INSOL INTERNATIONAL

FINANCING IN INSOLVENCY PROCEEDINGS

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International Association of Restructuring, Insolvency & Bankruptcy Professionals

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An insolvent debtor's ability to raise new funds from the credit market is a key factor in determining whether it can be reorganised successfully. For this debtor it may be especially difficult, and yet nonetheless essential, to obtain sufficient working capital so as to carry on business activities and to emerge from insolvency.

To encourage lending to insolvent debtors, the insolvency laws of some countries allow "new" lenders an almost risk-free super priority status over the assets. This raises several controversial issues, including whether post-insolvency financing can lead to excessive investment in high-risk projects. And should insolvency laws intervene in the credit markets of a country? Supporters of post-insolvency financing say that reorganisation is more value enhancing to the insolvent debtor in the long term than liquidation and should therefore be encouraged. It is also known that companies receiving new funds are more likely to have a shorter reorganisation period and to emerge more quickly.

Clearly, this is a hot topic. INSOL has decided that information on this subject could be useful to its members. A range of practical issues on post-insolvency financing appears in this publication and we hope you find the information useful as well.

I would like to express our heartfelt thanks to Lars Westpfahl of Freshfields Bruckhaus Deringer, Germany, the project co-ordinator, for his assistance and we are appreciative of the time he has devoted to guiding this publication.

Sijmen de Ranitz
President
INSOL International

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Foreword

Restructuring laws are currently going through a period of dramatic change. In a significant number of jurisdictions, over the past couple of years, insolvency regimes have been modernised and the key trend is to facilitate the rehabilitation of an insolvent debtor. To that end, specific restructuring procedures have been introduced or at least new elements such as (US Chapter 11 style) reorganisation plans or the availability of a debtor-in-possession status.

As these new provisions are intended to help stabilise and continue troubled businesses, in-court financing becomes more relevant and important.

At the same time, mostly Anglo-Saxon distressed debt investors begin to operate globally. Being familiar with US Chapter 11 and its workings they are willing to provide liquidity post-petition and therefore speed up the process of testing the new restructuring laws around the globe. It is against this background that this publication is indeed about a “hot” topic.

Like always when INSOL undertakes to give a cross-jurisdictional overview, it has been a challenge to put together a framework questionnaire that is suitable for a variety of legal systems such as common law on the one hand and civil law on the other. We do hope however that the outcome is being viewed as a helpful comparative international analysis for those dealing with the topic of financing in insolvency proceedings.

Some major expressions of gratitude are necessary. Thank you indeed to the contributors of the material set out below – without their hard work and dedication we would literally have had no work product. Thank you as well to my colleague Riaz Janjuah who shouldered the main burden of organisation and driving the project forward.

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Australia

1. Briefly summarise the types of insolvency proceedings available in your jurisdiction and indicate, in each case:

(a) The extent to which the debtor remains "in possession";

(b) Whether or not a specialist insolvency professional is likely to be appointed and, if so, a summary of his powers;

(c) The role of the court in the process.

The Australian law relating to corporate insolvency is set out in Chapter 5 (External Administration) of the *Corporations Act 2001* (Cth) ('the Act') and relating to personal bankruptcy is set out in the *Bankruptcy Act 1966* (Cth).

There are three principal corporate insolvency regimes in Australia:

Receivers and Managers ("receivers") (Chapter 5.2 of the Act)

A receiver takes control of a debtor's property and realises that property for the benefit of the person entitled to that property. The appointment can be privately by a secured creditor or by the Court. The latter it is increasingly rare.

A receiver must be registered to act as a liquidator. A person can only be registered as a liquidator if they have certain qualifications and experience as insolvency practitioners.

To the extent that a receiver has control of the assets and affairs of the company, the directors of the debtor cannot act.

The most common form of appointment is by a charge holder (often a financial institution) over the property the subject of the charge following a default by the debtor.

A receiver takes possession of and administers the property covered by the charge. Under a fixed and floating charge this could be the entirety of the assets and undertaking of the debtor. A receiver and manager will also manage the affairs of the debtor. A receiver generally has wide powers conferred under section 420 of the Act and the terms of his/her appointment.

Typically, the receivership will continue until the purpose of the receivership is fulfilled. Mostly that is when the assets the subject of the charge have been sold or the financier repaid.

The receiver is the agent of the debtor and not of the appointing creditor (unless the debtor is concurrently in liquidation). The receiver is generally not concerned with the general body of creditors (other than employees who have a limited priority over the charge holder). This is very different from the position of an administrator or a liquidator, which emphasise that creditors are to participate rateably.

The Court generally has no supervisory role of a privately appointed receiver, although a person affected by a breach of duty by a receiver can seek an appropriate remedy from the Court. This may include an order that the Court inquire into the conduct of the receiver under section 423 of the Act.

A Court appointed receiver is an officer of the Court and is obliged to obey the directions of the Court. The range of powers conferred by the Court varies with the nature and purpose of the appointment. Court appointed receivers who have doubt about the extent of their powers or duties may apply to the Court for directions.

Voluntary administrators and deed administrators

An administrator may be appointed by:
- the directors of a debtor company;
- a charge holder; or
- by a liquidator or provisional liquidator of the debtor.

The object of the regime is for a debtor to be administered in a way that maximises the chance of the debtor continuing in existence or, if that is not possible, results in a better return for creditors and members than would result from an immediate winding up.

A person cannot act as an administrator (or deed administrator) unless he/she is registered to act as a liquidator. During administration, the powers of the directors are suspended. Only the administrator may deal with the debtor's property. Subject to some exceptions, the Act imposes a moratorium on enforcement action against the debtor. Also, the powers of charge holders and lessors are limited during the administration period. The administrator is personally liable for most debts incurred during the administration period. Even so, a security holder who has security over all or nearly all of the assets of the company, is able to enforce its security within a short period of the commencement of the administration, or later with the consent of the administrator or leave of the Court.

The administrator must convene two meetings of the company's creditors. At the first meeting the creditors may replace the administrator and/or decide whether to appoint a committee of creditors. At the second meeting the creditors may vote on the future of the debtor.

Creditors vote on one of three outcomes from the administration:

- the debtor executes a deed of company arrangement;
- the administration ends and control of the debtor is returned to its directors; or
- the debtor is wound up.

A deed of company arrangement is a flexible instrument for rearranging the affairs of a debtor. A deed can be proposed by any interested party. Typically the proposal is from one or more directors seeking to avoid liquidation. Most proposals attempt to provide a better return to creditors than would be paid in a liquidation. Control of a debtor subject to a deed of company arrangement may rest with the directors or with the deed administrator depending on the terms of the deed. Once a company executes a deed of company arrangement it ceases to be in administration and the administrator generally becomes the deed administrator.

Administration has a very limited supervisory role for Courts as the decision making power rests with creditors. However, subject to the general moratorium described above, creditors aggrieved by an administration or by a deed of company arrangement may seek an appropriate remedy from the Court.

Liquidators

Liquidation (or winding up) is the process undertaken by a liquidator to realise the assets of a debtor company for the benefit of creditors and members. A liquidator can be appointed by a Court, by the members of the debtor or following a voluntary administration. Once a liquidation is complete the debtor is de-registered as a company and ceases to exist.

A provisional liquidator may be appointed by the Court to preserve the status quo until the Court determines whether or not the debtor should be wound up.

In most cases, liquidators and provisional liquidators must be registered. There is an exception in the case of a liquidator of a solvent winding up of a proprietary company.

The liquidator's role is to turn the assets of the debtor into cash to be distributed amongst its creditors and, if creditors are repaid in full, as a return of capital to the debtor's shareholders. The liquidator also has a number of statutory rights to avoid some pre-liquidation transactions such as unfair preferences and uncommercial transactions. These are measures intended to ensure that all creditors are treated equally.

Additionally, a liquidator may seek to recover money from directors who allow the debtor to incur debts whilst insolvent. A similar claim can be made against the holding company of a debtor.

A secured creditor (such as a charge holder or mortgagee) may have priority rights to the proceeds of any assets the subject of the security. Any surplus from those assets, or any assets not subject to a security interest, are shared between creditors in a strict order of priority. The priority rules in the Act are complex but, in summary, the costs of the liquidation come first, followed by employee entitlements and then ordinary unsecured creditors.

Liquidators are subject to Court supervision if it appears to the Court that the liquidator has not faithfully performed or is not faithfully performing his or her duties or has not observed or is not observing a requirement of the Court, the Act or regulations or rules made under the Act; section 536 of the Act.

Liquidators, provisional liquidators, administrators and deed administrators all have powers to seek formal examinations of "officers" of the debtor and others who may hold relevant documents or information.

2. Are lenders permitted to refuse to continue lending because of the insolvency proceedings?

The obligations of a lender to a debtor are governed by the terms of the loan contract between the lender and the debtor. Commercial loan contracts almost universally provide that it is an event of default for a borrower to experience an insolvency event such as the appointment of a liquidator, administrator or receiver.

There are no statutory provisions that limit a lender's contractual rights except that a secured creditor cannot generally enforce against a debtor that is in voluntary administration. The general rule does not apply if the lender holds security against all or nearly all of the property of the debtor and acts within a short period after the appointment of the administrator (known as the "decision period"). Nor does it apply if the secured creditor has the consent of the administrator or the leave of the Court. In those circumstances a secured creditor can act to appoint a receiver, however the secured creditor must do so within 10 days of the administrator's appointment (or later obtain the written consent of the administrator or leave of the Court).

3. Alternatively, can the borrower require the lender to continue to advance previously committed but undrawn amounts?

The same considerations, as stated in the answer to question 2 apply.

The obligation of a lender to continue to advance a previously committed but undrawn amount is, again, determined by the contract between the loan debtor and the lender.

Most commercial loan contracts will require the debtor to provide a certificate (or similar) prior to any loan draw down. That certificate will contain a representation that the debtor has not experienced an insolvency event. If the representation cannot be made by the debtor then the lender will generally not have any obligation to make additional advances under the loan contract.

4. Are there specific provisions for lending in any of your insolvency proceedings? If so, provide details, including the text of any statutory provisions.

A receiver has power "to borrow money on the security of property of the corporation": section 420(2)(d) of the Act. The exercise of this power is subject to the terms of the receiver's appointment.

A liquidator has power to "obtain credit, whether on the security of the property of the company or otherwise": section 477(2)(g) of the Act. However, the exercise of this power must be seen in the light of the liquidator's role of realising the debtor's assets in a winding up. Further, the liquidator must obtain the leave of the Court or a resolution of the committee of inspection or of the creditors if the performance of the contract is to take more than 3 months: section 477(2B) of the Act.

The terms of the borrowing are a matter for private contractual arrangements. A prudent lender will ensure that the security arrangements are sufficient to ensure repayment of the loan.

5. In the absence of a specific provision, is there any ability for a company to obtain financing when it is in an insolvency proceeding?

There are no specific provisions in the Act relating to the ability of an administrator to cause the debtor to borrow. An administrator has the general power to "perform any function, and exercise any power, that the company or any of its officers could perform or exercise if the company were not under administration": section 437A. This general power would include a power to

cause the debtor to borrow money but it would be unusual for an administrator to do so.

6. Is there any mechanism for the court to approve the financing by a company/officeholder in an insolvency proceeding? If so, is there protection for lenders against reversal or modification of court authorisation for borrowing available?

The Act contains no specific provision relating to Court approval of a borrowing by a debtor subject to an insolvency appointment. However, a liquidator, a provisional liquidator, an administrator, a deed administrator and a receiver have the power to approach the Court to seek directions from the Court. The Court will give directions on matters of law and will not generally give directions on matters of commercial judgment. The terms of the borrowing by the debtor are generally regarded as a matter of private contract with the lender and, therefore, a "commercial" matter so that Court sanction will rarely be forthcoming.

7. In an insolvency proceeding, are there provisions governing the extension of credit in the ordinary course of business (e.g., trade credit)? If so, what protections are available to the extender of credit?

Liquidators and administrators have power to carry on the business of the debtor over which they have been appointed. Depending on his/her powers, a receiver may have powers to carry on the business of the debtor over which he/she has been appointed.

Both receivers and administrators are personally liable for most debts incurred for services rendered, goods bought and property hired, leased, used or occupied during the receivership or administration: sections 419 and 443A of the Act, respectively.

There is no equivalent of sections 419 and 443A for liquidations. However, the costs of carrying on the debtor's business is a claim paid in priority to the claims of other unsecured creditors (including the remuneration of the liquidator): section 556(1)(a) of the Act. A prudent liquidator will ensure that there are sufficient funds available to pay post-liquidation debts. In limited circumstances, a liquidator can be personally liable for debts incurred after his/her appointment.

8. Outline the ranking of financing provided to company/officeholder in any applicable insolvency proceeding. Discuss the comparative position of any such borrowings with respect to:

(a) Pre-proceeding liabilities;

(b) Expenses relating to the proceeding in question, including the expenses of the officeholders;

(c) The costs of any committee of creditors which is required or established as a matter practice in any particular procedure and the expenses of any such committee.

Secured creditors generally rank in priority over all other creditors but only in relation to assets over which they have security (subject to the priority of employees of the debtor out of floating charge assets) and to some claims by insolvency practitioners in preserving and selling those assets.

Priority arrangements for unsecured creditors (other than priority unsecured creditors) are generally irrelevant to receivers—their role is to realise the debtor's assets for the benefit of their appointor (usually a secured creditor). Under section 433 of the Act certain priority unsecured creditors (being principally employees) rank in front of secured creditors out of the proceeds of floating charge assets. Further, a payment made to the debtor under an insurance contract must be paid to the third party to which the insurance payment relates. There may be priority arrangements between secured creditors and they will usually be recorded in private contractual arrangements between the secured creditors.

An administrator's role is not to pay out amounts due to creditors at the date of his/her appointment. Administration is intended to provide a pause to enable the administrator to take stock of the debtor's financial position. During that pause (subject to some exceptions) creditors are unable to take enforcement action against the debtor and the administrator is not obliged to pay debts owing. The administrator is personally liable for the trading debts he/she incurs during the course of the administration.

If a debtor in administration moves to being subject to a deed of company arrangement or being wound up the priorities of unsecured creditors will be paramount. A deed of company arrangement will make provision for unsecured creditors to be paid some or all of the debts owed to them. The order of priority under a deed of company arrangement is usually the same as the order of priority that would apply if the debtor were being wound up. The creditors may vote to accept a deed of company arrangement that has a different order of priority to that applying in a winding up providing that no creditor is unfairly prejudiced by the proposed order of priorities.

The priority arrangements for creditors of debtors in liquidation are set out in Part 5.6 Division 6 Subdivision D of the Act. The claims of unsecured creditors rank equally except where the Act provides otherwise. Section 556 of the Act accords certain unsecured creditors priority over other unsecured creditors. In very general terms that order of priority is:

i. The costs of the liquidation (including the liquidator's remuneration and expenses);

ii. The costs of any previous administration or deed of company arrangement (including the administrator's or deed administrator's remuneration and expenses);

iii. The costs of the committee of inspection;

iv. Employee's wages and superannuation contributions claims;

v. Amounts due by the debtor to employees in respect of personal injuries; and

vi. Other employee entitlements.

Where the debtor is liable to a third party and the debtor has received a payment under an insurance contract corresponding to that liability, then the insurance payment must be paid to the third party outside the above priority arrangements. Similar provisions apply in relation to reinsurance arrangements.

After the above priorities all creditors generally rank equally in a winding up.

9. Matters relating to security

(a) Can a company/officeholder in any of your insolvency proceedings grant security?

(b) Can a company/officeholder in an insolvency proceeding obtain priority to any pre-existing security? If so, what is the test for adequate protection of the security holder?

A liquidator has power to "obtain credit, whether on the security of the property of the company or otherwise": section 477(2)(g) of the Act. A receiver has power "to borrow money on the security of property of the corporation": section 420(2)(d) of the Act. Both of these powers are exercised by the liquidator or receiver in the name of the debtor company.

An administrator has the general power to "perform any function, and exercise any power, that the company or any of its officers could perform or exercise if the company were not under administration": section 437A. This general power would include a power to cause the debtor company to borrow and grant security.

Priority arrangements between secured creditors are essentially a matter of private contractual arrangement, failing which the first in time has priority. There is nothing preventing secured creditors of a company in administration, receivership or liquidation from agreeing to alter priority arrangements between themselves.

As a general rule a receiver or liquidator does not obtain priority to any existing security. However, as described above, certain classes of unsecured creditors will rank in priority in relation to the proceeds of floating charge assets and insurance payments. These priority amounts may pass through the hands of the insolvency appointee. Further, as a general rule, a secured creditor must bear the costs of preserving and realising his/her security. Consequently, if a secured creditor does not enforce and allows a liquidator to realise a secured asset, the secured creditor must pay the liquidator's costs of realising that asset.

An administrator is entitled to be indemnified out of the debtor's assets for the debts for which he/she is personally liable and for his/her remuneration. This right of indemnity has priority over debts of the debtor secured by floating charge assets unless the chargee appoints a receiver over the floating charge assets or enters into possession of those assets.

10. Can a secured creditor roll over pre-petition loans into post-petition lending?

This is a matter regulated by the contract and negotiations between the lender and the debtor. There are no specific statutory provisions.

11. Are the directors/officeholders personally liable for post-petition borrowings (unless otherwise agreed)?

Generally no.

Receivers and administrators are only personally liable for debts incurred for services rendered, goods bought and property hired, leased, used or occupied: sections 419 and 443A of the Act, respectively. They are not personally liable for post-appointment borrowings of the debtor (unless otherwise agreed with the lender).

A liquidator has power to cause the debtor company to borrow: section 477(2)(g) of the Act. The liquidator would not be liable for post-appointment borrowings of the debtor (unless otherwise agreed with the lender).

12. Can affiliated debtors be treated as one consolidated entity for post-petition financing purposes?

This is a matter of private contractual arrangements between the lender and the affiliated debtor companies.

13. Outline any developed practices other than statutory or regulatory provisions that go beyond the legal framework.

There is a general practice that a secured creditor will not seek to appoint a receiver within the "decision period" after the appointment of a voluntary administrator if the voluntary administrator gives a general consent to the secured creditor taking enforcement action at a later stage. This practice has the advantage that secured creditors do not appoint a receiver in haste following the appointment of a voluntary administrator, thus stifling the possibility of the voluntary administration process saving the debtor or one of its businesses.

Brazil

1. Briefly summarise the types of insolvency proceedings available in your jurisdiction and indicate, in each case:

(a) The extent to which the debtor remains "in possession";

(b) Whether or not a specialist insolvency professional is likely to be appointed and, if so, a summary of his powers;

(c) The role of the court in the process.

Insolvency proceedings in Brazil are governed by Law No. 11,101, the Bankruptcy Law[1]. The Bankruptcy Law provides for a liquidation proceeding ("Bankruptcy") and for two forms of reorganization: (i) a court-supervised reorganization procedure known as "Judicial Restructuring" and (ii) an out-of-court reorganization procedure known as "Extra-judicial Restructuring".

Bankruptcy

Creditors may petition to have a debtor declared bankrupt. Bankruptcy may also be voluntarily commenced by a debtor, should reorganization be unfeasible.

If a debtor is declared bankrupt, a liquidation proceeding shall begin. In a liquidation the debtor's assets are scheduled and liquidated, and the proceeds distributed to satisfy creditor claims, pursuant to an order of preferences established in the Bankruptcy Law.

In the decision declaring a debtor bankrupt, the judge shall pronounce with respect to the provisional continuation of the business or the sealing off of the establishment. In any event, in a liquidation the debtor does not remain in possession. The judge shall appoint a judicial administrator upon the declaration of bankruptcy and such judicial administrator shall have essentially the same duties as a trustee, including the authority to represent the bankrupt estate before government entities and initiate litigation against third parties. That is, it will manage the bankrupt estate/company until its liquidation is complete. Pursuant to the Bankruptcy Law, the judicial administrator shall be a reputable professional, preferably a lawyer, economist, business manager or accountant, or a specialized legal entity.

[1] Insolvency proceedings in Brazil were governed by Decree-Law No. 7,661 since 1945. However, after nearly 12 years of discussions in the Brazilian Congress, and as a result of the efforts of law practitioners, economists, politicians and the civil society as a whole, a new bankruptcy law (Law No.11,101/2005) was enacted by President Luiz Inácio da Silva on February 9, 2005, coming into effect on June 9, 2005. The new bankruptcy law introduced significant changes and improvements to the Brazilian insolvency system, which was outdated and did no longer meet the needs of the Brazilian economy..

The roles of the court in a bankruptcy proceeding are both administrative and juridical, encompassing activities such as authorizing the sale of assets, approving contracts for the use of experts, accountants and other professionals, and rendering decisions regarding the continued operation of the business. In addition, all actions of the judicial administrator are directed and supervised by the bankruptcy judge. The bankruptcy judge has absolute and exclusive jurisdiction over all the parties related to the bankrupt estate, which includes the debtor, its officers, directors, assets, secured creditors, unsecured creditors, holders of equity interests, and matters related to debtor, its assets or its relation to creditors.

The Bankruptcy Law further provides that a creditors' general meeting may be called by the judge upon the declaration of bankruptcy so as to form a creditors' committee. The creditors' committee is entitled to supervise the judicial administrator's activities and make recommendations regarding issues related to the administration of the bankrupt estate.

Reorganization

Only the debtor may propose a reorganization plan. No plan may be adopted over the debtor's objection. Consequently both a pre-pack and a judicial reorganization require the debtor's co-operation and consent.

(i) Judicial restructuring

Only a debtor may petition the court for commencement of a judicial restructuring. The petition must include a statement of the causes of the financial distress, financial statements, a listing of creditors and claims, among other information and documents.

If after reviewing the petition the court concludes it is appropriate to admit the debtor into judicial reorganization, the court will issue a decree commencing the proceeding. The decree commencing a judicial restructuring produces a 180-day automatic stay of all actions commenced against the debtor.

The debtor shall propose a restructuring plan to its creditors within the 60 days following the issuance of the court's decree commencing the judicial restructuring. The court will convene a Creditors' General Meeting to vote on the proposed plan. Should the proposed plan be rejected, the debtor shall be declared bankrupt.

In judicial restructuring, as a general rule, the debtor remains in possession, i.e., the debtor retains the right to administer its assets, and may continue to run its business under the supervision of a judicial administrator who will be appointed by the court, and under the supervision of the Creditors' Committee, should there be one. The court-appointed judicial administrator will be responsible for, among other things, managing the claims verification

process and overseeing the debtor's management of its day-to-day affairs.

The role of the judge in a judicial restructuring is the same as in a bankruptcy proceeding, that is, the primary duties of the judge are to oversee the actions of the administration of the company and to adjudicate the judicial restructuring proceeding.

(ii) Extra-judicial restructuring

Commencement of out-of-court negotiations to implement a pre-pack does not trigger an automatic stay, differently from what occurs in judicial restructuring.

A pre-pack reorganization plan may include virtually any agreement between the debtor and its creditors. If supported by a minimum of 60% of the creditors and judicially approved, a plan may be binding on all creditors affected by the plan.

In an extrajudicial restructuring, the debtor remains in possession and there is no such thing as the appointment of a judicial administrator. The primary duty of the judge is to ratify the restructuring plan.

2. Are lenders permitted to refuse to continue lending because of the insolvency proceedings?

Pre-filing scenario

The lender's right to terminate a loan on a regular (contractual) basis is not hindered by the fact that the borrower is in financial distress. The Brazilian Civil Code (Law No. 10,406) stipulates, in article 590, that the lender may request the borrower to provide guarantee of payment if, before the maturity of the loan, a notorious change in the debtor's financial situation takes place. Pursuant to legal scholars and case law, should the borrower fail to provide such guarantee, the lender may terminate the loan agreement and refuse to carry on lending. This is likely to be the case where the debtor is in financial distress or insolvent.

Post-filing scenario

(i) Bankruptcy

Under article 121 of the Brazilian Bankruptcy Law, current accounts maintained by the debtor are automatically terminated upon the declaration of bankruptcy. Accordingly, when a credit line is tied to a current account, it is automatically extinguished upon the declaration of bankruptcy.

As to credit lines arising from regular loan agreements, the decree of bankruptcy determines the early maturity of all of the bankrupt party's debts. Furthermore, in the event of bankruptcy the lender is entitled to refuse to carry on lending, at its sole discretion.

(ii) Judicial restructuring

Judicial restructuring has no effects over the agreements entered into by the debtor which, should continue to be performed on their regular basis. However, as explained above, lenders would still be entitled to terminate the loan agreement based on article 590 of the Brazilian Civil Code, alleging the change in the debtor's financial situation, should the borrower fail to provide effective guarantee of payment.

Should a lender choose to continue to extend credit to an entity undergoing judicial restructuring, all credits extended to the debtor during the course of such proceedings shall enjoy an absolute priority over all other credits, in the event of bankruptcy. Although DIP ("debtor-in-possession") financing is still an unusual practice in Brazil, this statutory preference provided for by article 67 of the Bankruptcy Law is aimed at encouraging lenders to continue to carry on lending after the filing of a restructuring proceeding.

3. Alternatively, can the borrower require the lender to continue to advance previously committed but undrawn amounts?

The same comments to question 2 above are applicable, i.e, a lender is not obliged to continue to carry on lending after the commencement of insolvency proceedings (bankruptcy or judicial restructuring). Specially when considering undrawn amounts, lenders' disposition to continue to advance amounts is likely to be even smaller.

4. Are there specific provisions for lending in any of your insolvency proceedings? If so, provide details, including the text of any statutory provisions.

The only specific provision for lending in the Brazilian Bankruptcy Law refers to the absolute preference enjoyed by post-filing credit extended to the debtor in judicial restructuring. Article 67 of the Bankruptcy Law reads as follows:

> *"The claims resulting from obligations contracted by the debtor during judicial restructuring, including those relating to expenses with goods or service suppliers and loan agreements, shall be considered post-petition claims in the event of decree of bankruptcy, with due regard, as applicable, for the order established in article 83 hereof."*

As regards to liquidation, article 84, item II, of the Bankruptcy Law provides for the same absolute repayment priority in relation to monies delivered to the bankrupt estate by creditors. Although this provision may encompass amounts delivered under arrangements other than loans, and although it refers to monies delivered to the bankrupt estate by creditors only, we understand that loans extended to the debtor by any parties (either creditors or not) shall also enjoy repayment priority in bankruptcy, provided all legal requirements are met (see question 6 below).

5. In the absence of a specific provision, is there any ability for a company to obtain financing when it is in an insolvency proceeding?

See answer to question 4 above.

6. Is there any mechanism for the court to approve the financing by a company/officeholder in an insolvency proceeding? If so, is there protection for lenders against reversal or modification of court authorisation for borrowing available?

In a judicial restructuring, as a general rule the debtor is maintained in possession of its business, which should continue to be conducted on a regular basis. This means that the debtor does not need a court authorization to engage in financing transactions which are part of the company's ordinary business. However, during the period preceding the approval of the judicial restructuring plan, any disposal of fixed assets or the establishment of guarantees are conditioned to prior court approval, the Creditors Committee having been heard (Article 66 of the Bankruptcy Law).

In addition, the law provides that should the debtor have been removed from the management of the company (which shall be the case in the event of fraud, bankruptcy crimes, and other suspect behaviors on the part of the debtor and/or its officers), not only the disposal of fixed assets or the establishment of guarantees are conditioned to prior court approval, but also any acts resulting in the increase of the company's indebtedness, such as the engagement in loan agreements (Article 27, item II, "c" of the Bankruptcy Law).

On the other hand, post-filing financings provided for under the approved judicial restructuring plan do not require court authorization since they have already received the creditors' approval.

In liquidation proceedings, in turn, should the bankrupt company have received court authorization to continue to carry on its activities on a provisional basis, under the management of the judicial administrator (as provided for in article 99, item XI of the Bankruptcy Law), financing

transactions which are part of the debtor's ordinary course of business do not require court authorization. In any event, the debtor is prevented from giving any guarantees to third parties without prior court approval (and approval of the Creditors Committee), as expressly provided in article 99, item VI, of the Bankruptcy Law.

7. In an insolvency proceeding, are there provisions governing the extension of credit in the ordinary course of business (e.g., trade credit)? If so, what protections are available to the extender of credit?

In addition to the priority given to claims arising from post-filing financing, the sole paragraph of article 67 of the bankruptcy law provides for a further benefit, for creditors who continue their relationship with the debtor during judicial restructuring. Such provision stipulates that unsecured claims subject to judicial restructuring held by suppliers of goods or services who continue to provide them normally after the petition for judicial restructuring shall have general privilege of receipt in the event of decree of bankruptcy, to the limit of the amount of the goods or services supplied during the restructuring period.

8. Outline the ranking of financing provided to company/officeholder in any applicable insolvency proceeding. Discuss the comparative position of any such borrowings with respect to:

(a) Pre-proceeding liabilities;

(b) Expenses relating to the proceeding in question, including the expenses of the officeholders;

(c) The costs of any committee of creditors which is required or established as a matter practice in any particular procedure and the expenses of any such committee.

As mentioned in the answer to question 4 above, post-filing financing enjoys a super-priority in terms of repayment, under articles 67 and 84 of the Bankruptcy Law. However, such super-priority claims still rank below restitution's (the return of assets which do not belong to the estate) and the payment of labor-related claims of a strictly salary nature (i.e., claims falling due during the three months prior to the decree of bankruptcy, to a limit of five minimum wages per worker). Such labor claims of a strictly salary nature shall be paid before any other claim, as soon as cash is available.

Labor claims of strictly salary nature having been paid and restitutions having been made, post-filing financing credits shall be paid, together with expenses relating to the proceedings (including the remuneration of the judicial

administrator and other expenses of the estate). Such claims rank above all other credits listed under article 83 of the Bankruptcy Law, which must be paid under the following order:

1.) Labor related claims up to one hundred and fifty monthly minimum wages per creditor, and occupational claims;
2.) Claims with *in rem* guarantees to the limit of the value of the encumbered asset;
3.) Tax claims independent of their nature and length of constitution, except for tax fines;
4.) Special privileged claims;
5.) General privileged claims;
6.) Unsecured claims;
7.) Contractual penalties and fines for breach of criminal or administrative law, including tax related fines;
8.) Subordinate claims.

As to the Creditors Committee, Committee members' fees shall not be defrayed by the debtor or the bankrupt estate. However, expenses incurred to perform any act provided for in the law, if duly evidenced and authorized by the judge, shall be reimbursed in accordance with available cash funds.

9. Matters relating to security

(a) Can a company/officeholder in any of your insolvency proceedings grant security?

(b) Can a company/officeholder in an insolvency proceeding obtain priority to any pre-existing security? If so, what is the test for adequate protection of the security holder?

Although the debtor remains in possession of its business during the course of judicial restructuring, pursuant to article 66 of the Bankruptcy Law he may not dispose of or encumber any items or rights of the company's permanent assets, without prior authorization from the judge, the Creditors' Committee being heard, except in the case of sales/guarantees provided for under the approved judicial restructuring plan.

As regards to bankruptcy, article 99, item VI, of the Bankruptcy Law provides that the decision that decrees a debtor's bankruptcy shall, among other requirements, forbid the disposition or encumbrance of any of the bankrupt estate's assets, unless there is prior authorization from the court and from the Creditors Committee.

Regarding priority over pre-existing securities, it should be noted that under Brazilian law any securities held by creditors shall, upon the commencement of liquidation, become part of the bankrupt estate. The proceeds of the liquidation of estate's assets, including securities, will be distributed among creditors, pursuant to the order of preferences provided for under the law. A secured creditor is in a privileged position in relation to an unsecured creditor, up to the value of the security. However, this does not mean that the proceeds of the sale of such security will be used directly/exclusively to pay the creditor who held it. Accordingly, should a post-filing loan be extended to the debtor, it will enjoy a super-priority over other credits (as explained in item 4 above) and will be paid out of the proceeds of the bankrupt estate as a whole (which will include securities, as explained above), thus potentially reducing the credit recovery of other creditors, including secured creditors. The Bankruptcy Law does not provide any protection to security holders in this respect.

10. Can a secured creditor roll over pre-petition loans into post-petition lending?

In principle, an arrangement providing for the conversion of a pre-petition claim into a post-petition claim would be forbidden, since it would potentially harm the interests of other creditors (given that post-filing claims are given an absolute repayment priority in the event of bankruptcy). However, should the judicial restructuring plan provide for such conversion and should it be approved by the majority of creditors, such arrangement would, in principle, be possible.

11. Are the directors/officeholders personally liable for post-petition borrowings (unless otherwise agreed)?

Under Brazilian law, as a general rule, officers and directors are not personally liable for obligations incurred in the corporation's name by virtue of administrative acts performed in the course of business. Exceptions to this rule are the cases in which directors/officeholders: (I) within the scope of their powers, act recklessly, negligently, incompetently or fraudulently; or (II) violate the law or act in an *ultra vires* manner, whether or not they do so in a negligent or fraudulent manner. There is no special system for insolvency proceedings, in terms of directors and officers liability. Accordingly, the general rule outlined above is applicable.

As to the judicial administrator and the members of the Creditors Committee, article 32 of the Bankruptcy Law provides that they shall be held liable for losses caused to the bankrupt estate, the debtor or the creditors by malice or negligence. Accordingly, those disagreeing with a Committee resolution - such as in the approval of post-filing finance, for example - must state their disagreement in minutes in order to hold themselves harmless against liability.

12. Can affiliated debtors be treated as one consolidated entity for post-petition financing purposes?

As a general rule, if two or more companies of the same corporate group file for insolvency simultaneously, Brazilian courts will initiate individual insolvency proceedings for each of them. In certain cases, the same judicial administrator may be appointed, depending on the relationship between the companies (as it occurred in the Parmalat case, where the holding and the operational companies, both subject to judicial restructuring, share the same judicial administrator).

In any event, in exceptional cases where different legal entities may be considered as a single *de facto* entity (such as in the case where two companies share the same funds), Brazilian courts have chosen to extend the effects of bankruptcy from one company to another, thus treating them as a consolidated entity, for insolvency purposes.

13. Outline any developed practices other than statutory or regulatory provisions that go beyond the legal framework.

The assignment of receivables to guarantee the financing of distressed entities has become an increasingly common practice in Brazil. Under such arrangements, the debtor assigns receivables directly to factoring companies or to funds dedicated to investment in creditors rights ("FDICs"). The assignment of receivables has become increasingly popular since in the event of bankruptcy the assigned receivables do not revert to the bankrupt estate.

Canada

1. Briefly summarise the types of insolvency proceedings available in your jurisdiction and indicate, in each case:

(a) The extent to which the debtor remains "in possession";

(b) Whether or not a specialist insolvency professional is likely to be appointed and, if so, a summary of his powers;

(c) The role of the court in the process.

In Canada, bankruptcy, restructuring and insolvency law is largely governed by three statutes: the *Bankruptcy and Insolvency Act* ("BIA"), the *Companies' Creditors Arrangement Act* ("CCAA") and the *Winding-Up and Restructuring Act* ("WURA"). The WURA is a rarely used statute that is concerned with the liquidation of banks, trust companies and other corporations that are subject to the authority of the federal Parliament. For the purposes of this chapter, we will focus on the BIA and the CCAA.

Recently, the Canadian government initiated a reform of the bankruptcy and insolvency regime which culminated in the passing of Bill C-55. Bill C-55, which received Royal Assent on November 25, 2005, is a piece of legislation that will significantly affect the bankruptcy and restructuring regime in Canada. As there was a rush to pass this legislation before the dissolution of the 38th Parliament, the Standing Senate Committee on Banking, Trade and Commerce requested and received from the federal government assurances that Bill C-55 would not be proclaimed into force before June 30, 2006, at the earliest. The Senate Committee has requested that it have a further opportunity to review the legislation.

Bill C-55, as enacted, addresses a number of insolvency law topics. While some of the provisions of Bill C-55 provide certainty where there was confusion, fill gaps in the current legislation, and strive to balance the interests of various stakeholders, other provisions in Bill C-55 upset the current delicate balance between stakeholders, create uncertainty, and restrict the currently flexible legal regime. The Senate Committee has recognized this and there is a possibility that there will be amendments to the enacted version of Bill C-55 before it is proclaimed into force. Therefore, while there may be some amendments to Bill C-55, it is important to note the amendments to the BIA and the CCAA that will impact the areas covered in this chapter. This chapter will identify the areas in which the new legislation in Canada may modify the existing regime.

Liquidation

With respect to the questions on the insolvency proceedings available in Canada, the process's can be separated into two main categories, namely liquidation and reorganization.

In liquidation proceedings, the debtor is generally not in possession or control of its property. An independent court officer is appointed (other than in private receiverships) to take possession and control and realize on the assets in a commercially reasonable manner, which generally can include, a private sale, a public sale and an auction. In each type of sale, the assets can be sold piecemeal, en bloc or as a going concern. The court officer will generally be empowered to distribute the proceeds of realization in accordance with various priorities. In private receiverships, the debtor generally remains in possession of it assets but not control. The following is a brief discussion of the three major methods of liquidation.

a) Bankruptcy
   Under the BIA a debtor can either voluntarily file an assignment in bankruptcy or it may be petitioned into bankruptcy by its creditor(s). Once a debtor has been declared bankrupt, a trustee in bankruptcy is appointed. A trustee in bankruptcy, who is an officer of the court, is a professional trustee licensed by the Superintendent of Bankruptcy, a federal government official. The trustee takes possession and control of the property of the bankrupt, subject to existing security, liens and charges. The trustee is usually unable to transfer the assets free of security, liens and charges.

   There is an automatic stay of proceedings in respect of claims of unsecured creditors. However, secured creditors are not stayed from taking proceedings or realizing on their collateral.

   While the court supervises the process, most of the steps are taken by the trustee with input from the inspectors (elected at a meeting of creditors) and without the need for court supervision.

b) Court Receiverships
   A receiver or receiver and manager may be appointed by the court on request of the creditor and, in some circumstances, the debtor. The court appointed receiver or receiver and manager is not the agent of the debtor or the secured creditor, but is an officer of the court and the scope of its powers, duties and liabilities emanate from the appointment order. The court order will generally provide the right for the receiver to sell the assets, which must be done in a commercially reasonable manner. There is generally a broad court ordered stay of proceedings (including

in respect of secured and unsecured claims) in the order appointing the receiver. The court supervises the process throughout and court approval will be sought by the receiver for all major activities including the sale of assets and the distribution of proceeds. The receiver will frequently be given the power to transfer assets free and clear of secured claims, provided that the proceeds of sale stand in the place of the transferred assets.

c) Private Receiverships
A private receiver or receiver and manager can be appointed by a secured creditor that has security over some or all of the assets of the debtor, provided that the security agreement gives the secured creditor such right. The secured creditor appoints the receiver by simple letter. So long as the debtor does not object to the receiver taking control, the receivership is effective. If the security agreement and appointment letter are properly drafted, the receiver will be the agent of the secured creditor for realization purposes but the agent of the debtor for the purposes of carrying on the business. In such event, the receiver is in control of the business and property and the debtor remains in possession of the business and property. There is no stay of proceedings and there is very little court supervision of the process.

Bill C-55 contains the following amendments to the BIA with regard to receiverships:

- private and court appointed receivers will be required to be trustees;
- private and court-appointed receivers will be provided with similar protection afforded to trustees in bankruptcy concerning pre-appointment and environmental liabilities; and
- the introduction of a “national” receiver with federal scope.

Reorganisation

The debtor has two alternatives to reorganize its business while remaining in possession and control of its business and property under the BIA or the CCAA. The first is to file a proposal under the BIA and the second is to commence proceedings under the CCAA.

a) BIA Proposals
The process of reorganization under the BIA begins with the debtor filing a notice of intention to file a proposal or a proposal itself. Upon the filing, a licensed trustee is appointed to oversee and monitor the affairs of the debtor until the proposal is completed or defeated by the creditors voting thereon. The filing of the notice or the proposal itself under the BIA

imposes an automatic stay of proceedings. The stay of proceedings is originally for 30 days and can be extended for five additional periods of up to 45 days each by court order. The stay of proceedings provides the debtor with an opportunity to develop an acceptable proposal to its creditors without the threat of proceedings from such creditors. The proposal must be approved by a double majority of each class of voting creditors (2/3rds in dollars and 50% in number) and the court, failing which the debtor will automatically be declared bankrupt and the trustee will liquidate its assets.

b) CCAA Restructuring
The CCAA provides a flexible process for a corporation to restructure its debts, since the CCAA grants the court wide supervisory powers and discretion to determine the appropriate procedure in each situation. To initiate CCAA proceedings the insolvent company must bring an application before the court and prove, among other things, that there are claims against it in excess CDN $5 million and they are insolvent. The initial order granting protection under the CCAA proceedings will contain a broad stay of proceedings against all creditors. The stay of proceedings under the CCAA is not automatic as in the BIA and its scope and duration are defined by the initial order. The stay of proceedings is initially for 30 days and can be extended by court order. Unlike the BIA, the stay of proceedings can be extended beyond six months provided that the court is satisfied that an extension is warranted.

The insolvent debtor usually develops a plan of arrangement and compromise to be voted in on by its creditors. The plan must be accepted by each class of creditors with the same double majority as a proposal under the BIA. Following approval of the creditors, the plan must be approved by the court. Once sanctioned by the court, the plan is binding on all creditors affected by the plan.

In some cases, a court will authorize the sale of assets while a debtor is under CCAA protection free and clear of any claims, provided that the proceeds of such sale stand in place of the transferred assets. Court approval for each sale will usually be sought.

The initial order will also appoint a monitor to supervise the business and affairs of the corporation while it is under CCAA protection. The monitor owes its primary duty to the court and is required to represent the interests of all creditors.

The CCAA process is supervised closely by the court and most major activities will be presented to the court for approval.

When Bill C-55 is proclaimed into force, monitors under CCAA proceedings will be required to be licensed trustees and, except with the permission of

the court, may not be appointed if, within the preceding two years, the monitor was (i) the auditor, accountant or legal counsel of the company or a partner thereof; (ii) a director, officer or employee of the company; or (iii) related to the company or to any officer or director of the company. A monitor may not be appointed at all if it is already the trustee under a trust indenture or related to the trust indenture trustee. Certain duties of the monitor have been specifically codified and will include: (i) publishing notice of the initial order once a week for two consecutive weeks; (ii) sending a copy of the initial order to the creditors and making a list showing the names and addresses of those creditors; (iii) determining with reasonable accuracy the state of the company's business and financial affairs and cause of its insolvency and filing a report with the court thereon; (iv) filing a report with the court on the state of the company's business and financial affairs after ascertaining any material adverse change in the projected cash flows or financial circumstances; (v) advising the court if it is of the opinion that it would be more beneficial to the company's creditors if proceedings were taken under the BIA; and (vi) making publicly available all documents filed with the court and all court decisions.

2. Are lenders permitted to refuse to continue lending because of the insolvency proceedings?

Generally speaking, a lender cannot be forced to lend funds during an insolvency proceeding. The BIA expressly prohibits a lender from terminating an agreement with an insolvent person or claiming an accelerated payment by reason only that the insolvent person is insolvent, or that the insolvent person has filed a proposal. The BIA also expressly states that any term of a lending agreement that has the effect of permitting the lender to terminate the agreement on the basis of the debtor's insolvency is of no force or effect. However, the BIA contains provisions which specifically do not require the further advance of money or extension of credit to an insolvent person. In a restructuring under the CCAA, the stay of proceedings in the initial order usually prohibits creditors from terminating agreements with the debtor company. However, similar to the BIA, the CCAA provides that a stay cannot operate to require the further advance of money or extension of credit.

3. Alternatively, can the borrower require the lender to continue to advance previously committed but undrawn amounts?

In liquidation proceedings, the company cannot require a lender to continue to advance previously committed credit. In bankruptcy proceedings under the BIA the trustee in bankruptcy cannot force further advance of credit. The same is true for a restructuring proceeding.

However, there is a recent decision of a New Brunswick court that has suggested that a lender under a committed but not fully drawn revolving credit facility may be required to continue to lend the amount that was not drawn notwithstanding the filing by the insolvent company under the BIA. The lender was precluded from unilaterally capping the amount available to the insolvent company under the revolving line of credit. The court's view in this case was that the lender was not advancing further money to the debtor. It remains to be seen whether this case will start a trend or will be considered an anomaly.

4. Are there specific provisions for lending in any of your insolvency proceedings? If so, provide details, including the text of any statutory provisions.

Neither the BIA nor the CCAA currently provide any statutory basis to allow a debtor to borrow funds in the midst of insolvency proceedings. However, in both liquidation and restructuring proceedings, lending can be permitted by court order and is often provided for. These situations and the court ordered charges to secure such loans will be addressed in greater detail in the following section.

Bill C-55 contains amendments that include a statutory authority in both the CCAA and the BIA that directly permit a court to make an order declaring that the company's property is subject to new security or a charge that ranks in priority to the claims of any secured creditor.

More specifically, Bill C-55 provides statutory authority for the court ordered granting of security over the insolvent person's property in connection with debtor-in-possession (DIP) financing. Any such security granted would rank in priority over the claims of any existing secured creditors of the debtor. Only the debtor will be able to bring an application for an order authorizing DIP financing. The court must consider the debtor's cash flow statement in determining the amount of financing to approve.

Under Bill C-55, if obtained on the initial order without notice, the DIP financing and corresponding court ordered charge will only be effective for the initial 30-day stay period. For DIP financing and the corresponding charge to be effective for longer than this initial 30-day period, the order must be sought after the initial application and on notice to all secured creditors likely to be affected by the security or charge. In deciding whether to make the order, the court must consider: (i) the period the debtor is expected to be subject to the restructuring proceedings; (ii) how the debtor's business and financial affairs are to be governed during the proceeding; (iii) whether the debtor's management has the confidence of its major creditors; (iv) whether

the loan agreement will enhance the prospects of a viable restructuring; (v) the nature and value of the debtor's property; and (vi) whether any creditor will be materially prejudiced as a result of the debtor's continued operations.

5. In the absence of a specific provision, is there any ability for a company to obtain financing when it is in an insolvency proceeding?

In liquidation proceedings, lending will most frequently occur in court appointed receiverships. In such circumstances, the court order will authorize the receiver to borrow funds to carry on the business of the debtor. The borrowings will be capped at a certain amount by court order. As evidence of such borrowings, the receiver will be authorized to grant the lender a certificate (called a receiver's certificate) under which it will promise to pay to the lender the amount borrowed. The receiver's certificate will permit the receiver to borrow up to the capped amount without obtaining court approval for each advance. A court ordered charge over the debtor's assets will also be granted to secure the amounts borrowed in priority to secured claims. As the order appointing the receiver is usually made on notice to secured creditors, there is an opportunity for creditors whose interests are being primed to argue that the order authorizing the borrowing not be made. In private receiverships and bankruptcies borrowing by the receiver or the trustee are not common.

In a restructurings under a BIA proposal, the debtor is not prohibited from borrowing but has no ability to grant priority security to a lender to secure the loan unless there are unsecured assets. There may be other alternative methodologies for a debtor under a BIA proposal process to obtain funding but these require use of either the inherent jurisdiction of the court or other insolvency proceedings coupled with the BIA proposal.

Under the CCAA, the court has interpreted its expansive supervisory role and inherent jurisdiction to include the ability to create super-priority DIP financing both in restructuring and liquidation contexts. The timing and the amount of the DIP financing approved by the court varies in each circumstance, depending on the facts. Any secured creditor that believes that it is being prejudiced by the DIP financing order has an opportunity to make submissions to the court either when the order is made or when the order comes to its attention.

While the easiest order to obtain is one where no secured creditors interests are being primed, there have been numerous cases where secured creditors interests have been primed in whole or in part either with their consent or, less frequently, notwithstanding their opposition.

6. **Is there any mechanism for the court to approve the financing by a company/officeholder in an insolvency proceeding? If so, is there protection for lenders against reversal or modification of court authorization for borrowing available?**

   As discussed above, under the CCAA the court is usually asked to approve a DIP financing, and to grant a charge in favour of the DIP financing lender. Under this scenario the borrower is the debtor (CCAA applicant). This charge will usually be granted priority, and may in some cases prime existing lenders. A similar situation exists for court appointed receivers, however, in those cases, the receiver is the borrower.

   Currently, there are no protections for lenders from reversal or modification of the court authorization of the issuance of receiver's certificate or DIP financing. In either event, there is some risk of reversal or modification on appeal. Such reversal or modification is extremely rare. Technically, it is possible to move to set aside or vary the order approving the financing even after the appeal period has expired although this would also be extremely rare.

   Bill C-55 contains certain amendments to permit financing in insolvencies. Please refer to the preceding sections for a discussion of these amendments.

7. **In an insolvency proceeding, are there provisions governing the extension of credit in the ordinary course of business (e.g., trade credit)? If so, what protections are available to the extender of credit?**

   As previously discussed, both the BIA and the CCAA provide that no person shall be required to further advance money or extend credit to an insolvent person. In a bankruptcy or court appointed receivership, if the court officer purchases goods or services on credit it will invariably pay for them. However, in a BIA proposal or CCAA arrangement, a post filing creditor does not have any protection unless it is provided for in the court order or a mechanism is set up to give such protection. These mechanisms are not always established and accordingly, creditors will usually either require cash on delivery terms or will seek the implementation of an acceptable mechanism. The trustee or monitor, as the case may be, will frequently be involved in these mechanics.

   When Bill C-55 is proclaimed into force, it will provide a statutory authority with respect to critical suppliers in the context of CCAA restructurings. The court will be statutorily permitted to make an order declaring a person to be a critical supplier and make an order requiring continued supply on terms and conditions consistent with the supply relationship or on the basis the court considers appropriate.

8. Outline the ranking of financing provided to company/officeholder in any applicable insolvency proceeding. Discuss the comparative position of any such borrowings with respect to:

(a) Pre-proceeding liabilities;

(b) Expenses relating to the proceeding in question, including the expenses of the officeholders;

(c) The costs of any committee of creditors which is required or established as a matter practice in any particular procedure and the expenses of any such committee.

Where financing is available in insolvency proceedings (see discussion above), it is generally up to the court to determine the ranking of priority relating to the security for such borrowings. In respect of unencumbered assets, these will generally not pose a difficulty. However, if the assets are secured there may be tension between the pre-existing secured creditors and the post filing lender.

In addition, there are various other potential claims against the assets that may be in competition with the desire of the lender for first ranking priority. These include a charge/lien created by statute or the court in favour of certain of the insolvency practitioners for the fees and expenses (i.e. receiver/monitor and their counsel and debtor's counsel in CCAA proceedings) and, in CCAA proceedings, a charge/lien in favour of the directors and officers for various potential statutory personal liabilities. In the court order authorizing the lending and creating the charge/lien in favour of the lender, the court will set out the ranking of these various charges/liens. Typically, the fees and expenses of the receiver/monitor and their counsel and debtor's counsel (in a CCAA proceeding) will be granted a priority ahead of all other charges/liens although there are certain exceptions to this.

There is no statutory committee of creditors in Canada. However, if the court approved of one being appointed it will determine whether it is appropriate for the fees and expenses of such committee to be funded by the debtor and whether a charge/lien should be granted.

Bill C-55 codifies such administrative charges by providing that the court may make an order declaring that property of the debtor company is subject to a security or charge, in an amount that it considers appropriate, in respect of (i) the costs of the monitor and any financial, legal or other experts engaged by the monitor in the course of the monitor's duties; (ii) the remuneration and expenses of any financial, legal or other experts engaged by the debtor; and (iii) the costs of any interested party in relation to the remuneration and expenses of any financial, legal or other experts engaged by it, if the court is

satisfied that the incurring of such costs is necessary for the effective participation of such interested party in the proceedings.

9. Matters relating to security

(a) Can a company/officeholder in any of your insolvency proceedings grant security?

(b) Can a company/officeholder in an insolvency proceeding obtain priority to any pre-existing security? If so, what is the test for adequate protection of the security holder?

In the liquidation context under the BIA, the company is not in control of its assets and, therefore, cannot grant security. However, the court may order that such security be granted, but this would be extremely rare. In the context of a court appointed receivership, while the court technically can order the company to grant security, this is rarely done. More often the court creates a charge/lien over the company's assets to secure any obligations of the receiver, including any borrowings by receiver.

In restructurings under the BIA or CCAA, a company can grant security. Most frequently, under the CCAA the lender will insist that this be done with court approval and a court ordered charge/lien obtained to secure the advances.

With respect to the question on obtaining priority, pre-existing secured lenders are generally stayed from realizing on their security in restructurings. Usually they are not granted additional security to protect their pre-existing position. However, their security continues to apply over all present and future assets of the debtor (provided that their security agreement so provides). Notwithstanding the foregoing, the debtor in a restructuring is usually entitled to use the cash flow from the assets to continue to operate the business. If the lender's security position is deteriorating it may apply to the court for relief from such deterioration. Each case depends on its own facts.

Where the DIP lender is the pre-existing first ranking secured creditor, it will generally consent to an order that primes its security. In certain cases the court will grant a charge/lien to protect a pre-existing lender. In some cases this has been done in favour of critical suppliers to the business and other exceptional circumstances.

There is not statutory concept of adequate protection in Canada. The court will consider a multitude of factors including what the position of the parties would be in the event of a liquidation.

10. Can a secured creditor roll over pre-petition loans into post-petition lending?

While it is possible in the appropriate circumstances to roll over pre-petition loans into post-petition lending, there is no requirement for this to be done because the debtor company in a CCAA or a BIA restructuring is not a new separate legal entity.

11. Are the directors/officeholders personally liable for post-petition borrowings (unless otherwise agreed)?

The directors of the insolvent company are not personally liable for borrowings of the company unless they personally guarantee such borrowings.

12. Can affiliated debtors be treated as one consolidated entity for post-petition financing purposes?

In the appropriate circumstances affiliated entities that have filed for court protection can have each of their assets subject to a charge/lien ordered by the court to secure post-petition financing.

13. Please outline any developed practices (as opposed to express statutory or regulatory provisions) that go beyond the legal framework as set out above.

Canadian insolvency proceedings frequently require significant judicial intervention and application of inherent jurisdiction. Most Canadian courts have shown a willingness to exercise this discretion. As a quid pro quo, the courts look to counsel and insolvency practitioners to use common sense, communicate and cooperate (at least on procedural matters). The practice before the courts in insolvency matters is to attempt to build consensus and have as many matters as possible dealt with on a non-objected basis. Of course there are contested matters that are dealt with by the courts, but it is expected that all stakeholders will have attempted where possible to resolve the matter in the boardroom prior to seeking the court's intervention.

Germany

1. Briefly summarise the types of insolvency proceedings available in your jurisdiction and indicate, in each case:

(a) The extent to which the debtor remains "in possession";

(b) Whether or not a specialist insolvency professional is likely to be appointed and, if so, a summary of his powers;

(c) The role of the court in the process.

The German Insolvency Code (*Insolvenzordnung*) provides a "single gateway" for insolvency proceedings, i.e. there is only one uniform insolvency process the outcome of which is initially open[1] and which can take the form of a rehabilitation, liquidation or any other type.

The insolvency process starts with a provisional stage which is an interim procedure initiated by the insolvency court upon having received the motion for insolvency to establish whether the debtor is indeed technically insolvent and, if so, has sufficient assets to cover the costs of the insolvency proceedings. Where this is the case, the court opens formal insolvency proceedings. As a rule, a final insolvency administrator will be appointed who will then be exclusively authorised to act for and on behalf of the debtor. However, the Insolvency Code also provides for a debtor in possession status (*Eigenverwaltung*) with only an examiner (*Sachwalter*) being appointed.

Provisional insolvency proceedings

It is the purpose of provisional insolvency proceedings to establish whether the debtor is indeed technically insolvent and, if so, its assets are sufficient to cover at least the costs of the insolvency proceedings. To that end, the insolvency court will normally appoint a provisional insolvency administrator who can, at the discretion of the court, be granted certain powers:

(i) As a rule, the right to enter into transactions will remain with the debtor however subject to consent by the provisional insolvency administrator (so-called "weak" provisional administrator).

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[1] In addition, the German Insolvency Code introduced a specific insolvency regime with regard to consumers. An individual debtor qualifies as a consumer in the meaning of the German Insolvency Code if he does not carry out independent commercial activities or, if he does, his financial situation is not complex, e.g. he does not have more than 20 creditors (Section 304 of the German Insolvency Code).

In these consumer insolvency proceedings a trustee (in lieu of an insolvency administrator) is appointed. The first duty of this trustee is to promote an in-court settlement (*Schuldenbereinigungsplan*) between the debtor and his creditors.

(ii) As an exception, the provisional insolvency administrator will already be exclusively authorised to enter into transactions on behalf of the debtor and, to this extent, replace management (so-called "strong" provisional insolvency administrator). In these cases, obligations incurred by the provisional insolvency administrator will later on qualify as preferred debts.

(iii) Alternatively, the provisional insolvency administrator can be authorised to enter into transactions on a case-by-case basis by the insolvency court and, to this extent, incur preferred debt.

In very rare cases, a professional without any powers will be appointed who will then only have the duty to establish whether the debtor is indeed technically insolvent and, if so, whether its assets are sufficient to cover at least the costs of the insolvency proceedings.

It is expressly stipulated that it is the duty of the "strong" provisional insolvency administrator, beyond the above, to (i) maintain and secure the assets of the company and (ii) continue the operative business unless the insolvency court approves a close down in order to avoid a further significant deterioration of the financial situation. The duties of the "weak" provisional insolvency administrator will be determined by the court on a case by case basis.

The court supervises the provisional insolvency administrator. At any time, the court may request the provisional insolvency administrator to provide detailed information on the progress of the proceedings and the administration of the estate.

Formal insolvency proceedings

When opening formal insolvency proceedings, the court will appoint a (final) insolvency administrator (almost always identical with the provisional insolvency administrator) who becomes the sole representative of the insolvent estate and assumes the right to administer and to dispose of the assets. Dispositions made by the management of the debtor after the opening resolution are void.

If not already closed down, the insolvency administrator has to continue business operations of the debtor until the first creditors' assembly so that it can decide whether to reorganise the debtor or liquidate it, the latter either by selling the business (assets) in its entirety or piecemeal. The first creditors' assembly is to take place not earlier than six weeks but not later than three months after the opening of formal insolvency proceedings. In principle, the creditors have to take all decisions that are fundamental for the process; they may delegate this right however to a creditors' committee. Importantly, the

insolvency administrator has the right to continue or discontinue mutual contracts provided that neither contractual party has already completely fulfilled its obligations under the contract (Section 103 of the Insolvency Code) and to challenge transactions detrimental for all other creditors. The Insolvency Code also provides for the right of the debtor or the insolvency administrator (instructed by the creditors) to file an insolvency plan which is very similar to the plan of reorganisation known under US Chapter 11.

Again, the court has the duty to supervise the insolvency administrator.

As an exception and upon a respective motion by the debtor, the court can grant a debtor in possession status (*Eigenverwaltung).* In this case, the management of the debtor remains in charge of administering and disposing of its assets, albeit subject to the supervision of the court and an examiner (*Sachwalter*) to be appointed by the court. The debtor will only be restricted to enter into transactions where (i) obligations are incurred which fall outside the scope of the ordinary course of business (and, thus, will need consent by the examiner) or (ii) the examiner raises an objection. The court has the duty to supervise both the debtor and the examiner.

2. Are lenders permitted to refuse to continue lending because of the insolvency proceedings?

Situation pre-filing

The answer depends on whether the lender terminates the loan on a regular basis or extraordinarily. In addition, there are specific rules for so-called reorganisation loans.

In principle, the lender may terminate a loan on a regular basis even if the borrower is in financial distress. Modifications of such a termination right include that the lender will have to give adequate notice; as a rule of thumb a notice period of 3 months (as provided for in section 488 of the German Civil Code) appears adequate. Under certain circumstances, however, the lender may be required to refrain from terminating the loan temporarily. Aspects to be taken into consideration include whether there are other lenders, a security has been furnished to the lender or it has exercised any influence on the business operations of the borrower. Under no circumstances however, may the lender be required to refrain from terminating the loan on a permanent basis.

According to section 490 of the German Civil Code, the lender is entitled to terminate the loan extraordinarily if the financial situation of the debtor has deteriorated to such extent that the repayment of the loan is at risk (a similar

provision is contained in no. 19 of the Standard Terms and Conditions of Banks 2002 (*AGB-Banken 2002*)). This is likely to be the case where the debtor is in financial distress or insolvent. Where a security has been furnished to the lender, it has to be taken into consideration. In other words, where the security has a sufficient value for satisfaction of the outstanding debt, a lender may not be permitted to terminate the loan.

Where a loan has been granted for the purpose of restructuring of the borrower, it can only be terminated to the extent the restructuring process deviates from what was anticipated at the time of the granting of the loan.

Situation post-filing

German insolvency law distinguishes between business management contracts (*Geschäftsbesorgungsverträge)* such as current account credit lines on the one hand and other mutual agreements such as annuity loans, loans to be paid back in fixed instalments and bonded loans on the other hand.

Current accounts

According to the prevailing view among German academics, current accounts are business management contracts (*Geschäftsbesorgungsverträge*). Under German insolvency law, such business management contracts are automatically terminated upon the opening of formal insolvency proceedings (Section 116 of the Insolvency Code).

Thus, repayment of the amount taken out by the debtor on the basis of such current accounts becomes immediately due upon the opening of formal insolvency proceedings and the debtor and the insolvency administrator respectively can no longer draw under the current account credit line. A declaration of termination by the lender is obsolete as these consequences are already incurred by operation of law.

Annuity loan, loan to be paid back in fixed instalments, bonded loan

Annuity loans, loans to be paid back in fixed instalments and bonded loans do not qualify as business management contracts. These contracts are not automatically terminated upon the opening of formal insolvency proceedings.

Rather, upon the opening of formal insolvency proceedings the insolvency administrator - but not the creditor - assumes a right of choice whether to continue or discontinue these contracts provided that neither contractual party has already completely fulfilled its obligations under said contract (Section 103 of the Insolvency Code)[2]. Thus, unless the insolvency

[2] It is currently highly debated among German academics whether or not the lender has completely fulfilled its obligations in the sense of Section 103 German Insolvency Code upon full payment of the agreed sum to the debtor.

administrator opts to discontinue the loan contract, the lender has no statutory right to refuse to carry on lending.

There is a debate among German academics whether the lender remains entitled to terminate the loan agreement during the insolvency proceedings because of the insolvency of the debtor on the basis of Section 490 of the German Civil Code, Standard Terms and Conditions of Banks or an explicit provision in the loan contract granting him such termination right.

3. Alternatively, can the borrower require the lender to continue to advance previously committed but undrawn amounts?

Situation pre-filing

Whereas, in principle, the same as set out above in relation to the question whether a lender may refuse to carry on lending applies, the threshold is even higher where advancing undrawn amounts is at issue. The reason obviously is that, from a commercial perspective, reacting to a damage already suffered is to be distinguished from increasing the risk.

Situation post-filing

Undrawn amounts under current account credit lines can no longer be called by the borrower (respectively the insolvency administrator) since the underlying agreements are automatically terminated according to section 116 of the Insolvency Code (cf. 2 above).

Undrawn amounts under other forms of loans can be requested. In this case, the insolvency administrator has the right of choice under section 103 of the Insolvency Code, i.e. the right to continue the loan agreement.

4. Are there specific provisions for lending in any of your insolvency proceedings? If so, provide details, including the text of any statutory provisions.

Although partly drafted along the lines of US Chapter 11, the German Insolvency Code does not stipulate such regime (and comparable with Chapter 11 DIP financing).

The only specific regime for funding borrowing exclusively applies to funding in the context of an insolvency plan and is to be found in sections 264 - 266 of the German Insolvency Code. They read as follows:

Section 264 – credit frame

(1) The constructive part of the insolvency plan may provide that unsecured creditors rank behind creditors with claims arising from loans or other credit instruments incurred by the debtor or a transfer company during the period of supervision or extended by a preferred creditor during the period of supervision. In such case, the total amount of these loans is to be determined (credit frame). The credit frame must not exceed the value of the assets listed in the list of assets attached to the plan (Section 229 Sentence 1).

(2) Non-preferred creditors shall rank only behind those creditors with who it has been agreed that and in which amount the loan including principal amount, interest and cost falls within the credit frame and vis-à-vis who the insolvency administrator has approved such agreement in writing.

(3) Section 39 para 1 No. 5 shall remain unaffected.

Section 265 - Ranking behind of new creditors

Creditors with other contractual claims founded during the period of supervision also rank behind creditors with loans incurred or extended in accordance with Section 264. These other contractual claims include claims under a contract for continued performance entered into prior to the period of supervision but having arisen after the first point in time after the beginning of the period of supervision at which a creditor could terminate.

Section 266 - Recognition of ranking behind

(1) The ranking behind of non-preferred creditors and those creditors mentioned in Section 265 will only be recognised in insolvency proceedings opened prior to the termination of the period of supervision.

(2) In such new insolvency proceedings, these creditors will rank above the other lower-ranking creditors.

The underlying idea is that, where an insolvency plan is filed in order to reorganise the debtor, additional liquidity will likely be required. In order to give the new financier enough comfort, the creditors can agree on a certain limit until which new funds will be privileged should another insolvency process become necessary. In fact, the financier would not only have priority over creditors of the first insolvency process but also those who have assumed claims subsequent to the first insolvency process (during the period of supervision).

5. In the absence of a specific provision, is there any ability for a company to obtain financing when it is in an insolvency proceeding?

As stated above (cf. 1 above), the Insolvency Code provides for a "single gateway". In principle, during all stages of the insolvency process those who are authorised to act for the debtor can borrow subject only to the restrictions mentioned herein. It is evident that new funds will only be obtained where the claim for repayment qualifies as a preferred claim (i.e. if incurred by a "strong" provisional insolvency administrator, a "weak" provisional insolvency administrator upon authorisation by the insolvency court or the final insolvency administrator) and the lender has enough comfort that the assets will be sufficient to cover the claim.

6. Is there any mechanism for the court to approve the financing by a company/officeholder in an insolvency proceeding? If so, is there protection for lenders against reversal or modification of court authorisation for borrowing available?

As mentioned above, the court may on a case by case basis authorise a "weak" provisional insolvency administrator to borrow and, in doing so, to incur preferential debt (cf. above).

As for formal insolvency proceedings, there is no such mechanism for the court. The court, however, may temporarily interdict certain transactions including new borrowings by the insolvency administrator with significant impact on the estate and call for a meeting of all creditors (section 161 of the German Insolvency Code). This applies where the administrator has - as it is supposed to - sought approval for such a transaction by the creditors' committee but the debtor or a certain number of creditors apply to the court to ask the creditors' assembly.

7. In an insolvency proceeding, are there provisions governing the extension of credit in the ordinary course of business (e.g., trade credit)? If so, what protections are available to the extender of credit?

There are no specific rules dealing with the extension of credit in insolvency proceedings; general rules apply.

Provisional insolvency proceedings

If a loan is taken out during provisional insolvency proceedings the question whether it has priority over pre-existing financial creditors depends on the status of the provisional insolvency administrator (cf. 1 above). Claims for

repayment of loans taken out by a "strong" provisional insolvency administrator qualify as preferred claims (*Masseforderungen*) and, therefore, do have priority. The same is true where a "weak" provisional insolvency administrator has been authorised by the insolvency court to borrow. By contrast, even if a "weak" provisional insolvency administrator has consented to a borrowing by the debtor, the repayment claim still qualifies as a non-preferred claim (*Insolvenzforderung)* and, as a consequence, ranks equally with pre-existing claims.

Germany insolvency does not know the concept of "priming". Securities for pre-existing financial creditors remain unaffected.

Formal insolvency proceedings

Claims for repayment of new borrowings taken out by the insolvency administrator, or by the debtor where a debtor in possession status has been granted, qualify as preferred claims and, as such, have priority over the claims of pre-existing financial creditors; again securities held by such creditors remain unaffected.

8. Outline the ranking of financing provided to company/officeholder in any applicable insolvency proceeding. Discuss the comparative position of any such borrowings with respect to:

(a) Pre-proceeding liabilities;

(b) Expenses relating to the proceeding in question, including the expenses of the officeholders;

(c) The costs of any committee of creditors which is required or established as a matter practice in any particular procedure and the expenses of any such committee.

In principle, German insolvency law distinguishes between claims existing at the time of the opening of formal insolvency proceedings, i.e. non-preferred claims (*Insolvenzforderungen*) on the one hand and claims arising after the opening of formal insolvency proceedings, i.e. administrative expenses or preferred claims (*Masseforderungen*), on the other. Administrative expenses include procedural costs such as court fees, remuneration for the (provisional) insolvency administrator and remuneration for members of the creditors' committee but also liabilities incurred by the administrator. Among the unsecured creditors preferred creditors are entitled to full satisfaction before all non-preferred creditors who will only receive a dividend quota.

Secured creditors can realise their security without being affected by this ranking. Their position only depends on the type of collateral granted:

- creditors secured by mortgages or charges on immoveable property and those secured by moveable property which they are in possession may enforce their rights outside of insolvency proceedings by foreclosing on the property;

- where the insolvency administrator is in possession of moveable property (granted as security) or claims have been assigned the right to realise the security is on the insolvency administrator who is entitled to a handling fee with the remainder of the proceeds to be paid out directly to the secured creditor.

Creditors who claim that an asset does not belong to the estate (*Aussonderungsrecht*) may enforce surrender of the item at issue against the insolvency administrator.

Provisional insolvency proceedings

Financing provided to a "weak" provisional insolvency administrator or to the debtor during provisional insolvency proceedings results in a non-preferred claim. Thus, it takes the same rank as other pre-insolvency debts but ranks behind all preferred claims including expenses relating to the procedure and the costs of the creditors' committee.

Where a "strong" provisional insolvency administrator has borrowed or a "weak" provisional insolvency administrator was authorised by the insolvency court to borrow thereby incurring preferred debt, the claim for repayment qualifies as a preferred claim to be satisfied ahead of all non-preferred claims.

Formal insolvency proceedings

New financing provided to the insolvency administrator also qualifies as preferred debt as described above.

It should be mentioned that, among German academics, there is an ongoing debate as far as loan agreements existing at the time of the opening of formal insolvency proceedings in respect to which undrawn amounts remain are concerned. Whereas it is undisputed that the insolvency administrator may opt to draw further amounts (cf. 2 above), it is disputed whether repayment only of such additional amounts or the entire amount qualifies as a preferred claim. It certainly is prevailing opinion that only additional drawings results in preferred debt with pre-opening drawings remaining non-preferred; however some academics are of the opinion that additional drawings transform the entire loan into preferred debt.

9. Matters relating to security

(a) Can a company/officeholder in any of your insolvency proceedings grant security?

(b) Can a company/officeholder in an insolvency proceeding obtain priority to any pre-existing security? If so, what is the test for adequate protection of the security holder?

Yes.

Any company or office holder is authorised to act for the debtor during provisional insolvency proceedings may also grant security.

Likewise, upon the opening of formal insolvency proceedings the (final) insolvency administrator can grant security; however to the extent such transaction would have a significant impact on the estate it might require consent by the creditors' assembly/committee (in accordance with sections 160ss of the German Insolvency Code). Where the debtor remains in possession in addition consent by the examiner may be required.

With respect to the question on priority, German insolvency law does not know the concept of "priming".

10. Can a secured creditor roll over pre-petition loans into post-petition lending?

German insolvency law does not expressly allow the rolling over of secured pre-petition loans into post-petition lending. However, if the insolvency administrator finds it to be beneficial to the estate, upon consent by the creditors' assembly a respective arrangement can be entered into.

11. Are the directors/officeholders personally liable for post-petition borrowings (unless otherwise agreed)?

Officeholders can be liable for post-petition borrowings if, at the time of incurring the debt, it was foreseeable that the assets would not be sufficient to repay what was received. This is true for both the "strong" provisional insolvency administrator and the insolvency administrator appointed in formal insolvency proceedings.

In principle, directors are not liable for post-petition financing. Only if, with just a "weak" provisional insolvency administrator being appointed, the debtor incurs debt during provisional insolvency proceedings a director may become liable but only if the creditor can show that the director had failed to disclose to the creditor the petition.

12. Can affiliated debtors be treated as one consolidated entity for post-petition financing purposes?

Despite the fact that German corporate law provides an elaborated set of rules for affiliated or related debtors, German insolvency law remains silent as far as such groups are concerned. In other words, even if several group companies file for insolvency simultaneously, German insolvency courts will initiate individual insolvency proceedings for each of these companies and likely with different administrators appointed. There is no joint administration or consolidated process, neither in general nor for the purpose of post-financing purposes.

13. Outline any developed practices other than statutory or regulatory provisions that go beyond the legal framework.

There is no such practice for the time after formal insolvency proceedings have been opened. However, as far as provisional insolvency proceedings are concerned, German insolvency administrators have developed a useful tool to finance the debtor during that stage of the process.

In Germany, payment of wages is guaranteed by a public security system which covers entitlements for a period of up to three months preceding the opening of formal insolvency proceedings (*Insolvenzausfallgeld*). However, employees will only be entitled to claim such payment after formal insolvency proceedings have been opened or the motion has been dismissed. In order to benefit from such support, provisional insolvency administrators cause the employees to transfer their - future - claims to a financial institution which will in turn make monthly payments to the employees already during provisional insolvency. Subsequent to the opening of formal insolvency proceedings, the financial institution will claim payment from the relevant authority.

It should be added that, currently, following a decision by the European Court of Justice on 15 May 2003 it is unclear whether the determination of the periods during which wages are guaranteed under German law is in line with the European Directive on Harmonisation of Rules governing Protection of Employees in the event of Illiquidity of the Employer.

Hong Kong

1. Briefly summarise the types of insolvency proceedings available in your jurisdiction and indicate, in each case:

(a) The extent to which the debtor remains "in possession";

(b) Whether or not a specialist insolvency professional is likely to be appointed and, if so, a summary of his powers;

(c) The role of the court in the process.

In Hong Kong, the main objectives of the insolvency law are to protect and maximise the value of the insolvent party for the benefit of all creditors. Insolvency law in HK is based on the UK law, which provides a mechanism that will provide for the equitable treatment of all creditors. Equitable treatment does not necessarily require equal treatment. Different creditors may have different commercial arrangements with the debtor (eg through the granting of security and credit) and, therefore, different treatment for creditors that are not similarly situated may be necessary as a matter of equity.

The principal relevant legislation governing insolvency in Hong Kong consists of the Companies Ordinance, the Companies (Winding-Up) Rules and the Bankruptcy Ordinance.

The following insolvency proceedings are available in Hong Kong:

Informal workouts

An informal workout is a contractual arrangement negotiated by a debtor and its creditors, which aims to prevent liquidation and enable the debtor to rescue its business.

The terms of an arrangement must be unanimously approved by the relevant class of its creditors. The courts are not involved in the entire process and the success of workouts will depend on reaching an agreement, which inevitably involves some form of financial arrangement.

Once an arrangement is agreed, creditors often monitor its implementation through a committee of creditors or an insolvency professional but the debtor remains in control of its business.

Bank workouts

A bank workout is, strictly speaking, an informal contractual arrangement between a debtor and a group of its lenders or financial creditors, which aims to prevent liquidation and enable the debtor to rescue its business.

The banks and the debtor must unanimously approve the terms of the arrangement. If there is a clear majority of support, The Hong Kong Monetary Authority and the Hong Kong Association of Banks (HKAB) have issued formal guidelines that strongly recommend that the minority carefully review their position. However, such guidelines are only recommendation to HKAB members and it is not mandatory.

The process usually carried out by an insolvency practitioner registered on the Official Receiver's Office's Administrative Panel of Insolvency Practitioners for Court Winding-ups in Hong Kong, who work through a steering committee of financial creditors led by a liaison bank.

Once an arrangement is agreed, the steering committee monitors its implementation and execution.

Scheme of arrangement under section 166 of the companies ordinance

A scheme of arrangement is a binding arrangement between the debtor and its creditors or shareholders, which aims to prevent the debtor's liquidation, although it can also be implemented after a company have gone into liquidation. This type of arrangement must be sanctioned by the court.

The terms of the scheme must be approved by at least 75% in value and 50% in numbers of the classes of creditors or shareholders voting at the meetings convened to approve it.

It is not necessary for a company to show that it is unable to pay its debts or that it is likely to become unable to do so. Solvent companies in group reorganisations, mergers and de-mergers often use schemes of arrangement.

Once approved and sanctioned, the scheme is binding on all creditors and the debtor. An administrator (who is usually an insolvency practitioner) would be appointed to implement it under the terms of the scheme.

The power of the scheme administrator is laid down under the terms of the scheme.

In recent times, many scheme of arrangements had been carried out by the provisional liquidators, Section 186 of the Companies Ordinance states that

no action or proceeding shall be proceeded with or commenced against the company except by leave of the court, which enables the provisional liquidator the necessary time to carry out the negotiation.

Compulsory liquidation

Compulsory liquidation involves realising a company's assets and distributing them to creditors in order of their priority. This type of insolvency proceedings are dealt with by the Court of First Instance of the High Court of Hong Kong.

A winding-up petition must be presented to the court. This can be done by any one of the following:

- The company;
- The company's directors;
- The company's creditors;
- Government officials.

Most compulsory liquidations are initiated by unpaid creditors or creditors who have served a statutory demand and not received payment within 21 days.

If, after a petition is presented, there is evidence that a company's assets are being dissipate; the court can appoint a provisional liquidator to protect such assets. It is not uncommon for the court to appoint a provisional liquidator whenever necessary to maintain the status quo of a company until a rescue plan has been arranged.

A winding-up order must be granted by the court.

The official receiver is appointed as the provisional liquidator of the company once the court makes a winding-up order. The first creditors' meeting to be convened by the official receiver will generally takes place within three months of the winding-up order. At this meeting, a liquidator is appointed by the creditors to take control of the company and replace the official receiver, and the powers of its directors cease.

A committee of inspection, which usually comprises between two and five creditors or their representatives, is usually appointed at the first creditors' meeting, and its role is to supervise the liquidator. In particular, it must sanction creditor compromises and the conduct of proceedings by or against the company.

The power of the provisional liquidators and liquidators are governed under the Companies Ordinance and the Companies (Winding-Up) Rules.

Creditors' voluntary liquidation

A creditors' voluntary liquidation involve winding up a company without involving the court.

The directors of a company can begin this procedure if they form the view that the company is unable to meet its liabilities. The directors, will convene an extraordinary general meeting of shareholders for the company, where shareholders may pass a special resolution for winding up by at least 75% of all votes cast. A creditors' meeting is normally held within the same day of the extraordinary general meeting of shareholders, appointing a liquidator (and, possibly, a committee of inspection).

Another type of creditors' voluntary liquidation is under Section 228A of the Companies Ordinance. The majority of the directors of a company must form a view and pass a resolution that the company, by reason of its liabilities, cannot continue its business. A director of the company is required to make a statutory declaration to this effect and that the declaration must specifically state that is it not reasonably practicable for the winding-up to be commenced under another section of the companies Ordinance. The winding-up commences upon the filing of the Statutory Declaration and the resolution to the Companies Registry of Hong Kong.

2. Are lenders permitted to refuse to continue lending because of the insolvency proceedings?

Companies that are placed into insolvency proceedings are invariably in financial distress and, therefore, from a commercial perspective, the answer depends on the terms of the loan agreement between the parties. In general, lenders would usually having the right to refuse to continue lending because of insolvency proceedings.

Standard loan documents commonly contain a default clause of which, in the event of default, would allow the lenders not to continue lending should the company have a winding up petition presented against it. In general, lenders who continue to contribute any new funding would assess their respective positions as regards to their risk and apparent preference in respect of repayment of any new loans.

Notwithstanding any contractual terms specified in a loan agreement, there is no statutory legislation in Hong Kong requiring lenders' obligation to continue lending under the insolvency proceedings. When a company is going through an informal or bank workouts, the Hong Kong Court generally are not involved. Under Section 166 of the Companies Ordinance, any compromise,

if sanctioned by the Court, is binding on all the class of creditors and members. Any post-scheme lending and its respective rights may be written into the terms of the scheme. In a case where a company is under compulsory or creditors voluntary liquidation, there is no legislation in Hong Kong requiring lenders' obligation to continue lending.

3. Alternatively, can the borrower require the lender to continue to advance previously committed but undrawn amounts?

After the commencement of a winding-up proceeding, all contract obligations would be unenforceable. As illustrated in 2 above, it is possible for lenders not to continue any lending previously committed if the borrower is subject to winding up proceedings and the loan document authorises such action.

In the absence of any express terms specified in a loan agreement, no statutory legislation in Hong Kong provides a borrower the right to require lenders to continue to advance previously committed but undrawn amounts. Whether a company is undergoing a period of informal or bank workouts, going through a scheme of arrangement or under compulsory or creditors voluntary liquidation, there are no statutory legislation in Hong Kong vesting a right in the borrower to continue requiring the lender to advance for any undrawn amounts. In fact, all contractual obligation would be suspended in the commencement of winding-up.

4. Are there specific provisions for lending in any of your insolvency proceedings? If so, provide details, including the text of any statutory provisions.

There are no specific provisions under Hong Kong legislation for lending in any insolvency proceedings. However, the Hong Kong Association of Banks (HKAB) has issued a guideline on Corporate Difficulties, which address the subject. The guideline, however, has no statutory authority.

5. In the absence of a specific provision, is there any ability for a company to obtain financing when it is in an insolvency proceeding?

It is possible for a company to obtain financing from a willing lender when it is under insolvency proceeding, in general, under a contractual arrangement other than statutory. It is not uncommon where a provisional liquidator is appointed to obtain financing from creditors to continue its operations; or where a "white knight" is identified, to finance the company, following a scheme of arrangement or restructuring of the company under insolvency proceedings.

Often the formal insolvency proceedings will be permanently stayed in such circumstances when the company returned to a state of solvency.

6. Is there any mechanism for the court to approve the financing by a company/officeholder in an insolvency proceeding? If so, is there protection for lenders against reversal or modification of court authorisation for borrowing available?

There is no specific mechanism provided under the legislation in Hong Kong to approve any financing of a company or office holder in an insolvency proceeding. However, under Section 199(2)(h), the liquidator in the winding-up proceeding by the court shall have power to do all such other things as may be necessary for winding-up the affairs of the company and distributing its assets. The power of the liquidator provided in this provision including the liquidator a power to obtain financing in an insolvency proceeding. Further, under Section 199(2)(e), the liquidator is further given power to raise on the security of the assets of the company any money requisite. The exercise of this power by the liquidator is subject to the control of the court.

Although a liquidator has such power given, a prudent liquidator would, before obtaining any financing in an insolvency proceeding, often seek consent from the court.

7. In an insolvency proceeding, are there provisions governing the extension of credit in the ordinary course of business (e.g., trade credit)? If so, what protections are available to the extender of credit?

There are no specific provisions under Hong Kong jurisdiction governing any extension of credit in any insolvency proceeding. Protection to lenders extending credit is purely on a contractual basis based on lenders' assessment i.e. unless repayment is assured in some form ordinarily through collateral, priority, or both. In a situation where the company is undergoing a corporate restructuring, the company, its creditors, the provisional liquidators or liquidators, may apply to the court for the sanction of a scheme of arrangement between the company and its creditors in order to seek its protection. Depending on the circumstances, it is not uncommon during this negotiations that lenders, or financial creditors of a company may agree to extend the credit lines before the court sanction, so that the company could continue its restructuring.

In a winding-up proceeding, where a lender is willing to provide new money for the purpose of preserving and realizing the assets of a company, such lending can contract a "post liquidation" borrowings, as an expense properly

incurred by the liquidator for the same purpose. This "post liquidation" borrowings can rank in priority to any "pre-liquidation" debts.

8. Outline the ranking of financing provided to company/officeholder in any applicable insolvency proceeding. Discuss the comparative position of any such borrowings with respect to:

(a) Pre-proceeding liabilities;

(b) Expenses relating to the proceeding in question, including the expenses of the officeholders;

(c) The costs of any committee of creditors which is required or established as a matter practice in any particular procedure and the expenses of any such committee.

In insolvency proceedings, the priority positions of each type of creditors are set out in the Companies Ordinance and the related Winding-up Rules. The priorities are:

(i) The expenses of the winding-up, including the liquidator's remuneration. All costs, charges and expenses properly incurred in preserving, realising or getting in the assets of the Company the winding up shall be payable out of the assets of the company in priority to all other claims.

Liabilities from post-liquidation borrowing would fall under this category provided if such borrowing is necessarily required for the preservation of, or realization of assets.

(ii) Secured creditors
These creditors are entitled to be paid out of the proceeds of their security ahead of all other claims. However, pursuant to Section 265(3B) of the Companies Ordinance, if the security is by way of a charge created as a floating charge, the preferential creditors must be paid before the charge holder.

(iii) Preferential creditors
Section 265(1) of the Companies Ordinance contains a lengthy list of preferential creditors, the two main categories of which relate to sums owing to (a) workers in respect of unpaid wages, severance payments, long service payments, and (b) the Government for unpaid taxes, which fell due within 12 months.

(vi) Petitioning creditors' taxed costs of the petition and the out-of-pocket expenses incurred by the committee of inspection, subject to the approval of the Official Receiver, and various other assorted liabilities are next in priority. The costs of a committee of creditors or committee of inspection are accorded no express statutory authority. Without the express sanction of the courts, no remuneration shall in any circumstances be paid to a member of a committee for services rendered by him in the discharge of the duties attaching to his office as a member of such committee; (r.152 Winding up rules); and

(v) Unsecured creditors
Based on the general principle of pari passu distribution, unsecured creditors should rank equally amongst themselves. However, Section 265(5B) of the Companies Ordinance allows a departure from this pari passu principle: "where in any winding up assets have been recovered under an indemnity for costs of litigation given by certain creditors, or have been protected or preserved by the payment of moneys or the giving of indemnity by creditors, or where expenses in relation to which a creditor has indemnified a liquidator have been recovered, the court, may, on the application of the Official Receivers or the liquidator or any such creditor, make such order as it deems just with respect to the distribution of those assets and the amount of those expenses so recovered with a view to giving those creditors an advantage over others in consideration of the risk run by them in so doing."

Therefore, where a creditor has undertaken a substantial risk when giving the liquidator an indemnity for costs, the court may grant the creditor in question a greater share of the particular assets recovered than would be normal under the pari passu principle.

9. Matters relating to security

(a) Can a company/officeholder in any of your insolvency proceedings grant security?

(b) Can a company/officeholder in an insolvency proceeding obtain priority to any pre-existing security? If so, what is the test for adequate protection of the security holder?

As illustrated in para 6 above, Section 199(2)(e) of the Companies Ordinance provides that a liquidator in a winding-up by the court shall have the power to raise any money required on the security of the assets of the company. The exercise of this power by the liquidator is subject to the control of the court. Any security necessary under a formal scheme of arrangement would also be requisite to be sanctioned by the court as the scheme itself.

There is no existing legislation covering the question of whether a company or office holder can obtain priority to any pre-existing security but the consultation paper prepared by The Law Reform Commission on Corporate Rescue talks about the introduction of " super priority borrowing" - borrowings that would rank first in priority. Without the consent of a prior ranking secured lender, super priority borrowing cannot be achieved. In other words, the priorities may be altered but only on a consensual basis.

10. Can a secured creditor roll over pre-petition loans into post-petition lending?

There is no specific affirmative answer to this question. When a company is under winding-up proceeding, a secured creditor would normally realize their charge assets. However, under certain circumstance where post-petition lending is required, the lenders could negotiate with the liquidator on terms for providing further funding to the company which would include the rolling over of pre-petition loans.

11. Are the directors/officeholders personally liable for post-petition borrowings (unless otherwise agreed)?

A provisional liquidator or liquidator can be liable for post-petition borrowings where at the time of incurring such debts, it was reasonably clear that the assets of the company would not be sufficient to repay the debts i.e. The office holder or appointment taker failed to assess the risks before incurring further debts, without proper justification of a company "post-petition" revenue and expenses. However if the provisional liquidator or liquidator acted diligently in discharging their duties and responsibilities, they should not be personal liable for the post-petition borrowing. Directors have no power to borrow on behalf of a company, once the company is in liquidation.

12. Can affiliated debtors be treated as one consolidated entity for post-petition financing purposes?

The financial positions of a company and its affiliated companies would determine whether it is beneficial to treat them as one consolidated entity for post-petition financing. However, this is more of an exception than common in Hong Kong.

13. Outline any developed practices other than statutory or regulatory provisions that go beyond the legal framework.

The process of passing the Companies (Corporate Rescue) Bill into legislation is still under consideration. In the absence of a statutory corporate rescue legislation in Hong Kong, the decisions of the court in a number of cases have given direction to, the role of a provisional liquidator, in the implementation of a rescue by providing a moratorium on any claims brought against a company under S186 of the Companies Ordinance as mentioned in para 1 above, which allows a company to negotiate a restructuring and emerge from provisional liquidation as a solvent entity. Subject to court sanction, this procedure permits the company (acting through the office holder) to come up with a rescue structure that is acceptable to the requisite majorities of creditors, to implement the restructuring of the debtor company.

India

1. Briefly summarise the types of insolvency proceedings available in your jurisdiction and indicate, in each case:

(a) The extent to which the debtor remains "in possession";

(b) Whether or not a specialist insolvency professional is likely to be appointed and, if so, a summary of his powers;

(c) The role of the court in the process.

Companies in India are governed by the following insolvency and restructuring regimes:

- Winding-up or liquidation of a company (Under Companies Act, 1956) – ("the Act");
- Schemes of arrangement/compromise between the company and its creditors and members (Under the Act);
- Restructuring of 'sick companies' (companies whose accumulated losses are equal to or exceed their net worth) in certain specified industries – under Sick Industrial Companies (Special Provisions) Act, 1985 – ("SICA").

However, the above provisions are not applicable to certain entities such as corporations incorporated under statutes, including certain public sector banking and insurance organizations.

Winding up/*Liquidation*

The Act provides two different modes for winding-up of a company:

a) Winding-up by the Court/Tribunal which may be sanctioned on a petition by the Company, its creditors or its shareholders, in certain specific circumstances such as inability of a company to pay its debts, or when its shareholders agree for its liquidation by the Court/Tribunal.

b) Voluntary winding-up may be initiated if the company's articles provide for its dissolution at a particular time or if its shareholders agree through a special resolution (75 per cent majority). In case a company is solvent and its directors make a declaration to this effect, the shareholders appoint the liquidator. Alternatively, a creditors' meeting must also be held

in which the details of the company's affairs will be shared with them. In such a case, the creditors have the right to nominate a liquidator and their nomination prevails over that of the shareholders.

While both schemes of arrangement/compromise and restructuring of 'sick companies' can be categorized as corporate rescue mechanisms, the schemes of arrangement/compromise are primarily designed for internal restructuring/reorganization of the company. A scheme of compromise/arrangement may be proposed by a company or any of its creditors/shareholders. In the case of a compromise with creditors, the creditors affected by the scheme are divided into appropriate classes, with creditors having majority in number and holding 75 per cent by value approving the scheme. The Court/Tribunal must sanction the calling of the creditors' meetings, as well as the scheme after its approval by each class of creditors. The company may also apply to the Court/Tribunal for protection against actions by its creditors pending the approval of the scheme.

The Board for Industrial and Financial Reconstruction (BIFR), a quasi-judicial body, was set up for the restructuring of sick companies. SICA requires the Board of Directors to refer a sick company to the BIFR, who often conducts an enquiry into the 'sickness' status of the company before admitting any reference. If the BIFR is satisfied that a company is sick and requires restructuring, a scheme shall be prepared for its restructuring. The BIFR has been vested with wide powers for the restructuring of sick companies and a BIFR sanctioned scheme is binding on the members and creditors of the company. However, the scheme involving any concessions or additional funding from its creditors requires approval from each of such creditors. However, in case BIFR is not able to come up with an acceptable restructuring scheme, it may recommend the sick company for winding up.

Amidst widespread criticism on account of delays in court processes and BIFR ineffectiveness, in 2002, the Government made several amendments to the Act to effect changes in the existing insolvency and restructuring regime. The amended Act envisaged setting up a special tribunal - The National Company Law Tribunal ("Tribunal") which would take over the role played by the Court, the BIFR and the Company Law Board and both company liquidation and the schemes of arrangement/compromise were envisaged to be carried out under the Tribunal's jurisdiction. However, pending constitution of the Tribunal, the amended provisions on restructuring and insolvency regime could not be notified. Further, in the last year, the Government began a fresh exercise for a comprehensive revision of the Act following a broad based consultative exercise. A concept paper on Company Law drawn up in the legislative format was circulated for public comments. Subsequently, the Government constituted an expert committee – *The Irani Committee*, to consider proposals contained in the concept paper and review comments received thereon. The Government is currently in the process of coming up

with a revised concept paper as per feedback received on the earlier concept paper and the Irani Committee recommendations.

In addition, Corporate Debt Restructuring (CDR) mechanism provides the informal workout platform and was set up through contractual arrangements between Indian lenders under the aegis of the Reserve Bank of India, the central bank of India, in 2002. Reference to CDR Forum can be made either by a lender (with >20% stake in debt outstanding) or by the company in cases with outstanding debt exceeding Rs.100million. The restructuring decision by majority (60% in number and 75% in value) is binding on the remaining CDR signatories. CDR mechanism permits lenders who are not CDR signatories to participate on case to case basis.

Discussed below are a few specific aspects in relation to the existing insolvency and restructuring regime:

Moratorium

Under SICA, reference of a company to the BIFR triggers an automatic statutory moratorium on the enforcement of security and the initiation of legal proceedings by its creditors. As this provision of statutory moratorium has been often misused to stave off creditors' action without any genuine attempt to restructure, the amended Act did not envisage any moratorium under the Tribunal regime. Instead, it provided a fixed time frame for the Tribunal to complete the process (60 days extendable to 90 days). However, the Irani Committee has, in its report, suggested a limited standstill if specifically requested by the debtor and with the approval of creditors. Under CDR mechanisms, CDR signatories have contractually agreed to a standstill period of 90 days (extendable to 180 days). This standstill period commences once the CDR forum decides to admit a case for restructuring.

To what extent debtor remains "in possession"

The Company's management remains almost unaffected during a scheme of arrangement/compromise and during CDR proceedings. However, the Court/Tribunal usually supervises implementation of the scheme of arrangement/compromise. Under SICA, BIFR has the right to appoint special directors on the company's board for safeguarding of its financial and other interests, or in public interest. These directors are required to act in accordance with the directions of the BIFR. In addition, the BIFR may pass an order restricting the company from disposing of its assets. In addition, the sanctioned scheme may involve a change in or take over of the company's management. The amended Act envisaged almost similar provisions under Tribunal regime. The Irani Committee has recommended an automatic prohibition on debtors' rights to undertake transfer, sale or disposition of assets or parts of business except with the approval of the Tribunal. It has

also suggested that capacity for management of the affairs of the business by debtor should be put to test in consultation with secured creditors and secured creditors should be given right of substitution. Further, assets of the debtor can be subjected to supervision or management by independent and qualified administrators.

In winding-up¸ the winding-up order by the Court/Tribunal and appointment of Official Liquidator have the effect of discharging all the officers and employees of the company and causing the powers of the directors to cease. If necessary, the court may limit the provisional liquidator's powers by the order appointing him. Otherwise, he would have the same powers as an Official Liquidator. In the case of a voluntary winding-up, the directors' powers cease upon appointment of a liquidator.

Involvement of insolvency expert

Existing laws and practices do not envisage the involvement of a specialist insolvency expert. Under SICA, the BIFR usually appoints an Operating Agency ("OA"), usually the lead lender, to assist it in ascertaining "sickness" of the company and in formulation of the rehabilitation scheme. The amended Act envisaged widening of OA definition to include industry experts.

Under the existing regime, the Official Liquidator is a High Court official. However, the amended Act had envisaged widening of this definition to include a firm of professionals, a corporate body consisting of professionals approved by the Government of India for this purpose, or an officer appointed by the Government of India. In voluntary liquidation, there are no eligibility requirements (academic or experience) for appointment as a liquidator. However, a corporate body cannot be appointed as a liquidator in a voluntary winding up. The Irani Committee has recommended involvement of insolvency experts in both rehabilitation and liquidation proceedings.

Role of Court/Tribunal

Courts have ongoing involvement in the Indian restructuring and liquidation process and approve all key decisions/steps during these proceedings. While BIFR approves the overall restructuring scheme under SICA, Court approves convening of creditors' meetings, sanctions the scheme and supervises its implementation. Under liquidation, the Court admits the petition, orders winding up and appoints the Official Liquidator. Further, the Official Liquidator exercises all its powers under supervision of the Court. The Irani Committee has recommended that the Tribunal have a general, non-intrusive and supervisory role in rehabilitation and liquidation process.

2. Are lenders permitted to refuse to continue lending because of the insolvency proceedings?

The Companies Act and SICA do not have any specific provisions on this aspect. However, the above question also needs to be viewed in context of relevant provisions in the Companies Act and SICA.

- SICA provides for approval of every creditor in case the rehabilitation scheme formulated by it envisages any additional financial assistance or financial concession from any of the existing/new creditors of the Company.

- The Companies Act provides for majority approval (majority in number and three fourth in value) of creditors (class-wise) before sanctioning a scheme of settlement.

- The CDR guidelines require a majority approval (60% in number and 75% in value) for a scheme to be binding on the remaining CDR signatories. These also allow cash flow (repayment) priority to the providers of additional finance, whether existing or new, in respect of additional exposure.

The usual loan documentation between borrower and the lenders contains provisions identifying appointment of liquidator/receiver as an event of default by the borrower company and these exempt lenders from carrying on lending to the borrower company. Further, internal bank guidelines often cause banks to discontinue lending and they attempt to reduce their exposures to a borrower facing acute financial distress. Apprehension of adverse observations by auditors or vigilance departments within the public sector banks also tend to curb further lending. In normal practice, it would be considered quite difficult to force a lender to disburse un-drawn money after a company is referred to BIFR or admitted for liquidation as existing Indian regulations do not recognise any priority rights for any such lending. Having said that, there are instances in which Lenders are willing to extend financing if this is done collectively, e.g. under BIFR proceedings, CDR proceedings, in which all lenders agree to extend financial assistance to these companies. Also, in the recent past, there have been cases, where some banks, generally private sector, have taken the lead in lending additional money to distressed companies on viability consideration.

3. Alternatively, can the borrower require the lender to continue to advance previously committed but undrawn amounts?

As discussed above, the Companies Act and SICA do not have any specific provisions on this aspect. Further, as discussed above, it would be difficult for a borrower to require a lender to advance un-drawn amounts even if the loan document does not have any express language over these aspects.

4. Are there specific provisions for lending in any of your insolvency proceedings? If so, provide details, including the text of any statutory provisions.

SICA/Companies Act provides for approval of every creditor in case the rehabilitation scheme formulated by it envisages any additional financial assistance or financial concession from any of the existing/new creditors of the company.

"Section 19 of SICA /Section 424E of the Companies Act:

(1) Where the scheme relates to preventive, ameliorative, remedial and other measures with respect to the sick industrial company, the scheme may provide for financial assistance by way of loans, advances or guarantees or reliefs or concessions or sacrifices from the Central Government, a State Government, any scheduled bank or other bank, a public financial institution or State level institution or other authority required by a scheme to provide for such financial assistance being hereafter in this section referred to as the person required by the scheme to provide financial assistance to the sick industrial company.

(2) Every scheme referred to in sub-section (1) shall be circulated to every person required by the scheme to provide financial assistance for his consent within a period of sixty days from the date of such circulation or within such further period, not exceeding sixty days, as may be allowed by the Tribunal, and if no consent is received within such period or further period, it shall be deemed that consent has been given.

(3) Where in respect of any scheme the consent referred to in sub-section (2) is given by every person required by the scheme to provide financial assistance, the Tribunal may, as soon as may be, sanction the scheme and on and from the date of such sanction the scheme shall be binding on all concerned.

(4) On the sanction of the scheme under sub-section (3), the financial institutions and the banks required to provide financial assistance, shall designate by mutual agreement a financial institution and a bank from

amongst themselves which shall be responsible to disburse financial assistance by way of loans or advances or guarantees or reliefs or concessions or sacrifices agreed to be provided or granted under the scheme on behalf of all financial institutions and banks concerned.

(5) The financial institution and the bank designated under sub-section (4) shall forthwith proceed to release the financial assistance to the sick industrial company in fulfilment of the requirement in this regard.

(6) Where in respect of any scheme consent under sub-section (2) is not given by any person required by the scheme to provide financial assistance, the Tribunal may adopt such other measures, including the winding up of the sick industrial company, as it may deem fit."

Further, the amended Act provides for creditors of a company submitting a rehabilitation scheme if three fourth of them by value agree. However, this provision could not be notified pending constitution of the Tribunal.

In a winding up, a liquidator has the power to raise requisite funds on the security of the assets of the company with the sanction of the Court/Tribunal in winding up by the Court/Tribunal (members in voluntary winding up). While there are no specific provisions allowing priority for lending during insolvency proceedings, it would be relevant to mention that routine debts, if any, incurred by a liquidator in routine operations (carried for beneficial winding up) of the company, get recognised as expenses during liquidation and get priority over other claims. These debts may include items such as trade creditors and lease rentals for premises.

"Section 457 of the Companies Act states: The Liquidator in a winding up by the Court/Tribunal shall have power, with the sanction of the Court/Tribunal to raise on the security of the assets of the company any money requisite"

CDR guidelines allow cash flow (repayment) priority to the providers of additional finance, whether existing or new, in respect of additional exposure.

Extracts of CDR guidelines on additional finance

4.5. Additional finance

4.5.1 Additional finance, if any, is to be provided by all creditors of a 'standard' or 'substandard account' irrespective of whether they are working capital or term creditors, on a pro-rata basis. In case for any internal reason, any creditor (outside the minimum 75 per cent and 60 per cent) does not wish to commit additional financing, that creditor will have an option in accordance with the provisions of para 4.6.

4.5.2. The additional finance may be treated as 'standard asset', up to a period of one year after the first interest/principal payment, whichever is earlier, falls due under the approved restructuring package. However, in the case of accounts where the existing facilities are classified as 'sub-standard' and 'doubtful', interest income on the additional finance should be recognized only on cash basis. If the restructured asset does not qualify for upgradation at the end of the above specified one year period, the additional finance shall be placed in the same asset classification category as the restructured debt.

4.5.3 The providers of additional finance, whether existing creditors or new creditors, shall have a preferential claim, to be worked out under the restructuring package, over the providers of existing finance with respect to the cash flows out of recoveries, in respect of the additional exposure.

4.6. Exit option

4.6.1. As stated in para 4.5.1 a creditor (outside the minimum 75 per cent and 60 per cent) who for any internal reason does not wish to commit additional finance will have an option. At the same time, in order to avoid the "free rider" problem, it is necessary to provide some disincentive to the creditor who wishes to exercise this option. Such creditors can either (a) arrange for its share of additional finance to be provided by a new or existing creditor, or (b) agree to the deferment of the first year's interest due to it after the CDR package becomes effective. The first year's deferred interest as mentioned above, without compounding, will be payable along with the last instalment of the principal due to the creditor.

4.6.2. In addition, the exit option will also be available to all lenders within the minimum 75 percent and 60 percent provided the purchaser agrees to abide by restructuring package approved by the Empowered Group. The exiting lenders may be allowed to continue with their existing level of exposure to the borrower provided they tie up with either the existing lenders or fresh lenders taking up their share of additional finance.

4.6.3 The lenders who wish to exit from the package would have the option to sell their existing share to either the existing lenders or fresh lenders, at an appropriate price, which would be decided mutually between the exiting lender and the taking over lender. The new lenders shall rank on par with the existing lenders for repayment and servicing of the dues since they have taken over the existing dues to the exiting lender.

4.6.4. In order to bring more flexibility in the exit option, One Time Settlement can also be considered, wherever necessary, as a part of the restructuring package. If an account with any creditor is subjected to One Time Settlement (OTS) by a borrower before its reference to the CDR mechanism, any fulfilled commitments under such OTS may not be reversed under the restructured package. Further payment commitments of the borrower arising out of such OTS may be factored into the restructuring package.

As discussed earlier, the lenders in India are willing to extend financing if this is done collectively, e.g. under BIFR proceedings, CDR proceedings, in which all lenders agree to extend financial assistance to these companies.

5. In the absence of a specific provision, is there any ability for a company to obtain financing when it is in an insolvency proceeding?

Indian lenders are often reluctant to extend additional assistance to distressed companies as well as unwilling to allow any preferential treatment to a lender willing to bring in new money. By virtue of this, in the past companies have relied on sponsors' funding, including induction of new equity stakeholders, the sale of business assets, or tighter working capital management for additional funding in restructuring cases. Availability of corporate (group and associate companies) and personal guarantee of sponsors in a number of cases, brings additional pressure to contribute funds for rehabilitation. Companies also resort to job-work, leasing of their production facilities to other units, disposal of surplus, unencumbered assets for arranging interim cash. In the recent past, there have been instances of specialized distressed debt special situation investors lending/infusing funds for one time settlement with the existing lenders and/or to meet additional funding requirements.

6. Is there any mechanism for the court to approve the financing by a company/officeholder in an insolvency proceeding? If so, is there protection for lenders against reversal or modification of court authorisation for borrowing available?

As discussed above, the Court/Tribunal in the case of a winding up by the Court/Tribunal (members sanction in the case of a members' voluntary winding up and the creditors sanction in the case of a creditors' voluntary winding up) may sanction the Official Liquidator to raise requisite funds on the security of the assets of the company. However, there is no specific provision protecting the lenders against reversal or modification of the Court/Tribunal authorisation for borrowing.

7. In an insolvency proceeding, are there provisions governing the extension of credit in the ordinary course of business (e.g., trade credit)? If so, what protections are available to the extender of credit?

The Court/Tribunal in the case of a winding up by the Court/Tribunal (members sanction in the case of a members' voluntary winding up and the creditors sanction in the case of a creditors' voluntary winding up) may sanction the Official Liquidator to carry on business of the company as may be necessary for the beneficial winding up (not for profit making) of the company. The Act envisages continuation of business in exceptional circumstances to prevent deterioration in value and to complete partly manufactured products. However, there are no specific provisions governing extension of credit in the ordinary course of business (e.g. trade credit).

8. Outline the ranking of financing provided to company/officeholder in any applicable insolvency proceeding. Discuss the comparative position of any such borrowings with respect to:

(a) Pre-proceeding liabilities;

(b) Expenses relating to the proceeding in question, including the expenses of the officeholders;

(c) The costs of any committee of creditors which is required or established as a matter practice in any particular procedure and the expenses of any such committee.

The Act governs disbursement of assets/cash of the company under liquidation proceedings. In the existing cash flow cascade, secured creditors enjoy priority status in respect of funds realized through assets secured in their favour, subject to protection given to workmen's dues. The secured creditors have the option of enforcing their security outside of the winding-up process, or of relinquishing their security and proving their debt in the winding-up process, where they would be treated on par with unsecured creditors. If a secured creditor selects to enforce its security, it must share the proceeds with the liquidator for payment to the company's workmen on a *pari passu* basis.

However, if a company's assets are insufficient to meet its liabilities towards its creditors, then the proceeds from the enforcement of a floating charge are first used to make certain preferential payments (mentioned in (c) below) prior to paying the holder of the floating charge. If the floating charge holder is unable to recover the whole amount of the debt due to it, it may prove the balance as an unsecured creditor in the winding-up. In such cases any excess proceeds from the enforcement of security must be handed over to the liquidator.

Funds realised from a company's assets are distributed by the liquidator in the following order:

a) Payments to workmen and payments to secured creditors of any amounts that they may have paid to the workmen out of the proceeds of the enforcement of their securities;

b) Expenses incurred during liquidation, including the Liquidator's remuneration. In the case of winding up by the Court/Tribunal, the Court/Tribunal may pass an order changing the priority of such amounts;

c) Preferential payments:

- taxes due from the company to the central/state government or any local authority;
- employees' wages/salaries;
- accrued holiday remuneration to employees amounts due in respect of contributions payable by the company as an employer under the Employees' State Insurance Act, 1948, or any law in force;
- amounts due in respect of any compensation or liability for compensation under the Workmen Compensation Act (1923) due to the death or disablement of any employee;
- sums due to any employee from a provident fund or any fund for the welfare of employees;
- expenses of any investigation held in certain circumstances;

d) Unsecured creditors;

e) Shareholders according to their rights and interests in the company.

Distribution among each class of claim is *pari passu*.

9. Matters relating to security

(a) Can a company/officeholder in any of your insolvency proceedings grant security?

(b) Can a company/officeholder in an insolvency proceeding obtain priority to any pre-existing security? If so, what is the test for adequate protection of the security holder?

As discussed above, the Court/Tribunal in the case of a winding up by the Court/Tribunal (members sanction in the case of a members' voluntary winding up and the creditors sanction in the case of a creditors' voluntary

winding up) may sanction the Official Liquidator to raise requisite funds on the security of the assets of the company. However, there are no specific provisions which discuss the issue of priority in repayment and consent of existing creditors. The existing CDR guidelines, which deal with informal workouts, provides for cash flow (repayment) priority to the providers of additional finance, whether existing or new, in respect of additional exposure.

With respect to the question of a company /officeholder obtaining priority the Act does not contain any specific provision on this. Usual commercial arrangements between borrowers and lenders in India require existing lenders' specific approval for creating additional charge over the existing security.

10. Can a secured creditor roll over pre-petition loans into post-petition lending?

Under existing Indian restructuring and insolvency regime, there is no specific provision on distinction between pre-commencement and post-commencement borrowing/lending. Usually date of winding up (date of winding up order in case of winding up by the Court/Tribunal and date of special resolution in case of voluntary winding up) becomes the reference date for crystallisation of various dues.

11. Are the directors/officeholders personally liable for post-petition borrowings (unless otherwise agreed)?

In both formal (scheme of arrangement/compromise and BIFR reference) and informal restructuring proceedings, management of the company continues to be "in possession" of the company and responsible for its day to day operations. These proceedings do not contain any specific restriction on directors/officeholders borrowing money after reference to these forums. However, under liquidation a liquidator is permitted to carry on business of the company as may be necessary for the beneficial winding up (not for profit making) of the company, with approval of the Court/Tribunal in case of winding up by the Court/Tribunal and by members/creditors in case of members/creditors' voluntary winding up. A liquidator may be held personally responsible for any unauthorised borrowing during liquidation proceedings.

12. Can affiliated debtors be treated as one consolidated entity for post-petition financing purposes?

The Indian restructuring and insolvency regulations do not contain any specific provision for post petition borrowing. While information on insolvency petition in one company (from a group of companies) may influence lenders' decision in appraising other party's loan application, for determination of group exposure and in recalling its loans to related entities, there are no existing legal provisions which treat related entities as a consolidated borrower for post-petition borrowing.

13. Outline any developed practices other than statutory or regulatory provisions that go beyond the legal framework.

Indian lenders are often reluctant to extend additional assistance to distressed companies as well as unwilling to allow any preferential treatment to a lender willing to bring in new money. By virtue of this, in the past, companies have relied on sponsors' funding, including induction of new equity stakeholders, the sale of business assets, or tighter working capital management for additional funding in restructuring cases. In the recent past, there have been instances of specialized distressed debt investors lending infusing money for one time settlement with the existing lenders and/or to meet additional funding requirements.

Over the years, Government/RBI has recognised the need of additional funding in restructuring cases. The CDR guidelines allow cash flow (repayment) priority to the providers of additional finance, whether existing or new, in respect of additional exposure.

Japan

1. Briefly summarise the types of insolvency proceedings available in your jurisdiction and indicate, in each case:

(a) The extent to which the debtor remains "in possession";

(b) Whether or not a specialist insolvency professional is likely to be appointed and, if so, a summary of his powers;

(c) The role of the court in the process.

There are four types of insolvency proceedings available in Japan. The current straight bankruptcy system was established by the enactment of the Bankruptcy Law, which was reformed in 2004 and became effective on January 1, 2005. It is a liquidation procedure for individuals, business corporations, and decedents' estates. The debtors and/or the creditors are eligible to file for commencement of the case under this law if the debtor is unable to pay its debts as they come due or if the debtor company is insolvent (i.e., its liabilities exceed its assets). A bankruptcy court, which is a part of the Japanese civil court system, will appoint a bankruptcy trustee, who is always a certified lawyer. Japan doesn't have a licence system that includes an "insolvency professional" such as exists in the United Kingdom. The role of a bankruptcy trustee is: realization of the assets of the estate; collection of the accounts receivables; termination of any employment contracts; acceptance or denial of executory contracts; examination of proof of claims; and distribution of the property of the estate to the creditors. The role of the court in this proceeding is to appoint a trustee, supervise this trustee, convene a creditors' meeting, approve the sale of the business, etc.

The second type of proceeding is a liquidation procedure called Special Liquidation, which was introduced in 1938 under the current Commercial Code. However, in March 2006, the new Corporate Law will become effective. The new Corporate Law is to be separated from the existing Commercial Code and the Special Liquidation proceedings will remain under the new Corporate Law. While under normal liquidation proceedings, supervision of the court is not required of an entity under which there is a solvent company, Special Liquidation proceedings are conducted under the supervision of the court in order to protect the rights of creditors. The debtor must be a stock company to file under these circumstances. A member of former management usually becomes the liquidator, and he may then become a special liquidator if the company is either insolvent or in the case where the execution of normal liquidation is seriously impeded. The debtor sometimes remains in possession, but alternatively, it is not unusual for the debtor to hire a certified lawyer who

becomes the special liquidator. The power of the special liquidator is similar to that of the bankruptcy trustee, but in addition, the special liquidator formulates the liquidation plan, gets approval at the creditors' meeting, and executes the plan. The role of the court is to supervise the proceedings of the debtor; submit the opening decree (commencement of the case); issue necessary temporary orders before commencement of the case; approve the enactment of significant transactions of the debtor; convene and supervise the creditors' meeting; and approve the liquidation plan.

The third type of proceeding is the proceeding under the Civil Rehabilitation Law, which is the rehabilitation proceeding and is very common in Japan. This is a DIP type proceeding which went into effect in 2000. The management usually remains in position and manages the debtor company during this type of proceeding. A supervisor, who is also a certified lawyer, is always appointed by the Tokyo District Court and confirms important debtor conduct on behalf of the court. The role of the court is to submit the opening decree of the case, appoint a supervisor, convene and supervise the creditors' meeting, and to approve the rehabilitation plan.

The last type of proceeding is the proceeding under the Corporate Reorganization Law. This law was reformed in 2003. In this type of proceeding, the court appoints a trustee, who is also a certified lawyer, after commencement of the case. The role of the trustee in this proceeding is very similar to that of the DIP under the Civil Rehabilitation Law. The biggest difference in proceedings between those under the Civil Rehabilitation Law and those under the Corporate Reorganization Law is that secured creditors can execute their right outside the proceeding under the former proceeding while both secured and unsecured creditors are bound to the proceeding under the Corporate Reorganization Law. The court directly supervises the trustee.

2. Are lenders permitted to refuse to continue lending because of the insolvency proceedings?

(a) Japanese banks usually enter into a uniform master bank agreement with debtor companies (borrowers). Under this type of agreement, banks have the right to ask the debtors who are unable to pay debts when due, or are insolvent, to pay all unpaid debts at once. Therefore, banks are permitted to refuse to carry on lending to debtors who fall under the above condition.

(b) A related question is whether banks are permitted to terminate the loan after debtors commence a case under an insolvency proceeding. In almost all the lending contracts between banks and debtors, included among events of default is filing for commencement of a case under the Insolvency Laws, which would allow the debtor party to be released from

the contract. However, the Japanese Supreme court has decided that such an *ipso facto* clause is null and void. Though there remains a dispute whether this decision prevents banks from obtaining interest after commencement of the case, most academics believe that banks can obtain interest even after debtor's bankruptcy.

Even absent express language in the loan agreement granting the lender the right to refuse to carry on lending upon the insolvency of the debtor, lenders are permitted to refuse to carry on lending and the type of insolvency proceeding the debtor has chosen will have no effect on this right.

3. Are there specific provisions for lending in any of your insolvency proceedings? If so, provide details, including the text of any statutory provisions.

As stated above (cf 2(a)), debtors are asked to repay all unpaid loans if an event of default occurs under the master bank agreement. Therefore, debtors can't require banks to continue to advance previously committed, but undrawn, amounts. Furthermore, the borrower has no right to require the lender to advance undrawn amounts, regardless of the type of insolvency proceeding the debtor has chosen, and on the contrary the borrower will be asked by the lender to repay all unpaid loans.

4. In the absence of a specific provision, is there any ability for a company to obtain financing when it is in an insolvency proceeding?

Corporate Reorganization Law

Article 128 I of the Corporate Reorganization Law provides that the right to demand arising out of borrowing of funds, which were done by the preservation administrator based on its own authority in connection with the business and properties of the pre-reorganization company shall be the claims for common benefits. Article 128 II of the Law provides that in the case where the pre-reorganization company, (except for those on which the preservation administrator was appointed), borrows funds...after the application for commencement of reorganization proceedings, the court may render permission stating that the other party's right...shall be the claims for common benefits. This Article 128 relates to the situation where the debtor borrows money after filing for commencement of the case but before the court issues opening decree. It may take the court a month to order the opening decree. During this gap period, the preservation administrator, appointed by the court, examines the assets and the business of the debtor, and the possibility of reorganization. Claims for common benefits have priority over all estate claims

except secured claims. These are paid at anytime from the estate of the debtor. Therefore, these articles help the debtor to borrow money during this period. While it may be problematic if the lender can't get permission from the court under the Article 128 II, the fact that the preservation administrator is almost always appointed reduces this risk.

After commencement of the case, Article 127 V of the Law provides that the right to demand arising out of borrowing of funds..., which were done by the trustee, on its own authority in connection with the business and properties of the pre-reorganization company shall be the claims for common benefits.

Civil Rehabilitation Law

Article 120 I of the Civil Rehabilitation Law provides that a court may, in cases where a rehabilitation debtor borrows funds...after filing for commencement of rehabilitation proceedings, but before the rehabilitation proceedings commence, give permission to treat a claim which is to be created by the other party by such acts as a claim for common benefits. Article 120 II of the Law provides that a court may empower a supervisor with an authority to make an approval which takes the place of the permission in the preceding paragraph. It is the equivalent provision of Article 128 of the Corporate Reorganization Law mentioned above. However, the gap period, which is from the filing for commencement of the case to the time of issuing the order of opening decree (commencement of the case) under the Civil Rehabilitation Law, is very short compared to that under the Corporate Reorganization Law. This is problematic for lenders because claims created by lending money don't automatically become claims for common benefits.

Article 119 V of the Law provides that claims which have been created by the borrowing of funds in relation to its properties after commencement of rehabilitation proceedings shall be claims for common benefits.

5. In the absence of a specific provision, is there any ability for a company to obtain financing when it is in an insolvency proceeding?

DIP finance has been developed since 2000 in Japan. Though there exists no mechanism of super-priority and a priming lien like in the U.S. Chapter 11 proceeding, DIP financers provide financing by obtaining security on present and future account receivables and inventories. There are several defensive-type financiers whose main concern is to protect existing loans, and a few offensive-type financiers who are newcomers for the debtor. Some insolvency practitioners are concerned that there is no collateral if the debtor executed structured financing arrangements and all the account receivables and inventories, whether in present or in the future, were collateralised before filing for commencement of the case. Nothing is left as collateral for a DIP financier.

6. Is there any mechanism for the court to approve the financing by a company/officeholder in an insolvency proceeding? If so, is there protection for lenders against reversal or modification of court authorisation for borrowing available?

As stated above (cf. 4 above), the court has the authority to make claims of funding as claims for common benefits.

7. In an insolvency proceeding, are there provisions governing the extension of credit in the ordinary course of business (e.g., trade credit)? If so, what protections are available to the extender of credit?

There is no specific provision. The extension of credit, however, is granted if the court issues preservation measures which prohibit the debtor from repaying the claims.

8. Outline the ranking of financing provided to company/officeholder in any applicable insolvency proceeding. Discuss the comparative position of any such borrowings with respect to:

(a) Pre-proceeding liabilities;

(b) Expenses relating to the proceeding in question, including the expenses of the officeholders;

(c) The costs of any committee of creditors which is required or established as a matter practice in any particular procedure and the expenses of any such committee.

Under the Bankruptcy Law, estate claims, equivalent to administrative claims under U.S. Chapter 11, get priority over unsecured claims. Secured claims are not bound to the procedure. Under the Civil Rehabilitation law, claims for common benefits and general priority claims get priority over unsecured claims and are paid at anytime. DIP finance after commencement of the case, and expenses for professionals are claims for common benefits. Secured claims can be executed outside the procedure. Therefore, only unsecured claims are bound to the proceedings and are paid according to the rehabilitation plan. Under the Corporate Reorganization Law, claims for common benefits are paid at anytime. Both secured and unsecured claims are bound to the procedure. Secured claims get priority and are usually paid in full before unsecured claims are paid under the reorganization plan.

Regarding the costs of the creditors' committee, both under the Civil Rehabilitation Law and the Corporate Reorganization Law, members of the committee ask the court to reimburse their expenses from the estate of the debtor if the committee is deemed to have performed an activity contributing to a rehabilitation/reorganization of the debtor. However it is very rare to establish creditors' committees under these procedures.

9. Matters relating to security

(a) Can a company/officeholder in any of your insolvency proceedings grant security?

(b) Can a company/officeholder in an insolvency proceeding obtain priority to any pre-existing security? If so, what is the test for adequate protection of the security holder?

Yes. DIP can grant security to creditors who lend money to the company after obtaining approval by a supervisor, who is appointed by a court. The supervisor is always a qualified lawyer. There may be at least two stages where the DIP grants security to the creditors; one is the "early stage" finance (DIP finance) where the company files for rehabilitation proceedings and needs working capital to survive on a day to day basis; the second is the "later stage" finance (exit finance) where the company overcomes a shortage of funds and needs capital investments to grow its business and then to exit the rehabilitation procedure.

With respect to the question on priority there is no concept of priming lien in Japan.

10. Can a secured creditor roll over pre-petition loans into post-petition lending?

No. However, a similar result would be achieved in the following manner: the court can agree that claims, which arise between the time of filing and the time of the order for relief, should be common benefit claims if the claims arise from lending funds, purchasing raw materials or any other acts which are necessary to achieve the rehabilitation of the debtor company both under the Civil Rehabilitation Law and the Corporate Reorganization Law. The preservation administrator, who is appointed by the bankruptcy court and works between the date of filing and the time of the order for relief under the Corporate Reorganization Law, has the right to borrow funds which automatically become common benefit claims without the approval of the court.

11. Are the directors/officeholders personally liable for post-petition borrowings (unless otherwise agreed)?

No. Even if, in a case where the debtor has borrowed funds after filing for corporate reorganisation or civil rehabilitation proceedings, it turns out that the estate is insufficient to meet all claims for common benefits, there is no personal liability for the trustee or the debtor.

12. Can affiliated debtors be treated as one consolidated entity for post-petition financing purposes?

No, they can't. There is no consolidating process under Japanese insolvency laws. It is possible, however, that the trustee of a case be appointed as the trustee of other related cases

13. Outline any developed practices other than statutory or regulatory provisions that go beyond the legal framework.

There is a unique system called "sponsorship" in Japan. A sponsor is a kind of buyer of the debtor company. He can be a financer to the debtor after commencement of the case. He lends money, buys notes at a discounted price to provide money to the debtor company. He imputes new capital after the right of the existing equity holder extinguishes and obtains 100% of the equity under the rehabilitation/reorganization plan.

Netherlands

1. Briefly summarise the types of insolvency proceedings available in your jurisdiction and indicate, in each case:

(a) The extent to which the debtor remains "in possession";

(b) Whether or not a specialist insolvency professional is likely to be appointed and, if so, a summary of his powers;

(c) The role of the court in the process.

Dutch insolvency law is mainly laid down in one statute, the Dutch Bankruptcy Act (*Faillissementswet*, "DBA"). The DBA provides for three formal insolvency proceedings: bankruptcy (*faillissement*), suspension of payments (*surseance van betaling*) and debt reorganisation of natural persons (*schuldsanering natuurlijke personen*). The last-mentioned proceeding only applies to natural persons, whether or not they carry on a business, but not to incorporated debtors and will not be discussed hereinafter. Suspension of payments and bankruptcy will hereinafter both be referred to as insolvency. We note that a reform of Dutch insolvency law is currently being prepared and that major changes are to be expected. A first draft of the reform bill is expected in the course of 2006.

Suspension of payments

In suspension of payments the keyword is continuation. The purpose of a suspension of payment is to give the debtor an opportunity to reorganise, search for (new) means of financing (its) debts and continue its business.

The debtor who foresees that he will not be able to continue to pay his debts as and when they become due and payable can apply for suspension of payments by filing a petition with the court. Application can only be made by the debtor, not by his creditors or other third parties.

The court will immediately grant a provisional suspension of payments and appoint an administrator (*bewindvoerder*). Generally, in the Netherlands only attorneys specialised in insolvency law are appointed as administrators.

The court usually also appoints a member of the court as supervisory judge (*rechter-commissaris*). The role of the supervisory judge in a suspension of payments is essentially an advisory one.

A final suspension of payments will only be granted after a creditors' meeting has been held. It may be granted for a maximum period of one and a half years. The debtor may request one or more extension(s) of this period.

During the (provisional) suspension of payments, the debtor company, that remains the owner of the assets, is only entitled to administer and dispose of its assets with the consent of the administrator. The debtor's management and the administrator cannot dispose of the debtor's assets one without the other.

Basically, a suspension of payments only affects the claims of non-preferred and non-secured creditors. For example, claims of tax authorities and employees are preferred and therefore do not fall within the scope of a suspension of payments. Secured and preferred creditors fall within the scope of a suspension of payments to the extent they cannot take recourse on the goods over which they have security or preference. Creditors that are affected by the suspension of payments are prohibited to take recourse against assets belonging to the estate of the debtor. All measures of recourse already taken by such creditors are – by virtue of law – suspended. Existing seizures are suspended (and cancelled once suspension of payments or ratification of a composition plan has become final). During the course of the suspension of payments, payments of all debts falling within the scope of the suspension of payments may - in principle - only be made, pro rata parte i.e. to all affected creditors in proportion to their claims.

Suspension of payments may terminate by way of a court approved composition plan or if the debtor has been successful in securing funding and is again able to meet his obligations as they become due. In practice, most cases of suspension of payments fail and are turned into bankruptcy proceedings swiftly.

Bankruptcy

The keyword in bankruptcy is liquidation. The purpose of a bankruptcy is to liquidate the assets of the bankrupt estate. However, in practice bankruptcy proceedings serve as an important instrument to reorganise the businesses of financially troubled debtors by way of a sale of (part of) the debtor's business as a going concern.

The debtor – legal entity or natural person – whose condition is such that it has ceased to pay its creditors, is subject to being adjudicated bankrupt by court order. Adjudication of bankruptcy can be requested by the debtor itself, by one or more of its creditors (whether foreign or domestic) or – for reasons of public interest – by the public prosecutor.

Simultaneously with the opening of bankruptcy proceedings, the court will appoint one or more receivers (*curatoren*) who are entrusted with the

administration of the bankruptcy. Generally, in the Netherlands only attorneys specialised in insolvency law are appointed as receivers.

The court will also appoint a judge in charge of the supervision of the bankruptcy (*rechter-commissaris*). This supervision entails – among other things – that with respect to a number of actions (e.g., a private sale of assets of the bankrupt estate, the (temporary) continuation of the debtor's business, of dismissal of employees) the receiver is required to obtain the prior consent of the supervisory judge. In addition, each creditor (as well as the debtor itself) may file a petition with the supervisory judge to object to any act by the receiver or to request the supervisory judge to order the receiver to perform or refrain from performing an act.

In bankruptcy the debtor is divested of the right to administer and dispose of his assets. As from the opening of the bankruptcy proceedings, it is the court appointed receiver who is entrusted with the administration and liquidation of the bankrupt estate.

Bankruptcy can be considered a general statutory seizure of the assets of the debtor followed by liquidation for the benefit of the creditors. Creditors are prohibited to take recourse against assets belonging to the estate of the debtor. Attachments made by the creditors are cancelled. However, secured creditors can in principle enforce their security as if there were no bankruptcy.

Generally, bankruptcy of a company and subsequent liquidation of the company's assets will result in the dissolution of the company.

2. Are lenders permitted to refuse to continue lending because of the insolvency proceedings?

In principle and unless contracted for otherwise, an insolvency alters neither the validity nor the contents of an agreement to which the debtor is a party. The provisions of the law of obligations are also applicable in bankruptcy and suspension of payments. However, if an agreement contains rights and obligations for both the debtor and its counterparty and neither party has completely fulfilled its obligations, the counterparty is entitled to request the administrator/receiver in writing to declare within a reasonable period of time whether he will perform the agreement. If the administrator/receiver fails to reply within a reasonable period of time, the administrator/receiver loses his right to claim performance. If the administrator/receiver chooses to perform the agreement resulting liabilities are claims against the estate (administrative expenses) and he will have to provide security for the performance thereof. If the administrator/receiver chooses not to perform the agreement, the counterparty may terminate the agreement.

In practice, loan agreements will generally contain the provision that the debtor is in default in the event of a bankruptcy or a suspension of payments. As a result the lender will have the right to terminate the loan agreement and to demand repayment of the outstanding amounts. Such termination clauses are in principle valid and enforceable in insolvency.

3. Alternatively, can the borrower require the lender to continue to advance previously committed but undrawn amounts?

As set out hereinbefore, an insolvency does not alter the validity or the contents of an agreement to which the debtor is a party. However under Dutch law, a party is entitled to suspend performance of its obligations if the counterparty does not fullfil its obligations or if circumstances have come to its attention after the entry into the contract, giving it good reason to fear that the other party will not perform its corresponding obligations. As a result thereof in the event of an insolvency, the lender will in general be entitled to suspend its obligation to advance the undrawn amounts. However the suspension does not discharge the lender from its obligations. In order to be discharged from its obligations, the lender will have to terminate the agreement.

If the counterparty has not exercised its authority to stipulate a time-limit, the receiver or administrator may either request the counterparty in writing to declare within a reasonable period of time whether he will perform the agreement or terminate the agreement or the administrator can demand for performance of the agreement.

4. Are there specific provisions for lending in any of your insolvency proceedings? If so, provide details, including the text of any statutory provisions.

No, there are no specific provisions for lending.

5. In the absence of a specific provision, is there any ability for a company to obtain financing when it is in an insolvency proceeding?

Yes. During an insolvency, new funding could generally be attracted by those who are authorised to act for the debtor (in bankruptcy the receiver, in suspension of payments the debtor and the administrator jointly). Obligations arising from such new borrowings (e.g. payment of interest and repayment of the principal sum) will constitute claims against the estate (administrative claims) that must be paid in priority to all pre-insolvency claims (with the exception of secured claims). Obviously, a lender must have enough comfort

that he will find sufficient means of recourse in case of default. Attracting new funds is facilitated if the estate has unsecured assets available that can serve as security for the lender.

6. Is there any mechanism for the court to approve the financing by a company/officeholder in an insolvency proceeding? If so, is there protection for lenders against reversal or modification of court authorisation for borrowing available?

As set out before, the bankrupt company loses its right to administer and dispose of its assets. The new financing will therefore be obtained by the receiver. The receiver will need the consent of the supervisory judge to obtain financing. It is possible to appeal against the approval of the supervisory judge. However, if the approval is annulled, the agreement whereby the financing was advanced remains valid. Third parties can only hold the receiver liable.

During a suspension of payments, the debtor can only enter into a new loan agreement with the cooperation or consent of the administrator. Prior court approval is not required.

7. In an insolvency proceeding, are there provisions governing the extension of credit in the ordinary course of business (e.g., trade credit)? If so, what protections are available to the extender of credit?

There are no specific provisions governing the extension of credit in the insolvency proceedings.

8. Outline the ranking of financing provided to company/officeholder in any applicable insolvency proceeding. Discuss the comparative position of any such borrowings with respect to:

(a) Pre-proceeding liabilities;

(b) Expenses relating to the proceeding in question, including the expenses of the officeholders;

(c) The costs of any committee of creditors which is required or established as a matter practice in any particular procedure and the expenses of any such committee.

Suspension of payments does not lead to distribution of realisation proceeds to the creditors following the liquidation of the debtor's assets (other than in

the context of a composition plan) and therefore, ranking of claims is not a real issue in that respect. Claims relating to financing provided by lenders during the debtor's insolvency will have to be met on the contractually agreed terms. They constitute claims against the estate ("administrative costs") and thus are not affected by the insolvency proceedings.

The starting point of Dutch law is that all creditors have an equal right to be paid out of the proceeds of the estate in proportion to the amount of their claims. During bankruptcy proceedings the ranking of claims could be described as follows:

a) Creditors with de facto priority
   De facto priority may result from, for example, set off or a (de facto) monopoly.

b) Secured claims, to the extent such claims can be recovered from the net proceeds of the security
   Claims secured by a right of pledge (*pandrecht*) or mortgage (*hypotheek*) on the debtor's assets. Secured creditors can in principle foreclose on their collateral as if no bankruptcy exists. Among other things, this entails that they do not have to share in the costs of the bankruptcy and do not have to file their claims for verification purposes with the receiver, unless a residual claim remains.

c) Estate claims
   Claims which arise by virtue of law (e.g. lease costs, employee wages and employees' claims against the employer relating to pension obligations that have come into existence as of the date of the bankruptcy adjudication) and claims that have come into existence through actions of the receiver (e.g. claims pursuant to contracts concluded by the receiver, such as contracts with lenders financing the business during the insolvency proceedings). Estate creditors have a direct claim on the estate and may enforce their claims by means of individual claim enforcement mechanisms provided in the general law. The receiver's fees have to be paid in priority to all other estate claims.

d) Preferred bankruptcy claims
   Claims in respect of which statutory law confers a privilege (*voorrecht*) – e.g. tax and social security claims, certain claims against the employer relating to pension obligations insofar as they relate to the pre bankruptcy period - and other grounds of preference provided for by statutory law (e.g. right of retention).

e) Non-preferred ordinary bankruptcy claims
   For example, trade creditors and claims relating to liability for wrongful acts (tort).

f) Subordinated bankruptcy claims
A creditor can contractually agree to subordinate his claim (in respect of all or certain other creditors), resulting in a ranking lower than that conferred by law.

g) Any funds remaining after full payment of all creditors will be made available to the debtor again.

If lenders finance a company subject during insolvency proceedings with co-operation of the administrator respectively at request of the receiver, the claims of the lenders are regarded as estate claims for the amount of the new loan (including interest).

9. Matters relating to security

(a) Can a company/officeholder in any of your insolvency proceedings grant security?

(b) Can a company/officeholder in an insolvency proceeding obtain priority to any pre-existing security? If so, what is the test for adequate protection of the security holder?

With respect to the question of granting security in bankruptcy proceedings, the receiver can grant security over the debtor's assets. He will need the prior consent of the supervisory judge. During the (provisional) suspension of payments security can only be granted by the debtor with the consent of the administrator.

On the question of priority, the security rights existing at the time of the insolvency will preserve their priority.

10. Can a secured creditor roll over pre-petition loans into post-petition lending?

A creditor can not independently roll over pre-petition loans into postpetition lending. However, if the receiver chooses to obtain new financing or to make use of undrawn amounts, the claim of the creditor has the rank of an estate claim.

11. Are the directors/officeholders personally liable for post-petition borrowings (unless otherwise agreed)?

The debtor's management will in principle not be liable for post-petition borrowings. A receiver can be held liable for his actions only in exceptional circumstances.

12. Can affiliated debtors be treated as one consolidated entity for post-petition financing purposes?

Dutch statutory law does not recognise the concept of consolidated bankruptcies of group companies. In cases where it was factually impossible to separate the various estates, consolidation has been allowed in case law. In principle, other entities within a group will only be liable for post-petition financing of one of the group companies, pursuant to an agreement to that effect.

13. Outline any developed practices other than statutory or regulatory provisions that go beyond the legal framework.

Dutch Social Security law provides for a guarantee for employees of wages, both for a limited period of time prior to the insolvency as well as during the notice period (during the insolvency). If, during bankruptcy, the receiver dismisses all employees, arranges payment of wages through the social security system and continues the business, the receiver creates a huge working capital advantage and thus cash flow. Production and sales continue for some time, but costs are considerably reduced as no wages are paid by the receiver. The social security authorities subrogate in the employees' claims and obtain a preferential pre-insolvency claim with respect to wages relating to the period prior to the insolvency and a claim against the estate for wages relating to the notice period during insolvency.

Poland

1. Briefly summarise the types of insolvency proceedings available in your jurisdiction and indicate, in each case:

(a) The extent to which the debtor remains "in possession";

(b) Whether or not a specialist insolvency professional is likely to be appointed and, if so, a summary of his powers;

(c) The role of the court in the process.

The Polish Bankruptcy and Rehabilitation Law of February 28, 2003 which became effective on October 1, 2003 ("Bankruptcy Law") includes the following proceedings:

- Rehabilitation proceedings in the case of threat of insolvency;
- Proceedings to secure the assets;
- Bankruptcy proceedings with the possibility to conclude a reorganization of debts arrangement;
- Bankruptcy proceedings by liquidation of assets.

In addition, the law provides also for a possibility to conclude an arrangement on repayment of debts in the initial phase of proceedings as regards the bankruptcy.

During the proceedings, as a general rule, it is also possible to transform the proceedings with the possibility to conclude make an arrangement into liquidation proceedings and vice versa.

The bankruptcy is declared with respect to a debtor who has become insolvent, i.e. a debtor who fails to perform its due obligations.

A debtor who is a legal person or an unincorporated organizational unit possessing legal capacity is also deemed insolvent when the sum of its obligations exceeds the value of its assets, even if it duly performs such obligations on a current basis.

1. Rehabilitation proceedings in threat of insolvency

These proceedings are addressed to an entrepreneur who still meets its obligations, but, based on rational estimate, it is evident that it will become insolvent shortly. The basic goal of the rehabilitation proceedings is to enter into a reorganization arrangement by a debtor with creditors under such conditions, which ensure recuperation of his capacity to compete on the market.

The effect of the opening of rehabilitation proceedings is the suspension of fulfillment of the entrepreneur's obligations, and suspension of the accrual of interest due. Also execution proceedings pending against such entrepreneur are suspended, and new ones cannot be initiated. Upon a motion of the entrepreneur, the court may annul any seizure over its assets.

The opening of rehabilitation proceedings shall not eliminate the possibility to initiate lawsuits or other kinds or court proceedings against the entrepreneur, provided that a creditor's petition for declaration of bankruptcy is subject to examination after the end of the rehabilitation proceedings or together with the decision on approval of the debt arrangement concluded in such proceedings.

The general rule is that the debtor - petitioner conducts the rehabilitation proceedings on its own, upon submission of a rehabilitation plan, which must be approved by way of a debt arrangement during the creditors' assembly. The entrepreneur conducting such proceedings is not deprived of the right to administer its property, there are only statutory limit with respect to the possibility of the disposal or encumbering of his assets.

In rehabilitation proceedings, the provisions authorizing the court supervisor to give his consent enter into transactions outside the ordinary course of business do not apply, because the assets are administered by the entrepreneur and the role of the supervisor is of controlling character only.

The court supervisor is appointed by the court for the duration of proceedings and he presides over the creditor's assembly. The court supervisor may also be appointed for the period the debt reorganization arrangement is being performed.

The court revokes such debt arrangement if the entrepreneur fails to perform the arrangement or if any negative prerequisites were discovered when the arrangement has been performed. The court may invalidate the arrangement if the entrepreneur fails to implement the rehabilitation plan approved during the rehabilitation proceedings.

2. Bankruptcy proceedings

2.1 Proceedings to secure the assets

During proceedings to declare bankruptcy, the court *ex officio* conducts the proceedings to secure the assets and appoints a provisional court supervisor.

The effect of appointment of the supervisor consists in limitation of the debtor in his right to administer its assets in such way that transactions outside the ordinary course of business require consent of the provisional court supervisor. There is, however, no clear provision as to invalidity of the debtor's actions exceeding ordinary course of business.

The utmost way to secure the assets, which results in depriving the debtor of possibilities to administer and dispose of its assets, is the mandatory administration by a mandatory administrator (acts of the debtor outside the ordinary course of business are null and void).

The court appoints a provisional court supervisor or mandatory administrator.

The court may apply other measures to secure the assets of the debtor, in particular it may order the mandatory administration of the debtor's assets as a remedy of the risk that the debtor may conceal its assets or otherwise act to the detriment of the creditors, and if the debtor does not comply with the instructions of the provisional court supervisor.

As part of proceedings to secure the assets, the court may suspend the enforcement proceedings conducted against the debtor and annul the seizure of his assets.

2.2 Bankruptcy with the possibility to conclude a debt arrangement

The bankruptcy with the possibility to conclude a debt arrangement is declared at the debtor's request if it is evidenced that by way of an arrangement the creditors will be satisfied to the extent higher than they would be satisfied after conducting bankruptcy proceedings including liquidation of assets. The proceedings with the possibility to conclude a debt arrangement are not conducted if, due to the behavior of the debtor, it is not certain whether the arrangement would be performed, unless the debtor's arrangement proposals provide for a liquidation of assets arrangement.

The court may allow the bankrupt to carry out the ordinary administration of the assets in whole or in part only where the bankrupt is able to assure due administration thereof, and if his insolvency is the effect of exceptional circumstances beyond his control.

The entrepreneur administers his assets, to the extent defined by the court, provided that this concerns only the transactions within the ordinary course of business. In the case of transaction outside such course of business the consent of the court supervisor is required. Without the court supervisor's approval, such transactions of the bankrupt are invalid.

The debtor loses such power over his assets if he - even unintentionally - violates the law while performing the administration or the manner of exercising the administration by the bankrupt does not guarantee the performance of the arrangement.

The main role of the court supervisor appointed where the administration is carried out by the debtor is to supervise the bankrupt's transactions. The

court supervisor and administrator undertake actions in cases concerning the bankruptcy estate in their own name, but to the benefit of the bankrupt.

The court supervisor is also responsible for fulfilling procedural obligations in court and administrative cases regarding the assets forming part of the bankruptcy estate. The court supervisor may institute action for considering the bankrupt's transactions ineffective. He defines the composition of the bankruptcy estate, prepares an inventory, submits reports, participates in creditors' assemblies, performs obligations connected with the establishment of the list of creditors. Upon commencement of his duties, the court supervisor prepares financial statement as at the day immediately preceding the declaration of bankruptcy.

Upon declaration of bankruptcy with the possibility to conclude a debt arrangement, the court appoints an administrator, if the bankrupt may administer only a part of the assets or if he is deprived of administration. The administrator administers the assets of the bankruptcy estate. The role of the administrator is similar to the role of the bankruptcy trustee, i.e. he immediately takes administration of the bankrupt's assets, secures the bankrupt's assets, prepares an inventory, if it has not been made so far, prepares financial statements as at the date preceding the declaration of bankruptcy, defines the composition of the bankruptcy estate, prepares a list of payables, enters decisions on declaration of bankruptcy into the land and mortgage register and into other registers, undertakes actions connected with satisfaction of employees' claims. The administrator has an exclusive right to institute actions for declaring the transactions undertaken by a bankrupt as ineffective. He may also subrogate the plaintiff in a lawsuit initiated by a creditor who challenged the bankrupt's transactions.

2.3 Bankruptcy by liquidation

The core bankruptcy proceedings are intended to liquidate the bankrupt's assets and distribute the funds of the bankruptcy estate or are conducted with the intention to conclude a debt arrangement.

Upon declaration of bankruptcy, the court appoints a bankruptcy trustee. When the trustee assumes his duties, the entrepreneur in bankruptcy is totally deprived of administration over its assets. During the liquidation proceedings, the bankruptcy estate is administered by a trustee appointed by the court.

The trustee takes over the bankrupt's assets, administers them to produce maximum profits and avoid loss, secures them against destruction, deterioration or appropriation by third parties, and initiates the process of liquidation of the assets. Thus, the trustee's duties include administration and liquidation of the bankrupt's assets. The trustee notifies creditors about bankruptcy, prepares a list of payables, defines the composition of the

bankruptcy estate by making inventory and valuations, and prepares a distribution plan of the bankruptcy estate funds.

The trustee may carry on the bankrupts' enterprise. If it is possible to sell the enterprise as a whole or its organized part, then the task of the trustee is to take all measures to ensure that the condition of the enterprise does not deteriorate.

After bankruptcy has been declared, the assets of the bankruptcy estate may not be encumbered with a pledge, registered pledge or tax lien, nor may any entries in the land and mortgage register or in any register concerning such assets be made in order to secure a claim, even if such claim arose prior to the declaration of bankruptcy, however, the possibility of such encumbrances exists if bankruptcy has been declared with the possibility to conclude a debt arrangement and the bankrupt has retained the right to administer all or a part of the assets and the court supervisor has consented to the bankrupt's assets being encumbered, or if the bankruptcy estate is administered by the administrator and the creditors' committee has consented to the assets included in the bankruptcy estate being encumbered.

Once the bankruptcy order has been made, the acts within the bankruptcy proceedings are performed by the judge-commissioner, save for acts within the court's scope of duty. The judge-commissioner directs the course of the proceedings, supervises the acts of the trustee, court supervisor and administrator, specifies the transactions which the trustee, court supervisor or administrator may not enter into without his approval or without the consent of the creditors' committee.

2. Are lenders permitted to refuse to continue lending because of the insolvency proceedings?

The basic rule in the bankruptcy proceedings with the possibility to conclude a debt arrangement is to stop payments of all obligations of the bankrupt included in the arrangement. The bankrupt's obligations may be performed only upon the consent of the judge-commissioner, if they result from the obligations occurred after the date of declaration of bankruptcy and upon the consent of creditors out of the obligations originating from the period to the declaration of bankruptcy, if they are included in the arrangement and if this is necessary for conducting business activity or increasing the efficiency of the bankrupt's enterprise.

All bankrupt's obligations become due and payable at the time of declaration of bankruptcy by liquidation of assets and as at the same day in-kind obligations are transformed into cash obligations. Only the interest for a period until the date of declaration of bankruptcy may be paid from the bankruptcy estate. As at the date of declaration of bankruptcy, a credit

agreement expires if prior to such date the lender has not yet disbursed the funds to the bankrupt. The creditor may claim compensation of losses in the bankruptcy proceedings, filing a statement of claim with the judge-commissioner. If only a portion of the funds was disbursed to the bankrupt prior to the date of declaring bankruptcy, the bankrupt loses the right to request the disbursement of the remaining balance.

In exceptional cases - if it is indispensable for conducting the bankrupt's business activity or increasing the bankrupt's enterprise effectiveness - it is possible to pay certain dues upon the consent of the judge-commissioner.

The trustee has the right to decide as to the performance or withdrawal from mutual agreements to which the bankrupt is a party. The bankrupt's contractor may request the trustee to make a written declaration whether he renounces the agreement or whether he intends to perform it. There are though opinions in the doctrine that neither loan nor credit agreements qualify as mutual agreements.

However, in accordance with the Banking Law of 1997 ("Banking Law"), if the borrower has failed to meet the credit conditions or if the borrower has lost its creditworthiness, the bank may reduce the amount of the credit or terminate the credit agreement. The Banking Law provides for a 30-day period of notice of termination of a credit agreement.

Any provision in a contract stipulating that the transaction, to which the bankrupt is a party, is to be changed or terminated upon a declaration of bankruptcy shall be null and void.

The poor financial standing of the borrower is defined as the situation where there is no ground to declare bankruptcy, however, the circumstances prove that the repayment of the credit is objectively threatened. The period of notice of a credit agreement, if the borrower is threatened with bankruptcy - is 7 days. None of the provisions of the Banking Law explains how such threat should be understood or who should decide on the occurrence of such threat, i.e. whether the assessment is to be based on a subjective feeling of the bank or whether there should be an objective measure of such threat. Thus, it is the bank who decides whether such threat has occurred and such bank's decision may be verified by the court.

Termination of the credit agreement due to the fact that the borrower has lost its creditworthiness or is threatened with bankruptcy shall not take place if the bank agreed that the borrower implements the reorganization program (rehabilitation proceedings) and it concerns the whole period of implementation of the reorganization program, unless the bank comes to the conclusion that the reorganization program is not duly implemented.

As far as extending a new credit is concerned, as a general rule, the bank makes its decision dependent on the borrower's creditworthiness. The creditworthiness means the ability to repay the credit including interest thereon within the time limits specified in the credit agreement. The borrower is obliged to submit, at the bank's request, any documents and information necessary to assess such creditworthiness.

It is assumed in the doctrine that extending a credit by a bank to a person which is not creditworthy shall not cause the invalidity of a concluded agreement. In such case, certain consequences may only be drawn in relation to a bank within the scope of banking supervision measures. In rehabilitation proceedings, a credit agreement or a loan agreement may be concluded upon the consent of the creditors' committee, and in its absence, upon the consent of the judge-commissioner.

The declaration of bankruptcy does not affect the validity of bankrupt's bank account agreements.

During the proceedings with the possibility to conclude a debt arrangement until its annulment or entering into such arrangement, or a change of the decision on declaration of bankruptcy with the possibility to conclude an arrangement into bankruptcy through the liquidation of the bankrupt's assets, the creditor, without the consent of the creditors' committee, may not, inter alia, terminate bank account agreements, surety and bank guarantee agreements, or letters of credit. The arrangement may ban the termination of such agreements until the arrangement is fully performed.

In accordance to the Directive 98/26/EC, a declaration of bankruptcy and depriving the bankrupt of the right of administration does not affect the use of the funds gathered and registered on the bankrupt's account, if such funds have not been encumbered with the rights *in rem* or were not object of security. This concerns also securities registered on the account, which were subject to collateral security obtained within the system of securities settlement, if the settlement order was introduced into the system at the latest on the date of declaration funds have not been encumbered with the rights *in rem* or were not object of security. This concerns also securities registered on the account, which were subject to collateral security obtained within the system of bankruptcy.

3. Alternatively, can the borrower require the lender to continue to advance previously committed but undrawn amounts?

Generally, the rules described in point 2 above apply.

4. Are there specific provisions for lending in any of your insolvency proceedings? If so, provide details, including the text of any statutory provisions.

Certain provisions concerning credit and loan agreements are set forth in the Bankruptcy Law, Banking Law and the Commercial Companies Code 2000.

Bankruptcy Law

Article 80

The declaration of bankruptcy of a participant in a payment system or a securities settlement system (…), irrespective of whether bankruptcy with the possibility to conclude an arrangement or with the liquidation of the bankrupt's assets has been declared, shall not prevent from making use of:

(1) (…)

(2) Securities recorded on the bankrupt's settlement account as a collateral security for a bank credit extended within the payment system or securities settlement system if such credit may be disbursed under an existing loan agreement - for the purpose of performing the bankrupt's obligations that arise from settlement orders entered into the system on the date bankruptcy is declared at the latest.

Article 105

In the case of bankruptcy of either party to a loan agreement, the loan agreement shall expire if the object of the loan has not yet been disbursed or delivered.

Article 111

(1) A bank credit agreement shall expire on the date bankruptcy is declared if prior to that date the creditor has not disbursed the funds to the bankrupt. The creditor may pursue a claim in the bankruptcy proceedings for compensation, filing the claim with the judge-commissioner.

(2) If a part of the funds has been disbursed to the bankrupt before the date the bankruptcy has been declared, the bankrupt shall not have the right to request the disbursement of the remaining part.

Article 184

(1) The administrator shall perform all acts of administration related to the on-going operation of the bankrupt's enterprise and to the preservation of the bankruptcy estate in unimpaired condition.

(2) The consent of the creditors' committee shall be required for the alienation of an asset which is not related to the economic activity of the bankrupt's enterprise, as well as for encumbering assets with limited rights in rem and for raising bank credits and loans.

Article 206

(1) The following acts concerning the bankruptcy estate may not be undertaken without the permission of the creditors' committee:

1) *further operation of the enterprise by the trustee, if the enterprise is to be operated for more than three months from the date bankruptcy is declared;*

2), 3), 4) *(…);*

5) *taking loans and bank credits and encumbering the bankrupt's assets with limited rights in rem;*

6) *the performance of a mutual agreement entered into by the bankrupt or the rescission of such agreement, as well as the performance or rescission of an agreement entered into by the bankrupt to which the provisions of articles 98 and 99, respectively, apply;*

7) *(…).*

Article 279

(1) The terms and conditions of restructuring the bankrupt's obligations should be equal with respect to the creditors of the same class of interests, unless a creditor has explicitly consented to less favorable terms and conditions.

(2) More favorable terms and conditions of restructuring the obligations may be extended to creditors who have small claims, as well as to creditors who, after the declaration of bankruptcy, have extended or are to extend a bank loan indispensable for the performance of the arrangement.

Article 284

(1) If the debt arrangement provides that its performance is to be secured by third parties, that a bank credit is to be extended to the bankrupt or that consent of third parties is to be granted for modification of rights or legal relationships, voting on such debt arrangement may be held only if at the meeting of creditors documents are submitted that confirm that these obligations will be performed after the arrangement has been adopted.

Banking Law

Article 75

(1) Where the borrower has not met the conditions for granting the credit or where the borrower has lost the creditworthiness, the bank may reduce the amount of the credit granted or terminate the credit agreement.

(2) The period of notice referred on in Section 1, unless the parties provide in the agreement for a longer period, shall be 30 days, and if the borrower is threatened with bankruptcy - 7 days.

(3) The credit agreement may not be terminated if the borrower loses the creditworthiness or is threatened with bankruptcy, if the bank has agreed that the borrower shall implement the rehabilitation program.

(4) The provision of Section 3 shall be applied throughout the entire period of implementation of the rehabilitation program, unless the bank establishes that the rehabilitation program is not duly implemented.

Commercial Companies Code

Article 14 paragraph 3

A shareholder's claim under a loan extended by the shareholder to the capital company shall be deemed to be the contribution of that shareholder to the company in the case where its bankruptcy is declared within two years of the date of the loan agreement.

5. In the absence of a specific provision, is there any ability for a company to obtain financing when it is in an insolvency proceeding?

The above provisions, and in particular Article 279(2) and 284(1) of the Bankruptcy Law and Article 75(3) of the Banking Law, refer to the events of borrowing in the course of bankruptcy and rehabilitation procedure.

6. Is there any mechanism for the court to approve the financing by a company/officeholder in an insolvency proceeding? If so, is there protection for lenders against reversal or modification of court authorisation for borrowing available?

Yes, there is such a mechanism in the rehabilitation proceedings and in the bankruptcy proceedings with the possibility to conclude an arrangement and even in the bankruptcy liquidation proceedings, if the trustee manages the

bankrupt's enterprise. Such mechanism is the consent of the court (rehabilitation proceedings), the consent of the judge-commissioner and creditors' committee (bankruptcy proceedings).

The provisions do not exclude the possibility that the court changes its decision or withdraws its consent however, shall not adversely affect the interests of a lender with respect to amounts disbursed prior to such change or withdrawal.

7. In an insolvency proceeding, are there provisions governing the extension of credit in the ordinary course of business (e.g., trade credit)? If so, what protections are available to the extender of credit?

There are no specific provisions governing the extension of credit in insolvency proceedings, except for certain provisions of the Bankruptcy Law presented in point 4, and the general rules referred to in point 2 apply.

Claims for repayment of a credit taken by the administrator or bankruptcy trustee, or by the bankrupt upon a consent of the court supervisor, belong to the first category of satisfaction of unsecured claims as payables resulting from transactions undertaken by such officeholders. Such claims have priority over unsecured pre-bankruptcy proceeding claims. As presented in more detail in point 8 below, the specific rules apply with respect to the satisfaction of the claims which are secured by a mortgage, pledge, registered pledge or other security instruments specified in the Bankruptcy Law. Taking new credits does not affect security of pre-bankruptcy proceeding creditors.

8. Outline the ranking of financing provided to company/officeholder in any applicable insolvency proceeding. Discuss the comparative position of any such borrowings with respect to:

(a) Pre-proceeding liabilities;

(b) Expenses relating to the proceeding in question, including the expenses of the officeholders;

(c) The costs of any committee of creditors which is required or established as a matter practice in any particular procedure and the expenses of any such committee.

The following claims and payables belong to the first category of satisfaction:

(a) the costs of the bankruptcy proceedings,

(b) the payables resulting from the acts and transactions undertaken by the bankruptcy trustee or administrator,

(c) payables resulting from mutual agreements concluded by the bankrupt before the declaration of bankruptcy the performance of which has been requested by the trustee or administrator, and

(d) payables resulting from the acts and transactions undertaken by the bankrupt upon the consent of the court supervisor;

together with employees' retirement and disability insurance premiums, payables arising out of employment relations, farmers' claims arising under agreements for the supply of products from their own farms for the previous two years, pensions due as compensation of diseases, disability or death, alimonies, payables resulting from unjust enrichment of the bankruptcy estate.

The costs of the bankruptcy proceedings include, in particular, the remuneration of the bankruptcy trustee, administrator and the court supervisor and their deputies (if appointed), their expenses if approved by the judge-commissioner, remuneration of persons employed by such office holders upon a consent of judge-commissioner, the costs of holding the creditors' assembly and the expenses incurred by the creditors' committee and the remuneration of such committee members, the compensation of employees employed in the bankrupt enterprise during the period after the bankruptcy has been declared, departure payments and compensations connected with the termination of the labor agreements with such employees, the taxes and other public charges due for the period after the bankruptcy has been declared and the costs of conducting of business activity by the bankruptcy trustee after the declaration of bankruptcy.

The payables referred to under items (b) - (d) may include the amounts of financing provided to a bankrupt or its respective office holder in the bankruptcy proceedings to the extent permitted by law and described in more detail above. In result such financing has the first priority position together with the privileged unsecured liabilities in the bankruptcy proceedings.

The bankruptcy trustee, upon consent of judge-commissioner, satisfies the payables belonging to the first category gradually in accordance with the receipt of respective amounts to the bankruptcy estate. If such payables shall not be satisfied in full in such a way, they will be satisfied through the distribution of the bankruptcy estate funds. The costs of the bankruptcy proceedings, however, are covered immediately to the extent of possessed funds.

If the amount assigned for distribution is not sufficient to satisfy all claims in full, the claims of a lower priority category shall be satisfied only after the claims of a higher priority category have been satisfied in full. If the funds are

not sufficient to satisfy in full all claims of the same category, the claims shall be satisfied pro rata.

The claims secured by: mortgage, pledge, registered pledge, tax lien, or maritime mortgage as well as the right expiring by operation of law and personal rights and claims encumbering the immovable property of the bankrupt shall be satisfied from the proceeds of the sale of so encumbered asset, in an amount reduced only by the costs connected with the sale. The interest secured by such collateral and the costs of proceedings up to 1/10 of the principal amount are satisfied along with so secured claims.

In the event of sale of the immovable property the perpetual usufruct of land, the co-operative right to an apartment or a sea vessel entered into the ship register encumbered, respectively, by a mortgage, maritime mortgage or rights expiring by operation of law and personal rights and claims, only the following payables shall be satisfied before the satisfaction of so secured claims:
– alimonies;
– salaries of the employees employed by the bankrupt who have worked on the sold immovable property or vessel for the period of the latest three months before the sale of such property or vessel, not exceeding, however, the amount of minimum salary for the three months period, and
– pensions due as compensation of diseases, disability or death.

9. Matters relating to security

(a) Can a company/officeholder in any of your insolvency proceedings grant security?

(b) Can a company/officeholder in an insolvency proceeding obtain priority to any pre-existing security? If so, what is the test for adequate protection of the security holder?

As a general rule, after declaration of bankruptcy, the assets of the bankruptcy estate may not be encumbered with the exceptions presented in point 2.3 above.

On the basis of a consent of a court supervisor in the debt arrangement proceedings, or of the creditors committee in the bankruptcy by liquidation, an entrepreneur, administrator or trustee, respectively, may secure a debt resulting from a transaction he has undertaken through establishing a limited right *in rem* such as mortgage, pledge, registered pledge, tax lien, or maritime mortgage over component(s) of the bankrupt's assets. The priority of satisfaction of so established encumbrances is subordinated to the general rules of civil law in accordance with which such priority depends, generally, on the date of filing with a court a respective application regarding registration of encumbrance.

Thus, the encumbrance established by such officeholders shall not have any priority over encumbrances established earlier.

The proceeds resulting from the realization of assets encumbered with limited rights *in rem* are excluded from the general division of the funds of the bankruptcy estate and divided, generally, only among the holders of encumbrances whose priority is governed by the above mentioned rule.

In the event a debt undertaken, upon a required consent, by an entrepreneur, administrator or trustee, has not been secured, a respective claim shall belong to the first category of claims satisfied from the general division of the funds of the bankruptcy estate as payables resulting from the acts or transactions undertaken by the trustee or administrator or by a bankrupt upon a consent of the court supervisor.

10. Can a secured creditor roll over pre-petition loans into post-petition lending?

Yes, if such transaction is included in the approved debt arrangement, provided that in the arrangement proposals including modification of existing legal relationships or rights, or the establishment or modification of the security of a claim, an unconditional statement must be enclosed in the form set forth by law, made by those persons whose consent is necessary to modify the legal relationship, right or the security.

11. Are the directors/officeholders personally liable for post-petition borrowings (unless otherwise agreed)?

The trustee, court supervisor and administrator are not liable for obligations in cases concerning the bankruptcy estate, provided that such persons are liable for damages caused intentionally or resulting from performance of their duties without due care.

The following are examples of actions undertaken by such officeholders without due care:

1) delays in taking over the bankrupt's assets by the trustee or administrator or delay of the court supervisor in commencing the supervision over the bankrupt's property;

2) defective stock-taking resulting in the fact that a portion of the bankrupt's property has not been included in the list;

3) defective evaluation which resulted in the disposal of bankruptcy assets below their value;

4) including in the list of receivables the non-existing receivables or receivables whose existence or amount is doubtful,

5) a failure to take legal actions aimed at satisfying the bankrupt claims against its debtor(s);

6) a failure to take legal actions aimed at obtaining court decision(s) adjudicating respective transactions of the bankrupt ineffective.

In addition, the trustee may be held liable if he sold the assets in violation of applicable provisions governing the liquidation of the bankruptcy estate. An administrator may be held liable if he undertakes a decision, which is not economically justified and results in the diminution of the bankruptcy estate.

12. Can affiliated debtors be treated as one consolidated entity for post-petition financing purposes?

The Bankruptcy Law does not contain regulations permitting to conduct the particular bankruptcy proceedings with respect to more than one debtor/bankrupt.

13. Outline any developed practices other than statutory or regulatory provisions that go beyond the legal framework.

There is no such practice.

South Africa

1. Briefly summarise the types of insolvency proceedings available in your jurisdiction and indicate, in each case:

(a) The extent to which the debtor remains "in possession";

(b) Whether or not a specialist insolvency professional is likely to be appointed and, if so, a summary of his powers;

(c) The role of the court in the process.

Natural and juristic persons are guided by different statutory regulations. The Insolvency Act governs insolvency proceedings relating to natural persons. Juristic persons are governed by winding-up and judicial management provisions in the Companies' Act, the Close Corporations Act and other Acts (e.g. the Banks Act), which incorporate a large portion of the Insolvency Act by reference thereto.

The insolvency proceedings available in South Africa are broadly categorised as:

1. Informal arrangements with creditors
2. Judicial management in respect of companies
3. Liquidation for judicial persons/Sequestration for individuals
4. Scheme of arrangement with creditors

The central and guiding principle in the South African liquidation law is that of "concursus creditorum" i.e. at the date that the liquidation order is effective, all debts, whether payable in the future or currently due, become payable as at that date and all contracts, legal actions, etc, are simultaneously suspended. The liquidator/trustee takes total control of the estate and the insolvent/directors are divested of all authority.

Extent to which the debtor remains "in possession"

Insolvency legislation does not envisage the concept of debtor "in possession". All assets of a person or entity that has been sequestrated/liquidated vest in the appointed trustee, liquidator or judicial manager.

However, the Acts applicable to juristic persons provide for schemes of arrangement with creditors and other stakeholders, whereby the entity may approach its creditors with a plan and have this plan ratified, firstly, by the

stakeholders and, secondly, by the Courts. The debtor may under these arrangements remain "in possession". Very often though, the scheme of arrangement will require the appointment of a receiver to control the scheme process, and which may entail partial control of assets.

Whether or not a specialist insolvency expert is likely to be appointed and, if so, a summary of his powers:

1) The powers of an insolvency expert that may be appointed for purposes of implementing an informal arrangement are not statutory but are again per agreement by the parties. The Court is not involved in this process.

2) Judicial Management
   If the Court is convinced that there is a reasonable probability that a company trading unsuccessfully may return to profitability, it may appoint a provisional judicial manager, to assume the management of the company and take possession of the assets of the company. He must convey his assessment of the viability of the company should it continue to trade to creditors "without delay". If the creditors vote in favour of continuing with the judicial management, the judicial manager must approach the Court to make the judicial management order final. The order shall confer upon the provisional judicial manager the power, subject to the rights of creditors, to raise money without the authority of shareholders. There are no other powers specified in the statute.

3) A liquidator/trustee of a liquidated/sequestrated person has the following statutory powers:

   - The trustee of an insolvent natural person, trust or partnership may only take control and protect the insolvent's assets. The creditors may confer upon him the powers to *deal* with them: to realise assets, to continue to trade where appropriate, to bring and defend legal actions, to institute enquiries into the affairs of the insolvent, etc.

   - The Companies' Act provides the liquidator with the following powers without referral to the creditors or the Court:
     - execute legal documents;
     - draw, accept, make and endorse bills of exchange or promissory notes, provided that no additional liabilities are imposed upon the company;
     - settle and collect outstanding debts;
     - obtain directions from the creditors or, in the absence thereof, to apply to the Master or the Court for directions;
     - subject to the specific statutory sections, take measures to better administer the estate in the ordinary course of his duties without the specific authority of creditors or the Court.

- The Companies' Act provides the liquidator with the following powers, subject to the authorisation of the creditors, contributories, members, the Master of the High Court or the Court itself:

  To realise or deal with assets
  - terminate property leases;
  - realise movable or immovable property;
  - compromise or admit claims.

  To litigate
  - launch urgent legal proceedings to recover debts;
  - bring or defend civil and criminal legal actions.

  To negotiate
  - submit disputes to arbitration.

  To proceed with general administrative functions
  - carry on or discontinue any part of the business of the company;
  - raise money on the security of the assets of the company (with the Court's consent).

4) A trustee/liquidator who has received a written proposed scheme of arrangement that he believes the creditors will probably accept, must immediately circulate to every proved creditor, a copy thereof with his report thereon. If the trustee believes that the creditors are unlikely to accept the offer, he must accordingly inform the insolvent and advise that he does not intend to circulate a copy to the creditors. If the scheme provides for the discharge of the winding-up order or for the dissolution of the company without winding up, a liquidator is simply required to lodge a report with the Master of the High Court, regarding the company's compliance with statutory obligations prior to the liquidation order being granted and summarising its assets and liabilities. There are no further requirements of a liquidator if a scheme of arrangement is confirmed.

The role of the Court in the process

An informal arrangement is not required to involve the Court, although a Court may be requested to ratify such arrangement.

The Court is at the centre of the formal processes throughout. All functions of the liquidator are overseen by the Master of the High Court. The Court also considers schemes of arrangement and, with reference to the various parties, elects whether the proposed scheme is acceptable.

2. Are lenders permitted to refuse to continue lending because of the insolvency proceedings?

No. See explanation incorporated in the answer to question 3.

3. Alternatively, can the borrower require the lender to continue to advance previously committed but undrawn amounts?

The liquidation/sequestration/judicial management suspends all legal contracts. No bank or other lender or creditor can be forced to extend further credit after the Court orders the liquidation/sequestration/judicial management. It is then up to the liquidator/trustee/judicial manager, with the necessary authority from creditors, to borrow funds for purposes of the proper performance of his duties. These borrowings will be totally unsecured except where an application is made to Court and the Court authorises encumbering the estate's otherwise unencumbered assets to secure these borrowings. If the trustee borrows funds which are unsecured, he must do so with the full knowledge and consent of the lender.

To the extent that there are sufficient unencumbered assets realised to repay the unsecured loan which was borrowed for the purpose of paying appropriate administration or trading expenses, these loans may be repaid and the costs are costs in the administration of the estate which are preferred over claims of pre-liquidation creditors.

4. Are there specific provisions for lending in any of your insolvency proceedings? If so, provide details, including the text of any statutory provisions.

Where litigation is required to recover unencumbered assets which were disposed of by the company in circumstances of undue preference, collusion or without value, any creditor/s who finance the costs of such recovery, will be paid their claim in full and all of the costs incurred in the recovery before any other creditor benefits. This is facilitated by Section 104(3) of the Insolvency Act as read with Section 32 thereof.

Other relevant sections of the Companies Act are:

386(1)(c) "to draw, accept, make and endorse any bill of exchange or promissory note in the name and on behalf of the company: Provided that no liquidator shall, except with the leave of the Court or the authority referred to in subsection (3) or (4), or for the purposes of carrying on the business of the company in terms of subsection (4)(f) have power to

impose any additional liabilities upon the company;" [1]

386(5) "In a winding-up by the Court, the Court may, if it deems fit, grant leave to a liquidator to raise money on the security of the assets of the company concerned or to do any other thing which the Court may consider necessary for winding up the affairs of the company and distributing its assets."

5. In the absence of a specific provision, is there any ability for a company to obtain financing when it is in an insolvency proceeding?

The insolvent company has no ability to obtain financing in insolvency proceedings. The liquidator/trustee may do so as discussed above.

6. Is there any mechanism for the court to approve the financing by a company/officeholder in an insolvency proceeding? If so, is there protection for lenders against reversal or modification of court authorisation for borrowing available?

Yes, refer to answers in question no. 4 above.

If the lender has advanced unsecured funds, he will be paid out of the available free residue, if any, in preference to any pre-liquidation creditors. However, if the Court has authorised the liquidator to borrow against the security of an estate asset, then the proceeds of the realisation of such asset will first be utilised to repay that loan.

7. In an insolvency proceeding, are there provisions governing the extension of credit in the ordinary course of business (e.g., trade credit)? If so, what protections are available to the extender of credit?

Refer to answers in questions 2 & 3 above.

In general terms, a liquidator may trade, provided the purchases necessary for the continuation of the trade are paid out of available funds. The liquidator may motivate to the Court the necessity of encumbering unencumbered assets in order to borrow funds to continue trading.

[1] Subsections (3) & (4) refer to the general powers granted by the creditors, the Master of the High Court or the Court itself as detailed in 1 above.

8. Outline the ranking of financing provided to company/officeholder in any applicable insolvency proceeding. Discuss the comparative position of any such borrowings with respect to:

(a) Pre-proceeding liabilities;

(b) Expenses relating to the proceeding in question, including the expenses of the officeholders;

(c) The costs of any committee of creditors which is required or established as a matter practice in any particular procedure and the expenses of any such committee.

Pre – proceeding liabilities (secured/unsecured)

Creditors are classified into three groups viz. Secured, Preferent and Concurrent:-

(i) Creditors secured by a charge over specified assets, e.g. mortgage bonds, cessions of book debts and pledges of shares, will be paid out of the net proceeds from the realisation of those assets, after deducting the direct expenses described above and a portion of general expenses (such as liquidator's fees).

(ii) The free residue (i.e. all unencumbered assets) is also burdened with the costs of preservation, maintenance and realisation as well as general administrative expenses. The net available is then distributed according to the statutory preferences being:

(1) Employees (to a limited extent)
(2) State contributions (e.g. taxes, workmen's' compensation, unemployment insurance, etc).
(3) Unperfected notarial bonds which is a charge over unspecified movable assets which have not been legally enforced prior to liquidation.
(4) The remaining funds are then distributed to all other ("concurrent") creditors.

Expenses relating to the proceeding in question including the expenses of the office holders

Post-liquidation expenses, including necessary legal, accounting and other professional advice and services, are treated as costs of administration and must be paid for from the proceeds of estate assets before payments in respect of the pre-proceeding liabilities can be made. These expenses must be directly incurred to preserve, maintain or realise the assets of the estate.

Also, refer to paragraph 1 of question 4 hereof, which relates to a preference to creditors who finance the recovery of assets.

9. Matters relating to security

(a) Can a company/officeholder in any of your insolvency proceedings grant security?

(b) Can a company/officeholder in an insolvency proceeding obtain priority to any pre-existing security? If so, what is the test for adequate protection of the security holder?

The Court may, if it deems fit, grant leave to a liquidator to raise money on the security of the assets of the insolvent company for winding up the affairs of the company and distributing its assets.

A company or office holder in an insolvency proceeding cannot obtain priority to any pre-existing security. The secured creditor has, to the extent of his claim, an absolute right to the net proceeds of the encumbered asset.

10. Can a secured creditor roll over pre-petition loans into post-petition lending?

No. A new lending arrangement would have to be entered into by the liquidator if necessary.

11. Are the directors/officeholders personally liable for post-petition borrowings (unless otherwise agreed)?

In a liquidation proceeding, this is not the case. The directors/officeholders are divested of all their authority and may no longer contract in the name of the company. The liquidator acts in a representative capacity and, provided, there is nothing untoward and he is properly authorised, he will not be held personally liable.

12. Can affiliated debtors be treated as one consolidated entity for post-petition financing purposes?

No. Each distinct legal entity must be dealt with separately.

13. Outline any developed practices other than statutory or regulatory provisions that go beyond the legal framework.

In appropriate circumstances, informal arrangements have been negotiated with stakeholders. This may include restructuring the company's debt, a compromise on the quantum of creditors' loans, etc. However, this requires, in the most part, agreement of all creditors as there are no cram-down provisions available in such cases.

United Kingdom

1. Briefly summarise the types of insolvency proceedings available in your jurisdiction and indicate, in each case:

(a) The extent to which the debtor remains "in possession";

(b) Whether or not a specialist insolvency professional is likely to be appointed and, if so, a summary of his powers;

(c) The role of the court in the process.

The corporate insolvency proceedings available in England and Wales as collective remedies for creditors are (1) administration, (2) company voluntary arrangements (CVAs), and (3) liquidations. Liquidations instigated through a creditor's application to court are known as compulsory liquidations. Those instigated by the company's directors, with the appointment of a specified liquidator subject to creditors' approval, are creditors' voluntary liquidations (CVLs).

Additionally, historically, where lenders have held security over all or substantially all of a company's property and the security incorporates a floating charge, lenders have been able to enforce their security by appointing an administrative receiver to realise the secured assets on their behalf and for their benefit. This is not a form of collective insolvency proceeding, but an individual contractual enforcement method, with additional statutory provisions. Where the relevant security has been created since 15 September 2003, administrative receivership is not now available, unless the transaction falls within one of a limited number of exceptions.

Although not technically 'insolvency proceedings', schemes of arrangement under the Companies Act 1985 provide an alternative statutory mechanism for compromising creditor claims.

Finally, for large, multi-national companies, restructurings are increasingly agreed on an informal basis, following negotiation, and either without insolvency proceedings being opened, or with proceedings opened only at the end of the negotiation process to provide a mechanism for giving effect to the negotiated settlement (often referred to as a "pre-pack").

Administration

Following changes introduced by the Enterprise Act in 2003, administration is the key rescue procedure for companies in or nearing insolvency.

During the period following the commencement of the administration, the company is run by administrators (usually 2) with powers to act jointly and severally. Administrators must be licensed insolvency practitioners. The administrators take control of the company's property and have full power to run the business in line with the objectives set out in the legislation, and following the first meeting with creditors, their proposals as approved by creditors. During the administration, the directors' powers are suspended, except to the extent that the administrators allow them to act or delegate powers to them. However, the directors remain in office unless removed by the administrators and they continue to be bound by their statutory and common law duties.

Administration must be pursued for a single purpose, which operates in a hierarchy of permissible objectives, so that they must carry out their functions with the objective of:

(1) Rescuing the company as a going concern (for example, by putting into effect a scheme of arrangement under S425 Companies Act 1985 or a CVA), or if that cannot reasonably be achieved

(2) Achieving a better result for the company's creditors as a whole than would be likely if the company went into liquidation (for example, by selling the business as a going concern), or if that is not achievable

(3) Realising assets in order to make a distribution to one or more secured or preferential creditors (for example, where existing lenders wish to enforce their security and other financing is not available, or it is not otherwise feasible to pursue the first two objectives as there will be insufficient realisations to pay a dividend to unsecured creditors).

Administration can be initiated by a court application or out of court by holders of qualifying floating charges, the company or its directors, provided that certain conditions are satisfied.

Administrators owe duties to the creditors as a whole and to the court. However, ordinarily, the court has a limited role in the administration process, and administrators are expected to exercise their professional commercial judgment in carrying out their functions. Administrators can apply to court for directions where court guidance is required on a particular issue.

Company Voluntary Arrangements

The aim of a CVA is to enable a company in financial difficulty to reach a compromise or arrangement with its creditors and avoid liquidation. A proposal for a CVA is usually made by the company's directors, but

sometimes by its administrators. A copy of the proposal is filed in court, but the court has no involvement in approving it. The CVA takes effect and becomes binding on all unsecured creditors if and when its terms have been agreed by (1) a majority of unsecured creditors representing over 75% by value of those voting and usually also by (2) a simple majority of the company's members. If the creditors and members disagree on the proposed arrangement, the views of the creditors will normally prevail. The rights of secured and preferential creditors cannot be altered through a CVA without their consent. A 'supervisor', a licensed insolvency practitioner, oversees the CVA and its operation.

The supervisor's role, power and duties are dependent on the terms of the proposal agreed by the creditors, but the directors usually remain in control of the company, subject to supervision, where the company is not in administration or liquidation. The court has no involvement in the process unless there is a challenge to the validity of the approval process.

Liquidation

When a liquidator is appointed, the directors' powers cease. Ordinarily the liquidator, who must be a licensed insolvency practitioner, will not continue to run the business unless this is appropriate to complete contracts or work in progress. Joint liquidators are commonly appointed. The court's role is limited once a liquidation has commenced, but creditors can apply to court if they are unhappy with the liquidator's actions.

Administrative Receivership

An administrative receiver is appointed by secured creditors under powers in the security documents, and the administrative receiver has full power to run the company in place of the directors. He will also determine whether to continue the business by selling it as a going concern or on a break-up basis. Administrative receivership may be followed by or operate in parallel with a liquidation. The court has no involvement in the process.

Schemes of Arrangement

A scheme of arrangement can be used to achieve a compromise of creditors' claims when approved by a majority in number representing 75% in value of each class of creditor voting on the scheme. The scheme then becomes binding on all creditors falling within the classes of creditors included in the scheme.

A scheme of arrangement does not involve the formal appointment of an insolvency office holder (unless proposed by an administrator), but expert insolvency specialists will advise the debtor, which continues to be run by its

existing management. In some cases the board will be bolstered by the appointment of a chief restructuring or other officer(s).

A scheme of arrangement must also be sanctioned by the court as fair and equitable after it has received the requisite creditor support. Until so approved, and then registered at Companies House, the scheme is not binding.

2. Are lenders permitted to refuse to continue lending because of the insolvency proceedings?

This is a matter of contract, and therefore depends upon the terms of the credit agreement governing the lending. Typically overdraft facilities are repayable upon demand, whilst term loan facilities will become repayable upon demand at the option of the lender, upon the occurrence of an event of default. Events of default invariably include non-payment, serious breach of covenants (including financial covenants) and insolvency events. In practice, the contractual terms will always permit lenders to refuse to carry on lending because of insolvency.

In the very unlikely event that there were no express terms in the banking facility agreements entitling the lender to refuse to carry on lending if a specified insolvency event took place:

(i) Were the company to go into administration, its existing contracts would continue and this would include its bank facility agreements. There are no statutory provisions which deal expressly with a lender's ongoing obligations. If the lender was providing overdraft facilities only, however, under English common law rules, terms would be implied into the facility agreement to the effect that the facilities were repayable on demand so that the lender could demand immediate repayment.

In practice, however, the bank facility agreement would always incorporate a right for the lender to terminate the facilities, leaving the lender to decide whether it considered it to be in its own best interests to continue to supply finance to the company in administration as a means by which the bank might achieve a better financial recovery. Lending further money might, for example, enable goodwill to be preserved and the business to be sold as a going concern. Alternatively, the administrator may in some cases be able to negotiate ongoing funding arrangements with a potential buyer of the business.

(ii) If a company were to enter into a company voluntary arrangement ('CVA') and in that context proposed to carry on running its business, whether to achieve a rescue or to effect an orderly wind down, the terms for the

provision of any further monies required would invariably be set out in the proposal.

The entering into the CVA would not in itself as a matter of statute or common law cause existing banking facility agreements to terminate, but the banking facility agreements will almost always include express termination provisions in these circumstances and such termination clauses are effective under English law. Additionally, in the absence of any express termination clause in the facility agreement, under English common law principles a term would probably be implied into the agreement that they would be repayable on demand.

English insolvency legislation requires that the terms of a CVA cannot compromise the claims of any secured or preferential creditor unless every creditor in those categories agrees to the compromise. Consequently, English CVAs are usually only put in place with regard to unsecured creditors and in many circumstances the company's lenders will be secured creditors. A CVA approved by the relevant majorities is binding on creditors in respect of debts incurred as at the date the meeting is held to approve the CVA proposal.

(iii) Where a company goes into liquidation, its business will in practice cease, except to the extent necessary for the company to be wound up. Therefore even in the absence of a contractual termination clause triggered by liquidation and entitling the lender to refuse to continue to provide facilities, the question of the provision of further monies is unlikely to arise. Further, in the case of compulsory liquidations instigated by a petition (usually by a creditor) the company's bank accounts will in practice be frozen. This is because there are statutory provisions the effect of which is to deem the commencement of the liquidation to be back-dated to the time at which the winding up petition was presented and which provide that any disposition of the company's property and transfer of its shares is void from the commencement of the winding up, unless the court orders otherwise. In a compulsory liquidation, court approval is necessary, if continued funding is required to complete a project for the benefit of the company's creditors, Such monies would rank to be paid as an expense of the liquidation.

(iv) Where a company is in administrative receivership, its lender will have elected to exercise this procedure as an enforcement mechanism to recover assets up to the value of debts secured, and which assets will necessarily encompass all or substantially all of a company's assets. It will be for the administrative receiver to determine the strategy to pursue to achieve the best financial outcome for the lender which has appointed him. The administrative receiver will have power to borrow more money to

fund the recovery strategy, but the lender cannot be compelled to provide more funds. When the administrative receiver is appointed the floating charge will crystallize and the company will have no power to deal with the secured assets without the consent of the chargeholder, so the question of the provision of further funding can only arise consensually.

3. Alternatively, can the borrower require the lender to continue to advance previously committed but undrawn amounts?

This would again depend upon the terms of the relevant credit agreement. However it is usual to provide that any undrawn portion of a facility will be cancelled upon the occurrence of an event of default (which will be defined to include any insolvency event). Therefore, in practice, under the contract terms, there will be no requirement for the lender to continue to advance undrawn amounts.

For further information please refer to the response to question 2 above.

4. Are there specific provisions for lending in any of your insolvency proceedings? If so, provide details, including the text of any statutory provisions.

Schedule 1 of the Insolvency Act 1986 lists powers applicable to all administrators and administrative receivers (pursuant to paragraph 60 of Schedule B1 Insolvency Act 1986 and Section 42 Insolvency Act 1986 respectively). Amongst the powers expressly listed (at paragraph 3 of Schedule 1) is 'power to raise or borrow money and grant security therefor over the property of the company.'

A liquidator also has power, as expressly provided for in Schedule 4 of the Insolvency Act 1986, to 'raise on the security of the assets of the company any money requisite.' This power is, however, seldom exercised, bearing in mind that where a liquidator is empowered to carry on the business of the company this may only be done so far as may be necessary for its 'beneficial winding up.' There is also power for a liquidator to initiate administration proceedings.

In some circumstances the liquidator may enter into a funding arrangement with a creditor or group of creditors in order to fund litigation brought in the liquidator's own name or by the company acting through the liquidator.

5. In the absence of a specific provision, is there any ability for a company to obtain financing when it is in an insolvency proceeding?

By way of providing a context to the response to this and subsequent questions, it should be noted that in an insolvency proceeding in England and Wales, a secured creditor with a fixed charge is entitled to be paid out first from the sale proceeds of fixed charge assets. Realisations from assets secured by any floating charge are applied first to pay any creditors falling within the very limited remaining categories of preferential creditors. A proportion of net floating charge proceeds, capped at £600,000, is then usually allocated to unsecured creditors, with the remaining monies being paid to the floating charge holder. Any remaining surplus after the floating charge holder has been paid is then available to the unsecured creditors.

Whilst a company is in a form of insolvency proceeding, it may be possible for it to obtain financing from:

(i) an existing lender;

(ii) a potential purchaser of the company's assets or shares; or

(iii) a new lender or financier.

In practice, additional finance is more likely to be provided in an administration rather than in any other form of insolvency proceeding. However, because administration proceedings can be initiated by a company only at a late point in its financial difficulties, when it 'is or is likely to be insolvent', potential additional finance may in practice be available too late in the day. Consequently, many companies are likely to look for rescue finance at an earlier stage and outside formal insolvency proceedings (see Question 13).

In the case of a CVA, given that the statutory provisions require that the rights of secured and preferential creditors may not be affected without their consent, no terms for the repayment of rescue finance would be enforceable were they to purport to allow the financier to be repaid ahead of any secured or preferential creditors (unless the 100% agreement of these constituencies had been obtained). It would, however, be open to the unsecured creditors to agree under the terms of the proposal for additional finance to be paid ahead of this class of creditors. These terms may in practice prove to be insufficiently attractive to prospective lenders, presumably dependent on the likely distribution outcome in any given case.

In administration, it has been common practice in recent years for companies' existing secured lenders in appropriate cases (where they are satisfied that administration is the best strategy) to agree to allow the proceeds of book

debts circulating in the business to be used as a source of continued finance for the company in administration. This had been seen as a pragmatic lender concession, as book debts had commonly been assumed to be or treated as fixed charge assets following a series of court decisions. Following the recent House of Lords' decision in *Re Spectrum Plus (2005) 2 BCC 694*, it is now clear that in most cases book debts will be floating rather than fixed charge assets. Given that an administrator is permitted by statute to use floating charge assets for the purposes of the administration whether or not the lender consents to this use, the significance of the Spectrum decision is that the pool of floating charge assets to which the administrator can unilaterally have recourse for the purposes of the administration is greater than had previously been assumed.

An administrator is permitted to enter into new contracts and expressly has power to borrow and raise finance. As appears further at the responses to Questions 7 and 8, irrespective of whether security has been provided as a term of the provision of new finance, the new monies would be repayable after any prior fixed chargeholder had been paid from assets subject to the relevant fixed charge(s), but ahead of any existing floating chargeholder.

6. Is there any mechanism for the court to approve the financing by a company/officeholder in an insolvency proceeding? If so, is there protection for lenders against reversal or modification of court authorisation for borrowing available?

No formal mechanisms are included in legislation specifically for the court to approve the obtaining of finance by a company officeholder in an insolvency proceeding. In practice, were an insolvency practitioner (e.g. an administrator) to seek a court declaration approving a financing transaction, the court may decline to provide approval and rule that the decision is a matter for the professional commercial judgment of the insolvency practitioner. A prudent administrator would seek to obtain at least an informal indication of creditor support for the proposed raising of new finance.

7. In an insolvency proceeding, are there provisions governing the extension of credit in the ordinary course of business (e.g., trade credit)? If so, what protections are available to the extender of credit?

There are no such provisions.

8. Outline the ranking of financing provided to company/officeholder in any applicable insolvency proceeding. Discuss the comparative position of any such borrowings with respect to:

(a) Pre-proceeding liabilities;

(b) Expenses relating to the proceeding in question, including the expenses of the officeholders;

(c) The costs of any committee of creditors which is required or established as a matter practice in any particular procedure and the expenses of any such committee.

In the UK there is no dedicated regime provided for in the insolvency legislation enabling post-petition financiers to claim repayment in priority to pre-proceeding creditors. Before the Insolvency Act 1986 was substantially amended (by the provisions of the Enterprise Act 2002, which came into effect on 15 September 2003), the UK government had in its Report on the Review of Company Rescue and Business Reconstruction Mechanisms considered but ultimately rejected suggestions that US "DIP style" finance provisions might be introduced in the UK. The Government's position was that the matter was one of too great complexity which required a wider consultation, particularly if it were intended that the UK courts would have a role in approving the grant of super-priority funding on a case by case basis.

Under the current statutory framework the position is fairly cumbersome as follows:

Administration

In an administration, new financing falls within the definition of a 'debt or liability on a contract entered into by the administrator' under paragraph 99(4) of Schedule B1 Insolvency Act 1986 and ranks according to the order provided for at paragraphs 99 and 70 of Schedule B1. The effect of these provisions is that any new finance raised is repayable from the company's assets after any pre-proceeding liabilities due to existing fixed chargeholder(s) have been met from fixed charge assets. The new finance is, however, repayable ahead of any pre-proceeding liabilities which are secured on floating charge assets (and likewise is payable ahead of pre-proceeding unsecured liabilities).

Note, however, that floating charge security in the UK invariably contains terms expressly prohibiting the creation of security interests ranking ahead of that floating charge (a clause which is commonly termed the 'negative pledge'), as under UK priority rules fixed charge security ranks for payment

ahead of floating charge security, whenever created. In practice, any new lender will have actual notice of a negative pledge provision from its review of the borrower's finances including its prior charges which are registered at Companies House (conducted as part of its due diligence before offering further finance). Although the grant of new finance to the company may be in breach of the terms of its pre-existing loan agreements and the new lender and administrator will know this, it seems very unlikely, however, that the existence of prior contractual terms could have the effect of overriding the clear statutory order.

New finance also ranks for repayment ahead of both the administrator's remuneration and expenses (at least to the extent that these have not already been paid ahead on account by the time of the end of the administration) and the claims of preferential and unsecured creditors. Insolvency Rule IR 2.67, which has been recently introduced, prescribes the order in which administration expenses are to be met (subject to the power of the court to vary the statutory order in its discretion where there are insufficient assets to meet the liabilities).

The expenses of the administration committee are a subset of the expenses of administration and are payable ahead of the administrator's remuneration. However, payment of the committee's expenses is limited to committee members' reasonable travelling expenses and the committee is not entitled to re-imbursement of any other expenses, such as the costs of any professional advisers the committee might wish separately to instruct. Under the statutory rules, the costs of any legal or other advisers appointed by the administrators are also payable ahead of the administrators' remuneration.

These provisions may make administration appointments incorporating new funding unattractive from the point of view of a prospective office-holder, unless provided with express assurances concerning their fees from secured creditors, or the circumstances are such that the company's assets are not the subject of existing or full fixed charge security.

Liquidation

Following the decision of the House of Lords in *Re Leyland Daf*, (also known as *Buchler v Talbot*) in March 2004, the costs and expenses of a liquidation can only be met from a company's free assets (i.e. those not subject to a fixed or floating charge, except to the extent that there is a surplus). Note, however, that the UK government has indicated that it will introduce legislation to reverse the effect of this case.

Were a liquidator to raise further finance for the purposes of the liquidation, these costs would be met as expenses of the liquidation, according to the

prescribed statutory order (and to the extent that there were assets available to meet them). Whilst it would be unusual for a liquidator to try to raise monies for the purposes of continuing the business, a liquidator may wish to raise money to fund litigation which might result in recoveries for the benefit of the company. Accordingly, a liquidator may enter into a funding arrangement with one or more creditors with terms providing for the sums lent to be repaid as a liquidation expense under Insolvency Rule 4.218(1)(a) in priority to any distribution to the unsecured creditors. Alternatively, a creditor may agree to indemnify the liquidator with regard to the costs of the litigation, including any adverse costs order made, to the extent that the company does not have free assets to meet these costs. Here the creditor providing the indemnity is entitled to reimbursement of any amount they have paid, as an expense, ahead of any distribution to unsecured creditors.

Where the company has insufficient assets from which to pay these expenses, or subrogated rights to expenses, the court may order that they be met from any recoveries resulting from a successful claim, applying common law equitable principles. Any adverse costs awarded against a company in liquidation will be payable ahead of the liquidator's expenses.

Rule 4.218 of the Insolvency Rules sets out a general rule as to the priority in payment of expenses in a liquidation (but is subject to the discretionary power of the court to vary the order of priority in a compulsory liquidation, where there are insufficient assets to meet the liabilities.) The effect of the insolvency rule is to rank the order of repayment so that, inter alia, those providing new finance would be paid ahead of members of the liquidation committee entitled to reimbursement of their reasonable travelling expenses, who in turn would be paid ahead of the liquidator's claim for remuneration. Pre-proceeding unsecured liabilities would be paid thereafter on a pro-rata basis to the extent that there were any remaining monies.

9. Matters relating to security

(a) Can a company/officeholder in any of your insolvency proceedings grant security?

(b) Can a company/officeholder in an insolvency proceeding obtain priority to any pre-existing security? If so, what is the test for adequate protection of the security holder?

In response to question (a) of this section please see the answers given to questions 4, 5 and 8 above.

Similarly, in response to question (b), please see the answers to questions 5 and 8. Under UK insolvency laws, the rights of the secured creditor are paramount and there can be no prospect of rescue finance being granted priority ahead of or ranking at an equivalent level to pre existing fixed charge security without the agreement of the secured creditor. Paragraphs 70 and 99 of Schedule B1 set out the order of entitlement to repayment and there may be little advantage achieved by the new financier also seeking any available security. There is no test for adequate protection and this is not relevant.

10. Can a secured creditor roll over pre-petition loans into post-petition lending?

No.

11. Are the directors/officeholders personally liable for post-petition borrowings (unless otherwise agreed)?

Directors are very unlikely to be personally liable for any post-petition borrowings. It is also unlikely in practice that personal liability would arise where insolvency proceedings have been instigated, at least in so far as any borrowings have post-dated the commencement of insolvency proceedings. The principal reason for this is that in most cases the insolvency practitioner, who is likely to be an administrator, will have taken over the running of the business and will be arranging the new finance, so that the decision would be outside the control of the directors.

It is unlikely that an administrator would be held to be personally liable for any post–petition borrowings, unless a creditor can on the facts persuade the court that their action in arranging such finance amounts to misconduct or misfeasance actionable under paragraph 75 Schedule B1, alternatively that it is conduct unfairly harming their interests under paragraph 74 of Schedule B1. Neither of these outcomes appears likely, save in extreme circumstances.

In practice it is likely to be difficult in most cases for directors to raise post-petition borrowings. Compulsory liquidation is the only insolvency proceeding initiated by petition. S127 Insolvency Act 1986 operates so as to avoid retrospectively dispositions of property (which would include the grant of security for a loan), where a compulsory winding up order is subsequently made, unless the court has given an order expressly sanctioning the transaction. There may, however, be circumstances, for example where directors are in the process of negotiating the terms of a scheme of arrangement, where existing lenders are prepared to put in further finance notwithstanding that a petition has been issued. Whilst there is a potential here for the directors to face actions for wrongful trading if the scheme

negotiations collapse or the scheme fails, in practice, provided that directors are acting on the basis of informed and on-going expert insolvency advice, it is unlikely that they will be held liable under the wrongful trading provisions. This is because the wrongful trading provisions at S214 Insolvency Act 1986 will require a liquidator to satisfy the court as to certain elements including that the directors 'knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation.' This element is amongst those unlikely to be made out.

In the case of liquidation, in practice, monies are likely to be provided primarily where there are insufficient funds to pursue a claim by the company (or a claim which can be brought by the liquidator as an officeholder) and a creditor(s) agrees to provide funds for this purpose. It is unlikely that a liquidator would be held personally liable to repay any monies so provided, but there are risks that the fruits of any successful action may not be available to meet all of the liquidator's costs of litigation.

12. Can affiliated debtors be treated as one consolidated entity for post-petition financing purposes?

No.

13. Outline any developed practices other than statutory or regulatory provisions that go beyond the legal framework.

Most reorganisations, in particular of large global companies, are conducted outside of any formal insolvency proceedings. Alternatively, terms are negotiated and new finance provided outside of insolvency proceedings and the restructuring then wrapped up by way of formal approval into an insolvency proceeding (a procedure which is generally called a pre-pack). This reflects the fact that under existing UK insolvency law rescue finance is available only late in the day, and that neither super priority nor equivalent priority to existing fixed charge lenders is possible. New monies are typically lent on the basis of the INSOL Global Principles for Multi-Creditor Workouts, which provide that so far as practicable additional funding should be accorded priority status over other indebtedness.

USA

1. Briefly summarise the types of insolvency proceedings available in your jurisdiction and indicate, in each case:

(a) The extent to which the debtor remains "in possession";

(b) Whether or not a specialist insolvency professional is likely to be appointed and, if so, a summary of his powers;

(c) The role of the court in the process.

All bankruptcy proceedings in the United States are governed by the United States Bankruptcy Code, which sets forth the rights and obligations of debtors, creditors and other parties in interest upon the commencement of the proceedings. Unlike the laws of other jurisdictions, there is no specific event (*i.e.*, insolvency) that requires an entity to seek bankruptcy protection. Instead, the precipitating event for most corporate bankruptcies is a lack of sufficient liquidity to fund ongoing operations or otherwise pay debts as they come due. Where the company's going concern value is greater than its dissolution value, a Chapter 11 reorganization (the majority of proceedings), rather than a Chapter 7 liquidation generally, will be appropriate. A bankruptcy judge will oversee all aspects of the case and must approve all transactions outside the ordinary course (such as substantial assets sales and store closures) and interested parties have the opportunity to object to such transactions.

Chapter 11

The filing of a voluntary Chapter 11 petition by a company affords it the benefits and protections of the Bankruptcy Code without further order of the bankruptcy court. Creditors have the right, under certain circumstances, to file an involuntary petition. Involuntary petitions, which account for less than 1% of all Chapter 11 petitions filed, are rarely filed against public companies principally because those filing such petitions could incur hefty liabilities if an involuntary petition is dismissed by the bankruptcy court.

The debtor's board of directors and management generally remain in control of the business and assets of the Chapter 11 debtor for the purpose of continuing operations in the ordinary course. Nevertheless, the bankruptcy court has the power to displace management and appoint a trustee to operate the business under extreme circumstances involving gross mismanagement or fraud. If the circumstances of the case do not warrant the appointment of a trustee, a bankruptcy court, on request of a party in

interest, will appoint an examiner to investigate any allegations of fraud, dishonesty, incompetence, etc., if such appointment is in the best interests of the parties or if certain debts exceed $5 million, and usually will leave the debtor in possession in control. The powers of an examiner generally are limited to investigations. Another possibility is the debtor's retention of a chief restructuring officer ("CRO"), which often is hired prior to commencement of a proceeding to assist with an out-of-court restructuring and subsequently is approved by the bankruptcy court upon the filing. The CRO's duties vary from case-to-case, and may involve aspects of both financial and operational restructuring.

In a traditional proceeding, the debtor files a petition and then negotiates with key creditors a plan of reorganization that sets forth the treatment of claims, seeks approval of a disclosure statement that describes the plan, solicits votes and finally has a hearing to "confirm" that plan. In a prepackaged proceeding (or "prepack"), the plan is negotiated and the votes obtained prior to the filing. In "prenegotiated" proceedings, the plan is negotiated prior to the filing, but solicitation of votes occurs after the filing. Prepackaged and prenegotiated proceedings share a common goal of having the shortest possible Chapter 11 case and minimizing the adverse impact of Chapter 11 on the business. Finally, in a liquidating Chapter 11 case, the debtor remains in control through the liquidation process given that there are sufficient funds to pay "administrative expenses" (as described below) of the estate.

Chapter 7 cases

A Chapter 7 case may be commenced by filing a Chapter 7 petition or, in appropriate cases, conversion from a Chapter 11 case. The Bankruptcy Court appoints a trustee and the debtor is divested of control of its business and assets. The trustee typically closes the business immediately, liquidates the assets and distributes the proceeds from the sales to creditors.

Chapter 15 cases

Pursuant to amendments to the Bankruptcy Code that became effective on October 17, 2005 (the "Amendments"), which apply to proceedings commenced after such date, a new Chapter 15 was adopted, which generally adopts the method of recognition of foreign insolvency proceedings and cooperation among U.S. and foreign courts formulated by the United Nations Commission for International Trade Law. This replaces the pre-existing Section 304 of the Bankruptcy Code and permits a foreign representative authorized in a foreign proceeding to commence a case under Chapter 15 by filing a non-substantive "petition for recognition."

Chapter 15 provides, under certain circumstances, for among other things (a) an automatic stay, which prohibits parties from taking any action that has an

adverse effect on the entity's property, (b) co-operation or "comity" regarding orders issued in the foreign proceeding and (c) the use, sale or leasing of property of the foreign debtor in the U.S. A trustee or another entity may be authorized by the bankruptcy court to act in a foreign country on behalf of the U.S. debtor.

2. Are lenders permitted to refuse to continue lending because of the insolvency proceedings?

Under the Bankruptcy Code, a debtor generally is permitted to assume or reject pre-petition executory contracts (*i.e.*, agreements under which both parties have material obligations outstanding). Contractual clauses contained in such executory contracts that provide for termination or modification of any agreement either upon the filing for bankruptcy or due to insolvency or financial impairment are not recognized under the Bankruptcy Code.

There are, however, exceptions to a debtor's right to assume or reject pre-petition executory contracts. One of these exceptions prohibits a debtor from assuming an executory contract that requires a third-party to "make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor." This prohibition is absolute, and cannot be overcome by an agreement of the parties otherwise. Accordingly, a pre-petition lender cannot continue to advance funds under a pre-petition financing arrangement after the commencement of a bankruptcy proceeding.

3. Alternatively, can the borrower require the lender to continue to advance previously committed but undrawn amounts?

As described above, neither a debtor borrower nor a lender can continue to perform under a pre-petition financing agreement after the commencement of a bankruptcy proceeding. Accordingly, the debtor borrower cannot require a pre-petition lender to continue to advance undrawn amounts under a pre-petition financing arrangement.

4. Are there specific provisions for lending in any of your insolvency proceedings? If so, provide details, including the text of any statutory provisions.

A. *Obtaining credit*

One of the principle benefits of Chapter 11 is enhanced liquidity. While in bankruptcy, a debtor will have the ability to obtain financing to fund its operations

during the Chapter 11 case. This financing is known as "debtor in possession" or "DIP" financing, and often is provided by the debtor's pre-petition lenders. A DIP loan is virtually risk free for the lender because, in addition to the administrative priority (*i.e.*, priority over all other unsecured claims, as described below) afforded to post-petition obligations of a debtor, DIP lenders generally are granted liens senior to existing secured indebtedness. DIP loans, like non-bankruptcy credit facilities, typically include letter of credit facilities or sublimits within the broader facility. Except for unsecured credit obtained in the ordinary course, all other financings require Bankruptcy Court approval.

Section 364 of the Bankruptcy Code is the key provision of the Bankruptcy Code in respect of lending in bankruptcy proceedings. Specifically, Section 364 provides, in relevant part:

> § 364. Obtaining credit
>
> (a) If the trustee[1] is authorized to operate the business of the debtor under . . . this title, unless the court orders otherwise, the trustee may obtain unsecured credit and incur unsecured debt in the ordinary course of business allowable under section 503(b)(1) of this title as an administrative expense.
>
> (b) The court, after notice and a hearing, may authorize the trustee to obtain unsecured credit or to incur unsecured debt other than under subsection (a) of this section, allowable under section 503(b)(1) of this title as an administrative expense.
>
> (c) If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt –
>
> (1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;
>
> (2) secured by a lien on property of the estate that is not otherwise subject to a lien; or
>
> (3) secured by a junior lien on property of the estate that is subject to a lien.
>
> (d) (1) The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on

[1] In Chapter 11 cases, a debtor in possession generally has the same rights and powers, and performs all the functions and duties, of a trustee. Accordingly, in reviewing the provisions that relate to Chapter 11 cases under the Bankruptcy Code, "trustee" may be substituted with "debtor in possession", where appropriate.

property of the estate that is subject to a lien only if –

(A) the trustee is unable to obtain such credit otherwise; and

(B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.

(2) In any hearing under this subsection, the trustee has the burden of proof on the issue of adequate protection.

(e) The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal.

The most common DIP loan is secured by a senior or equal lien (a "priming lien") to existing lienholders. In connection with such priming liens, a primed lienholder must be adequately protected. Although "adequate protection" is not defined in the Bankruptcy Code, the Bankruptcy Code does provide examples of such protection: (a) cash payment or periodic cash payments; (b) granting additional or replacement liens; or (c) such other relief, other than the granting of an administrative expense claim, that results in the realization of the "indubitable equivalent" of the interest in property. Although the circumstances of each case will determine the necessary relief, a pre-petition secured lender often is found to be adequately protected if there is a sufficient equity cushion in the value of the collateral to protect the lender from diminution in value of its interest. It is less common that the pre-petition secured lender will be granted replacement liens.

B. *Cash collateral*

Pre-petition lenders frequently have security interests in "cash collateral" (as defined below). Under the Bankruptcy Code, a debtor cannot use cash collateral without the consent of each party having an interest in such collateral or, after notice and a hearing, the bankruptcy court authorizing such use. This often is done consensually in exchange for "adequate protection" payments. Without such consent, the Bankruptcy Court commonly will approve a debtor's use of cash collateral over a secured party's objection if the Debtor establishes that the secured party's interest in such collateral is adequately protected or, if not, grants such protection. As with priming liens described above, adequate protection depends on the circumstances

of the case. A sufficient equity cushion and replacement liens have been found sufficient.

It is important to note that, while debtors often seek use of cash collateral as well as obtain DIP financing, authorization to use cash collateral may be used in lieu of obtaining DIP financing if (a) the cash collateral would provide sufficient funds to finance the bankruptcy proceeding, thereby saving the cost of obtaining the DIP financing or (b) the debtor is unable to obtain DIP financing. Some debtors prior to commencement of a bankruptcy proceeding will stockpile cash to avoid the expense of obtaining a DIP loan.

Specifically, Section 363 of the Bankruptcy Code, in relevant part, provides as follows:

> § 363. Use, sale, or lease of property
>
> (a) In this section, "cash collateral" means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other that the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.
>
> ...
>
> (c) (1) If the business of the debtor is authorized to be operated under section 721, 1108, 1203, 1204, or 1304 of this title and unless the court orders otherwise, the trustee may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice and a hearing.
>
> (2) The trustee may not use, sell, or lease cash collateral under paragraph (1) of this subsection unless –
>
> (A) each entity that has an interest in such cash collateral consents; or
>
> (B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section.

(3) Any hearing under paragraph (2)(B) of this subsection may be a preliminary hearing or may be consolidated with a hearing under subsection (e) of this section, but shall be scheduled in accordance with the needs of the debtor. If the hearing under paragraph (2)(B) of this subsection is a preliminary hearing, the court may authorize such use, sale, or lease only if there is a reasonable likelihood that the trustee will prevail at the final hearing under subsection (e) of this section. The court shall act promptly on any request for authorization under paragraph (2)(B) of this subsection.

(e) Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest.

5. In the absence of a specific provision, is there any ability for a company to obtain financing when it is in an insolvency proceeding?

As set forth above, Section 364 of the Bankruptcy Code governs obtaining financing in bankruptcy proceedings.

6. Is there any mechanism for the court to approve the financing by a company/officeholder in an insolvency proceeding? If so, is there protection for lenders against reversal or modification of court authorisation for borrowing available?

As set forth above, Section 364 of the Bankruptcy Code requires Bankruptcy Court approval of all financing arrangements other than unsecured credit incurred in the ordinary course of business (and the Bankruptcy Court also may require its approval of ordinary course unsecured credit arrangements). Section 364(e) protects lenders by providing that, on appeal, any reversal or modification of a financing arrangement or the granting of a priority or lien does not impact the validity of any debt incurred or granting of any priority or lien if the credit was extended in good faith unless the incurrence of debt or granting of any priority or lien was stayed pending appeal. The finding that a lender acted in good faith is critical to a lender availing itself of the protections afforded on reversal or modification.

7. In an insolvency proceeding, are there provisions governing the extension of credit in the ordinary course of business (e.g., trade credit)? If so, what protections are available to the extender of credit?

Ordinary course payments

In respect of pre-petition claims, debtors generally are prohibited from making any payments, absent the specific approval of the bankruptcy court. However, debts incurred post-petition are given administrative expense priority in the event that a plan of reorganization cannot be successfully confirmed. Moreover, post-petition obligations are payable by the debtor in the ordinary course of business pursuant to the terms of the contracts giving rise to the obligations. The entitlement to such priority typically will provide sophisticated trade creditors with the comfort that they will be repaid for post-petition shipments, which often results in the maintenance or increase in trade credit following the commencement of a Chapter 11 case.

Reclamation claims

The Bankruptcy Code recognizes the state law rights (*i.e.*, under the Uniform Commercial Code) of sellers to reclaim goods sold on credit to an insolvent entity. Specifically, the Bankruptcy Code excepts from certain of a debtor's powers to avoid particular transactions as, for example, preferential, the rights a seller has under state law to reclaim goods sold to the debtor in the ordinary course. Pursuant to the Amendments, to qualify for such a reclamation claim (i) the sale must have been in the ordinary course of the seller's business, (ii) the debtor must have received such goods while insolvent and within 45 days prior to the commencement of its bankruptcy case, and (iii) the seller must demand in writing reclamation of the goods up to 45 days after the debtor's receipt of such goods, unless the date of commencement of the case intervenes, in which case it is limited to 20 days after the commencement of the case. For cases commenced prior to October 17, 2005, these reclamation rights are limited to instances where the seller demands in writing reclamation of goods prior to 10 days after the receipt of such goods or, if such 10-day period expires after commencement of the bankruptcy proceeding, before 20 days after receipt of such goods. These rights are subject to the rights a secured creditor or other good faith purchaser may have to these goods. The seller must demonstrate that the debtor had possession of the goods at the time of the reclamation demand and such goods are identifiable and, accordingly, a seller is not able to reclaim goods that have been converted into other goods.

Pursuant to the amendments, trade creditors have an additional protection. The value of goods received by a debtor in the ordinary course of the debtor's business within 20 days prior to the commencement of its bankruptcy case will be treated as an administrative expense. This right is

regardless of whether demand for return of goods is made, the goods are identifiable or the debtor was insolvent at the time.

Set-off

The Bankruptcy Code generally recognizes a creditor's right under applicable nonbankruptcy law to offset a mutual pre-petition debt owed by the creditor to the debtor against a pre-petition debt owed by the debtor to the creditor, provided that the creditor first seeks approval of the bankruptcy court to lift the automatic stay (although under certain circumstances, such as under repurchase agreements and forward contracts, court approval is not required to lift the stay) and, among other things, the claim of the creditor is not disallowed. It is important to note the "mutuality" requirement of setoff, meaning that a pre-petition obligation must be owed by and to the same debtor entity and a pre-petition obligation must be owed by and to the same creditor entity.

Recoupment

Recoupment is another right of creditors often used in bankruptcy cases and is similar to the right of setoff. However, unlike setoff, recoupment does not require that the obligations be incurred pre-petition or mutuality. Furthermore, recoupment requires that the obligations be incurred in the same transaction or occurrence, for example, under the same agreement.

8. Outline the ranking of financing provided to company/officeholder in any applicable insolvency proceeding. Discuss the comparative position of any such borrowings with respect to:

(a) Pre-proceeding liabilities;

(b) Expenses relating to the proceeding in question, including the expenses of the officeholders;

(c) The costs of any committee of creditors which is required or established as a matter practice in any particular procedure and the expenses of any such committee.

In general, the priority in ranking of claims is as follows: (1) secured creditors; (2) administrative claims, which are claims for the necessary post-petition costs and expenses incurred in preserving the estate and include post-petition trade payables, professional fees for both the debtor and any official committee appointed in the case[2] and wages; (3) statutory priority claims,

[2] An official committee of unsecured creditors (the "Creditors' Committee"), and perhaps another creditor committee (*i.e.*, a trade creditors' committee) or a shareholders' committee, are appointed in a bankruptcy proceeding and retain both counsel and financial advisors at the debtor's expense. Bankruptcy courts frequently give deference to the views of official committees, thereby requiring the debtor to negotiate with them over significant transactions.

which in a corporate bankruptcy proceeding often only consists of certain pre-petition tax claims and pre-petition employee claims; (4) general unsecured claims, which generally will consist of pre-petition trade claims, other non-priority pre-petition claims and, to the extent a secured creditor is undersecured, the unsecured portion of such claim; and (5) equity interests.

As set forth above, under Section 364 of the Bankruptcy Code, a post-petition lender under a DIP loan may provide such financing outside the ordinary course on a secured basis (and its claims may be senior, pari passu or junior to the claims of other secured creditors) or on an unsecured basis. It is rare for a lender to provide unsecured post-petition financing, but if so provided, the lender would be entitled to a superpriority administrative expense claim, which is senior to all other administrative expense claims, including professional fees.

9. Matters relating to security

(a) Can a company/officeholder in any of your insolvency proceedings grant security?

(b) Can a company/officeholder in an insolvency proceeding obtain priority to any pre-existing security? If so, what is the test for adequate protection of the security holder?

As set forth above, under Section 364(c) of the Bankruptcy Code, a debtor may grant a security interest to a post-petition lender if the debtor is unable to obtain financing on an unsecured basis. To demonstrate that unsecured financing arrangements are not available, the debtor does not need to exhaust all possibilities, but merely make a reasonable effort.

Section 364(d) of the Bankruptcy Code provides for priming liens on encumbered collateral, which may be authorized by the bankruptcy court only if the debtor is unable to obtain financing without granting such priming liens and the interests of the holder of the pre-existing lien is adequately protected, as described above.

10. Can a secured creditor roll over pre-petition loans into post-petition lending?

Bankruptcy courts do recognize the ability of a pre-petition lender to roll-up its pre-petition loans into post-petition lending under certain circumstances and often after much scrutiny. Pursuant to varying local bankruptcy court guidelines, bankruptcy courts often require specific information prior to approval of such lending. For example, the parties may need to provide evidence that the pre-petition lenders are fully secured, the DIP loan will provide funding in excess of

the pre-petition loans outstanding and the benefits to the estate of obtaining such a financing outweigh the harms. Some courts may require that the order approving a roll-up reserve the right of the bankruptcy court to unwind the paydown of the outstanding amounts under the pre-petition financing arrangement if there is a successful challenge to the validity, enforceability, extent, perfection and, where appropriate, priority of pre-petition claims or liens, or a determination that the pre-petition lenders were undersecured on the date of commencement of the bankruptcy case.

A roll-up may be accomplished either in a one-time transaction or gradually. In the latter case, for example, if a pre-petition lender has a security interest in receivables, as payments on receivables come into the estate they are used to pay down the pre-petition loan, and then the lender simultaneously re-advances the same amounts under the post-petition financing arrangement.

11. Are the directors/officeholders personally liable for post-petition borrowings (unless otherwise agreed)?

No, directors and officeholders are not personally liable for post-petition borrowings.

12. Can affiliated debtors be treated as one consolidated entity for post-petition financing purposes?

Bankruptcy Courts do recognize the equitable remedy of "substantive consolidation" of assets and liabilities of various entities, pursuant to which distributions to creditors would be satisfied out of the pooled assets. The test for substantive consolidation varies among different jurisdictions, and generally requires a proponent to demonstrate one or more of the following: a disregard of separateness of the legal entities; that the affairs of the entities in question are so entangled that consolidation will benefit all creditors or that separating them is prohibitive and would harm all creditors; or that the benefits of consolidation heavily outweigh the harm. Although this remedy exists, under U.S. law, there is a general respect of corporate separateness and substantive consolidation is rarely granted.

13. Outline any developed practices other than statutory or regulatory provisions that go beyond the legal framework.

Cross-collateralization - Cross-collateralization allows a DIP lender that also is a pre-petition lender to obtain a security interest on unencumbered assets to secure both pre-petition and post-petition debt, thereby securing the pre-

petition debt with assets in which the lender would not otherwise have a security interest by virtue of its pre-petition security agreement or applicable law. In effect, the pre-petition lender improves its position in exchange for providing the post-petition loan. Some courts are willing to approve this security after much scrutiny, although the courts may reserve the right to unwind the protection afforded if there is a successful challenge to the validity, enforceability, extent, perfection and, where appropriate, priority of pre-petition claims or liens, or a determination that the pre-petition lenders were undersecured on the date of commencement of the bankruptcy case. However, the majority view is to disallow cross-collateralization and, therefore, this security is not sought often.

Section 506(c) waiver - Generally, the costs of administering the bankruptcy estate are not charged to specific collateral. However, section 506(c) of the Bankruptcy Code permits a debtor to invade a secured parties' collateral for the necessary and reasonable costs of preserving, or disposing of, the collateral to the extent of any benefit to the holder of a security interest in such collateral. In DIP loans, the lender often will require that the debtor waive its right to recover such costs. Although the approval of the waiver is scrutinized by the bankruptcy courts because it decreases amounts available to junior creditors, it often is granted. It is important to note that, notwithstanding a bankruptcy court's approval of such a waiver, if the debtor later determines that it is necessary to liquidate, lenders often permit the payment of these costs out of the sale proceeds otherwise there may not be sufficient resources to dispose of the collateral.

Professional fees carve-out - As described above, administrative expenses, such as professional fees, are second in priority to secured creditors. If a debtor is administratively insolvent, meaning that it does not have sufficient funds to pay all of its administrative expenses in full, there will be insufficient funds for a debtor to employ professionals in the assistance of the wind-down of its business and sale of its assets (including a lender's collateral). As a result, DIP loans generally provide for a "carve-out"of professional fees, which allows such fees to be paid ahead of the secured lenders under certain circumstances, to ensure that there will be adequate resources for an orderly wind-down. The carve-out is capped with the debtor's professionals often having a higher allocation than the professionals of the Creditors' Committee. Bankruptcy courts often require a justification for such discrepancy between professionals.

Investigation waiver - In connection with a DIP loan provided by the pre-petition lenders, the lenders often seek a waiver of the right to investigate the validity and perfection of their pre-petition liens. This waiver generally is permitted if the Creditors' Committee is granted a period, usually approximately 60 days, to investigate such liens, and such period often is extended. In connection with the Creditors' Committee investigation, DIP loans often limit the amount of the loan proceeds that can be used by the Creditors' Committee to investigate and prohibit any loan proceeds from being used to challenge such liens.

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