ARTICLE

The Convergence of Creditor-Driven and Formal Insolvency Models

Paul J. Omar, Barrister, Gray's Inn, London,UK

Introduction[1]

The position of secured creditors upon the insolvency of their debtor is at once secure and precarious. It is secure to the extent that the law accords priority to their interest for reasons of economic efficiency, given that lending is seen as a prime catalyst for the encouragement of entrepreneurship, and so as not to discourage contractual determination of outcomes upon acts of default by the debtor. It is precarious to the extent that 'overreaching' by judicial or legal processes resulting in the postponement of the security through involuntary or equitable subordination can occur. Furthermore, on occasion, the legal framework behind the security may fail resulting not only in the loss of priority but also that of the security itself. That said, a certain amount of insecurity may also arise from the availability of pre-insolvency and insolvency measures under domestic legislation. The paradox is that, in legal terms, the security (in the sense of safety) that is granted by having a legally determined insolvency framework with observable rules and a reasonably predictable outcome may not be in the creditor's interest to experience because of the inherent delays to which all legal process is subject and also because of the risk that the security obtained may be judicially overreached, postponed or avoided, often by reference to other applicable principles of insolvency and the intervention of other interests deemed superior, often because of inherent doctrines and social views in that legal system.[2] For those reasons, the resolution of insolvency cases by means of informal workouts has been seen to act in the creditor's favour by encouraging a participative approach to resolving insolvencies.

The relative speed of the process, flexibility and informality, despite the often complex legal advice supplied and documentation required, assist the refinancing needs of the debtor and any hiving off as well as sales, acquisitions or consolidations of assets necessary. However, even agreements seen as watertight may be in theory later upset, despite the willingness of debtor and creditors to continue performance. Nonetheless, informal workouts, standstill arrangements, mediated resolution and arbitrated disputes are popular and seen as advancing all the interests involved. Perhaps because of this, insolvency systems have developed models seeking to take the perceived advantages of creditor-debtor negotiated outcomes, essentially in deference to the ideal of laissez-faire, while circumscribing certain undesirable outcomes by providing for scrutiny and/or validation by a court at certain points in the process. Conversely, in certain jurisdictions, informal arrangements hitherto outside insolvency frameworks have acquired as part of the process a phase where agreements are voluntarily submitted for approbation by a court as a form of risk-management strategy. Although not universal in practice, the tendency to incorporate some court-involvement leads to a rapprochement with the formal insolvency model.

There is quite considerable interest shown in this field by the European Bank for Reconstruction and Development ('EBRD'), International Monetary Fund, Asian Development Bank ('ADB') and the World Bank, all of which have been working on insolvency models appropriate for their constituencies. In many instances, the recommendation is for a more 'formal' informal approach with framework guidance for those jurisdictions without an active history of workouts, which would certainly be of interest to many countries in the developing and developed world. Often, the availability of debtor-friendly approaches in voluntary arrangement schemes seen in many Western European jurisdictions have usefully served as models in this respect. Conversely, formal insolvency regimes appear to become more streamlined in their structure

Notes

1 This article is based on a paper presented to the annual conference of INSOL Europe in Prague, Czech Republic on 7–9 September 2004. The author would like to thank Mr Peter Ito of Foley and Lardner LLP for responding to the paper during the conference session and for providing a number of useful criticisms. Any errors or omissions remain, however, the author's own.

2 'Interventionist' doctrines of this type include family interests in property as well as priorities granted in a distribution to protected interests such as those of employees.

and seem to be taking on elements that might conceivably appeal to those seeking a negotiated solution. This article makes the case that the issues underlining the position of the creditor in an international insolvency are being affected by developments occurring in relation to both formal rescue-type procedures and informal creditor-driven processes in which there is the potential for convergence between the various models and the blurring of the boundaries between what have hitherto been seen as two quite separate points of intervention reliant on the debtor entering a defined state of insolvency. This article will use the models offered in two jurisdictions, France and England and Wales, where the laws take very different approaches to the need for rescue, by way of contrast to determine whether convergence is taking place and on what basis. It will also seek to determine whether there is an advantage in convergence, especially where a creditor is seeking to minimize the impact that insolvency of the debtor will have and their exposure to risk, and what effect making a number of models available to the debtor will have on general reform strategies in these jurisdictions.

Alternatives to the formal process

The concept of the informal workout is seen as a substitute for or alternative to formal processes. Its ancestry can be traced to informal compacts, agreements and concordats between debtors and creditors and may even predate the rise of formal insolvency systems. Even today, many legal systems do not prevent such compacts from being agreed, but may curtail their operation subject to requirements for validity through special contract rules. This is ostensibly to prevent abuse, where arrangements inure to the detriment of non-participants or infringe deeply held canons of belief in insolvency, as can be seen in the rules relating to voidable preferences and vulnerable transactions. However, such limitative restrictions on the compact are not of any application when the creditors as a whole agree to it, as they are free to waive, curtail or diminish their rights. Even where not all creditors are participating, there is a strong suggestion that the law should be facilitative and not intervene where it can be shown that other creditors are not unduly prejudiced on the principle of equal suffering or are not adversely affected. In this type of workout, the two key issues will be the nature of the contract that embodies the agreement reached by the negotiation process and what impact it has on the position of creditors, both participating and non-participating. Nonetheless, despite the antiquity of the informal process, it has tended to be eclipsed in the rush towards corporate rescue, ongoing since the 1960s, and did not re-emerge until the late 1980s or early 1990s as a serious alternative to the application of formal insolvency law procedures. In this regard, the pioneering work encouraging the development of this approach was performed in a largely unofficial capacity, as opposed to its current regulatory role, by the Bank of England. It has since been taken on and further developed by leading British commercial banks and has known some success in the field of corporate reconstruction. This development is now known as the 'London' approach and many similar models pioneered largely by financial institutions around the world are based on this initial development.[3] It has also been copied in other related sectors, such as the financial services and insurance sectors, with appropriate changes reflecting sector-specific requirements.

The World Bank provides a number of reasons for the development of this process.[4] It states that the reasons are important because they tend to suggest that even the more developed and historically secure 'modern' formal rescue regimes may not always be suitable to the task of rescue. The World Bank outlines the claims that informal processes arise because there is a need for something more flexible and less rigid than the processes that are available under formal insolvency rescue regimes. In fact, many cases of corporate financial difficulty require greater early pro-active responses from key creditors, notably bank and financial institutions. This is not normally possible under the formal rescue regimes as first developed, although increasingly there is a tendency even here towards greater involvement of the principal creditor or creditors at an early stage. The World Bank also puts forward the claim that informal processes are much more private in nature and less prone to unwanted publicity and speculation. This might assist rescue in delicate situations where confidentiality is a must. Furthermore, informal processes are less confrontational and for that reason provide a better environment for 'market place' negotiations between creditors (as to the approach to be taken towards the debtor) as well as between the debtors and creditors as a whole. Although the fact that informal processes are perceived to carry less stigma than the formal process is also cited as a reason for promoting them, it is not always the case that recourse to insolvency proce-

Notes

3 See M. Havranek, 'The Bank of England and Bank Failures' [2000] 2 Insolv L 73.

4 World Bank Insolvency Initiative, Symposium Paper No. 6: Building Effective Insolvency Systems in Section 8: Informal Corporate Insolvency Practices (September 1999) at 26 ('World Bank Report'). A copy of this document may be obtained at: <www4.worldbank.org/legal/insolvency.ini/WG6-paper1.htm> (last viewed 10 May 2005).

dures necessarily provides a damning picture of the debtor business as rescue in the form of reconsolidation may be a perfectly acceptable business practice.

Nonetheless, the World Bank does state that a number of necessary conditions are attendant on the use of informal processes.[5] The report states that an informal work out would probably not be attempted unless a number of well-defined conditions are present. These are mainly that a significant amount of debt is owed to a number of main bank or financial institution creditors, which would preclude the vast majority of insolvency cases, the corporate debtor is unable to service that debt according to the terms of its contract, the view among creditors of the firm concerned that it may be preferable to negotiate an arrangement to resolve its financial difficulties and the concurrence by the debtor that this is the case, the availability of relatively sophisticated refinancing, security and other commercial techniques with view to restructuring the debts themselves or the business of the corporate debtor in such a way as to deal with the liabilities, the availability of an exit strategy which may involve the application of a formal insolvency procedure in the event of the failure of negotiations, which could also act as a sanctions feature for the negotiations overall and, perhaps the economic key to the use of informal procedures generally, that there are prospects that there may be greater benefit for all through the negotiation process as opposed to the use of a direct and confrontational formal insolvency process. Nonetheless, an important factor for consideration and present behind any discussion between debtor and creditor is the presence of the sanction: 'the shadow of the insolvency law', effectively compelling parties to the table to negotiate as an avoidance strategy.

The main stages of the process as described by the report are the creation of a 'forum' through which debtor and creditors explore and ultimately negotiate an arrangement to deal with the business' financial difficulties.[6] The provision of a forum is regarded as also being important for the creditors as a group to assess the strategy to employ and whether it is realistic. Next comes the appointment of a 'lead creditor' for the purpose of organizing, managing and leading the process as well as completing the necessary administration and formalities. The collective nature of the process is reflected in the selection of a 'steering' committee to represent the general body of creditors and to act as a provisional sounding board in respect of proposals put forward whether by the debtor or creditors. The most useful element of administration that should be completed early on is the conclusion of a 'standstill' agreement, which reflects the use of the moratorium in conventional formal processes, usually for a short defined period. It is in the interests of all creditors that this agreement is not undermined by the execution of process, recovery of goods or other measures that would encourage a free-for-all and race to the court. The steering committee is usually also a useful channel for the gathering and provision of complete and accurate information regarding the debts outstanding and the information held by creditors. At this time, information is also collected about the corporate debtor, its business activities, current trading position, general financial position, general assets and liabilities, especially contingent and unquantifiable liabilities, such as may arise in the insurance sector. This information is then used for the purposes of negotiating, agreeing and implementing a rescue. The stages of this process do not present any particular novelty, given that they can also occur in a voluntary arrangement-style procedure and in some instances, notably in the French model, reflect the structure of a more formal model. The differences are of course in the general distinction between formal and informal methodologies, but may also illustrate how the development of procedures in one field influences parallel developments in another.

The World Bank Report highlights a number of practical issues and problems with the informal process.[7] An informal process, it states, has no law to govern it and thus needs to be initiated. Although this is crucial for bringing the debtor and creditors together, the debtor may be reluctant to engage this process for personal reasons, perhaps the fear of losing economic control, and certain creditors may not see it as within their remit, preferring instead to act for their own advantage and avoid the collective nature of the process. The existence of a 'rogue' creditor is considered to be the element most likely to endanger the process. One way of getting around the difficulties with initiation is the availability of well established and utilized creditor remedies, which can be used as bargaining counters to persuade the debtor to the table. In other words, the 'invitation' should not be refused unless the debtor wishes to see itself subject to more formal procedures. While this could also act to persuade reluctant creditors, it is by no means certain that debtors wish to avoid formal insolvency, especially where there is a degree of sanction for failing to use formal procedures where they are available.[8]

Notes

5 Ibid. at 26–27.

6 Ibid. at 27.

7 Ibid. at 27–28.

8 The insolvent trading rule is one example of a coercive rule in this regard.

However, of interest in developing countries, where formal insolvency regimes are little resorted to for cultural reasons or because they do not really work or are not seen to deliver creditor-friendly results, informal processes may work with the presence of a 'facilitator'.[9] The World Bank highlight this approach in Malaysia with the work of Pengurusan Danaharta Nasional Berhad ('Danaharta') and the Corporate Debt Restructuring Committee under the aegis of Bank Negara (the national bank).[10] Problems in the process generally can also arise with locating expert advice. Rescue may require a combination of legal, financial, accounting, fiscal, business and marketing advice, which is not always easy to locate under one roof and may be a more acute problem in jurisdictions with less experience of this type of matter. Further to the 'rogue' creditor debate, the report states that in some situations it may be unfeasible or inefficient to deal with all creditors. Although these creditors may be important to the continued business of the debtor, a technique that may invite attention is to pay them off, which also requires acceptance that financing will be required and any attendant risks. Post-commencement financing and the priority it may or may not have in any subsequent insolvency is also a problem in formal procedures. The problem this approach invites is its infringement of the equality (or pari passu) principle, especially where those creditors that are participating are being asked for significant concessions.[11] The danger of breaching preference rules and falling foul of the no-creditor-to-be-disadvantaged rule is ever-present in this strategy. A possibility might be, however, for voluntary submission of the finalized negotiation document to a court for its imprimatur, which could be obtained by the conversion of the informal process in its final stages to a formal procedure of brief duration.

It is interesting that the World Bank do not see much sense in the convergence of informal and formal processes, arguing that each has a place in the commercial order of things.[12] However, the systems may be mutually interdependent to the extent, as outlined earlier, they influence developments in each other. Nonetheless, the World Bank is of the view that informal processes may still benefit from a certain amount of 'formalization', particularly if this consists of the promotion, introduction and development of a 'code of conduct' or informal set of rules directed toward the use of an informal out-of-court process for dealing with cases of corporate financial difficulty. This would be especially beneficial where banks and other financial institutions are or risk being significantly exposed. The participation of a central bank or ministry of finance may be included in this process of development, principally by way of encouragement and technical assistance. The interrelationship between formal and informal processes might be underlined by providing that a formal process may include the processing of a pre-packaged plan resulting from an informal procedure, perhaps for the purposes of court validation or binding recalcitrant creditors. Furthermore, the review of formal mechanisms could be enhanced by inviting consideration of informal techniques for creditor-debtor promoted joint resolution and the existence of adequate creditor remedy and insolvency law regimes should be seen as a sine qua non for the parallel development of cogent and efficient informal processes. In fact, the World Bank relies in part on research conducted by the ADB into the emergence of structured informal processes.[13] This reflects the development in certain South-East Asian jurisdictions of structured initiatives geared towards filling the absence of viable workout strategies, engendered by the lack of the appropriate commercial environment for such measures. In fact, a later ADB report states that the impetus for the development of these structured initiatives came as a direct consequence of the 1997 financial crisis affecting the region. There are two principal types of workout: the structured workout process that has seen the establishment of state-sponsored or state-led organizations working with the financial sector to promote an environment for the collective negotiation of solutions to the problems of corporate debtors; the other seeing a workout on the basis of asset-management by intermediaries, again usually state-sponsored, that acquire non-performing loans and deal directly with debtors, a form of distressed debt exchange that results, normally following the restructuring of the debtor, in the hiving off of viable units or businesses. This 'formalization' may be directly contrasted with the experience of more formal rescue procedures that

Notes

9 World Bank Report at 28.

10 Danaharta is organized under the terms of the Pengurusan Danaharta Nasional Berhad Act (Act 587). See A. Bidin, 'Insolvency and Corporate Rescues in Malaysia' [2004] ICCLR 344 at 349–354.

11 For example, the voluntary arrangement affecting Eurotunnel SA, where repeated debt-equity swaps have left creditors less sanguine about the prospects of recovery.

12 World Bank Report at 29.

13 World Bank Report in Section 9: Structured Informal Processes at 29–30, referring to the ADB Report on Insolvency Law Reform in the Asian and Pacific Region (April 1999). See also ADB Interim Report on Promoting Regional Co-Operation in the Development of Insolvency Law Reforms (June 2004) in Part 6.

are undergoing, as will be outlined next, a review that is tending to introduce elements that are representative of the informal processes already examined.

Review of formal insolvency procedures

In insolvency law, a shift in emphasis from liquidation of the failing entity to the preservation of the economic benefits of a continued existence for the company is a feature of modern developments in this field. Why this should have emerged as a potent force in legislative initiatives in this area has long been a subject of debate. One view states that recognition of the loss of confidence likely in a system that delayed creditors' recovery till formal insolvency has had an 'enlightened' effect in generating the need for timely intervention in failing businesses, the likely effect of which has been felt to be the restoration of the equilibrium of the company and prudence in its governance, measures that could ultimately avoid the disaster of insolvency.[14] The result has been the development from the 1960s onwards of measures tending to preservation as well as external controls on the liquidation process attempting to halt irreversible decline of the company. The introduction of a 'rescue culture', reflecting the use of the term 'corporate rescue' originating it is said in the United States, was seen as expressing the need for more control by economic entities of their destiny. The legislative expression of this culture has allowed Governments to create effective and efficient legal systems for the management of insolvency, an economically sensitive subject for many states, while not compromising essential philosophical views on the nature of entrepreneurship and employment. Part of the search for the ideal rescue procedure has also led to the introduction of early interventionist measures before the formal moment of insolvency, to attempt to resolve the problem before it presents itself in an unfavourable aspect. This twin-track approach, seen in the classification of measures into insolvency and pre-insolvency, has virtually shaped the economic thinking of today. Insolvency proceedings are no longer thought of as a final measure but as a form of rescue that can occur throughout the life of the company, often as a type of reconsolidation. The use of informal as well as formal measures is now firmly regarded as being part of the range of tools for use by business for its betterment.

The World Bank is of the view that for rescue to be commercially and economically effective, the law that institutes the procedures must permit rapid and easy access to the process, must provide sufficient protection for participants in the process, must provide a structure that permits the negotiation of a commercial plan for recovery, must enable creditors in favour of a plan or other course of action to bind all other creditors by the exercise of voting rights (the majority principle), and must provide for judicial or other supervision to ensure that the process is not subject to unfair manipulation or abuse.[15] It is also of critical importance that access to the process must be available to a company in financial difficulty at a time when it is still appropriate for the business to act for purposes of recovery. Whether firms need to act under the threat of possible sanctions or the influence of potential benefits is a matter the report leaves open to the individual enacting authority. A further element necessary for the successful conclusion of the process is that attempts by creditors, whether secured or otherwise, to intervene in the process and pursue their individual rights, including self-help and individual recovery against company assets, must be restrained as far as possible. This is potentially the element that signals the collective nature of the process more than any other and the focus of rescue on the needs of the collective. Furthermore, the process must be sufficiently transparent and involve the creditors in the decision process and, finally, must be capable of quick and speedy resolution. The question of timings of the process itself is considered particularly acute in terms of overall management of rescue.

Modern rescue procedures are known, inter alia, in legislation introduced in Australia,[16] Canada,[17] France,[18] Singapore,[19] South Africa,[20] the United States[21] as well as the United Kingdom.[22] Many other

Notes

14 See I.F. Fletcher, *Insolvency in Private International Law* (Clarendon Press, Oxford, 1999) at 4.

15 World Bank Report in Section 7: Principles and Guidelines for a Formal Rescue Law at 15–16.

16 Corporate Law Reform Act 1992, based on proposals in the Australian Law Reform Commission Report No. 45 (1988), now replaced by the Corporations Act 2001.

17 Companies Creditors Arrangement Act 1985 and Bankruptcy and Insolvency Act 1992.

18 Law no. 84-148 of 1 March 1984 and Law no. 85-98 of 25 January 1985, now consolidated in the Commercial Code 2000.

19 Part VIIIA of the Companies (Amendment) Act 1987.

20 Companies Act 1973.

21 Chapter 11 of the Bankruptcy Code.

22 Parts I and II of the Insolvency Act 1986, now reformed as a result of the combined impact of the Insolvency Act 2000 and the Enterprise Act 2002 (amendments in force 1 January and 15 September 2003 respectively).

jurisdictions are in the course of adopting similar procedures, although the availability of rescue across the international arena is not universal. Depending on the date of introduction of the various procedures, there can be seen a gradual change in emphasis from the requirement that the undertaking pay all debts in full for the benefit of creditors to a more holistic approach requiring the debtor and creditors to co-operate in the recovery of the business concerned. Nonetheless, many of these changes have only come as a result of experimentation and experience in the jurisdictions concerned, where quite often rescue has to build on earlier attitudes to insolvency law and the culture of preservation takes some time to become established. Even within jurisdictions that have accepted the rescue model, it may be under reasonably frequent revision that takes into account the experience of participants in the process. Examples may be given of Germany,[23] Spain[24] as well as in the United Kingdom and France, which will be highlighted below. Reforms are also said to be progressing in Italy and many of the accession candidates to the European Union are also in the process of updating their laws. Some authors speak of a 'second wave' of collective reforms, which may lead to a convergence in European insolvency laws, perhaps on the model of the American 'Chapter 11' procedure.[25] What is clear from this ongoing review is that, in a number of instances, the review is seeking to take on-board elements of processes, including those deriving from informal ones, which are seen to be successful.

In the United Kingdom, the Cork Committee Report in 1982[26] suggested that British law had few methods to rescue companies in financial difficulties. Receivership did not guarantee rescue and, although designed to offer an alternative to liquidation, often just consigned companies to waste. Some companies could be saved under reconstruction procedures in companies' legislation,[27] but these were costly and time-consuming. A comparative view of laws in other jurisdictions (the United States, France and South Africa to name but a few) showed that rescue was a viable proposition for quite a few companies. In line with the report's recommendations, the Insolvency Act 1986 introduced two rescue-type procedures: the corporate voluntary arrangement ('CVA'), to cover companies before insolvency became a reality, and administration, to cover companies in a formal state of insolvency. CVAs were designed to be a cheap, quick, efficient method of dealing with financial difficulties without engaging formal procedures. The idea was that companies deal with creditors and negotiate terms. It was very similar in structure to the model in the Companies Act 1985 for schemes of arrangements and reconstructions. The advantages it had were that it was a simple framework, which avoided assets being used to fuel the formal insolvency process, it could be of benefit for all creditors and otherwise avoid the secured creditor getting the most benefit to the detriment of the mass. It also allowed for possible changes in management within the process to assist recovery and it was debtor-friendly by encouraging companies to seek help at an early stage. However, its disadvantages were that it was little used because of the uncertain effect if the company defaulted later despite the CVA, potentially leaving creditors in a worsened position. It was also unpopular because it was seen as being too debtor-friendly with creditors often required to give significant waivers or concessions, although this could be balanced against the risk of little or no recovery in the event of a formal liquidation. Furthermore, the secured creditor's support remained crucial for the success of arrangements and it was ineffective at preventing a creditor from petitioning for formal proceedings. A new framework for CVAs was introduced by the Insolvency Act 2000, although enforcement of its provisions was delayed till after the adoption of the Enterprise Act 2002. The modifications included a new procedure for obtaining a moratorium on application by the directors lasting for 28 days or until meetings take place with view to adopting an arrangement. It becomes an offence to make false representations with view to obtaining a CVA order and new provisions permit the prosecution of delinquent directors where an offence has been committed in relation to the obtaining of a CVA with moratorium so as to guard against the possibility of directors using the benefit of a 28-day grace period without there being good cause. Despite these changes, which allow for greater flexibility in the negotiation of the CVA, there remain continuing criticisms, including that problems will remain as long as CVAs continue to be not well regarded because of uncertainty about the debtor's ability to adhere to arrangements, a cultural view that may be difficult to eradicate. Also, the procedure remains time-consum-

Notes

23 Insolvenzordnung of 18 October 1994 (in force 1 January 1999).

24 Insolvency Law of 10 July 2003 (in force 1 September 2004).

25 See R. Parry, Introduction to K. Broc and R. Parry (eds.), *Corporate Rescue in Europe: Recent Developments* (Kluwer Law International, The Hague, 2004) at 2–5. The 'first wave' is regarded as having occurred in the 1980s, of which the laws in France and the United Kingdom are examples.

26 Report of the Review Committee into Insolvency Law and Practice 1982 (Cmnd. 8558).

27 Schemes of arrangement under section 425 of the Companies Act 1985.

ing despite new time limits being set and CVAs are still seen as being too debtor-friendly and inimical to creditors, particularly if a challenge by shareholders, which are permitted where the views of shareholder and creditors meetings differ, is likely to be successful.

Administration was perceived as responding to the need for a type of rescue procedure that allows the business to continue thus preserving employment, trading and the generation of profits and the eventual satisfaction of most creditors. Its advantages were that it provided a secure court-supervised framework for the benefit of all creditors thus avoiding ravages caused by the secured creditor's recovery of assets. It was also debtor-friendly encouraging companies to seek help at an early stage and it avoided the bad publicity of receivership by promoting rescue as a joint effort between debtor and creditors, banks and lending culture having been the subject of great criticism. Nonetheless, it had some disadvantages, particularly in that it was an expensive procedure so was not beneficial for small companies and the floating charge holder used to be able to block the appointment of an administrator.[28] The old framework enacted in Part II of the Insolvency Act set out the 'purposes of administration' in section 8, these being the survival of the company, the approval of a CVA, the sanctioning of a scheme of arrangement under companies' legislation as well as a more advantageous realization of assets in a winding up. Administration was viewed as leading somewhere, not just to the company being rescued but also, because of the facility offered to manage a company, to some other procedure being successfully implemented. The new framework for administration was introduced by the July 2001 White Paper,[29] which set out reforms to corporate and personal insolvency subsequently enacted in the Enterprise Act 2002. The reforms reflected concerns about the position of unsecured creditors, the need to streamline administration as a rescue tool and the importance of collective insolvency procedures as opposed to private recovery methods like receivership. Despite great opposition from lenders, the Government saw it as being desirable to promote administration and restrict receivership. However, the holder of a floating charge would be given a part to play in the administration proceedings through appointment of the administrator and a new purpose for administration being introduced specifically tying proceedings to a benefit for secured creditors. The new purposes are stated as being the rescue of the company as a going concern, achieving a better result than liquidation as well as realizing property to make a distribution to secured or preferential creditors, thus akin to the function of a receiver.[30] The impact of the changes may be seen as providing a greater focus on rescue, the feeling under previous arrangements being that the continued existence of receivership was incompatible with notions of rescue, the fact being that what was often left after receivership was so slight so as to make liquidation inevitable, thus putting the unsecured creditors in an especially vulnerable situations. Costs of receivership were also an issue of public concern. When the Government decided to tip balance firmly in favour of rescue, by restricting the right to appoint an administrative receiver,[31] it ushered in an emphasis on the collective nature of proceedings. This is a position that might at first be seen as inimical to the position of secured creditors. However, the capacity for intervention by this type of creditor in administration proceedings and the initiative given to them restore the balance somewhat. To that extent, their position is an acceptable compromise given the some say inevitable removal of receivership. It also enhances the involvement of the collective in decision-making, a position that is not dissimilar to the need in informal workouts for a concerted stance to be taken by creditors involved in a standstill arrangement. Nevertheless, it is clear that in the United Kingdom, there remains a conceptual difference between the two types of formal procedure and only the CVA attempts to provide a framework for the type of debtor–creditor negotiation that is similar to that seen in the context of the informal workout. To that extent, this dichotomy reflects the view taken by the World Bank that there remains a need for differentiation between these processes so as to provide for varying circumstances affecting the debtor. This seems to be very different from the position in France that will apply with the adoption of a new insolvency law expected to occur in 2005.

Modern reform of French insolvency law began with a text introduced in 1984,[32] which promoted pre-insolvency arrangements in the shape of '*règlement amiable*'.[33] This featured the appointment by courts of a nominee to serve as a focus for negotiations between the debtor and creditors with a plan being

Notes

28 These problems have now been addressed by an informal procedure for appointment by directors and floating charge holder.

29 Productivity and Enterprise – Insolvency: A Second Chance (Cm 5234).

30 Rule 3, Schedule B1 of the Insolvency Act 1986 (as amended).

31 New sections 72A–H of the Insolvency Act 1986 (as amended).

32 Law no. 84-148 of 1 March 1984 ('Law of 1984'), now in Book 6 of the Commercial Code 2000.

33 Amicable settlement.

submitted at the end of a period of three months to a court for validation. Two further laws passed in 1985 dealt with the law and institutions of insolvency and the introduction of a new regime governing insolvency practice respectively.[34] The purpose of the new legislation was firmly set as being threefold: the rescue of the firm, the continuation of business activity and employment and, finally, the settlement of debts. A rescue procedure was instituted, characterized by a three-step approach. An opening phase would be followed by an observation period, during which the activity and health of the business would be monitored and throughout which the collection of assets and the preservation of the company's activity would be carried out. The process would end with the adoption of a rescue plan, providing for either the continuation of the business or its sale as a going concern. The outcome in the event of the failure of rescue would be liquidation, which would also be an option ab initio for businesses presenting a profile that indicated prospects for recovery were bleak. The Laws of 1984 and 1985 were the subject of a further reform in 1994, based on the recognition that the Law of 1985 represented a movement towards a greater priority for rescue and was more pro-debtor in nature, running counter to the philosophy behind previous legislation seeking to maximize debt-recovery for the benefit of creditors.[35] As a counterpoint, the Law of 1994 was dedicated to redressing the balance between the interests of the debtor and its creditors. A further reform initiative was precipitated by scandals affecting insolvency practitioners and the Commercial Courts, prompting the Ministry of Justice to issue a paper in early 1999 entitled '*document d'orientation préparatoire*',[36] containing quite detailed substantive changes to insolvency law, including improving the efficiency of insolvency law procedures through better diagnosis and prevention of financial difficulties at a stage before the formal onset of insolvency, the informal treatment of business difficulties through compositions and agreements with creditors, the proper supervision of rescue plans and the simplification of liquidation procedures. The final phase in the reform initiative, which was much delayed by ongoing reforms in general commercial law, saw the production of a discussion text in late 2003, which was rapidly replaced by a later version produced in early 2004, which contained a number of new proposals, including the introduction of a new procedure called '*sauvegarde*'.[37] This in turn was superseded by a final draft produced on 12 May 2004, which has formed the basis of the working text introduced into Parliament.[38]

The substantive changes affecting pre-insolvency arrangements, apart from a change in nomenclature, which will see the current term replaced by 'conciliation', include making the outcomes of the process more secure, with transactions occurring as a result of the negotiations or the eventual agreement being immune from attack in any subsequent insolvency proceedings by reason of the debtor being in cessation of payments, the formal pre-requisite for triggering insolvency proceedings.[39] The conclusion of an agreement and its subsequent validation by the court will raise a conclusive presumption that cessation of payments has not occurred and that any contracts and security may not subsequently be rendered void by deeming them to have occurred within a relation-back period. This development also ties in with the new definition of eligibility for the opening of proceedings, which will allow debtors to have recourse to conciliation within forty-five days of cessation of payments occurring. With a view to ensuring the success of any agreement, new payment priorities are to be instituted so that parties who provide new funding will be paid in priority to creditors relying on debts acquired prior to the opening of proceedings or even those arising post-commencement. The text also addresses one of the concerns that banks and financial institutions have raised about '*soutien abusif*',[40] a doctrine that deems a credit-provider liable to other creditors for providing funds that lead to the continuation of business activity later deemed unlawful. The reasoning employed by the Explanatory Memorandum for changes here is that the information provided to all parties for the purposes of negotiating an agreement puts all parties in the best negotiating position possible.[41] It would thus be iniquitous and unreasonable to allow the creditors to invoke a right to pursue a fellow creditor on the basis that previous

Notes

34 Law no. 85-98 of 25 January 1985 ('Law of 1985') and Law no. 85-99 of 25 January 1985, now in Books 6 and 8 respectively of the Commercial Code 2000.

35 Law no. 94-475 of 10 June 1994 ('Law of 1994').

36 Preparatory orientation document.

37 Preservation.

38 At time of writing, the law has completed its first stage in the National Assembly and is before the Senate for debate.

39 Exposé des Motifs (Explanatory Memorandum) at 5–6.

40 Improper support.

41 Exposé des Motifs at 6.

financing arrangements seemed to give a misleading impression of the debtor's financial status except where fraud and manifestly improper behaviour were features of the case.

The core of the reform project is the new procedure of '*sauvegarde*', the provisions dealing with which being grafted onto the existing section containing current provisions dealing with rescue. A new and smaller rescue procedure will remain available and the two procedures will have many features in common. The logic in retaining rescue, albeit in a smaller form, is two-fold. The Government are of the view that the diagnosis and prevention measures highlighted in the 2004 text will not be able to deal with the problems of all firms. In fact, it is probable that many firms will not, for good reasons, be able to accurately forecast their difficulties and may miss the opportunity for conciliation or '*sauvegarde*'. The availability of a rescue option is thus a sensible alternative to having to liquidate these firms. The most profound change to this set of provisions is that, in order to qualify for '*sauvegarde*', the debtor must not be in a state of cessation of payments. However, the debtor must be able 'to justify [being in] difficulties capable of leading to a cessation of payments'. The effect is to shift the emphasis on rescue in its broadest sense to a time before the debtor becomes unable to meet its contingent liabilities. For that reason, '*sauvegarde*' has been called an 'anticipatory rescue procedure'.[42] '*Sauvegarde*' is conceived as a type of debtor-in-possession procedure which permits the management to stay in charge and help resolve the problems facing the business. Where the business meets a threshold requirement, an administrator may be appointed in an advisory capacity. The procedure will carry with it an automatic moratorium and will allow the debtor to propose a plan with the assistance of its creditors with view to a reorganization of the business, the plan subsequently being validated by the courts. The voluntary (and thus non-coercive) nature of the procedure is underlined by two elements, the first being that the plans will generally be of a continuation-type, one of the two options available under the Law of 1985, and will not usually allow for the sale of assets or of the business itself. Nevertheless, parts of the business may still be sold if they constitute autonomous and separately viable units with new provisions ensuring that any such sales will be free of the opportunity for fraud. This limitation to a continuation-type plan is designed to ensure that directors of potentially insolvent companies are given the incentive to seek help early and will so act if they do not face the possibility of their companies being sold underneath them. The second element is that the courts will lose the right ex officio to remove directors from office on grounds that this may be essential to the survival of the business, this provision often being used under the Law of 1985 as a quasi-sanction. The '*sauvegarde*' procedure is expressly designed to serve as part of an overall negotiation strategy between the debtor and creditors leading to the conclusion of a plan with common objectives, thus underlining its essentially co-operative nature. Approval by creditors is to be signified through the constitution of two committees, representing financial institutions and principal suppliers respectively. The interests of unrepresented creditors will be considered when any agreed plan is presented to the court for validation. The objective is that the debtor-in-possession, assisted, it being the case, by an administrator, will present a draft to these committees for their views, the subsequent exchanges of opinion and observations contributing to the final draft submitted to court. A positive vote by both committees is required for the plan to make it into court for validation and validation will be normally accompanied by the appointment of a supervisor to oversee the implementation of the plan. The Explanatory Memorandum makes it clear that these proposals are designed to encourage durable restructurings and reorganizations and to allow for credible negotiations to take place involving creditors in the rehabilitation of their debtor.[43]

What is interesting about the French proposals is that it is intended that formal and informal measures be available at a stage prior to formal insolvency. In theory, it will be open to debtors to select the scheme that best represents the opportunity for rescue or reconsolidation. In practice, it is felt that the formalism inherent in the new procedure of '*sauvegarde*' is so similar to that of rescue that there will be an attraction to debtors to choose this from the standpoint of liability, given that the sanctions regime in France is a particularly heavy one. As a result, the more informal regime, similar to the CVA in operation, which already sees a low rate of take-up, may be further sidelined. This does not augur well for the informalization of insolvency procedures or indeed for the likelihood that French debtors would use informal processes outside the scope of the law. Nevertheless, it is also evident that the reforms to pre-insolvency measures clearly take on board issues highlighted in the World Bank Report such as the need to examine whether creditors are adversely affected, validation as a method for binding recalci-

Notes

42 See P-M. Le Corre, 'Présentation générale du projet de réforme des entreprises en difficulté: de l'avant-projet au projet de loi de sauvegarde des entreprises' *Gazette du Palais* 2004.56-57.4 at 6.

43 Exposé des Motifs at 7.

trant creditors and the issue of financing during the rescue stage.[44] This may in fact contribute towards making this procedure quite attractive, subject to the caveats already mentioned. The articulation between all these procedures will bear close scrutiny when the reforms are in place and they are tested before the courts. Nonetheless, the impact of this reform initiative is to blur the boundaries between formal and informal procedures, albeit to the advantage of the debtor in having more choice of the procedure appropriate to its needs.

Summary

The ideal position for creditors to be in is one where they have adequate security, are guaranteed priority and where the focus on the resolution of any problems with regards to the lending contract or contract for the provision of goods or services is firmly based in the law of contract and articulates with the maximum permitted freedom for contractual principles to dominate. This, most creditors would argue, enhances the availability of lending and supply and is, for them, the most economically efficient outcome, one in which the element of risk can be nearly wholly quantified. In this arena, there would also be the greatest opportunity for creditors to avoid or delay the application of formal insolvency procedures through a benevolent use of the laissez-faire principle. The reality, however, is that creditors have ostensible security: security that is to all intents and purposes effective and that is immune to most challenges. Nevertheless, courts can creatively and in the pursuit of other principles of law deem the underlying contractual framework to be ineffective at protecting the right in question. In most instances, courts are cautious and will not unnecessarily promote a situation in which the result is uncertainty for participants in that framework. Yet, overreaching and involuntary subordination through the judicial promotion of a competing interest can occur to frustrate pre-existing contracts. What results, often for quite good reasons, is a movement away from the single or limited creditor's interest towards a collective outcome, one in which elements of tyranny can predominate. The position of the otherwise secured creditor is vulnerable if the courts for any reason are determined not to give effect to that security.

The advantages of informal resolution of the process are well-known. Contractual resolution is the preferred outcome and it is generally participative, although there is a debate as part of the formulation of principles governing workouts in Asia about limiting participation to financial creditors and possible extension to trade creditors. The opportunity to negotiate outcomes that take account of the possibility of rescue and yet attempt to preserve as far as compatible the position of creditors is one that creditors would wish to take. Law in this respect could be more facilitative. Other advantages of informal resolution are the relative speed, flexibility and informality of the process. Provided there is access to good legal advice and financial planning, something which may differ from jurisdiction to jurisdiction, the drafting of a plan is relatively straightforward. Disadvantages that can arise in this process, however, include securing the consent of all creditors whose participation is essential, the difficulties of articulating the necessary compromise as part of the negotiation of the final contractual documents and the voluntary nature of any standstill agreement, particularly vulnerable if creditors have a sudden attack of panic about their debtor's fate. Paradoxically, speed and informality might lead to debtors and creditors being railroaded into a solution, while advice and access to advice must be as impartial as possible so as to avoid later challenges based on duress, coercion or even unequal bargaining power. Yet, overall, informal processes are perceived very favourably by creditors and debtors alike and their development over the past two decades has allowed for a great deal of expertise to build up in their operation, which continues to be flexible enough to be adaptable to the individual needs of the debtor enterprise. It is perhaps a lack of expertise that explains why, in many developing jurisdictions, the emphasis has turned to attempting to provide a framework of rules by which these informal processes can be conducted. The World Bank and ADB have both provided a useful lead in this regard by formulating a set of conditions and principles to guide those keen on seeing the introduction of informal processes in their own jurisdictions. Some Governments, taking this a stage further, have instituted state-led or state-sponsored schemes, such as Danaharta in Malaysia, to assist the rehabilitation of firms particularly at risk from the global tide of recession. It remains to be seen whether this type of state-sponsored rescue will have the desired effect. However, one of the key advantages in pursuing this type of process is that it provides a ready made system or facility for developing jurisdictions without a history of informal workouts. Nevertheless, there remain concerns about the level of legal and administrative training that may be necessary as part of the process of 'acclimatization' to these procedures.

As for formal procedures, the perceived wisdom is that they are good at promoting consideration of the wider interest. In an era when stakeholding has

Notes

44 World Bank Report at 19–20 and 23–24.

entered corporate consciousness, this same concept is making inroads into insolvency law by promoting the collective ideal and resolution of the insolvency in the collective interest. Although the promotion of some consensual outcomes is provided for, notably through voluntary arrangement-style procedures, most outcomes are judicially imposed. Here, the relative training and expertise of judges in insolvency matters becomes an issue and may need to be addressed in jurisdictions without an active history of curial involvement in insolvency matters. Access to experience and the availability of appropriate fora may also be issues that will concern developing states. Judicial expertise also becomes important when one talks about judicial flexibility and creativity in finding outcomes to particularly complex and difficult cases. Formal procedures can enjoy relative speed and the tendency towards tightening time limits and strong case-management by courts is a positive step towards enhancing the attractiveness of a formal solution. Nonetheless, formal processes have drawbacks, not least of which is the potential for court proceedings to engender costs that reduce amounts available for distribution to creditors and/or reinvestment in rescue. Furthermore, proceedings can be cumbersome and lead to inordinate amounts of appeals and challenges before a final determination can be reached. In some systems, even when a rescue plan has been adopted, there is often a long delay in its overall implementation and the chance of reduced prospects for creditors unwilling to wait except over the very long-term. Finally, formal procedures, although conferring the vital element of curial scrutiny absent from many informal processes, can become subject to prevailing orthodoxies in the courts that may be dissonant and difficult to reconcile with developments in practice.

From the developments in both fields of formal and informal processes, an argument may be made that some form of convergence is occurring, in that informal processes are acquiring a veneer of predictability by the development of principles and guidelines, while formal processes are taking on board the ideals of participation, in which creditors and debtors alike work towards the reestablishment of the failing business. These developments are consonant with the idea of promoting the value of contract as a potential resolution mechanism and are in keeping with the doctrine of laissez-faire. A consensual outcome is viewed as optimal for participants. Indeed there could be a control of undesirable outcomes through either the negotiation process itself or its subjection for resolution by an agreed third party, which is the essence of those mediation and ADR techniques that are making an appearance in the insolvency field. The use of courts here as a mechanism for validation would avoid many of the pitfalls to which creditors might unwittingly fall subject. In essence, formalizing informal processes achieve that object by crafting a principled framework to guide participants into resolving disputes by the use of contractual outcomes that meet with predetermined criteria of validity, again avoiding many otherwise unforeseen challenges to negotiated outcomes. The advantage of such a convergence would be in making available ready-made systems for use in developing states through outline rules and guidance. Perhaps in this way, the spread of the rescue culture might be strengthened through making access to rescue a feature of the domestic justice system. Further steps could include, as the World Bank suggest, the pioneering of diagnostic and insolvency avoidance tools to assist entrepreneurs in preparing, as far as humanly possible, for the vicissitudes of the market. This would eventually lead, it is hoped, to the equalization and potential diminution of risks for all participants.