confirmation

There are many sound reasons to include a judicial or administrative control over the content of a plan. In short, the following would be the most evident ones:

- A restructuring plan that, may be imposed on non-participating or dissenting creditors, implies a change in the legal rights assigned ex ante to the parties, altering the normal functioning of the market and affecting the subjective/property rights of stakeholders. These “game-changing” effects constitute exceptional law, and hence its application should be monitored by an independent authority.
- An indirect effect with regard to the position of creditors, also non-participating ones, is also given by the protection afforded by the law against ex post avoidance actions; in such case, if, for the sake of speed and efficiency, the law of a Member State allows protection from avoidance actions even without court/administrative confirmation, then a reasonable compromise seems to require an independent expert’s opinion that the legal requirements are met and the plan is commercially reasonable in a manner that facilitates the rescue of the business in the interest of creditors as a whole, not of individual - even if majority - creditors.
- In line with the foregoing, a judicial or administrative confirmation protects legality, increases legal certainty and gives credibility to the system, fostering its use as a consequence thereof.
- A confirmation constitutes a mechanism to protect minority creditors (and, ultimately, in some cases, shareholders). Moreover, a confirmation that includes a revision of the viability of a plan serves to protect non-participating stakeholders (i.e., creditors not bound by the plan, employees, etc.), who cannot influence the plan but whose risk will often be changed by the content of the plan.
- In the case of medium and large debtors, more likely to have cross-border connections, it facilitates international recognition and fosters the participation of foreign creditors.

However, the inclusion of a mandatory confirmation of the plan does not come without costs. Essentially, there are two risks that need to be considered:

- Firstly, the confirmation may delay the implementation of the plan: the more inefficient/underdeveloped the court system, the longer the delays. Surveys and interviews collected during the project confirm that time is of the essence in out of court proceedings, especially since time “in court” is bound to affect the reputation of the debtor and lower considerably its chances to access affordable -interim- financing.
- Secondly, there is a risk of excessive intervention by the judge or the administrative authority. The risk, allegedly not infrequent in jurisdictions with a rigid procedural system, is that the confirming body “substitutes” the will of creditors, revising the risk voluntarily accepted by the latter. Confirmation based on the objective lack of viability of the plan, following an analysis of the merits, should be exceptional and very well founded on sufficient evidence. Judges/administrative authorities are not

best placed to assess the viability of a plan, and should only substitute the voluntary risk-taking of a majority of creditors when there is evidence of abuse or a very clear case of damage to minority creditors.

In the light of the advantages and risks identified above, the following sections analyse the possible systems of confirmation. The recommendations that will follow the analysis shall aim to maximize the pros and to minimize the risks listed above.

4.3. Who should confirm the plan?

The body competent to confirm a plan must be independent of the parties and have the legal capacity to alter subjective rights of debtors, creditors and -eventually- third parties. To be sure, such a body would normally have a public nature, since most legal systems would only assign such competences to entities having judicial or administrative powers [20]. A comparative outlook shows that the competent body would be either a court/judge (most often, the court/judge that would be competent to open a formal insolvency case) or the insolvency agency (ie, an administrative agency, most often part of the Ministry of Justice or the Ministry of Economy/Finance), with the former model being the most common one.

In abstract, there is no reason to consider one model above the other in terms of legal knowledge and experience: in most developed countries, judges have a good technical capacity and an adequate level of specialization; but this is not always the case (and it is hardly ever true for developing jurisdictions), and there is no reason why an administrative agency could not hire people with at least as good a command of the subject matter [21]. The administrative model has its advantages: the agency could be designed with an inter-disciplinary team, including experts in economic analysis, a most useful resource when assessing the viability of a plan; alternatively, these organizations tend to be more free and hence “nimble” to engage expert opinions on a given plan if deemed necessary; the decision making process is generally internal and hence not subject to strategic delays by the parties (eg, by constant appeals); and, finally, these entities could be more efficient generally than courts, and their degree of specialization more intense (at least in comparison with those judicial systems where judges do not only decide insolvency -and pre-insolvency- cases).

And yet, the Court system has one clear advantage: in most systems, it will be considered the most correct body, from a technical point of view, to confirm a plan whose effect will be the alteration of subjective rights (contractual or property rights). In fact, there is little doubt that the intervention of a court must be a possibility at least in the form of an appeal in the vast majority of jurisdictions to avoid problems of constitutionality. Hence, systems with a confirmation assigned to an agency (or, even more, to a private body) may incur delays, with their decisions being challenged in court anyway.

[20] However, it is not impossible to conceive the assignment of the confirmation powers to a specialized private person/body. This private system would be similar to a mandatory legal arbitration. We are not aware of any jurisdiction with such a system Naturally, the parties (ie, creditors) cannot be the confirming body, since, by definition, their consent will have already been given before confirmation (and one of the main reasons for a confirmation is, precisely, the protection of minority creditors).

[21] As a matter of fact, some jurisdictions (ie, Peru, Colombia) have successfully created specialized agencies to handle insolvency matters, precisely with a view to improve the technical level and raise the level of honesty.

In view of the foregoing, and having in mind the pros and risks of the mandatory confirmation system, we would conclude the following:

- The court is the most obvious solution, and it is the more correct the more developed the court system of the jurisdiction. It is especially apt to generate legal certainty. It reduces the possibility of challenging the decision to one appeal (to the upper court). However, and as our surveys have shown, time is of the essence. Hence, the procedure leading to confirmation must be short, with few formalities, and challenges on procedural matters should be drastically limited. Even the most specialised and technically prepared judges may need help when assessing the viability of the plan. In this regard, a streamlined procedure should be envisaged to allow the judge to retain expert opinion, which ought to be fully independent of the parties. This procedure should be encapsulated and protected from the parties, beyond obvious cases of fraud. Resorting to an additional expert opinion, though, should be an exception whenever the case already counts on the opinion of experts issued previously in accordance with the procedure, or even at the request of the parties (insofar as the appointment of the expert has been conducted by means ensuring independence).
- The administrative agency can be an excellent alternative in countries with slow and inefficient court systems. It is especially appropriate for the smaller businesses, where the plan should be simple, the use of templates widespread, the amount and sophistication of creditors limited and the risk of "political" decisions limited due to the small size of the case. Often, the agency will have also followed the case during the negotiation and approval of the plan, and in some jurisdictions relevant information on the debtor will be lodged in the agency itself. In the procedures involving MSMEs, the use of an administrative agency is bound to liberate the court system from the burden of many small -or very small- cases, which, due to rigid procedural schemes, take many time and resources anyway. The decision of the agency to confirm or to reject the confirmation of a plan should be open to challenge by affected parties. This appeal ought to be decided by a court of justice. It is, however, essential, that the competent court has some degree of specialisation in commercial matters. This may not always be evident in jurisdictions where the decision of a public agency will need to be taken to a court of the administrative jurisdiction for appeal.
- In both cases, it is essential that the appeal against the confirmation does not suspend the efficacy of the plan. Naturally, the competent judge should have the possibility to adopt cautionary measures, but the general effects of the plan should not be withheld unless there are very sound reasons for it.

4.4. Content and different types of plan confirmation

As stated above, the benefits of a plan confirmation would seem to clearly outweigh its disadvantages, and, in those countries where the said disadvantages are likely to pose a real problem, it is easier to take action to reduce them than it would be to find a substitute for the benefits of confirmation. This section, thus, takes the need for some type of confirmation as a starting point, at least whenever the agreement is protected from ex post avoidance actions or it binds third parties. There are different possible models and types of confirmation. We shall briefly consider the most common scenarios.

But before laying out the different scenarios, brief consideration should be given to the scope of confirmation, which is something that affects all models. *The confirming body would need to focus on three different sets of issues which are part of the plan content:*

(i) **The general formal legal requirements.** This would consist in ensuring that formalities have been met: the issuance of mandatory expert reports, the intervention of a notary public, notifications to all relevant parties, the use of mandatory templates for MSMEs, etc. This is the most basic part of the judicial/administrative control, which can even be mainly conducted by court officials in some instances.

(ii) **The consent of creditors.** This would refer to controlling compliance with the material aspects of the formation of consent by creditors. This would include, naturally, checking that the necessary majorities have been reached, but also more complicated aspects, such as the adequate formation of voting classes or even the determination of participants, when the agreement is one of a kind limited to certain creditors. The formation of classes may be pre-determined by the law, or, with some legal limits, it can be freely determined by the debtor with a view to increase the chances of approval and to tailor the plan to the needs of the different groups of creditors. This last model, which adds flexibility to the system, has created problems of litigation. It is noteworthy that, for example, in the UK the schemes of arrangement provide for two court confirmations, being the first one about the formation of classes. While this has proved helpful in large, complex cases (schemes of arrangement often concern this type of cases), it would seem unjustified in smaller entities and, specially, in jurisdictions with less efficient court systems. While it may increase clarity, it would be at the high cost of a lengthy delay of the process, in a situation when time is of the essence [22].

(iii) **The material content of the plan**. By this, we refer to the control over the viability and feasibility of the plan, of its potential to be realised/implemented in practice. This is one of the most controversial aspects of confirmation, since, by definition, the successful implementation of a plan is uncertain and implies the assumption of a new risk, a risk which has been voluntarily accepted by a majority of creditors. The analysis of the proposal and its context by a judge or an administrative body with a view to confirm or reject its conclusion entails a substitution of the will of private parties which should be handled with care. In reality, the question boils down to answering the following question: what degree of discretion should the Court/Agency have when deciding to confirm or reject a previously agreed plan? This is not the right place to have a full discussion about a classic debate of insolvency law, so this report only purports to express what has been identified as best practice, stemming from the research conducted.

The scope of this project is the analysis of several EU jurisdictions, which share with the rest of the Member States a market economy model. In this context, the decisions of stakeholders freely adopted with an adequate level of information available should, as a matter of principle, be respected. A financially distressed debtor and the existence of a collective procedure are not ordinary situations, which can always be left entirely to the

[22] As stated earlier in this chapter, Spain has a peculiar system where homologated refinancing proceedings only concern "financial creditors" (*acreedores financieros*). The determination of what constitutes a financial creditor has proven controversial and is one of the most common grounds of complaint by the stakeholders most often involved in this sort of out of court procedure.

parties (and to the law). A restructuring plan that changes the business, that is to be protected from *ex post* avoidance actions, and that is binding on some dissenting/non participating creditors can have important effects on third parties (including, especially, creditors not affected by the plan and even future creditors – involuntary and non-adjusting– of the distressed debtor). This situation is tackled by the control of the Court/Agency, which should ensure that the process leading to the plan has been correct and compliant with legal requirements, that the content of the plan meets the requirements envisaged to protect affected and participating creditors, and that the plan is objectively "feasible". It is in this third part where discretion ought to be limited. A Court/Agency will not always be in the best position to make such type of judgment. And, even if it were, it would be unjustified, generally, for the judge/agency to substitute the will of the parties. Voting in favour of a plan implies -almost inevitably- a change in the risk level of creditors. This change of risk has been willingly accepted and no confirming authority can replace a decision voluntarily adopted by the "owners" of their rights over the claims against the debtor. The confirmation would, thus, be granted to *protect those who did not participate*, or *those who objected by voting against* the said risk-level change. But this must surely have a limit. A minority (dissenting creditors) cannot possibly impose their will on a majority; majority which, in many countries, implies a high percentage of the outstanding liabilities[23]. And creditors not bound by the plan should generally suffer no damage, since their debts will be fully repaid in case of plan implementation. Their risk is, thus, limited to the damage they would suffer in case the plan could not be effectively implemented and the effects of the plan could not be reversed.

Both the interests of minority participating/bound creditors, and non-bound creditors merit protection, but it must be balanced against the objective, informed decision of the rest of creditors. In light of this, the discretion of the confirming authority must be limited to ensuring there is no misuse of the plan. We take it to conform to the standard by which the judicial or administrative authority should override the decision of a majority of creditors, hence rejecting a plan on its merits (*rectius,* based on its lack of "feasibility") when it would be obvious, for a market participant in the sector of activity of the debtor, using a minimum, basic commercial diligence, that it could not be successfully implemented. Finally, it should be highlighted that an excessive judicial/administrative discretion would lower predictability, damage legal certainty and undermine the use of the system [24].

[23] In some countries, a majority of 75% is required (e.g. Spain); in others, a majority of 50%+1 of the amount of the claims plus a majority of heads (Germany); in others, a simple majority of 50%+1 of the amount of the claims (formal insolvency proceedings in Italy; in out-of-court restructurings the majority is 75%).

[24] This is consistent with the result obtained in Spain, where stakeholders showed more concern with the low predictability of the system than with the risk of abusive behaviour by the debtor and its main creditors (ie, non-minority creditors).

The research in Spain, however, did show some concern about possible abuse by the majority creditors in very large restructurings. In particular, (see page --- of the National Report on Spain) foreign investment funds that had acquired large packages of distressed debt, but which were nevertheless minority creditors, complained that Spanish banks (the majority creditors) accepted "objectively unfeasible" plans for what they labelled as "political" reasons. It must be said that these complaints were not supported by the courts. It is interesting to observe that financial creditors can have very different profiles and their interests are not always aligned. While distressed funds will often seek to make a quick profit, banks may want to make an effort to keep a repeat client; further, it seems reasonable to believe that, at least in the largest cases (*Abengoa, FCC*, etc.), banks valued the

The content of the plan must also be controlled concerning the treatment of affected creditors. Specially in out of court restructuring agreements, some creditors may be treated differently to similar creditors, or be asked to assume a sacrifice that could be deemed unjustified. If the judge finds this to be the case, the plan should not be confirmed. In most models, however, the control of this sort of illegality is handled *ex post,* by means of an *ex parte* appeal against the plan confirmation. From an efficiency standpoint, it is arguably more reasonable to have this control *ex post,* since it is the affected parties that may realize the mistreatment incurring lower transaction costs. This topic will be thus further covered in the next section.

Finally, confirmation will also be the procedural act to consider a cram down of dissenting creditors and classes of creditors. The intricacies of this are analysed elsewhere in this report [25].

Taking the foregoing into consideration, the possible scenarios for a confirmation of a restructuring plan would be the following:

- **Scenario I. Mandatory confirmation with control *ex ante*.-** According to this scenario, the debtor -or, less often, creditors- would file a request for confirmation of a previously agreed-upon restructuring plan by the requisite majorities. The request for confirmation should include not only the formal petition with the plan and its annexes, but also any valuation of the plan drafted by experts (independent or *ex parte*). According to this scheme, the Court/Agency will conduct a full analysis of the plan. This includes: (i) checking that all formal legal requirements are met; and (ii) an analysis of the merits, including an assessment of the viability of the plan. This scenario has two possible models, depending on when dissenting parties can make allegations: in the more common model, the time between the request for confirmation and the issuance of a decision is short (e.g., 10 days for Spain), and there is no possibility for anyone to provide documents or allege arguments, a possibility which would only exist in an ex-post appeal against the decision to confirm the plan; alternatively, a procedure may allow the parties to provide information during the time leading to the confirmation or rejection of the plan, facilitating the decision-making process of the relevant authority (see also Art. 10(4) of the Directive, which requires a decision to be handed down in 30 days from the filing of the request)[26]. As stated, the latter model could enrich a decision that has to be adopted on the merits; but it may also delay the procedure (if more information is available, the judge/agency may need more time to decide). In any case, either model should allow the parties to challenge the decision. The appeal, which should be made to the upper court, *should not suspend the implementation of the plan,* safe the possibility of the relevant court to order cautionary measures. The said cautionary measures ought to be limited and affect only the part of the plan that would cause a damage that could not be repaired (or that would be too costly to repair). Our research shows that long periods of suspension of the effects of the plan cause severe damage to the credibility of the system.

negative reputational consequences that a negative vote may have created. Is this unfair? Should this be tackled by the system?

[25] See Chapter II, pgs. --- .

[26] In Italy, e.g., creditors have 30 days to object to confirmation and the court usually decides within the subsequent 30 days [add reference to empirical evidence].

- **Scenario II. Mandatory confirmation with control *ex post*.-** This model seeks to speed the decision making process by including a light initial control and leaving the analysis on the merits for an ex post appeal against the plan. This type of model relies heavily on the idea that the process leading to the agreement already incorporates sufficient controls and mechanisms to ensure that participating parties are well protected, and hence that litigation (appeals against the confirmation) will be rare. Naturally, this idea will be more convincing, the higher the majorities required to approve a plan and the more information is mandatorily incorporated to the process (ie, mandatory experts´ reports, etc.). According to this scenario, the debtor (or creditors) will request the confirmation of the plan that has already been agreed upon with the required majorities. The Court/Agency will only conduct a light check on the merits (mere objective appearance of "feasibility") as well as a thorough control of compliance with the legal requirements (formal requirements, majorities, etc.). The decision may, obviously, be subject to appeal by non-participating or dissenting creditors. It is in the appeal that the competent judge will make a decision on the merits of the plan, including on its "feasibility". Creditors may also challenge any of the formal and legal requirements of the process, which had already been checked by the first instance judge or by the administrative agency. In this case, the lack of initial control of the merits of the plan advices caution with regard to the immediate implementation of the agreement. While there is still no reason to delay its full efficacy until the appeal has been resolved, the admission of the appeal for consideration could include an initial suspension of some of the parts of the plan. This ought to be decided by the competent court upon acceptance of the case.
- **Scenario III. Potential confirmation.** According to this scenario, confirmation would be the automatic consequence of the passage of a period of time: if no one requests a judicial/administrative control or challenges the confirmation (depending on the model), the plan would be deemed confirmed after the time has expired. This model system would have two aims: on the one hand, it would seek to reduce court intervention, streamlining the process and reducing the burden of the relevant institutional framework; on the other hand, it would seek active participation by creditors, often too passive when it comes to restructuring proceedings, with special regard to micro and small businesses. As it is mentioned in Chapter ---, passivity may also be tackled by the introduction of a "deemed consent" rule. Deemed consent plus potential confirmation might be excessive. The legislator ought to be careful if there is an intention to combine both rules. In any case, confirmation attained by the passage of time should also be subject to possible appeal by dissenting/non participating creditors, on the grounds that their rights may be prejudiced; the fact that they did not act promptly does not seem a sufficient argument, in this case, to deprive them of every right to appeal.
- In this case, the deciding judge would be the one competent to confirm (not the upper court), acting in first instance [27]. It must be noted that, in some cases (especially in

[27] An alternative would be to allow dissenting/non participating creditors to request a confirmation during a period envisaged in the law. In this case, the petitioning creditor could add documents, reports and other elements of probation to the case. Naturally, even in this case -and consistently with previous scenarios- creditors could challenge the confirmation, but this time to the upper court. However, it is less evident if duly notified creditors, who were given the chance to request a confirmation and did not, should be allowed to appeal against the automatic confirmation attained by the passage of time. If allowed, the law could limit the reasons for appeal.

larger cases, where potential confirmation would seem less appropriate), new financing will be provided. In many systems, new financing is protected ex post in an insolvency of the debtor. This would immediately affect the risk levels of all creditors, including those that are -on paper- not to be affected by the plan. In these cases, all creditors should be allowed to request confirmation, even if for limited causes.

The effects of the confirmation of the plan is its immediate application, the substitution of any legal effects on the debtor and creditors by those foreseen in the plan, and the rescheduling and/or the writing down of the claims. The rejection of the plan usually means the end of the regulated procedure and any legal effects it may have generated, although in some cases the parties may reformulate the plan. The failure of the confirmation most often leads to the opening of formal in-court insolvency proceedings (if the debtor is insolvent) or, in some cases, to the commencement of liquidation [28].

4.5. Appeals against the decision to confirm or reject the confirmation of the plan

As it transpires from the previous sections, the possibility of an appeal against the decision to confirm or to reject the confirmation of the plan is included in most systems and it is in accordance with best practice. In fact, depriving the parties generally of the possibility to appeal may create issues of constitutionality in some jurisdictions [29]. In most cases, the upper court will be competent to decide on the appeal. This may, however, not be the case when there has been a confirmation following a mere control of formal requirements, or when initial decision has been adopted by an administrative agency, when the appeal can be decided by the first instance court. Whether functional jurisdiction will be attributed to the commercial court (i.e., the civil court that would be competent to open formal insolvency proceedings over a given debtor) or to an administrative court, is to be decided by the law on jurisdiction of each country. However, if the solution is the latter, it would be advisable to allocate the appeal in a court that has some expertise on commercial or economic matters (or, at least, that the competence is clustered in one or very few first instance administrative courts, so that, thanks to a critical mass of cases, they may gain experience).

The decision should be adopted in a quick procedure. Restructuring operations deal poorly with long periods of uncertainty: reputation is eroded, financing becomes increasingly difficult and new projects are withheld. Moreover, it is essential for the correct functioning of the system that the appeal does not, as a general rule, have the effect of suspending the implementation of the plan. In order to protect the interests of those whose rights could be damaged by the implementation of the plan, it should be sufficient to provide the Court (the confirming court or the upper court, depending on the procedural system existing in the jurisdiction) with the possibility to limit the implementation to only some of the items envisaged in the plan or to apply certain cautionary measures. A wholesome paralysation of the plan should be exceptional and founded in very clear grounds.

[28] The automatic opening of liquidation in case of failure of out of court regulated restructuring proceedings revealed a big mistake in Spain. Such was the regulation before 2015 for the special out of court procedure for MSMEs (*Acuerdo Extrajudicial de Pagos*). As a consequence of this rule, the procedure was hardly ever used, since debtors would not want to risk going straight to liquidation. The rule has since been changed.

[29] Although this is not necessarily the case in every jurisdiction. According to the European Charter of Human Rights, a second instance is only strictly necessary in criminal cases.

In most systems, the plan may be challenged based on the same causes that were listed above as the topics to be reviewed by the confirming judge/agency. In those jurisdictions where the initial confirmation has been merely formal, and there has not been a thorough analysis of the content based on the merits of the "feasibility" of the plan, the appeal should review this topic in detail. Absent clear cases of abuse (which, in most situations, will not have escaped the control of the first judge/agency), the review of the "feasibility" need not be as thorough when the control had already been conducted in first instance (a limit in the revision of the judgment concerning the valuation of facts is consistent with many procedural systems). An appeal against the confirmation may be filed based on what the dissenting/non-participating creditor considers an unjust treatment of its contractual or proprietary right. Not uncommonly, the laws use undefined legal concepts to justify the appeal: for example, the expression "disproportionate sacrifice" applicable in Spanish Law, or "unfair prejudice" used by the Directive proposal. While these expressions may be dealt with appropriately in jurisdictions with a high level of judicial expertise, they may create uncertainty in others, where the judges are do not have such a high technical level of expertise. In the latter cases, some legislative help in clarifying those concepts might be the better option [30].

The system should regulate clearly the effects of a ruling in favour of an appeal. There is little controversy when the confirmation is reversed due to the breach of a legal requirement, the mistaken counting of majorities or the evident, objective impossibility to implement the plan: the implementation is cancelled, its foreseen effects disallowed and effects that had already taken place may be reversed insofar as this is still possible, safe the protection of good faith third parties. In other words, the agreement falls for every creditor. But the scope of the effects of a successful appeal that affects only one or more litigants is less clear and may give rise to problems of uncertainty[31]. This would be the case, for example, when the Court accepts that a creditor or a group of creditors have been inflicted a "disproportionate sacrifice", as in the Spanish system, or that the best interest of creditors test is not met with regards to one creditor or one class of creditors.

In many cases, this will call the feasibility of the whole plan into question, in particular where a major creditor or a large number creditors are (potentially) affected. In this scenario, the entire plan should be cancelled (*rebus sic stantibus*). To avoid this consequence, the plan can provide for sufficient reserves to cope with adverse contingencies (see Chapter 4), of which challenges by creditors are an example. The law may provide[32] that in the absence of such reserves the court has to reject or cancel the entire plan outright, or it may allow the judge the discretion to, having consulted with the participating creditors, decide whether to cancel the entire plan or not.

In case an appeal only concerns an individual stakeholder's position under the plan and the feasibility of the plan is not called into doubt, a strict application of procedural tenets would restrict the effect of the court's decision to the appellant (subjective scope of litigation), and the fruits of their litigation (= better treatment) would not be extended to other stakeholders in the same position. It cannot be argued validly that such a result would foster litigation (i.e., since the successful appeal only benefits the appellant, every stakeholder in the

[30] Even in jurisdictions where the technical level and the experience of the judiciary competent to deal with these matters is adequate, stakeholders complain about the concept being too vague and hence the predictability difficult. This is the case of Spain, where - after a rather intense application of the system - there is still lack of clarity as to what constitutes a "disproportionate sacrifice" of creditors.

[31] This has been the case in Spain (see Spain´s National Report, page ---).

[32] As it does, for example, in Germany.

same position has an incentive to appeal), since – or rather, insofar as – basic procedural rules allow for the accumulation of identical suits, which would – should – be tried in one procedure and decided in one court decision. It is true, though, that this would result in a situation of relative unfairness (identical stakeholders being treated differently), but stakeholders are free to appeal and should not be allowed to benefit from someone else´s – costly – proactivity (*caveat creditor*).

Policy Recommendation #6.4 (*Confirmation of the plan*). A confirmation of a plan is to be preferred when the law protects the agreement against avoidance actions, creates an ex post priority for new financing or binds dissenting or non-participating creditors.

An adequately designed judicial or administrative confirmation protects legality, increases legal certainty and gives credibility to the system. It also it facilitates international recognition and fosters the participation of foreign creditors.

Confirmation may be issued by a judge or an administrative agency. Preference over one model or the other depends on the characteristics of the relevant jurisdiction

Confirmation should review (i) compliance with formal legal requirements, (ii) the adequacy in the consent by creditors leading to an approval of the plan, and (iii) the material content of the plan, including its objective viability.

By approving a plan, a majority of creditors voluntarily assume a new risk. While the judge/agency must protect minority creditors, it should refrain from assessing the adequacy of the risk assumed: only in *very clear* cases of non-viability of the plan, its confirmation should be rejected.

There may be different models of confirmation: mandatory confirmation with control ex ante or ex post, and even, in some cases, merely potential confirmation

The confirmation should be subject to appeal. The process to decide the appeal should be quick and simple, and the effects of the plan should not be withheld as a general rule, subject to cautionary measures when justified.

In principle, a successful appeal concerning an individual stakeholder's treatment under the plan should only limit its effects to the appealing stakeholder, not to others in a similar or even identical situation. However, the court should have the possibility to cancel the plan when the new situation makes the plan no longer viable or the sacrifice demanded by creditors excessive.

Chapter 7
Implementing and Monitoring Plans

1. Introduction

The implementation phase follows the approval of the restructuring plan and its court confirmation, if the plan is subject to confirmation. The length and relevance of that phase is very different according to the terms of the plan: it is very compressed, indeed substantially absent, in case of restructuring plans providing an instantaneous implementation (*i.e.,* setting forth actions to be implemented just upon the plan approval/confirmation, such as the sale of the whole business to a third party identified in the plan); on the contrary, in all other cases, the implementation and monitoring of the restructuring plan could take place over the years, thus acquiring greater complexity.

In light of the above, the paragraphs below address the implementation and monitoring only of those plans that are "non-instantaneous". In these cases, the law should always deal, among the others, with the following issues:

(i) who is in charge of the plan implementation (*e.g.,* person/body ordinarily in charge of running the business, the liquidator, or a chief restructuring officer);

(ii) whether the monitoring activity should be performed directly by the court or demanded to an independent insolvency practitioner, to the creditors and/or other person/body (*e.g.,* one or more directors, the board of statutory auditors, a professional appointed by the creditors);

(iii) to whom the person/body in charge of monitoring the implementation of the plan should report (typically, to the debtor and, when it is a company, to the board of directors, but very often also to the creditors), and what are the consequences of a failure to comply with the terms of the plan (*e.g.,* forbearance, insolvency, or amending the plan directly by order of the court or upon the agreement of the debtor and its creditors);

(iv) what the reaction to the prolonged non-implementation of a restructuring plan should be.

However, due to historical reasons, the rules concerning these issues are often not as effective as they could be. Indeed, insolvency law is generally more concerned with the debtor's access to restructuring tools, the fairness of the procedure to obtain creditor approval and court confirmation of the plan, rather than with the implementation and monitoring phase. Such phase, however, is particularly important, and the empirical data show that significant problems emerge during the implementation phase.

In light of the above, those provisions included in restructuring plans that are purported to set rules and criteria ensuring effective implementation and monitoring are to be regarded particularly favourably[1].

[1] B. Wessels, S. Madaus, Instrument of the European Law Institute - Rescue of Business in Insolvency Law (2017), p. 339. Such provisions "can either be contractual in nature (e.g. reporting duties under covenants) or make use of a specific statutory right to mandate the insolvency practitioner (or an independent auditor),

In any case, the provision of formal implementation and monitoring systems, either by contract or by law, should always consider the costs associated therewith. In light of this, the size of the restructured firm is a relevant aspect to be considered: in case of small firms, the benefits arising from an effective implementation and monitoring system may be easily outbalanced by the expenses that would be incurred to put in place such systems.

2. Implementing the plan

The issue of adequate implementation of a restructuring plan is twofold:

(i) on the one hand, a successful implementation rests, to a large extent, on meticulous drafting of the plan, particularly concerning the reasonableness of the measures and expected results as well as putting in place effective self-adjusting mechanisms.

(ii) on the other hand, with respect to plans due to be executed in an extended timespan, the responsibility concerning their implementation must be clearly allocated.

The provisions to be included in the plan with a view to ensuring a proper implementation of the plan have been already addressed in Chapter 4, par. 5. The following paragraphs will focus on the second of the above-mentioned issues, namely the effective allocation of the implementation responsibility.

2.1. Responsibility for implementing the plan

One of the defining features of the restructuring tools and proceedings is to leave the debtor in possession, possibly under the supervision of the judicial authority depending on the type of tool/procedure and according to the choices made by each legislator. In light of that feature, unless the plan provides "instantaneous" implementation (see par. 1), the responsibility for implementing the restructuring plan is ordinarily allocated to the person or body in charge of running the business (*i.e.*, the entrepreneur in case of individual firms; directors and officers in case of companies).

Stakeholders, namely creditors, are clearly affected by the adequateness and timeliness of the plan implementation. The time and rate of their recovery is strictly dependent on the ability to carry out the actions envisaged in the plan. However, given that the debtor is left in possession while resorting to restructuring tools (cf. Art. 5 of the draft Restructuring Directive), the creditors are not entrusted under the law with the power to directly implement the plan, being granted only with monitoring rights and the possibility of activating remedies in case of inadequate implementation (see below par. 3).

In certain cases, it may be advisable to replace the members of the board of directors and the senior management and/or appoint someone specifically entrusted with the task of implementing the restructuring plan. The debtor and its creditors may always negotiate in the plan such type of measures, which may be deemed valuable in the perspective of those

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supervise the debtor and alarm the creditors in case of wrongful actions or a negative development in order to allow them to initiate a plan modification or new (insolvency) proceedings" (ibid.).

creditors required to consent to the plan (*e.g.,* when creditors do not trust the management or the management lacks relevant skills and expertise required to implement the plan, or both).

However, imposing such measures by force of law – enacting what would unavoidably be a one-size-fits-all provision – may not be efficient, especially regarding the replacement of the debtor company's directors and senior management that would most likely pose adverse incentives (see par. 2.2). It may be instead advisable, in certain cases, to enact legal provisions mandating the appointment of a person entrusted to realise the debtor's assets, known as a "liquidator" in some jurisdictions (see par. 2.4).

2.2. Change in board composition and retention of key employees

As mentioned, the plan may provide for changes in the board of directors and senior management of the debtor company. Such measures may be particularly beneficial in the perspective of the implementation of the restructuring plan, whenever the existing directors or managers do not have the skills or expertise required to successfully implement the plan. Even when directors and managers are skilled and experienced, it may well be the case that the creditors do not trust them anymore and, thus, make their consent to the restructuring plan conditional on their replacement or that they may not be in a sufficiently objective and independent position to carry out properly what the plan requires (*e.g.,* they may be bound by personal ties to redundant employees, they may have to fully disclose past transactions that turned out being disadvantageous to the company, etc.).

There is strong empirical evidence showing that, when the plan provides for the continuation of the business by the same company, the replacement of the board of directors is positively correlated to the likelihood of full implementation. One of the possible reasons is that the appointment of new directors may contribute specific turnaround knowledge and "fresh eyes" to the business, thereby facilitating the implementation of the measures envisaged in the plan. *[TBC]* It should be noted, however, that in out-of-court restructurings, when the business is continued by the debtor (*i.e.* with no transfer of business), change in the board happens very seldom[2].

Although the plan provisions concerning the replacement of whole or part of the board of directors and the senior management may entail the abovementioned benefits, it appears unadvisable to mandate under the law the application of such measures for all companies' restructurings. Such a general obligation may set inefficient *ex ante* incentives to the directors and officers, with the likely effect of delaying access to preventive restructuring measures.

To the contrary, it is important to retain in the company the most skilled and knowledgeable employees[3]. These employees can contribute to the implementation of the restructuring plan, especially in the shorter term, when the survival of the business may depend on handling issues swiftly and neutralizing threats (*e.g.,* cash management, pending litigation, collecting receivables, preserving relationships with strategic suppliers and clients). To the purpose of retaining the company's key employees, who are also those more likely to receive other offers, it is important to have them involved in the plan negotiation soon and set

[2] See results from Italy, _____

[3] The importance of retaining key employees has been highlighted in the context of qualitative interviews. ***[Data from interviews to be added]***

adequate economic and moral incentives for them to stay with the company (see Chapter 5, par. 4.2).

Policy Recommendation #7.1. ***(Provisions on changes in board composition).*** **The law should permit restructuring plans to include provisions committing the company to carry out, as part of the plan implementation, a change in the composition of the board of directors and/or the senior management team. However, there should not be any legal duty to include this sort of provisions in restructuring plans, due to the discouraging *ex ante* effects that the perspective of a change in the composition of the board of directors and the senior management team, if perceived as unavoidable by the existing directors and officers, would exert on early access to preventive restructuring.**

2.3. Directors and officers specifically appointed to implement the plan (CRO)

The implementation of the restructuring plan may be delegated to a chief restructuring officer ("CRO"), appointed to the specific goal of supporting the company in putting in place the measures envisaged by the restructuring plan. This officer may or may not be appointed in the context of a wider change in the board composition and/or senior management team.

The appointment of a CRO yields significant benefits in a variety of circumstances. Of course, the additional costs associated to the appointment of the CRO may be outweighed by the benefits of his or her activity only when the restructured business has a noteworthy size.

The main benefits associated with the appointment of a CRO are the following.

First, the restructuring process requires significant time commitment. In certain cases, the time the management would be required to devote to the restructuring efforts could slow down the business activity and, ultimately, be the very reason for failing to implement the restructuring plan. The appointment of a CRO allows the management to remain focused on business strategy as well as the daily operations of the business, while the CRO leads the company through the restructuring.

Second, even if management has time to devote to the restructuring process, it often lacks the necessary specific expertise. Thus, hiring a CRO may be advisable when the existing management team lacks the relevant turnaround knowledge.

Third, creditors may deem the company's directors and officers not trustworthy and do not believe that they are able to undertake the restructuring with integrity and credibility. In such a circumstance, large creditors may condition their consent to the restructuring plan to the appointment of a CRO enjoying wide powers concerning the plan implementation, thereby practically binding the debtor company to appoint a CRO chosen by the same creditors.

Fourth, besides the knowledge brought by the CRO to the company, which may or may not be already part of the company's management team expertise, the qualitative empirical evidence shows that one of the main benefits of hiring an external CRO is that he or she is not attached to the debtor's management team, thereby being more inclined to lead the company

through whatever changes he or she deems necessary without having any emotional ties limiting his or her action. [4]

The CRO is usually a temporary position filled by a professional (most often a licensed trustee, insolvency practitioner or a chartered insolvency and restructuring professional) retained by the debtor company upon determination by the financial creditors. Additionally, the CRO often has vast experience in accounting, finance, or law.

The CRO's compensation is determined according to the terms of his or her engagement letter with the debtor company. Compensation structures vary, commonly involving hourly rates, daily fees or fees for service. Sometimes, the engagement letter may include a provision detailing a "success fee", which is dependent on the letter's definition of "success". This could be based on a "percentage of the (…) value of a transaction (sale or refinancing) or a portion of the improvement in financial performance the CRO is able to implement". [5]

The role of the CRO is not defined under the law, being shaped case by case by the parties according to the provisions included in the restructuring plan. Nevertheless, in most cases, the CRO is commonly required, *in the short term*, to acquire all relevant information on the company and the restructuring plan, focus on cash management, and address the organisation's current threats (*e.g.*, closing down unprofitable business lines, handle outstanding or pending litigation). Tackling these short-term potential problems, thereby ensuring the short-term continuation of the debtor's business, is a crucial pre-condition to successfully implement the plan. *In the intermediate to long term*, in light of the company's corporate goals, strengths, and weaknesses, the CRO should take formal control of the restructuring of the distressed company, particularly adopting the measures envisaged by the restructuring plan and, where needed, winning the resistances to change internal to the company (as may be the case when the existing management or employees, although formally complying with the restructuring plan, contrast the effects of the plan implementation).

It is worth mentioning that the involvement of the CRO may also precede the approval (and confirmation) of the restructuring plan. Although not very common in any of the jurisdictions examined, a CRO may be appointed with a mandate having a wider scope than the mere implementation of the plan, including instead also its conception and negotiation. In this regard, however, it is to be noted that the involvement of the CRO in the plan drafting and negotiation may, on the one hand, be beneficial due to a greater knowledge of the company, which could help in the implementation phase; on the other hand, his or her previous involvement may sometimes interfere with his or her "fresh view" while implementing the plan, thereby reducing his or her capacity to promptly spot the need to adapt the plan in light of unforeseen circumstances or actual mistakes in the plan conception and making him or her more reluctant to ascertain the possible supervening unfeasibility of the plan. TO BE DECIDED IF THIS RISK IS REAL

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[4] The CFO of a large corporation that recently underwent a restructuring (name redacted for confidentiality) explained that although many companies may never want a CRO to step in as it signals financial difficulty, the CRO is often an invaluable resource to the debtor company for his/her "fresh set of eyes" and expertise.

See Henrich (2004). *The Role of the CRO in Debtor/Lender Communications in Bankruptcy*. American Bankruptcy Institute Journal 23 (6).

[5] T. Onich, *The Chief Restructuring Officer: What Does He or She Do?* (2013), at https://www.dailydac.com/commercialbankruptcy/alternatives/print-view/268 (accessed 24 June 2018).

<u>Guideline #7.1</u> *<u>(Appointment of a CRO)</u>*. The appointment of a chief restructuring officer (CRO) in charge of implementing the restructuring plan is recommended for all large business, whereas the additional costs of the appointment of a CRO may outbalance the benefits in the case of small businesses.

2.4. Appointment of a professional with the task of realising assets

When the restructuring plan provides for the sale of whole or part of the firm's assets (e.g., the sale of the entire business as a going concern), the responsibility for implementing the plan (or the part thereof envisaging the realization of the firm's assets) may be allocated to an IP or another professional acting upon a specific mandate.

The appointment of a professional with this task may be either mandated by the law, which may entitle the Court or the creditors to appoint him or her, or envisaged in the plan[6].

The first approach appears superior when the plan provides for the sale of all the firm's assets or a major part them: if the sale of the assets is the main measure envisaged by the plan, the debtor (*i.e.*, the person or body ordinarily in charge of running the business) would have no or limited interest in maximising value in the interest of creditors, particularly when the debtor may enjoy limited liability or a second chance. The choice of the professional to be appointed should be given primarily to creditors (possibly, with the court sanctioning their choice); should the creditors not exercise their power, to the court.

In all other cases, the second approach, leaving the decision on whether to appoint a professional with the specific task of realising the firm's assets, seems superior. The appointment of such a professional entails additional costs; when there is no risk of the debtor's lack of interest in the plan implementation, it is reasonable to leave to the bargaining between the debtor and creditors the decision on whether his or her appointment be a value-creating measure. This assessment is evidently strictly dependent on the market value of the assets to be sold and their marketability: the higher the market value and the lower the marketability, the more the need for a professional having the specific task of realizing the firm's assets acting in the best interest of the creditors.

<u>Guideline #7.2</u> *(Appointment of a professional to realise assets)*. When the restructuring plan envisages the sale on the market of certain assets having a relevant economic value, particularly when such assets are not easily marketable, the plan should consider granting the creditors the right to appoint a professional entrusted with the task of selling the assets in the best interest of creditors.

<u>Policy Recommendation #7.2</u> *(Appointment of a professional to realise assets)*. The law should provide for the appointment of a professional entrusted with the task of implementing the plan concerning the sale of the firms' assets in the best interest of creditors, when the plan is completely or in prevalence based on the

[6] Under Italian law, the court appoints a professional acting in the interest of creditors as a liquidator when the in-court restructuring plan ("*concordato preventivo*") is purported to sell the firm's assets.

realisation of the firm's assets. The creditors should have the right to choose the liquidator.

3. Monitoring the implementation of the plan

3.1. The importance of proper monitoring

Plans are often complex and include many different measures, some that are planned to happen immediately at the execution of the plan (or its confirmation), others that occur further on in time. As time goes by, the debtor and the creditor may lose focus on the implementation of the plan and this may cause it to stall. Empirical evidence from some jurisdictions suggests that a strikingly high percentage of plans is not implemented in full[7]. The degree of incompletion is not known, so data could capture both cases in which implementation is almost complete and cases in which it has just started and even cases, which anecdotal evidence show exist, in which the main planned undertaking has not been implemented. Adequate monitoring and, in some cases, reaction to such lack of implementation is very important to avoid this phenomenon (see par. 4.1 for some possible explanations and par. 4.2 for the reasons why unfulfilled plans are not commendable).

3.2. Monitors

The plan is implemented by the debtor and, when the debtor is a company, by its directors and officers. Besides carrying out the actions that the plan requires the debtor to, the debtor is also the first monitor of the implementation of the plan. It is in the interest of the debtor to check whether the assumptions of the plan and the prospected events have actually taken place or appear to be taking place in due course, while managing directors and officers of the debtor certainly have a duty to monitor the implementation of the plan. Such duty may also lie with auditors or independent directors, depending on the governance system adopted by the debtor.

While directors and officers have an interest in continued and attentive monitoring, however, they have no interest in sharing this information with the creditors, or at least they may want to be selective in disclosing the degree of implementation and possible critical issues. In some cases, for example, some problem in implementation, even involuntary, may be a breach of a covenant, and debtors may not want to reveal this to creditors, because they fear that creditors may not want to waive the breach.

Auditors and independent directors may have better incentives to take steps vis-à-vis problems in plan implementation. However, all these gatekeepers face the well-known issues of, for example, lack of independence, or lack of immediate information, etc.; issues which are here enhanced by the fact that the main disciplining factor towards creditors may be liability, whereas appointment rights still lie with the debtor or its shareholders.

Therefore, in order to protect adequately the interests of creditors it is important to include them in the monitoring process. Of course, direct monitoring by the individual creditor, although possible, faces significant hurdles (time, costs, access to information) and is

[7] See evidence from Italy, ___

subject to "classical" collective action problems, insofar each monitoring creditor bears the full cost but shares the advantages of its behaviour. It is therefore assumed that some form of "collectivised" monitoring is efficient, at least to the end of the generation of adequate information (for possible reaction measures, see par. 4.2).

There are various ways to involve and protect creditors in the monitoring of the implementation of the plan.

The main instrument for creditor monitoring could be the appointment of an *ad-hoc* creditor committee or a creditor representative who can monitor the implementation, provide timely information to creditors, and interact with the debtor on behalf of the creditors. This form of "direct" monitoring requires that there are sufficient incentives to perform this task, which will typically be when the size of the deal is big.

Besides costs, a voluntary system may be very effective when participant creditors are party to the plan. However, the same system cannot work when the plan has been crammed down on some creditors. Since non-consenting creditors did not participate in the appointment of the committee, they cannot trust it to assert their interests, exactly as creditors in general cannot trust the debtor in the monitoring of the plan.

Therefore, when the plan has an effect on non-consenting creditors, a fully independent monitor should be appointed. The monitor could be an independent expert appointed by the court or by an administrative authority or, perhaps and depending on the case, an organisation of experts or similar. Monitors should be experts, such as insolvency practitioners, in order to understand not only the business developments, but also the insolvency-law implications of possible issues in implementation.

Since many national laws provide for protection for transactions carried out to further the implementation of a restructuring plan (Art. 17 of the draft Directive) and for new financing, including exemption from civil, administrative and criminal liability (Art. 16), one could argue that, in all cases in which there are non-consenting creditors, even if the plan provides for their full repayment, these could have an interest in adequate monitoring. The consequence is that a creditor-appointed committee could *never* be sufficiently independent, even if there was no cram down, because the plan has also effects that go beyond cram down (the mentioned safe harbours).

It is reasonable, however, to distinguish between direct effects on creditors' rights (cram down on dissenting creditors) and indirect effects, that occur as a consequence of the protection afforded to certain transaction. The draft Directive itself shows there is a difference between measures that directly affect creditors (cram down and stay on enforcement actions) and measure that only indirectly affect them (all the other measures) when it provides that an insolvency practitioner must be appointed when there is a stay or cross-class cram down (Art. 5) and plans must be confirmed by the Court or an administrative authority when the plan affects the interests of dissenting creditors or provides for new financing (Art. 10). As a general rule, therefore, one could argue that an independent monitor should be appointed when the plan directly affects dissenting creditors' claims.

<u>Guideline #7.3</u> ***(Monitoring in case of plans affecting only consenting creditors)*. Plans should provide for proper creditor monitoring, with a view to triggering the actions and remedies that the plan envisages in case of non-performance.**

<u>Guideline # 7.4</u> *(Monitoring in case of plans affecting non consenting creditors)*. When the plan has an effect on dissenting creditors' rights and the law does not provide for appropriate monitoring devices [see PR #7.3], the plan should provide for proper independent monitoring.

<u>Policy Recommendation #7.3</u> *(Monitoring in case of plans affecting non consenting creditors)*. The law should provide for proper monitoring, at least with regard to plans that affect the rights dissenting creditors, to ensure that non-performance does not go undetected due to the lack of incentives for creditors to monitor the implementation of the plan.

3.3. Monitoring devices

Monitoring implementation requires, first of all, an independent (and expert) monitor (see par. 3.2). Monitoring can be made easier in various ways, such as by setting milestones and thresholds (see Chapter 4, par. 5). In some cases, however, the issue is not only to detect implementation issues, but to make sure that the debtor takes adequate steps to get back on track when the plan is lagging behind. Not always is it possible to rely on creditors' reaction, both because of collective action problems (see par. 4.XX below) and because creditors could have no interest in reacting, although there may be a public interest in not leaving plans unimplemented (see par. 3.1); and of course the debtor is not a proper monitor of its own plan – at least with regard to third parties' interests.

It may be the case, therefore, to provide for a default mechanism that shifts the burden of action from the creditors (or the monitor) to the debtor. The plan or, more likely, the law could set a specific term to implement the plan and require the debtor or any other interested party to file for an extension, in order to avoid that the plan comes to a stop. The law could provide increasing requirements for the extension of the plan, at least when the request comes from the debtor. This kind of mechanism is common and is used also by the draft Directive for extensions of the stay on enforcement actions (see Art. 6(4-6)).

<u>4. Reacting to non-implementation</u>

4.1. The problem of "zombie plans"

The empirical data show that a significant part of the restructuring plans do not perform as expected, as mentioned above[8]. In some cases, it is only a matter of delay, in other it is a matter of results, in many cases it is both, *i.e.* plans are not implemented within the projected timeframe *and* do not yield the expected results (see par. 3.1)

This may result in a wide set of situations. First, the plan may have built-in mechanisms to deal with non-performance, *i.e.* the plans are to a certain extent self-adjusting. For instance, the plan may contain contractual clauses by which creditors have accepted *ex ante* the result of a best-effort liquidation of specific assets, whatever such results are, or clauses by which creditors' claims are automatically reduced if the business, for objective reasons, performs

[8] See data from the concordato preventivo in Italy: ________

worse than expected. This kind of mechanisms are typical of well-drafted and high-quality plans (see Chapter 4), and, being the product of the negotiation between the debtor and the creditors, they must in principle be observed.

Second, the debtor or the creditors may take the initiative to renegotiate the plan to cope with the circumstances at hand. Repeated restructuring is extremely frequent [DATA]. On the one hand, this phenomenon appears the product of optimism and reluctance to fully acknowledge the extent of the losses incurred (see Chapter 4, par. 4.5, on the importance of realistic cash flow projections), on the other hand renegotiation is facilitated by the fact that the parties involved have acquired significant information and, especially for the debtor, have acquired skills that debtors rarely possess in normal circumstances. In such case, a new plan will have to be drafted, agreed-upon and confirmed, according to the rules that are applicable in the new setting (*e.g.,* a fully consensual plan may end up in a plan that requires judicial confirmation). If this happens, the non-performance will be cured. Given the fact that renegotiating a plan entails costs, the law may consider giving the judge, at least for minor failures to comply with the plan terms, the power to amend the plan according to what appears to be in the best interest of creditors.[9]

Third, the creditors may demand that the plan be terminated and their original claims be reinstated, forcing the debtor into insolvency.

The plan, however, may simply lie in a non-implementation stage, with no initiative taken to amend it or, if this is the case, to move the case to proper insolvency. This may happen due to the cost that individual creditors must bear to acquire information on the debtor and the prospects of the plan being properly implemented. This is the very reason why it is advisable to provide for proper and effective monitoring on the plan with a view to reduce the costs that creditors must bear in order to make informed decisions (see par. 3.2).

Having said that, what if fully informed creditors decide to remain passive? Should the law provide for automatic termination of the plan, or other mechanisms to address the problem of "zombie plans"?

<u>Policy Recommendation #7.4</u> ***(Amending and curing the plan during implementation)*.** **The law should empower the judge, or the independent IP appointed to monitor the implementation of the plan, with the authority to amend the plan, curing minor failures in its implementation in line with what appears to be the best**

[9] Only a few Member States provide for simplified modifications of the plan: see B. Wessels, S. Madaus, Instrument of the European Law Institute - Rescue of Business in Insolvency Law, cit., p. 326: "In France and Poland, for instance, the court may adapt the plan to new circumstances upon request. In Greece, a plan cannot be amended after its judicial ratification in principle except that in recovery proceedings the agreement can be amended by the bankruptcy court, but only once, based on a subsequent agreement concluded by all the contracting parties and as long as specific conditions are met".

Art. L626-26 of the French Commercial Code states: "*Substantial modifications of the goals or means of the plan may be made only by the court, on motion of the debtor and based on the report of the plan performance supervisor. When the situation of the debtor permits a substantial modification of the plan to the advantage of creditors, the motion to the court may be filed by the plan performance supervisor* (…).

The court shall rule upon the case after having received the opinion of the Public prosecutor and after hearing or duly summoning the debtor, the plan performance supervisor, the controllers and representatives of the works council or, in the absence of a works council, the employee delegates and any interested party".

interest of creditors. Such power should be exercised by the judge or the independent IP after having acquired sufficient information from the parties.

4.2. Possible remedies

One might wonder whether the law should be concerned with zombie plans at all: if creditors do not react to non-implementation, why should anyone else do? Although this is true in principle, a well-designed law should also be concerned with the reliability of the system, in the sense that a large number of plans that do not perform as expected may undermine public confidence in the restructuring process, therefore inducing creditors, *ex ante*, to be more sceptical even towards good candidates for restructuring[10]. This, of course, is particularly relevant especially for repeat players, typically financial creditors, and less so for other kinds of creditors, such as trade creditors. However, the relevance for financial creditors is indeed enough to be very careful not to undermine the credibility of the debtors' commitment in restructuring frameworks; and many trade creditors may not be *per se* repeat players, but they may have resorted to credit insurance, factoring, etc., thus transferring their credit management to repeat players.

Secondly, resources of the participants in the plan may remain tied up uselessly for a long time, instead of being reinvested in other ventures. For example, one can imagine a restructuring process in which non-core assets are sold. If the liquidation part of the plan never materialises, these assets, while not going to the benefit of creditors, are not even available for the debtor.

Third, it should be noticed that monitoring is important in the perspective of liability: continuing with the implementation of a plan that is no longer suitable to achieve the restructuring goals that were initially set may result in liability for the debtors and its directors and officers.

Further, the formal prosecution of the implementation phase, while no measures or initiatives are carried out, may nevertheless require some activities and generate costs (*e.g.,* fulfilling reporting duties), which are not justified with respect to plans whose implementation will never take place.

As mentioned, there are historical reasons that explain why insolvency law tends to overlook the implementation and monitoring phase, while being very concerned about the debtor's access to restructuring tools, the fairness of the procedure to obtain creditor approval and Court confirmation of the plan. Therefore, it should be appreciated that the plan provides for the right of the monitor, or of a creditors' representative, to provoke the termination of the plan, thereby fully reinstating creditors' rights, or anyway to take those actions that appear appropriate in the interests of the creditors. The plan may, for instance, provide for the mandatory substitution of the board or the managers in case of significant differences between the plan and the actual results.

When there is a collective action problem, provisions along these lines might also be inserted in the law, to ensure that the restructuring package that is negotiated by the parties is

[10] Out of concern with the problem of "zombie plans", for instance, the Italian Court of Cassation has ruled in 2017 that the debtor that has obtained confirmation of *a concordato preventivo* can be subjected to insolvency proceedings (on demand of the public prosecutor) without any previous court decision to terminate the plan (that requires a specific demand by a creditor), when the implementation of the plan has ceased or appears manifestly inadequate to satisfy the creditors (Court of Cassation, 11 December 2017, No. 29632).

complete also with respect to implementation phase. The law could, for instance, entrust the monitor or supervisor with the power to initiate remedies (including, as the case may be, the power to file for the insolvency of the debtor). Moreover, the law should consider whether, after a proper span of time without the complete implementation of the plan, its continuation be conditional upon the determination expressed by the interested parties.

The law should avoid overkill, however: a mandatory provision that entrusts a creditor "representative" such as an insolvency practitioner to file for debtor insolvency, etc. makes sense only once that it is ascertained that creditors are not doing so themselves because they have no incentive. When their passivity is rational also on a collective level, there must be a very strong case to allow an independent monitor (e.g. court-appointed insolvency practitioner) to file for insolvency when creditors have not.

Policy Recommendation #7.5 *(Power to initiate remedies)*. The law should consider whether to give the monitor/supervisor the power to initiate remedies (including, as the case may be, the power to file for the insolvency of the debtor). The law should consider whether, after a proper span of time without the complete implementation of the plan, its continuation be conditional upon the determination expressed by the interested parties. [Such provisions should be non-mandatory, thus allowing the parties to opt out of them] [TO BE FURTHER DISCUSSED].